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Ukrainian Oligarchs and the "Family", a New Generation of Czars—or Hope for the Middle Class?

SCHOLAR RESEARCH BRIEF

Since achieving independence over 20 years ago, Ukraine has strived to attract and increase foreign investment and spur individual entrepreneurship and small and medium sized business creation. Optimism ran high at the outset; yet, today the "oligarchs" and the political "family" associated with President Yanukovych dominate the economy and wealth creation in Ukraine. This project focuses on the current complex landscape, the control held by relatively few individuals, and the legislative efforts to improve the business enabling environment through the Commercial Law Center, a project funded by the U.S. Agency for International Development.

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RESEARCH IN CONTEXT

In November 1993, I arrived in Kyiv to work as an attorney in private practice, representing multinational corporations in establishing businesses, joint ventures, export/import operations, and in starting other potentially profitable arrangements in this newly opened, emerging market. At that time, Ukrainian citizens, the far-flung Ukrainian diaspora, and international observers held much optimism for the country's development into a thriving economy with opportunity for all classes. In the intervening years, a series of national and international events—the disappointing aftermath of the Orange Revolution, rigged political elections, widespread corruption, the 2008 global financial crisis and subsequent recession—combined to quash middle class dreams. This project focuses on factors influencing local business and foreign investment in Ukraine. While I initially expected to review legislation as being drafted by the Commercial Law Center, funded by the U.S. Agency for International Development, I quickly realized that it was more important to address the actual daily operating environment.

My approach became one of examining and analyzing the overall economic, industry, and business impacts felt by the general population as influenced by the "oligarchs" and "family" rule by the extended (President of Ukraine) Yanukovych family.

The wealth held by the "oligarchs"—or influential and extremely wealthy businessmen--and "family" in the context of overall GDP and population of Ukraine is staggering. With a Ukrainian population of ***46 million***, an estimated ***100 individuals represented by the "oligarchs" and "family" –or 0.00003%--of the total population control 80%-85% of Ukraine's GDP/wealth.*** **Translation: over** ***45 million individual Ukrainians, or over 99.9999% of the population is left with just 15%--20% of the GDP/wealth pie.***

The intricacies of the ever-shifting political situation on the Ukrainian landscape are beyond the scope of this paper, as is the historical evolution of the "oligarchs" and "family' since Ukraine's independence. I would refer the reader to the excellent book recently written by Slawomir Matuszak: **The Oligarch Democracy—*The Influence of Business Groups on Ukrainian Politics.*** As he states: "*…the overall influence of Ukrainian big business is harmful and hinders the country's development in both political and economic terms…The monopolization of key economic sectors has constrained competition and is one of the causes of the unfavorable investment climate in Ukraine."*

This inequality is most evident in the vanishing middle class—those still dependent on country *dachas* or small garden plots to survive the winter—compared to those shopping at upscale clothier *Chanel* or jeweler *Tiffany's* in Kyiv.

Caveat: The numbers in this report are generated from publically available sources and all errors are the author's as stated and/or calculated. In researching data with assistance from many sources, it was determined that official Ukrainian government data is dated, inaccurate, and not readily available in any case. However, the magnitude and trends indicated are corroborated through interviews with credible professionals in the legal, international aid, technical assistance, consulting and accounting fields "on the ground" in Ukraine.

RESEARCH PROCESS AND RESULTS

"Everybody knows that most members of Parliament are corrupt billionaires, with chauffeurs/bodyguards driving the latest model black Mercedes with blacked-out windows." "How do the President's two sons become multimillionaires before the age of 30?" "The young people want to leave Ukraine—or they escape through the internet…the older generation is resigned to the situation as it is…there could never be an Arab spring here." "Why start a business—it will be taken away by the 'raiders' if it is profitable." "I can file the documents to start a business in 1 day, but it can take up to 7 years and $2,000 dollars to close it during which time I cannot work or get any State benefits." "The police are corrupt." "Customs officers take bribes at 50 percent of the value of the merchandise—and the monies are divided up the chain of command from the customs officer at the border crossing to those at the top of the [Ukrainian Government] Ministries.""I may have gotten shares in a privatized company 15 years ago, but I do not receive dividends nor do I have shareholder's rights—everything is under the oligarchs' control." "I am afraid to buy even a small plot of land, because the thugs may take it away from me and am afraid of the lack of legitimacy of the titles." "There are enough laws enacted, but the problem is enforcement."

