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Articles

Regular Features

Highlights

Inside Russian Private Equity Funds

In the past decade, the Russian private equity industry has grown substantially, with the number of general partners reportedly doubling and total assets under management rocketing from less than US$500 million to more than US$5 billion. *REEG* examines the structures of these funds.
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Overview of the Licensing Regime for the Use of Subsoil in Ukraine in 2007

Ukraine has two alternative regimes for the use of subsoil: the Licensing Regime and the production sharing agreements regime (the “PSA Regime”). There are serious and on-going flaws in the legislative basis for the Licensing Regime, as well as in its practical application. Despite these flaws, the Licensing Regime exists and has been used by domestic and international companies in Ukraine with various degrees of success.
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A Look at Changes to Privatization of Land Plots in Russia

REEG reports on changes and new requirements for land ownership put in place by the Russian Federation, which range from a new method of delineating the buy-out price for state and municipal land plots to opportunities for owners of real estate purchased in the process of privatization.
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Incentive Payments and Discounts: To Tax or Not to Tax

Whether incentive payments and discounts provided to customers should be subject to VAT has increasingly become an issue for companies since the Russian tax authorities have paid increased attention to such transactions.
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Introduction to Real Property in Ukraine

By Frishberg & Partners

Demand has always exceeded supply for commercial and residential real estate in Ukraine. In recent years, however, the prices have gone completely out of control. Today, residential prices in the center of Kiev are hovering at around $6,000 per meter, threatening to increase anytime. Office rent goes for as much as $85 per meter per month (see Leonardo, across from the Opera Theater).

Rent is also on the rise, and fast. Just in 2006-07, the lease prices in the center of Kiev have grown by 20-35%, finally reaching record numbers even for Western Europe. At the same time, the construction boom, which Ukraine is currently undergoing, is clearly not enough to satisfy the market. Whether it's warehouses, office buildings or hotels, Ukraine needs them all!

And yet, there have been no radical changes for the better in the Ukrainian real estate legislative system. The process for procuring land plots is well-known, and many Western players have entered the Kiev market either by partnering with local companies on unfinished construction sites or paying top dollar for finished properties (i.e., registered at BTI). These days, large cities like Kiev, Donetsk and Dnepropetrovsk are hard to penetrate, but the rest of Ukraine is wide open for investment. In sharp contrast to the reception foreign investors get in Kiev, they are welcomed with open arms in places like Zaporozhye, Ivano-Frankovsk, and other smaller towns.

So how does an innocent foreign investor get in on the action? Before spending a penny, any investor should insist on seeing clear property title documents, unencumbered by any liens or risks of future litigation, as an absolute minimum requirement prior to effectuating any investment. Due diligence can easily uncover the various risks associated with investing in any Ukrainian property. When acquiring land, it is especially important to learn precisely how the land parcel was allocated (leased, sold or otherwise transferred) to the current owner. In certain cases, land that was improperly allocated by the Local Council of People's Deputies could be returned to municipal ownership by the subsequently elected Local Council of People's Deputies.

Due to legal barriers, investors usually do not acquire land per se, but instead wisely purchase the corporate rights of the legal entity that owns the land and has the necessary construction permits. This alternative greatly simplifies the land re-registration process and minimizes on taxes. An investor can acquire 100% of the company or any portion thereof. To have maximum control, however, we advise our clients to retain at least 75% + 1 share.

Immediately below we will review the basic legal and practical issues applicable to Ukrainian real property transactions (buildings and land, private and state-owned).

Agricultural and Industrial Land

Agricultural Land

Moratoriums on the sale of farm land are not new in Ukraine and, until recently, were never a serious impediment to the selling of farm land for logistical (warehouse) use. One only had to change the land allocation (zoning) to "OSG" status in order to circumvent the law. To become the lawful owner of OSG land, a foreign investor merely had to register a Ukrainian holding company.

The new and improved moratorium on the sale of agro-industrial land, which came into effect on January 1, 2007, specifically prohibits anyone from selling and even changing land allocation of their farmland, including OSG land. This temporarily slowed down the notaries, who were reluctant to alienate a farmer's "pai" (land share) or OSG land, especially in Kiev. However, in the summer of 2007, both "pai" (land share) and OSG land were very actively bought and sold on the thriving gray market notwithstanding the effects of the moratorium, especially in the surrounding Kiev area (Borispol, Brovary, etc).

Because many of the true owners were acting deputies to the local council or worked elsewhere in the government, they often included the illegal change of allocation (official re-zoning from farm land to industrial land) into the bargain. A very interesting condition precedent, indeed.

Non-agricultural (Industrial) Land

(i) Privately Owned Land

Legal restrictions almost require foreign companies or individuals to invest through their Ukrainian resident company. For instance, a non-resident can acquire a land parcel within a city limit only, provided that a structure (building) already exists on such land, or to construct a building thereon. Outside city limits, a foreign investor may acquire land rights only when purchasing the building thereon. These limitations apply to non-residents and Ukrainian companies with foreign capital, regardless of the percentage of foreign ownership. Thus, foreigners often end up structuring their investment through at least two Ukrainian resident companies.

