

BUSINESS INNOVATIONS AND STRUCTURE OF CORPORATE OWNERSHIP IN UKRAINE

by Alexander Kostyuk¹

Abstract

Purpose of this paper is to test a link between the type of corporate ownership and business innovation activities, with application to Ukrainian joint stock companies. This objective is achieved through conducting a series of observations of 42, the largest companies of metallurgy and machine-building industries for the years 1998-2001. The theoretical scope of the paper is to identify motives of owners in Ukraine, affecting their views on an innovation policy of companies they own. We found that approaches of various groups of owners to the innovation policy differ and depend on the motives of their behavior at the market for corporate control. Thus, executives, owing companies, try to keep the control in their hands to set an abnormally high remuneration. This leads to the lack of funds to finance innovation project because of cash flows reduction and absence of intentions to issue equity. The value of this paper is that this explains an impact of ownership structure on market opportunities of companies via an impact on the business innovation parameters.

Key words: business innovations, corporate ownership structure, research and development expenses, corporate control

Introduction

There is a lack of scientific research to establish whether type of ownership influences innovation decisions and activity of the companies, or not. The first economist who considered indirectly a link between the type of corporate ownership and innovation activity was S.Myers (Myers, 1998). The author of the theory of asymmetry of information insisted that performance of corporate governance depends mainly on the way principals and agents communicate with each other. According to Myers, in the case of inefficient communications management, shareholders face a problem of asymmetry of information. Asymmetry of information is a difference in content and volume of information belonging both to shareholders and managers, which concerns recent corporate financial performance and market opportunities of the company. With reference to the theory of asymmetry of information it is possible to conclude that problems of asymmetry of information do not disappear even when relations between managers and shareholders are free of conflicts. To improve its transparency, a company should use signals, such as dividends, stock repurchases

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and investment. The last signal - investments - is effective in the case if the company with many of investment projects, for example in the field of innovations. That is why, innovation can execute a function of informational signal, improving transparency of the company.

A. Radyghin (1999) is sure that transformation of ownership structure in such countries in transition as Russia is followed with a transformation of the approach of owners to innovation. He said that "as a result of transformation, all companies will be divided by some groups by degree of transparency. It is obvious that the most transparent companies will experience higher returns as a result of innovation. In turn innovation will make the companies more transparent".

R. Kapeliushnikov (Kapeliushnikov, 1994), Russian specialist in the field of innovations, says that "the transformation of corporate ownership structure in Russia under the process of privatization can be taken as a positive trend in the Russian economy only if transformation of ownership types is followed by transformation of views of owners about innovations".

A. Adamchyuk (2000), Ukrainian expert in corporate governance, said that Ukrainian owners are not inclined to undertake many of risks, related to innovations "because owners are not equipped with the required instruments of innovation management".

Methodology of research

A very detailed investigation of the most active Ukrainian joint stock companies has been undertaken by the author. The following items have been researched:

- ownership structure;
- financial statements elements (earnings, sales, volume of export of goods and services, operating expenses and structure of operating expenses, degree of depreciation of fixed assets, size of fixed assets).

Total number of the companies under research is 42. They belong to the most developed industries - metallurgy and machine-building. The complete list of the companies under research is provided in appendix 1. The period of investigation is from 1998 to 2001. The following data sources have been used to conduct investigation:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trade System in Ukraine;
- stock market reports, developed by famous Ukrainian investment companies.

The procedure of research consists of the following stages.

The first stage is to determine a role of the companies under research in economic and social development in Ukraine.

The second stage is to assess the importance of innovation for the companies under research.

The third stage is to research ownership type of the companies.

The fourth stage of research is to find out whether company ownership type influences innovation efforts of the companies.

Finally, the fifth stage is to describe the correlation between ownership type of Ukrainian companies and the innovation policy, followed by them.

Results of research

The first stage - the role of the companies under research in economic and social development in Ukraine

The contribution of the companies under research in economic development in Ukraine can hardly be over-estimated. The companies under research account for about 10.4 per cent of gross domestic product. Their contribution in export of goods and services is 15.3 per cent. They employ 5.6-5.8 per cent of active population in Ukraine (see table 1).