These are a sampling of the comments I heard repeatedly when I arrived in Kyiv to work on this project. It soon became clear that without examining the underlying fundamentals, reading and analyzing legislation would not provide me with an accurate depiction of the current economic and investment situation in Ukraine. Thus, most of my research was based on interviews with a wide variety of individuals in Kyiv: chiefs of party and program managers for projects funded by the U.S. Agency for International Development (USAID); representatives from other international donor agencies, foreign embassy and Ukrainian government officials; multinational corporate managers; professionals representing international legal, consulting and accounting firms; and academicians.

Who are these Ukrainian oligarchs and "family" and what do they control?

Oligarchs exist throughout the former Soviet Union (FSU), being most visible in Russia, but also in the smaller countries such as Bulgaria and Moldova. With privatization in the FSU, these oligarchs came to their wealth through various methods—"cherry-picking" the best assets, taking control of privatization certificates, leveraging personal connections/financial contributions with corrupt leaders in positions of political power. Allegations of gang-style murders, opaque transfers of company control at bargain basement prices, and imprisonment of opposition party leaders have all been reported in the Ukrainian press.

After Ukraine's independence, the oligarchs took majority control over massive State entities in basic industries: metallurgy, chemicals, oil and gas, power engineering, machinery building—manipulating the supply chain from raw materials out of the ground to the final, processed product being shipped overseas. *Kings of steel, fertilizer, titanium and chocolate now prevail in Ukraine*.

In recent years, oligarchs have expanded their business tentacles into finance and banking, the relatively new insurance business and the media—including television and internet portals. Those interviewed and independent reports indicate that government/oligarch censorship is rampant and journalists are routinely harassed while reporting on political rallies held by the opposition parties.

Through the ***transfer pricing*** mechanism, companies controlled by the oligarchs continue to record domestic *inside* prices on their

SECTOR HOLDINGS

UKRAINE'S RICHEST PEOPLE	BASIC INDUSTRY						FINANCIAL SECTOR	CONSUMER			IN 2011 (USD MILLIONS) $ ESTIMATED	
	METALLURGY	CHEMICALS	OIL/GAS/COAL	TITANIUM	POWER ENGINEERING	TRANSPORT MACHINE BUILDING	BANKING FINANCE INSURANCE	AGRICULTURE FOOD	MEDIA	RETAIL TRADE		
Rinat Akhmetov	x	x	x		x	x	x	x	x	x	25600	15590
Privat Group	x	x	x			x	x		x		12800	10298
Dmitry Firtash		x	x	x			x		x		2250	1489
Victor Pinchuk									x		5900	2970
Serhiy Tihipko	x					x	x				535	796
Kostyantin Zhevago	x					x	x				3200	2675
Vadym Novinsky						x		x			n/a	2683
Oleh Bakhmatyuk								x			2200	1093
Andriy and Serhiy Klyuyev	x				x	x					n/a	901
Serhiy Taruta	x							x	x		730	2126
Petro Poroshenko						x			x		980	1193
Borys Kolesnikov								x			448	n/a
Valeriy Khoroshkovsky											599	n/a
Tariel Vasadze						x	x				n/a	n/a
TOTALS											55242[1]	41814[2]

Privat Group comprised of Ihor Kolomoyskyi and Hennadiy Boholyubov
RUE Group: Firtash, Khoroshkovskyi, Boyko along with Akhmetov are the most influential oligarchic group

