Attracting Capital Through Good Governance

BLEYZER INITIATIVE
To stabilize FSU region

Michael Bleyzer
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SigmaBleyzer, UGF and IPCTF

- US company managing one of the premier Ukrainian Investment Banking groups
- Largest Private Equity Fund in Ukraine, one of the largest in FSU
- Seven years in Ukraine, International investors, Institutions, high net worth individuals / families
- Ukrainian Growth Funds (UGF) – over $100M under management
- Investments in over 70 Ukrainian companies
- Substantial experience in managing and restructuring Ukrainian companies
- Significant number of successful exits
- Significant Ukrainian infrastructure
- Leadership in International Private Capital Task Force (IPCTF)
#### Transition to Free Market Economy

<table>
<thead>
<tr>
<th></th>
<th>Centrally Planned Economy</th>
<th>Transition Economy</th>
<th>Market Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Decision Making</strong></td>
<td>Centralized</td>
<td>Chaotically Decentralized</td>
<td>Mainly Decentralized</td>
</tr>
<tr>
<td><strong>Sources of Savings for Investments</strong></td>
<td>The State</td>
<td>Initially, without domestic savings, source is principally foreign capital, and primarily debt.</td>
<td>Savings of Individuals and Corporations (Retained Earnings)</td>
</tr>
<tr>
<td><strong>Coordination</strong></td>
<td>Compulsory Plans, Overly Restricted</td>
<td>Weak State and Inefficient Markets</td>
<td>Primarily Market, but with some State Regulation</td>
</tr>
<tr>
<td><strong>Ownership</strong></td>
<td>The State</td>
<td>State, Legally Private, Semi-Private, and Shadow</td>
<td>Primarily Private</td>
</tr>
<tr>
<td><strong>Incentives:</strong></td>
<td>None, Collective Success</td>
<td>Money</td>
<td>Individual Success</td>
</tr>
</tbody>
</table>

_Every Transition Economy has to start being a capital importer. With successful reforms it hopes to become a capital exporter._
How to Finance Transition?

• Debt (foreign, public, private, domestic)
• From Debt to Equity
  – Successful Transition Economies attract private equity capital
• Effects of Private Equity Investment
  – Fundamental change in the structure of economy
  – Reduction of government’s role and responsibility
  – Promotion of healthy sustainable businesses
  – Increased tax revenue base
  – Happy and prosperous taxpayers
Why Transition?

- Improved Quality of Life
  - Higher Income
  - Lower Unemployment
  - Improved Social Stability
  - Higher Rates of Economic Growth
    - Foreign and Domestic Private Investments
  - Investments in Education and Health
    - Higher Budget Resources
  - Protection of the Poor
    - Higher Income
    - Improved Social Stability
    - Improved Business Environment
      - Macroeconomic Stabilization
      - Economic Liberalization
      - Reform of the State and Legal System
Objective: Benchmark transition economies to identify best practices in government policies, which improve investment climate and attract private capital

The study was conducted by SigmaBleyzer and the Thunderbird Corporate Consulting Group, the consulting arm of one of the best international business schools in the United States

IPCTF Steering Committee members provided valuable input

The views expressed in this study are those of the authors and do not necessarily coincide with those of individual members of the IPCTF Steering Committee or the organizations they represent
IPCTF Steering Committee

Benchmarked Countries

• Argentina
• Chile
• Hungary
• Poland
• Russia
Countries Included in Statistical Analysis

Angola, Argentina, Armenia, Azerbaijan, Belarus, Bolivia, Botswana, Bulgaria, Burkina Faso, Cameroon, Chile, Colombia, Costa Rica, Croatia, the Czech Republic, Ecuador, Egypt, El Salvador, Estonia, Ethiopia, Ghana, Hungary, India, Indonesia, Jordan, Kazakhstan, Kenya, Lithuania, Malawi, Moldova, Morocco, Mozambique, Nigeria, Peru, Philippines, Poland, Romania, Russia, Senegal, Slovak Republic, South Africa, Tanzania, Tunisia, Turkey, Uganda, Ukraine, Venezuela, Vietnam, Zambia, and Zimbabwe.
Foreign Direct Investments – Selected Countries
(in millions of US Dollars)
Key Drivers / Policy Action Groups