Table 1. Contribution of Ukrainian companies under research to economic and social development in Ukraine

Economic and social development measures	A contribution of the companies under research to economic and social development in Ukraine, per cent			
	1998	1999	2000	2001
GDP	10.2	9.9	10.1	10.4
Export of goods and services	17.4	16.3	15.1	15.3
Employment	6.3	5.9	5.6	5.8

All of these companies are represented in the rating "top 100 Ukrainian companies", developed by Investment Gazette (Investment newspaper). The average sales, achieved by the company under research are far over HRUA 100 mln. (US\$ 19-20 mln.).

Many of these companies compose a list of so named "strategically important" companies, developed by Ukrainian government. 22 of the companies under research were included by Ukrainian government in this list. The remaining eight companies in the list represent mainly the power-generating and distributing industry. These companies have not been researched because all of them are still under control of the State.

The second stage - the importance of innovation to the companies under research

Despite the very remarkable contribution of the companies under research to economic and social development in Ukraine, they have experienced many problems. The main problem is a very high degree of depreciation of fixed assets. Average book value of fixed assets (calculated on average company under research) is HRUA 240 mln. (US\$ 45 mln.). From the beginning of the process of privatization, many of the companies under research were experiencing an increase in the degree of depreciation of fixed assets (see table 2). Thus, at the beginning of 1998 an average degree of depreciation of fixed assets of the companies was 46 per cent. At the beginning of 2002 a degree of depreciation increased remarkably (up to 63 per cent).

Table 2. Dynamics of depreciation of fixed assets, the share of cost of energy in cost of sales and number of companies which reported losses

	By the end of period			
	1998	1999	2000	2001
Accumulated depreciation of fixed assets, %	46	49	55	63
The share of cost of energy in cost of sales, %	38	36	37	39
Number of companies, reported losses	13	9	2	0

A. Korpinsky (2000), Head of Management Board of investment company "Kinto" said that "at this time Ukrainian companies, representing metallurgy industry, are still "blue-chips" of Ukrainian stock market. These companies are real leaders of the stock market mainly because they are exporters. I think that Ukrainian companies of metallurgy industry may lose their leading position at the stock market if they do not reconsider their approaches to innovation. These companies should invest much more in research and development to reduce operating expenses which are very high in comparison to companies in Poland, Czech Republic or Hungary".

Technology of manufacturing is still a very energy-consuming. The share of cost of energy in metallurgy is about 35-40 per cent in total cost of sales. In Poland companies in metallurgy have adopted advanced technology of production through the implementation a strong innovation strategy. As a result, the share of cost of energy in metallurgy production costs in Poland is much lower than in Ukraine (about 16-18 per cent).

Degree of depreciation of fixed assets of companies under research has increased despite an improvement of financial performance of the companies. Thus, at the beginning of 1998 some of the companies under research were not profitable. 13 of 42 companies experienced negative profitability. At the beginning of 2002 all of the companies were profitable.

N. Terletsky (2001), Head of Management Board of investment company "Sokrat" said that "simultaneous increase in earnings and degree of depreciation of fixed assets of Ukrainian companies of metallurgy industry is very negative signal to the market. It seems that Ukrainian companies are ill hopelessly. They do not want to solve the problem of depreciation of fixed assets through the injection of innovation and new technology".

The third stage - research on ownership type of the companies

Corporate structure in Ukraine experienced many of changes during process of privatization, which has taken place over the last ten years. The process of privatization can be divided into stages, three of which were over by 1998.

In the first stage the privatization in Ukraine was very liberal: only those companies that wanted to be privatized, were privatized. So, the first stage was given over to the will and intentions of Ukrainian companies.

On completion of the first stage in 1995, the second stage was initiated by the state authorities. During 1995, the Ukrainian parliament was troubled with finding the best methods of privatization. As a result of the hesitation of the Ukrainian parliament, the process of privatization slowed down.

In November 1995 the President of Ukraine, who was not satisfied with the work of parliament of Ukraine, initiated the third stage of privatization. The third stage was named "mass privatization". All citizens of Ukraine obtained so called "vouchers" which certified their right of ownership of the state property. According to many experts, mass privatization had a very negative impact on development of corporate sector in Ukraine. Individual investors - citizens of Ukraine - had no skills or desire to manage assets they own.

In April 1996 tender offers of the state property were initiated. The state authorities planned to attract the attention of foreign investors to the state property, who could come to Ukraine with huge financial resources. Moreover, the state authorities wanted to obtain the real, market value of the state property to be privatized.