(ii) State-owned Land

In general, state-owned land can be purchased by non-residents or resident companies with foreign ownership only with the permission of the Cabinet of Ministers and the consent of the Parliament. Sale to foreign investors of any land plots that are being privatized along with state-owned enterprises is carried out by the State Property Fund's branches with the Cabinet's permission and Parliament's consent. Privately owned land, except agricultural land, can be freely transferred.

Land in Kiev

Unfortunately, very few parcels of land in Kiev are currently available to investors for construction. Most of such parcels have already been leased to various local organizations, which are currently looking for investment (sometimes via IPO on London's AIM). For example, a company called "Century XXI" obtained a lease of a .23-hectare prime land parcel on Melnikova No. 3 for construction of an office/hotel/trade complex with a total area of 25 thousand square meters. Another company, "Graal," acquired a prime, 2-hectare land plot on Kreschatik No. 5 for a reported 8,700,000 Hryvnia (4,300 Hryvnia per square meter). They are planning on building a 5-star hotel complex with class A offices, an investment of 160 million Euros.

Of course, there are plenty of local companies that are eager to sell off 100% of their corporate rights, along with the land allocated for construction and the accompanying architectural drawings, to any foreign investor willing to pay a tidy sum of money. In the past, potential foreign investors have been extremely reluctant to undertake a large construction project in Kiev without a strong local partner, and for excellent reasons. Times are changing, however, and at last foreign investors are beginning to enter the market.

For example, in 2007 an Israeli billionaire called Benny Steinmetz (reportedly the 583rd richest person in the world) announced that his company will finance three property projects in Kiev, estimated to cost more than $1 billion: (1) a 1,200 unit residential complex called "Park Avenue" on the outskirts of Kiev (near Goloseevsky Park); (2) a 30,000 square meter office and retail building in the Podol district, overlooking the Dnepr River; and (3) a warehouse and logistics facility on 50 hectares near Borispol airport. Note that all of his properties were acquired via lease agreements for construction (see discussion below).

In fact, with so much construction going on in Kiev, the smaller construction companies that lease their cranes are out of luck. There are about one hundred construction companies working in Kiev today, using up to 500 cranes, but only a handful actually own them, including TMM, KievZhilStroy and Planeta-Bud. The rest either own a few cranes or, more likely, are leasing them from a company called "Stroimechanizatsia," which has no more cranes to lease for the upcoming year. And not everyone can afford to pay EUR 300,000-650,000 per crane. As a result, in a strange way, the boom in the capital's construction market spells out trouble for the smaller companies.

Land Outside Kiev

Dealing with a government is never easy. Land auctions in the Kiev oblast were promised as early as 2006, including land parcels in the Borispol rayon, land adjoining the ring road around Borispol and Brovary, and the railroad branch between Borispol and the village of Kirovo. Parcels of land along the main roads, Odessa, Chernigov, were also slated to be auctioned off for industrial and recreational uses. In most cases, however, the issues of transparent land valuations and truly open auctions (instead of the usual sole-source contracts) remain unresolved to this very day.

Because of the above reality, foreign companies usually end up buying land from private owners (LLCs) and build their own warehouses, cottage developments and even hotels. For instance, Vienna-based GLD Invest Group is investing $240 million into three projects,

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Real Property *(from page 13)*

two outside Kiev and another near Odessa. Incidentally, more then 1/2 of GLD's East Gate Logistic (40,000 square meter warehouse about 5 kilometers from Borispol airport) has already been leased to the German logistics provider, FIEGE Group. Also, DHL Excel Supply Chain (logistics arm of DHL) is developing its first big logistics center in Ukraine, consisting of 50,000 square meters (in addition to its 2 other warehouses). As an interesting side note, none of these projects required involvement of a local partner.

Buildings

Commercial Buildings

Of the three fastest developing sub-sectors of Ukrainian commercial real estate (office, retail, and industrial space), the office sector has shown the most growth to date.

Perhaps that is because all commercial real estate in Kiev is grotesquely overpriced and tremendously undersupplied. Many reasons co-exist to explain this phenomenon. First and foremost, the development process is extremely bureaucratic and corrupt. For instance, in order to erect a building, a company needs about 150 permits plus heavy-duty connections in the Kiev City Administration to obtain the coveted construction permits. Some foreign investors, who lack such resources, prefer to acquire completed buildings, registered in BTI. Others enter into partnerships with local companies that have access to choice land plots and the resources to overcome administrative/political barriers, obtain permits, etc. Everyone else, who tried to construct something on their own, had failed.

At the same time, foreign investors can get 10-15 percent yields on property in Kiev because rent levels in Kiev are twice those in Warsaw and Budapest. That is why companies like Quinn Group, with billion-dollar budgets for Eastern Europe, have acquired commercial properties like Leonardo, where rent prices range from \$50 to \$70 per meter, plus VAT and service charges. Others prefer to pay less for land outside the center, including London-based 1849 PLC, who acquired Pyramida Shopping Center for \$21 million and plans to buy 5-10 more shopping centers in the next 4 years.

