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# EU Support to the Private Sector in the context of Association Agreements/DCFTAs

## Summary Report - Ukraine

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## 1. INTRODUCTION

The European Neighbourhood Policy (ENP) provides a privileged relationship which promotes common EU values such as democracy and human rights, rule of law, good governance, market economy principles and sustainable development. Within the framework of this broader policy Association Agreements (AAs) incorporating Deep and Comprehensive Free Trade Areas (DCFTAs) represent a new generation FTA which provided the opportunity to negotiate regulatory and beyond-the-border issues that are not included in traditional FTAs. It summarises the findings of the wider study on Georgia, Moldova and Ukraine. More detailed analysis can be found in the main report should be read in conjunction with this summary.

Negotiations for AA/DCFTAs in Ukraine were effectively launched in 2009, followed by Moldova and Georgia in 2010. The AA, including the DCFTA, was signed between the EU and Georgia and, EU and Moldova on 27 June 2014 in Brussels. These apply provisionally as of 1 September 2014. This report details the findings of the study on EU Support to the Private Sector in the context of Association Agreements (AA) including the Deep and Comprehensive Free Trade Area (DCFTA) and covers the newly signed agreement in Ukraine.

### 1.1 SME DEFINITIONS

The focus of support from the European Commission will be on small and medium enterprises (SME). Whilst during the survey and analysis stage, the EU definition will be used, it is not possible to differentiate national statistics between large firms as defined nationally, and medium firms as defined by the EU. As a consequence, throughout this report, when referring to national data, we necessarily have to use the national definition as follows:

**Table 1 Definition of SME in Ukraine<sup>1</sup>**

Indicator	Employees	Turnover
Large	>250	>€ 50 million
Medium	50-250	€ 10 million – € 50 million
Small	10-49	€ 2 million - € 10 million
Micro	<10	< € 2 million

### 1.2 SME SECTOR IN UKRAINE

According to the IMF Country Report No. 14/263, the economic recession in Ukraine is deepening, due to the ongoing situation in the eastern Ukraine with forecast growth in GDP for 2014 of -6.5%. Even prior to the political and security crisis, Ukraine's economy had been experiencing low growth with average GDP growth between 2010 and 2013 of only 2.4% and growth in 2012 of only 0.2% and 0% in 2013.

Manufacturing is the largest sector of economic activity in the economy, representing 31% of GDP compared with agriculture of 9%, wholesale and retail sectors (13%) and transport, Mining and construction contributing 7, 5 and 6% respectively.

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<sup>1</sup> Law of Ukraine N4618-17 of 22.03.2012 "On development of State support to the small and medium size enterprises in Ukraine

**Table 2 Major sectors of the Ukrainian economy**

Sectors of the economy	Sector % contribution to GDP
Agriculture, hunting and forestry; fishing	8.50%
Mining and quarrying	4.80%
Manufacturing	30.90%
Electricity, gas, steam, water supply and waste management	5.30%
Construction	5.80%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	12.70%
Transport, warehouse and post services	7.10%
Touristic services	0.80%
Communication services	2.80%
Financial and insurance services	3.20%
Real estate, renting and business activities	4.00%
Professional, scientific and technical activities, other administrative services	3.90%
Public administration	2.80%
Education	3.40%
Health and social work	2.60%
Other community, social and personal service activities	1.20%

Total employment in business (excluding government) is 18.75 million with 3.3 million employed in manufacturing, 2 million in wholesale and retail and 2.8 million in agriculture. Unemployment in Ukraine is at approximately 8.8% of total labour force.

Ukraine has a relatively small trade deficit of €10.2 billion<sup>2</sup> (or 7.5% of GDP), with exports totally €47.5 billion and imports €57.7 billion in 2013. The CIS is Ukraine's principal trading partner accounting for 35% of exports and 35% of import. The EU is also significant accounting for 27% of exports and 37% of imports. Other trade partners include: export destinations Asia (27%), Africa (8%) and the Americas (3%) and; import sources Asia (20%), Americas (6%) and Africa (1%).

Ukraine's main exports (HS code 4 digit) are: Ferrous metals and manufactured products (26.7%); Crops (14%); Mineral products (11.8%); Mechanical and electrical machines (11%); Chemical products (6.8%); Edible food products (5.6%); Fats and vegetable oils (5.5%) and; Road vehicles, aircraft, ships (5.3%).

Ukraine's main imports (HS code 4 digit) are: Mineral products (29.1%); Mechanical and electrical machines (16.2%); Chemical products (11%); Road vehicles, aircraft, ships (7.7%); Ferrous metals and products made of ferrous metals (4.5%); Polymer products and plastics (3.2%); Edible food products (4.2%) and; Textiles and clothing (3.2%).

Table 3 shows the number of enterprises by size, contribution to GDP and employment:

**Table 3 Profile of SME Sector in Ukraine**

Indicator	Large	Medium	Small
No. of Enterprises (2014)	698	20,550	1,578,879
Contribution to Output (2012)	88%		12%
Employment No.	6.0 million		7.5 million

Table 4 shows SME activity by sector. The information is incomplete as the data is not available from statistical sources but provides an indication of where SMEs participate in the economy. By value, SMEs are most active in agriculture (€15bn), transport (€12bn) and services (professional and real

<sup>2</sup> Source for Chapter - [http://www.ukrstat.gov.ua/express/expr2014/02\\_14/29w.zip](http://www.ukrstat.gov.ua/express/expr2014/02_14/29w.zip)

estate) (€12bn); although figures were not provided for manufacturing and wholesale/retail. By number of SMEs, the largest SME sectors are wholesale/retail, agriculture, manufacturing and services.

**Table 4 SME Activity by Sector**

	Value of Sector (€m)	Contribution of SMEs to the total Sector (%)	No. of SMEs in sector
Wholesales and retail, repair of cars	153 130	na	110 348
Manufacturing/Industry	104 737	na	49 384
Agriculture, hunting and forestry; fishing	15 241	99.0%	49 939
Construction	12 864	93.5%	36 369
Transport, warehouse and post services	19 636	40%	16 670
Real estate services	4931	95%	33 867
Hotel and restaurants	1598	40%	10 178
Information and telecommunication	7628	50%	14 888
Administrative and business supporting service	7442	50%	17 331
Financial and insurance services	8970	50%	5074
Professional services (accounting, head hunting, consulting, scientific work)	14 654	49%	33 987
Art, sport and entertainment	1195	85%	2369

In addition, there are 4.24 million<sup>3</sup> individual agricultural households and 1,022 cooperatives. In so far as any of these will sell into formal markets, these will also be affected by the AA/DCFTA provisions.

The majority of registered SMEs in Ukraine are located in Kyiv metropolitan area, Donetsk, Dnipropetrovsk, Kharkiv and Odessa accounting for 49.4% of all SMEs in Ukraine.

**Table 5 Geographical Distribution of SMEs (number of SMEs)**

	Large	Medium	Small
Autonomous Republic of Crimea	12	722	13230
Vinnitska	11	586	8147
Volynska	12	349	4816
Dnepropetrovska	81	1591	25691
Donetska	106	1733	26170
Zhitomirska	7	445	5769
Zakarpatska	7	298	5322
Zaporizhka	24	724	13553
Ivano-Frankivska	9	314	7352
Kyivska	49	1039	16394
Kirovogradska	5	389	6617
Luganska	32	722	9978
Lvivska	29	935	16368
Mykolaivska	12	384	9802
Odeska	23	1012	23641
Poltavska	24	640	9108
Rivnenska	6	315	4604
Sumska	9	398	5025
Ternopil'ska	6	307	4497
Kharkivska	36	1231	23693
Khersonska	3	340	7298
Khmel'nitska	9	412	6167

<sup>3</sup> <http://minagro.gov.ua/ministry?nid=13881>

	Large	Medium	Small
Cherkasska	13	527	6646
Chernivetska	4	197	3793
Chernigovska	6	426	5455
c. Kyiv	159	3978	71201
c. Sevastopol	4	175	3711

## 2. ISSUES AND SCOPE OF IMPACT

In this study, we have focused exclusively on the provisions that will have a direct impact on the day-to-day operations of a business. This section details those provisions. It also details the gap analysis between existing legislation in country and the requirements to align to the EU acquis relevant to SMEs as detailed in the AA/DCFTA.

### 2.1 IDENTIFICATION OF KEY PROVISIONS OF THE AA/DCFTA THAT WILL AFFECT BUSINESS

Based on our audit of the AA/DCFTA and its provisions that will have a direct effect on the business administration of SMEs, the following summarises these effects.

Area of Association Agreement	Likely Impact on business	Sectors potentially affected
Money laundering/crime & corruption	Requirement for increased financial reporting/controls	All
Market access	Market opportunities in EU and cheaper imported inputs	Depending on current structure of tariffs
Approximation of TR, standards, and CA and labelling	Adaption of production and CA.	Manufactures
Approximation of SPS	Compliance with EU SPS and animal welfare standards	Agriculture Agro processing sector of manufacturing
Approximation to EU customs law (customs code)	Procedures for customs administration	All importers and exporters
Phasing out of use of certain GIs in Ukraine and third markets	Rebranding of products affected by GIs	Agriculture Agro processing sector of manufacturing
Approximate on public procurement	Opportunities to bid on EU contracts	Professional services Construction Manufacturers
Area of Association Agreement	Likely Impact on business	Sectors potentially affected
Approximation relating to energy cooperation	Product standards regarding energy and labelling thereof, of products and buildings	Manufacturing Construction Real Estate Professional services
GMO monitoring	Use and control of GMOs	Agriculture
Road transport	Road and vehicle safety	Transport Wholesale/retail Manufactures (of dangerous products in particular)
Company law, corp. governance, accounting and auditing	Changes in corporate governance	All
Environment	Control of industrial pollutions and hazards (vehicle emissions waste and waste water)	Transport Manufacturing (esp chemicals) Agriculture
Health and safety	Safety and health of workers at work,, use of work equipment, personal protective equipment	All sectors Especially construction Manufacturing (esp chemicals)

### 2.2 GAP ANALYSIS

A total of 29 organisations in Ukraine were interviewed comprising government ministries, departments or agencies responsible for implementation or regulation and donor projects (mainly EU funded) assisting with implementation of the acquis.

