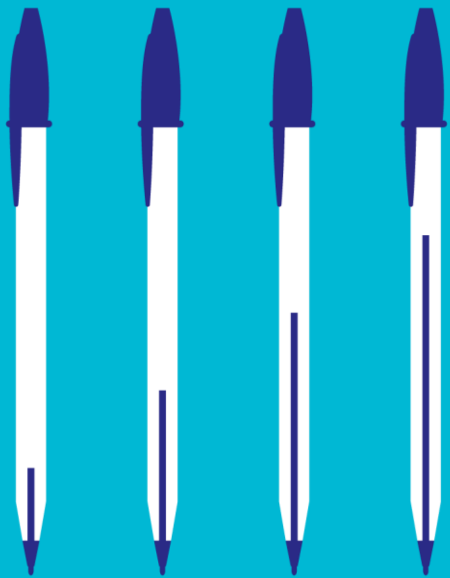
Small Business Initiative

Finance for SMEs in Ukraine

Small Business Impact Fund

1 January – 31 December 2018



European Bank
for Reconstruction and Development

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1. Description

Title of the Programme	Finance for Small and Medium-sized Businesses in Ukraine: First Loss Risk Cover instrument for SBI-eligible projects in Ukraine (the "Programme")
Programme value	USD 3.0 million
Funded by	Small Business Impact Fund (SBIF)
Start date and end date of the reporting period	January – December 2018
Target countries	Ukraine
Final beneficiaries / target group	Small and Medium-Sized Enterprises

2. Executive Summary

In September 2016, following the approval of the contributors to SBIF, the EBRD's SME Finance & Development Group allocated USD 2 million of the SBIF funds to a portfolio-based First Loss Risk Cover instrument for Ukrainian SBI-eligible projects (the "FLRC Instrument"). In January 2019 the contributors approved the USD one-million replenishment to the Programme.

The initial USD 2-million funding has been supporting direct EBRD lending to, and also co-financing/risk sharing with, local financial institutions of Ukrainian SMEs. Leveraged at a minimum ratio of 1:10 the funding has been aimed at supporting a portfolio of USD 20 million. The Programme is structured and designed to help strengthen the position and dynamism of local SMEs in the economy by improving their access to finance through direct finance in the form of debt and equity by the EBRD, and by supporting the relaunch of commercial bank lending to Ukrainian SMEs via risk sharing.

In November 2018 the EBRD signed the fifth direct finance project with Kiev Medical University for the amount of USD 1.5 million. Therefore, since the launch of the Programme in September 2016 five direct finance projects with Ukrainian SMEs have been successfully signed under the EBRD's Direct Financing Framework (DFF) bringing the portfolio of the Programme close to its USD 20-million capacity.

A co-financing agreement is being negotiated with Raiffeisen Bank Aval under the EBRD's Risk Sharing Framework (RSF). In 2017 the EBRD already signed a co-financing agreement with UkrSibBank for USD 50 million (EBRD exposure). These two RSF co-financing agreements will allow the EBRD to finance local enterprises together with the Partner Financial Institutions (PFIs), sharing the risk under either a funded participation, i.e. providing the share of the loan amount to the borrower, or an unfunded participation, i.e. by guaranteeing its share of the borrower's risk. A further USD 125-million agribusiness SME financing facility with UkrSibBank and a EUR 40 million FLRC line with Raiffeisen Bank Aval will help expand the market reach to a much greater number of SMEs in the country, including in rural areas.

With the recently approved replenishment, the contributors to SBIF also agreed to the modification of the FLRC Instrument from portfolio- to transaction-based. This change has been introduced in order to improve the guarantee mechanism, as the switch from a portfolio first loss guarantee to an individual loan first loss guarantee will prevent one bad loan from utilising the full available guarantee facility and reducing the likelihood of further loans being approved under this arrangement. The approval also allowed the team to re-cycle the resources of the initial USD 2 million as loans get re-paid, i.e. re-use the freed amounts to support more SMEs with a transaction-based FLRC Instrument.

This report covers the Programme's operations from 1 January to 31 December 2018.

