



CONCORDE CAPITAL

Ukraine/Politics

Blue Revanche

Yanukovich Steers Back to Russia

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The New Cabinet

Yanukovich & Allies

Prime Minister
Viktor Yanukovich
First Deputy PM, Finance
Nikolai Azarov
Deputy PM, Energy
Andry Klyuyev
Deputy PM, Construction
Volodymyr Rybak
Deputy PM, Social
Dmytro Tabachnik
Energy
Yuri Boiko
Coal
Serhy Tulub
Labor, Social Affairs
Mykhailo Papiyev
Environment
Vasyl Dzharta
Cabinet Affairs
Anatoly Tolstoukhov
Parliament Affairs
Ivan Tkalenko

Yushchenko Allies

Foreign Affairs
Boris Tarasyuk
Defense
Anatoly Hrytsenko
Interior
Yuri Lutsenko
Agriculture
Yuri Melnyk
Industry
Anatoly Holovko
Justice
Roman Zvarych
Health
Yuri Polyachenko
Emergencies
Viktor Baloha
Sport and Youth
Yuri Pavlenko
Culture
Igor Likhoviy

Socialists

Transport, Communications
Mykola Rudkovsky
Education
Stanislav Nikolayenko

Unaligned

Economy
Volodymyr Makukha

With the return of Viktor Yanukovich as prime minister, the center of gravity of Ukrainian politics has shifted back to the country's pro-Russian, industrial East. Yanukovich has strong constitutional powers and firm support in parliament, which virtually ensure that he will stay in the driver's seat until at least 2010. As he did as prime minister in 2002-2004, he will promote the development of heavy industry and cooperate closely with Russia. Domestic big business groups will be the chief engines of economic progress.

Yanukovich Has the Power

In order to become prime minister Yanukovich needed to compromise with the pro-western, economically liberal president, Viktor Yushchenko. But Yanukovich did not give much of importance away, and Yushchenko can do nothing to get rid of Yanukovich now that he is prime minister. The new parliamentary-presidential political system that Ukraine adopted this year gives most, but far from all, executive powers to the prime minister. Yanukovich will have to compromise with the president, who can veto legislation and appointments of local governors, and with other parties in parliament. However, Only if the Socialists or Communists turned against him, which is very unlikely, would he be truly threatened.

Orange Economic Policies to be Partly Rolled Back

Yanukovich and his first deputy prime minister, Nikolai Azarov, are taking aggressive positions on economic policy, calling for a reversal of many of the key changes since the Orange Revolution. Yanukovich and Azarov are calling for increases in import tariffs, a devaluation of the hryvnya, a lowering of rail cargo tariffs, and the restoration of tax privileges to special economic zones. Most of these proposals would do more harm than good, but they are likely to be watered down significantly before they are adopted. Azarov is also proposing to gradually lower general tax rates from 2008, which we support.

Lure of Western Capital to Drive Transparency

Although there will be a let-up in government pressure on big domestic business groups to reveal their true incomes, and policy will be more geared toward helping those groups accumulate capital, the lure of Western capital will remain. We expect major groups such as Rinat Akhmetov's System Capital Management to go full steam ahead with plans to IPO their assets in the West. That will lead them to introduce western standards of transparency, and also spur the government to create an environment where large business groups feel comfortable revealing their full incomes. Russian business groups, who have not invested much in the past two years, could return in force. However, western strategic investors will be wary.

Russia Relationship Still Tricky, WTO Faces Delays

Yanukovich will be strongly politically allied with Moscow. The relationship will still be tricky but less confrontational. Russia wants a stake in the management of Ukraine's gas pipelines, and it wants Ukraine to give up control of its external tariff policy and join a customs union with Belarus and Kazakhstan. If Yanukovich agreed on either count, he would face a major political confrontation at home. Temporary compromises seem the most likely outcome. Although Yanukovich has committed himself to joining the World Trade Organization by the end of 2006, we see 2008 as a more realistic date.

