



British Embassy
Kyiv



ANALYTICAL REPORT

SMALL AND MEDIUM BUSINESSES IN THE DONBAS: DEVELOPMENT AND SUPPORT POLICY



MARCH 2017

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The views expressed in this publication are those of the authors and may not coincide with the official position of the UK government or UNDP.



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Acronyms

COSME	EU programme for the Competitiveness of Enterprises and Small- and Medium-sized Enterprises
EBRD	European Bank for Reconstruction and Development
EFSE	European Fund for Southeast Europe
EIB	European Investment Bank
EU	European Union
GCA	Government-controlled area
IER	Institute for Economic Research and Policy Consulting
IOM	International Organization for Migration
NBU	National Bank of Ukraine
NGCA	Non-government-controlled area
PIN	People in Need, a Czech nonprofit, non-governmental organization
SME	Small and medium enterprise
UNDP	United Nations Development Programme
USAID	US Agency for International Development
WNISEF	Western NIS Enterprise Fund

Executive summary

In Ukraine, SMEs are a major source of employment and generate a large portion of economic activity. However, their contribution to innovation and economic growth is far below full potential. SMEs in Ukraine are disproportionately focused on trade and individual services, where space for productivity gains is small. Access to finance is difficult for many SMEs, which forces them to rely on primarily on self-funding for working capital and investment in equipment.

The armed conflict in eastern Ukraine has taken a heavy toll on SMEs in Donetsk and Luhansk oblasts (the Donbas region). Donbas SMEs accounted for 13 percent of sales by Ukrainian SMEs in 2013. In 2015, the share of sales of SMEs in the government-controlled part of the Donbas of total SME sales fell to just over 3 percent. Many SMEs closed or relocated to other parts of Ukraine. Still, over 60,000 private entrepreneurs and corporate SMEs continue working in the Donbas in government-controlled areas (GCAs).

The remaining Donbas SMEs work in extremely difficult conditions. The conflict has disrupted infrastructure, including roads, bridges, rail links

and power lines. They have lost access to major population centers on the other side of the contact line, and customers in other regions of Ukraine are sometimes reluctant to do business with Donbas companies. The bank network in the Donbas is well developed, with at least two bank branches in most towns in Donbas GCAs. However, obtaining a bank credit can be very difficult for Donbas SMEs, both due to the risks involved and legal prohibitions on repossessing collateral in the Donbas.

Thus, Donbas SMEs need all the support they can get to get back on their feet. State employment centers provide training for aspiring entrepreneurs

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and lump-sum payments of unemployment benefits for people with a business plan. Local governments in the Donbas do some promotion and logistical support and coordination of international partner efforts for SMEs, but they spend very little money on SME support. Donetsk Oblast budgeted funds to support SMEs through subsidized bank loans, but few SMEs signed up in 2016. International partners support Donbas SMEs through programs available throughout Ukraine (such as EIB SME and midcap financing facility) and in programme targeted for the Donbas, i.e. microbusiness start-up grants provided by several charities and international organizations.

Nevertheless, international partners and government institutions do not have the capacity to help all SMEs that need help, and there are gaps in existing assistance options. International partners may need to provide funding directly to Donbas SMEs until banks are ready to resume lending in the Donbas. Small businesses with intermediate financing needs may be too large for micro-grants, but too small for full-service and reporting-heavy funding options. Co-operative funding of SME support by regional and local governments and potentially international partners may aggregate funds and help tailor support to local needs.