Valeriy Khoroshkovsky sold Intermedia Group Ltd. to Dmytry Firtash 100% for $2,5Billion USD

Business Partners

Victor Pinchuk is suing Privat in a London court alleging breach of contract for sale of formerly state-owned iron ore KzhRK, privatized in 2004. Allegedly purchased through verbal agreement for $143 million USD, but valued at $2 billion USD. Source: "Ukrainian Follows other oligarchs into London's courts", *Financial Times*, 19 May 2013

Sources: THE OLIGARCH DEMOCRACY, The Influence of Business Groups on Ukrainian Politics, Slawomir Matuszak, OSW—Centre for Eastern Studies, Osrodek Studiow Wschodnich im. Marka Karpia, Number 42, Warsaw, September 2012. Various published press reports.

1 Estimated by "Korrespondent"
2 Estimated by "Focus"
Note: Differences in estimated values indicates lack of reliable data

accounting books while funneling foreign profits received through offshore ***shell intermediary*** subsidiaries. Under this murky system, domestic tax policies are circumvented and reinvested income returns to Ukraine as foreign investment.

Most oligarchs have designed a convoluted spider's web of companies registered not only in Ukraine, but also in Switzerland, Cyprus, Bulgaria, Italy, Hungary, Austria, Russia, the United Kingdom, and the British Virgin Islands.

One of the most publically visible Ukrainian oligarchs, Rinat Akhmetov (operating through his wholly owned **SCM or System Capital Management**), is listed by *Forbes* as the 46th wealthiest man in the world. His assets were estimated to be between $16 and $26 billion USD in 2011.

Through his **SCM** organization, Mr. Akhmetov has major control over 10 industry sectors in Ukraine: metallurgy, power engineering, media, finance/banking, telecommunications, real estate, mining, agriculture, retail trade (gas stations, supermarkets, drugstores), and shipping. An example of the magnitude in just one industry sector is through **DTEK**, **SCM's** power generation unit. **DTEK** is an integrated, independent production chain with 111,000 employees; income in 2011 was estimated to be $5 billion USD—or one-ninth of the Ukrainian State Budget of $43 billion USD.

Another oligarch, known as the *"*New Fertilizer King of Ukraine*"*, Dmitry Firtash (through the **DF Group**) also has a monopoly on titanium production after taking over State-owned assets in 2004. With agriculture key to the country's economic development, control over the local fertilizer supply is critical. The **DF Group,** through its **Ostchem Holding Company**, has companies registered in nine countries—ranging from Tajikistan to the British Virgin Islands. Firtash has also distinguished himself as a philanthropist and counts among his friends former President Bill Clinton and entertainer Elton John.

Under President Yanukovych's tenure (data available from February 2010 through June 2013), foreign investment has dwindled to virtually nothing—and newly wealthy young oligarchs have risen to become extremely influential in both business and politics. During this three year period, two Ukrainian oligarchs went on a major shopping spree—adding to their holdings in metals, chemicals, gas/oil, electricity, fertilizer, transportation, telecommunications, media. Combined, the **DF Group** (43 percent/$4.7 billion) and **SCM** (40 percent/$4.2 billion) accounted for a **total of 83 percent** of spending.

A newcomer to this scene, Andriy Verevsky—a recent member of Parliament and also of Yanukovych's inner circle— through his **Kernel Group** purchased Black Sea Industries during this period. This latest transaction, although just 1 percent of the total spending, resulted in control of the largest producer of sunflower oil—a major export commodity--and a shipping port for transporting it. The **Kernel Group** is the largest holding company for the trade and export of grain, and crucial for this agrarian economy, historically recognized in the Soviet era as the breadbasket of the region and earlier, Europe.

Of the remaining large investments in Ukraine under Yanukovych, 14 percent/$1.8 billion came from **Russian financial groups;** 1 percent each from an Irish company and a Netherland firm.