The following analysis relates specifically to articles of the AA/DCFTA that will have a **direct** effect on the operations or opportunities for business as identified in the audit. It also reflects the understanding of those interviewed rather than any new analysis undertaken by the team. The following analysis presents the findings of both interviews and review of implementation plans and strategies along the relevant areas of the AA/DCFTA.

### **Money laundering and terrorism financing and Fight against crime and corruption**

Legislative Gap	Institutional Gap
To be prepared, MoUs and Cooperation Agreements with FATF, MONEYVAL, Eurojust and authorities of EU Member States.	Establish national mechanisms for cooperation and participation in international fora.
Second and final reading of legislation expected imminently.	Strengthening national authorities on enforcement.

### **Market access (reduction in tariffs, export duties, TRQS and reference prices)**

Legislative Gap	Institutional Gap
Changes in legislation already in place.	New procedures and systems needed for customs officers in issuing certificates of origin and for MEDT on administration of TRQs.

### **Approximation of technical regulations, standards, and conformity assessment and EU standards and labelling**

Legislative Gap	Institutional Gap
Approximation of the horizontal legislation almost completed.	Establishing new independent non-governmental body responsible for standardisation and transfer of the functions of the Secretariat of 30 technical committees on standardization.
22 of 27 Technical regulations of the EU (16 of them enforced, 6 will be adopted during 2014-2020).	Accreditation body will have to sign mutual recognition agreements with ILAC and IAF.
27,000 National Standards will have to be amended or repealed.	

### **Sanitary and phyto-sanitary, animal welfare and other legislative measures**

Legislative Gap	Institutional Gap
Will adopt full SPS acquis. It is estimated that 1,000 laws need to change and adapt to comply and that 50% of laws and sub-laws are already compliant with the EU Laws and Directives; removal of duplicate laws which is rarely undertaken due to the enormous amount of acts that are simply forgotten to be cancelled.	In 2014, the State Service for Food Safety and Consumer Protection was established but is not operational. Food and Veterinary Office (FVO) approved system of : milk, eggs, honey, poultry and aqua-culture.

### **Customs Law (Customs Code)**

Legislative Gap	Institutional Gap
Introduction of legal provision for authorised traders, simplification and standardisation of data and documentation and guaranteeing the right of appeal against customs.	Reform of customs administration procedures including risk assessment, post clearance controls and company audit methods.

### Approximation of legislation to the relevant EU acquis on public procurement

Legislative Gap	Institutional Gap
Changes are required to the Public Procurement Law (2014) regarding bidders information, contracting entities covered; Thresholds , Mixed Contracts; Valuation; E-procurement, competitive procedures and Life-cycle Approach.	Capacity-building and guidance for procuring entities, new administrative procedures and/or secondary legislation.
Creation of Utilities law on public procurement.	

### Legislative and Institutional Gap on Phasing out of use of certain GIs in third markets

Legislative Gap	Institutional Gap
Changes in the Legislation and regulation of GI's that are protected under EU regulation and are part of the AA/DCFTA will have to be drafted and adopted.	Authorities will have to develop procedures and systems including: electronic database of EU GI's, train Customs in the protection of the GI's at the border and; enforce GI protection nationally.

### Approximation of legislation relevant relating to energy cooperation

Legislative Gap	Institutional Gap
Already in process of adopting the following legislation: On efficient use of fuel and energy resources, approval of Technical regulations on energy labelling, standards for energy-using products and equipment and technical Regulations for energy labelling of household goods.	This will be enforced through market surveillance bodies (see technical regulations above).

### Approximation of legislation relevant relating to GMO monitoring

	Institutional Gap
Need to approximate legislation on GMO issues (plan to be submitted six months after EIF along with SPS)	There is no capacity or authorities for control of GMOs.

### Approximation of legislation relevant relating to Road Transport

Legislative Gap	Institutional Gap
Need to amend 50 legislative acts related to: deliberate release into the environment of GMO's; transboundary movements of genetically modified organisms and contained use of genetically modified micro-organisms.	There is insufficient Government structure for control of GMO and where it exists, there is dual shared responsibility. Considering the establishment of a single authority.

### Approximation of legislation relevant relating to Company law, corporate governance, accounting and auditing

Legislative Gap	Institutional Gap
Will have to adopt and implement EU Directives related to: Protection of shareholders, creditors and other stakeholders, international accounting standards and corporate governance.	Planning to create a Financial Investigation Bureau

### Approximation of legislation relevant relating to Environment

Legislative Gap	Institutional Gap
Partially adopted legislation on Environmental governance and integration of environment.  Air Quality (partial compliance). The rest remain to be adopted	Administrative system for air and water quality monitoring in place but other systems and authorities need to be developed.

**Approximation of legislation relevant relating to Health and Safety**

Legislative Gap	Institutional Gap
<p>A National Plan for improving safety, hygiene and working conditions has been developed.</p> <p>Most of national legislation related to health and safety of workers has been developed but is yet to be adopted.</p>	<p>The State Service for Mining Supervision and Industrial Safety will enforce this legislation but requires capacity building.</p>

### 3. SURVEY RESULTS

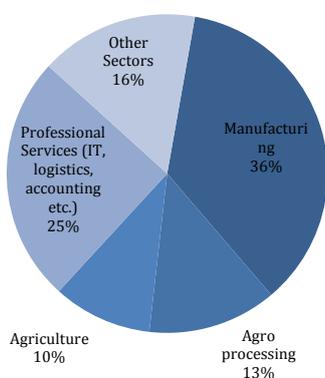
The following section presents the findings of 3 surveys undertaken under this study, of SMEs, Business Support Organisations and Financial Institutions. This presents the results and should be used for reference only. An analysis of the implications of these results are presented in section 4 of this report.

#### 3.1 SME SURVEY RESULTS

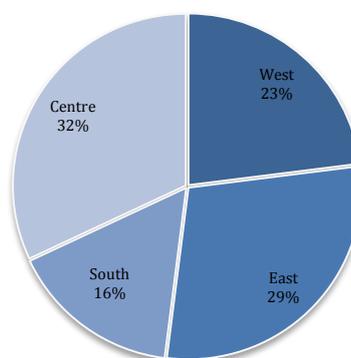
##### Scope and Coverage of Survey

The SME survey was undertaken between October and December 2014 and 196 SMEs were surveyed. A profile of the respondents is provided by sector, regional and size, as well as a breakdown of those currently exporting:

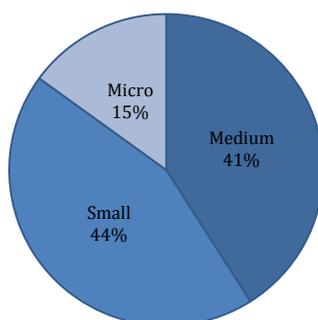
Ukraine - Sector Coverage



Ukraine - Regional coverage



Ukraine - Size of company coverage



##### General Business Environment

###### Top 5 Constraints Perceived by SMEs Surveyed

- Cost of finance
- Availability of finance (willingness to lend)
- Political instability
- Corruption
- Tax rates

Political instability is perceived as the next biggest constraint, combined with corruption and high/number of taxes.

### Opportunities under the AA/DCFTA

#### Firms who can sell or want to sell to EU

- 58 %of the surveyed firms estimate that they can sell to EU now.
- 70% of the surveyed firms expressed their wish to sell to EU.

#### Market Access to the EU market

- There is a certain level of knowledge amongst those that were surveyed of how to access the EU market and where to obtain information with 37 % having the knowledge.
- Around 30% knew how to find information on exporting to the EU.

#### Understanding of the Changes to EU market access under the DCFTA

There is understanding amongst those surveyed of the changes in market access resulting from the DCFTA:

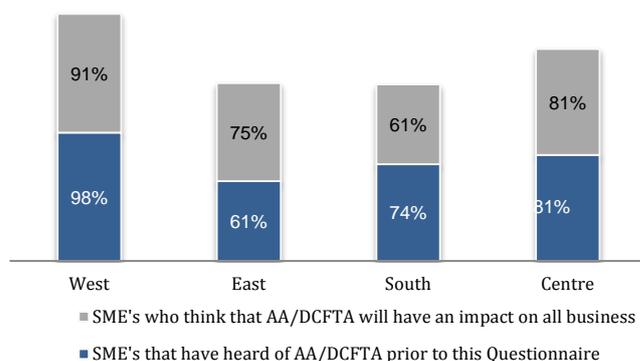
- 36 % knew about the changes affecting tariffs;
- 33 % about TRQ's; and
- And 34 % about Certificates of Origin.