From the beginning of 1999, mass privatization got to gathering features of process of investment. Large foreign institutional investors have come to Ukraine with real, not virtual investments. The last stage of privatization named as "industrial" privatization started at the end of 1999. That time the President of Ukraine issued a fiat according to which only industrial companies from Ukraine or abroad could take part in tender offerings of shares of Ukrainian companies which must be privatized. Regrettably, no fundamental research had been undertaken since 1999 in the field of corporate governance in Ukraine, especially it concerns changes in the structure of corporate ownership.

At the beginning of 2002 many companies under research have a very concentrated ownership structure. Taking into account that metallurgy and machine-building are industries of strategic importance for the State, the very powerful Ukrainian financial-industrial groups (FIG) are very active in grasping a corporate control over these companies. At the beginning of 2002 many companies under research (31 of 42 companies) were controlled mainly by Ukrainian financial-industrial groups. Moreover, many of these 31 companies were controlled by one Ukrainian financial-industrial group named as "Donezk region group". A profile of this financial-industrial group is given in appendix 2.

The quick process of a capital generation, which started in the end of 80's, facilitated development of cooperatives. Cooperators, who earned much profit very quickly, moved from industrial production to financial services sphere. As a result of such transformation, criminal capital was mixed with the capital of cooperators to establish new form of business organization - financial-industrial groups. Founders of financial-industrial groups aspired to obtaining access to political levers of economic process regulation by any means. Ukraine becoming independent provided to these men a good chance. Elections to the parliament of Ukraine were not free and but based on corruption to let these people be elected. As soon as they become parliamentarians, they started to protect their business interests. They obtained a label "Oligarkhs".

At the beginning of 90s' the process of privatization started. Oligarkhs regulated the process in the way, which would meet their business interests. They bought whole Ukrainian companies at the lowest price (A. Krakovsky, 2000). He insisted that large shareholders do not follow the corporate governance best practices. They do not care about transparency and responsibility. Moreover, minority shareholders are helpless, because they are not protected by the legislation, they are not equipped with knowledge of corporate governance

mechanisms and they are not used to consolidate they minority power to run companies in their interests.

Uncertain origin of their initial capital forced financial-industrial groups to run their business in an opaque manner. Public information about Ukrainian FIG does not allow market participants detect whether a certain market participant is FIG or not.

Mechanism of concentration of corporate ownership structure in Ukraine during 1998-2001 is illustrated by next figure.

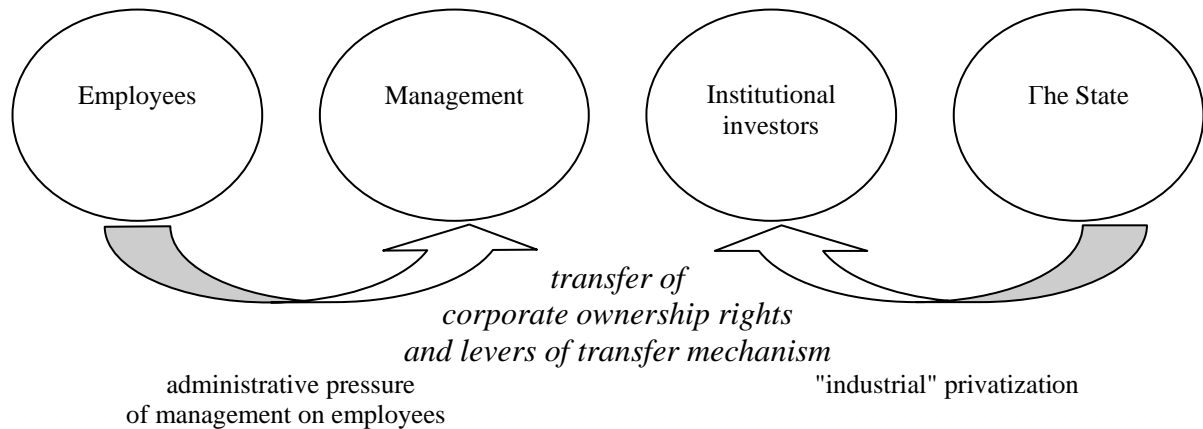


Fig.1. A mechanism of concentration of corporate ownership structure in Ukraine during 1998-2003

With reference to figure below, it may be concluded that during 1998-2001, corporate control over the companies under research moved from employees to Ukrainian financial-industrial groups and executives.

