

Risk Advisory

Helping our clients evaluate, manage and mitigate risk

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Outside the Ukrainian Embassy on Holland Park Avenue in west London there is a statue of Prince Vladimir, ruler of Kievan Rus. In November and December of 2004 this became the focal point for the orange army of expatriate Yushchenko supporters hoping for a fundamental change in their country. Ultimately democracy prevailed and Yushchenko was declared Ukraine's new ruler.

In this edition of **Risk Advisory** we focus on the implications of this victory. Does it, as some sections of the media claimed, portend the break up of Ukraine into its pro-Russian East and Ukrainian West? Will Ukraine look to the developed West or will it continue to depend on Russia for its economic and military security? How will Putin respond to the rejection of a candidate in whom he invested so much of his own political capital?



While you may not agree with our analysis we hope you find it provides food for thought.

Just before the Ukraine elections The Risk Advisory Group had its own fundamental change. In October we completed a management buy out of the venture capital house that provided initial financing for the business. With more than 90 percent of the equity of the business now owned by management and employees we believe that the change will mean an even greater commitment to providing exceptional service to our clients among all of our staff. The change will also allow us to respond more quickly to our clients' requirements and to expand our business.

This month will see the first step in that expansion, with new offices opening in Madrid, to serve our clients investing in Iberia and Latin America, and in Nairobi, to service clients with interests in East Africa. More exciting developments are planned for later in the year.

I thank all our clients who have supported us over the last seven years and enabled us to build a successful business and to acquire it from the venture capitalist who initially financed us.

The management team and employees look forward to continuing to help you help your companies evaluate and mitigate risk.

Bill Waite
Chief Executive
The Risk Advisory Group



THE RISK
ADVISORY
GROUP LTD



DIARY

24 February 2005

7.45am – 9.15am, London

'Ukraine Update'

BABi Members: £24.50+VAT (£28.79) Non-members: £29.50+VAT (£34.66)

in association with British American Business Inc (BABi) and the European Bank for Reconstruction & Development

With the election of President Yushchenko, will the Ukraine now be looking to Russia or the EU for its economical and security support?

This breakfast briefing will have expert speakers from both the European Bank of Reconstruction and Development and The Risk Advisory Group providing an economic and political analysis of the situation in Ukraine.

To book for any event, please call Emily McFadyen on 020 7578 0000 or email at emily.mcfadyen@riskadvisory.net

Preventing Procurement Fraud – reduction of avoidable loss'

2 March 2005

8.00am – 9.15am, London

Free to attend

Fraud in purchasing is very common but is frequently overlooked by organisations when designing fraud prevention strategies. Unless effectively controlled, it can cause serious financial and reputation damage. The briefing will provide practical guidance on how to prevent and detect procurement fraud thereby reducing losses and preventing reputation damage.

The briefing will include:

- High risk areas – functions and geographies
- Types of procurement fraud
- Effective investigation
- Effective prevention and loss reduction
- Case studies

Protect and Survive – Managing Information Security Risks

In association with Simmons & Simmons

24 March 2005

Free to attend

Organisations can suffer substantial damage through the loss of sensitive information, particularly if the leaks are malicious or are intended to gain commercial advantage.

Experts from the Simmons & Simmons and The Risk Advisory Group will be providing practical advice on how to manage these information security risks.

Simmons & Simmons

5 April 2005

7.45am – 9.15am, London

European Corporate Governance Standards - What is the Cost to Business?

in association with British American Business Inc (BABi) and Hammonds

Across the globe, the movement towards improved corporate governance is gathering pace with an unprecedented number of initiatives undertaken or planned for implementation over the coming years. Is there a danger that an over emphasis on compliance with corporate governance codes will effectively stifle the legitimate taking of business risk? To what extent is a pan-European Corporate Governance Code emerging/desirable and at what cost to business?

Nigel Turnbull, Chairman of The Risk Advisory Group will be speaking at this event



Does the western media get Ukraine wrong?

“... Ukraine has so far proved to be a much more cohesive and robust entity than many suspected...”

”

The recent hotly disputed presidential election in Ukraine was widely viewed in sections of the western media as an acrimonious proxy tussle between an overbearing and possessive Russia that could not bear to see its Slavic junior kinsman and companion slip from its grasp and fall into the rival arms of the EU. Clearly the geopolitical implications for both sides of the election result have been immense, the more so for Russia and for Putin in particular, who has invested significant political capital in supporting the Yanukovich candidacy, and in promoting a policy of reintegration of Ukraine with Russia.