3. Activities and Results during Reporting Period

3.1. Macroeconomic update

Micro, small and medium enterprises (MSMEs) represent an overwhelming share of total registered businesses in Ukraine. In 2016 MSMEs accounted for 99% of total companies, majority of which were micro enterprises. They employed around 80% of the entire workforce and created around 62% of total value added (at factor costs). While having a significant contribution to job creation, the this segment in Ukraine has long faced structural problems due to the legacy of state control in the overall economy and a large share of cash-based shadow economy, estimated at the 40% by the IMF.

The MSME segment is underbanked. While large majority of MSMEs have a bank account, according to some estimates only approximately 11% of them have credit exposures with commercial banks, down from an estimated 22% prior to the crisis. The total volume of loans to MSMEs is estimated at approximately 11.6% of the total banking sector loan portfolio (2.2% of the GDP). For comparison, in selected CEE countries that participated in the OECD 2018 SME study loans to SMEs made up 48-88% of the total portfolio outstanding.

The recent economic crisis dealt a blow to the private sector, although there are signs of restarting credit activity. Following a cumulative drop of 16% in 2014-15, GDP growth accelerated from an average of 2.5% in 2016-17 to an estimated 3.5% year-on-year in the first half of 2018 supporting gradual recovery of the private sector. The corporate loan portfolio decreased from 49% of GDP in 2014 to 28% of GDP in 2017 on the back of balance sheets deleveraging, reduction in the number of operating banks, increased risk-aversion, tightened credit conditions, as well as decreased number of creditworthy customers, deteriorated credit history, and SMEs inability to present acceptable collateral. In the first nine months of 2018, corporate lending grew by 6.7% in nominal hryvnia terms. In the latest Bank Lending Survey performed by the National Bank of Ukraine (NBU) in October 2018, the majority of banks expect corporate lending to increase in the near future.

However, access to finance for viable companies remains constrained by a number of factors. As only a minor share of MSMEs have export revenues, borrowers prefer local currency financing. However, hryvnia liquidity available to the banks is volatile and mostly short-term, making it difficult for the banks to offer and price medium- and long-term loans. Local currency interest rates remain elevated (at 17.4% for new corporate loans in August 2018), although the reduction in lending rates might be imminent in the context of macro stabilization, decreasing inflation and cheaper funding base. Non-price lending conditions are unfavourable. Insufficient creditor rights protection and inefficient judicial system are holding back corporate lending. The foreclosure procedure invoked upon failure of a borrower to service its loan obligations is long, costly and unreliable. While necessary for financial stability preservation, banks have been applying increasingly stringent credit criteria raising the entry requirements for loan applicants. This is particularly demanding for smaller companies. On the other hand, some large banks surveyed by the NBU reported easing lending standards for SMEs in the third quarter of 2018, citing stronger competition from other banks in this segment.

Alternatives to bank financing have been limited to date. The non-banking sector (including insurance companies, pension funds, credit institutions and financial companies) is small, comprising approximately 12% of financial sector assets. Microfinance institutions are not actively operating in the market. Leasing penetration is low at approximately 0.7% of GDP (compared to 4-14% in CEE countries) and represented mainly by bank-owned leasing companies. Access to equity capital is constrained, in the context of very low private equity penetration (0.004% of GDP, compared to a 0.1% average in CEE) and only few institutional level funds operating in Ukraine, with new fundraising in recent years complicated by the weak macro environment and geopolitical situation.

3.2.Small business investments

The Programme has been demonstrating good progress in implementation, with five direct financing projects signed since its launch in 2016. Please refer to Annex 3 for more detail and the current status of the projects signed before 2018.

In November 2018 the EBRD signed a DFF transaction with the Kiev Medical University:

USD 1.5 million for Private Higher Educational Establishment (signed November 5, 2018)
Background: Kiev Medical University is a medical education provider in Ukraine with the revenues of EUR 3.6 million and EBITDA of EUR 0.8 million in 2018. The number of students at the University has grown by 15% year on year since 2014 and reached 2,380 in July 2018. The availability of a full-scope English language education led to a 4-times increase in the number of foreign students over the same period, and in 2017/18 reached 709 students from 56 countries. Hence, 55% of the University's revenue is generated in foreign currency. **Business need:** In response to the increased demand for its services Kyiv Medical University planned an expansion project of a total value of USD 2.3 million with USD 1.5 million of EBRD financing. The Company is to acquire a new campus, upgrade it and invest in educational equipment, which would allow the University to lift the licence limit and apply for an increase in the licensed maximum number of domestic and international students. The expansion will also include new educational programmes. **Current status:** The Company has disbursed the full amount of the loan. The campus has been acquired and the Company is in the process of receiving the license extension. The current financial position of the Company is satisfactory and meets all EBRD covenants.