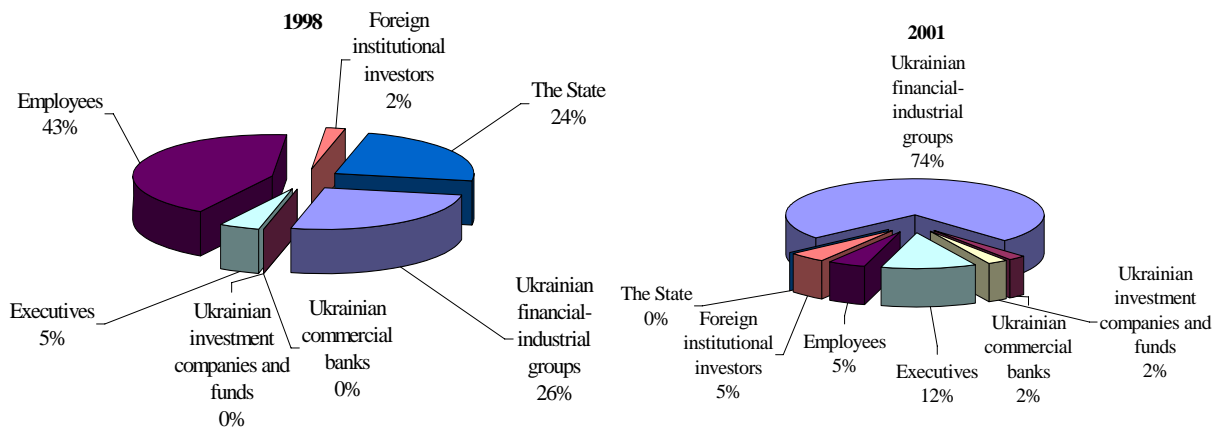


Fig. 2. Structure of corporate ownership in Ukraine

Thus, at the beginning of 1998 only 11 companies were under control of Ukrainian financial-industrial groups and only two companies were controlled by executives. At the beginning of 2002 the number of companies under research, controlled by Ukrainian financial-industrial groups and executives had increased up to 31 and 5 companies respectively. The number of companies controlled by employees decreased from 18 to 2 companies.

The fourth stage - influence of ownership type of the companies on innovation efforts of the companies

One of the most effective indicators of efforts of the companies in the way of innovation is the level of research and development expense and the proportion of these expenses in the total operating expenses.

With reference to table 3, it may be concluded that there is a strong dependence of innovation efforts on ownership type of the companies.

Table 3. Pay-out ratios at the companies under control of various groups of shareholders

Groups of stakeholders	Pay-out ratios, %			
	1998	1999	2000	2001
Executives	21	25	24	22
Commercial banks	-	-	32	35
Ukrainian investment companies and funds	34	37	36	41
Foreign institutional investors	26	24	27	28
Ukrainian financial-industrial groups	35	36	48	57

Foreign institutional investors, as controlling owners, are much more inclined to bear research and development expenses than those companies, controlled by Ukrainian financial-industrial groups or executives. The share of research and development expenses in operating expenses in the companies under control of foreign institutional investors is 39 per cent, in comparison to 27 per cent at the companies under control of Ukrainian financial-industrial groups.

A. Korpinsky (2000), Head of Management Board of investment company "Kinto" said that "foreign owners try to manage the companies in the way to be one step ahead to competitors. Almost always foreign owners begin with development of concept to manage innovation. I think that this is very strong signal to the market".

At the same time at the companies, controlled by executives the share of general and administrative expenses is very high (25 per cent). This is higher than the share of research and development expenses (21 per cent). Companies are inclined rather to increase sales and marketing expenses than research and development expenses.

The fifth stage - describing reasons which make ownership type of Ukrainian companies be correlated to innovation policy, followed by the them

The best way to describe reasons to correlate ownership type of Ukrainian companies to innovation policy followed by them is to study the motives of large shareholders.

The main objective of purchasing shares by executives is obtaining a total control over the compensation policy. At the companies under control of executives, executives can compensate their passive behavior at the stock market by fixing the compensation to themselves at a high level. This hypothesis is supported by data of table 4. The share of general and administrative expenses in operating costs in the companies, under control of executives is much higher than in the companies, controlled by foreign institutional investors.