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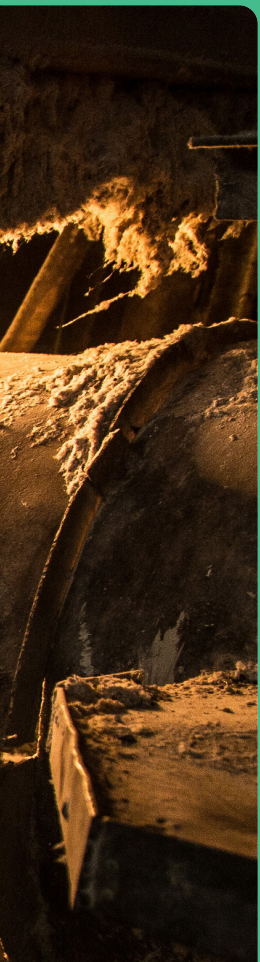
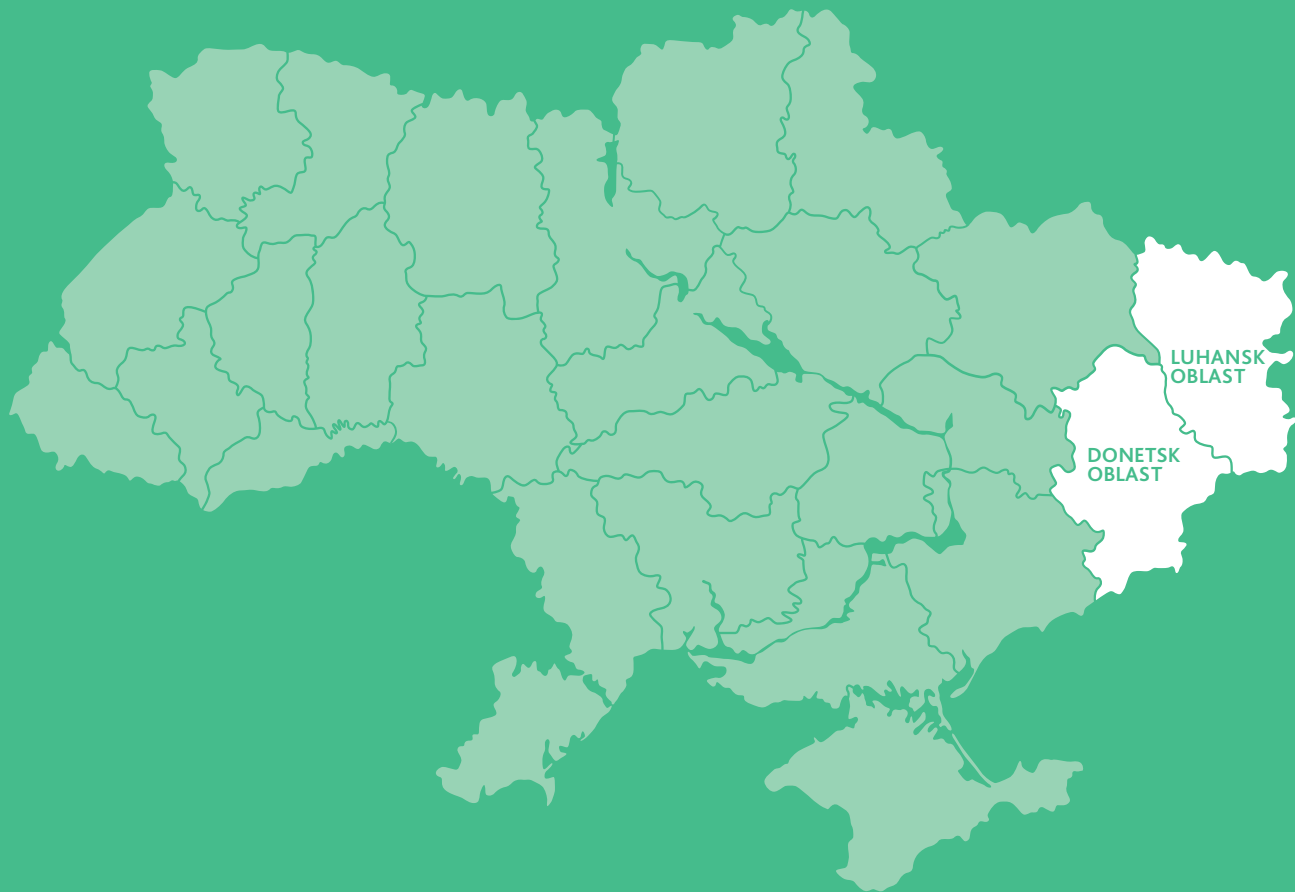
Introduction

A strong SME sector is a vital part of the social fabric, and usually a key source of economic resilience. The SME sector can also be a breeding ground for innovative and breakthrough ideas, and a driver of economic growth. In Ukraine, SMEs are a major source of employment and generate a large portion of economic activity, but their potential contribution to economic growth is likely smaller.

Many microbusinesses are focused on the retail trade and services. They often have little scope for productivity growth and do not aspire to grow significantly (reflecting the fact that many people went into business by necessity rather than by choice). Besides, a significant share of small businesses work under Ukraine's simplified taxation scheme, which reduces the tax and compliance burden, but also creates incentives against business growth (due to limits on the number of workers and annual turnover restricting eligibility for the scheme).

Access to finance is another key concern for SMEs. Over half of the SMEs cited insufficient working capital as an obstacle to business growth in the latest Institute for Economic Research survey. Bank loans are expensive, while banks are reluctant to take on risk. On top of that, small businesses frequently lack the collateral





needed to secure a loan or the expertise to provide a viable business plan. There are also few alternatives to banks. There are credit unions and a number of other financial institutions providing credit to businesses, but their portfolio of business loans is small compared to the banks. Thus, most SMEs either fund themselves internally or through informal means. This places serious constraints on business growth.

In Donetsk and Luhansk oblasts even fewer banks are willing to lend to SMEs. There are also ruined roads and railways, occasional shelling of areas near the contact line, disrupted supply links with non-government-controlled parts of the Donbas, and an unwillingness of many

businesses in other regions to do business with Donbas SMEs. Thus, it is important to review what part of the SME sector still works in Donetsk and Luhansk oblasts, and dig deeper on how to help the SME sector take the lead in economic recovery and reconstruction in the Donbas. This report is further structured as follows: In the next part, we review the current conditions of the SME sector in the Donbas. The third and fourth sections of the report are devoted to the key constraints on SME development and a review of the access to financing of SMEs. The next section analyzes the efforts of local government and international partners to support SMEs in the Donbas. The final section gives recommendations.

SMEs in Donbas

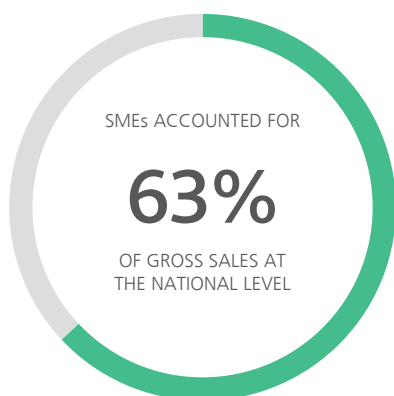
After the conflict started in the Donbas in 2014, the government lost control over eastern parts of Donetsk and Luhansk oblasts, including the regional centers – Luhansk and Donetsk. Donetsk and Luhansk oblasts are traditionally referred to as the Donbas. While some businesses moved to the government-controlled part of the Donbas¹, a large part of the SME sector remained outside of government control.

Just how much of the SME sector remains is difficult to calculate based on publicly available statistics. Indicators for the SME sector in Donetsk and Luhansk oblasts are available for 2015 and previous years. These include the number of enterprises, sales, the number of employees and labour costs. Figures are available as totals and are broken down by industry. However, several challenges exist in assessing the data.