### Understanding of the changes from implementation of the AA/DCFTA

#### General Awareness of the AA/DCFTA

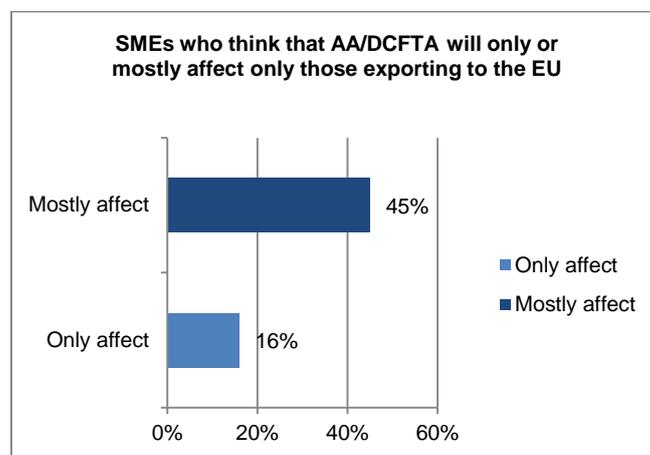
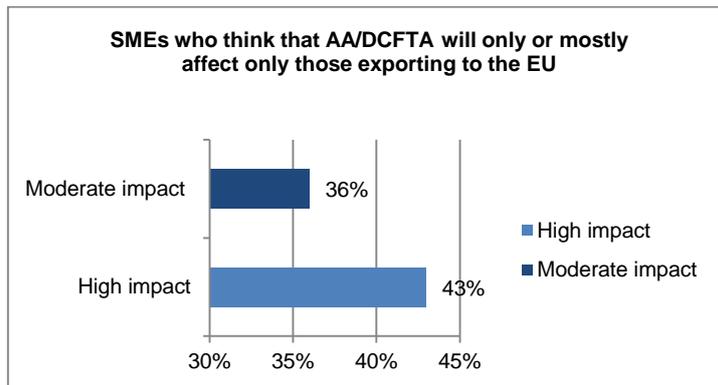
- 78%of the surveyed SME's heard of AA/DCFTA prior to the Questionnaire
- 79 % of the surveyed SMEs thing that AA/ DCFTA will have an impact on all business in country

Ukraine - SMEs General Awarness by region



Awareness of AA/DCFTA by Region

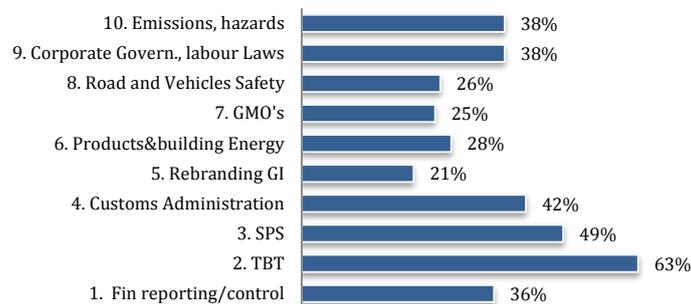
Impact of AA/DCFTA on SMEs



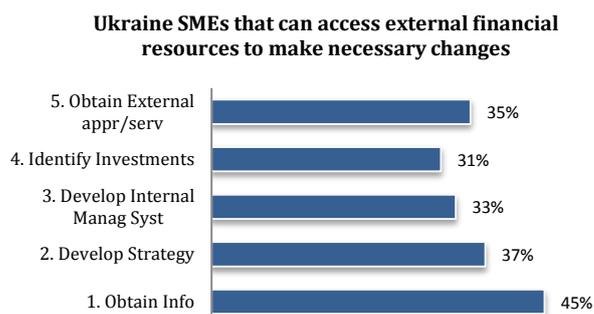
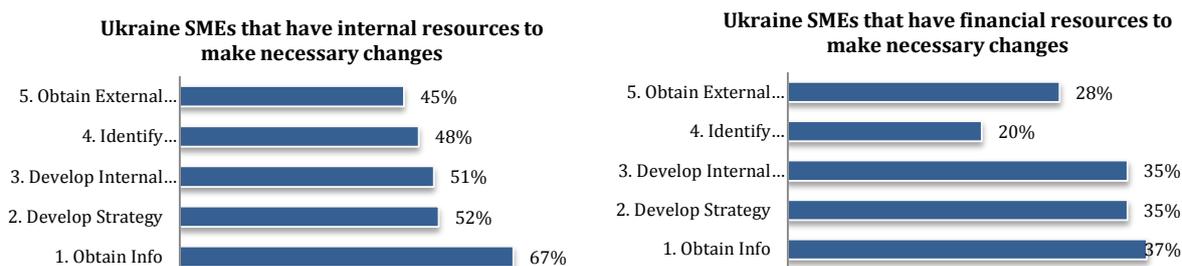
Nearly 80% of Ukrainian SMEs think that there will be a serious impact on business in Ukraine. This can lead to an assumption that they have a pretty good understanding of the AA/DCFTA in general.

Specific knowledge of Changes amongst SMEs

**Ukraine SMEs that understand the changes to their business in specific areas**



## Availability of resources for compliance with AA/DCFTA



- Around 50% of SMEs in Ukraine believe that they have internal resources to be able to implement the necessary changes resulting from implementation of the DCFTA.
- However, only around one third stated they had sufficient finance to fund these changes, dropping to only 20% stating they had the finance for any required investment.
- Similarly, around one third of firms thought that they would be able to access external finance to make necessary changes. This means that for example, around 50% of SMEs believe they can fund any necessary investments from own finance or loans.

### 3.2 SURVEY OF BUSINESS SUPPORT ORGANISATIONS AND BUSINESS SUPPORT PROJECTS

#### Scope and coverage

A total of 63 organisations supporting SME development across the 3 countries were interviewed to gather data and information, these including 13 Ministries and state organisations responsible for business support, 34 business support projects (BSPs), 3 think tanks focussing on SME needs and 14 business support organisations (BSOs).

**Table 6 Breakdown of BSOs and BSPs Surveyed**

	Ukraine
Ministries Responsible for SME Development	2
State Business Support Institutions	2
Business Support Projects and Donors	8
Business Support Organisations	4
Think Tanks	1
	<b>17</b>

#### Awareness of the AA/DCFTA

##### Awareness of AA/DCFTA requirements/opportunities amongst BSOs interviewed

- DCFTA is a popular topic, but the overall awareness, in particular in view of implications of DCFTA on firms is rather low

- SMEs are little aware of the implications of DCFTA on their firms, but export, export-ready and “better-off” firms in all countries are quite well aware
- SMEs are not really aware of how to benefit from DCFTA
- The awareness on DCFTA also differs between sectors; e.g. IT and manufacturing firms are better aware than most of the agricultural firms
- the Government has taken steps to inform people on DCFTA, e.g. via web sites

#### Management and marketing capacities of SMEs to comply/benefit DCFTA

In general, management and marketing skills are considered to be low.

Many firms are not aware of what needs to be done to comply with DCFTA.

Export and export-ready firms in all countries possess the necessary skills to comply with DCFTA

EU export helpdesk is widely used.

#### *Technical capacities of SMEs to comply/benefit DCFTA*

Technical capacities are better developed than the managerial and marketing ones, but still considered to have room for improvement.

Exporting, export-ready and “better-off” firms usually have better technical knowledge to comply with DCFTA than SMEs.

Technical capacities of firms seem to be quite advanced as 24.000 EUR1 certificates were issued by CCI.

#### Financial capacities of SMEs to comply/benefit DCFTA

It is expected that compliance with DCFTA will require a lot of funds.

Many firms have difficulties to quantify their financial needs as they are not aware of the requirements for adapting to DCFTA.

Access to finance is difficult as interest rates are considered high; in all countries collaterals are an issue and prices for loans are considered too high.

Liquidity for SME lending is said to be no problem (some banks being an exception) but banks mention a lack of bankable projects due to the lack of financial literacy and business planning skills.

Lending is the most used financial instrument; leasing and factoring is available, but trade finance is usually not used by SMEs; the demand for any other instrument than lending is low.

SME lending is heavily collateralized.

Long-term local currency lending is practically not available for SMEs.

Similarly, significant efforts and creativity are often required to identify and exploit support mechanisms available for DCFTA implementation at the firm level.

Non-functioning legal system creates problems for banks and firms alike.

Banks are very risk-adverse and conservative in SME lending.

Banking sector is paralyzed due to the present macroeconomic situation and has a negative reputation.

#### **Available support for AA/DCFTA Compliance and realising opportunities**

#### Capacity to support SMEs in AA/DCFTA compliance and realising opportunities

- BSOs have no capacities to offer services on DCFTA

- capacities seem to be concentrated in the capital cities with limited outreach to remote areas
- there seem to be international chambers leading the DCFTA process, but not really reaching SMEs
- there are some State Agencies, such as the Export Promotion Agency, the Food Safety Agency and the Enterprise Development Agency intending to offer services to SMEs on DCFTA with capacities to be developed

#### Available services for AA/DCFTA compliance (e.g. for testing, certifying, auditing)

- there are some facilities for testing and certification, but with limited capacities; only a few of them are internationally accredited
- there are State labs and a limited number of private labs, which are competing with each other
- many facilities are outdated and need upgrading and improvement
- international donors are supporting the setting up of testing and certification bodies
- There is a competition between State and private labs
- Many of the facilities are outdated and costs for certification are high

### **3.3 SURVEY OF FINANCIAL INSTITUTIONS**

#### **Scope and coverage**

A survey of 6 financial institutions was undertaken in Ukraine as well as interviews with EBRD and EIB.

#### **Major challenges in lending to SMEs**

##### General Lending Environment

- SME lending is an attractive market for banks, but it is difficult to find clients able to prepare bankable projects;
- banks considered themselves as “partners of SMEs”
- There is a liquidity problem within banks for SME lending
- Financial literacy is countries low in all
- there is a lack of demand for SME lending noted by the banks
- Costs of loans are considered too high
- Many SMEs lack knowledge on banking products and do not understand the logic (and needs) of the banks
- Long-term, local currency loans are a problem in all countries
- In general, banks are rather risk-averse and conservative in SME lending  
The banking sector in Ukraine is paralyzed and in de-capitalization as the Hryvna has devaluated so much possibly

##### Loan Applications

- Banks are supporting SMEs to prepare loan applications, but banks are complaining that the financials of most firms are sub-optimal and not well structured or opaque
- MFIs have less sophisticated loan applications than banks; often loan officers visit firms to prepare the loan application with the clients together on-site.
- there is no real microfinance system established

##### Realisation of Collaterals

- Credits are heavily collateralized.
- the realization of collaterals is a very difficult, time-intensive and expensive process
- As all collaterals must be sold via auctions, it’s an expensive process also for banks

- Courts need to be involved in order for collaterals recovery.
- there is a buyer's market for collaterals, which makes the selling of collaterals difficult for banks
- The recovery via court systems is very time consuming (up to 4 years)
- court systems are considered highly inefficient and corrupt

#### Loan Performance

- The overall NPL rate of banks are reported at between 7% and 50% (12% official NBM rate; 40-50% Moody's and Fitch). NPL rates of smaller firms are lower than bigger firms in all countries as one default loan of millions of USD can bring down the NPL of a bank substantially;
- MFI NPL rates are much lower than NPL rates of banks
- The interest rate at banks ranges between 10-15% (many firms with good projects can get loans for less than 10%) [as of the time of the research; however, recently rates of up to 35% have been reported in mid 2015)

#### **Awareness of AA/DCFTA**

##### Awareness of AA/DCFTA amongst Financial Institutions (FIs)

- knowledge on DCFTA among financial institutions is rather limited
- some banks are aware that DCFTA will be a topic for SMEs – providing business opportunities – but the overall knowledge even in these banks remains rather limited
- banks and MFIs would be interested to receive further training on DCFTA as many of them have realized that there are a lot of opportunities upcoming for financial institutions
- banks are not too much concerned regarding DCFTA – at least partly due to the overall difficult situation of the banking system

##### Awareness of AA/DCFTA amongst SMEs

- All financial institutions consider that the awareness, knowledge and management, technical and financial capacities of SMEs with respect to DCFTA are rather limited

##### Support from FIs to SMEs on AA/DCFTA implementation

- Most of the FIs were not really aware of DCFTA and its implication on firms; however, some of the banks conduct information and awareness creation events on DCFTA using external expertise;
- All banks interviewed in all countries would like to see some training on DCFTA for FIs.