A Lasting Shift in Power

One of the characteristics of a politically polarized country is that a seemingly ordinary event can produce a powerful and lasting shift in direction. Last month's move by the Socialist party to quit the coalition that had backed the 2004 Orange Revolution and instead form a coalition with the Party of Regions was such an event.

Do not be fooled by the show that President Yushchenko put on last week, which was meant to make it appear that he was still in control and that he could ensure that the government would stick to the policies he declared when he came to power last year. The fact is that Yushchenko surrendered control, and the new prime minister, Viktor Yanukovich, has all the constitutional powers he needs to steer the country in the direction he wants, which is back into an alliance with Russia.

Yushchenko threatened to call early elections unless Yanukovich signed a "Universal of National Unity" including commitments to a range of pro-western policies. But Yanukovich knew Yushchenko was bluffing. Yanukovich stood his ground, and when the deadline came for Yushchenko to make his decision, he let Yanukovich edit the "Universal".

Now, only 20 months after he was forced out of power by the Orange Revolution, Yanukovich and his Regions party are back stronger than ever. Although he was denied the presidency by the 2004 uprising, he has ended up with something nearly as strong. Thanks to a revision of the constitution that came into force this year, the prime minister is Ukraine's most powerful political position.

Moreover, Yanukovich's support in parliament virtually assures that he will stay on as prime minister at least until the next presidential election in 2009. The only way he can be removed is if the majority of parliament turns against him. Yanukovich's party has just over 41% of parliament's seats, and in addition he has a very solid alliance with the Communists, who have just under 5% of seats, and a strong alliance with the Socialists, who have just under 7%. Thus, the only way Yanukovich could really be threatened would be if the Socialists or Communists turned against him. That is very unlikely because neither of them have anywhere else to go. The Socialists could not now return to the old Orange coalition, and they would be the biggest losers if the break-up of Yanukovich's coalition resulted in new elections.

Alliance With Yushchenko Not Crucial

Yanukovich has also made weaker alliances with Yushchenko and with parts of the president's center-right Our Ukraine bloc. Our Ukraine holds almost 18% of parliament's seats, but less than half its MPs voted to confirm Yanukovich and his Cabinet. The extent of support from Yushchenko and Our Ukraine for Yanukovich's Cabinet is likely to waver in the months and years ahead, and the alliance might well fall apart quickly. But Yanukovich does not need Yushchenko's or Our Ukraine's support to stay in power.

There are checks on Yanukovich's powers. The presidency still has significant constitutional powers. All the regional governors are Yushchenko appointees, and any dismissals or new appointments of governors have to be agreed between the Cabinet and president. Most importantly, the president can veto legislation, which will force Yanukovich and his Cabinet to negotiate with Yushchenko on major policy changes. Also, although Yanukovich does not depend on Yushchenko's continued support, the alliance is valuable for the boost it gives to Yanukovich's image in the West.

Implications for Policy

Yanukovich's last term as prime minister coincided with a boom in economic growth, which averaged almost 11% in 2003-2004. His removal from office coincided with a steep decline in growth, to just 2.6% last year. Our view is that the high 2003-2004 growth owed mainly to a surge in prices for Ukraine's main export commodities, while the drop in growth in 2005 owed mainly to the drop in export commodity prices and big social spending increases, which required a simultaneous increase in the effective tax burden and decrease in state infrastructure spending. With steel prices having recently returned to 2004 levels, GDP growth in the past two months has returned to rates nearly as high as those recorded in 2003-2004.

However, Yanukovich and his allies believe the growth in 2003-2004 owed mainly to efforts they made to support export-oriented heavy industry, which in their view helped local business accumulate capital and provided them with a secure environment for investment. These efforts included keeping down prices for state-controlled inputs such as electricity and rail transport; using import tariff policy to shelter domestic producers; and a complex range of tax exemptions and selective interpretation of the tax rules which mainly benefited the big business groups who owned heavy industry. Yanukovich and his allies believe the reversal of these policies, and the inexperience and poor organization of their "Orange" successors, led to the decline in growth in 2005.