The Ukrainian definition of SMEs is more expansive than those of Eurostat. In practical terms, some of the top-10 Ukrainian companies in several service sectors fall under the definition of medium enterprises. Thus, the share of SMEs in economic activity reflects this definition. At the

national level, SMEs accounted for 63 percent of gross sales, while companies with less than 250 employees generated 53 percent of gross sales. In addition, SME indicators include economic activity reported by companies that continued working in the non-government-controlled part of the Donbas. Out of 15,117 reporting enterprises (legal entities) in Donetsk and Luhansk oblasts in 2016, 3,818 reported from the non-government-controlled part of the Donbas. These 3,818 companies accounted for 33 percent of sales and 25 percent of the reported employment in Donbas. Thus, we had to estimate SME activity attributable to the government-controlled part of the Donbas. The key indicators for Donbas SMEs are summarized in Table 1:

Table 1. SMEs in Donbas in 2015	Total number of SMEs	Sales by SMEs, UAH million	Labour force of SMEs
Donetsk Oblast	69,310	120,630	282,594
Luhansk Oblast	21,313	23,883	87,549
Donbas	90,623	144,513	370,143
Government controlled area (GCA)	60,538	113,834	281,807
Share in Ukraine, %	3.1	3.1	4.3



Source: estimates based on Ukrstat, Donetskstat, Luhanskstat, local authorities' figures and data from Donetsk Oblast Tax Service

Note: Estimates are based on the assumption that SMEs account for the same share of economic activity (i.e. sales, labour force) in GCAs in Luhansk Oblast as do large enterprises in the Donbas



Overall, it is estimated that 61,000 SMEs were operating in the government-controlled part of the Donbas as of the end of 2015 with total 2015 sales of UAH 114 billion or EUR 4.9 billion. They accounted for more than 3 percent of total sales by companies, and 4 percent of employment in Ukraine. The SME footprint in the Donbas is much smaller than the 13.4 percent share in sales of Ukrainian SMEs and 12.6 percent share in SME employment observed for Luhansk and Donetsk oblasts in 2013, the last pre-conflict year. This reflects both the loss of major population centers and damage to businesses in the government-controlled part of the Donbas. At the same time, some businesses moved from the non-government-controlled part of the Donbas to the western Donbas.

FOR EXAMPLE,

7,747 businesses

MOVED FROM THE NON-GOVERNMENT-CONTROLLED PART OF DONETSK OBLAST TO OTHER PARTS OF UKRAINE IN 2015.

Some of them moved their registration formally, while others moved outside of the Donbas. Anecdotal evidence points to some service businesses also moving to the government-controlled part of the Donbas.

Obstacles to SME development in Donbas

SME development in the Donbas suffers both from general obstacles to doing business in Ukraine and being close to the conflict zone.

First, consumer and business demand in Ukraine remains weak, while most SMEs work on the domestic market. The Ukrainian economy has suffered from the effects of two economic crises over the last 10 years (in 2008-2009 and 2013-2015). In 2016, the economy returned to very slow growth, but economic growth is projected to remain anemic over the next few years. As a result, a significant number of SMEs have struggled to remain in business.

In a 2016 Q4 enterprise survey by the National Bank of Ukraine (NBU), the key obstacles to increasing SME production were still those related to the crisis (such as high energy and input costs, exchange rate volatility, and low demand). The high tax burden was another key concern for SMEs, in particular for SMEs subject to general tax rules and reporting obligations. Thus, tax compliance may be costly for larger SMEs. The taxation of wages was reduced



in 2016, but the tax wedge remains close to the EU average at 34 percent of labour costs. This adds incentives for informal payment of wages, which distorts competition.

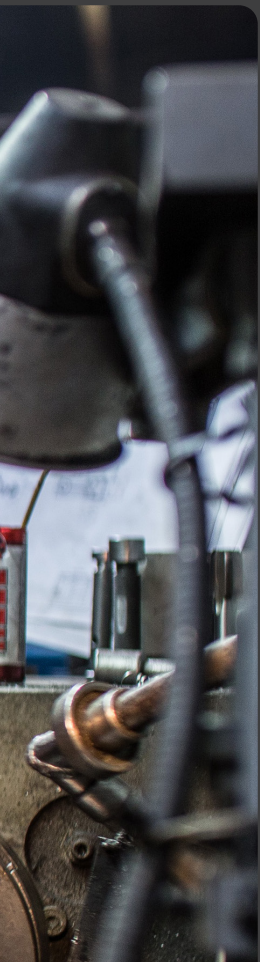
Corruption also remains a problem in Ukraine – Ukrainian businesses face some of the highest rates of corruption in Europe. This adds to the costs of SMEs, increases barriers for market entry (particularly for public procurement) and distorts competition. High corruption perceptions restrict foreign investment in SMEs.

In addition to general concerns, SMEs in the Donbas face conflict-ravaged infrastructure, with some critical objects such as power lines and water mains crossing the contact lines. While the electricity supply is reliable in the parts of the Donbas not immediately adjacent to the contact line, more intense hostilities could disrupt power supplies over a wider part of the Donbas. The largest industrial center in the government-controlled part of the Donbas, Mariupol, is very near to contact line and its outskirts are subject to shelling.

Besides, several large population centers such as Donetsk (and neighboring Horlivka/Yenakiieve), Luhansk and Alchevsk ended up on the other side of the contact line. With them vanished important markets for SMEs in the government-controlled part of the Donbas. Transporting goods is difficult with the limited capacity of rail and road links remaining under government control. Some routes come close to the conflict zone and may be damaged by fighting. Several local governments in the Donbas also pointed to insufficient start-up infrastructure, such as office/production space, business incubators and co-working spaces.

