Translation from Bulgarian

INTERIM REPORT

ON THE ACTIVITY OF BULGARTABAC-HOLDING AD
FOR THE SECOND QUARTER OF 2011
in accordance with Art. 100o, para. 4, i.2 of Public Offering of Securities Act (POSA) and Art.33 of Ordinance No 2

1. Important events, which have occurred during the second quarter of 2011 and their impact on the results reported in the financial statements

At the regular General Meeting of Bulgartabac-Holding AD, Sofia, held on 23 June 2011, the following resolutions were passed in accordance with the agenda previously announced:

- The General Meeting approves the report of the registered auditor on the results of the audit of the company's financial statements for 2010.
- The General Meeting approves the report of the registered auditor on the results of the audit of the company's financial statements for 2010.
- The General Meeting approves the audited annual financial statements of the company for 2010.
- The General Meeting approves the proposal of the Board of Directors for distribution of the Company's profit for 2010, as follows:

  - 10% to Reserve Fund in accordance with Art. 246, para. 2, i.1 of the Commercial Act;

  - after deducting the allocations for Reserve Fund, 80% of the profit to be distributed as dividends to the shareholders on the grounds of Art. 26 of a Council of Ministers Decree /CMD/ No. 334 of 29 December 2010 for execution of the State Budget of Republic of Bulgaria for 2011;

  - on the grounds of Art. 33, para. 9 of the Rules for exercising the rights of the state companies with state participation in capital, approved by CMD No 112 of 23 May 2003 /promulgated in State Gazette issue 51 of 03 June 2003/, latest amendment SG issue 72 of 14 September 2010, effective 14 September 2010, tantiemmes to be allocated to the members of the Board of Directors of the company in an amount of one average salary as received during the year;

  - the remaining amount of the 2010 profit, after the above distributions, to be transferred to Other Reserves Fund.

- General Meeting of Shareholders takes a decision for distribution of the company's retained earnings among the shareholders of Bulgartabac-Holding AD proportionately to their shares.
- The General Meeting approves the Report of the Board of Directors on the activity of Bulgartabac Group for 2010.
- The General Meeting approves the report of the registered auditor on the results of the audit of the consolidated financial statements for 2010 of Bulgartabac Group.
- The General Meeting approves the audited consolidated annual financial statements of Bulgartabac Group for 2010.
- The General Meeting approves the report of the Investors Relations Director on his activity in 2010.
- The General Meeting approves the transactions carried out under Art. 114, para. 4 of POSA,

which are disclosed in detail in the substantiated report, as follows:

- Annex 47 of 01 February 2010 to the Trademark License Agreement No 005-L of 01 January 1995 regarding royalties for sales of tobacco products in the domestic market in the amount of BGN 4 672 797.00, VAT excluded;

- Annex 48 of 14 June 2010 to Trademark License Agreement No 005-L of 01 January 1995 regarding royalties for sales of tobacco products in the domestic market in the amount of BGN 2 302 938.00, VAT excluded;

- Annex 2 of 19 May 2010 to the Contract No 133-Ц of 03 July 2000 on the trade representation remunerations upon sales under intra-Community supplies and supplies to third countries (export) of tobacco products and cut tobacco manufactured by Blagoevgrad-BT AD in the amount of BGN 4 031 102.31, VAT excluded;

- Contract No 347 – DP of 15 November 2010 on the sale of tobaccos owned by BTH AD in the amount of BGN 2 230 000.00, VAT excluded;

- Contract No 353 – DP of 15 November 2010 on the sale of tobaccos owned by BTH AD in the amount of BGN 470 000.00, VAT excluded."

- ➢ The General Meeting is against the approval of decisions under this item.
- ➢ The General Meeting exonerates from responsibility of the members of the company's Board of Directors for their activity in 2010, as follows:
  - Ivan Atanasov Bilarev
  - Alexander Dimitrov Manolev
  - Georgi Serafimov Kostov
- ➢ The General Meeting appoints the specialized audit firm „HLB Bulgaria" OOD, Sofia, registered auditor No 017, to audit and certify the separate and consolidated financial statements for 2011 of BULGARTABAC-HOLDING AD.
- ➢ The General Meeting determines the remuneration of the members of the Board of Directors who will not be entrusted with the company's governance shall be determined in accordance with the principles, indicators, criteria and amounts stipulated in Art.33 of the Regulation for the Order for Exercising of the rights of the State in the Commercial Companies with State Participation in the Capital, in compliance with the requirements of Art.19, para.7 of the Administration Act, effective 01 January 2009, and Art.7, para.3 of the Civil Servants Act, effective 01 January 2009.
- ➢ General Meeting of Shareholders takes a decision for payment of dividends to the shareholders of Bulgartabac-Holding AD, proportionately to their shares, on account of item "retained earnings", account 117 "Additional Reserves" of the company, in the amount of BGN 30,193,124 (thirty million one hundred ninety-three thousand one hundred and twenty-four Bulgarian leva).

