*Translation from Bulgarian*

# INTERIM REPORT

## ON THE ACTIVITY OF BULGARTABAC GROUP
## AS OF 30 JUNE 2011
## (prepared in accordance with Art. 100o, para. 4, i.2 of Public Offering of Securities Act (POSA))

**1. Important events, which have occurred during the second quarter of 2011, with accumulation from the beginning of the year, and their impact on the results reported in the financial statements**

**Dividends**

1. At the regular General Meetings of Shareholders of the subsidiaries of Bulgartabac Group held in June 2011 decisions for distribution of dividends for 2010 were taken by the following subsidiaries:

| | |
|---|---|
| Blagoevgrad-BT AD | BGN 31 158 447.10 |
| Sofia-BT AD | BGN 7 001 259.03 |
| Total | BGN 38 159 706.13 |

Out of dividends approved, the amount of BGN 32,034,897.41 will be paid to the parent company Bulgartabac-Holding AD, and the amount of BGN 6,124,808.72 will be paid to minority shareholders.

2. The exact amount of dividends to be paid by Bulgartabac-Holding AD to its shareholders is as follows:

- The total amount of dividends under items 5, 6 and 16 of the agenda is BGN 52,983,360.41, incl. for the State, represented by the Ministry Economy, Energy and Tourism – BGN 42,297,527.65 and for the minority dividends – BGN 10,685,832.76.
- Gross amount of dividends per share – BGN 7.191769219;
- Net amount of dividends per share /less tax on dividends of 5% for the persons under Art. 194, para.1 of Personal Income Taxation Act /PITA/ - BGN 6.832180758.

- **New procedure for privatisation/sale of Bulgartabac-Holding AD**

By a decision No 1646-A of 18 December 2009 (published in "Pari" newspaper of 21.12.2009), an open tender procedure was opened by the Privatisation Agency for the selection of a consultant on the privatisation of Bulgartabac-Holding AD. The consultant would be entrusted with the entire consulting process and with the task to provide support to the PA in connection with the preparation and execution of the privatisation deal for the company in compliance with the privatisation method selected and the legislation in force.

By the expiration of the deadline on 1 February 2011, 4 companies had submitted their bids: Citigroup Global Markets Limited, the consortium KBC Securities and Tokushev& Co., Raiffeisen Investments – Kamburov and Renaissance Securities Ltd. Upon examination of the submitted bids, the Agency of Privatisation and Post Privatisation Control (APPC) had taken a decision to ask the participants to submit additional information and clarifications on their bids in the tender. Upon submission of the required supplements and their examination, the Tender Committee would have to prepare a report on which basis APPC should come out with a decision ranking the bidders in the tender.

On 25 February 2010 APPC announced that Citigroup Global Markets Limited was selected to be the consultant for the privatisation of Bulgartabac-Holding AD.

On 13 September 2010 APPC published information that the Supervisory Board of the Agency had approved the contract for entrusting Citigroup Global Markets Limited with the implementation of Bulgartabac-Holding AD's privatisation. The consultant should carry out a marketing research for the needs of Bulgartabac-Holding AD's privatisation, overall consultancy and support of APPC with regard to the preparation and implementation of the privatisation deal for the company in compliance with the privatisation method selected and the effective legislation.

Pursuant to the Contract, on 18 November 2010 the consultant deposited to APPC an information memorandum, legal analysis and privatisation evaluation of Bulgartabac-Holding AD, while the actual sale procedure was expected to commence within a short period of time.

With regard to the announced procedure for sale of the state-owned interest in Bulgartabac-Holding AD's capital, by a Decision No. 1490 of 17 February 2009, on the grounds of Art. 4, para.1 and Art. 28, Par. 1

and Par. 2 of the of Privatisation and Post Privatisation Control Act (PPPCA), pursuant to a Protocol Decision No.12503 of 17 February 2009 of the Executive Board, the Privatisation Agency informed Bulgartabac-Holding AD that it was forbidden to perform disposal transactions with long-term assets of the company, to conclude contracts for the acquisition of shares, rental contracts, contracts for joint operations, loan contracts, contracts for securing receivables, as well as to undertake any bill-of-exchange obligations, except with the permission of the Privatisation Agency.

By a letter of APPC dated 23 November 2010, Bulgartabac-Holding AD was informed that the prohibition under Art. 28 PPPCA for conclusion of transactions and performance of activities should apply also to its subsidiaries, except for those that were undergoing liquidation or insolvency proceedings.

By a decision № 3219-П dated 18 April 2011 (promulgated in the State Gazette, issue 34 of 10 May 2011), on the grounds of Art. 1, para. 2, Art. 3, para. 1, Art. 4, para 1, and Art. 32, para. 1, i. 3 of the Privatisation and Post Privatisation Act, Ar. 2, para. 1, i. 1, Art. 3, para 3, Art. 5, Art. 7, and Art. 10 of the Ordinance on the Tenders and Competitions, and a protocol decision No 777 dated 18 April 2011 of the Executive Board, the Privatisation and Post Privatisation Agency determined the method for sale of 5, 881,380 shares being approximately 79.83 % of the capital of Bulgartabac-Holding AD, Sofia – a publicly announced tender to be held in one stage. The decision specified also the preliminary qualification requirements to be met by the interested parties – participants in the tender, as also the main procedural terms. Pursuant to this decision, the participants in the tender were required to submit their bids by the 110 day as of the date of promulgation of the decision in the State Gazette /29 August 2011/.

Within the term for purchasing tender documents - 09 June 2011, such have been purchased by ten companies: Djingov, Gouginski, Kyutchukov & Velichkov AD, Kamburov & Partners AD, Kings Tobacco EAD, Plovdiv, British American Tobacco Ltd, London, Japan Tobacco International S.A., Switzerland, CB Family Office Services GmbH, Austria, BT Invest GmbH, Austria, Phillip Morris Bulgaria EOOD, Science Capital Management LLC, USA, and “KT&G Corporation”, Korea.

Of all companies which have bought tender documents, three submitted documents in compliance with the pre-qualification requirements of the tender - CB Family Office Services GmbH, Austria, BT Invest GmbH, Austria, and British American Tobacco Ltd, London.

On 14 July 2011 the Privatisation and Post-privatisation Control Agency allowed BT Invest GmbH, Austria, to continue its participation in the next stages of the procedure, and with regard to the documents filed by British American (Holdings) Tobacco Ltd, London, and CB Family Office Services GmbH, Austria, the Agency required the applicants, by 19 July, to provide clarifications and additional documents in respect with documents already filed by them in compliance with the pre-qualification requirements.

After reviewing the additional information filed to the compliance documents, the Privatisation and Post-privatisation Control Agency allowed British American (Holdings) Tobacco Ltd, London, and CB Family Office Services GmbH, Austria, to continue their participation in the next stages of the procedure.

By the expiry of the deadline – 25 July 2011, two companies both the information memorandum for the sale of Bulgartabac-Holding AD, Sofia, namely British American (Holdings) Tobacco Ltd, London, and BT Invest GmbH, Austria. The third company, which was allowed to this stage of tender procedure - CB Family Office Services GmbH, Austria, dropped out of further participation.

On 1 August, the Privatisation and Post-privatisation Control Agency announced that a formal letter was received from the Privatisation and Post-privatisation Control Agency, stating that the company took a decision to discontinue its further participation in the tender procedure. The arguments laid down in the letter included “reasons of commercial and strategic nature”.

The deadline for making the required deposit and filing a binding offer by the only applicant who has left, and namely BT Invest GmbH, Austria, expiries on 29 August 2011, at 3 p.m.