At the same time much of the same Western media has tried to promote a schismatic view of the Ukrainian people: that is, the majority in the western half of the country being Ukrainian-speaking and pro-Yushchenko, and the minority in the east being Russian-speaking and pro-Yanukovich, with the two sides nursing a deep mistrust and animosity for the other which could degenerate into civil war and the break-up of Ukraine as an entity.

It must be said that some wiser media voices on the ground in the election process resisted the efforts of their editors to foist upon them this pleasingly symmetrical interpretation of the election. The truth, as always, is much more complex.

One of the things that has come over very clearly in the elections is that in spite of the east-west schism theory, Ukraine has so far proved to be a much more cohesive and robust entity than many suspected. In spite of the fact that the spectre of civil war was frequently raised – by some – for tactical reasons, such a calamity never really seemed likely. The street protests that dominated the central squares of Kiev lately have been far too friendly, with Yanukovich supporters often sharing remarkably good-natured banter with their Yushchenko counterparts, to reflect a deepening divide founded on hatred. It has also become evident that support has split down generational lines, with older members of

families preferring the Kremlin's favoured candidate while younger members of the same families have turned out for Yushchenko.

Certain things in the new Ukraine will undoubtedly change. The new president and his government will not represent the regional commercial/political power base of Donetsk that was the source of Kuchma's power, but it may be expected that Yushchenko will attempt to reach a rapprochement with sections of society that may not represent his natural constituency. At the same time certain oligarchic interests may come under scrutiny while others will be in the ascendancy. There is likely to be a change of style too: away from the corrupt post-Soviet style of Kuchma which stifled freedom, investment, diversity and development, and towards a more open and self-consciously populist approach.

Much of the content, however, is likely to be unchanged. Don't expect Brussels, Berlin, Paris or London to be first on the list of destinations for Yushchenko following his presidential inauguration. In spite of his avowedly anti-Kremlin stance as seen through the eyes of western media, Moscow will remain the priority destination because good relations with Russia remain the most important long-term guarantor of Ukraine's economic stability and military security.

Richard Prior is Deputy Chief Executive of The Risk Advisory Group. If you would like to know more about Ukraine, please contact him at richard.prior@riskadvisory.net



“Yushchenko is likely to conclude that he must improve the environment for the emergence of small and medium enterprises...”

Prospects for investors in the new Ukraine

The recent change of regime in Ukraine represents a major new opportunity to international emerging markets investors. While investment opportunities remain in abundance in the countries of Central Europe, many of the factors which first attracted investors no longer hold true to the same extent as they did in the early 1990s. This is particularly true with regard to issues such as low-wage labour and regulation: the accession of the countries of Central Europe to the European Union has moved standard wages in those countries towards the EU average. Similarly with regulation: with the fall of communism, many Central European countries scrapped large swathes of regulation in order to further their newly found competitive edge over Western Europe. Accession to the EU has brought with it demands for new regulations requiring expenditure on issues such as social security and benefits, workplace conditions, environmental standards, pensions trade tariffs and taxation.

The potential opening up of Ukraine, a country on the EU's borders of over 48 million people (exceeding the combined total of all new EU members excluding Poland) with a relatively developed national infrastructure, industrial base and educated population, thus presents these positive investment factors to potential investors on a plate. The average wage in Ukraine is far below that to be found in Central Europe, while the country's regulatory environment, while confusing, currently imposes fewer expensive demands on private companies. Furthermore, the country will be attractive to those emerging market investors who, for a large number of reasons, are seeking to diversify from Russia.

Ukraine's economic base is currently driven by a few large financial-industrial groups which are all based in the east of the country and are dominated by oligarchs who were closely connected to the outgoing regime and who are opposed to President Viktor Yushchenko. These groups have been largely responsible for the spectacular growth in Ukraine's GDP in recent years (estimated to have been approximately 12 percent in

2004). They are predominately active in the financial services, energy and heavy industry sectors. While the new government is likely to challenge the process by which some of these groups were acquired, it is not expected to undertake a root-and-branch confiscation and reallocation of their assets. Consequently, an awkward cohabitation seems the likeliest outcome. To strengthen his political base in western Ukraine and among the middle classes across the country, therefore, Yushchenko is likely to conclude that he must improve the environment for the emergence of small and medium enterprises (SMEs) so that in time they will come to counterbalance and even outweigh the influence enjoyed by the oligarchic financial-industrial groups. This is likely to be in sectors not currently dominated by the eastern oligarchs, including agriculture, food & beverages, telecoms and manufacturing. At the same time he must improve the conditions for outside investment which, to date, has been only a fraction of that seen in both Central Europe to the west and in Russia to the east. This will mean reform of the tax, customs and regulatory codes, a crackdown on corruption, and a strengthening of the country's financial organisations. Without these, there will be little incentive for SMEs to set up or for foreign investors to enter the market.