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 31 158 447.1
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, Par.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.

2. Development of the activity for the period 01 April – 30 June 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 Bulgartabac-Holding AD approved the following purchase prices by classes in BGN/kg of purchased tobacco for groups Basma, Kaba Koulak and Burley, crop 2010:

Class	Variety group		
	Burley	Kaba Kulak	Basma
I class	3.90 BGN/kg	3.80 BGN/kg	7.35 BGN/kg
II class	2.60 BGN/kg	3.10 BGN/kg	4.85 BGN/kg
III class	1.40 BGN/kg	1.85 BGN/kg	1.90 BGN/kg

The quantities of tobacco, crop 2010, purchased on behalf and on account of Bulgartabac-Holding AD, were as follows:

Basma	- 2 317 tons
Kaba Koulak	- 540 tons
Burley	- 973 tons
Total	3 830 tons amounting to BGN 13 567 thousand

During the first six months of 2011, based on the service contracts concluded, Pleven-BT AD made the industrial processing of tobacco of Burley tobacco and commenced the processing of oriental tobaccos, crop 2010.

Finished products manufactured at 30 June 2011 were as follows:

Burley	814 tons
Kaba Kulak	445 tons
Basmi	1682 tons

During Q’1 of 2011 Bulgartabac-Holding AD concluded a contract with Pleven-BT AD for the sale of tobacco stems for the amount of BGN 118 thousand, VAT excluded, which impacted the financial result of the Holding for the same quarter.

During Q’2 of the year, Bulgartabac-Holding AD concluded contracts for the sale of Burley strips, crop 2010, with Blagoevgrad-BT AD and Sofia-BT AD for the amount of BGN 1 241 thousand, VAT excluded, and BGN 1 679 thousand, VAT excluded, respectively. The above two contracts will have an impact on financial result of the Holding for Q’3 of 2011.

- **Trade in tobacco**

Tobacco export

Bulgartabac-Holding AD traditionally exports oriental and large leaf tobacco under conditions of high competition and performs its activity in selling tobacco under conditions of liberalized tobacco market. 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 and 2011. Lots from crops 2008, 2009 and 2010 were included in the export structure during this period, as also some small quantities from crop 2006. In the first six months of 2011, Bulgartabac-Holding AD directed its efforts towards offering and binding by contracts these quantities of tobacco that were available for sale. New contracts were signed, and contracts with traditional clients of the Holding were renewed. Compared with the same reporting period of 2010, during the first six months of 2011 there was an increase in the total volume of tobacco sold in terms of quantity and increase in revenue from trade representation fees. The total quantity of own tobacco sold through export, intra-Community supplies and domestic sales during the first six months of 2011 was 375 162.4 kg, or BGN 1 967 465.87.

The total quantity of tobacco sold by Bulgartabac Group during the first six months of 2011 was 651 522.4 kg amounting to BGN 3 371 191.73.

Tobacco import

For the needs of cigarette production and on the grounds of contracts of trade representation, Bulgartabac-Holding AD is mediating in the overall process of purchasing by the subsidiaries of the required quantities of raw tobaccos from imports, and its activities cover the selection of tobaccos by regions and qualities, contracting, delivery and coordination of payments to sellers. Virginia and Burley tobaccos, tobacco stems and reconstituted tobacco are imported for the needs of manufacturing. 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.

The operating results from the sales of tobacco (exports, Intra Community Supplies and domestic sales to unrelated parties) by Bulgartabac-Holding AD at 30 June 2011 were as follows:

Sales of own tobaccos (Exports, Intra Community Supplies and Domestic Sales to unrelated parties) by Bulgartabac-Holding AD	
30.06.2011	30.06.2010
375.1 tons	312.2 tons
BGN 1 967.4 thousand	BGN 2 075.9 thousand

Fees from trade representation paid to Bulgartabac Holding AD re: Exports, Imports, Intra Community Supplies & Acquisitions and Domestic Sales to unrelated parties (in BGN, VAT excluded)	
30.06.2011	30.06.2010
BGN 669 thousand	BGN 492 thousand

- **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 Holding 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:

1. 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.

2. 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 the previous year.

3. The 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.

4. 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.

Subsidiaries pay royalties to the Holding as follows.

Royalties for Bulgartabac-Holding AD in relation to rights of trademarks	
30.06.2011	30.06.2010
BGN 6 212 thousand	BGN 3 903 thousand

- **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.