- **Termination of the insolvency procedure and obliteration of Harmanli-Tabac AD, town of Harmanli – a subsidiary of Bulgartabac-Holding AD**

By a decision of the Haskovo District Court dated 28 December 2010 issued in relation to a civil case No 138/2007 the insolvency procedure of Harmanli-Tabac AD /in insolvency/, with registered address and address of management: town of Harmanli, 13 Bulgaria Boulevard, UIC 126065718, was terminated due to exhausting the insolvency mass. The powers of the trustee in bankruptcy were ceased and also the effectiveness of the general interdiction and pledge on the debtor's property. The obliteration of the company was enacted doe to exhausting the insolvency mass. The court decision was entered into the Trade Register on 5 January 2011 and entered into force on 12 January 2011.

## 2. Development of the activity during the first six months of 2011

- **Tobacco buy-up and processing**

During Q'4 of 2010, the Board of Directors of Bulgartabac-Holding AD took a decision to replace Pleven-BT AD as a party to the contracts for manufacturing and purchasing with tobacco growers of groups Basma, Kaba Koulak and Burley varieties, crop 2010. The purchasing of group Burley started late in the year and 99 tons of raw tobacco were purchased by its end.

The purchasing of these three groups of varieties was done by Pleven-BT AD by 31 March 2011 in accordance with the purchase contracts concluded.

With regard to the calculations of the quantities of Bulgarian tobaccos required by Bulgartabac Group and the market situation, the purchasing prices of large leaf tobaccos were increased as compared to the minimum purchasing prices of the same variety groups valid for crop 2009. Taking into consideration the balance on the market, purchasing prices by classes for the variety group Basma were preserved at the levels of crop 2009. The purchasing prices of Kaba Kulak variety group were not changed as well.

The Board of Directors of Pleven BT AD took a decision to determine the purchasing prices for Variety group Virginia, and that of Bulgartabac-Holding for groups Basma, Kaba Koulak and Burley, respectively. The approved purchasing prices by classes for crop 2010 are as follows:

| Class | Virginia | Burley | Kaba Koulak | Basma |
|---|---|---|---|---|
| I | 6.10 BGN/kg. | 3.90 BGN/kg. | 3.80 BGN/kg. | 7.35 BGN/kg. |
| II | 4.00 BGN/kg. | 2.60 BGN/kg. | 3.10 BGN/kg. | 4.85 BGN/kg. |
| III | 1.80 BGN/kg. | 1.40 BGN/kg. | 1.85 BGN/kg. | 1.90 BGN/kg. |

The quantities of raw tobacco, crop 2010, purchased during the first quarter of 2011 by the Group were as follows:

| | |
|---|---|
| Virginia | - 2 297 tons |
| Basma | - 2 317 tons |
| Kaba Koulak | - 540 tons |
| Burley | - 973 tons |
| Total | 6 127 tons |

During Q'4 of 2010 and Q'1 of 2011, Pleven-BT AD completed the processing of Variety group Virginia, crop 2010. Total finished products manufactured amounted to 1,992 tons with carrying amount of BGN 11,434 thousand, of which 1,396 tons were envisaged for sale to the cigarette factories of Bulgartabac Group and 149 tons – for sale outside the Group. Tobacco stems manufactured were used primarily in the production of expanded tobacco stems. During the first six months of 2011, the company ,manufactured 641.6 tons of expanded tobacco, mainly sold to the Groups cigarette factories.

During the first six months of 2011, the company made the processing of tobacco of Burley and Kaba Kulak varieties, crop 2010, and commenced the processing of Basma. Finished products manufactured, owned by the Holding, were as follows:

| | |
|---|---|
| Burley | 814 tons |
| Kaba Kulak | 445 tons |
| Basma | 1 682 tons |
| Total | 2 941 tons |

During Q’2 of 2011 Bulgartabac-Holding AD sold to Pleven-BT AD tobacco stems for the amount of BGN 118 thousand.

During Q’2 of the year, Bulgartabac-Holding AD concluded contracts for the sale of 400 tons of Burley strips, crop 2010, with Blagoevgrad-BT AD and Sofia-BT AD. The above two contracts will have an impact on financial result of the Holding for Q’3 of 2011.

- **Trade in tobacco**

The operating results as of 30 June 2011 relating to tobacco sales /export, Intra Community Supplies and domestic sales/ aggregated for Bulgartabac Group as a whole, are presented in the tables below:

| **Sales of tobacco for Export and Intra Community Supplies - total for BULGARTABAC Group** | |
|---|---|
| 30 June 2011 | 30 June 2010 |
| 478.4 tons | 645 tons |
| **Sales of tobacco in the domestic market to third parties outside BULGARTABAC Group** | |
| 30 June 2011 | 30 June 2010 |
| 173.1 tons | 129.1 tons |
| **Total sales of tobacco /Export, Intra Community Supplies and domestic market/ for BULGARTABAC Group** | |
| 30 June 2011 | 30 June 2010 |
| 651.5 tons | 774.1 tons |

*Tobacco export*

Tobacco supply is directed mainly to leading tobacco dealers in the sector, thus on the one hand allowing the maintenance and activation of export possibilities, and on the other hand reducing significantly existing trade risks. Risks related to payment of tobaccos sold are cut down to the minimum, and no tobacco deliveries are made under deferred payment conditions to markets and firms at risk.

In the first six months of 2011, tobaccos were sold under contracts concluded in 2009, 2010 as also in the beginning of 2011. Compared with the same reporting period of 2010, during Q’1 of 2011 there was a decrease in the total volume of tobacco sold outside the Group in terms of quantity. The total quantity of tobacco sold by Bulgartabac Group during the first six months of 2011 was 651,522.40 kg of tobacco amounting to BGN 3,371,191.73 thousand.

*Tobacco import*

For the needs of cigarette production the Bulgartabac group companies import Virginia and Burley tobaccos, tobacco stems and reconstituted tobacco. The main sources for purchasing high quality large leaf Virginia and Burley tobaccos are the countries with the most developed production and international trade – Brazil, Zimbabwe, USA, Argentina and Malawi. Tobacco stems are imported mainly from China and Argentina, and reconstituted tobacco from France due to the sufficiently good quality characteristics and good trade terms and conditions. In the first six months of 2011, 4,221,160 kg of raw tobacco were imported for the amount of USD 29,027,066.40 and EUR 886,160.00.

- ***Domestic market of tobacco products***

The policy pursued by Bulgartabac-Holding AD during 2011 is entirely consistent with the market conditions and is subject to the aim of stabilizing and maintaining the positions on the domestic market achieved in the end of 2010.

The company reports growth in sales of cigarettes for the first six months of 2011 on the domestic market compared to the same period of the previous year.

The usual fluctuations in the separate months are observed during the reporting period; in general, however, we report a trend of regaining the company's market share.

Since the beginning of the year Bulgartabac-Holding AD has been manufacturing and marketing to the domestic market a new format of consumer pack containing 10 cigarettes by the piece of the well-known brands Melnik, MM and GD.

The market of tobacco products during the reporting period was characterized by extraordinary dynamics and experienced a number of objective factors which had a direct impact on the sales of cigarettes on the domestic market:

- **Pricing policy and competition**

During the current calendar year, for the first time in the last five years, the excise duty rate of tobacco products was not changed and the 2010 levels were kept. Nevertheless, the declining trend in consumption reported in 2010 continued to exist throughout the first six months of this year as well.

For most of the Bulgarian smokers, their preferences for a given trademark are strongly influenced by its price.