In a nutshell, Yanukovich and his allies want to restore pre-2005 conditions. That means higher import tariffs, the restoration of tax privileges to special economic zones, less pressure on major companies to report their real income, and a small devaluation. Most of these proposals would do more harm than good.

However, Yanukovich and his allies aren't pushing for a complete reversal to pre-2005 conditions, and much of the reversals that they are pushing for will be watered down or dropped. Yanukovich and his allies will support western-oriented reforms when they don't conflict with their interests. We expect particular progress in the financial and agriculture sectors, which will develop rapidly thanks to foreign investment in the former and the initiation of land trading in the latter.

We believe the government would do better trying to create conditions that encourage efficiency, including pricing state-controlled inputs at their real cost; courting foreign investment by liberalizing foreign trade; and encouraging transparency through introducing international accounting standards, to mention just a few things. But we also recognize that politics is the art of the possible, not of the ideal. There is some truth to Yanukovich's view.

Big Business Groups to Lead

The worst thing about Yanukovich is that he caters to the specific interests of big business groups closely allied to him, and particularly to his main backer, Rinat Akhmetov. During Yanukovich's last term, the government sold to Akhmetov stakes in the country's biggest steel mill, two iron ore producers and three coal producers, mostly at prices far below their value. (The steel mill was renationalized and re-sold last year for \$4 bn more.)

One of the strongest arguments in Yanukovich's defense is the argument for stability. Having gone through the ugly process of developing a domestic business elite from the ashes of communism, there is much to be said for letting them get on with the process of transforming themselves into internationally acceptable business leaders. While the Orange politicians promised to create a level playing field, they spent much of their efforts trying to weaken the established business elite and create a new one.

Under Yanukovich, pressure from the government on big domestic business groups to reveal their true incomes will recede, and they will have an easier time accumulating capital. Nonetheless, the lure of Western capital will still be strong. Most of the major industrial groups – System Capital Management, the Industrial Union of the Donbass, Interpipe, Zaporizhstal and others – are preparing to IPO their assets on western exchanges. That will lead them to introduce western standards of transparency, and it will also spur the government to create an environment where large business groups feel comfortable revealing their full incomes.

Alliance With Russia to be Renewed

One of the main uptakes of the past month's events will be a restoration of the alliance Ukraine had with Russia in the latter years of Leonid Kuchma's presidency. Yanukovich and his allies will devote considerable attention to the Common Economic Area (CEA), a planned four-country trade bloc including Russia, Ukraine, Belarus and Kazakhstan. Yushchenko and the ministers of defense and foreign affairs, which he nominates, will continue to promote a pro-western course including the ideas of Nato and European Union membership, but they will not make much real progress.

But the relationship with Russia will still be tricky. Russia has proposed an extremely ambitious version of the CEA in which the countries would form a customs union and give up control of their external tariff policy to an international body. Essentially, in return for domestic Russian prices on oil and perhaps gas, Ukraine would give up its ability to independently negotiate trade policy with the EU. Yushchenko adamantly opposes this idea, which he sees as a sort of trap that would cut Ukraine off from the EU. Putin's government has threatened that if Ukraine doesn't join the customs union, the three other states will be obliged to apply their standard tariffs to Ukraine.

We expect Putin will initially push on Yanukovich to agree to enter the customs union, but even Yanukovich will resist going that far, and eventually Putin will compromise. A customs union is politically unachievable and one has to wonder if Putin really wants one anyway, given the scope for abuse.

In gas, Yanukovich has sent a clear signal that he does not intend to challenge the gas agreement signed with Russia in January by appointing Yuri Boiko as energy minister. Boiko, who was chairman of Ukraine's state oil and gas company, Naftogaz, in 2002-2004, is a close ally of Dmytro Firtash, Gazprom's partner in RosUkrEnergo, the company that supplies all of Ukraine's imported gas. However, Yanukovich will probably install a close, trusted ally as chairman of Naftogaz. During last winter's shortages, Yanukovich's business allies learned what it means not to be in control of one's gas supply. For the same reason, they will not be eager to cede management control of Ukraine's gas pipelines, much less ownership, to Russia.