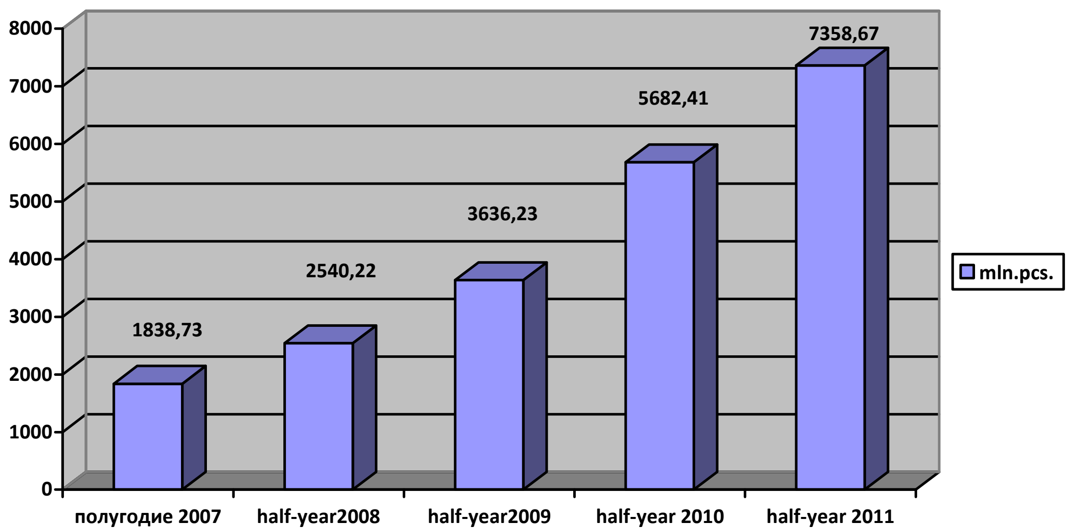
The types of products included in the export list of Bulgartabac-Holding AD for 2011 are in full compliance with the requests, needs and preferences of the clients of each of the regions. Special attention is paid to consumer packing of cigarettes – the quality of design and print of the pack, corresponding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

The results achieved during the first six months of 2011 compared with those for the same period of previous years are as follows:

(thousand pieces)

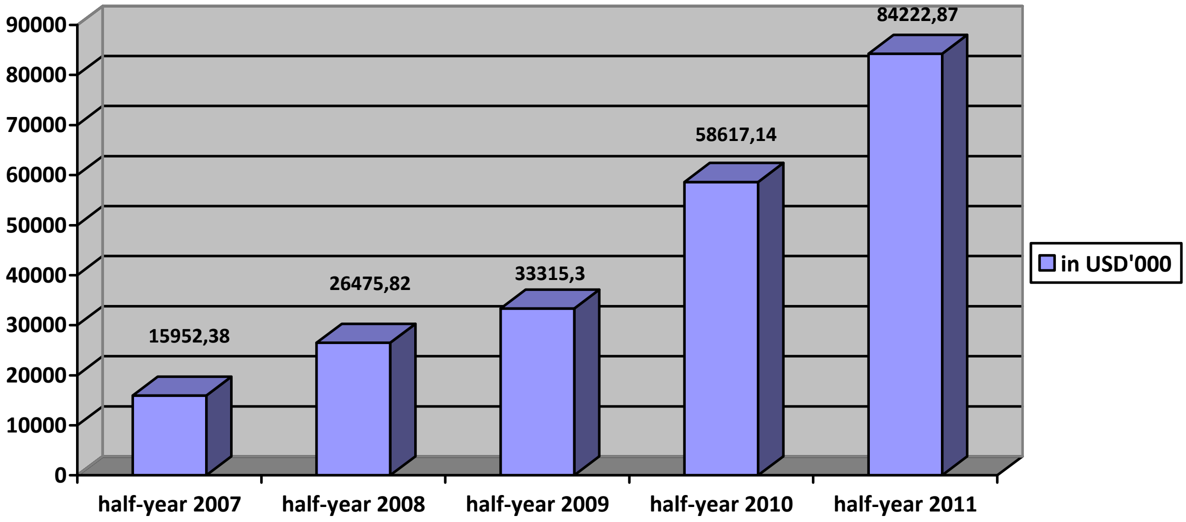
half-year 2007	1,838,730
half-year 2008	2,540,220
half-year 2009	3,636,227
half-year 2010	5,682,413
half-year 2011	7,358,665



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%.

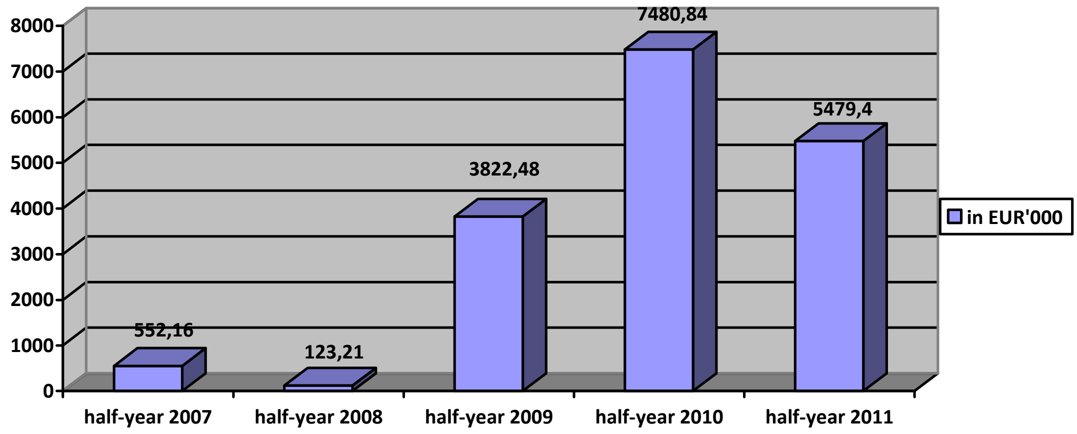
(in USD)

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.

