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Mergermarket
An Acuris company

M&A IN UKRAINE
CATCHING THE REBOUND

CONTENTS

DEAL METHODOLOGY

Deals within regular Mergermarket criteria have a transaction value greater than or equal to US$5 million, except for some minority stake acquisitions where a higher threshold applies. If the consideration is undisclosed, deals are included on the basis of a reported or estimated deal value greater than or equal to US$5 million. If the deal value is not disclosed and cannot be confirmed to be greater than or equal to US$5 million, the deal is included if the target's turnover/revenue is greater than or equal to US$10 million. If neither the deal value nor the target revenue is disclosed, Mergermarket will use other indicators to determine inclusion, including but not limited to number of employees of the target company, assets under management exceeding US$200 million for the asset management firms, and value of assets/deposits exceeding US$50 million for banks.

To capture a wider scope of the Ukrainian M&A market, for this report, some deals outside of the regular deal criteria have been included.

FOREWORD

The coronavirus crisis brought mass disruption to global M&A, including the Ukrainian market. Having navigated significant headwinds, signs point to an economic and dealmaking recovery for the country in 2021

Like virtually all other economies, Ukraine's gross domestic product (GDP) fell in 2020 – an inevitable consequence of the Covid-19 pandemic. A contraction of 4.2% was registered according to the International Monetary Fund (IMF), which, although steep, was less severe than the recession of 2015 during the period of elevated geopolitical tensions.

Within this context, M&A value fell to its lowest level in five years to €171m. Volume held up more robustly as investors continued to back smaller deals, the 54 transactions recorded in 2020 being higher than for any of the years between 2014 and 2017.

Private equity was not immune to this pullback. There were only six PE deals in 2020, down from ten a year prior. These were valued at a combined €13m, representing an annual rise of 22%.

The retrenchment of foreign investors played an important part in this dealmaking downturn. In 2019, nearly nine out of every ten M&A dollars invested came from overseas entities. This share of inbound value fell to 52% in 2020, while volume dropped to just 31%.

Following the establishment of the High Anti-Corruption Court, reforms stalled in 2020, at least in the eyes of the IMF. The government has had its bandwidth consumed by attending to the pandemic and it should be anticipated that attention will return to these reformation efforts in 2021 onwards. Indeed, pushing through further changes and adopting pro-business measures will help to entice foreign capital back to the country at a time when it is most needed. The passing of a law to unblock big ticket privatisation in early 2021 is an obvious plus and can be seen as symbolic

of an intent to win back the confidence of the private sector.

The government is well aware that, now more than ever, the IMF's US$5.5bn loan programme will have a crucial influence in stabilising the economy and stimulating growth following the herculean challenges of 2020. Therefore, there is a huge incentive to press ahead with the pro-business reform agenda. As economies the world over convalesce as the threat of the pandemic recedes and vaccination programmes are rolled out, Ukraine is positioned to see a sharp return of foreign capital. Investors who recognise the country's strengths, including its high levels of technical expertise and well-developed business process outsourcing industry, have an opportunity to catch the rebound.

KEY FINDINGS

M&A OVERVIEW

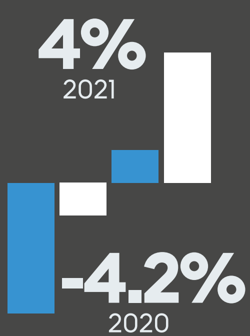
€171m

Total value of deals with disclosed value in 2020 dropped to the lowest annual total since 2015

54

Volume in 2020 dropped from 87 to 54

ECONOMIC GROWTH



The Ukrainian economy is expected to return to growth in 2021 after a severe Covid-related contraction of 4.2% in 2020

SECTOR WATCH

TMT

58% Value

The TMT sector dominated deal activity in 2019-2020, accounting for 21% of volume and 58% of value

PHARMA, MEDICAL & BIOTECH

17% Value

The PMB sector took up a large proportion of M&A value in 2019-2020

FOREIGN VS DOMESTIC

69% Volume

69% of deals in 2020 were domestic deals, up from 55% the previous year

M&A OVERVIEW

Investors have a firm eye on ongoing reforms and the pace of the economic recovery in 2021 after the pandemic took its toll on deal activity in 2020

Following an impressive run of growth, the Covid-19 pandemic brought Ukraine's economic ascent to an abrupt halt in 2020. GDP contracted by 4.2% in the country – a less severe rate of decline than the 6.1% contraction in the European Union (EU). With the gradual easing of restrictions and with it a return of economic activity, not only in Ukraine but among its trading partners, output is forecast to return to positive growth of 4% in 2021. This should bring with it a return of M&A after what was an arduous year.

There were 54 recorded transactions in 2020, down 38% on the 87 deals reported in 2019. Total declared deal value had been increasing since 2015 but 2020 saw a sharp decline of 86% to a total of €171m. However, it should be highlighted that only 15 deals had their price disclosed last year and so the true value of M&A in 2020 is likely to be considerably higher than this.

"M&A activity in Ukraine has been in line with the world's trends and followed the pandemic curve as other countries," says Anna Babych, partner and head of M&A at Aequo. "During the lockdown in early spring, we witnessed clients becoming extremely cautious. However, from June onwards, activity started to be restored," she adds.

There has been a clear retreat from the market by foreign investors, a trend that is by no means exclusive to Ukraine. In high-risk periods, corporates focus on their core markets and financial sponsors gravitate towards more established geographies with deeper asset bases and lower currency risk.

According to the National Bank of Ukraine, only US$221m in foreign direct investment (FDI) trickled into the country in the first ten months of 2020, a massive 95% year-on-year decline on the US$4.5bn that flowed in during the same period in 2019. This retrenchment was reflected in the M&A data. In 2019, 90% of M&A deal value was accounted for by inbound cross-border transactions involving non-Ukrainian buyers. In 2020 this share of inbound value fell to 52%, while 69% of secured deal volume was claimed by Ukrainian entities acquiring compatriot assets.

"In terms of the split in M&A deals between domestic and foreign players, in most cases local companies were more active last year," says Denis Lysenko, managing partner at Aequo.

"We have seen that some of the foreign strategic players were looking to exit in order to focus on their home markets."

One example of an M&A transaction which is illustrative of this trend was the acquisition of supermarket chain Billa Ukraine by UAB Consul Trade House, a Lithuanian company that already owned Billa competitor Novus Ukraine. The deal, Ukraine's largest of 2020, advised by Aequo on the buy side, stemmed from Austrian corporate Rewe International's decision to concentrate its efforts in its domestic market.

That transaction was marginally larger than the biggest domestic deal – the acquisition of Dnipro Hotel by Smartland from the state for a total value of €36m. This sale was indicative of another trend that is playing out in Ukraine: its massive privatisation programme.

GOING PRIVATE

The long-awaited sell-off of more than 3,000 state-owned enterprises, which holds significant potential for investors, is showing signs of progress. Just before the Covid-19 pandemic reached the country, the government approved a decision to sell 435 public entities including JSC State Food and Grain Corporation, SJSC Khlib of Ukraine, SE Artemsil and JSC First Kyiv Machine Building Plant.

All told, the State Property Fund held around 1,900 auctions in 2020 worth UAH3bn (€90m), five times more than in 2019 and ten times more than in 2018, according to the Fund. However, the pandemic has slowed progress.