The risks for those interested in potential investments in Ukraine are largely the same as for those who entered the Central European and Russian markets at the early stages of their development, although they will vary according to whether the target is an established financial-industrial group, or whether it comes from the nascent SME sector. In the case of the former, investors will want to know whether the new government will demand investigations or prosecutions into the nature of their connections to the outgoing regime, and the likely outcomes of these. Investigations are likely to include allegations of rigged privatisations, massive tax evasion, involvement in high-level corruption, nepotism (one of the country's most powerful oligarchs is the son-in-law of the outgoing President Leonid Kuchma), and undeclared offshore holdings. In the case of SME



“The power of parliament may be abused...”

targets, other issues will be of more primary concern, including the track record and reputation of management, the identity of ultimate shareholders, the presence of any untoward influence by outside parties, transparency and corporate governance.

On the macro-economic and political front, a number of risk factors prevail. To a certain extent, the coalition which has ousted the previous regime was united more by its opposition to Kuchma than by a common platform. The coalition consists of socialists, nationalists, free-marketeters, trade unions, church groups and youth organisations. Furthermore, the various sub-groups are often marked more by their loyalty to individual personalities rather than specific policies: each of these personalities will jockey for significant posts in the new government. The risks of infighting and its consequent effect on reform, therefore, are very real.

Corruption, and the penetration of organised crime, is another significant risk. While there is general consensus that it must be combated, no coherent programme for this has been put forward. Many individuals and groups, including some players who have backed Yushchenko, had hidden interests in the status quo under Kuchma, and are unlikely to give up these quietly or willingly. The emergence of new turf wars, accompanied by violence, cannot be excluded. The power of Parliament may be abused: as part of an agreement reached between Yushchenko and Kuchma at the peak of the recent protests, it was agreed that the powers of Parliament would be increased at the expense of the Presidency. A seat in Parliament brings with it immunity from prosecution, and many Kuchma loyalists, both in business and in government, also had parliamentary seats. It is noticeable that they have been returning to these in recent weeks, and may use them to block reform.

The role of Russia cannot be overlooked. President Vladimir Putin has not welcomed the rise of Yushchenko, viewing his openness to the West as a threat to Russia's traditional dominance in the region. It will watch Yushchenko's every move and will use its influence, particularly in eastern Ukraine, to thwart him when it deems it necessary. This carries the risk of destabilising the whole country, especially if the Russian-speaking east of Ukraine comes to look primarily to Moscow rather than Kiev for support. However, it also offers Yushchenko an incentive and an opportunity significantly to diversify Ukraine's economy in order to reduce its economic and political dependence on Russia and thus offset Russia's leverage, though he must proceed cautiously in this.

Confidence in Ukraine's future development has already been shown by the country's stock market (albeit a small and illiquid one): stock prices in Ukraine have risen by 30 percent since 21 November (the date of the second, fraudulent, round of voting), demonstrating optimism in the eventual outcome and benefits a Yushchenko presidency would bring, while in the same period the Russian market has fallen sharply on concerns over President Putin's commitment to free markets. Experience in other countries of the region has proved that the above risks can be foreseen, identified and mitigated. When this is correctly done, the Ukrainian investment story becomes a compelling one.

Christopher Peters is a Senior Associate in the Emerging Markets practice of The Risk Advisory Group. You can contact him at christopher.peters@riskadvisory.net



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“...the political and social conditions in the country could soon present an ambitious and charismatic leader with an opportunity to destabilise the current government”

An ‘Orange Revolution’ in Russia?

Almost everybody in Georgia, from ordinary citizens to independent political analysts, agrees that since the Rose Revolution the most influential person in the country is now Badri Patarkatsishvili. By many accounts, Patarkatsishvili – a businessman and partner of exiled London-based Russian tycoon Boris Berezovsky – has more actual power than Mikheil Saakashvili, the Georgian President. Many observers also point out that it was Badri who sponsored the students’ movement which played a key role in overthrowing Eduard Shevardnadze’s regime and which helped bring Shevardnadze’s former justice minister to the president’s office. Could the ripples from these events in Georgia, and the more recent Orange Revolution in the Ukraine, cause similar upheavals in Russia?