Russia will continue to use gas price increases as a form of pressure. Given the substantially lower gas prices that Russia appears willing to offer in return for a long-term pipeline management contract, we don't rule out that Yanukovich could compromise on this front.

WTO Likely to be Delayed

The best aspect of Yushchenko's "Universal" is a clause that committed the signatories to support entry in the World Trade Organization by the end of the year. Nikolai Azarov, the new first deputy prime minister, argued in a recent interview that the Cabinet's plans to increase import tariffs would not conflict with plans to join the WTO. But we are skeptical – we think the Cabinet and parliament will delay entry by pushing through watered-down versions of the legislation that the US and others are demanding. Ukraine is likely to enter the WTO around the same time as Russia, in about 2008.

Outlook Good for Coal and Agriculture

In the coal sector, we expect the new Cabinet will push privatization of coal mines roughly in line with the 25-year energy plan adopted last year, which features gradual privatization amid continued state support for the industry including machinery upgrades to boost coal output and reduce gas imports. Yanukovich's business backer Akhmetov is already the biggest private player in the coal sector.

In agriculture, sales of agricultural land will go ahead and we expect there to be an agricultural land market by 2009. The relevant law currently includes a moratorium that expires in January, but the "Universal" signed last week said the moratorium could be extended to 2008. The law also bans foreigners from owning land, but we expect locals will find loopholes, so that they can own land through offshore companies. In the initial stage, access to land will be dominated by local business groups and authorities, but even so this reform will give an important boost to the economy.

In the electric power sector, the Yanukovich government will seek to reduce prices for industry and will at the same time seek to slow the pace of increases for households. There is a small risk that thermal generators, which still have large debts despite the last government's program designed to clear them, could be forced into bankruptcy or privatized cheaply.

Who's Who in the New Cabinet

The power center of the new cabinet will be Yanukovich and his two close allies, Andry Klyuyev and Nikolai Azarov. The latter two hold the same positions they held in Yanukovich's previous Cabinet in 2002-2004: Azarov is first deputy prime minister and finance minister, while Klyuyev is deputy prime minister in charge of the energy sector. Another very important figure who is not in the Cabinet is Rinat Akhmetov, Yanukovich's long-time business ally and owner of System Capital Management.

This elite leadership quartet will drive all major policy initiatives. Although they will agree about most things, Azarov is more conservative in the post-Soviet sense. He is taking the role as the main generator of policy initiatives, while Klyuyev and Akhmetov will naturally be the ones to engineer compromises with other political and business interests.

The coal minister, Serhy Tulub, is closely allied to Akhmetov and more broadly to Donetsk-based business groups. He is a true veteran, having held the same post back in 1998 and various other top energy posts since then. He will promote privatization of the coal sector, and he will also support coal machinery companies with stable orders.

Yuri Boiko, the new energy minister, has historically been very closely allied to Dmytro Firtash, the Ukrainian businessman with ties to Gazprom who is the dominant player in Ukraine's gas market. As chairman of Ukraine's state oil and gas company, Naftogaz, in 2002-2004, Boiko was instrumental in giving Firtash's companies (Highrock, Eural Trans Gas, RosUkrEnerg) the dominant position in supplying Central Asian gas to Ukraine. Although Boiko was not directly involved in the January 2006 gas agreement with Russia, which further strengthened RosUkrEnerg's role, he is a solid supporter of the deal.

Dmytro Rudkovsky, the new transport and communications minister, is an ambitious young businessman who helped engineer the party's switch to Yanukovich's side. He has never talked publicly about his businesses, but he drives an Aston Martin. Since his public face is still that of a Socialist, we expect he will pursue very shady deals and will oppose privatization within his spheres of influence. Notably, he will have limited influence over the state railways, whose CEO has not yet been changed.