During the current year, the efforts of Bulgartabac-Holding with regard to its pricing policy for the domestic market are directed towards stabilising and maintaining the market share of the Holding's leading brands within the separate price groups. In response to the reduced purchasing power of the population, a new format of cigarette pack was launched - cigarettes in packs of 10 pieces – a format which market share has increased constantly over the last six months of the year and reached 7% of total sales of tobacco products in the territory of the country.

The competition is strong, with the cigarette factories in the country facing a constantly shrinking market. Moreover, the product we offer and sale is under a regime that imposes gradually various normative restrictions and other restrictive legal measures to limit smoking.

- **Unregulated trade**

During the first six months of 2011, the levels of offering and unregulated trade in tobacco products remained high. The levels of contraband offering of cigarettes and ROY tobacco of an unclear origin and quality remained the same. The sale of cigarettes with foreign excise stamps or without excise stamps is nation-wide and covers the entire territory of the country including the tiniest settlements.

According to data of an independent marketing agency, the excise market of tobacco products for the first six months of 2011 has shrunk by almost 14% compared to the same period of 2010.

- **Financial and economic crisis**

The trend of decrease in sales of tobacco products with Bulgarian excise stamps applies to ours, as well as to competitor's cigarette brands. The sensible fall of consumption of FMCG is due to the decreased purchasing power of the population, shrinking of households' expenses, the trend among smokers to reduce their smoking or even quit smoking completely.

Retailers experience some difficulties in ensuring the required working capital due on the one hand to the expensive credit resources and on the other hand to the significant decline in business. This reflects on the range of tobacco products offered in the points of sale. Only the best selling brands are supplied in limited quantities.

- **Distribution**

The marketing studies of the reporting period /data covers the period until March 2011/ show that the distribution of Bulgartabac-Holding AD covers 96.2% of the points of sale of tobacco products in the country.

During the reporting period, the Holding updated the packing of the most sellable brand in Bulgaria - “Victory”. Since March the family has been offered to the trade network in a new format and design. The new vision of the family “Victory” was supported by a large-scope marketing activity.

The brands of the Bulgartabac Group have a sustained nation-wide presence and in almost all points of sale, regardless of their size and importance.

- ***Export of tobacco products***

Based on the objective analysis of the markets and the potential of our brands, the aim of Bulgartabac-Holding AD is to reach a sales volume of 15 549 240 thousand pcs., or a growth of 19 % compared to the volumes in 2010.

On the grounds of its long lasting experience and traditions, the production of Bulgartabac group is well known on the Middle and Far East, Africa, Balkan countries and CIS markets. Our standing market presence in these regions allows us to sell quality products at prices that guarantee constant net income and makes it possible to meet the companies’ fixed costs.

The good results achieved during the years in the Middle East, the Far East and the Balkans region depend directly on the right choice of partners with well developed distribution networks in each of the regions.

In the conditions of an ever-growing competition on the part of the multinational companies and changing factors on micro-and-macro level, Bulgartabac-Holding AD has to increase its competitiveness and enter new markets.

When launching new products on the foreign markets, Bulgartabac-Holding AD needs to analyse thoroughly the market specifics as well as the intra-company prerequisites for development of the company.

The creation of an overall strategy from a marketing point of view, setting the pattern for product launch will minimize the risk upon entering new markets. Factors that facilitate the success of new products like orientation on the changing consumer needs, establishment of consumers’ tastes and preferences, analysis of the consumers’ sensitivity to the prices of the products have also to be accounted for.

Over the years Bulgartabac-Holding AD transformed into a flexible market-oriented structure, manufacturing market-oriented products compliant with the main demand factors in the specific region. In this connection and in order to strengthen the positions already conquered in 2010, expenses for implementation of the strategies of launching new products on established markets and new products on new markets have to be provided for.

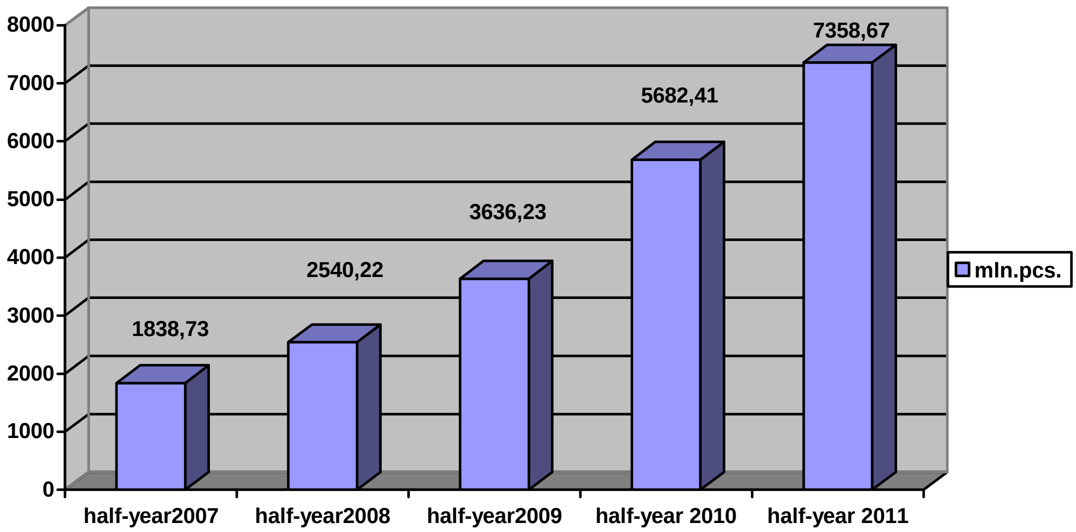
The types of products included in the export list of Bulgartabac-Holding AD for 2011 are in full compliance with the requests, needs and preferences of the clients of each of the regions. Special attention is paid to consumer packing of cigarettes – the quality of design and print of the pack, corresponding to the consumers’ preferences on the specific markets.

During first six months of 2011, the export of Bulgartabac-Holding AD reached **7 359 million pieces**, while for the same period of 2010 it was **5 682 million pieces**. There is a growth of **29.5%** in the natural volumes, or **47.23%** of volumes budgeted in the export programme of the company for 2011.

Respectively, Blagoevgrad-BT AD manufactured and exported 3 824 180 thousand pieces during the first six months of 2011 vs. 2 853 640 thousand pieces for the same period of 2010, or a growth by almost 34%, while Sofia-BT AD manufactured and exported 3 534 485.2 thousand pieces during the first six months of 2011 vs. 2 828 773.2 thousand pieces in the first six months of 2010, or a growth by 24.95% in the volumes sold.

(thousand pieces)

| | |
|---|---|
| half-year 2007 | 1,838,730 |
| half-year 2008 | 2,540,220 |
| half-year 2009 | 3,636,227 |
| half-year 2010 | 5,682,413 |
| half-year 2011 | 7,358,665 |




Sales revenue for ***the first six months*** of 2011 amounted to USD 84,222,873.44 and EUR 5,479,404.76 vs. USD 58,617,140.00 and EUR 7,480,840.00 for ***the first six months*** of 2010.