A significant number of business people were among the hundreds of thousands internally displaced persons that moved out of the Donbas entirely. Thus, there was a significant drain of entrepreneurial talent from the Donbas. This reduced the pool of potential start-ups.

Finally, SMEs in the Donbas suffer from risks added by proximity to continued fighting. There is anecdotal evidence that some companies in other parts of Ukraine are reluctant to do business with Donbas SMEs because of the risks of more intense conflict in the Donbas. Many companies have a policy not to do business with companies in the non-government-controlled part of the Donbas due to reputation and enforcement risks. SMEs in the government-controlled part of the Donbas may be swept under the broad brush of this kind of policy, as a significant number of businesses only formally moved to the government-controlled part of Ukraine.



Access to finance for Donbas SMEs

DATA LIMITATIONS

Poor access to finance and a deficit of working capital are also key obstacles cited by SMEs throughout Ukraine. There is limited numeric data to back these claims up, as neither the National Bank of Ukraine (NBU) nor Ukrstat collect figures on loan financing raised by SMEs. There are plans by the NBU to start collecting this data in 2017 or 2018.

Ukrstat does report one item: short-term bank loans (up to 12 months) in the annual balance sheet of SMEs. As only legal entities are required to submit balance sheets, loans to private entrepreneurs are excluded. Short-term bank loans to SMEs in Ukraine accounted for 66 percent of the total of such loans in 2015. This may reflect the expansive SME definition (i.e. larger medium-sized companies are likely to get funding on similar terms to large companies) and the fact that retail and wholesale trade companies are the main recipients of short-term bank financing. Some of the largest retail networks are organized as a group of medium and small companies. The figures may also be distorted by large-scale related - party lending in many of the banks that failed in 2014-2016. Many of the borrowers affiliated with bank owners fell under the definition of SMEs. This may have distorted statistical figures.

UKRAINIAN FACTORS

So far, there are several enterprise surveys, including ones conducted by the NBU, Ukrstat and the Institute for Economic Research (IER). The NBU also conducts a lending conditions survey that can be used to gauge whether obtaining a loan for SMEs has become tougher or easier. The surveys show that lending standards tightened sharply for SMEs in 2014 and 2015 and leveled slightly in 2016. In any case, the survey data indicates that getting bank loan was difficult and expensive for SMEs even before the banking crisis in 2014. The commercial property and used equipment markets are shallow in Ukraine, making it difficult for SMEs to offer liquid collateral. Many small companies have little collateral of any kind to offer. Some small businesses also have difficulty producing business plans and other documentation needed to get a loan. Access to long-term loans is even more difficult for SMEs, due to the high degree of economic uncertainty in their business plans and higher

collateral requirements. At the same time, most bank deposits have a maturity of up to 12 months. Thus, in 2010-2013 on average 17 percent of private sector investment in fixed assets was funded by borrowing, while in 2015-2016 the share of bank funding dropped to less than 10 percent.

Since 2014, the number of banks has almost halved, and the remaining banks are struggling with a large burden of bad debt. In September 2016, the banks recognized 31 percent of their outstanding debt as non-performing, but this share is expected to be higher when data is available under the more rigorous rules that came into effect in 2017. Thus, the banks booked large losses and had to increase capital to meet regulatory requirements. This restricted the supply of loans for both large business and SMEs. On the bright side, tougher requirements on related-party loans may increase the supply of loans for other borrowers.

Weaknesses in the legal system mean that borrowers at times could void a loan (with the bank losing the rights to all interest and penalties), evade paying fines on assets (by stripping assets from a company) or loan guarantees (if the main borrower had few assets but an affiliated business provided a loan guarantee). The flawed bankruptcy system meant there were few chances for recovery, even if there were assets to be recovered. This led to higher collateral requirements and increased interest rates.

Turning to the cost of borrowing: banks report moderate interest rates on corporate borrowing. In the last quarter of 2016, the average interest rate on corporate borrowing in hryvnias was 14 percent per annum, while the central bank target for 2017 inflation was 6-10 percent. However reported interest rates exclude commissions, but include loan restructurings and the interest rates of large companies that receive loans on preferential terms. Published interest rates on loans for SMEs range from 20 percent to 28 percent p.a.

Since 2008, Ukrainian banks have increasingly relied on deposits as a key source of funding, replacing external loans. The ratio of loans to deposits dropped from 2.2 at the end of 2008 to 1.25 at the end of November 2016, according to NBU data. This reduced vulnerability to capital outflows but increased funding costs for banks. This in turn increases borrowing costs for SMEs.

DONBAS



Before the conflict, SMEs in the Donbas likely had as good access to finance as in other parts of Ukraine. The NBU reported that in December 2013 nonfinancial corporations in the Donbas had 14 percent of loans outstanding, excluding loans booked in Kyiv and Kyiv oblasts, or 26 percent of loans if Dnipropetrovsk Oblast is also excluded. Loans are assigned to an oblast if they are booked by the head office of a bank from this oblast, or booked by local branch of a bank with its HQ in another oblast (large loans are often signed with the head office of a bank, and most banks have their head office in Kyiv, although the largest lender, Privatbank, has its HQ in Dnipro).

After the conflict started, the statistical picture changed dramatically. By November 2016, the share of corporate loans to the Donbas dropped to 4 percent (excluding Kyiv) and 9 percent (excluding Kyiv and Dnipro) respectively. It is difficult to estimate how much of the drop was in loans to SMEs in the government-controlled part of the Donbas. In 2013, the lion's share of loans likely went to companies on the other side of contact line but it is not clear how much of some of them remained on the banks' books in 2016. Banks frequently wait at least three years (when collection lawsuits become time-barred) before formally writing off the loan (even if it is fully provisioned).