At last, there is some activity in hotel sector. In addition to the five-star Opera Hotel, Premier Palace and Hyatt Regency, the second Radisson (near Borispol airport) is going to open, and InterContinental and Hilton are planning to open doors in 2008. Then there are smaller operations, like the Riviera hotel, Podol-Plaza, Golden Dome, and Pan Ukraine, among others. On the lowest level there is Polish Orbis Group, which has 68 hotels in Poland, setting up one and two star hotels in Western Ukraine.

Residential Buildings

Unlike commercial properties, residential developments are strictly monitored to ensure no financial manipulations take place (like they did with the notorious Elita Center). Thus, Article 4 of the Law "On Investment Activities" provides that financing of residential buildings may be carried out only via FFCs, FONs, non-governmental pension funds or bonds. Some Ukrainian developers prefer to create FFCs (Funds for Financing Construction) in accordance with Law of Ukraine No. 978-IV "On Financial-Credit Mechanism and Management of Property During the Construction of Residential Houses and Operations Involving Real Estate", dated June 19, 2003 (as amended on December 15, 2005). Others rely on bonds. For more information, please see discussion below.

Industrial Property

Industrial property is the least profitable sector, presenting development opportunities primarily for foreign strategic investors.

Considering the value of land, especially in Kiev, the authorities will begin relocating some of the Kiev-based industrial plants outside the city zone. Of the 540 enterprises currently semi-working in Ukraine, 150 are prime candidates, including such factories as Zahid, Radon, Bolshevik, Kvant, Kiev Motorcycle Factory, etc. This process, however, will take place only after the privatization process is completed. Afterwards, new office buildings and retail centers will take their place.

For instance, according to Igor Balenko, deputy to Kiev City Council and co-owner of the supermarket chain, Furshet, an old and dilapidated factory called Ukrcable (located in the Petrovka district of Kiev) will soon become a shopping mall. Likewise, another well-located ship-building factory, "Leninskaya Kuznitsa," will probably be relocated elsewhere after the SPF sells its 27% stock via tender later this year, leaving the river-front property of Rybalsky Island for residential property development.

Political Risks

Numerous risks exist in the construction business, including cost over-runs due to increases in price of materials and/or services, structural or geological defects, among others. The most common barriers, which cannot be discounted, involve the local authorities who stand in the way of getting access to land for construction, obtaining the necessary licenses and permits, etc. Plus the unstable political climate can easily derail virtually any construction project, at least in the city of Kiev.

For instance, in October of 2006, just 6 months before their scheduled elections, Mayor Alexander Omelchenko and the Kiev City Council suddenly and unilaterally cancelled eight of its resolutions, allocating land for construction. Soon, many other developers with seemingly valid lease agreements, officially approved architectural drawings and legitimate construction permits experienced similar problems. In the end, nearly 500 construction projects were frozen. Some of the developers went to court after the new Mayor Leonid Chernovetsky was elected. For instance, a company "Crown" went to court and managed to reverse the Kiev City Council's cancellation of their land rights. Many others were not as lucky.

Nearly one year later, in July of 2007, Mayor Chernovetsky and the Kiev City Council unilaterally cancelled a land lease agreement involving construction of a 23-story building by company "Mars" at 29 Milyutenko Street because of complaints by the neighbors. Six other lease terminations followed, involving the following construction companies: Interproekt, Aviakom, Olimpbud, NVP-Construction, Center of Business Support, and Polus-Plus, all of which received their land allocations for construction under the former Mayor Alexander Omelchenko's firm rule. Allegedly, these companies lacked the necessary paperwork to undertake the projects. Some of these companies have already filed claims in a court of law.

Conflicts with the Kiev city authorities sometimes involve even the President himself. For instance, in March of 2007, President Yushchenko signed Order No. 208/2007, requiring the Kiev City Administration to prohibit construction of high-rise residential and commercial buildings in the historic part of Kiev (as soon as they determine the borders). He also instructed the Cabinet of Ministers to prepare similar prohibitions for other cities in Ukraine. Importantly, this Order also gave the General Prosecutor's office 3 months to review the legality of land allocation for all high-rise construction in central Kiev. Should the prosecutor's office find any unlawful allocations, those land plots will be returned to the city and the investor will recover whatever amount it officially paid.

Following Yushchenko's specific orders, the chief of Kiev city construction prohibited high-rise buildings from being erected in the historical part of Kiev. In the future, he said, any high-rises must be specifically approved by the Ukrainian Society For Protecting Historical Monuments, the National Council of Architects and the Ukrainian Committee ICOMOS. In response, acting Mayor Leonid Chernovetsky passed his own law, permitting construction of mid-rises up to 25 stories. As a result, the cost of constructing such "mid-rises" in the center of Kiev is widely expected to increase several times, since additional bureaucratic barriers were also introduced (i.e., increased number of permissions and dubious issuing authorities such as the National Council of Architects).

The above recitation of facts offers a hard lesson for any investor: re-distribution of property for political reasons is always a significant risk in Ukraine, and nothing can be ruled out until the project is completed and the property is registered with the Bureau of Technical Inventory.

This article was written by Frishberg & Partners, Kiev and the firm's website is: www.frishberg.com.