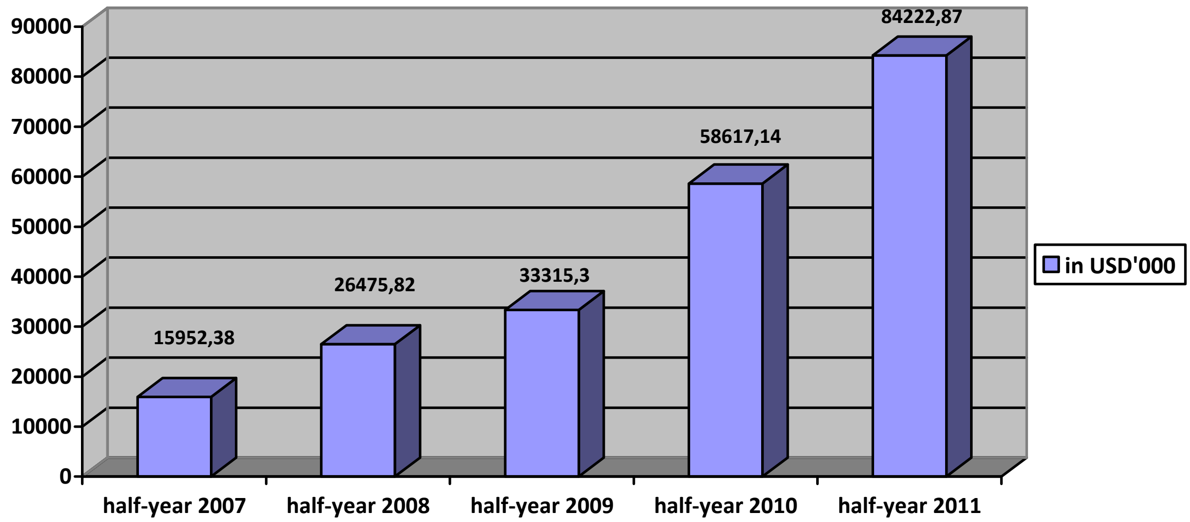
Respectively, USD sales revenue of Blagoevgrad-BT AD for 2011 amounted to USD 47 882 000 vs. USD 34 981 740 for 2010, or a growth of 31.16%. With regard to Sofia-BT AD, sales revenue for 2011 amounted to USD 36 340 873,44 vs. USD 23 635 400 for 2010, or a growth of 53.76%.

Revenue for ***the first six months*** of 2011 in EUR by factories was as follows: Blagoevgrad-BT AD – EUR 977,988.00 for 2011 vs. EUR 764,176.00 for 2010, or a growth of 27.98%, and Sofia-BT AD – EUR 4,501,416.76 for 2011 vs. EUR 6,716,624.00 for 2010, or a decline of 32.98%.

(in USD)

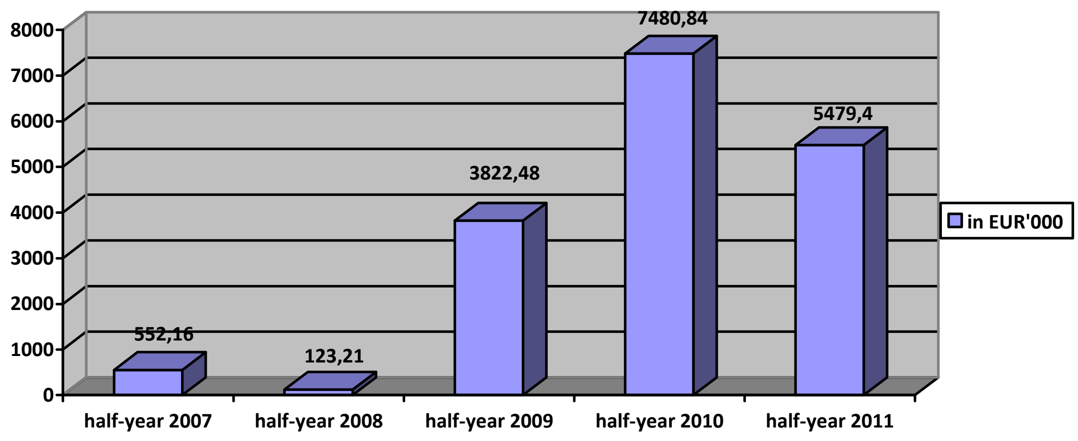
| | |
|---|---|
| half-year 2007 | 15,952,380.00 |
| half-year 2008 | 26,475,820.00 |
| half-year 2009 | 33,315,301.00 |

| | |
|---|---|
| half-year 2010 | 58,617,140.00 |
| half-year 2011 | 84,222,873.44 |




(in EURO)

| | |
|---|---|
| half-year 2007 | 552,155.00 |
| half-year 2008 | 123,205.00 |
| half-year 2009 | 3,822,483.00 |
| half-year 2010 | 7,480,840.00 |
| half-year 2011 | 5,479,404.76 |




Considering the above data, it may be concluded that **during the first six months of 2011, despite the gradual increase in export prices, the volumes sold are increasing compared to that sold in the first six months of 2010**.

Based on the trade representation contracts, Bulgartabac-Holding AD mediates in the overall process of negotiating, ordering and exporting the respective quantities of cigarette varieties by the subsidiaries. In relation to the above:

- Contracts were concluded and discussions were held with strategic partners operating well-developed distribution networks in each of the above-mentioned regions;
- The domestic competition of our brands offered in one and same region was successfully neutralised
- During the period under review, the negotiations were finalised and cigarettes were exported for the first time to Poland, Croatia (duty free shops), Israel, Turkmenistan and Moldova;
- Negotiations are ongoing for expanding the markets in the Far East region, as also in the region of Africa;
- We have started the development of cigarettes super slims 83 mm for export.

The results achieved at present are based on Bulgartabac-Holding AD's well-developed export portfolio for 2011.

- Well balanced – covering all possible formats and lengths in cigarette manufacturing – HLP (84 mm., 100 mm.), RC 84 mm., Slims 97 mm. (flap-flip top & octagonal), soft pack (84 mm.& 100 mm.);
- Optimal ratio "quality – price";
- State-of-the-art design;

In the short-term run, the activity of Bulgartabac-Holding AD will be focused on the following activities:

- Identification of new markets for the company;
- Identification of changes in consumer demand on each of the existing markets as well as the consumer characteristics of the new ones;
- Continued development and updating (customisation) of the portfolio - entirely customer-oriented;
- Development of cigarettes super slims 83 mm for export.

➢ ***In the area of auxiliary materials and spare parts***

The analysis of activity on supplying cigarette production with the required auxiliary materials and spare parts for the first six months of 2011 revealed the following:

- The main target in 2011 is to expand the range of suppliers in order to maintain the best prices and terms of delivery of auxiliary materials;
- The practice to carry out at the subsidiaries production testing to approve the quality of at least three suppliers for each material and avoid monopolization of supply by one supplier was continued;
- The supply of the required auxiliary materials and spare parts is centralized and carried out by Bulgartabac-Holding AD for all subsidiaries.

During the period 01 January -30 June 2011, the events directly related to this activity and having an impact on the financial results were in the following fields:

- In view of the drastic raise of PP resin prices – the main raw material for PP foil production and the increase of PP foil world prices, the foil prices are by approx. 3% to 5% higher than that in 2010.

- Considering the increased consumption in 2010 of stiff cardboard for recess filters production, a 5% discount was agreed upon when reaching certain annual quantities. The levels of supply prices of stiff cardboard in 2011 were 7% lower as compared to the average in 2010.
- Despite the raise in cellulose prices, upon negotiations, we managed to agree on prices for the supply of cigarette paper, wrapping paper and tipping paper for the first six months of 2011 that are equal to the 2010 supply prices.
- The price of inner frame cardboards has increased by 5% to 7% due to the increase in prices of cellulose.
- In 2011 the trend of limited supply of acetate tow in the global market continued due to the higher demand and shortage of raw materials. Production capacities of all manufacturers are filled up and in view of the increased prices of cellulose in the international markets, the prices for tow delivery in 2011 have increased by approximately 4 - 5% compared with that in 2010.
- Recess filters – due to the increased prices of tow, the main raw material for the production of filters, after negotiations held a minimum increase in prices of 2% to 3% was agreed compared with the 2010 prices.
- The analysis of the period under review revealed an increase in price of Tryacetin by 8% to 10% and maintaining their 2010 levels for the other chemical products - propilenglikol and glycerine.
- The prices of aroma products, aluminium foil, printing materials, glues and active charcoal maintained their 2010 levels.