However, we may assume that banks were not very eager to provide loans to SMEs in the government-controlled part of the Donbas. Proximity to the contact lines and weak economic activity was likely the key impediment to SME lending in the Donbas. Proximity to conflict adds to the risk of non-payment if fighting intensifies, and impaired value of collateral. Moreover, banks are prohibited from repossessing collateral located in the Donbas until hostilities end or the legislation is changed. This provision seems to apply to all loan contracts, including newly signed ones. Even if the legislation is changed, finding buyers for repossessed collateral in the Donbas would not be easy. Weak economic activity in the Donbas makes it difficult for SMEs to generate cash flow to cover debt servicing.

In 2014, all bank offices in areas outside of government control were closed, but the government-controlled part of the Donbas seems to be provided sufficiently with bank branches. At the end of 2016, some 31 banks operated in the Donbas with a total of 572

bank branches. Bank branch density in the government-controlled part of the Donbas is lower than average for Ukraine (excluding Kyiv), but only by 15 percent. At the same time, almost 75 percent of bank branches in the Donbas belong to Privatbank and Oshchadbank, which are both now state-owned. (Ukraine-wide they account for 57 percent of all branches). Most urban SMEs in the Donbas have access to at least two full-service bank branches in their town, while rural SMEs will have to travel to the nearest town or district center. However, choice may be limited, as only five more banks have more than 10 branches in 45 districts and cities of the government-controlled part of the Donbas. Seven banks with the largest number of branches working in GCAs belong to the country's top-10 banks by assets, as well as consumer deposits (See Table 2).

Table 2
Banks working in Donbas

	Total bank branches	Donetsk Oblast	Luhansk Oblast
Oschadbank	262	184	78
Pryvatbank	164	130	34
PUMB	21	20	1
Raiffeisen Bank Aval	15	11	4
Sberbank	13	11	2
Ukrsotsbank	12	9	3
Ukrsibbank	11	7	4
Other banks	74		
Total	572	431	141

Source: NBU

State-owned savings bank Oschadbank has the largest branch network in the Donbas and it moved to increase its market share in 2015-2016. In its communications, Oschadbank claims to be the only bank that has never stopped lending in the Donbas. At the end of 2015, the loan portfolio of Oschadbank branches in the Donbas (net of loss provisions) was UAH 900 million, and it had dropped to UAH 400 million by September 2016. Thus, it is unlikely that there was substantial new lending for SMEs. Oschadbank partnered with Donetsk Oblast Administration to provide loans with subsidized interest rates (with partial interest payment refunds from the oblast budget) but few loans were issued (see Table 3).

Table 3 Number of bank
branches by municipality

	Oschad	Privat	Other	Total
Mariupol	32	40	42	114
Kramatorsk	19	28	21	68
Sloviansk	14	11	10	35
Pokrovsk	9	3	9	21
Bakhmut	9	3	8	20
Konstantynivka	6	5	6	17
Toretsk	14	2	1	17
Druzhkivka	7	6	4	17
Selydove	7	4	1	12
Dobropillia	5	2	3	10
Myrnohrad	6	2	1	9
Volnovaha	3	3	2	8
Lyman	4	3	1	8
Vuhledar	1	1	2	4
Kurahove	2	2	0	4
Novogrodivka	3	1	0	4
Avdiivka	1	1	0	2
Bilytske	1	1	0	2
Bilozerske	1	1	0	2
Siversk	2	0	0	2
Soledar	0	1	1	2
Manhush	1	1	0	2
Novotroyitske	1	1	0	2
Velyka Novosilka	1	1	0	2
Nikolske	1	1	0	2
Oleksandrivka	1	1	0	2
Svitlodarsk	1	0	0	1
Mykolaiivka	0	1	0	1
Rodynske	0	1	0	1
Sviatogirsk	0	1	0	1
Ukraiinsk	0	1	0	1
Rural branches in Donetsk Oblast	32	1	0	32
Total for Donetsk GCAs	184	130	112	426

Table 3 Number of bank
branches by municipality

	Oschad	Privat	Other	Total
Severodonetsk	13	6	11	30
Lysychansk	10	6	6	22
Rubizhne	5	4	4	13
Starobilsk	6	3	2	11
Svatove	6	2	0	8
Kreminna	3	1	0	4
Novopskov	3	1	0	4
Popasna	2	1	1	4
Stanytsia Luhanska	3	1	0	4
Bilovodsk	1	1	0	2
Bilokurakyne	1	1	0	2
Markivka	1	1	0	2
Milove	1	1	0	2
Novoaidar	1	1	0	2
Troitske	1	1	0	2
Hirske	1	1	0	2
Shchastia	1	1	0	2
Rural offices in Luhansk oblast	19	1	0	21
Total for Luhansk GCAs	78	34	24	134
Total for Donbas GCA	256	157	130	543

Source: NBU

Note: The number of branches does not match in Table 2 and 3 as several bank offices still retain addresses in NGCAs, and thus were omitted from Table 3

As we can see in Table 3, Privatbank and Oschadbank are the only banks in many small towns in the Donbas. The two big banks see serious competition only in the eight largest cities of the Donbas. At the same time, it seems that almost all towns in the Donbas have at least two bank branches.

Besides banks, credit unions may provide loans to business owners (they are not authorized to lend to legal entities). Their funding is gained through member deposits and capital contributions. Their business loan portfolio is tiny, at 16,833 loans with a total debt of UAH 400 million as of September 2016 for the whole of Ukraine. Still, credit unions are well represented in the Donbas, with 83 credit unions and credit union branches registered in the government-controlled part of the Donbas as of January 2017. There are registered unions in most of the administrative divisions of Luhansk Oblast (in all except Popasna) but they are less widespread in Donetsk Oblast, where they are present only in nine cities and districts. This means that credit unions may be useful for microloans in rural areas of Luhansk Oblast, as they may help overcome some of the information asymmetries.