"There has been a pause because the government decided that quarantine measures and other global Covid restrictions would restrict the appetite of foreign investors to participate in the privatisation auctions for

Top three

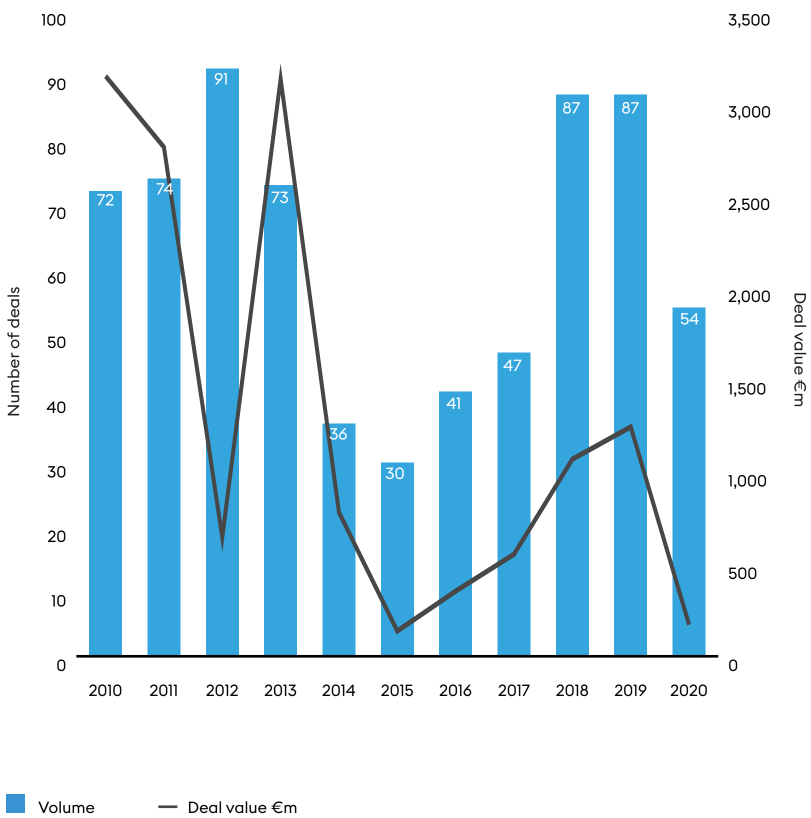
Deals in Ukraine in 2019/2020

1 **VF Ukraine,** the Ukrainian business of telecoms provider **Vodafone,** was sold to Azerbaijan-based **NEQSOL Holding** for €770m in a deal announced in November 2019.

2 Switzerland-based pharmaceutical firm **Acino International** acquired the Eastern European and Middle Eastern assets of Japanese biopharma firm **Takeda** for €181m in October 2019.

3 STADA, a German pharma company, bought the pharmaceutical prescription and consumer health business of **Biopharma** for €63m in December 2019.

Ukraine M&A, 2010-2020



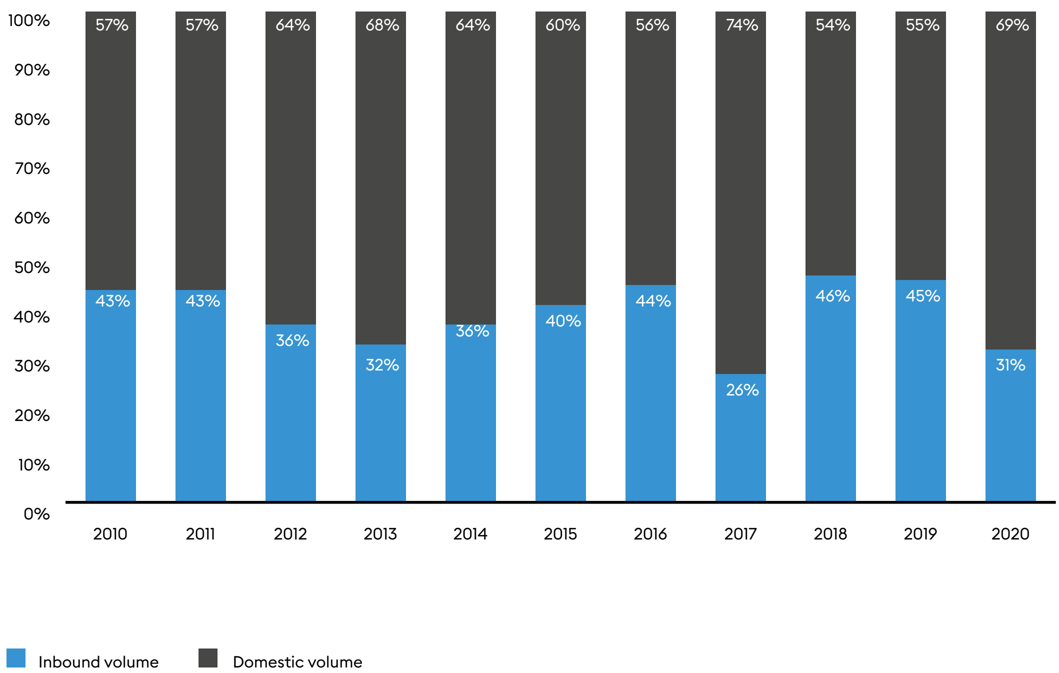
bigger government targets," says Lysenko. "So there was a moratorium in place for those large-scale privatisations and we expect that towards the second half of 2021 those could resume. They might include some companies in the industrial sector owned by the government, as well as some more hotel facilities in Kyiv."

Paving the way for this, the government passed a law in the first quarter of 2021 unblocking large-scale privatisation with aims of raising as much as UAH12bn (€360m) this year. If this is achieved, it will provide a clear signal to both global investors and the IMF that the country is committed to modernising its economy.

The ability to attract foreign capital back to Ukraine after its outflux in 2020 will depend on the success of the country's ongoing reforms. The IMF agreed a US$5.5bn three-year loan programme towards the end of 2019 to be disbursed in tranches. Some progress was made in 2020 with the successful passing of a long-awaited banking law in May, which prevented the former owners of banks nationalised or closed in recent clean-ups from making compensation claims. This resulted in the first disbursement being made in mid-2020.

It was hoped that a further US$700m payment would be granted in September 2020, but the IMF declined to issue the tranche due to a lack of progress on anti-corruption reforms. Since then, cooperation between the Ukrainian government and the international lender have stalled once again. Both sides had been in dialogue regarding improving governance of the central bank, strengthening the legislative and regulatory framework for bank supervision, and bolstering anti-corruption systems. Ultimately those talks resulted in the IMF once again deciding against releasing the already postponed US$700m tranche.

Share of inbound M&A by deal volume, 2010-2020



The government will need to make further progress in order to obtain financial support, which in turn will give investors confidence in the rule of law and should encourage a return of foreign capital.

As European companies review their supply chains in the wake of the pandemic, nearshoring operations as they seek suppliers that are closer to home, there is strong potential for Ukraine to see increased investor interest once the health crisis is resolved. High levels of technical education and software engineering expertise combined with low labour costs make it a highly compelling market.

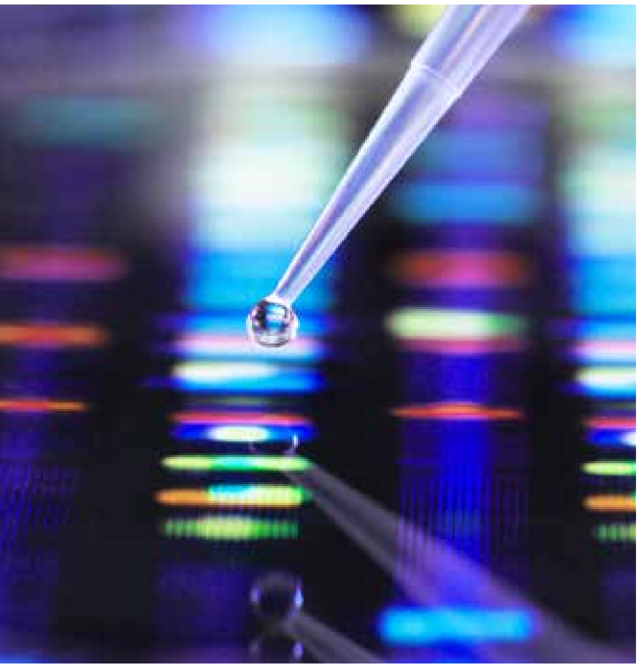
If the government can keep reforms on track and secure further IMF financial backing, which in turn is expected to precipitate loans from the European Commission, European Bank for Reconstruction and Development (EBRD), the European Investment Bank and the World Bank, M&A activity will almost certainly climb to new heights.