The production process is supplied with spare parts through orders to an approved supplier by the manufacturer of the plant and equipment.

➢ ***In the area of technological policy, recipes and blends***

During Q’2 of 2011 activities aimed at securing cigarette manufacturing with tobaccos and reconstituted tobacco, and technological developments for expansion of cut tobacco, design of cigarettes for export, production tests of self extinguishing cigarettes, as well as actualization of the technological documentation, were carried out:

**I. Provision of tobaccos and reconstituted tobacco for the production.**

1. Expert assessments, taste evaluations and chemical analyses of selected samples of leafs Virginia and Burley, crop 2011, origin Kenya, Bangladesh, India and Malawi, were carried out. A specification of the approved quality groups of tobacco to be processed by Pleven-BT AD was prepared and submitted. A balance sheet of the Bulgarian tobacco Virginia, including alternative quantities of Virginia tobacco from import, was drawn up with the aim to cover the needs of cigarettes manufacturing for a period of 2 years.

2. Assessments of selected tobacco samples of Virginia and Burley tobaccos, crop 2011, origin Brazil and Argentina, were carried out. A specification of the approved quality groups and schedule for the delivery of tobaccos by classes and suppliers for securing cigarettes manufacturing in 2011 and 2012 were prepared.

3. Expert assessments and analyses of regular samples of reconstituted tobacco, quality AZ6N of “LTR”, France, were made. A schedule for the delivery of lots in Q’4 of 2011 was prepared.

**II. Technological developments**

1. Implementation of a new technology for expansion of cigarette blends cut tobacco at Sofia-BT AD.

72-hour tests for expansion of sample trials of Virginia tobacco blends were conducted at an installation of the company COMAS, Italy. At Sofia-BT AD, production surveys in the process of adding the expanded cut tobacco to cigarettes blends were carried out, as also an evaluation was made of the effectiveness of the process of expansion of cigarette blends cut tobacco and of the quality characteristics and indicators of cigarettes manufactured by Sofia-BT AD and Blagoevgrad-BT AD.

2. The recipes of all the cigarettes brands produced by Sofia-BT AD by brands, by clients of Bulgartabac-Holding AD and for export were updated and approved.

3. The stages of the program for carrying out production tests at the cigarettes factories for using LIP cigarette papers for self extinguishing cigarettes were completed. A complex quality evaluation was made – chemical indicators and taste evaluation of cigarettes manufactured with LIP cigarette papers supplied by various suppliers. A specification was prepared and LIP cigarette papers were approved that meet the requirement for extinguishment of cigarettes tested under the ASTM method. Actions were undertaken for the delivery of the approved quantities of cigarette papers for securing self extinguishing cigarettes manufacturing for the domestic market.

**III. Cigarettes**

1. The development of cigarettes for export upon requests of Bulgartabac-Holding AD's clients was completed. Production samples of cigarettes Slims, 97 mm, flat hard box, a new variety of Virginia blend, to be manufactured by Sofia-BT AD, and cigarettes 84 mm, hard pack, American blend, to be manufactured by Blagoevgrad-BT AD, were prepared. Cigarettes are of different levels of indicators for smoke, and smoking and taste qualities approved by Bulgartabac-Holding AD's clients.

2. New versions of cigarettes of the Prestige RF variety, RC, 84 mm and Global Gold, 84 mm, developed upon requests of Bulgartabac-Holding AD's clients.

- ***Liquidation and insolvency procedures of group companies***

<u>Haskovo Tabac AD (in liquidation)</u>

The decision of the General Meeting for winding-up of the company and starting a liquidation procedure was entered with a decision of Haskovo District Court dated 31 March 2006. On 11 July 2006 the creditors were invited by a published invitation by liquidators to request their receivables within a three- month period as from that date. Encashment of company's property was forthcoming for their settlement. With a decision of the General Meeting of Shareholders, dated 9 May 2007, the initial financial statements and the balance sheet at the liquidation date were approved. Initially the deadline to effect the liquidation was 12 January 2008.

By a decision of the extraordinary General Meeting of Shareholders of the company held on 21 December 2007, the term for completing the company's liquidation was extended by 18 (eighteen) months as of the date of expiry of the term set by a decision of the extraordinary General Meeting of Shareholders of the company held on 15 March 2006.

By a decision of the regular General Meeting of Shareholders held on 26 June 2009, it was agreed that the company's liquidation deadline should be extended by 12 (twelve) months as of 11 July 2009 - the date of expiry of the term set by a decision of the extraordinary General Meeting of Shareholders held on 21 December 2007.

By a decision of the regular General Meeting of Shareholders held on 23 June 2010, it was agreed that the company's liquidation deadline should be extended by 12 (twelve) months as of 11 July 2010 - the date of expiry of the term set by a decision of the regular General Meeting of Shareholders held on 26 June 2009.

By a decision of the regular General Meeting of Shareholders of the company held on 21 June 2011, it was decided that the term for completion of the liquidation of Haskovo Tabac AD, in liquidation, to be extended by 6 /six/ months as of 11 July 2011 – the date of expiry of the term decided upon by a decision of the regular General Meeting of Shareholders held on 23 June 2010.

<u>Dulovo Tabac AD ( in insolvency)</u>

By a decision No 32 dated 22 January 2010 of the Silistra District Court, on the grounds of Art. 632, para. 1 with reference to Art. 710 of the Commercial Act, the insolvency of „Dulovo Tabac" AD was announced, effective 17 November 2008; an insolvency proceeding was opened as regards the company; collateral is allowed in the form of pledge and interdiction imposed on the entire property of the company; the activity of the entity „Dulovo Tabac" AD was terminated. By a decision dated 28 April 2010 of the

Varna Appellate Court, the decision of the Silistra District Court dated 22 January 2010 was repealed in its part determining the initial date of insolvency of „Dulovo Tabac” AD on the grounds of Art. 630, para. 1, i. 1 of the Commercial Act, and instead, a new date of insolvency of „Dulovo Tabac” AD was set, namely 26 April 2002. In January 2011, two appeals were filed for the re-initiation of proceedings – by the National Revenue Agency and CD TAB EOOD. At present, procedures are ongoing with regard to the claims filed.