The subsidiaries pay fees for trade representation for exports carried out by Bulgartabac-Holding AD on their account that are fixed as percentage of the transaction value.

Fees for trade representation paid to Bulgartabac-Holding AD re: Export of cigarettes (commissions)	
30.06.2011	30.06.2010
BGN 4 488 thousand	BGN 2 141 thousand

- **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.

Fees for trade representation to Bulgartabac-Holding AD (commissions) in Intra Community Acquisitions and Imports of auxiliary materials and spare parts	
30.06.2011	30.06.2010
BGN 469 thousand	BGN 260 thousand

- **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.

- **Quality Management System**

In Q'2 of 2011, the process of preparation of the input materials for conducting a review by the QMS management started, aiming to achieve the requirements of the standard and to develop the Quality Management System (QMS) of Bulgartabac-Holding AD. The summarised reports and statements on the achievement of the 2010 Quality Goals were combined and rendered systematic, in compliance with the requirements of the standard. As a result of the review conducted by the QMS management on 28 April 2011 specific recommendations were made in connection with the system's development. The 2011 Quality Goals were updated and made more specific in view of the recommendations made and discussions held during the meeting.

Pursuant to the internal audits plan of QMS, an audit of the process *Trade in Tobacco* at the Tobacco Import and Export Department was carried out. The audit was completed with the issuance of a report stating that there were no inconsistencies as per the requirements of the standard ISO 9001:2008.

Upon requests of Tobacco Products Directorate and Tobacco Directorate, the procedure ПР 7.4.021 "Import of tobacco for the needs of cigarettes manufacturing" was changed, and the effectiveness of the work of QMS and departments affected by the procedure was improved.

An important task in maintaining the required competence of internal auditors is their periodical training. During the period 19-20 April 2011 three internal auditors took part in a training course held by AFNOR International Bulgaria. The subject of the training was the audit of management systems. The training course was completed by a test passed by the three auditors with scores between 70 and 80 and an overall rating of "very good".

During this period there were no inconsistencies recorded and claims raised by our clients.

The employees of Bulgartabac-Holding AD started using the updated QMS system published in our intranet.

3. Analysis of the financial status and financial result of Bulgartabac Holding AD as of 30 June 2011

Under conditions of highly competitive environment and significant share of unregulated sales of tobacco products, Bulgartabac-Holding AD closed the first six months of 2011 with a positive financial result of BGN 34,091 thousand. In comparison, the result for the same interim period of 2010 was a loss amounting to BGN 577 thousand.

Revenue for the interim reporting period of the current year amounts to BGN 45,966 thousand, a significant increase compared with the revenue reported for the comparative period of 2010. The above increase is a result of the accrued higher amount of dividends which have been approved for distribution at the General Meetings of Shareholders of both cigarette factories, as well as to the positive trend in the Company's business activity and consistent measures to maintain financial discipline.

A number of factors and events have affected the financial performance of Bulgartabac-Holding AD, the major ones being the following:

1. The General Meetings of Shareholders of Sofia-BT AD and Blagoevgrad-BT AD held in June 2011, whereat much higher dividends were approved for distribution compared to dividends distributed in 2010 (being the natural result of the improved financial ratios of both cigarette factories and a consequence of the decision of the majority shareholder of Bulgartabac-Holding AD to distribute dividends from prior year retained earnings), as follows:

Company	Dividends approved for distribution among shareholders	incl. for Bulgartabac-Holding AD
Blagoevgrad-BT AD – profit for 2010	7 103 890,09	6 055 218,17
Blagoevgrad-BT AD – prior year retained	24 054 557,01	20 503 637,99

earnings		
Sofia-BT AD	7 001 259,03	5 476 041,25
Total	38 159 706,13	32 034 897,41

2. At the General Meeting of Shareholders of Bulgartabac-Holding AD held on 23 June 2011, it was decided to distribute dividends against the 2010 profit, prior year retained earnings and additional reserves, as follows:

Against the 2010 profit	4 194 224,99
Against the retained earnings	18 596 011,42
Against the additional reserves	30 193 124
Total for distribution, incl. for the State	52 983 360,41 42 297 527,65

On 15 July 2011, Bulgartabac-Holding AD transferred the amount of BGN 42 297 527.65 as dividend for the Bulgarian state, in its capacity of a majority shareholder, whereas the transaction will be reported in the financial statements for the following reporting period.