#### **4. MAIN FINDINGS**

##### **4.1 NEEDS OF SMES TO COMPLY WITH CHANGING BUSINESS RULES DURING AA/DCFTA IMPLEMENTATION**

###### **Lack of Awareness of the Impact of the AA/DCFTA on business**

The scale of the task facing small and medium sized business in Ukraine in order to both take advantage of the opportunities, and to comply with the national reforms resulting from implementation of the AA/DCFTA cannot be underestimated. There are eleven areas of the AA/DCFTA that will have a direct impact on the operations of business, implementing over 1,000 new EU directives and introducing over 500 new harmonised standards. These will affect the majority of SMEs including the 1.7 million economically active registered SMEs.

Moreover, the current level of knowledge and understanding of the changes required is little known within the country with 78% of SMEs surveyed, having heard of the AA/DCFTA, and 79% of these believing that it will actually impact their business. There is also a significant difference across the various regions of Ukraine with awareness highest in Western Ukraine at 88% dropping to 81% in central regions, 74% in the south and only 61% in the east of the country. Therefore, the basic need is for the Government and donors to increase the general awareness amongst business of the AA/DCFTA. It should be recognised that efforts have been made over recent years to inform business and there have been a plethora of seminars relating to the AA/DCFTA provided by the Government, BSOs and donors. However, the survey of BSOs, donors, donor support projects and Government Ministries, Departments and Agencies highlighted a lack of knowledge and understanding of the actual impact of the AA/DCFTA which has been reflected in the lack of focus on the concrete effects on business noticeable during previous rounds of events and aforementioned seminars; they tend to concentrate on the overall benefits of integration with the Single European Market, rather than actual changes that will arise. Similar attitude is noticeable within government Ministries and Donor Support programmes for implementation of specific aspects of the AA/DCFTA, which tend to focus on regulatory compliance rather than on communicating and supporting business to adapt to the new reforms

###### **Lack of knowledge of the scope and coverage of the changes to business operations**

There is a general lack of understanding of the scope of changes that will effect business. Of the SMEs surveyed, 61% stated that any changes under the AA/DCFTA would only or mostly affect exporters and similarly, only 36% thought that any impact on all SMEs would be high. Only around 40% of SMEs stated that they understood the changes that would arise from the AA/DCFTA across the various sectors, with the highest level, 63% of SMEs stating an understanding on changes to technical regulations and lowest understanding, only 26% stating they understood the road transport safety and GI changes for business arising from legislative changes in implementation of the AA. It should be noted that these figures probably overestimate the actual understanding as for some firms interviewed, although they stated they understood, clearly did not.

###### **The needs of SMEs to take advantage of the provisions of the AA/DCFTA**

The majority (70%) of SMEs surveyed want to export to the EU, but only 58% of SMEs believe the AA/DCFTA provides business with an opportunity.

However, there is a lack of knowledge amongst SMEs as to the changes in market access under the DCFTA, with only 34% of SMEs stating they know, or know where to obtain information on, exporting to the EU.

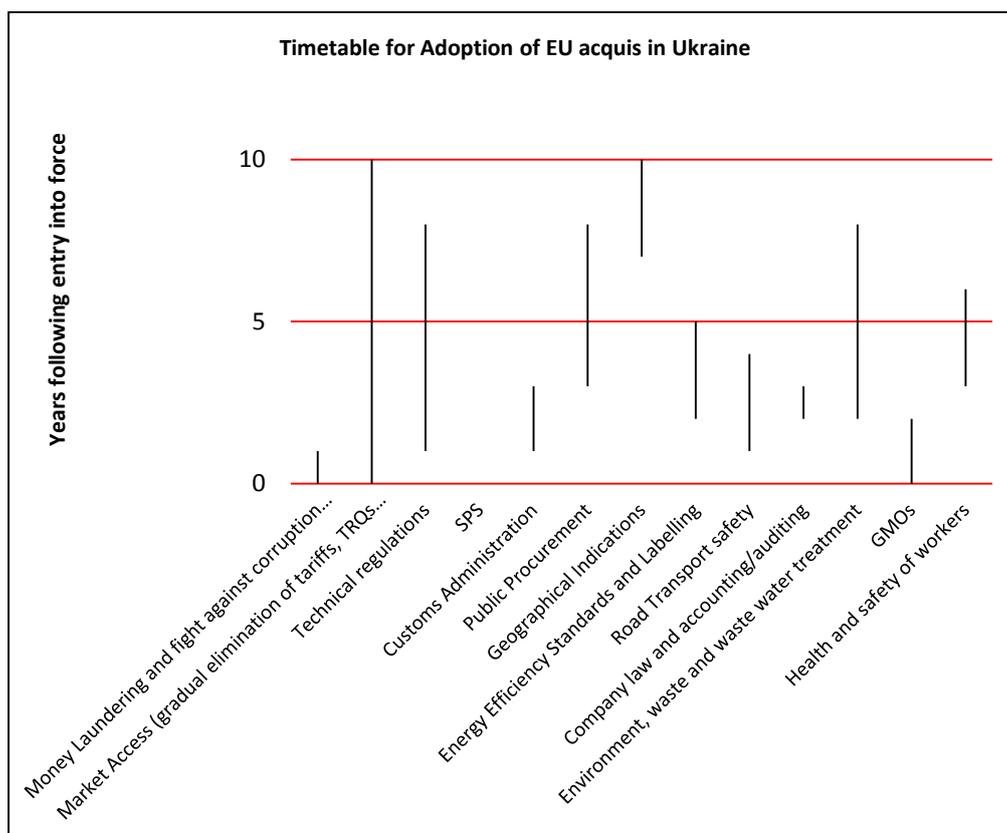
SMEs do not have the technical capacity to understand requirements with limited knowledge and understanding of where to find information on exporting and EU tender opportunities with only 20% of SMEs stating they know where to find information.

#### 4.2 SCALE AND SCOPE OF CHANGES

Not all areas will affect all business in the same way. There will be varying levels of scale of changes required, levels of investment and timing.

##### Timetable for adoption of the EU Acquis directly affecting business

It is important to recognise that implementation of the AA/DCFTA will be over a 10 year period and therefore, within each strategy it is necessary to prioritise not only sectors that are prominent in each country and will be affected most, but according to the timeframe for implementation.



**Note:** The timetable for adoption of regulations on SPS has yet to be determined and is in preparation by the Government of Ukraine

The timetable indicates that most of the changes affecting SMEs will occur within the first 4 years focusing on financial reporting (for money laundering and fight against corruption purposes), market access changes, changes in customs administration, and adoption of company law, energy efficiency, road safety requirements, GMOs, health and safety at the workplace and technical regulations. In the longer term, further adoption of technical regulations and environment regulations and the adoption of public procurement procedures and GIs.

##### Scope of changes for SMEs

Moreover, some of the changes that will affect business will not be too onerous, nor require high levels of investment.

Those areas that will require little investment will be:

- Money Laundering, Terrorism Financing and Fight Against Crime and Corruption: will lead to increased record keeping of financial transactions. The effect on SMEs will be allocation of internal human resources to improve accounting and reporting of finances within the business, training, use of external BDS (accountants/book keepers) and some very minimal investment perhaps in accounting software, largely OTS packages.
- Market Access (reduction in tariffs, export duties, TRQS and reference prices): will mean that importers of certain agricultural products will have to obtain licenses and exporters will see administrative changes on issuance and confirmation of compliance with rules of origin (EUR 1 certification by Customs). Whilst this will affect logistics management, it will not require any investment.
- Phasing out the use of Certain GIs in Ukraine and Third Markets: Provisions in the AA/DCFTA relate principally to enforcement nationally. Ukraine, exercised grandfather rights to continue the use of protected GIs under WTO but the AA/DCFTA will gradually phase out the use of EU protected GIs in 7 years (for cheeses) and 10 years (for alcoholic drinks). This will mean Ukrainian producers will not be able to use protected names in both domestic and third country markets. This will require renaming which may need legal IP advice on permissible replacements and rebranding of products. No investments will be necessary.
- Gradual Approximation to the Union's Customs Law (Customs Code) and some International Law, as well as the EU Law on Customs Enforcement of IPR: all importers and exporters will have to work with new customs procedures and rules. Again, whilst this will affect logistics management, it will not require any investment.
- Approximate National Legislation to the Relevant EU acquis on Public Procurement: developing open and transparent systems for government tendering will provide opportunities for SMEs to supply and work on government contracts. In order to do so, SMEs will need to understand the rules, monitor publications and exercise rights (transparency and disputes). This will not require investment.
- GMO Provisions: ensuring the control and use of GMOs (deliberate release/spread of GMO into the environment, trans-boundary movement and contained use) will require agricultural producers and agro processors to put in place monitoring, tracking, record keeping and ensure labelling of food when GMO products are used. This would require limited investments.
- Company Law, Corporate Governance, Accounting and Auditing: largely this relates to the adoption of international standards on accounting practices, record keeping and financial reporting. For SMEs, improved accounting and reporting of finances within the business, training, use of external BDS (accountants/book keepers) and some very minimal investment perhaps in accounting software, largely OTS packages.
- Employment, Social Policy and Equal Opportunities: largely this relates to health and safety of workers and requires procedures put in place, signage and a small amount of investment in safety equipment but this would be small purchases of personal protective equipment such as safety shoes and fluorescent jackets.