### 3. Financial result of Bulgartabac Group as of 30 June 2011

### I. CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

| | **1.01-30.06.2011** | **1.01-30.06.2010** | **Change** | |
|---|---|---|---|---|
| | **BGN'000** | **BGN'000** | **BGN'000** | **%** |
| Sales revenue | 166,242 | 127,507 | 38,735 | 30.38 |
| Cost of products and services sold | (129,264) | (92,971) | 36,293 | 39.04 |
| | **36,978** | **34,536** | **2,442** | **7.07** |
| Write down of inventories | - | (10) | (10) | (100.00) |
| Cost of production below the normal capacity | (2,861) | (1,973) | 888 | 45.01 |
| **Gross profit (margin)** | **34,117** | **32,553** | **1,564** | **4.80** |
| Other operating income / (losses), net | 2,485 | 1,469 | 1,016 | 69.16 |
| Distribution and realisation expenses | (6,233) | (4,911) | 1,322 | 26.92 |
| Administrative expenses | (14,697) | (13,965) | 732 | 5.24 |
| Other operating expenses | (8,490) | (7,431) | 1,059 | 14.25 |
| **Operating profit** | **7,182** | **7,715** | **(533)** | **(6.91)** |
| Finance income | 3,140 | 2,223 | 917 | 41.25 |
| Finance costs | (6,751) | (1,122) | 5,629 | 501.69 |
| **Operating profit after finance items** | **3,571** | **8,816** | **(5,245)** | **(59.49)** |
| Expenses on stopped production activities in subsidiaries | (108) | (117) | (9) | (7.69) |
| **Profit before income tax** | **3,463** | **8,699** | **(5,236)** | **(60.19)** |
| Income tax expense | (249) | (1,172) | (923) | (78.75) |
| **Net profit for the period** | **3,214** | **7,527** | **(4,313)** | **(57.30)** |

| | | | | |
|---|---|---|---|---|
| Attributable to : | | | | |
| **The owners of the equity of the parent company** | **2,890** | **5,788** | **(2,898)** | **(50.07)** |
| **Non-controlling interest** | **324** | **1,739** | **(1,415)** | **(81.37)** |

For the period from 1 January to 30 June 2011, the financial result of Bulgartabac Group is a profit amounting to BGN 3,214 thousand, including – attributable to the owners of the equity of the parent company – BGN 2,890 thousand and of non-controlling interest – BGN 324 thousand.

If compared with the same period of 2010, the financial result has decreased by BGN 4,313 thousand (57.30%), including a decrease for both the owners of the equity of the parent company by BGN 2,898 thousand (50.07%) and the non-controlling interest by BGN 1,415 thousand (81.37%).

**The gross profit of Bulgartabac Group for the period from 1 January to 30 June 2011 amounted to BGN 34,117 thousand; if compared with the same period of 2010, the increase is by BGN 1,564 thousand (4.80%). The increase in gross profit for the current period, compensated, is due mainly to:**

- the increase in **net sales revenue** by BGN 38,735 thousand (30.38%) – mostly affected by the compensated influence of:
    - ***domestic market:*** the increase in sales of tobacco products (cigarettes) by BGN 12,745 thousand (59.62%); increase in sales of tobacco by BGN 641 thousand (366.29%); decrease in revenue from ROY tobacco by BGN 201 thousand (89.33%), decrease in revenue from sales of expanded stems by BGN 157 thousand (86.26%) and decrease in revenue from services by BGN 57 thousand (60.64%);
    - ***foreign market:*** the increase in sales of tobacco products (cigarettes) by BGN 26,2264 thousand (25.71%), increase in sales of expanded stems by BGN 3 thousand (1.55%), decrease in sales of tobacco by BGN 315 thousand (11.40%) and decrease in sales of filter rods by BGN 78 thousand (63.41%).
- the increase in **cost of goods and services sold** during the period under review is by BGN 36,293 thousand (39.04%). The higher pace of increase (39.04%) compared with the pace of increase in net revenue (30.38%) leads to decreasing the gross financial result for the current period.

    The following have also affected the change in gross profit for the period from 1 January to 31 March 2011 vs. the same period of 2010:
- the decrease in **costs of impairment of inventories** by BGN 10 thousand (100.00%) is affected by the costs incurred for impairment of auxiliary materials by BGN 10 thousand;
- the increase in **costs of production below normal capacity during the current period compared with the previous one** by BGN 888 thousand (45.01%) is affected mainly by:

- the increase in expenses on salaries and wages by BGN 684 thousand
- the increase in social security expenses by BGN 97 thousand
- the increase in depreciation / amortization expenses by BGN 89 thousand, and
- the increase in costs of protective food by BGN 18 thousand.

**The operating profit of Bulgartabac Group for the period from 1 January to 30 June 2011 amounts to BGN 7,182 thousand. The decrease in operating financial result for the current period compared with the previous one is by BGN 533 thousand (6.91%), which is due, compensated, to:**

- the increase in **gross profit;**
- the increase in amount of **other operating profits / (losses), net** by BGN 1,016 thousand (69.16%) is mainly due to the compensated effect of:

● the net increase by BGN 707 thousand in foreign exchange gains (↑ BGN 876 thousand) and losses (↑ BGN 169 thousand) related to trade receivables and payables;

● the increase in gain on sales of services by BGN 206 thousand;

● the increase in interest income on current accounts by BGN 72 thousand; and

● the increase in income from surpluses of assets by BGN 15 thousand .

- the increase in **distribution and selling expenses** by BGN 1,322 thousand (26.92%) is mainly due to the increase in advertising costs by BGN 803 thousand, the increase in costs of commissions by BGN 117 thousand, the increase in costs of salaries and wages by BGN 238 thousand, the increase in expenses on security by BGN 51 thousand, and the increase in customs and other charges by BGN 28 thousand;
- the increase in **administrative expenses** by BGN 732 thousand (5.24%) is mainly due to the increase in costs of salaries and wages by BGN thousand (6.68%) and the increase in business trip expenses by BGN 238 thousand (104.85%); and
- the increase in **other operating expenses** by BGN 1,059 thousand (14.25%), is mainly due to:

● the increase in costs of tobacco buy-out by BGN 793 thousand;

● the increase in fixed overheads upon prophylaxis by BGN 666 thousand;

● the increase in costs of social activity by BGN 109 thousand (2.07%);

● the decrease in expenses on severance pay upon staff cut-offs by BGN 478 thousand (56.84%); and

● the decrease in interest expenses for delays on payables to the State budget by BGN 29 thousand (4.50%).

**The operating profit after financial items of Bulgartabac Group for the period from 1 January to 30 June 2011 amounts to BGN 3,571 thousand. If compared with the same period of 2010, the decrease in the financial result is by BGN 5,245 thousand (59.49%), which is due to the compensated effect of:**

- **the decrease in the operating financial result for the period from 1 January to 30 June 2011, and**
- the increase **in finance income** by BGN 917 thousand compared with the previous period (41.25%) is mainly due to the decrease in interest income on term deposits by BGN 771 thousand, the decrease in income from liquidated damages on loan contracts by BGN 45 thousand, and the increase in foreign currency gains by BGN 1,733 thousand;
- the increase **in finance costs** compared with the previous period by BGN 5,629 thousand (501.69%) is mainly due to the increase in foreign currency losses by BGN 6,185 thousand (100%), the decrease in interest costs on bank loans received by BGN 368 thousand and the decrease in expenses on bank charges on loans and guarantees by BGN 154 thousand;

**The profit before income taxes of Bulgartabac Group for the period from 1 January to 30 June 2011 amounts to BGN 3,463 thousand. The decrease in financial result vs. that for the same period of 2010 is by BGN 5,236 thousand (60.19%) and is mainly due to:**

- **the decrease in earned operating profit after financial items for 2011, and**
- the decrease in **costs of discontinued production activities** by BGN 9 thousand (7.69%).