SECTOR WATCH

Breaking down Ukraine's M&A activity by sector type and looking at what is motivating deals in these segments

The sector split by deal volume once again remained relatively constant between 2017-18 to 2019-20, notwithstanding the business services and financial services industries, which witnessed significant drops in deal numbers, of 38% and 50% respectively. Agriculture, one of the country's core economic activities and a recession resilient sector, meanwhile saw an increase of 5 percentage points by volume.

Pharma, medical and biotech (PMB) and technology, media and telecommunications (TMT) stole the show on a deal value basis. Pharma deals claimed 17% of Ukraine M&A value in 2019-2020, up from just 1%, while TMT transactions leaped from a share of 2% to 58%. That is largely thanks to the VF Ukraine PJSC deal announced in November 2019 for a total value of €770m.



Agriculture may have been strong in volume terms, but its share of deal value collapsed from 35% to 2% as investors kept their investments small due to continued regulatory restrictions on buying up large swathes of land. Steep falls were also seen in industrials and chemicals, down from 24% to 1%, and energy, mining and utilities, down from 23% to 4%.

TECHNOLOGY, MEDIA AND TELECOMMUNICATIONS

Technology is one of Ukraine's greatest strengths and TMT one of its most active sectors. The industry accounted for a notable proportion of deal volume in 2019-2020 at 21%, the same proportion as in 2017-2018. M&A value reached €822m over the most recent period too, however, there was a stark turn in the market in 2020 with a mere €5m of TMT deals recorded.

These figures have been distorted by the aforementioned €770m VF Ukraine transaction at the end of 2019, a landmark deal. Also, many TMT deals were announced with undisclosed enterprise values and so the weaker showing in 2020 amid the pandemic is likely to be at least partially due to underreporting.

There has been no shortage of small technology deals, including the acquisition of Liki24, an e-commerce platform for pharmacies, for a value of €4m. The e-commerce platform was bought by a consortium comprising TA Ventures, Genesis Investments and iClub. While the deal is tech-centric, it also has a clear health angle which makes it especially relevant in the context of the pandemic. Liki24 brings together offers from thousands of pharmacies by integrating with their enterprise resource planning (ERP) systems. It then analyses prices and product

AGRICULTURE

2019-2020

	Volume	Value (disclosed)
% of market	16%	2%
2019-2020	23 deals	US$27m
vs. 2017-2018	▲45%	▼-94%

BUSINESS SERVICES

2019-2020

	Volume	Value (disclosed)
% of market	5%	1%
2019-2020	7 deals	US$14m
vs. 2017-2018	▼-38%	▼-67%

CONSTRUCTION

2019-2020

	Volume	Value (disclosed)
% of market	3%	0%
2019-2020	5 deals	US$0m
vs. 2017-2018	0%	▼-100%

CONSUMER

2019-2020

	Volume	Value (disclosed)
% of market	13%	6%
2019-2020	18 deals	US$83m
vs. 2017-2018	▲18%	▼-25%

ENERGY, MINING & UTILITIES

2019-2020

	Volume	Value (disclosed)
% of market	11%	4%
2019-2020	15 deals	US$54m
vs. 2017-2018	0%	▼-83%

FINANCIAL SERVICES

2019-2020

	Volume	Value (disclosed)
% of market	8%	0%
2019-2020	11 deals	US$6m
vs. 2017-2018	▼-50%	▼-100%

INDUSTRIALS & CHEMICALS

2019-2020

	Volume	Value (disclosed)
% of market	5%	1%
2019-2020	7 deals	US$20m
vs. 2017-2018	▼-17%	▼-96%

LEISURE

2019-2020

	Volume	Value (disclosed)
% of market	1%	3%
2019-2020	2 deals	US$36m
vs. 2017-2018	▼-50%	N/A

PHARMA, MEDICAL & BIOTECH

2019-2020

	Volume	Value (disclosed)
% of market	5%	17%
2019-2020	7 deals	US$245m
vs. 2017-2018	0%	▲1,600%

REAL ESTATE

2019-2020

	Volume	Value (disclosed)
% of market	2%	0%
2019-2020	3 deals	US$1m
vs. 2017-2018	0%	▼-100%

TMT

2019-2020

	Volume	Value (disclosed)
% of market	21%	58%
2019-2020	29 deals	US$822m
vs. 2017-2018	0%	▲2,800%

TRANSPORT

2019-2020

	Volume	Value (disclosed)
% of market	10%	8%
2019-2020	14 deals	US$106m
vs. 2017-2018	▲150%	N/A

availability and develops the best routes for couriers. The company has already expanded into Poland, the largest market in Central and Eastern Europe.

"A lot of companies shifted to some distance working or hybrid types of work," says Lysenko. "The tech industry, including subsectors such as e-commerce and fintech startups, but also outsourcing businesses have benefited from distance-based work and changes in the overall economy."

Outsourcing, especially IT outsourcing, is one of Ukraine's specialities for the same reason that it excels in software and app development. A large talent pool of 200,000 IT professionals and strong tech education is making it one of the leading outsourcing destinations in Europe. Because of these foundations, we anticipate that the TMT sector will go from strength to strength, supported by a flourishing venture capital ecosystem.

Going forward, IT businesses in Ukraine could gain more favourable legal and taxation regimes. "The proposed Diia City law is expected to offer a special legal framework for the country's IT industry, allowing businesses to benefit from new regulation and a better taxation regime," says Babych. The draft law has been submitted to Parliament and is awaiting first reading.

AGRICULTURE

Agriculture made up 16% of Ukraine's total M&A deal volume in 2019-2020, making it the second most active sector. However, it constituted only 2% of deal value, down from 35% recorded in 2017-18. This equates to just €27m worth of M&A for the period and only €3m in 2020, although once again, this total can be misleading, as it only includes deals which have disclosed transaction values.

A recent case in point, Epicentr K, a large local investor, acquired Khmelnytsk-Agro in May 2020. Epicentr K began to move into the agriculture sector in 2016 having established a chain of shopping centres branded under the same name in the 2000s. While the price of that deal remains private it is understood to be valued in the region of US$100m. This illustrates the huge impact that deal price disclosures can have on overall M&A figures.

In principle, agriculture is one of the biggest investment opportunities in Ukraine given its contribution to the economy. With 41.5 million hectares of agricultural land covering 70% of the country, agriculture is Ukraine's largest export industry. In 2019, Ukraine's agriculture sector, which is dominated by crop farming such as corn, barley and wheat, generated approximately 9% of GDP. With an estimated 45,000 enterprises operating in the field, the sector is also ripe for consolidation. However, there are restrictions in this regard.

Reform in this sector is set to spur further deal activity. The lifting of the land moratorium on 1 July 2021 will allow businesses to utilise agricultural land as collateral for the financing of the agricultural sector by banks and enable the process of consolidation and amalgamation of the small land plots into the bigger tracts of land.