4. Lessons Learned

As at the end of December 2018 the Programme has demonstrated solid progress towards achieving the target in terms of directly financed deals with USD 19.5 million of financing with five companies.

The risk-sharing transactions with PFIs proved more challenging to execute than might be expected since the banks were keen to keep the exposure to good borrowers on their books. However, the EBRD is in discussion with Raiffeisen Bank Aval on a potential pipeline, and a few deals are on track within the agribusiness framework signed with UkrSibBank.

5. Communications and Donor Visibility

The EBRD works to ensure that maximum donor visibility is achieved, including through press releases on transactions. Clients are made aware of the donor-funded support from SBIF. In general, however, the EBRD does not actively publicise the existence of the FLRC instrument to prospective borrowers in order not to undermine the payment discipline and to avoid creating the impression that the loan is 'soft' (especially during restructuring negotiations).

The SME Finance & Development Group maintains an online resource https://smallbusiness-ebrd.com/, which features this Programme, including through case studies (e.g. on the Khask Group transaction).

6. Conclusion and Next Steps

The continuing recovery of the Ukrainian economy should open up possibilities for SMEs to grow and expand. It is vital that their development plans are supported with financial resources available not only from international financial institutions but also from local banks. In this regard every additional support effort from donors counts and provides assurance in ongoing and long-term assistance to the SME sector. This will be especially relevant given the FLRC instrument underpinning this Programme will be fully extended to a portfolio of USD 20 million by the year-end 2019.

ANNEX 1: Results Framework – Progress to Date

Specific objective	Outputs	Target	Result (30 December 2018)
Strengthened role of SMEs in economy through enhancing their competitiveness and innovation	Number of SMEs financed by EBRD directly or through co-financing arrangements, at least	6 (minimum)	5
	Volume financed by EBRD directly or through co-financing arrangements	$20,000,000	$19,500,000
	Outcomes		
	Average turnover/productivity growth of SMEs that access EBRD direct or co-finance during investment/loan period	to be monitored	Please refer to Annex 2
	Job creation in EBRD financed or co-financed SMEs during investment/loan period	to be monitored	Please refer to Annex 2
	% of enterprises receiving financing achieving increases in turnover one year after investment	75%	100%
	Evidence of innovation (in product, process, marketing and organisation) by SMEs supported through finance by EBRD and PFIs	to be monitored	Please refer to Annex 2
	Evidence of enhanced corporate governance practices by SMEs supported through finance or business advice by EBRD	to be monitored	Please refer to Annex 2
Improved access to finance for SMEs through restarting lending to the economy by PFIs	**Outputs**		
	Number of PFIs signing risk-sharing agreements with EBRD	2 (minimum)	1
	Total volume of PFI loans to the SMEs (including EBRD risk-sharing part of up to 65%)	$10,000,000	n/a-
	Outcomes		
	Total number of SMEs financed by PFIs under risk-sharing arrangement with the EBRD, at least	4 (minimum)	n/a-
	Evidence of PFIs' successful introduction of new products (ex. factoring) or product specificities (ex. longer tenures, local currency etc)	Qualitative	n/a