Those areas that will require higher levels of investment will be:

- Approximation of Technical Regulations, Standards, and Conformity Assessment and EU Standards and Labelling: compliance with one or more technical regulations will require understanding of the requirements (key characteristics), review of available standards that confer presumption of conformity, product redesign and adaption of production processes, industrial metrology, testing and analysis, certification of conformity assessment. To comply with these technical regulations and associated standards, SMEs may need (depending on the product) to invest in new technologies and equipment. In addition, some SMEs will have

to either purchase testing equipment or outsource testing to laboratories, as well as certification to designated conformity assessment bodies. This will apply to domestic production as well as imported products for distribution and sale domestically).

- Gradual Approximation of Sanitary and Phytosanitary, Animal Welfare and Other Legislative Measures: Compliance with EU SPS measures nationally will mean agricultural producers and agro processors will need to comply with risk, hygiene and food safety standards. This will involve understanding requirements, putting controls in place, testing and monitoring throughout production and in batches and certification and external approvals. It will also mean checking standards throughout the supply chain and verifying compliance of suppliers (farm to fork). This will affect record keeping, production processes and hygiene (procedures, training and facilities) as well as in-house or external testing and control verification. This will require investments in both facilities (adapting buildings, product & production quality and standards) and technologies and equipment.
- Road Transport: adopting EU road safety acquis will affect any business that operates commercial vehicles and transport of goods, whether logistics/transport firms or producers with own vehicles. Compliance with road safety provisions will include regular testing of roadworthiness, maintenance records and procedures. For commercial transporters, either having weigh bridges or access to external facilities would be required as well investments and retro fitting of required equipment such as speed limiters, driving log meters, GPS systems etc).
- Approximation Relating to Energy Efficiency: compliance with legislation on energy efficiency and labelling of buildings and household goods would require manufacturers of household goods and building materials to adapt production, to measure and rate products for energy efficiency and certify such. Investments would be needed in new equipment and technologies for manufacturers, as well as testing facilities; building materials manufacturers may also require new technologies and equipment although this applies only to new buildings.
- Environmental Protection: compliance with air quality and waste management (including waste water) directives will require SMEs that are involved in sectors that produce potentially hazardous waste to understand requirements, monitor waste and install systems to control, limit and treat their commercial waste, or have it disposed of by external commercial providers. This may require investments in monitoring and treatment facilities and equipment.

#### **4.3 RESOURCES AND CAPACITY TO ADAPT AND COMPLY WITH THE REQUIREMENTS OF THE AA**

##### **Resources of SMEs**

SMEs do not have the resources to comply with AA/DCFTA requirements with around 50% of firms with internal capacity to manage and implement the necessary changes resulting from implementation of the AA/DCFTA. Although it is likely that firms have under-estimated the complexity of the changes necessary and these figures are therefore overstated.

Based on case studies and experiences of other countries there are 5 generic steps which SMEs will need to undertake to comply with, or take advantage of, the AA/DCFTA:

- Step 1: Information and knowledge of changes required
- Step 2: Strategy for implementation and compliance
- Step 3: Internal management and process changes
- Step 4: Investment in plant and equipment
- Step 5: External certification (as necessary)

Whilst 67% of SMEs stated they had internal capacity to obtain information and knowledge, only 52% stated they would be able to develop the necessary strategy and make management changes, 48%

identify investments needed and 45% be able to qualify for external certification. This identifies a big gap for BSOs to provide support to SMEs.

Moreover, these SMEs stated that even with capacity, they do not have their own financial resources nor can they obtain external finance for these steps with 37% stating they had financial resources for obtaining information, 35% for developing a strategy and making management changes, 20% for necessary investments and 28% for external certifications. Only 35% of SMEs believe they will be able to obtain financial resources to fund these steps. Again, there is a needed role to provide such funding.

### **Capacity of BSOs**

Notwithstanding the need identified above for BSOs to provide business development services to SMEs to support compliance with AA/DCFTA requirements, the ability and capacity of existing BSOs (public and private sector), government departments and donor SME support programmes is limited and needs to be strengthened.

Few SMEs (only 22% of those surveyed) use business development services and of those using BDS, 84% were unsatisfied with the services provided, 86% wanted a broader range of services and 84% think such services are unaffordable.

There are few BSOs with knowledge of AA/DCFTA in both the private and public sector. The BDS market is very weak and concentration of both governments and donors is in legal compliance and none of the actors has so far been seriously involved with ensuring SMEs are supported.

### **Finance**

External finance to fund compliance with the AA/DCFTA and taking advantage of the opportunities is an extremely important factor identified above. Many of firms (69% of those surveyed) had experience of obtaining loans from financial institutions and only 42% reported these loans were easy to obtain, 83% reported the interest rate was unaffordable and most financial institutions report that SMEs have inadequate financial literacy.

### **General Constraints to Business**

It should be borne in mind that the general business and finance environment will affect the ability of SMEs to comply, as well as affecting their ability to survive and develop in the short to medium term. Whilst we do not address these factors in this report (as we concentrate on direct effects of AA) these should be addressed within the wider PSD development framework. These include:

- SMEs face major constraints: Cost and access to finance; Taxation rates and drawback; Slow and inconsistent implementation of reforms; Geopolitical instability caused by Russia; Corruption, Business Licensing and red tape; Unfair competition and macro-economic instability.
- Finance and enforcement of new regulations by government were cited by BSOs as a concern in all countries for compliance with AA/DCFTA. Other constraints listed by SMEs, BSOs and FIs were not related to the business environment but rather BDS such as availability of information on AA/DCFTA.
- The overwhelming constraint within the general business environment that will affect AA/DCFTA compliance and taking advantage of the opportunities is access to finance. Most SMEs, all BSOs and even FIs in each country listed access to finance as a binding constraint to SMEs compliance.

## **5. RECOMMENDATIONS**

The scale of the task for SMEs to understand the changes resulting from AA/DCFTA compliance and to adapt their administration procedures, production processes and facilities cannot be underestimated. In order that business in each of the countries can be better prepared to comply with changing national legislation, as well as take advantage of the opportunities, a full range of support and “hand holding” is required through a comprehensive programme of targeted and very specific support. The following summarises the recommendations. Full details of these are elaborated in the main report.

### **5.1 STRATEGY 1: AWARENESS**

To improve the understanding of the actual effects of the AA/DCFTA on business and the opportunities it provides. Current and future planned awareness across all countries is based on high level political statements rather than concrete information, so all information in this programme will be specifically oriented to business.

Awareness of AA/DCFTA to business must be more than current “headline” approach and be specific as to the ‘effects’ (as well as impact) on SMEs business operations. The specific objectives will be:

- to ensure that all SMEs understand how the agreements affect business;
- to stimulate SMEs to consider and incorporate AA/DCFTA implications into their corporate planning;
- to ensure FIs and BSOs understand the needs of SMEs;
- to encourage government to consider and communicate changes to business.

In order to achieve these objectives, the following programmes could be developed in each country:

1. National Business Awareness Campaign
2. Outreach Programme for and through Financial Institutions, BSOs and Government MDAs (Ministries, Departments and Agencies)

### **5.2 STRATEGY 2: KNOW HOW**

The overall objective of this strategy is to enable SMEs to comply with the requirements of the AA/DCFTA as they are adopted nationally and take advantage of the opportunities it provides; also to provide SMEs with assistance and tools to make all the necessary changes within their business operations to enable them to adapt and prepare for the AA/DCFTA.

The specific objectives of this strategy will be:

- Increase the cadre of skills and knowledge of how to operate and adapt business under the AA/DCFTA
- To create and make available adequate and available BDS for AA/DCFTA compliance

In order to achieve these objectives, the following programmes could be developed in each country:

1. Availability of BDS for AA/DCFTA strategy and planning
2. Thematic Specific BDS (new and existing)
3. Business Linkages Approach
4. Establishment of National AA/DCFTA Centre (creator and keeper of knowledge)

### **5.3 STRATEGY 3: INVESTMENT FINANCE**

The changes that will occur as a result of implementation of the AA/DCFTA, as well as taking advantage of the opportunities, will require investments. However, not all these changes will affect all businesses, not all will apply to all sectors and not all will require financial investment. Therefore, the objective of the AA/DCFTA financial strategy is to fund activities and investments targeted to those

enterprises that will be most affected so as to enable them to comply and take advantage. These recommendations relate exclusively to the financing needs for compliance with AA/DCFTA requirements. However, as detailed in the analysis, there are a number of underlying access to finance issues that need to be addressed in parallel including financial literacy, systems for realisation of collateral, cost of finance, effects of devaluation (recapitalisation of banks) and local currency lending, amongst others. Without such actions, the reach and effect of these other suggestions will be limited (for example, access to finance is limited by financial literacy of SMEs, so unless this is addressed, SMEs will not be able to access the suggested facilities).

The general approach to providing finance to SMEs to assist in compliance with the requirements arising from national implementation of the AA/DCFTA must have the following considerations:

- SMEs in each country need investment for upgrading to meet market requirements and to ensure competitiveness. Whilst this investment is needed, it is not necessarily linked to the needs arising from compliance with the rules to be adopted as a result of the AA/DCFTA. Therefore, it is important that the facilities offered provide a direct link to effects of AA/DCFTA compliance.
- It should be recognised that the focus should not just be on compliance but for taking advantage of the resulting opportunities. So although existing exporters already comply with the EU acquis, facilities should also be made available to potential exporters to the EU. Therefore, the principle focus should be on SMEs supplying structured domestic markets and potential exporters.