FINANCIAL SERVICES

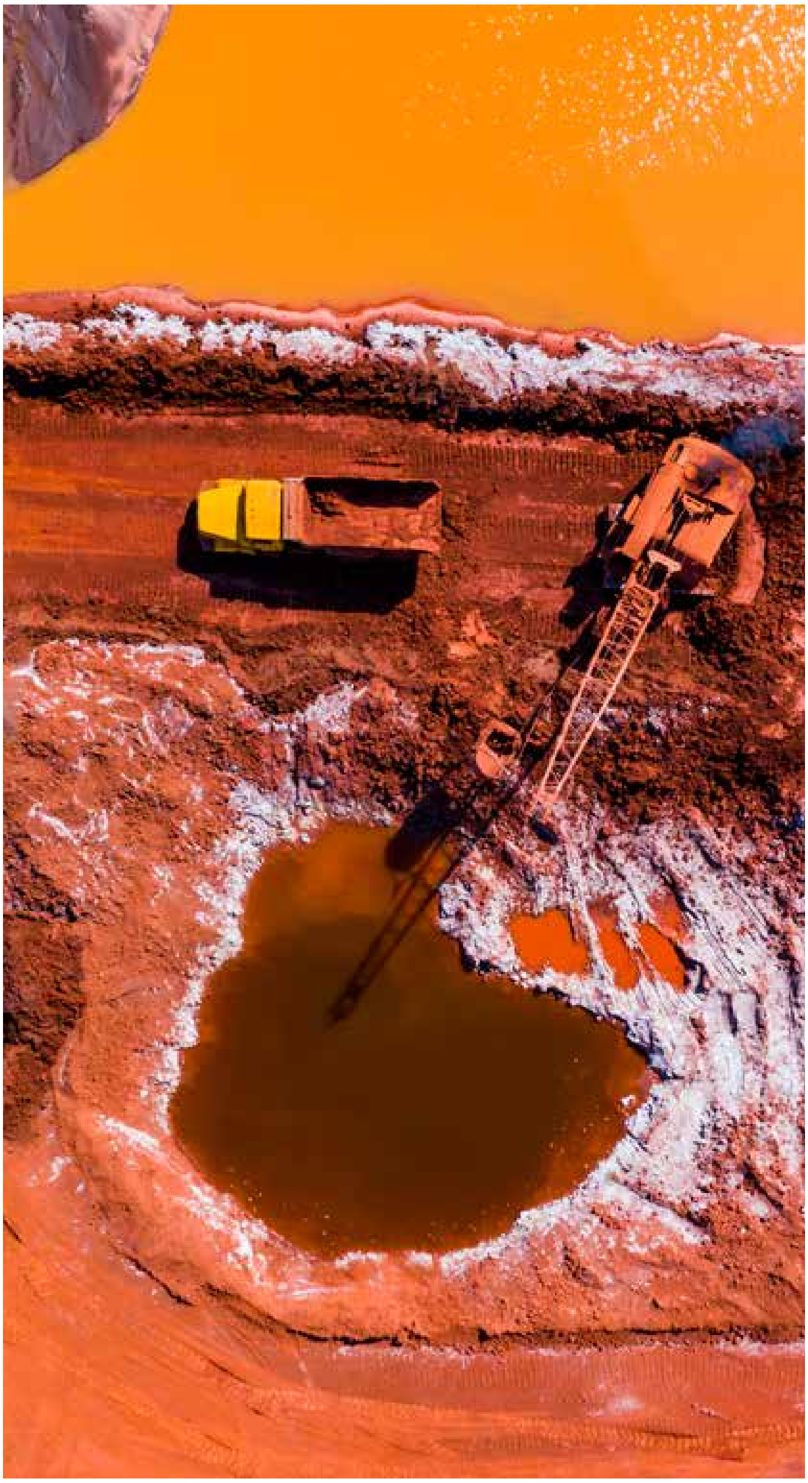
Ukraine's financial services sector has been through a mass restructuring, not only with the consolidation of the banking landscape but also in terms of the management of non-performing loans (NPLs) held on lenders' books. Following the global financial crisis, many foreign banks have retreated – this is part of a wider trend that is seeing many banks retreat to focus on domestic markets. Home Credit Bank, Renaissance Capital, SEB, Swedbank and Erste Bank are among the foreign banks that have left the Ukrainian market.

Like many other Central and Eastern European countries, Ukraine has a highly fragmented banking sector, although less so today than in previous years. Between 2016 and mid-2020 the number of lenders fell from 117 to 75, according to Statista, due to a wave of consolidation. The retrenchment of a number of major foreign banks has also seen the loan-to-GDP ratio fall back to a more manageable 30% from a high of 80%.

The accumulation of NPLs in the financial system has prompted the government to take action. In 2019 a law was passed extending an existing mechanism introduced in 2016 following the country's geopolitical and economic crisis for the restructuring of bad debts for a further three years. The law allows for the voluntary out of court restructuring of the loans of corporate debtors. The National Bank of Ukraine has recommended that a liquid secondary market for NPLs be established so that lenders are better able to manage their NPL exposure. The upshot of these efforts in the lead up to 2020 was a healthier, more robust banking system.

Inevitably, the pandemic has had major implications for banks. Those with credit exposure to sectors hammered by the current health crisis, such as leisure, indoor dining and discretionary retail, will suffer the most. Perhaps unsurprisingly then, financial services has not been an active M&A sector recently. The industry was the second largest in 2017-18, accounting for 16% of volume albeit only 2% of value. In 2019-20, in the context of the pandemic, financial services accounted for 8% of volume and registered no value. However, once again, this is owed to the limited number of deals in the market with publicly disclosed deal values.

One of the more notable transactions saw businessman Oleksandr Yaroslavsky purchase via his Development Construction Holding, the largest construction company in the



country, a 100% stake in JSC Bank Credit Dnepr from owner Victor Pinchuk. The central bank has noted that Yaroslavsky is committed to providing support to the bank to ensure its financial stability.

ENERGY, MINING AND UTILITIES

Energy, mining and utilities was especially hard hit by recent conditions following the collapse in the oil price in early 2020, keeping investors at bay. The sector accounted for 11% of deal volume and 4% of deal value in Ukrainian M&A in 2019-20, aggregate value decreasing by as much as 83% compared with the 2017-18 period, down to €54m.

The oil price has since staged a solid recovery which may prompt greater interest in traditional energy deals in the short to medium term. Renewables has been an area of focus for investors, particularly the country's burgeoning solar and onshore wind segments, although short-term challenges have presented themselves here too.

"Last year represented a pause in terms of new entries as the government was very heavily in discussions with existing investors in the sector regarding the potential for reducing the feed-in tariff. This was because of budget deficit issues and the fact the country was consuming less energy," says Lysenko. "The so-called green (or feed-in) tariff was one of the highest, if not the highest, in Europe. The government had to renegotiate some of these tariffs with the existing pool of investors and those discussions were pretty complex. The government is still considering options to deal with outstanding debts to those renewable energy producers, including issuing bonds for them."

Onshore wind plants with a capacity of two megawatts and upwards have seen retroactive reductions of the feed-in tariff of up to 7.5%, depending on the commissioning date of the plant. Solar plants have been even more dramatically affected and with a lower threshold of one megawatt of capacity, shouldering feed-in reductions of as much as 15%. For solar projects approved from 1 November 2020 onwards investors can expect 30% to 60% reductions on the tariff. This will naturally impact returns and has forced investors in the space to recalculate the feasibility of such projects.

“These changes are significant but compared to energy sector investors looking at more traditional, fossil fuel sources, the renewables segment still looks pretty attractive given the long-term energy transition,” says Lysenko.

CONSUMER

In spite of the considerable headwinds faced by the consumer industry, M&A in the sector held up relatively well.

The share of total M&A volume in 2019-2020 for the consumer sector increased by two percentage points to 13% compared to the previous year. At the same time, transaction value was down by 25%, from 8% to 6% of aggregate M&A value. This equated to €83m and, in spite of the pandemic, €62m of this was attributable to 2020.

The acquisition of Billa by UAB Consul for €40m was responsible for a majority of the annual total. The deal is indicative of a trend that can be seen globally within the sector. Consumer staples have been a strong performer during the crisis. While such businesses have been under immense pressure to maintain operations amid challenging trading conditions, they have been generating consistent cash flows.