- The study pre-condition is macroeconomic stabilization, resulting from sound fiscal and monetary policies.
- Study identified the following key government policy actions, which stimulated foreign direct investments in successful transition economies:

1. Liberalize and De-Regulate Business Activities
2. Provide a Stable and Predictable Legal Environment
3. Enhance Governance & Reform Public Administration
4. Remove International Capital & Trade Restrictions
5. Facilitate Financing of Businesses
6. Eliminate Corruption
7. Reduce Political Risks (non-economic country risks)
8. Expand Country Promotion
9. Rationalize Investment Incentives
## Benchmarking Results

<table>
<thead>
<tr>
<th>Country</th>
<th>Business Liberalization Score</th>
<th>Legal Environment Score</th>
<th>Financial Sector Score</th>
<th>Governance and Privatization Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>UKRAINE</td>
<td>18</td>
<td>17</td>
<td>10</td>
<td>29</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>49</td>
<td>62</td>
<td>39</td>
<td>30</td>
</tr>
<tr>
<td>POLAND</td>
<td>87</td>
<td>99</td>
<td>62</td>
<td>89</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>80</td>
<td>93</td>
<td>68</td>
<td>82</td>
</tr>
<tr>
<td>CHILE</td>
<td>89</td>
<td>89</td>
<td>74</td>
<td>80</td>
</tr>
<tr>
<td>ARGENTINA</td>
<td>62</td>
<td>65</td>
<td>39</td>
<td>65</td>
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</table>
## Benchmarking Results

<table>
<thead>
<tr>
<th>Country</th>
<th>Political Risk Score</th>
<th>International Capital Controls &amp; Foreign Trade Score</th>
<th>Corruption Score</th>
<th>Governmental Promotional Effort Score</th>
<th>Tax and Investment Incentives Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>65</td>
<td>63</td>
<td>15</td>
<td>20</td>
<td>31</td>
</tr>
<tr>
<td>Russia</td>
<td>49</td>
<td>45</td>
<td>21</td>
<td>30</td>
<td>48</td>
</tr>
<tr>
<td>Poland</td>
<td>83</td>
<td>78</td>
<td>41</td>
<td>80</td>
<td>78</td>
</tr>
<tr>
<td>Hungary</td>
<td>82</td>
<td>79</td>
<td>52</td>
<td>100</td>
<td>82</td>
</tr>
<tr>
<td>Chile</td>
<td>71</td>
<td>84</td>
<td>74</td>
<td>90</td>
<td>63</td>
</tr>
<tr>
<td>Argentina</td>
<td>75</td>
<td>69</td>
<td>35</td>
<td>75</td>
<td>70</td>
</tr>
</tbody>
</table>
FDI For Ukraine - Possible Scenarios

- Ukraine’s government policies will determine the FDI flows over the next 15 years (5 years shown).

- The **Middle Scenario** would generate an incremental GDP growth rate of 4.8% per annum.

![Graph showing FDI in US Dollar million over years with different scenarios: Medium, Optimistic, and Status Quo.](image-url)
Conclusions for Ukraine

• With continuation of current policies, FDI flows will not increase from its current level of under US$1.0 billion per year (except for ad-hoc flows related to large privatizations).

• Under a middle scenario, with policy actions to reduce in five years 50% of the policy level differential with the Bests-in-Class, Ukraine could increase FDI to about US$3.4 billion per year by 2005, resulting in US$75 billion over the next 15 years.