3. The terms of buy-up changed in the previous period (for crop 2009), combined with the higher volumes and prices connected to the tobacco buy-up and processing in the current period impacted the structure of financial balances. Higher costs of materials, buy-up and processing were reported, as also higher stock of finished products.

<u>Analysis of the Statement of Comprehensive Income</u>

The increase in revenue from BGN 10 031 thousand (for Q'1 of 2010) to BGN 45 966 thousand (for the period 01 January -30 June 2011) is due to:

- growth in dividend income from subsidiaries, as described above. In comparison, for the first six months of 2010 dividends amounting to BGN 1 108 thousand were reported.

- growth in royalties from BGN 3 903 thousand in the first six months of 2010 to BGN 6 212 thousand in the first six months of 2011 (or 59.16%).

This favourite trend is due to the much higher volumes of tobacco products sold by the two cigarette factories in the domestic market and for export:

million pieces

Tobacco products sold		*Half-year 2010*	*Half-year 2011*	*Growth %*
Blagoevgrad-BT AD	Domestic market	667	1140	*70,91*
	Export	2854	3834	*34,34*
Sofia-BT AD	Domestic market	386	799	*106,99*
	Export	2829	3639	*28,63*

The high share of products for export has led to more than 2 times growth in revenue from trade representation fees upon the export of cigarettes – from BGN 2 141 thousand in the previous period to BGN 4 488 thousand in the reporting period. In general, the increase in total volume of products sold during the reported interim period of 2011 has led to higher volumes of tobacco and auxiliary materials supplied. This, in turn, has had a positive effect on the higher amount of revenue under trade representation contracts in relation to the import and export of tobaccos (by 34.14%), as also to the import of auxiliary materials (by 73.50%).

The implemented effective measures of the restriction-of-cost policy have also contributed to the overall successful performance of the company in the first six months of 2011. In this regard, the following has been reported, as compared with the same interim period of the previous year:

- a cut down of personnel expenses by BGN 148 thousand primarily due to lower amounts accrued for severance pay;
- a cut down of depreciation / amortization costs by BGN 381 thousand, or by 36.92%.

Besides the above mentioned circumstances, the following factors have also had a direct impact on the financial result for the first six months of 2011:

- ✓ increase in costs of hired services by BGN 2 414 thousand in total, or by 41.21% (mainly of advertising costs which report an increase by BGN 987 thousand, or a 49.87% growth). This was because the active intervention policy aimed at maintaining sustainable market positions and loyal consumers of products of Bulgartabac Group under conditions of high competition. During the period, the change in the packing and design of the leading trademark Victory was introduced, which had necessitated a targeted marketing campaign in support of the leading market share of the brand aiming at preserving the customers loyalty through making the mark more distinguishable. A similar trend had been observed in the first quarter of the year as well. As contrasted with Q'1 of 2010, when the lower price (at excise duty stamps of 2009) of tobacco products was used as a marketing tool, in Q'1 of 2011, the aggressive advertising campaign of competitors and indications of a price war presumed adequate investments in advertising and marketing events with the aim to preserve the leading market share of Bulgartabac;
- ✓ increase in costs of materials – tobacco (raw material) by BGN 1 324 thousand (11.86%) and increase in costs of tobacco processing by BGN 842 thousand, or by 38,96 %, and of administrative expenses on processing and buy-up by BGN 399 thousand vs. the figures reported for the first six months of 2010, which was due to the cumulative effect of the increased buy-up prices, the increased prices of buy-up and processing services per unit of raw material (raw tobacco) and the higher quantities of tobacco purchased and processed. The higher costs reported in the period under review which relate to the buy-up and processing of tobacco were due to the higher tobacco needs of the increased cigarette production of group companies, the maintenance of the required stock of inventories and also as part of the implemented trade policy. Naturally, in view of the above described trend, there was an increase in stock of finished products by BGN 2 471 thousand. It is expected that the increased costs reported in the current period will have a positive financial effect in subsequent periods when finished products will become part of the trade turnover of the Company.
- ✓ increase in investment income by BGN 337 thousand (41%). The positive contribution is due to the bigger amount of cash (temporary free own cash), which is managed by applying procedures for daily analysis and control with the aim to achieve maximum yield. The average yield achieved for the reporting period exceeded 5.5% on a year-to-year basis;
- ✓ other operating expenses (business trips, training, donations, wastes, etc) report an overall increase of about BGN 229 thousand.

Cash flow analysis

Cash of “Bulgartabac - Holding” AD at 30 June 2011 amounted to BGN 39,657 thousand, or by 29.15% more than cash available in the same interim period of 2010, the main reason being the increase in the net cash at the beginning of 2011.

For the first six months of 2011, Bulgartabac-Holding AD reported net decrease in cash and cash equivalents by BGN 9,903 thousand, or by BGN 5,559 thousand more than the decrease reported in the same interim period of 2010.