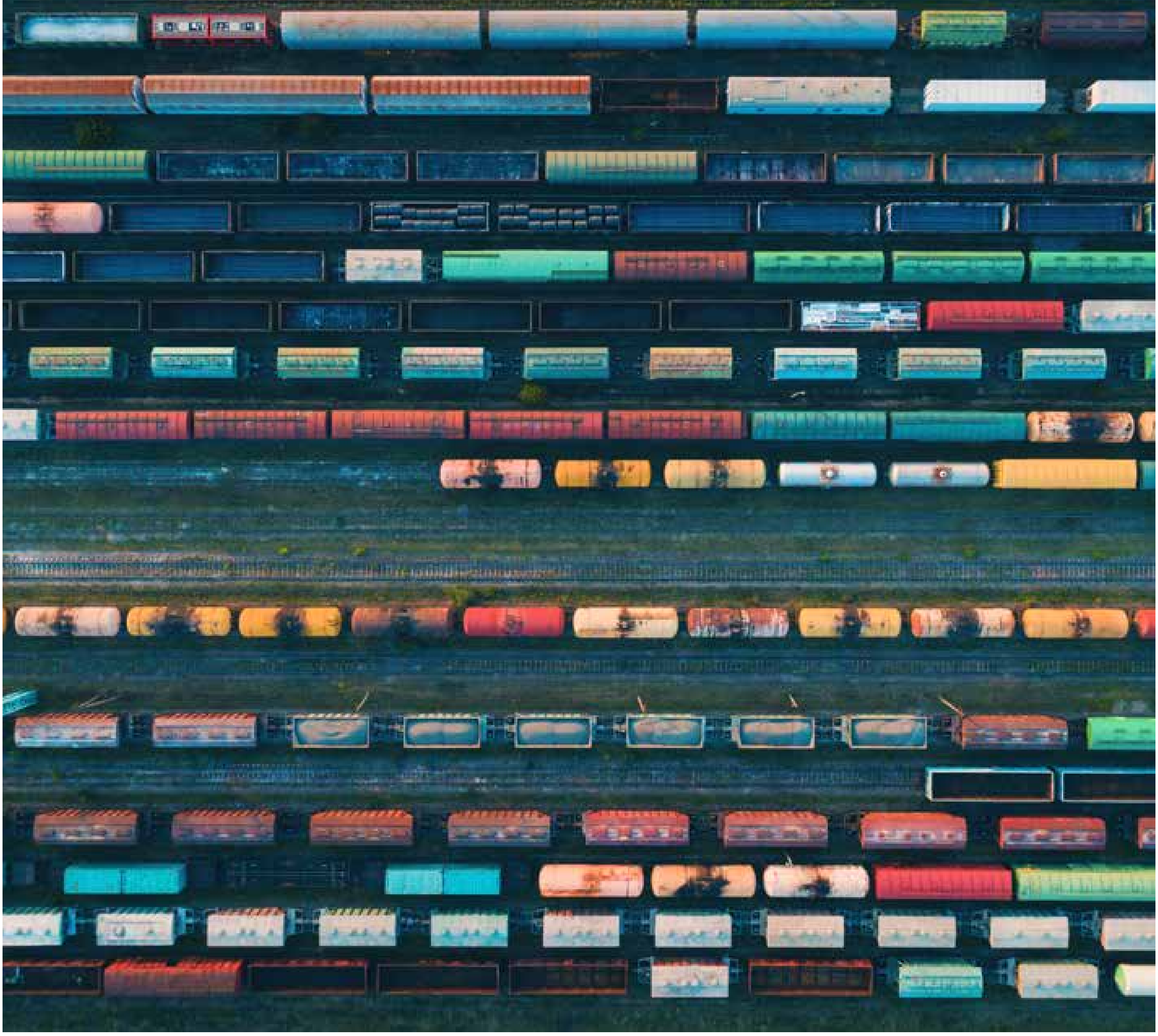
Billa, a supermarket chain, fits this profile. While primarily an Austrian company, it already has 35 stores in and around Kyiv. This concentration of its footprint also means there is scope to expand further into the country, into secondary cities such as Kharkiv and Odesa.

A further notable consumer deal of 2020 saw private investor Oleksandr Dubinin acquire

Parallel-M, a petrol station network with 80 sites, for €17m. While Ukraine has the eighth-largest population in Europe with 43.5 million people, just behind Spain, it is the second-largest land mass on the continent after Russia. The long distances people travel makes for a compelling investment case for consumer fuel supply.

Given Ukraine’s large agricultural base, there is also significant overlap with the food consumer sector. This can be seen in the investment by Kernel Holding, a major supplier of agricultural products from the Black Sea and the largest Ukrainian producer and exporter of sunflower oil, into bulk vegetable oil manufacturer ViOil in 2019. The deal saw Kernel take a small minority position of 5.85% in the business.

Another potential area of growth is in FMCG. “Innovative green packaging firms are seeing steady growth due to eco-trends,” says Babych.



TRANSPORTATION

The transportation sector was tied with TMT as the sector with the largest number of deals in 2020, amounting to ten transactions apiece. The industry can be better understood as the infrastructure required to transport goods and, once again, overlaps with Ukraine's large agricultural base can be observed. In another of Kernel Holding's transactions it acquired Rail Transit Kargo (RTK) for a sizeable €43m. The purchase gave Kernel access to nearly 3,000 grain railcars, around 15% of the market, making it the second-largest grain hopper wagon fleet operator in Ukraine after the state monopoly Ukrainian Railways.

Transport and logistics is a compelling space given its defensive qualities and this was made evident in 2020. While physical retail outlets were closed en masse, consumers continued to buy essential products which needed to be shipped, transported and warehoused, making logistics type investments highly attractive.

The government has also sought to incentivise investment into infrastructure and similar greenfield projects that it hopes will attract foreign investors and boost the economy. In early 2021, Parliament approved a new law which offers state support for such investment. "The government will support so-called significant investment projects, which entails a €20m investment over a five-year period in a greenfield or brownfield project," says Lysenko. "That applies across several target sectors such as infrastructural projects as well as the processing industry, certain types of mining, transportation, warehousing, logistics, healthcare and some other segments. Incentives that are offered by the government include tax exemptions, in particular exemptions for imported equipment, as well as some preferential land use rights."

PHARMA, MEDICAL AND BIOTECH

The PMB sector saw its volume remain steady with 5% of overall volume, while value was up significantly from 1% in 2017-2018 to 17% in 2019-2020, making it the second most dominant category after TMT. This share translates to €245m worth of deals.

The past 12 months have showcased the importance of medicine and healthcare, not only in direct response to the pandemic with Covid treatments and vaccinations, but also telemedicine and safeguarding mental health amid lockdown conditions. Naturally, this has drawn investors to the sector. Not only is the sector historically seen as a defensive investment in times of economic crisis, pockets of the industrial – particularly innovative biotech startups – are also high-growth assets.

The second- and third-largest deals of 2019-2020 were in the PMB sector, although both took place towards the end of 2019 before the pandemic had reached Ukraine. The biggest involved the sale of various assets belonging to Takeda Pharmaceuticals to Swiss firm Acino International for €181m. The second largest was Biopharma, bought by Germany's STADA Arzneimittel for €63m in December 2019. Since the buyout, Biopharma has assisted the laboratory of the Center for Public Health of the Ministry of Healthcare to establish a national reference lab for the detection of coronavirus and has completed clinical trials of a drug called Bioven for the treatment of patients with Covid-related pneumonia.

Given the ongoing management of the pandemic, which may require the development of medicines and vaccines for a mutating virus, the PMB sector is likely to remain a focal point for investors for the foreseeable future.

Moreover, the pandemic has brought about behavioural changes which may last. "A good example is telemedicine which saw a sharp rise we couldn't have imagined in 2019," says Babych.