ANNEX 2: Outcomes per Investment

INDICATOR	DFF - Ecopharm	DFF - Ecosoft	DFF - Khask II Solvent	DFF - Typhoon
Average turnover/productivity growth of SMEs	+10% From USD 6.5m (2016) to USD 7.2m (2018 est)	+50% From USD 15.4m (2016) to USD 23.4m (2018 est)	EBITDA margin increased from 13.5% in 2016 to 14.3% in 2017	+12% From EUR 15.8m (2017) to EUR 17.8m (2018 est)
Job creation in EBRD financed or co-financed SMEs	+25% From 169 (2016) to 210 (2018)	+42% From 225 (2016) to 320 (2018)	+6% from 422 in 2016 to 447 in Sep 2018	+22% from 317 in Jun 2017 to 390 in Dec 2018
Evidence of innovation (in product, process, marketing and organisation) by SMEs supported through finance by EBRD and PFIs	The company built its own GMP-compliant production facilities.	The company became leader in household water filters in Ukraine. New products launched including own production of reverse osmosis filtering membranes.	With the EBRD lending the company has increased its resource and energy efficiency capital investment and focuses on: (i) installation of state-of-the-art solvent recuperation system, which will allow Khask to achieve substantial efficiency recovering solvents used in the production; and (ii) implementation of several EE investments to achieve better energy efficiency.	With EBRD financing the company increased production by 20% in 2017, and satisfied circa 2.3% of lamellas consumption (1.8 million m2) of European demand. The growth was achieved with less than a 9% increase in wood consumption, since as a result of the project the conversion of raw wood into lamella reached 50 m2 from 1 m3 of wood with planned further enhancement to 65 m2 in contrast to previous 44 m2 in 2017. The company retained the 2nd place as the biggest oak lamellas producer in Ukraine with 30% share of Ukrainian multilayer engineered wooden flooring export sales; however, its financials reached the level of the top lamella producer in Ukraine.

INDICATOR	DFF - Ecopharm	DFF - Ecosoft	DFF - Khask II Solvent	DFF - Typhoon
Evidence of enhanced corporate governance practices by SMEs supported through finance or business advice by EBRD	The management of thecompany shifted from the founder and owner to a qualified management team. The company introduced IFRS reporting and ecological safety compliance framework.	Ecosoft is bought by the strategic investor - BWT (Austria), a sign of a well-structured and well-governed business.	As a result of financing the company has become more disciplined in furnishing key financial and operations data on a monthly basis and comprehensive management accounts (in accordance with IFRS guidelines) on a quarterly basis.	As part of the project implementation and the EBRD’s requirements, the ownership structure has been modified. The company has also improved corporate governance through better financial management by setting quarterly IFRS reporting.

ANNEX 3. Background and Progress of Projects Signed in 2016-2017

1. Ecosoft

USD 3 million for a producer of Water Purification Equipment (signed March 1, 2017)
Background: Ecosoft is a Ukrainian water filtering and treatment solutions manufacturer with the revenues of USD 15.4 million and EBITDA of USD 1.3 million in 2016. 85% of the Company's revenues are generated through sales of household water filters. The other 15% of sales are coming from B2B industrial engineering works in water preparation for food, energy, and chemical companies. The Company is exporting its products to over 40 countries and employs 255 workers. **Business need:** At the beginning of 2016 the Company approached the EBRD with the request for financing of its investment project aimed at a production and storage facility extension. Out of the total investment of USD 4.5 million the EBRD has supported the Company with a USD 3 million senior secured 5-year loan. **Current status:** The investment project is still at an implementation phase with the full amount of Tranche 1 financing (USD 1.55 million) disbursed. With the help of the EBRD funds the Company has completed the construction of a new warehouse and equipped its production with new machinery. The Company became the leader in household water filters in Ukraine. New products have been launched including own production of reverse osmosis iltering membranes. The Company is bought by the strategic investor – BWT (Austria), a sign of a well-structured and well-governed business. The current financial position of the Company is satisfactory and meets all EBRD covenants.

2. Khask

EUR 1.4 million for a producer of Flexible Plastic Packaging (signed September 9, 2016)
Background: Khask Group is a Ukrainian company and one the leading CIS producers of high-quality flexible plastic packaging materials (mostly for food-related sectors) and self-adhesive tapes. The EBRD has a long-standing relationship with the Company since it subscribed to an equity investment of USD 6 million in 2011. The Company, together with its strong and experienced management team and shareholders, has proven its commitment to the business by demonstrating high standards of business management and transparency of its operations as well as business conduct throughout the crisis in Ukraine. Despite the strong UAH devaluation (UAH lost approximately 70% of its value against USD during 2014-2016), the Company managed to increase revenues in USD terms and its profitability was supported by vertical integration. In 2017 the Company's revenue stood at USD 22.4 million, EBITDA at USD 3.2 million, and it employed 450 people. **Business need:** With the aim of supporting resource and energy efficiency, the Company requested EBRD's participation in a USD 4.3-million project that focuses on: (i) the installation of a state of the art solvent recuperation system, which will allow Khask to achieve substantial resource efficiency recovering solvents used in the production, and (ii) implementing several energy efficiency investments. **Current status:** By the end-2017 the EBRD has disbursed the full loan amount of EUR 1.4 million. The Company purchased all the required equipment and finalised the installation in late 2018. With the EBRD lending the Company has increased its resource and energy efficiency. As a result of tough market conditions the Company's margins were under pressure in 2018 and the financial covenants were exceeded. The Company missed a prinicipal prepayment in December 2018 and is currently in negotiations to restructure its debt portfolio.

