

TO: Clients and Friends of the Firm  
FR: Frishberg & Partners  
RE: Post-Privatization Investment and Due Diligence

## **I. Introduction**

Dealing with any government, especially the Ukrainian government, can be extremely frustrating. Probably the single most difficult aspect of effectuating investments in Ukraine is getting access to real property for production purposes. As a result, investors often enter into joint ventures or case-specific agreements (licensing, import-export, joint cooperation, joint production, etc.) in order to introduce their products to the 48 million-strong Ukrainian market.

In the past, foreign companies were allowed (but not actively encouraged) to participate in the privatization process, in which the government's first priority has always been to distribute state property to employees and Ukrainian citizens for privatization certificates, not "selling out" to foreigners. It is not surprising, therefore, that for many investors the more lucrative opportunities arise in the private, so-called "secondary" market, after the first privatization wave has passed.

In the secondary market, neither the new shareholders nor the old managers have the requisite management or marketing experience necessary for a new company to prosper in today's complicated economic environment. Their survival depends on the ability to independently adapt to the market rules of the game or seek outside assistance (investors, post-privatization consultants). Alternatively, without having the benefit of the necessary post-privatization assistance (in the form of foreign investment) they face premature bankruptcy.

For that reason, today foreign investment often takes place following privatization, even in cases when foreign investors have acquired initial shares by officially participating in privatization. In many cases, initial foreign investment only serves as a prelude to a drastic increase in capitalization following privatization (causing dilution of the Ukrainian shareholders' ownership in the company).

Below we will limit the discussion to direct investment in Ukrainian private enterprises by acquiring existing stock and increasing the company's capitalization.

## **II. Acquisition Strategy**

As Ukrainian privatization picked up speed, a wide variety of real property has begun to appear on the secondary market, where prices are ruled by supply and demand instead of politics. For many foreign investors, waiting for a factory to finally become privatized has proved to be a wise decision.

Many investors have learned that negotiations with a factory's management (also usually stockholders), who are facing termination, can be quite easy, especially if the investor has conducted due diligence which revealed, among other things, that the newly privatized enterprise cannot pay its electric bills, etc. In such situations, well-informed investors are often able to negotiate better terms with private factories than with state-owned enterprises undergoing or about to undergo the complicated process of privatization.

Under Ukrainian legislation, a private stock company is able to dispose of any or all of its property, sell its stock to foreign or Ukrainian buyers, and enter into joint ventures, subject to certain case-specific exceptions. In fact, one of the main advantages of dealing with a privatized stock company is that it can enter into all types of transactions, including real estate transfers, fairly easily.

Before undertaking any financial commitment, however, an interested investor should review all necessary documents, which together will provide a legal and business overview of the company's status and possible continuing obligations. At a minimum, the investor should learn of any restrictions in the privatization plan and confirm that the private open stock company is at least 61% privately owned (and identify of all of the shareholders).

To increase the chances of successful acquisition on the behalf of our clients, we routinely perform extensive business and legal due diligence concerning a particular investment opportunity prior to a client's commitment of a significant amount of time and resources to a given project. Typically, a team of local and foreign consultants visits the factory to research the various business and legal documentation. The resulting analysis is documented in a corporate profile and includes details concerning the company's structure, financial records, conflicting commitments, etc.

Based on the information contained in the due diligence report, as well as preliminary interviews with the Ukrainian partners, the principals can agree on the basic business conditions suited to their transaction (e.g., business form, share distribution, percentages of ownership, valuation of respective contributions, access to local and/or foreign markets, etc.). Only after this work is substantially completed will the investor seek legal advice to document the results of these negotiations. This process often involves a significant time investment, which is not always possible in cases with tight deadlines for the initiation of production.

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