Yushchenko's allies in the Cabinet are a curious assortment. They appear to have been cobbled together in a hurry and some of the appointments could prove to be short-lived. Since all cabinet ministers except the defense and foreign ministers are appointed and dismissed by a simple majority of parliament at the

prime minister's proposal, they serve at Yanukovich's pleasure and he can get rid of them whenever he wants. On the other hand, many are politically neutral figures who could stay on even if Yanukovich and Yushchenko fall out.

Initially, Yushchenko sought to negotiate the participation of several ministers from the Our Ukraine bloc, and Petro Poroshenko was tipped to be first deputy prime minister. Last week the leader of Our Ukraine's parliamentary faction, Roman Bezsmertny, signed an agreement with the Regions and Socialist parties to form a new "Coalition of National Unity." However, those talks apparently broke down and instead Yushchenko personally negotiated the make-up of the Cabinet with Yanukovich, without Poroshenko's involvement. Only 34 of Our Ukraine's 80 MPs voted to confirm Yanukovich's Cabinet. The "national unity" coalition has not been formed, and though the Communists got no Cabinet seats, they are still formally in the ruling coalition.

Boris Tarasyuk, the foreign minister, and Anatoly Hrytsenko, the defense minister, are both strongly pro-western and close Yushchenko allies. They both strongly support Nato accession. Yanukovich can not get rid of them because, by the constitution, they are appointed and dismissed by parliament at the president's proposal. However, we think Nato accession is for all practical intents and purposes off the table for the next few years. The most Yushchenko and his allies will be able to do is pursue military reforms aimed at Nato accession.

Yuri Lutsenko, the interior minister, is in the most sensitive position. He is a former street activist who rose to prominence as a leader of the 2000-2001 protest movement against former president Leonid Kuchma. His first months as interior minister last year were full of arrests, charges and investigations of Yanukovich allies, notably including the imprisonment for several months of Akhmetov's business partner Boris Kolesnikov and a showy raid of Akhmetov's home. Lutsenko said during the parliamentary election campaign that Yanukovich shouldn't be allowed to run because Yanukovich had faked a document purporting to show he had a clean criminal record (Yanukovich was convicted twice in his youth for fighting). As recently as last week Lutsenko said he would not work in a Yanukovich Cabinet. But he accepted the job, saying his mission is to secure rule of law. We think Lutsenko was never able to control the interior ministry's conservative hierarchy and he will surely not be able to do that in the future. Police control will be largely localized, with local governors and business groups having more influence than Lutsenko. Lutsenko is likely to be pushed out and replaced with a Yanukovich ally in a year to two years. The prosecutor general, jointly appointed by the president and parliament, has already allied himself to Yanukovich.

Yuri Melnyk, the agriculture minister, is said to be close to the owners of Myronivsky Khiboproduct, Ukraine's biggest producer of chicken meat. He was deputy prime minister for agriculture in Yuri Yekhanurov's Cabinet. We expect him to push forward on preparations for agricultural land sales.

Anatoly Holovko, the industry minister, is a former junior partner of Konstantin Grigoryshyn, the main owner of Sumy Frunze and other industrial companies. We understand they are still close but their interests are not completely identical. Holovko was deputy governor of Zaporizhya oblast last year, when another Grigoryshyn ally was governor.

Volodymyr Makukha, the economy minister, is a compromise figure. He was a deputy foreign minister in the Yanukovich, Tymoshenko and Yekhanurov Cabinets, until he was sent off to Japan as ambassador in April, allegedly because Tarasyuk doesn't like him. We expect he will adapt to the new situation easily and will take direction from Yanukovich and Azarov, not Yushchenko. His role will be like that of a diplomat, as much of the work will be on developing the Common Economic Area and accession to the World Trade Organization.

Most non-Cabinet positions have not yet been decided. These include the chief of the State Tax Administration; the heads of the Antimonopoly Committee, National Electricity Regulation Commission and National Communications Regulation Commission; and the CEOs of Naftogaz, Ukrtelecom and the state railway. It is not yet clear if Yanukovich plans to replace Valentina Semenyuk, the Socialist chairwoman of the State Property Fund.

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