3. Ecopharm

USD 3.3 million for a Pharmaceutical Producer (signed December 15, 2016)

Background: Ecopharm is a unique research-based local pharma producer that has developed and produces its own innovative antiviral medications from herbs. Its medications are also being successfully used as a part of a complex treatment of HIV and some cancers caused by oncogenic viruses in women. Ecopharm's products act a suppressor of virus replication with immunomodulatory effect. Ecopharm is holding about 6-8% market share in different sub-segments of the antiviral medications market. Its products are the only antiviral medicines derived from herbs, with all competing products being chemically synthesised. In 2016 the Company generated USD 6.5 million of revenues with an EBITDA of USD 2.4 million. Ecopharm provides jobs to 150 employees.

Business need: Having all of its production outsourced to contracted manufacturers, Ecopharm had difficulties ensuring and proving to the regulatory authorities that their products are GMP (Good Manufacturing Practice) compliant. This caused significant difficulties in obtaining drug registration permits and hampered the Company's export sales. Following the revision of the Company's strategy the owners of Ecopharm approached the EBRD with a request to financially support their USD 6-million project of building a GMP-compliant pharmaceuticals factory in Western Ukraine.

Current status: As of December 30, 2018 the EBRD has fully disbursed Tranche 1 of the USD 3.3 million of the signed loan amount. The Company has completed the construction of its production facilities and certified them in accordance with GMP requirements. The current financial position of the Company is satisfactory and meets all EBRD covenants. Tranche 2 has been cancelled due to the absence of investment need for the business.

4. Typhoon

EUR 8.0 million for an Oak wood processing company (signed November 30, 2017)

Background: Typhoon was founded in 2010 as a small manufacturer of premium-quality oak lamellas – an intermediate product supplied to major European producers of multilayer engineered wooden flooring. The Company's plant was built as a greenfield with technical advice from Bauwerk Boen, one of Europe's leading producers of multilayer parquets. Since the start of its business Typhoon has expanded its operations and reached EUR 17.7 million of revenues exporting 100% of its products. In 2018 the Company's output reached 1.8 million m2 of lamella from 36,100 m3 of oak logs (it 2017 it was 1.5 million m2 of lamella from 33,000 m3 of oak). Among its customers are the leading producers of multilayer engineered wooden flooring, such as Barlinek (Poland, a long-term client of the EBRD), Weitzer (Austria), Parador (Germany).

Business need: The machinery installed by the Company at its start in 2010 was new but the log-cutting process was based on relatively simple, manually-operated equipment, which does not allow the optimal log-to-lamella yield, and thus uses more oak logs. Moreover, the current output level cannot fully satisfy the growing demand from the existing client base. With that in mind the Company approached the EBRD with a request for EUR 8 million out of its EUR 13-million expansion and renovation programme for 2018. As the result of constructing new production facilities and purchasing log-drying and cutting equipment Typhoon will see an increased volume in overall output of oak lamellas, and improved yield (with less waste of wood) in manufacturing.

Current status: Typhoon successfully completed the first project financed by the EBRD and increased its annual processing capacity to 2 million m2 of lamella p.a. The output yield has improved from 44 m2 from 1 m3 to almost 51 m2 from 1 m3 of oak logs. The loan is in the process of repayment. The Company entered into negotiations with the EBRD regarding the financing of the construction of a new parquet production facility for the total estimated cost of EUR 16.5 million with planned EBRD exposure EUR 11.5 million. The signing of a Loan Agreement is planned for April-May 2019. The current financial position of the Company is satisfactory and meets all EBRD covenants.