Table 4. Structure of operating expenses in Ukraine

Groups of controllers	Structure of operating expenses, %			
	R&D	Sales & Marketing	General & Administrative	Total
Executives	21	54	25	100
Employees	23	56	21	100
Foreign investors	39	47	14	100
Ukrainian financial-industrial groups	27	51	22	100
Ukrainian commercial banks	29	53	18	100

The last finding does not support a Mehran's hypothesis, according to which the higher concentration of corporate ownership structure by management, the lower they are concerned with size of compensation they obtain, as they have an opportunity to gain stock return and cash dividends.

That is why executives of the companies, where they are shareholders, do not want to maximize net income, because in this event they will have share net income with other shareholders through paying dividends in cash. The pay-out ratio is only 22 per cent.

Besides this, increase of the share of management in corporate ownership structure in Ukraine is followed with changes in capital structure of Ukrainian companies. During 1998-2003, these companies were passive in equity issuing. Only 6 per cent of companies with ownership structure, concentrated by executives, issued equity. Companies with dispersed ownership structure attracted almost 9 per cent of financial resources through equity issuing. Thus, executives were concerned rather about preserving corporate control than issuing equity to finance innovation projects.

Under such circumstances it is hardly possible to suppose that executives will maximize their efforts in the way of research and development through investing in innovation.

N. Terletsky (2001), Head of Management Board of investment company "Sokrat" said that "we avoid investing in the companies where executives are owners. They do not realize meaning of such words as diversification, innovation and transparency".

In contrast to executives, Ukrainian financial-industrial groups are driven by other motives when they purchase large blocks of shares of Ukrainian companies.

First of all, with reference to table 3, it is possible to conclude that it is precisely the Ukrainian FIGs are mostly inclined to invest in companies with the purpose of obtaining cash dividends in the short term.

For the second, many Ukrainian financial-industrial groups are headed by famous men in power (politicians). They buy Ukrainian companies to have strong influence of economic and political situation in Ukraine.

Moreover, coming to the company of large institutional investors is not accompanied with improvement in efficiency of corporate monitoring. It can be explained by their concern to keep their activity "in the shade".

Considering the wish of Ukrainian financial-industrial groups to pay dividends it may be concluded that the companies under their control experience very low level of reinvestment. This factor is a strong barrier on the way of development of innovation in the companies.

Moreover, weak transparency of their companies can erode any success of these companies in the way of development of innovation. Such companies are not transparent to customers. So, innovation, developed and applied by the companies, will not be detected and valued by the market.

The most appropriate sample of such kind of financial-industrial group is FIG "Finance and Credit".

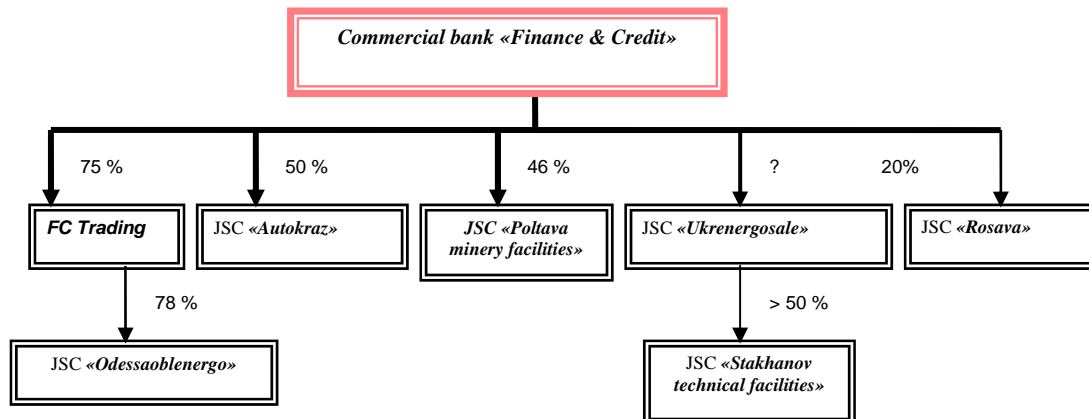


Fig. 3. Financial-industrial group "Finance and credit"

FPG "Finance and Credit" is owned by parliamentarians Mr. Konstantin Zhevago and Mr. Alexey Koucherenko. They are a sample of "oligharks" in Ukraine. All transaction are effected via bank "Finance & Credit". The motive of acquiring ownership is speculative. FIG "Finance & Credit" does not try to integrate its efforts in any particular industry. They buy equity of well-performing companies to obtain dividends in cash in short-run, and sell the companies in middle-run. Therefore, they are not concerned with investing in innovative projects, that, as a rule, gain a return in long-run

Foreign institutional investors are much more inclined to have innovative approach to governing the companies they control.