Efforts to support SMEs in Donbas

Most local government entities in the Donbas have support of SMEs as one of their priorities. Their efforts are usually implemented through sequences of two-year “SME support programme” approved by local councils. Most districts and all cities (oblast-level) apart from Mariupol in the Donbas have such a programme or are currently developing the 2017-2018 version of the programme.

This document is usually a few dozen pages long and follows a general template recommended by the state regulatory service. The suggested actions in these plans frequently include improvements in regulatory policy by local authorities, improvements to administrative services centers, education, training and information efforts, participation in events, better access to municipal property for SMEs and financial support for SMEs. However, local governments mostly take on coordination and administrative roles in these tasks. All of the programs reviewed included only symbolic funding from local budgets and included no grant/subsidy schemes for start-ups, business incubators etc. For example, the section on financial support for SMEs (present in most programme) primarily refers to work done by the local state employment center (as mandated by law) and/or donor funding. Work on administrative services centers is funded from the other sources.

At the same time, local employment centers of the state employment service are among the few government bodies that spend money on supporting SMEs. Employment centers fund training for prospective business owners, offer advice on business plans and provide lump sum payouts of unemployment benefits to the unemployed that have successfully defended their business plans. Under this scheme, the unemployed may receive all unemployment benefits they are eligible to receive in one payment if they do not find a new job. Any payments already received are deducted from this sum and payment is capped at 360 days of unemployment benefits. As maximum monthly unemployment benefit in Jan-Apr 2017 is UAH 6,400, a lump sum payment may not exceed UAH 75,747 or approximately EUR 2,600. This is a modest sum, but it may be sufficient to cover some of a startup's costs, particularly if it is outside of a high-cost urban area.



AS MAXIMUM MONTHLY
UNEMPLOYMENT BENEFIT
IN JAN-APR 2017 IS

UAH 6,400



A LUMP SUM PAYMENT
MAY NOT EXCEED

UAH 75,747

OR APPROXIMATELY EUR 2,600

According to Donetsk and Luhansk Oblast administrations, 80 persons received lump-sum unemployment benefit payments in the first half of 2016 to open new business in the Donbas. UAH 1.6 million was spent on payouts. This number is smaller than in previous years, possibly due to the higher costs of opening a business. Employment centers also serve existing SMEs by training unemployed people in the professions required by SMEs, helping them to fill vacancies. They also offer subsidies to companies that are willing to take on “priority” unemployed people. A company that provides jobs for priority applicants for 24 months receives a refund on their Single Social Contribution (SSC) for 12 months.

Based on average monthly wage of UAH 5,638 in the Donbas (in November 2016) and a 22 percent rate of SSC, the subsidy can average up to UAH 15,000 per sponsored employee. Over the first nine months of 2016, employment centers in the Donbas helped to create 828 jobs via this scheme. Donetsk Oblast also had an oblast programme to support SMEs for 2015-2016. As of January 2017, no new programme has been approved. The key activities in the 2015-2016 programme included continuing funding for administrative services centers, administrative support for donor-funded/ NGO initiatives, coordination of local authorities regarding potential industrial parks, information support and participation in conferences and round tables, support for farmers’ markets, and educational support for high school and university students. Most of these efforts were funded from general wage appropriation for oblast administration officials.



Donetsk Oblast also had a regional programme to support SMEs for 2015-2016. As of January 2017, no new programme has been approved.



80 persons

RECEIVED LUMP-SUM
UNEMPLOYMENT BENEFIT PAYMENTS
IN THE FIRST HALF OF 2016 TO OPEN
NEW BUSINESS IN THE DONBAS.



UAH 1.6 m

WAS SPENT ON PAYOUTS



BASED ON AVERAGE MONTHLY
WAGE OF UAH 5,638 IN THE
DONBAS (IN NOVEMBER 2016)
AND A 22 PERCENT RATE OF SSC,
THE SUBSIDY CAN AVERAGE UP TO

UAH 15,000

PER SPONSORED EMPLOYEE



828 jobs

CREATED VIA THIS SCHEME

DONETSK OBLAST
ADMINISTRATION IN 2016
BUDGETED**UAH 100 m**TO SUBSIDIZE INTEREST
COSTS FOR SME LOANS

IN 2017, ONLY

**UAH 0.5 m**WAS BUDGETED FOR INTEREST
SUBSIDIES IN DONETSK OBLASTTHIS MAY MEAN THAT NO NEW
SMEs WILL RECEIVE SUBSIDIES IN
2017.

Donetsk Oblast Administration in 2016 budgeted UAH 100 million to subsidize interest costs for SME loans. Donetsk Oblast offered to cover up to 50 percent of interest costs for SMEs, with payments capped at 14 percent p.a. (the discount rate of the NBU) and a total of UAH 200,000 per application. There were eight successful applications by October 2016, all from agricultural firms, with a total loan size of UAH 20 million. This may reflect distrust in state-administered support programs, and barriers (such as business plan and collateral difficulties) reducing loan demand from SMEs in the Donbas. Interest subsidies in 2016 will likely be much lower than the planned UAH 100 million. In 2017, only UAH 500,000 was budgeted for interest subsidies in Donetsk oblast. This may mean that no new SMEs will receive subsidies in 2017. However, the Donetsk Oblast budget may be amended by the head of oblast administration at any time and the planned sum may be increased.