Badri’s partner, Boris Berezovsky, who has been living in London for the past four years and who was granted political asylum in the UK in 2003, has recently announced a likely move of his residence and office from London to Kiev. Berezovsky’s real estate agents were looking for a building in central Kiev long before Viktor Yushchenko was announced the winner of the presidential election, while Berezovsky’s security advisors are now on their way to the Ukrainian capital for a security audit of their boss’s new home. With Mrs Berezovsky an official guest at Viktor Yushchenko’s inauguration, it is also noteworthy that one of Yushchenko’s closest aides during the Ukrainian Orange Revolution (and, reportedly, one of his main financial sponsors) was David Zhvaniya, a Ukrainian businessman of Georgian origin and a member of the Verkhovna Rada (the Ukrainian Parliament). Zhvaniya also just happens to be a close friend of Badri Patarkatsishvili.

In Russia, both Berezovsky and Patarkatsishvili face criminal charges of fraud and embezzlement (which they deny as politically motivated) relating to their activities at Russia’s biggest carmaker, AvtoVAZ, during the mid-1990s, when AvtoVAZ was regarded as one of the most criminally-influenced big companies in the country. Berezovsky and Patarkatsishvili are also suspected of –

but not so far charged with – complicity in the funding of ‘illegal armed formations’ in the rebellious Russian province, Chechnya, bases in Pankisi Gorge in Georgian territory having long been helpful for these ‘formations’.

The business opportunities opening up in Yushchenko’s Ukraine as the political and business elite of Leonid Kuchma’s era are asked to make way are certainly a major factor in attracting Berezovsky to Kiev. A more important reason for Berezovsky’s move to the capital, however, is that Kiev is a great deal closer to Moscow than is London. Recent developments in Russia, moreover, suggest that the political and social conditions in the country could soon present an ambitious and charismatic leader with an opportunity to destabilise the current government.

In the last month, nearly every major Russian city – including Moscow – has been shaken by protests against the so called ‘monetisation of benefits’. This Kremlin-initiated reform has hit the poorest groups of the population hardest: pensioners in Moscow, for example, stripped of their right to ride the municipal transport system free of charge, were offered ‘compensation’ of 200 roubles (\$7) per month, or one third of the price of a combined bus and metro monthly pass. The situation has been similar in all other regions: in the Moscow suburb of Mytishchi, pensioners blocked the road leading to Sheremetyevo international airport, rendering it impassable to buses and taxis for a whole day. It was a blessing for the Kremlin that students, who also lost their local transport benefit, were on holiday in January – but they are back to school on 1 February. According to the Russian Education Minister, student protests are highly likely.

As well as problems caused by benefits reform, the forthcoming utilities reform is expected to benefit Unified Energy Systems headed by Anatoly Chubais, but is also likely to result in large numbers of bad debtors in the residential sector having their hot water and electricity cut off. In some Siberian regions the new utilities bills



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//

are forecast to exceed the average monthly income by 70 percent. In yet another unpopular move, the Ministry of Defence is planning to end students' traditional exemption from mandatory military service: the Russian army is severely undermanned, and an intensification of fighting in Chechnya in the summer is believed to be more than merely probable. By some accounts, there are about half a million students in Moscow – enough to fill Manezhnaya Square with orange tents.

The political landscape is also uncertain, with all the main political parties lacking credibility. The pro-Putin United Russia party is gradually emerging as a version of the Communist Party of the Soviet Union: a rigid bureaucratic power bastion, minus the Marxist ideology. In the last direct gubernatorial elections, United Russia failed in most regions. Moreover, many of the ultimately successful candidates (i.e. election winners or runners-up) were intelligent and charismatic individuals rejected by United Russia in favour of well-connected bureaucrats (who, to the party's surprise, mostly failed to win). In one or two regions, candidates of the liberal Union of Right Forces, whose leaders are firmly associated by most Russians with the wiping out of savings in the early 1990s, came in a definite second place. The Union of Right Forces' biggest problem, however, is that many of its promising regional leaders' political careers are currently stymied by the party's national leadership, affected as it is by Anatoly Chubais' unrealistic political ambitions.