AN EYE ON PRIVATE EQUITY

Development finance and sovereign wealth continues to flow into Ukrainian PE and VC funds, which are well-positioned to capitalise on the country's booming IT outsourcing and software sectors amid the country's recovery

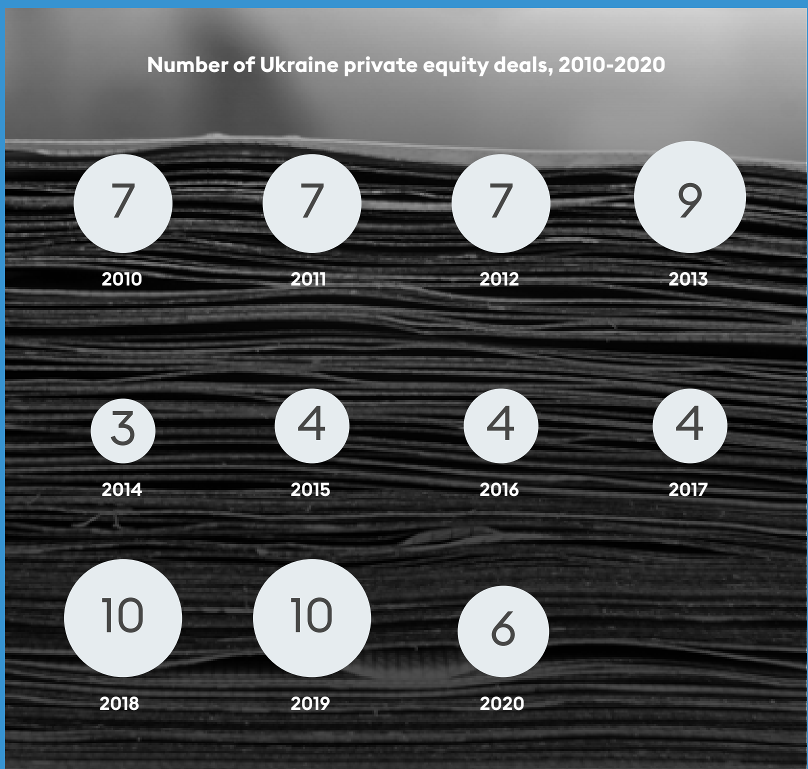
Private equity activity has been subdued for a number of years from a value perspective, with only one of the past seven years registering more than €20m (2018). This was the case in 2020 with €13m invested across six transactions, four less than 2019.

"Despite the challenges, PEs that have traditionally been active in Ukraine managed to complete several notable deals," says Babych "The usual suspects are technology (both products and outsourcing), e-commerce and classifieds, fintech, commercial property and even a bank."

The top deal of the year, while signed off in March 2020 before the true scale of the pandemic had been fully recognised, has qualities that make it defensive in light of the health crisis. Point Nine Capital paid €9m for Preply, an edtech tutoring platform that pairs those seeking to learn new languages with tutors around the world. The company has said the funding from Point Nine will be used to grow the Preply network of 10,000 verified tutors teaching 50 languages to tens of thousands of students in 190 countries worldwide.

Dragon Capital is one of the largest and most active PE houses in the country and co-invests with some large US investors such as Goldman Sachs into a range of assets, not just operational companies but also commercial real estate. The firm acquired a 13,800 square metre pharmaceutical warehouse complex near Kyiv in June 2020 for an undisclosed sum followed by Lviv Industrial Park. Dragon has also been highly active in the first months of 2021, taking a controlling stake in online financial supermarket Treeum and signing a memorandum of understanding with Mubadala Investment Company, the United Arab Emirates sovereign wealth fund, to explore investment opportunities in Ukraine.

Other notable local names in the field who remain active include ICU Ventures, Horizon Capital, TA Ventures, Genesis Investments, SMRK VC Fund, Quarter Partners, Pragmatech, UMG Investments as well as a number of angels and private investors.



THE TECH SECTOR IN UKRAINE

The global Covid-19 pandemic has only further foregrounded the importance of the technology industry to the global economy – a good sign for Ukraine and its prominent IT sector

Ukraine has an impressive pedigree in IT services and software engineering thanks to the high calibre of technical training in its education system, which has more than 450 state-funded universities. This has resulted in a high number of IT engineers per capita which, in turn, has made the country one of the most enticing IT outsourcing destinations in the world. According to one PwC report, Ukraine is ranked fifth among the top 25 IT services exporters, owing to its convenient location and competitively priced, high-skilled labour.

"The Ukrainian IT industry has been successful and continuously growing each year – even during the pandemic. The reason for this growth is a combination of several factors – geography, strong post-Soviet technology schools, and good value for specialist skills," says Babych. "Ukrainian IT outsourcing has a good reputation in the US and Europe and is relatively close in terms of culture and mentality. Finally, the business models deployed in Ukraine allow companies to be tax efficient and therefore competitive worldwide."

More than a fifth of Fortune 500 companies rely on Ukraine's IT sector to deliver services and software. Some unsung achievements that owe their existence to Ukraine include Nokia's online customer retail experience and Reuters' award-winning photojournalism app, The Wider Image. According to a report published in February 2020 by the State Statistics Service of Ukraine, IT services grew by 15% on the previous year to US$2.43bn, making up 16% of total services exports.

"The Ukrainian IT industry has been successful and continuously growing each year – even during the pandemic. The reason for this growth is a combination of several factors – geography, strong post-Soviet technology schools, and good value for specialist skills."

Anna Babych, partner, Aequo

This growth prompted the government to establish the IT Creative Fund in 2019 to train IT specialists. The scheme was launched after the government identified that the industry was growing by 25,000-30,000 IT jobs per year, but universities were only producing 16,000 graduates annually.

UKRAINE DRAIN

As well as supporting some of the most visible corporates in the world with their digital initiatives, Ukraine has birthed its own disruptors, such as Grammarly, the AI-powered writing assistant startup. Grammarly's journey is indicative of a wider trend in the country. The company has raised two funding rounds totalling US$200m, giving it a valuation in excess of US$1bn and making it Ukraine's maiden tech unicorn. However, Grammarly is no longer based in Kyiv after relocating its headquarters to San Francisco.

Many VCs based in the US or Western Europe require their portfolio companies to incorporate in those jurisdictions as a condition of the investment. “This has always been the case and not only for IT. Moreover, IT product companies think about the worldwide market, not only the Ukrainian one,” says Babych. “However, even after moving sales houses to the US and Europe, the R&D offices often stay in Ukraine.”

More broadly, Ukraine is seeing many of its best and brightest leave the country. According to the World Economic Forum Global Competitiveness Index, Ukraine’s ability to retain talent ranks it 129 out of 137 featured countries. Equipped with in-demand expertise, many highly skilled workers leave to earn higher salaries abroad and in more stable currencies.

This prompted the government to approve a loan programme for entrepreneurs in February 2020. The UAH2bn (€60m) scheme will provide loans of up to UAH1.5m (€45,000) to Ukrainians living overseas and wishing to return home, or those wanting to set up their own business. It is hoped that this will not only foster entrepreneurship but help to retain and attract back the highly skilled technical labour that makes the country so attractive.

Moreover, the proposal to create the Diia City framework for IT companies could further improve conditions for the industry. The new legal framework, which has been submitted to Parliament and is awaiting first reading, would allow IT firms to benefit from a special legal framework and a more favourable taxation regime.

SPOTLIGHT INTERVIEW

Andrii Nosok, Co-Head of Private Equity, Dragon Capital

WHAT IS YOUR VIEW OF THE MACROECONOMIC SITUATION IN UKRAINE IN 2020?
Ukraine's economy experienced a relatively moderate downturn in the second quarter of last year with the real GDP falling 9.9% quarter on quarter and 11.4% year on year because of the pandemic. But post-lockdown, the economy rebounded by 8.5% quarter on quarter and we ended up with a full year drop of just 4% for 2020.

Our forecast is quite optimistic. We forecast real GDP to grow by 5.3% this year, driven primarily by household consumption and the gradual recovery in investments. The commodities market environment is also favourable for Ukraine. Ukraine has a significant amount of commodities exports, mainly steel, grain, and iron ore. And the prices are growing at the moment so we should be benefiting from this as well.