Luhansk Oblast has a 2016-2017 SME support program. The key actions that are funded under the programme include advice to SMEs on business strategy, the preparation of investment projects, organizing investment forums and creating a revolving fund that would offer direct loans to SMEs. The programme suggests that UAH 40 million is to be spent on this fund in 2017. There is little further detail on how this fund is to work. Luhansk Oblast also funds vocational education for skilled labourers under its SME support program. The programme also contains a lot of "business as usual" items, such as preparatory work for technology parks, coordinating of SME support efforts by the local chamber of commerce and educational institutions, an ongoing review of local regulatory acts, and a review of the educational needs of SMEs.

LUHANSK OBLAST HAS A 2016-
2017 SME SUPPORT PROGRAM

THE PROGRAMME SUGGESTS THAT

**UAH 40 m**IS TO BE SPENT ON REVOLVING
FUND IN 2017

Donetsk SMEs also have access to funding from a variety of international financial institutions, UN system organizations, international charity organizations, and bilateral aid agencies. The list of international partners includes the EBRD, EIB, UNDP, IOM, USAID, EU, PIN, and the German-Ukrainian fund. Some of the international partners offer funding for SMEs all over Ukraine, while others focus on the Donbas and neighbouring oblasts. Funding and support opportunities for all Ukrainian SMEs include low-cost loans under the EIB-Ukreximbank SME and midcap financing facility, access to the EU COSME (excluding financing options) and InnovFin¹ facilities, WNISEF subsidized 5 percent p.a. loans to social SMEs from Oschadbank, assistance in preparing credit applications and credit enhancement under the EU/EBRD EU4Business initiative, and funding for agribusiness SMEs by the

EFSE.

The World Bank is now considering an Access to Long-term Finance Project, which is supposed to enhance the access of Ukrainian SMEs to long-term financing, which is the most difficult for them to receive. In fact, no Donbas companies received loans with over five years' maturity in 2016.

IN 2016, UNDP CONDUCTED
TRAINING SESSIONS FOR SMES
AS WELL AS AN SME GRANT
COMPETITION.

THE SIZE OF THE GRANTS
RANGES

FROM **USD 250**
TO **USD 2,500**

In 2016, UNDP conducted training sessions for SMEs as well as an SME grant competition in the Donbas. A number of charity organizations and the IOM, with financial support from the United States, the UK and other international partners, provide livelihood assistance for IDPs and residents of conflict-affected areas. The charity organizations include Mercy Corps, Caritas International, Save the Children, and the Danish Refugee Council.

One of the key tracks of assistance is microbusiness grants, where modest sums of money are provided as grants to promote self-employment and the opening of microbusiness. The grants are frequently combined with training sessions to help prepare aspiring entrepreneurs for their new vocation. This is sometimes done in cooperation with local employment centers. The size of the grants is relatively small, and ranges from USD 250 to USD 2,500.

As most of these projects are still at the implementation stage, it is difficult to assess the contribution of international partners in supporting Donbas SMEs. Nevertheless, they provide the most options for cheap or even free financing, or advice for Donbas SMEs.

Conclusions and recommendations

In general, SME development in Luhansk and Donetsk oblasts has encountered the same problems as in other Ukrainian regions. At the same time, the situation here has been exacerbated by the armed conflict.

CONSIDERING THESE AND OTHER CIRCUMSTANCES, THE FOLLOWING RECOMMENDATIONS HAVE BEEN FORMULATED:

- The moratorium on the repossession of collateral for companies in the Donbas needs to be repealed, at least for new loans to companies in GCAs: it remains a major obstacle for bank lending, especially after the tightening of rules on provisioning.
- (Some) added flexibility on provisioning for Donbas companies may be useful – i.e. allowing banks to assume that the contact line will not move significantly.
- International partners may still need to lend directly to SMEs or at least assume some of the credit risk, as collateral will still be poor.
- Micro-startup funding needs to be better covered. While government and charities provide funding and self-funding is not impossible, existing SMEs seem to have very few options.
- Better coordination among international partners to support social, women's and youth entrepreneurship would be helpful.



- Re-integration programmes may be needed to support business people returning to the Donbas from other parts of Ukraine. This should help expand the business community in the Donbas.
- Local governments should take the lead in supporting SMEs. Donetsk and Luhansk Oblast loan programmes may serve as pilots. Joint funding by oblast and local governments and international partners is worth considering after successful trials.
- Local governments, together with representatives of the financial community, should promote the idea of partnership among SMEs. Such a partnership should be viewed as a tool to jointly apply for financial resources, etc.
- A special financial risk insurance programme tailored to the needs of regional SMEs could be an option. This programme could be financed by the central and local governments, and international partners.
- Advisory services for SMEs in the preparation of significant credit applications and drafting business plans can help SMEs be more successful in applying for bank credits.
- Priorities for support may include intermediate-scale investment projects (small and lower-medium) that are too large for micro-grants, but too small for EBRD/EIB programmes.
- Preference may also be given to businesses with wider market reach, i.e. Ukrainian or international markets.
- Oschadbank and Privatbank are natural partners for any SME support programme attempting to reach small towns in the Donbas.
- Credit unions may also be considered as partners for Luhansk Oblast, especially if credit unions are permitted to provide direct funding to small enterprises.

Annexes

Annex 1:

Definition of government-controlled part of the Donbas

A practical definition of the government-controlled part of the Donbas is used. For the purposes of this research, the GCA includes administrative units (district- and oblast-level cities) of Donetsk and Luhansk oblasts with working government administrations at the time of writing of the report.

In Luhansk Oblast the GCA includes three cities: Lysychansk, Rubizhne and Severodonetsk and 12 districts with centers in Bilovodske, Bilokurakyne, Kreminna, Markivka, Milove, Novoaidar, Novopiskov, Popasna, Svatove, Stanytsia Luhanska, Starobilsk and Troyitske.