In order to achieve these objectives, the following programmes could be developed in each country:

- Credit Lines for compliance with technical regulations and SPS measures
- Credit Lines for Approved Technologies for transport, energy efficiency and environmental protection
- Credit Lines for Equipment for testing

#### **5.4 STRATEGY 4: SUPPORTING CERTIFICATION AND APPROVALS**

Adoption of EU legislation in each of the 3 countries under the AA/DCFTA or compliance with EU requirements in order to export, necessitate changes in businesses operations and processes. SMEs will not only be required to adapt but must also verify those changes through verification systems such as inspection by national authorities or independent certification and approvals. However, the availability and cost of certification is often a major constraint to growth and compliance and will be addressed within Strategy 4.

The specific objectives of this strategy will be:

- to ensure that certification and approval processes do not become a barrier to compliance with national legislation adopted within the context of AA/DCFTA implementation or access to the EU market;
- to reduce the cost of certification for SMEs;
- to improve access to competitive market for certification and approvals.

It should be noted that the development of the required quality infrastructure in each country for compliance approvals is necessary for implementation of the commitments under the AA/DCFTA. However, it is considered that this role will be undertaken within other programmes such as EU legal approximation and thematic programmes. Therefore, the activities within this strategy focus on “access” to the required quality infrastructure, not creating or strengthening the existing or planned structures.

In order to achieve these objectives, the following programmes could be developed in each country:

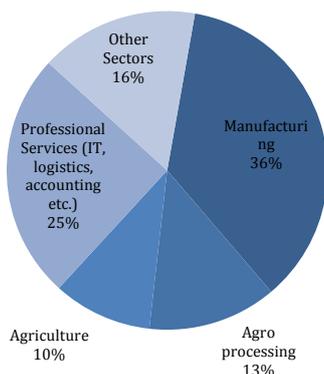
1. Financing Certification Costs
2. Facilitating Access to Certification Bodies

## Appendix 1: SME Survey Results

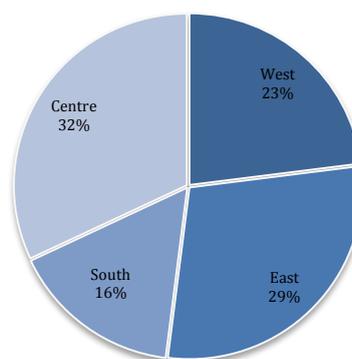
### Scope and Coverage of Survey

The SME survey was undertaken between October and December 2014 and 196 SMEs were surveyed. A profile of the respondents is provided by sector, regional and size, as well as a breakdown of those currently exporting:

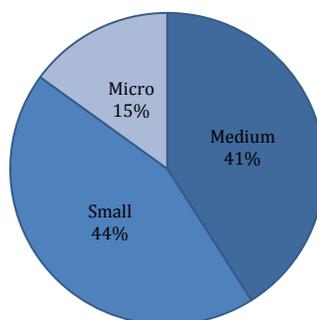
Ukraine - Sector Coverage



Ukraine - Regional coverage



Ukraine - Size of company coverage



### General Business Environment

#### Top 5 Constraints Perceived by SMEs Surveyed

- Cost of finance
- Availability of finance (willingness to lend)
- Political instability
- Corruption
- Tax rates

Political instability is perceived as the next biggest constraint, combined with corruption and high/number of taxes.

#### Views on Business Prospects

- 40% of firms surveyed think they can grow in the current business climate
- 28% of the surveyed firms state they are able to invest in the current climate

## **Opportunities under the AA/DCFTA**

### Firms who can sell or want to sell to EU

- 58 % of the surveyed firms estimate that they can sell to EU now.
- 70% of the surveyed firms expressed their wish to sell to EU.

### Market Access to the EU market

- There is a certain level of knowledge amongst those that were surveyed of how to access the EU market and where to obtain information with 37 % having the knowledge.
- Around 30% knew how to find information on exporting to the EU.

### Understanding of the Changes to EU market access under the DCFTA

There is understanding amongst those surveyed of the changes in market access resulting from the DCFTA:

- 36 % knew about the changes affecting tariffs;
- 33 % about TRQ's; and
- And 34 % about Certificates of Origin.

### Preparedness of SMEs for changes under AA/DCFTA

Although the vast majority of SMEs surveyed intend to develop a marketing plan to access the EU market, few believe they have the internal resources or can gain access to external resources to implement it properly.

- 47 % of the surveyed companies stated they will develop a marketing plan to access the EU Market;
- 18 % confirmed they have access to external financial to implement the plan; and
- 38 % stated they have internal resources to implement it.

The reported support needed to implement an EU marketing strategy: grants; liberalisation of legislation; financial assistance; information on EU tariffs and quotas and how to export in the EU; contacts.

### Opportunities to Participate in EU Government Tenders

There is reasonable knowledge of the EU public procurement opportunities with SMEs interested in participating in tenders. However, there is virtually no knowledge of where to get information on tender notices and the rules of tendering.

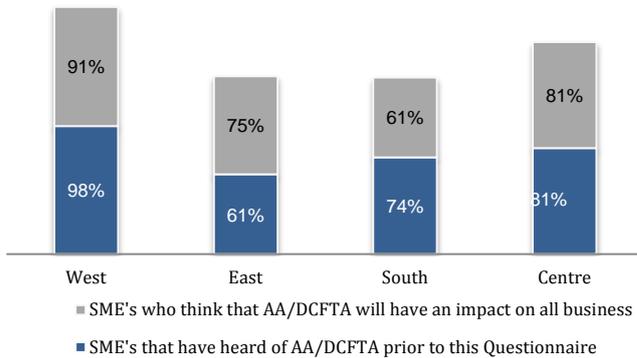
- 41% SMEs state they are aware of ability to participate in EU Government tenders;
- 58 % confirmed they interest to participate in the EU government tenders;
- 20% SMEs state they know where to find information about the rules for tendering in the EU;
- 20% SMEs surveyed know where to find information about calls for tender in EU.

## **Understanding of the changes from implementation of the AA/DCFTA**

### General Awareness of the AA/DCFTA

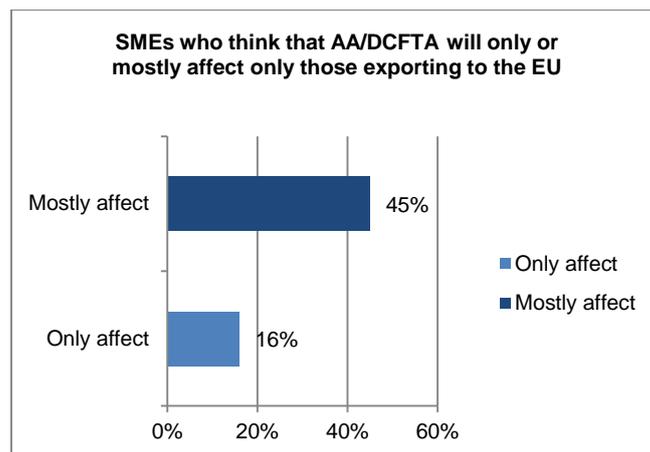
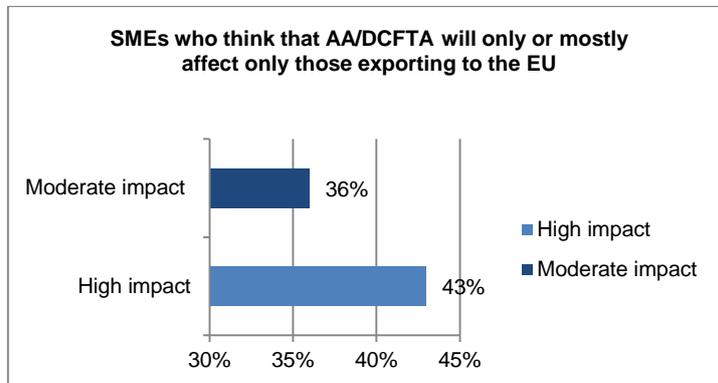
- 78% of the surveyed SME's heard of AA/DCFTA prior to the Questionnaire
- 79 % of the surveyed SMEs thing that AA/ DCFTA will have an impact on all business in country

**Ukraine - SMEs General Awareness by region**



Awareness of AA/DCFTA by Region

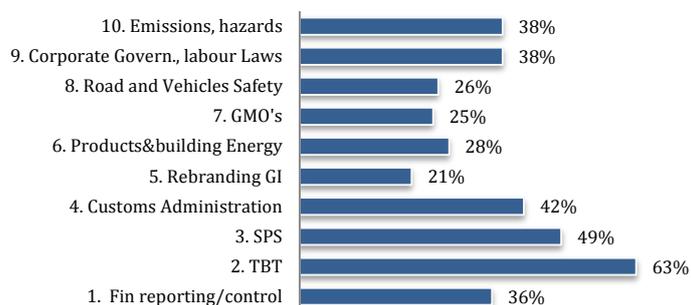
Impact of AA/DCFTA on SMEs



Nearly 80% of Ukrainian SMEs think that there will be a serious impact on business in Ukraine. This can lead to an assumption that they have a pretty good understanding of the AA/DCFTA in general.