HOW DOES THIS AFFECT M&A?
As to the M&A market in Ukraine last year, of course, because of the pandemic there was a certain slowdown in activity in the second and the third quarter mainly, but then we observed an increase. We ourselves have closed several transactions last year, in the fourth quarter mainly, but we also had some real estate transactions throughout the year. Generally, we see that there's increased interest in Ukraine from international investors who are incentivised to find alternative locations to deploy their capital, considering the situation in investment markets around the world. I mean, there is a lot of liquidity.

WE SAW A DROP IN FOREIGN INBOUND INVESTMENT INTO UKRAINE IN 2020, DO YOU EXPECT THIS TO IMPROVE IN 2021?
We are already seeing increased interest from newcomers. Investors who have not previously made acquisitions in Ukraine are exploring opportunities here. We have talked to a number of such newcomers during the past several months, so we believe that there will be increased demand for Ukrainian assets this year.

WHAT HAS THE LANDSCAPE FOR PE ACTIVITY BEEN LIKE IN UKRAINE IN 2020?
The biggest challenge for private equity was to manage the portfolio during the lockdown and the market shock in the second quarter last year. But then, when the situation stabilised and ways to conduct business from home were introduced, we and other players have demonstrated increased interest in new opportunities. As I mentioned, we have done several deals last year, mainly in the fourth quarter.

Moreover, new opportunities have been created by the pandemic. Some businesses that were significantly hit by the pandemic will be willing to seek support and new capital from private equity players.

IS THERE ANYTHING YOU THINK WILL AFFECT M&A IN THE COMING YEAR?
Well, generally, Ukraine's cooperation with the IMF is something to watch. Major reforms are

part of the IMF programme and IMF funding is tied to successful implementation by the Ukrainian government and the Parliament of these reforms. So, IMF funding is crucial for Ukraine to keep the economy stable and the interest of foreign investors in this market. Our base-case scenario assumes that Ukraine will progress in cooperation with the IMF and that it will keep receiving funding from the IMF later this year. This is something to continue to monitor.

WHAT OPPORTUNITIES DO YOU THINK WILL BE AVAILABLE TO UKRAINIAN BUSINESSES POST-PANDEMIC? COULD UKRAINE BENEFIT FROM NEARSHORING TRENDS?

Nearshoring is one of the investment ideas that we had in mind even before the pandemic. The pandemic might actually make it a stronger trend – Ukraine is basically located more or less in the middle of Europe, geographically, with one-to-two days shipping to any European country. And at the same time the cost of production here is significantly lower than in China. Long term, our view is that there will be a relocation of production capacities for major international players to locations that are beneficial cost-wise and logistics-wise, including Ukraine.

SPOTLIGHT INTERVIEW

Yuliya Sychikova, Director, AVentures

WHAT IS YOUR VIEW OF THE CURRENT MACROECONOMIC SITUATION IN UKRAINE AND HOW IT'S AFFECTING THE M&A MARKET?
All in all, of course Covid-19 affected Ukraine. It slowed things down significantly. But when you look at the IT sector, we actually had a record year in terms of investments and a relatively good year in terms of M&A.

The industry can be separated into IT outsourcing and then companies that sell their own software products. On the outsourcing side, it was a really strong year with a few flagship deals. Many European and US companies are looking to scale up through acquisitions and Ukraine has a deep IT talent pool with a lot of first-class technical expertise that comes from a tradition of tech education. Even during the pandemic you're still seeing double-digit growth across that industry.

On the product side, Ukraine is still in the nascent stages of developing its startup ecosystem, but we do have lots of interesting young companies. Some of them have already reached the unicorn level. As the ecosystem is still developing, we have more and more international funds that are looking at Ukrainian startups, including Tier-1 players.

WHAT DO YOU THINK ARE THE MAIN CHALLENGES FOR IT COMPANIES IN UKRAINE?
One of the core challenges is that there's still a huge lack of early-stage funding. So international funds start to look at Ukrainian startups at later stages because what they want to see is good traction – that is the number one factor they look for. That means Ukrainian startups are left to turn to domestic investors at the earliest stages and there are not that many local early-stage funds. That said, there is a recent initiative called the Ukrainian Startup Fund, which is a newly launched state-backed fund that provides grants to startups on a no-equity basis. And they've done close to 80 deals in 2020 and 2019. So, I think you'll begin to see that funding gap close in time.

LOOKING AHEAD, WHAT ARE YOU MOST BULLISH ABOUT IN 2021 AND BEYOND?
I remain super-optimistic about the IT sector. Even coming off the back of a record year for deals and investment, I expect 2021 to be even better. Most IT service companies cut expenses during the pandemic and increased their EBITDA margins by a few points, which left companies with more cash on hand. Many local players approach us because they want to make acquisitions to achieve inorganic growth. We also see the highest multiples ever in the public markets. That will translate to more funding and M&A, and possibly even a few IPOs of Ukrainian players this year or in 2022.

As a macro trend, the pandemic has accelerated digitalisation across all industries. Businesses were forced to operate remotely, which required digital processes by necessity. The sector's growth fundamentals look strong for the next few years.

THE LONG-TERM OUTLOOK

Ukraine's size, location and expertise stands it in good stead as global economic growth returns and corporates reappraise their outsourcing arrangements

There are a number of reasons to expect that the Ukrainian M&A market will rebound in 2021 and reach new heights shortly thereafter. One is the simple fact that the country's economy will rise in lockstep with global GDP this year as demand returns. Naturally, economic recovery hangs upon the efficacy of the vaccine programme – as it does for all countries – and there is still some uncertainty after repeated delays. Ukraine has lagged the rest of the continent in securing vaccines for its 41 million people and has asked the EU for assistance in this regard.

Broadly speaking, economies the world over are expected to grow in 2021 after contractions in 2020. The Ministry for Development of Economy, Trade and Agriculture of Ukraine has forecast an increase of 4.6%, while in January the World Bank put this figure at 3.1%, more than double the rate it predicted back in October 2020.

As economic activity picks back up and confidence recovers, attention will return to Ukraine's ongoing reforms and attendant negotiations with the IMF. After refusing the latest disbursement from the support fund last year, the ball is now in the government's court to make further changes before returning to the negotiating table. Unresolved issues include the management of the National Bank's banking supervision, fiscal risks to the budget deficit and strengthening the legal system. While this is not the be-all and end-all for foreign investors, closer cooperation with the IMF and further reforms will be strong encouragement, especially when it comes to continue anti-corruption reforms in the judiciary.

A survey carried out by the European Business Association, Dragon Capital, and Center for Economic Strategy at the end of October 2020 found that a "lack of trust in the judicial system" was named the main obstacle to foreign investment for the first time in five years. Despite the IMF's recent decision, progress is being made, most obviously with the establishment of the High Anti-Corruption Court in 2019.

The government has clearly identified the need to attract capital back to the country after its retreat in 2020. This was the clear rationale behind its recent decision to offer tax incentives to investors willing to commit upwards of €20m over five years to greenfield or brownfield projects that create at least 80 new jobs. "Essentially these projects will be developed based on special investment agreements between the government of Ukraine and local authorities, where applicable, and foreign investors and their local entities," says Lysenko. "That new regime is supposed to kickstart in 2021, so it's very recent and should have a positive impact."

The resumption of the state privatisation programme should also spur M&A activity following its temporary suspension in March 2020. Large-scale auctions could start from the second quarter of 2021 onwards following the passing of the law earlier in 2021 unblocking these sales. In a further win for investors, the State Property Fund of Ukraine is also developing legislation aimed at further improving the privatisation process. Major assets that are expected to be put on the auction block include United Mining And

Chemical Company, one of the world's biggest producers of titanium raw materials, and First Kyiv Machine-Building Plant, a processor of rubber, plastics and their wastes.

Outside of these privatisation opportunities it is likely that investors will continue to show a strong appetite for businesses that possess fundamental characteristics that stand them in good stead in what remains an uncertain economic environment. "There are targets with strong liquidity such as retail companies with good propositions that have both offline and online sales and steady cash flows," says Lysenko. "Whereas certain commercial real estate, such as office properties, may be relatively less attractive given the disruption to working arrangements and what that means for the longer term. So there continue to be some natural choices for those targets that are better placed to operate in this environment."