**The net profit for the period from 1 January to 30 June 2011 amounts to BGN 3,214 thousand, the decrease in net profit vs. that for the same period of 2010 is by BGN 4,313 thousand (57.30%).**

## II. CONSOLIDATED STATEMENT OF FINANCIAL POSITION

| | 30.06.2011 | 31.12.2010 | Change | |
|---|---|---|---|---|
| | BGN '000 | BGN '000 | BGN '000 | % |
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment, incl. | 220,080 | 212,350 | 7,730 | 3.64 |
| 1. Land | 13,690 | 13,690 | - | 0.00 |
| 2. Buildings | 64,365 | 65,669 | (1,304) | (1.99) |
| 3. Plant | 97,691 | 100,313 | (2,622) | (2.61) |
| 4. Equipment | 4,788 | 4,984 | (196) | (3.93) |
| 5. Motor vehicles | 1,400 | 1,280 | 120 | 9.38 |
| 6. Fixtures & Fittings | 1,631 | 1,372 | 259 | 18.88 |
| 7. TFA in progress | 35,359 | 23,825 | 11,534 | 48.41 |
| 8. Other assets | 1,156 | 1,217 | (61) | (5.01) |
| Intangible assets | 242 | 163 | 79 | 48.47 |
| Investments available for sale | 320 | 320 | - | 0.00 |
| Deferred tax assets | 460 | 460 | - | 0.00 |
| Other non-current assets | 1,101 | 1,218 | (117) | (9.61) |
| | **222,203** | **214,511** | **7,692** | **3.59** |
| **Current assets** | | | | |
| Inventories | 138,411 | 132,351 | 6,060 | 4.58 |
| Receivables from clients and suppliers, incl. | 27,230 | 25,523 | 1,707 | 6.69 |
| 1. Receivables from clients | 24,222 | 22,913 | 1,309 | 5.71 |
| 2. Advances to suppliers | 3,008 | 2,610 | 398 | 15.25 |
| Other current assets, incl. | 6,552 | 4,003 | 2,549 | 63.68 |
| 1. Taxes refundable | 4,233 | 3,073 | 1,160 | 37.75 |
| 2. Court and awarded receivables | 469 | 194 | 275 | 141.75 |
| 3. Other receivables | 422 | 308 | 114 | 37.01 |
| 4. Prepayments | 1,428 | 428 | 1,000 | 233.64 |
| Cash and cash equivalents | 167,155 | 183,595 | (16,440) | (8.95) |
| | **339,348** | **345,472** | **(6,124)** | **(1.77)** |
| **TOTAL ASSETS** | **561,551** | **559,983** | **1,568** | **0.28** |

| | | | | |
|---|---|---|---|---|
| **EQUITY AND LIABILITIES** | | | | |
| **Capital attributable to the owners of the equity of the parent company** | | | | |
| Share capital | 7,367 | 7,367 | - | 0.00 |
| Reserves | 108,638 | 106,815 | 1,823 | 1.71 |
| Retained earnings | 161,826 | 213,759 | (51,933) | (24.30) |
| | **277,831** | **327,941** | **(50,110)** | **(15.28)** |
| **Non-controlling interest** | **39,498** | **45,301** | **(5,803)** | **(12.81)** |
| **Total equity** | **317,329** | **373,242** | **(55,913)** | **(14.98)** |
| **LIABILITIES** | | | | |
| **Non-current liabilities** | | | | |
| Long-term bank loans | 9,940 | 6,782 | 3,158 | 46.56 |
| Deferred tax liabilities | 3,531 | 3,531 | - | 0.00 |
| Retirement benefit obligations | 17,429 | 16,838 | 591 | 3.51 |
| | **30,900** | **27,151** | **3,749** | **13.81** |
| **Current liabilities** | | | | |
| Payables to suppliers and clients | 29,281 | 38,277 | (8,996) | (23.50) |
| Short-term bank loans | 3,890 | 6,486 | (2,596) | (40.02) |
| Short-term portion of long-term bank loans | 7,102 | 4,054 | 3,048 | 75.19 |
| Tax liabilities | 102,449 | 98,402 | 4,047 | 4.11 |
| Payables to personnel | 7,418 | 8,128 | (710) | (8.74) |
| Payables to social security | 1,975 | 1,907 | 68 | 3.57 |
| Other current liabilities | 61,207 | 2,336 | 58,871 | - |
| | **213,322** | **159,590** | **53,732** | **33.67** |
| **TOTAL LIABILITIES** | **244,222** | **186,741** | **57,481** | **30.78** |
| **TOTAL EQUITY AND LIABILITIES** | **561,551** | **559,983** | **1,568** | **0.28** |

At 30 June 2011, the balance sheet figure of Bulgartabac Group is BGN 561,551 thousand and if compared with the figure as of 31 December 2010 it has increased by BGN 1,568 thousand (0.28%).

The change in the amounts of Group’s assets is due to the increase in non-current assets by BGN 7,692 thousand (3.59%), as also to the decrease in current assets by BGN 6,124 thousand (1.77%).

The increase in non-current assets is mainly due to the increase of carrying amounts of items of **property, plant and equipment** by BGN 7,730 thousand (3.64%). This increase is affected by the compensated effect of the following factors:

- the increase due to newly acquired assets and FTA in progress – BGN 15,114 thousand;
- the decrease due to depreciation accrued for the period from 1 January 2011 to 30 June 2011 – BGN 7,355 thousand and assets derecognised – BGN 29 thousand.

The increase in **intangible assets** by BGN 79 thousand (48.47%) is due to the compensated effect of:

- the increase due to newly acquired intangible assets – BGN 110 thousand
- the decrease due to depreciation accrued for the period from 01 January 2011 to 30 June 2011 – BGN 31 thousand.

**Other non-current assets** have decreased by BGN 117 thousand (9.61%).

The decrease in current assets is mainly due to the compensated effect of:

- <u>the decrease</u> in **cash and cash equivalents** by BGN 16,440 thousand (8.95%);
- <u>the increase in</u> carrying amounts of **inventories** – BGN 6,060 thousand (4.58%);
- <u>the increase in</u> carrying amounts of **receivables of clients and suppliers** – BGN 1,707 thousand (6.69%)
- <u>the increase</u> in **other current assets** – BGN 2,549 thousand (63.68%) (comprising the increase in taxes refundable by BGN 1,160 thousand, prepayments by BGN 1,000 thousand, court and awarded receivables by BGN 275 thousand, and other receivables by BGN 114 thousand).

The changes in equity and liabilities of the Group are due to the changes in the amounts of equity – a decrease by BGN 55,913 thousand (14.98%) and increase in liabilities by BGN 57,481 thousand (30.78%). The change in the Group's liabilities is due to both the increase in **non-current liabilities** by BGN 3,749 thousand (13.81%) and the increase **in current liabilities** by BGN 53,732 thousand (33.67%).

The increase in **non-current liabilities** is due to the compensated effect of:

- <u>the increase in</u> carrying amounts of: **long-term bank loans** – by BGN 3,158 thousand (46.56%) and **long-term retirement benefit obligations** by BGN 591 thousand (3.51%);

The increase in **current liabilities** is due to the compensated effect of :

- <u>the increase in</u> carrying amounts of: **short-term portion of long-term bank loans** – by BGN 3,048 thousand (75.19%); **tax liabilities** by BGN 4,047 thousand (4.11%); **payables to social security** by BGN 68 thousand (3.57%), and **other current liabilities** by BGN 58,871 thousand;
- <u>the decrease in</u> carrying amounts of: **payables to suppliers and clients** by BGN 8,996 thousand (23.50%), **short-term bank loans** by BGN 2,596 thousand (40.02%); **payables to personnel** by BGN 710 thousand (8.74%).