During the period under review, the Company reported negative net cash flows from operating activity amounting to BGN 10,717 thousand. The amount of this indicator is conditioned by the purchases of raw tobacco, crop 2010, which resulted in higher stocks of the company during the interim period of 2011 under review.

For the period 01 January - 30 June 2011, the Company reported positive net cash flows from investing activity, primarily due to the interest received on structured deposits of the company’s temporary free cash. This indicator is a positive figure for the comparative interim period of 2010 as well.

During the fist six months of 2011, Bulgartabac-Holding AD reported a negative net cash flow from financing activity in the amount of BGN 8 thousand, or much less than the cash flows reported for the comparative previous period when dividends to shareholders were paid. At the General Meeting of Shareholders of Bulgartabac-Holding AD held on 23 June 2011, a decision was taken to distribute dividends of BGN 52 983 360.41 against the 2010 profit, prior year retained earnings and additional reserves, which will be paid within the legally established deadlines.

Analysis of the Statement of Financial Position

The balance sheet figure of Bulgartabac-Holding AD at 30 June 2011 was BGN 133,654 thousand. In comparison, it amounted to BGN 99,459 thousand at 31 December 2010. The reason for this increase was the growth in current assets by 48.14%, primarily due to the following reasons:

- the higher stock of raw tobacco by BGN 15 584 thousand, or 174.59%, as a result of the higher stock of finished products. Therefore, cash and cash equivalents dropped by about 20% and were transformed into another type of assets - inventories.
- increase in related party receivables by BGN 26 323 thousand as a result of the higher amount of dividends approved for distribution by the shareholders of Sofia-BT AD and Blagoevgrad-BT AD.

In Q’1 of 2011, the equity decreased by 20.14% (BGN 18 897 thousand) after reporting (making an accrual of) the decision taken by the shareholders for distribution of dividends, as described above, against the 2010 profit, prior year retained earnings and additional reserves.

The current liabilities of the Company at the end of the first half of the year of 2011 showed an increase by BGN 52 867 thousand, again due to the effect of the accrued dividend liabilities. In contrast to the previous comparative period, at 30 June 2011 related party liabilities were reported in relation to the tobacco buy-up and processing service, as the formation of such liabilities is a trend continuing from the last quarter which could be explained with the higher quantities of tobacco purchased, in turn requiring a longer period of processing.

There was also an increase in payables to personnel by 32.22 %, or BGN 394 thousand.

Financial ratio analysis

Financial ratios	Report 30.06.2011	Report 31.12.2010	Report 30.06.2010
Price / Earnings (loss) per share (P/E)	7,40	38,98	-191,52
Market capitalisation / Sales revenue (P/S)	5,49	5,39	11,02
Price / Accounting value (P/B)	3,37	2,41	1,26
Return on equity (ROE)	45,49%	6,21 %	-0,66%
Return on assets (ROA)	25,51%	5,86 %	-0,61%
Earnings (loss) before taxes and interest expense – BGN'000 (EBIT)	34 180	6 356	-577
Earnings (loss) before taxes and interest expense / Equity (ROE using EBIT)	45,61%	6,78 %	-0,66%
Earnings (loss) before taxes and interest expense / Assets (ROA using EBIT)	25,57%	6,39 %	-0,61%
Market capitalisation / Earnings (loss) before taxes and interest expense (P/EBIT)	7,38	35,70	-191,52
Debt-Equity ratio	0,78	0,06	0,09
Liquidity ratio (COL)	1,86	17,35	10,31
Assets – Turnover	0,34	0,42	0,11

During the first six months of 2011, Bulgartabac – Holding AD preserved its financial stability and independence. The positive financial result, in contrast to the loss reported for the comparative period of the previous year, has had an impact on the improved financial ratios.

The low levels (below 1) of gearing ratio were some of the most important features of the company and of its ability to cover current and non-current liabilities which occur in the course of its normal business activity. The increase in the ratio vs. the one reported in the previous period was due to the above-described changes in the balance sheet structure with accrued dividend payables and reduced equity.

The decrease in liquidity ratio was due to the higher rate of growth of current liabilities vs. current assets as a result of the higher amount of dividends accrued for the shareholders of Bulgartabac-Holding AD.

The average-weighted price at which the company's shares were traded in the stock exchange at 30 June 2011 was BGN 34.25 per share, while at 30 June 2010 it was BGN 15 per share, which was a reason for improving the stock exchange ratios.

The movement of shares traded in the stock exchange in the short-term run is shown below:

4. Major risks and uncertainties faced by Bulgartabac-Holding AD 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 short-term 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.

Analysis of the conditions in which Bulgartabac-Holding AD will work during 2011

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 of the price of petrol 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 (2012-2013);
- 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 appreciation of petrol;
- 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:

<u>Risk factors specific to the Growing and Buying-up of Raw Tobacco Sector</u>

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 licensed company.

