



# Looking good in Ukraine?

Arthur Nitsevych and Vyacheslav Lebedev, of International Law Offices, look at developments in the Ukraine

The capacity of the world shipbuilding and commercial shipping markets is really vast but there is no reason for Ukraine to lose out. The historical level of Ukrainian shipbuilders' skills still makes the Ukrainian shipbuilding quite competitive in the world market.

When in 1991 Ukraine proclaimed the Declaration of Independence it inherited near 30% of shipyards of the USSR. The majority of the powerful shipbuilding base inherited by Ukraine falls into the Ministry of Industrial Policies of Ukraine.

It embraces no less than 10 huge yards plus machinery manufacturers, institutes and design bureaus. And Ukraine also has a number of ship building and ship repair facilities subordinated to the Ministry of Transport and Communications and other ministries.

Under the former USSR shipbuilding and ship repair yards were to a considerable extent separated. Now there are more than 50 shipbuilding companies in Ukraine able to build powerboats, ferries, barges, bulk vessels, tankers, etc. All in all there are more than 70 large and medium ship repair ventures (the

biggest yards are in Ilyichevsk, Mariupol, Kerch, Izmail, Kiliya, Sevastopol), without counting those involved in building yachts and small boats.

The production system of the shipyards in the USSR was rather effective. Ships were built in large lots to reduce the cost per unit. Reserves were so large that shipyards worked rhythmically for years, but the rupture of economic relations affected this work and the downswing began.

It was halted in 1999 by privatisation and reorganisation of state enterprises into public corporations.

## Privatisation pays

The volume of Ukrainian shipbuilding industry production in 2004 increased almost two and a half times compared to 2000. This motion promoted booming business in contiguous industries. It is generally considered that shipbuilding has a cumulative effect, for example, the creation of one workplace in this industry entails about five workplaces in contiguous industries. So, what is the concern?

The President of Ukraine in September 2006 said public shipbuilding and ship repair

companies must be sold as soon as possible. They say only private owners can provide effective management in this sphere. On the other hand, the government plans to receive substantial income from the privatisation deals. Three ship repair yards are to be included into the list of companies to be privatised.

In several years' time we would not be surprised to hear that the big yards would be split and there would be small handling terminals and small boat workshops.

On October 2, 2006 the Ministry of Transport and Communications of Ukraine issued an Order to merge 'Ukraine' yard, one of the biggest ship repair yards in Ukraine, with the public company Sea Commercial Port of Odessa. Today some ship repair yards are involved in yacht building and some ship building companies provide a wide scope of ship repair.

So, for the past year Ukrainian shipbuilders have been deprived of real state support. The government support for the shipbuilding industry is never a simple task - international agreements make national governments act very carefully in granting privileges to national producers in the competitive struggle against foreign rivals.

Nevertheless, the right policy and qualified legal protection make it possible for national shipbuilders to find adequate ways to cope with international competition. China has been particularly effective at this.

### Assembly only

It seems Ukraine is not threatened by shrinkage in capacity but this is due to some persistency by the industry. Ukrainian shipbuilding has already developed a reputation as an assembly operation. It means that in Ukraine they make only naked hulls, which are towed to foreign shipyards for completion. First, such a manufacturing strategy is inefficient; second, it leads to negative ecological implications and loss of high technology development - the assembly of a hull does not need high technology.

The quality of Ukrainian steel is higher than the quality of the Chinese metal, but this is not enough to give the Ukrainians a competitive edge in foreign markets.

The development of shipbuilding depends on the economic market. A brisk market will increase demand for carriage, so freight charges also increase. Such tendency increases the demand for ships and leads to the increase of ship prices. And vice versa, when the commodities' market is depressed, the shipbuilding market is depressed too.

Of course, this market analysis is quite primitive. Shipbuilding also depends on the capital and financial markets. The ship is a commodity; consequently, the mechanism of commodity exchange is spread to shipbuilding. However, the ship is not a classical piece of exchange trade because a ship, as a rule, is a specific thing.

Ships are produced with many different components - all subject to their own commercial pressures and quoted in their own commodity exchanges, thus, the cost of the ship is exposed to the influence of commodity market.

The labour market has a profound effect on the competitiveness of the shipbuilding. It is not a secret that the cheapness of manpower in China and countries of Eastern Europe helps the shipbuilding industries of these countries.

Finally, the political will and legal regulations of the state in which the yard is found have an appreciable effect on the competitiveness of its production.

### Foreign orders

Currently about 80% Ukrainian shipbuilders' order books are filled by foreign orders. This is problematic. On the one hand, it is evidence of

the export capacity of the country. On the other hand, it is a sign that national ship owners are not placing orders for new vessels among national shipyards.

If Ukrainian shipping companies could, they would place orders for new ships among national shipbuilding facilities, but the financial status of national ship-owners does not allow them to think about new builds.

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The way out may be to get a loan from a bank but the Ukrainian banking system is weak with little development in investment credit. The production cycle in shipbuilding industry is characterised by its long duration. That is why the cost of money is typically long-term credit.

According to the standard conditions of the export credit adopted by Economic Cooperation and Development Organization, a loan for shipbuilding is granted for 80% of the ship's cost at the 8% rate per annum for 8.5 years. To negotiate a loan with a Ukrainian bank at 12% rate per annum to finance the construction of a new ship now is a fantasy. Ukrainian ship-owners are forced to search for credit abroad.

Strictly speaking business initiatives should be free from the political policy of the state. But it seems full independence from politics is impossible for any branch of the industry. The shipbuilding industry responds to political changes very acutely. The legal regulation of the shipbuilding companies' activity may limit the development of business undertakings but they may also contribute to their progress.

Our law firm has a considerable experience in shipbuilding. In 2005 we worked on the draft of a development contract on the lot of ships at the price of US\$48,000,000 per unit. The delivery of one ship was an object of the option agreement. The conditions of delivery were ex-yard, and the terms of payment were the

following: 20% of the price the buyer ought to pay after making of contract, 15% - after steel cutting, 20% - upon keel laying, 15% - upon launching, 30% - upon ex-yard delivery.

To secure the mutual obligations the contracting parties were to exchange bank guarantees. Unfortunately, the Ukrainian shipbuilding company could not obtain the bank guarantee; therefore, the contract was not signed. And that is typical.

There are examples of business growth in the Ukraine. The shipyard Ocean based in Nikolaev was purchased by Damen Shipyard Group (the Netherlands) in 2001 in the most successful privatisation deal so far. Together with the Norwegian company Aker Yards they set up a joint venture in 2006 in Nikolaev (which is the heart of Ukrainian shipbuilding). It will manage the navy yard and will focus on constructing merchant boats.

Aker Yards has paid €10m and has also undertaken to repay the Damen Shipyards Ocean's €11m debts. The joint venture's initial order portfolio is expected to consist of 11 vessels, worth €30m. Now the Damen Ocean Yard is involved in its' own programmes and also in projects financed by EBRD and launched by the most successful Ukrainian ship owner Ukrichflot (privatised by the way too).

We are sure that the political and business factors hamper the progress of shipbuilding in our country. The institutional environment in Ukraine is not changing enough or moving rapidly enough to keep up with international market conditions.

We hope the democratisation of national politics will bring stable and advancing development for the shipbuilding industry. Meanwhile shipbuilders and ship owners ought to take care of themselves by means of substantive search for investors and legal ways of investment without expecting political consensus. Experienced and knowledgeable experts are at their service. ■



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