First of all, the share of research and development expenses in total amount of operating expenses of the companies, controlled by foreign institutional investors is quite high (39 per cent). The share of general and administrative expenses is very low (14 per cent). This means that foreign institutional investors want to follow an aggressive business strategy, where the key element is innovation.

The best example is JSC "Melitopol steel facilities". In 1999, before coming to the company foreign investors the share of research and development expenses in total volume of operating expenses was about 9 per cent. After coming to the company foreign investors the share of research and development expenses increased to 32 per cent.

For the second, foreign institutional investors are much more active in financing the companies' activity with equity, which can be considered in Ukraine as financial innovation. During 1998-2001 each company, under control of institutional investors effected three issues

of new equity. During the same period of time, each company controlled by Ukrainian financial-industrial groups and executives issued new equity only 0.9 and 1.1 times respectively.

The best example is JSC "Altchevsk Coke plant". The company effected four issues of new equity during 1995-1999. After coming to the company in 1999 one of the most powerful FIGs in Ukraine the company has not effected new equity issues. Financial leverage ratio increased from 0.1 to 0.5.

As a result of their very progressive approach to innovation, companies under control of foreign institutional investors report much better financial results than those, under control of Ukrainian financial-industrial groups or executives. The cost of equity, issued by companies under control of foreign institutional investors is equal to 16 per cent. The cost of equity, issued by companies, controlled by Ukrainian financial-industrial groups and executives is equal to 34 and 27 per cent respectively.

Conclusion

Companies where the process of transformation of the structure of corporate ownership still has a lasting effect, still suffer from under-evaluation by their shareholders of the importance of innovation. The old planned economy, a heritage of Ukrainian business, still strongly influences the way of business running in Ukraine. Many of Ukrainian companies consider innovation as a factor of risk which is not justified. Moreover, through conducting a strong innovation strategy, the company becomes more transparent. That is why, the largest controllers of Ukrainian companies - Ukrainian financial-industrial groups and executives - try to exclude the word "innovation" from the lexicon of businessman. They do not want the market to identify origin of their capital, their investment motives and business strategies.

It is obvious that shareholders of Ukrainian companies are interested in business innovation only if they are interested in increasing transparency of companies they control. Regrettably, only foreign institutional investors know the real value of transparency.

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A list of companies under research

1. JSC "Azovstal"
2. JSC "Khartyzsk pipe plant"
3. JSC "Dneprovsky pipe plant"
4. JSC "Novomoskovsk pipe plant"
5. JSC "Poltavsky GOK"
6. JSC "Danko"
7. JSC "Altchevsk Coke Plant"
8. JSC "Zaporozhstell"
9. JSC "Frunze plant"
10. JSC "Severny GOK"
11. JSC "Donetzk metallurgical plant"
12. JSC "Enakievsk Coke Plant"
13. JSC "Illytcha metallurgical plant"
14. JSC "Enakievsk metallurgical plant"
15. JSC "Altchevsk metallurgical plant"
16. JSC "Panteleimonovsk plant"
17. JSC "Avdeevsk Coke plant"
18. JSC "Energomachspezsteel"
19. JSC "Dnepropetrovsk metallurgical plant"
20. JSC "Lougansk metallurgical plant"
21. JSC "Donetzk steel facilities"
22. JSC "Makeevcoal"
23. JSC "Melitopol steel facilities"
24. JSC "Donetzk pipe plant"
25. JSC "Centrolit"
26. JSC "Artiomovsk steel facilities"
27. JSC "Krasnodoncoal"
28. JSC "Debaltzevo steel facilities"
29. JSC "Avdeevsk steel facilities"
30. JSC "Makeevsky metallurgical plant"
31. JSC "Kremenchiuk metallurgical plant"
32. JSC "Zaporozhiye ferro-alloys facilities"
33. JSC "Dneprospezstal"
34. JSC "Dneprodzerzhinsk metallurgical pant"