2. By issue 19 of the State Gazette of 08 March 2010 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 growers of large leaf tobacco first reacted to the legislative amendments and reduced their production by about 46% for crop 2010 vs. crop 2009. The production of oriental tobacco remained almost the same. With regard to crop 2011, the studies report that there is a significant decrease in areas where oriental tobacco is planted while the areas with large leaf tobacco remain relatively the same compared to crop 2010.

Risks in the area of tobacco trade

In 2011, Bulgartabac-Holding AD will continue 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.

Risks related to investing in shares of the Company

Bulgartabac-Holding AD is a registered public company whose shares are listed for trading on the Unofficial Market of Bulgarian-Stock-Exchange-Sofia AD, segment A. The market value of shares offered is determined on the basis of demand and supply and their price is dependent on both the economic and financial results of the company and the information being announced publicly by the company, and by the common factors having impact on the capital market in the country.

The company cannot guarantee that there will not be any fluctuations in prices of its shares. In a number of cases, these fluctuations neither relate nor correspond to the operating results of the company and therefore, they cannot be predicted.

The positive and consistent trend of good financial indicators of Bulgartabac-Holding AD for the last two quarters of 2010 and the last two quarters of 2011 has led to significant growth in the share price – by 72.11% (from BGN 19.90 per share at 30 September 2010 to BGN 30.80 per share at 31 December 2010, to BGN 30.42 per share at 31 March 2011, and to BGN 34.25 per share at 30 June 2011), which is an indication that investors have returned their interest and confidence in the company’s shares.

To support the above, we would also point out the fact that by a decision of the Board of Directors of Bulgarian-Stock-Exchange-Sofia AD dated 11 March 2011 Bulgartabac-Holding AD was included, effective 21 March 2011 in the database of two indices: **BG TOTAL RETURN 30** and **BG 40.**

BG TOTAL RETURN 30 is an index based on the price performance of the common shares included in the index portfolio. It comprises the biggest and most liquid 30 companies traded in BSE-Sofia classified in accordance with a number of criteria, each one having equal weight: market capitalization, number of transactions during the last 6 months, turnover during the last 6 months, and free-float.

BG 40 is an index based on the price performance if the issues and comprises 40 issues of common shares of the companies with the greatest number of transactions and the highest median value of the daily turnover during the last 6 (six) months as the two criteria shall have equal weight.

Financial risk management

In the ordinary course of its business activities, the company is exposed to a variety of financial risks the most important of which are market risk (including currency risk, interest rate risk and other price risk), credit risk and liquidity risk. 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 company 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.

Below are presented the various types of risks to which the company is exposed upon performing its commercial transactions as well as the adopted approach for managing these risks.

<u>Market risk</u>

Currency risk

The main part of the economic operations of the company is executed in BGN or EUR. At the same time, in its activities the company receives payments related to sales made in previous periods which were contracted in USD. Thanks to the currency board introduced in Bulgaria and the fixed exchange rate of the Bulgarian lev to EUR, the EUR-based currency risk is immaterial. Therefore, the company is exposed to currency risk mostly in relation to its USD exposure.

An immaterial part of the company's financial assets and liabilities are denominated in USD (incl. cash deposited for long time in escrow accounts (other long-term financial assets) and some of the deposits with commercial banks).

In order to control currency risk, the company has developed and applies the following measures:

- it has implemented a system to plan and monitor on daily basis the movements of USD exchange rate and to exercise control over the forthcoming payments to and from the company;
- the free funds in USD are invested by the company in short-term foreign currency deposits with good yields.

Interest rate risk

Interest rate risk is the risk that the fair value or the future cash flows of the financial instruments, held by the Company, will vary due to changes in market interest rates. Instruments with fixed interest are exposed to interest fair value risk - the price of Group's fixed-rate financial assets will decrease with the increase in the market interest rate, and vice versa.

Floating-rate financial assets and liabilities are exposed to cash flow risk - the future cash flows from floating-rate financial instruments will vary due to changes in market interest rates.

In general, interest-bearing financial assets hold a significant share in the structure of the Company's assets and are represented mainly by bank deposits, cash and fixed-rate loans granted. At the same time, the Company neither holds nor maintains interest-bearing liabilities. Therefore, the operating cash flows depend to a large extent to the changes in market interest rates.

With regard to interest-bearing assets, such as fixed-rate deposits with commercial banks, the Company applies the following procedures for current control and risk management:

- the deposit contracts concluded with commercial banks are short-term ones (usually of up to 1 month) with a maximum term of up to 3 months;

- approved procedures are followed when choosing a bank for the purpose of achieving best interest rates, as at the same time taking into consideration the financial soundness of commercial banks and the need to diversify the risk of concentration of financial resources in the separate banks;

- market conditions are constantly analysed with the support of a special department of the Company and the exposure of interest-bearing assets of the Company is controlled.

Funds in the current accounts bear interest rates according to the tariffs of the relevant banks, which remain relatively constant for a longer period of time, although they are affected by the changes in the basic interest rate.