In Donetsk Oblast the GCA includes the following 15 cities: Avdiivka, Bakhmut, Vuhledar, Dobropillia, Druzhkivka, Konstantynivka, Kramatorsk, Lyman, Mariupol, Myrnohrad, Novohrodivka, Pokrovsk, Selydove, Sloviansk, and Toretsk. Donetsk GCA also includes 13 districts with centers in Avdiivka, Bakhmut, Velyka Novosilka, Volnovakha, Dobropillia, Konstantynivka, Lyman, Maryinka, Manhush, Pokrovsk, Sloviansk and Yasynuvata (de jure, de facto center in Ocheretyne).

Annex 2:

Key business statistics in Donbas administrative divisions

	Number of enterprises	Number of employees	Labour costs, UAH	Sales, UAH	Controlled
Luhansk Oblast	3,354	110,977	5,033,173	34,583,991	
Cities					
Luhansk	325	4,464	131,002	2,106,523	
Antratsyt	8	152	4 651	13 801	
Brianka	2	● conf	● conf	● conf	
Holubivka	3	1	1	5	
Alchevsk	103	13,673	656,148	8,182,120	
Sorokyne	6	167	4,931	36,242	
Khrustalne	28	9	163	1,460	
Lysychansk	393	12,565	662,429	1,273,963	● Yes
Pervomaisk	6	21	452	21,235	
Rovenky	2	● conf	● conf	● conf	
Rubizhne	202	5,389	244,453	4,267,511	● Yes
Dovzhansk	8	90	2,474	5,981	
Severodonetsk	823	49,840	2,369,740	11,384,915	● Yes
Kadiivka	29	2,472	54,753	315,824	
Districts (listed by district center)					
Antratsyt	2	conf	conf	conf	
Bilovodske	157	1,451	37,220	401,787	● Yes
Bilokurakyne	87	1,143	40,996	380,268	● Yes
Sorokyne	1	● conf	● conf	● conf	
Kreminna	206	1,766	49,246	478,635	● Yes

	Number of enterprises	Number of employees	Labour costs, UAH	Sales, UAH	Controlled
Lutuhyne	2	● conf	● conf	● conf	
Markivka	44	871	28,447	300,244	● Yes
Milove	63	272	5,780	171,823	● Yes
Novoaydar	87	1,143	40,288	348,019	● Yes
Novopskov	81	1,021	28,688	483,964	● Yes
Perevalsk	2	conf	conf	conf	
Popasna	54	7,044	326,167	833,582	● Yes
Svatove	214	2,005	60,429	1,182,722	● Yes
Slovianoserbsk	2	● conf	● conf	● conf	
Stanytsia Luhanska	56	811	19,208	153,266	● Yes
Starobilsk	260	2,606	74,468	737,038	● Yes
Troytske	98	1,204	41,257	579,269	● Yes
Donetsk Oblast	11,763	408,080	24,732,942	325,495,152	
Cities					
Donetsk	2,665	93,065	7,024,486	101,394,178	
Avdiivka	22	3,819	305,094	13,639,490	● Yes
Bakhmut	477	12,840	673,735	6,577,148	● Yes
Horlivka	116	775	29,504	300,368	
Debaltseve	1	● conf	● conf	● conf	
Toretsk	62	4,682	234,399	440,702	● Yes
Myrnohrad	104	8,329	492,107	762,419	● Yes
Dobropillia	135	16,217	1,161,441	6,226,919	● Yes
Dokuchaivsk	10	2,002	82,334	66,798	
Druzhkivka	348	14,252	457,457	7,777,824	● Yes
Yenakiyive	56	1,392	89,957	1,744,210	
Zhdanivka	6	7	121	74	
Mariupol	2,818	105,315	6,463,871	98,549,705	● Yes
Khrestivka	0	0	0	0	
Konstantynivka	293	8,839	315,201	5,946,594	● Yes
Kramatorsk	1,130	47,843	2,436,775	30,499,473	● Yes

	Number of enterprises	Number of employees	Labour costs, UAH	Sales, UAH	Controlled
Pokrovsk	231	17,135	1,371,017	6,275,775	● Yes
Lyman	100	1,130	31,145	377,064	● Yes
Makiivka	299	7,796	371,490	4,453,061	
Novohrodivka	14	207	5,239	42,498	● Yes
Selydove	137	11,291	746,746	5,260,450	● Yes
Sloviansk	738	9,584	319,254	3,203,019	● Yes
Snizhne	15	273	1,224	2,364	
Chystiakove	21	18	647	6,678	
Vuhledar	42	6,627	493,811	968,444	● Yes
Khartsyzk	27	59	769	15,476	
Shakhtarsk	31	15	333	7,346	
Yasynuvata	24	121	1,886	10,469	

Districts (listed by district center)

Oleksandrivka	63	698	20,880	362,860	● Yes
Amvrosiivka	0	0	0	0	
Bakhmut	213	3,093	124,381	1,729,725	● Yes
Velyka Novosilka	170	1,258	38,619	468,154	● Yes
Volnovaha	306	6,651	270,125	3,248,510	● Yes
Nikolske	169	1,342	45,073	550,299	● Yes
Dobropillia	119	971	56,501	1,576,810	● Yes
Konstantynivka	110	2,673	117,601	1,659,857	● Yes
Pokrovsk	92	3,362	200,531	2,296,671	● Yes
Lyman	94	432	9,095	259,990	● Yes
Maryinka	155	8,699	570,164	16,982,779	● Yes
Novoazovsk	0	0	0	0	
Manhush	151	1,027	23,020	256,037	● Yes
Sloviansk	153	1,628	39,797	672,515	● Yes
Starobesheve	16	2,043	87,732	399,128	
Boykivske	0	0	0	0	
Shakhtarsk	2	● conf	● conf	● conf	
Yasynuvata	28	562	19,286	483,094	● Yes