Where does this leave the middle class in Ukraine? While in the EU, 65 percent of the population is considered middle class, only 5 percent in Ukraine ranks as such. More significantly, 42 percent of Ukrainians spend over 60 percent of their incomes on food, compared with less than 10 percent in the EU. *Forbes* estimated that 77 percent of Ukrainians rank below the poverty line. An average monthly pension equals $100 USD—not enough to survive without assistance from other sources.

STRUCTURAL CHANGES FOR EQUALITY

Under the current political and business scenarios, the oligarchs and the extended Yanukovych "family" will continue to dominate despite fractious lawsuits filed in London between them and brutal mafia-style tactics to eliminate competition. Fertilizer King Firtash, for example, runs his extensive business empire and is the President of the Federation of Employers—*uniting companies generating **70%** of Ukraine's GDP*, and is also a Member of President Yanukovych's Committee for Economic Reform. These players are most interested in maintaining the status quo—and continuing their exploitation.

Rampant corruption at all government levels, stagnation and battles in Parliament, contradiction in existing legislation and conflicting political/business interests have resulted in reform at a snail's pace. Existing laws are enforced sporadically or ignored.

The oligarchs built their fortunes by grabbing readily available assets such as raw materials and processing into finished goods for export. As these resources are depleted, economic change will likely be led by the lifting of the moratorium on land sales and development of agriculture—in which some oligarchs have already invested.

Accepting the premise that until there are broad sweeping political changes and effective legislation that is widely enforceable, what can be done?

Since 2003, the Commercial Law Center (CLC) has worked on various initiatives to improve the business enabling environment with focus on stimulating individual entrepreneurship, small and medium size business (SMEs) growth. Key to sustainable economic development, SMEs contribute 60 percent to GDP in the EU compared to only about 10-15 percent in Ukraine.

Through its legislative drafting, collaboration with supportive political allies, and debates on the Parliament floor, the CLC has made some progress, but Ukraine continues to rank low in the *World Bank's "Doing Business Report".*

Issues to be addressed in future research: legislation to stimulate SME establishment and growth; favorable foreign investment initiatives; transparent land and agricultural policies.

AT THE CROSSROADS ONCE AGAIN

In August 1991, Ukraine became independent from the Soviet Union and severed its official ties from Russia. Over 20 years later, the nation once again stands at a crossroads. Align with the West through the EU-Ukraine Association Agreement and its related Deep and Comprehensive Free Trade Agreement in November 2013 at the Vilnius Summit or continue to strengthen its ties with Russia?

Some of those I interviewed stated that there would be "chaos" in the streets of Kyiv if the Agreement is not signed. At the minimum, it would further deepen the psychological depression of the general population and increase the political/business stranglehold that the oligarchs currently hold. Russia is pushing for a Customs Union between Kazakhstan, Belarus, Russia and Ukraine, while threatening to escalate a trade war.

When I started interviewing, an attorney friend, specializing in international corporate transactions, stated that only Russian and Ukrainian oligarchs were investing in Ukraine. I thought he was joking, but clearly not as shown by the recent statistics. Despite this, there are shoots of optimism expressed by some. Entrepreneurs are finding opportunities through some relatively small endeavors in retailing, outsourcing of IT and other professional consulting services. Some operate in the ***shadow economy***, but, if visible, worry raiders will seize their business in the middle of the night.

The CLC recently introduced and continues to lobby for at least ten "priority" legislative acts to encourage SME establishment. These laws are in various stages of discussion in the Parliament and the dates of passage, implementation and actual effects on SME creation will remain to be seen.

On a national level, until and unless the overall political and business environment drastically changes, it is unlikely any significant foreign investment in Ukraine will be made in the short-term. Many Ukrainians hope for a new administration in 2015 when the Presidential elections are scheduled to be held. The agriculture sector is clearly going to be the focus in Ukraine in the long-term, particularly when the moratorium is lifted in 2016, but the oligarchs have clearly entered that arena. Future policy should focus on improving the national business environment—and enforcing legislation to ensure implementation.

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ENDNOTES

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