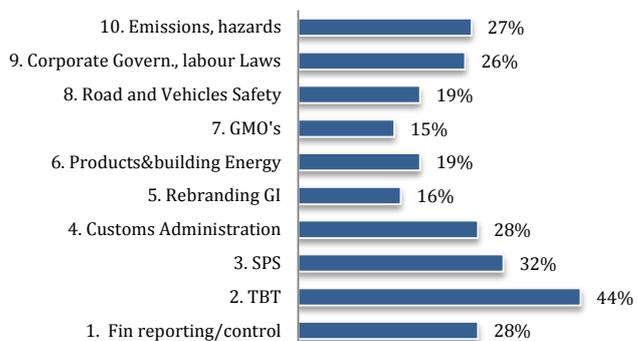
## Specific knowledge of Changes amongst SMEs

### **Ukraine SMEs that understand the changes to their business in specific areas**



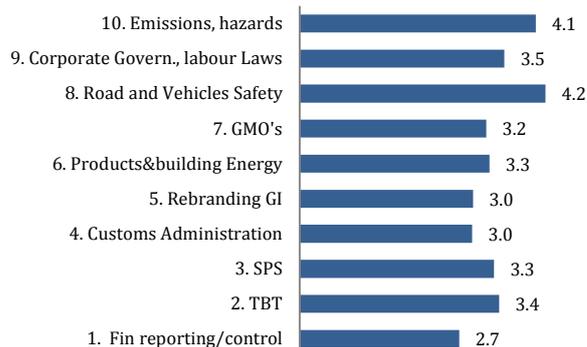
## Business who know where to find information on each area affected

### **Ukraine level of understanding of the changes required in areas affected**



## Timetable for adoption of EU acquis

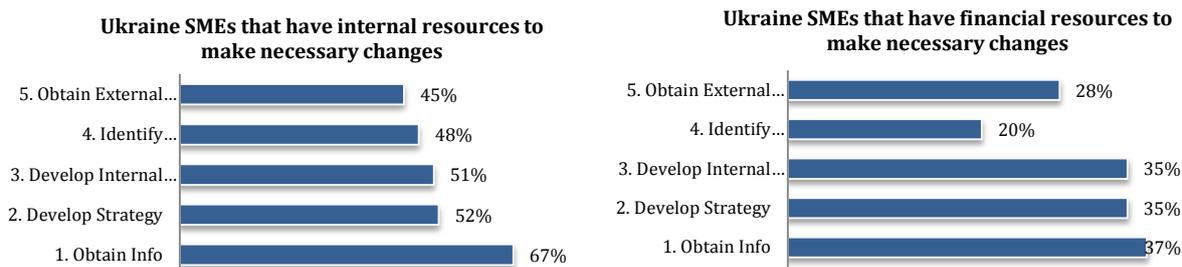
### **Ukraine SMEs view on timetable to become national legislation (years)**



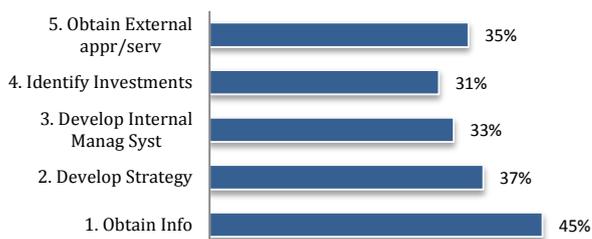
In general, SMEs have only very general and poor knowledge of the time table for the implementation of the legislation;

Most of the respondents didn't know the answer to this question and in most cases answers were made up.

Availability of resources for compliance with AA/DCFTA



**Ukraine SMEs that can access external financial resources to make necessary changes**



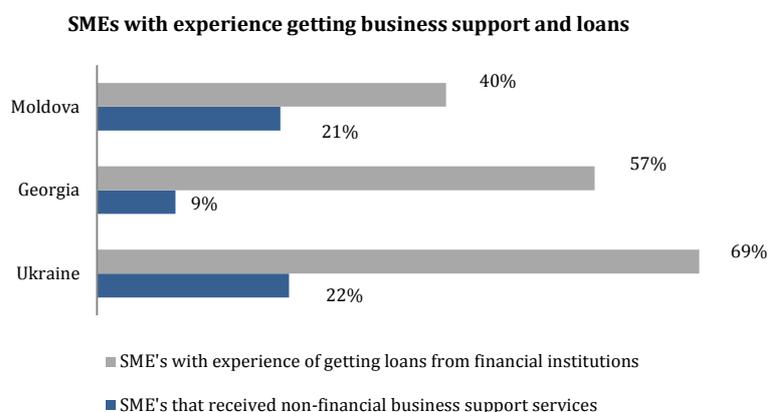
- Around 50% of SMEs in Ukraine believe that they have internal resources to be able to implement the necessary changes resulting from implementation of the DCFTA.
- However, only around one third stated they had sufficient finance to fund these changes, dropping to only 20% stating they had the finance for any required investment.
- Similarly, around one third of firms thought that they would be able to access external finance to make necessary changes. This means that for example, around 50% of SMEs believe they can fund any necessary investments from own finance or loans.

Support required for compliance with AA/DCFTA

Support suggested by Participants: Finances; Information; Training; Awareness creation, Human resources and New technologies.

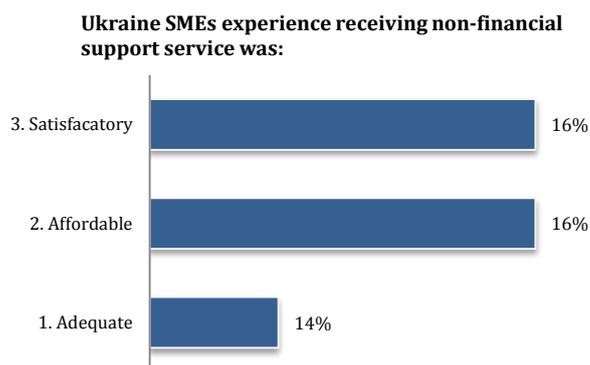
**Adequacy of available business development services**

Experience of BDS



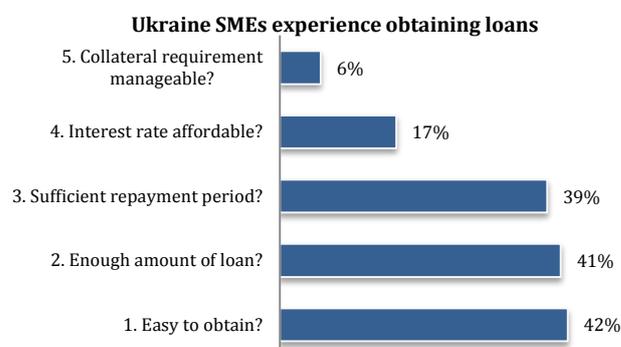
The majority of firms have received loans but few across the three countries have received BDS.

## Adequacy of Business Development Services



Of those companies with experience of BDS, around 85% of those reported that the range of services available is inadequate and unaffordable. Moreover, only about 15% of reported that they were satisfied with the services they received.

## Experience of loans



In general, 42 % of SMEs reported that loans were relatively easy to obtain, equal number reporting loans were sufficient and over a sufficient repayment period.

SMEs reported interest rates unaffordable with around 83% of SMEs stating unaffordable interest rates.

Collateral requirements were problematic for 94% of SMEs.

## Appendix 2: Survey of Business Support Organisations and Business Support Projects

### Scope and coverage

A total of 63 organisations supporting SME development across the 3 countries were interviewed to gather data and information, these including 13 Ministries and state organisations responsible for business support, 34 business support projects (BSPs), 3 think tanks focussing on SME needs and 14 business support organisations (BSOs).

### Breakdown of BSOs and BSPs Surveyed

	Ukraine
Ministries Responsible for SME Development	2
State Business Support Institutions	2
Business Support Projects and Donors	8
Business Support Organisations	4
Think Tanks	1
	<b>17</b>

### Awareness of the AA/DCFTA

#### Awareness of AA/DCFTA requirements/opportunities amongst BSOs interviewed

- DCFTA is a popular topic, but the overall awareness, in particular in view of implications of DCFTA on firms is rather low
- SMEs are little aware of the implications of DCFTA on their firms, but export, export-ready and “better-off” firms in all countries are quite well aware
- SMEs are not really aware of how to benefit from DCFTA
- The awareness on DCFTA also differs between sectors; e.g. IT and manufacturing firms are better aware than most of the agricultural firms
- the Government has taken steps to inform people on DCFTA, e.g. via web sites

#### Management and marketing capacities of SMEs to comply/benefit DCFTA

In general, management and marketing skills are considered to be low.

Many firms are not aware of what needs to be done to comply with DCFTA.

Export and export-ready firms in all countries possess the necessary skills to comply with DCFTA

EU export helpdesk is widely used.

#### *Technical capacities of SMEs to comply/benefit DCFTA*

Technical capacities are better developed than the managerial and marketing ones, but still considered to have room for improvement.

Exporting, export-ready and “better-off” firms usually have better technical knowledge to comply with DCFTA than SMEs.

Technical capacities of firms seem to be quite advanced as 24.000 EUR1 certificates were issued by CCI.

#### Financial capacities of SMEs to comply/benefit DCFTA

It is expected that compliance with DCFTA will require a lot of funds.

Many firms have difficulties to quantify their financial needs as they are not aware of the requirements for adapting to DCFTA.

Access to finance is difficult as interest rates are considered high; in all countries collaterals are an issue and prices for loans are considered too high.

Liquidity for SME lending is said to be no problem (some banks being an exception) but banks mention a lack of bankable projects due to the lack of financial literacy and business planning skills.

Lending is the most used financial instrument; leasing and factoring is available, but trade finance is usually not used by SMEs; the demand for any other instrument than lending is low.

SME lending is heavily collateralized.

Long-term local currency lending is practically not available for SMEs.

Similarly, significant efforts and creativity are often required to identify and exploit support mechanisms available for DCFTA implementation at the firm level.

Non-functioning legal system creates problems for banks and firms alike.

Banks are very risk-adverse and conservative in SME lending.

Banking sector is paralyzed due to the present macroeconomic situation and has a negative reputation.

Type of support needed by SMEs to comply with AA/DCFTA

### **Support Needs of SMEs as Perceived by BSOs Interviewed**

	Ukraine	Rank
Management	2,75 (2)	1
Marketing / Labelling	2,75 (2)	4
Technology / Product Development	2,75 (2)	3
Finance (Financial Literacy)	1,75 (1)	2

The relevance of support needs is rather close, but a ranking can be made according to which, the major need for support is management, followed finance / financial literacy, technology / product development and marketing, incl. labelling.