• Under a more aggressive scenario, with stronger policy actions to reduce in five years 80% of the policy level differential with the Bests-in-Class, the level of foreign direct investments could increase to US$6.4 billion per year by 2005, resulting in US$100 billion over the next 15 years.
IPCTF Prescription for Transition Economies

• Generic prescription for government policies based on benchmarking and best practices identification
• Low correlation between FDI flows and “natural characteristics” (e.g., location, size, resources, etc.)
• High correlation between government policies and FDI flows
• Measuring economic impact of government policies based on the gap between a given country and the best in class in each of the nine government policy areas
• Econometric model of a transition economy predicting FDI flows based on government policies
• Priorities for 9 areas may be different for different countries, but all will need to be addressed to attract private capital
• IPCTF Framework provides a comprehensive tool for building consensus and developing an Action Plan for any transition economy
The Future of FSU is the Key to Stability in Europe

• Russia has entered a new period of expansion
• The belt of countries from Belorus to Central Asia is being contested now
• Will CIS become a real Union?
• Ukraine, Georgia, Armenia, Azerbaijan, Kazakhstan and Turkmenistan are critical
• New Arms Race and Cold War are very expensive options
• The belt of market economies and democracy is an order of magnitude cheaper option and easier to pursue, but the time is critical
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- Refocus all multilateral and bilateral assistance to all belt countries on the creation of market economies
- Use IPCTF framework to create capital-friendly environment in the belt countries and attract private equity capital
- Focus all / most financial assistance on creating private businesses – SMEs and large multinational operations in the belt countries
- Leverage private capital with donor’s money
- Implement comprehensive coordinated assistance program to the belt countries: use donor capital to create the environment, which attracts private capital
- Use IPCTF framework as a broad umbrella conditionality, but couple it with specificity in the use of funds focused on private businesses creation
Financial Assistance to Belt Countries

- Must be focused on **Economic Growth**
- Minimize government-to-government money transfers and blind pools of money
- The use of proceeds is just as important as the conditionality of lending
- Eliminate adjustment lending and budget deficit financing
- Maximize equity investments instead of debt
- Leverage private capital investments with financial assistance dollars
- Structure financial assistance as “private equity funds” managed by money managers from private sector
Example of Private Equity Fund Structure Using Financial Assistance Funds

• Georgian Growth Fund (GGF) - $50M
• US grain transfer monetization under PL 480 or PL 416B (or similar)
• Private Equity Fund to invest in Georgian Agriculture and Food Processing Industry
• Investor – Georgian Government, open for private co-investors
• Money Manager – experienced US company, typical compensation structure:
  – 2% management fee plus expenses
  – 20% backend after distribution of original capital ($50M)
• Exit strategy – 5 year term, 3 years reinvestment option, exit to market, strategic investors, privatization auctions, at market valuations at the time of exit
• Acquire controlling stakes, provide secondary investments, company restructuring, market positioning, people development, P/L focus, value creation
• Use the fund to identify all investment environment problems, work with government to eliminate problems and improve the investment environment, publicize results to help improve country image and attract private investors
• Structure the next fund with mandatory 50/50 split between government and private investors (foreign and domestic), reduce government share in future funds
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Action Plan

• Convince US government at the most senior levels of the need to actively support the creation of market economy and democracy belt around Russia
• Convince EU countries of the same
• US must demonstrate leadership in building an alliance of developed countries to promote the belt creation
• Use IPCTF framework as broad conditionality for all financial assistance to the belt countries
• Work with the belt countries’ governments to create specific Action Plans for each belt country using IPCTF framework
• Create a series of satellite funds similar to GGF in the belt countries to advance Action Plans implementation
• Publicize the program in the Western press to attract private capital
Business Opportunity

- Developed countries Private Equity Firms do very little business in the FSU countries, almost none outside of Russia.
- The key to successful transition in any transition economy will be the private equity approach to investments.
- Private equity investments in the belt countries will generate exceptional returns to investors, while securing geopolitical stabilization.
- The synergy between political interests of the US, EU and other developed countries and private investments in the belt countries is very high.
- There is a rare convergence of market need and political necessity to create an FSU-focused private equity firm.
- SigmaBleyzer is well positioned to take advantage of this opportunity.