

German FDI in Ukraine: A valuation issue

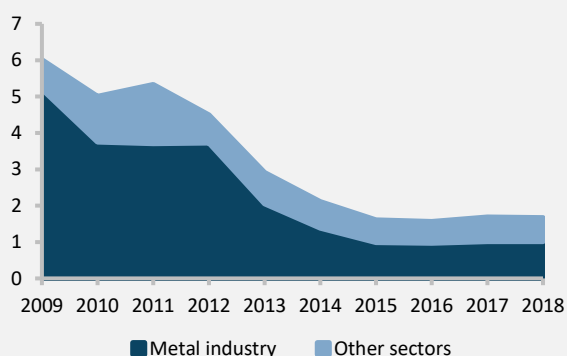
According to the Ukrainian National Statistics Office, German foreign direct investment (FDI) in Ukraine has considerably dropped since 2011. This is a remarkable development, as economic ties between the two countries have generally increased, particularly due to Ukraine's EU association.

Indeed, the negative development in the data is caused by a few specific reasons. The data are strongly driven by one large individual investment by the German subsidiary of a global steel corporation with Indian majority shareholders. This shows that bilateral FDI statistics should be interpreted cautiously. In addition, the valuation method employed for this investment plays a key role. In sum, one should not come to rash conclusions on the relations between the Ukrainian and German economies based solely on Ukrainian FDI data.

Surprising developments in FDI data

Economic ties between Ukraine and Germany are undoubtedly increasing, especially following the EU-Association of Ukraine in 2014. German imports from Ukraine, for example, increased by more than 50% between 2013 and 2019. All the more surprisingly, FDI data of the Ukrainian National Statistics Office indicate a large drop in the value of German foreign direct investment (FDI) in Ukraine since 2009.

German FDI in Ukraine, in USD bn



Source: Ukrstat

German FDI in Ukraine decreased from USD 6 bn in 2009 to USD 1.7 bn in 2018. Obvious drivers such as the devaluation of the Hryvnia and effects of the economic crisis after 2014 do not suffice to explain this development, as the decline already started in 2012. But do these data really indicate a weakening of economic ties between Ukraine and Germany?

One single investment dominates the data

In fact, the interpretability of the data is limited due to some general characteristics of bilateral FDI data and specific circumstances of German FDI in Ukraine. Investment in the Ukrainian metal sector valued at USD 5.2 bn in 2009 made up almost 90% of total German FDI in Ukraine and indeed explains almost all of the sharp decrease in FDI value between 2009 and 2018.

Most German FDI in the metal industry (USD 4.6 bn) in 2009 was in one single investment: The purchase of Kryvorychsteel (KSTL) by ArcelorMittal in 2005. At a volume of USD 4.8 bn, this privatisation was the largest single investment in the history of Ukraine. Due to its magnitude, it has a dominating influence on the development of the value of the German FDI stock in Ukraine.

Bilateral FDI data: Interpret cautiously

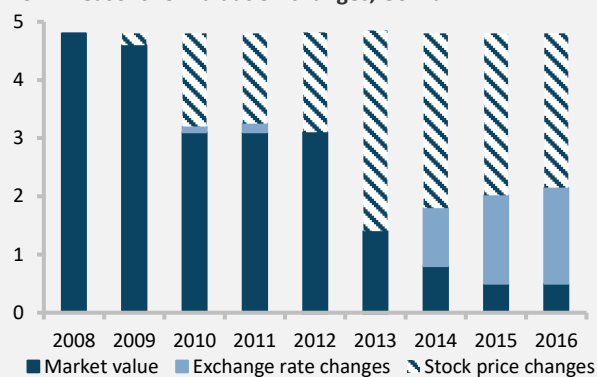
The influence of the investment of a global steelmaking company with Indian majority shareholders on German FDI in Ukraine highlights a general issue in bilateral FDI data: Often, FDI is made through special-purpose-vehicles or subsidiaries in third countries. In the data, this is however attributed to the FDI of the third country due to lack of information about the ultimate investing country. Hence, bilateral FDI data is only of limited use for drawing inferences on the development of bilateral economic ties.

Reasons for the reduction in valuation of KSTL

Due to its significance for the value of the entire stock of German FDI in Ukraine, it makes sense to investigate the reasons for the reduction in the valuation of the investment in KSTL. Between 2009 and 2013, the market value of this investment as measured by the market capitalisation, which is calculated from the stock market valuation of the remaining KSTL shares, decreased by more than two thirds.

The principal reason for this appears to be the development of the global steel market. Until 2008, the world market steel price and the Ukrainian steel production were increasing. Further increases in prices were expected due to growing demand from China. However, after the global financial crisis of 2009, the steel price never fully recovered. The Ukrainian steel industry, characterised by relatively high production costs, has been in crisis since.

KSTL: Reasons for valuation changes, USD bn



Source: NBU

After 2014, the devaluation of the Hryvnia also became a factor, whereas the stock market value recovered a little in values. In sum, the decrease of stock market value explains 60% of the total decrease of value until 2016, with the rest explained by the development of the Hryvnia-USD exchange rate. Apart from dividends, no capital movements took place.

What's a good measure of market value?

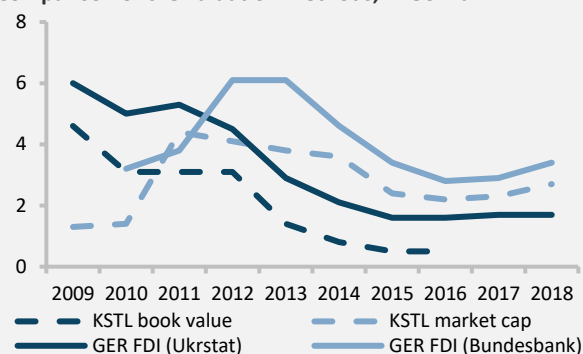
Although the crisis of the Ukrainian steel industry would explain the decrease of KSTL's valuation, it remains unclear whether indeed a stock market-based valuation is the ideal measure to value this investment. Only 0.4% of the company is owned by portfolio investors, ArcelorMittal owns the rest.

Formally, it is the correct measure. According to the relevant BPM-6 standard of the IMF, the market capitalisation of companies should be the principal method for measuring the value of investments. Still, due to the small number of freely traded shares, KSTL is an unclear case. Ukrainian authorities have decided on continuing to use the market capitalisation to measure the value of this investment.

Other method, other results

An alternative valuation method, employed inter alia by the German Bundesbank for German FDI abroad, uses the companies' book value measured by their equity, a balance sheet item. After the 2009 financial crisis, KSTL's value as measured by its equity recovered until 2011. Only once the economic crisis and Hryvnia depreciation set in around 2014, the company's equity, measured in USD, dropped. Hence, the value of German FDI in Ukraine in the Bundesbank's time series also increased until 2012 and only decreased after 2014.

Comparison of the valuation methods, in USD bn



Source: Ukrstat, Bundesbank, NBU

In the particular case of KSTL, no method is inherently "better" than the other. While the interpretability of the stock market value may be limited due to the small number of freely traded shares, the book value does not contain any information on expected future developments affecting a company.

Conclusion

The decrease of the value of the German FDI stock in Ukraine is not an indication of a decrease in the economic ties between the countries. Due to special factors such as the dominating influence of one single investment on the entire data series and its valuation issues, the bilateral statistics should be taken with care and not be interpreted strongly.

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