### **The General Business Environment**

Major constraints to business development

Constraints listed by all BSOs and BSPS:

- The implementation of rules and regulations was considered sub-optimal and reform processes are considered as taking too long
- The implementation of political decisions and the institutional framework for policy implementation is considered to be problematic
- The general geo-political situation – and the Ukrainian-Russian conflict – is considered as a major challenge for the business environment
- Some reluctance to organize in associations could be found
- The statistics related to SMEs could be improved
- Access to foreign markets was considered difficult

- Access to finance was mentioned as a major impediment for firms
- Access to innovation and new technologies, incl. technology infrastructure, was considered sub-optimal
- Business and entrepreneurial skills were said to be sub-optimal
- Taxes are considered too high; the tax system is considered to need an overhaul
- FDI attraction is considered sub-optimal due to the overall macro-economic and political situation,
- There is no coherent SME policy in place yet and state support to SMEs is practically non-existent
- There is no lobbying on Government level for SMEs
- Corruption, non- or mis-functioning legal systems, unfair competition, informal sector and lack of transparency were considered problematic for firms
- It was mentioned that there was too much red tape and that the governments are controlling firms rather than supporting them
- High transaction costs and difficult VAT return as well as non-transparent public procurement systems were mentioned as constraints
- In Ukraine the overall macroeconomic situation with high devaluation, a paralyzed banking system, 20% inflation and a lack of customer trust as well as the war in the east are not conducive for firms to do business as these factors prevent them from doing long-term planning, accessing finance and interacting with international partners

#### General Business Prospects

- Several sectors are considered as having good potential for international trade
- There are opportunities to attract foreign investment
- There are good human, natural and material resources to be exploited
- There are many well-trained, young people eager to learn
- The general business environment was considered positive, good and corruption free facilitating doing business
- The banking system is considered good and supportive to SMEs
- In Ukraine due to the entrepreneurial spirit of the people many firms still function and are able to adapt to the difficult macroeconomic situation in the country
- In Ukraine, there is a lot of EU enthusiasm
- In Ukraine the agriculture sector is considered as holding huge potential, in particular for export; Ukraine holds 30% of the world's black soil
- Ukraine is a large market and there interesting opportunities for investors

#### Effect of BEE constraints on AA/DCFTA compliance (all countries)

- There is a lack of understanding what SMEs will require to comply with DCFTA
- Access to information and knowledge on DCFTA was considered sub-optimal; there is also misinformation around, mainly by Russian propaganda
- There is some fear on the investment requirements to comply with DCFTA
- There are fears that there will be tougher competition, also in the country, and that some of the less competitive firms will not survive the DCFTA harmonisation
- The adaptation to the food safety standards are considered a particular problem
- Lack of appropriate testing and certification infrastructure was noted
- Firms were traditionally targeting the Russian market and there is a fear that the EU market will have no demand for CIS products

### Effect of BEE constraints on opportunities under the AA/DCFTA

- DCFTA is expected to have a positive impact on the country's competitiveness, product standards, environmental standards, food safety, etc.
- There is hope that DCFTA will bring more opportunities for SMEs and will improve firm competitiveness
- There is expectation for DCFTA to bring more export opportunities
- There is expectation that DCFTA will allow more FDI
- There are hopes to get via DCFTA legal stability and an overall better business environment as DCFTA is considered a modernization program

### **Available support for AA/DCFTA Compliance and realising opportunities**

#### Capacity to support SMEs in AA/DCFTA compliance and realising opportunities

- BSOs have no capacities to offer services on DCFTA
- capacities seem to be concentrated in the capital cities with limited outreach to remote areas
- there seem to be international chambers leading the DCFTA process, but not really reaching SMEs
- there are some State Agencies, such as the Export Promotion Agency, the Food Safety Agency and the Enterprise Development Agency intending to offer services to SMEs on DCFTA with capacities to be developed

#### Available services for AA/DCFTA compliance (e.g. for testing, certifying, auditing)

- there are some facilities for testing and certification, but with limited capacities; only a few of them are internationally accredited
- there are State labs and a limited number of private labs, which are competing with each other
- many facilities are outdated and need upgrading and improvement
- international donors are supporting the setting up of testing and certification bodies
- There is a competition between State and private labs
- Many of the facilities are outdated and costs for certification are high

### **Needed Support for AA/DCFTA compliance**

#### Support needed to improve policy and regulatory framework

- New Government should be supported in their attempts to improve the business environment
- Policies should have a consolidated approach
- Long-term capacity building programs are needed to support the Government in designing and implementing SME policy
- Knowledge should be institutionalized and trained staff should have decision-making power
- Support should be triggered at the highest possible level

#### Awareness and Information Needs

- A proper and in-depth awareness and information creation campaign targeted towards firms and farms should be designed and implemented
- The awareness campaign should use all available media channels
- The awareness and information campaign should involve SME and DCFTA experts as well as journalists and communication experts

#### Needs for improved Business Development Services and business linkages

- Firms should be made aware of the benefits of BDS
- Sustainability of collaboration among organizations should be ensured

#### Training Needs for AA/DCFTA compliance

- Knowledge should be institutionalized within training institutions
- International expertise should be used for local trainers speaking English
- Training on DCFTA should be sector- and product-specific
- Lots of case studies should be used
- People should be encouraged to participate more actively in trainings

#### Technical Service Needs (Testing, Certification)

- There should be more testing/certification and related facilities
- Such facilities where they already exist should be upgraded
- Facilities should be internationally accredited

#### Financial Needs for AA/DCFTA compliance and realising Opportunities

- Testing and certification bodies should be supported

## **Appendix 3: Survey of Financial Institutions**

### **Scope and coverage**

A survey of 6 financial institutions was undertaken in Ukraine as well as interviews with EBRD and EIB.

### **Major challenges in lending to SMEs**

#### General Lending Environment

- SME lending is an attractive market for banks, but it is difficult to find clients able to prepare bankable projects;
- banks considered themselves as “partners of SMEs”
- There is a liquidity problem within banks for SME lending
- Financial literacy is countries low in all
- there is a lack of demand for SME lending noted by the banks
- Costs of loans are considered too high
- Many SMEs lack knowledge on banking products and do not understand the logic (and needs) of the banks
- Long-term, local currency loans are a problem in all countries
- In general, banks are rather risk-adverse and conservative in SME lending  
The banking sector in Ukraine is paralyzed and in de-capitalization as the Hryvna has devaluated so much possibly

#### Loan Applications

- Banks are supporting SMEs to prepare loan applications, but banks are complaining that the financials of most firms are sub-optimal and not well structured or opaque
- MFIs have less sophisticated loan applications than banks; often loan officers visit firms to prepare the loan application with the clients together on-site.
- there is no real microfinance system established

#### Realisation of Collaterals

- Credits are heavily collateralized.
- the realization of collaterals is a very difficult, time-intensive and expensive process
- As all collaterals must be sold via auctions, it’s an expensive process also for banks
- Courts need to be involved in order for collaterals recovery.
- there is a buyer’s market for collaterals, which makes the selling of collaterals difficult for banks
- The recovery via court systems is very time consuming (up to 4 years)
- court systems are considered highly inefficient and corrupt

#### Loan Performance

- The overall NPL rate of banks are reported at between 7% and 50% (12% official NBM rate; 40-50% Moody’s and Fitch). NPL rates of smaller firms are lower than bigger firms in all countries as one default loan of millions of USD can bring down the NPL of a bank substantially;
- MFI NPL rates are much lower than NPL rates of banks
- The interest rate at banks ranges between 10-15% (many firms with good projects can get loans for less than 10%).

## **Awareness of AA/DCFTA**

### Awareness of AA/DCFTA amongst Financial Institutions (FIs)

- knowledge on DCFTA among financial institutions is rather limited
- some banks are aware that DCFTA will be a topic for SMEs – providing business opportunities – but the overall knowledge even in these banks remains rather limited
- banks and MFIs would be interested to receive further training on DCFTA as many of them have realized that there are a lot of opportunities upcoming for financial institutions
- banks are not too much concerned regarding DCFTA – at least partly due to the overall difficult situation of the banking system

### Awareness of AA/DCFTA amongst SMEs

- All financial institutions consider that the awareness, knowledge and management, technical and financial capacities of SMEs with respect to DCFTA are rather limited

### Support from FIs to SMEs on AA/DCFTA implementation

- Most of the FIs were not really aware of DCFTA and its implication on firms; however, some of the banks conduct information and awareness creation events on DCFTA using external expertise;
- All banks interviewed in all countries would like to see some training on DCFTA for FIs.

## **The General Business Environment**

### Major constraints to business development

- the general geo-political situation – and the Ukrainian-Russian conflict – is considered as a major challenge for business environment
- the political instability and the Russian embargo are seen as problems
- the implementation of political decisions and the institutional framework for policy implementation is considered problematic
- there is room for improvement was mentioned for law enforcement
- the regulatory framework for SMEs was considered sub-optimal; it was more the lack of SME policy as such, it was mainly over-regulation and excessive controls by inspectors causing problems for firms
- access to finance was considered a shortcoming, but often it was said that it is the access to rather than the availability of actual funds
- the size of the market is seen as a problem
- the grey economy was mentioned as problem
- the lack of business and financial skills among SMEs were often mentioned as challenging constraints
- corruption is considered a big problem
- the legal and court system is seen as a constraint for businesses
- there is no lobbying on Government level for SMEs
- the overall macroeconomic situation with high devaluation, a paralyzed banking system, 20% inflation and a lack in customer trust as well as the war in the east, mean that firms are unable to do long-term planning; all this is seen to have a negative impact on the business sector

### General Business Prospects

- the potential for agriculture was considered positive
- the potential in HR and skills are seen as conducive for doing business
- the entrepreneurial spirit was praised allowing many firms to still function and adapt to the difficult macroeconomic situation in the country

- the enthusiasm of people for the EU and the hope for the new government were considered positive
- the agriculture sector is not yet affected by the crisis in the country

#### Effect of BEE constraints on AA/DCFTA compliance

- it was mentioned that most of the SMEs are not yet aware of the implications of DCFTA on their firms
- it is expected that firms will have high costs expected to comply with DCFTA as a lot of investments will be required to adapt to the EU standards
- There is some kind of fatalism as it is considered as “just another hardship to come” (or “just another animal in the zoo....”)
- The pace of DCFTA implementation is considered as too slow

#### Effect of BEE constraints on opportunities under the AA/DCFTA

- it is expected that DCFTA will have a positive impact on the business environment
- it is expected that DCFTA will be conducive for the modernization of the country
- it is expected that DCFTA will open new market opportunities
- DCFTA is expected to improve the countries' competitiveness