The decrease in **equity** is due to:

- <u>the lower</u> carrying amount of **equity attributable to the owners of the equity of the parent company** by BGN 50,110 thousand (15.28%) – arising out of the decrease in **retained earnings** by BGN 51,933 thousand and the increase in **reserves** by BGN 1,823 thousand;

The decrease in **retained earnings** is due to the effects of profit distribution for dividends – ↓ BGN 52,983 thousand, profit distribution for reserves – ↓ BGN 2,184 thousand, profit distribution for tantiemmes – ↓ BGN 17 thousand, the financial result – ↑ BGN 2,890 thousand, and loss cover on account of reserves – ↑ 255 thousand, and transfer to accumulated profits upon withdrawal from use of items of property, plant and equipment – ↑ BGN 106 thousand.

The increase in **reserves** by BGN 1,823 thousand is due to the compensated effect of profit distribution for reserves – ↑ BGN 2,184 thousand, loss cover on account of reserves – ↓ BGN 255 thousand, and transfer to accumulated profits upon withdrawal from use of items of property, plant and equipment – ↓ BGN 106 thousand.

- the decreased carrying amount of **non-controlling interest** by BGN 5,803 thousand (12.81%) is primarily a result of the compensated effect of profit distribution for dividends ↓ 6,126 thousand, profit distribution for tantiemmes – ↓ BGN 1 thousand, and financial result attributable to non-controlling interest– ↑ BGN 324 thousand.

## 4. Major risks and uncertainties faced by Bulgartabac group companies in 2011

The management policy of Bulgartabac-Holding AD for 2011 will be directed towards performance of activities committed to the strategic directions of the company – the long-term and operating goals for the development of Bulgartabac Group:

**The long-term goals** for development of Bulgartabac Group for the period 2011-2013 are as follows:

- maintaining leading market share of at least 30% of the cigarette market in Bulgaria;
- increasing export volumes – reaching export levels for tobacco products of 20 thousand tons per year (2012-2017).

**The operating goal** of Bulgartabac-Holding AD is to ensure sustainable effectiveness of the company by improving financial discipline and implementing effective measures aimed at cutting down fixed expenses by 5% as compared with the previous reporting period.

***Factors that will have an impact on the group companies' operations throughout the year:***

*Political factors*

- Strong political will for the privatization of Bulgartabac-Holding AD;
- Legislative changes concerning the manufacturing, storage and sales of excise goods on the territory of the country;
- Presidential and local elections in 2011 and parliamentary elections in 2013;
- Legislative measures for restriction of tobacco smoking and advertising of cigarettes;
- Ambition of the Government to apply anti-crisis measures and incentives that should lead to positive trade balance of the country already during 2011;
- Political changes in some Arab countries, which have brought about an increase in oil prices in the beginning of 2011.

*Economic factors*

- Positive assumptions for the development of the global economy during 2011-2013 and coming out of the recession in 2011 already;
- Gradual transition of the Bulgarian economy to a model of development, in which export is the main growth factor;
- Smooth increase of consumer confidence as well as higher inflow of direct foreign investments (2011-2013);
- Increased excise rates of cigarettes (during 2011 only for the sizes that are not manufactured by Bulgartabac Group) and of roll-your-own tobacco - from BGN 100/kg to BGN 130/kg (2011);
- Considerable share of sales of cigarettes without excise stamp or with foreign excise stamp in the country;
- Expected increase in prices of basic raw materials due to the increase in oil prices;
- Increased sensitivity of the cash flows of the cigarette manufacturing companies of Bulgartabac Group due to the fluctuations of the USD exchange rate against that of the other world's currencies.

*Social Factors*

- Worldwide social and health policy of fighting tobacco smoking;
- Restrictive law on smoking in public places and restaurants;

- Drop in employment, although with subsiding rate of reduction, due to the continuing process of restructuring of the companies in the country;
- Binding the policy on income growth with the growth of labour productivity and the potential of the economy and the budget of the country;
- Potential threat of social tension with the progress of the process of privatization and restructuring of Bulgartabac-Holding AD;
- Need to cut down expenses, including personnel expenses, which also lead to the respective negative social consequences.

*Technological factors*

- Legislative restrictions on advertising and marketing of tobacco products, leading to intensification of the competition among manufacturers in the area of quality, sizes and outer appearance of the products and, respectively, to introduction of still newer technologies;
- Production of self extinguishing cigarettes (LIP paper) for the brands to be sold on the territory of EU starting as of 17 November 2011;
- Bulgartabac Group companies have modern technological equipment at their disposal which guarantees the manufacturing of high quality competitive products and enables them to develop and update their product ranges, in conformity with market trends;
- Consistent policy regarding the outer appearance of the products of Bulgartabac Group.

Other risks factors **inherent** to the company’s activity may be reviewed in the following directions:

***Risk factors specific to the Growing and Buying-up of Raw Tobacco Sector***

The membership of Bulgaria in the EU has led to dynamic changes in the development of the Raw Tobacco Growing Branch in the country and the legislative mechanisms of tobacco buy-up and processing.

1. Starting with crop 2010 the minimum purchase prices of raw tobacco, earlier being fixed each year by the Council of Ministers, were eliminated. Tobaccos of the crop were bought-up at market prices determined by each company licensed to conduct tobacco processing.

2. By issue 19 of the State Gazette of 08 March 2011 Articles 11, 16 and 33 of the Tobacco and Tobacco Products Act were repealed as also the texts of the Act related to the repealed articles. The main changes are as follows:

- liberalization of the raw tobacco market – this will lead to significant changes in the organization of the process of buying-up of this raw material with many “small” buyers that do not have permits for tobacco processing penetrating the market. This change is forecasted to have an insignificant impact on the tobacco processing companies operating in the country;
- the obligation to carry out the tobacco processing within the territory of the country was eliminated;
- the imperative regulation of the Tobacco and Tobacco Products Act for conclusion of contracts between the tobacco growers and the purchasers of raw tobacco was abolished.

The manufacturers of large leaf tobacco reacted first to the change in legislation and reduced their volumes of production by about 46% of crop 2010 compared with the volumes of crop 2009. The production of oriental tobacco remained almost the same. For crop 2011, the studies show that there is a significant decrease in areas planted with oriental tobacco and Barley, and relative preservation of areas planted with Virginia tobacco vs. crop 2010.

***Risks in the area of tobacco trade***

In 2011 as well, Bulgartabac-Holding AD continued to implement actively and carry out a flexible trade policy of offering and selling Bulgarian tobaccos on the international market, as well as supplying continuously cigarette production with the required raw tobacco.

***<u>Financial risk management</u>***

In the ordinary course of its business activities, the companies of Bulgartabac Group are exposed to a variety of financial risks the most important of which are: market risk (including currency risk, risk of changes in fair value, and price risk), credit risk, liquidity risk, and risk of interest-bearing cash flows. The general risk management is focused on the difficulties of forecasting the financial markets and minimizing the potential negative effects that might affect the financial results and position of the company. The financial risks are currently identified, measured and monitored through various control mechanisms introduced in order to establish adequate prices for the services, provided by the company, to appropriately assess the market circumstances related to its investments and the forms for maintenance of free liquid funds through preventing undue concentration of a particular risk.

Risk management in the Group is currently executed by the management and the respective structural units, depending on the type and specific features of various risks to which the company is exposed in its operations, and respectively by the respective structural units of the parent company – the Group as a whole.

*Financial risk management is described in detail in the notes to the interim financial statements.*

***<u>On the grounds of Art. 100o, para. 7 of POSA we hereby notify that the interim consolidated financial statements for the year ending 30 June 2011 of Bulgartabac Group have neither been certified nor audited.</u>***

**Ivan Bilarev**
Executive Director
of Bulgartabac-Holding AD