Despite the unpopular social reforms and the rigidity and corruption of the pro-Kremlin political structures, however, any Russian 'Orange Revolution' faces a major obstacle: the lack of a political leader similar in his or her populist appeal to Yushchenko or Saakashvili. The only possible exception, Mikhail Khodorkovsky, whose public image is rapidly changing from robber baron to martyr thanks to the authorities' heavy-handed treatment of the Yukos case, is in prison and will remain there in the coming months. But even without this component, there is now a shared understanding among the members of the Russian political elite that a Russian 'Orange Revolution' is almost inevitable. (Various structures of the current political regime, from the United Russia political party to state security and law enforcement, have allegedly been asked to prepare for just such an eventuality.) In these circumstances, Boris Berezovsky's likely move to Kiev means that the exiled oligarch is on the search for leaders for the Russian 'Orange Revolution', and that candidates for the leadership will themselves soon start making visits to the Ukrainian capital.

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Ukraine and Russia: tensions to build over Moldova?

// ...if Russia chooses to assume an increasingly assertive posture in the region it is liable to irritate the new Ukrainian leadership... //

The Republic of Moldova and Ukraine are neighbours and potentially natural partners in the post-Soviet arena of reform and national re-identification. Since independence both countries have had to negotiate similar internal problems and have asserted similar foreign policy priorities. The countries share the Ukraine's second longest border – after the Ukraine/Russia border – of 1222km. Bi-lateral relations, however, are yet to stabilise fully: complex historical ethnic and border disputes have long complicated dialogue between the countries. The issue of Moldova's separatist Trans-Dniester region has engendered a critical mistrust between political elites and a lack of co-operation in civil activity.

A narrow stretch of land situated along the Dniester River and sandwiched between Moldova proper and Ukraine, Trans-Dniester broke away from Moldova in 1990, electing its own president in December 1991. The self-asserted republic continues to lack international recognition despite commanding its own parliament, army and police force. Its persistent call for independence denies Moldova control of significant industrial assets and its long and now highly criminalised border with the Ukraine. The large ethnic Ukrainian minority in Moldova has historically sided with local ethnic Russians in supporting Trans-Dniester's separatist efforts, for fear of a reunification with neighbouring Romania. In 1992, following a short war between Moldova and Trans-Dniester, a Russian-mediated peace settlement enforced by Russian troops saw the permanent relocation of Russia's 14th Army into the region.

More recently, tensions in the area escalated when Moldova introduced new custom stamps in 2001, demanding that all foreign traders cease to recognise the former ones. The Moldovan government's motivation was an attempt to limit the illegal economic activity of a criminally out-of-control Trans-Dniester. Ukraine, however, refused to stop trading with the old stamps, maintaining that Moldova simply wanted to stifle and kill the region's economy. The heightened tensions gained international attention, with the Ukrainian position being criticised by the EU and the WTO.

However, with the election of a new Ukrainian administration, there is hope that progress can be made in what has developed into an entirely stale peace process. Earlier this month, Moldovan President Vladimir Voronin

announced his hopes that under its new leadership, Ukraine would stop supporting the separatists and help resolve the crisis. Previously, while not actually offering overt support to Trans-Dniester's separatist movement, Ukraine at best aimed to preserve the status quo in Trans-Dniester, allowing various powerful business-orientated political groups to benefit from cross-border criminal activities. Without openly articulating their position, these groups have pressured the Ukrainian government to maintain ties with Trans-Dniester's separatist leaders. The existence of a Ukrainian minority in the region has also been used to confer a degree of public legitimacy on Ukrainian policy. The administration's ambivalent and frequently contradictory attitude towards the issue has caused deep mistrust between Kiev and Kishinev.

Following the elections, a Western-orientated Yushenko might well encourage Western involvement in resolving problems in Moldova at Russia's expense. But with Russia's military presence in Trans-Dniester, there is a risk that it will become an increasingly volatile region from which Russia attempts to manipulate or confront a Ukrainian government that is no longer willing to toe the Russian line. This military presence in Trans-Dniester means that Russia's troops must cross Ukrainian territory or airspace to transit between Russia and bases in the troubled region. To the new government in Ukraine, the presence of Russia's 14th Army in such a position might easily be perceived as a potential source of intimidation. Indeed, if Russia chooses to assume an increasingly assertive posture in the region it is liable to irritate the new Ukrainian leadership, which will be keen to resolve the Trans-Dniester conflict in line with previous European thinking on the issue.

In conclusion, it is not in Ukraine's interest to have a large and well-equipped Russian military formation based within Trans-Dniester. Given Putin's steadily tightening grip on Russia, his increasingly authoritarian approach to governance and his interest in increasing control over the CIS, Moldova presents itself as a stage for possible future confrontation and geopolitical brinkmanship.

Crispin Black is a Director of Janusian Security Risk Management Ltd. If you would like to know more about security risk management, please contact him at black@janusian.com