Companies with hard foreign currency revenues such as euros or dollars will be especially attractive for investors. These are better insulated from currency fluctuations and have global reach in terms of marketing and sales, a major benefit whether Covid-19 restrictions are in place or not. Given the magnitude of the pandemic's impact, the attraction of these fundamentals is unlikely to fall out of fashion any time soon.

CONCLUSION

M&A in Ukraine was subdued in 2020 but dealmaking should begin to pick up again imminently against the backdrop of an economic rebound and renewed efforts to improve the judiciary and business environment

In the six months up to the end of January 2021, Mergermarket was tracking 26 companies being prepared for sale in Ukraine, down from 39 over the same period a year prior. The industrials and chemicals sector, a major component of Ukraine's economic activity, was in the lead with seven 'companies for sale' stories, just ahead of TMT with five assets being primed for acquisition.

In the main, industrials and chemicals deals tend to be of a larger size than those found in the TMT space, with the exception of large, incumbent telecoms transactions such as the VF Ukraine deal that closed towards the end of 2019. Tech assets are often smaller and better suited to venture capital and growth equity investors. One should expect these to take an increasing share of M&A value as Ukraine's already well-developed tech expertise is increasingly applied to establishing new businesses, and in addition the strong industry of businesses which provide support to large overseas corporates.

Ukraine M&A heat chart

Sector	Number of 'company for sale' stories
Industrials & Chemicals	7
TMT	5
Agriculture	4
Consumer	4
Energy, Mining & Utilities	3
Financial Services	2
Business Services	1
Grand Total	**26**

*Company for sale stories tracked by Mergermarket between August 1st, 2020 and February 2nd, 2021

A number of agriculture and consumer businesses are also preparing for sales, according to Mergermarket's heat chart. Agriculture will continue to play a major role in Ukraine's M&A landscape by virtue of its contribution to the economy and regulatory reforms in the industry. The country has a vast land mass and about 25% of the world's reserves of highly fertile black soil.

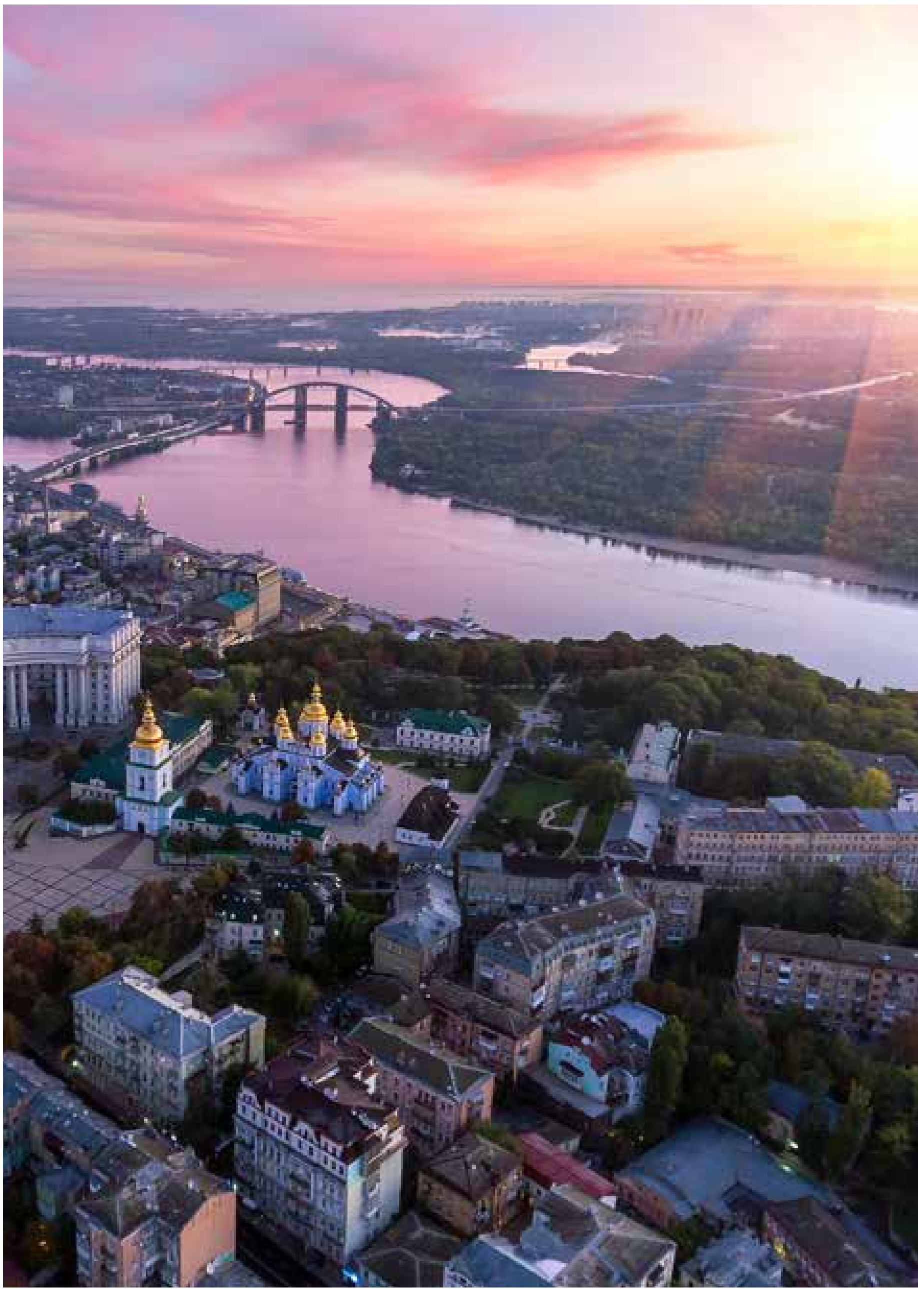
Consumer, meanwhile, continues to present opportunities as foreign corporates seek to restructure their portfolios and focus their efforts in their domestic markets. Acquirers are likely to be highly selective, seeking businesses that have demonstrated resilience through the pandemic, either with high levels of revenues from online channels or by selling essential goods like groceries.

There were three deals in the energy, mining and utilities sector tracked by Mergermarket and there continue to be long-term opportunities in the renewables space in particular. One challenge is the partial retroactive clawback of green feed-in tariffs and major reductions for new projects that are now going into development. There is little doubt that this will weaken demand for such assets as investors have to recalculate the feasibility of meeting their cost of capital under the new rules.

However, it is important to view this over a long-term horizon. Ukraine has committed to cutting power demand by 50% over the next three decades, reducing energy imports threefold. Energy independence will only be made possible through the development of renewables production and the country will need private capital to build out this capacity. This may prompt a decision by the government to reintroduce measures to stimulate investment into the sector once it has addressed fiscal concerns brought on by Covid-19 and energy demand returns to pre-pandemic levels.

There has been a clear lack of foreign capital in the M&A market in 2020, which is to be expected considering the circumstances and is not exclusive to Ukraine. Attracting this back to the country will have a stimulative effect for the economy and so there is now added impetus for the government to return its focus to the ongoing pro-business reforms it is attempting to resolve. Given the unprecedented challenges that 2020 presented, not only to Ukraine but its European and international trading partners, the desire to secure further IMF disbursements will be high.

If legislative progress made in early 2021 to push through greater privatisation is any measure, the likelihood of the IMF-mandated reforms being achieved has now increased. This is a highly positive sign. With this in mind, M&A activity is likely to gain momentum in the second half of this year before potentially reaching new heights in 2022 as vaccines hopefully reach critical mass, the economy gathers steam and investor confidence returns.



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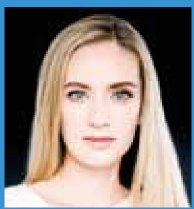

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