35. JSC "Dneprodzerzhinsk Coce plant"
36. JSC "Krivoy Rog metallurgical plant"
37. JSC "Krivoy Rog Coke plant"
38. JSC "Kremenchiuk Coke plant"
39. JSC "Zaporozhye metallurgical plant"
40. JSC "Donetzk Coke plant"
41. JSC "Mariupol Coke plant"
42. JSC "Marganetzky GOK"

Donetzk region group

Brief comments

The most powerful FIG in Ukraine. Its capital turnover is correspondent to turnover of leading European FIGs. DRG started to expand their business from regional to country level in 1999. Its interests are lobbied by some ministers. DGR established Donetzk Regional Energy Company to expand their influence to energy generating and distributing industry.

Advantages

DNG owns companies, which constitute a close cycle of production and sale of goods. These are energy generating and energy distributing companies. The group is supported by regional authorities.

Political lobby

Party of Regions of the Ukraine

Mass media under control

Television Company «UT-1»;
Television Company «Tonis»;
Newspaper «Segodnia».
Newspaper «President's bulletin»;
Newspaper «Power and politics».

Oligarkhs (persons in power)

Igor Goumeniuk
Sergey and Andrew Momots, Danko Company Directors;
Sergey Tarouta, Director of ISD Company;
Raouvil Soufullin, President of Professional Football League of Ukraine;
Artem Scherban, Director of Joint Venture "Gefest"

Political lobby

Nickolay Azarov, Parliamentarians
Vladimir Seminozhenko, Vice Premier Minister;
Oleg Doubina, the Deputy-Premier Minister
Igor Yushko, Minister of Finance.

Business interests

Coal mining industry;
Metallurgy;
Agriculture;
Gas and energy supplies.

Disadvantages

Absence of powerful mass-media at the National level and presence of strong competitors in metallurgy.

Companies under control

"ISD" company, Vizavi Ltd, ARS company, JSC "Azovstal", JSC "Novokramatorsky machine-building facilities", all machine-building plants (servicing mining industry) in Donetsk region, JSC "Khartyzsk pipe plant", JSC "Dneprovsky pipe plant", JSC "Danko", JSC "Altchevsk Coke Plant", JSC "Marckochim", JSC "Enakievsk Coke Plant", JSC "Enakievsk metallurgical plant", JSC "Altchevsk metallurgical plant", JSC "Silour", JSC "Panteleimonovsk plant", JSC "Donetzkoblenergo", JSC "Donbassenergo", JSC "Avdeevsk Coke plant", JSC "Azovmach", JSC "Donetzk Energy plant", JSC "Energomachspezsteel", JSC "Makeevcoal", JSC "Krasnodoncoal", JSC "Donetzk Brewery", JSC "Artiomosk Champagne plant", several agricultural companies in Donetsk region.

Curriculum vitae

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1.2. Assistant Professor of Corporate Governance, October 2001 - recently.

2) Publishing house "Virtus Interpress", Ukraine, position - Director and Founder. Date of appointment - May 2003.

3) Journal "Corporate Ownership & Control", Editor-in-Chief. Date of appointment - September 2003. The journal is published by Virtus Interpress. The journal was established in September 2003. The journal is devoted to the problems in corporate governance as a result of separation of ownership and control. It is published quarterly in English.

4) Journal "Problems and Perspectives in Management", Deputy-Head of the Editorial Board. Date of appointment - October 2003. It is published quarterly by Business Perspectives, Sumy, Ukraine.

Research experience:

1. Supervisor of research project "Corporate governance in emerging countries". The project was started in 2002. Participants - London School of Economics, London Business School, Vienna University, World Bank.

Written books, articles:

1. Papers written - 18, including 10 papers on corporate governance.

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2. *Prospects of development of monetary system of Ukraine*, international conference, Tchernovtzy State University, Ukraine, 25-27 October 2000;
3. *Prospects for banking system of Ukraine*, third annual national conference, Ukrainian Academy of Banking, Sumy, Ukraine, 17-19 October 2000.
4. *Corporate governance in Ukraine*, the first international conference, IFC, Kiev, Ukraine, March 2002.

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