The Company's management currently monitors and analyses the exposure against changed interest rates, and measures the impact on the financial result and equity in case of change with set points or percentage of interest. For each simulation, the same assumption for interest rate shift is used for BGN and USD.

Price risk

The Company is not exposed to price risk of adverse changes in the prices of goods and services, subject to its operations, because the goods are not traded in stock exchange and as per the contractual arrangements with clients and suppliers, prices are periodically analysed and discussed for revision and update in accordance with market changes. The major sales transactions executed by the Company cover sales of goods and finished products (tobacco), services - commissions related to purchase of raw materials, materials and sales of finished products to subsidiaries, as well as the service to provide a licence for trademarks for the production of tobacco products. As far as the licence service is directly related to the value of tobacco products (determined as a percent of the final selling price), management believes that no price risk exists considering that the prices to tobacco products in the domestic market are determined by the market and are only subject to registration.

In order to manage the price risk as regards the cigarette prices, the Company currently monitors the status and dynamics of the market (monitors the behaviour of the other market participants) for the purposes of adequate pricing of cigarettes depending on the market environment.

Upon sales of goods and finished products (tobacco), the Company was exposed to specific price risk until the year of 2010 in relation to the minimal purchase prices of tobacco determined by a Council of Ministers (CM) Decree. In 2010 the CM of the Republic of Bulgaria did not determine minimal purchase prices of tobacco, crop 2010, and therefore, the purchase prices had been set by a decision of the Company’s management, which minimized this type of risk. Moreover, the Company is exposed to possible negative changes in the tobacco prices in the global market.

The price risk to negative changes in prices is minimized by performing periodic analyses and discussions of the contractual relations in order to re-review and update the prices vs. the market changes.

The Company does not hold a significant portfolio of available-for-sale investments in terms of amount and the available-for-sale investments held by the Company are not traded in a stock exchange, and therefore, the Company is not exposed to risk of changes in the stock prices of securities.

Credit risk

Upon performing its activities, the Company is exposed to credit risk related to the risk that any of its clients or other counterparts will fail to discharge the obligations, related to due amounts under trade and other receivables, in full and within the normally envisaged terms. The latter are presented in the statement of financial position net, less any impairment accrued. Such impairment is made where and when events have existed identifying loss due to uncollectability as per previous experience.

The Company's financial assets are mainly concentrated in the following groups: other long-term financial assets, investments available-for-sale investments, cash – cash in hand and in bank accounts (current and deposit), trade receivables, and receivables from related parties (subsidiaries) and other receivables.

In view of the credit risk of cash flows in bank accounts (current and deposit), the risk management in the case of active transactions with temporarily free cash includes the activities on identifying, measuring and controlling any potential events or situations, which may impact negatively the achievement of the company’s goals to ensure additional stable source of income. The object of analysis is the possible negative consequence (income outflow) which could occur as a result of an unfavourable event and the resources that will be required to overcome this event.

In view of the long-lasting experience and good practices applied, since 2010 Rules for the procedure, methods and criteria for selection of financial organizations providing cash and cash equivalent management services, payment and related services, financing, purchase of specific financial instruments, hedging transactions and other financial services (the Rules) have been effective. The written procedures (Rules) are a methodology applied by a specialised department of the Company and thus, guaranteeing the achievement of maximum economic effect at minimum financial risk. The procedure for selection of a financial service contractor is detailed to such a materiality level that depends on the specifics and complexity of the particular service/transaction/operation and/or on its interim stages within the general implementation plan or its components. Prior to sending an invitation – request to particular financial organisations, an overall marketing analysis of the market of a given (specific) type of financial services transactions/operations is carrying out, the special attention being directed towards information about the level of specialisation of financial organisations and the evaluations (the opinion expressed) of the effectiveness of their joint operations with other financial organisations – correspondents. The criterion for classification of proposals is the economically most favourable offer in terms of the optimal ratio “yield (benefit)/risk”. The complex evaluation is made mandatorily by two groups of criteria – quantitative and non-quantitative ones. A component of the non-quantitative criteria is the diversification policy setting credit limits for the contractors. The diversification policy is applied with the aim to reduce to a minimum the concentration of risks for the Company and to guarantee its stability and steadiness.

The Company does not have a significant concentration of credit risk except for receivables from related parties and companies undergoing insolvency procedures, part of them being risk-bearing due to the worsening financial position of the respective companies. In relation to the credit risk of failure to collect receivables from these subsidiaries (under loan agreements, contracts for trade representation and other) the Company undertakes the following security measures:

- under the loan agreements - upon conclusion collateral is required (usually at 150% of the principal), which includes pledge of inventories, tangible fixed tangible assets, mortgage of real estate, etc. An additional requirement is to issue a promissory note in favour of Bulgartabac-Holding AD - at an amount equal to the sum of the principal and interest under the loan agreement as per the repayment schedule.

- with regard to trade and other receivables, which are past due and have not been secured on their origination, agreements are being concluded for their deferral and collateral is agreed at an amount not less than the initially recognised amount of the receivable. The collateral usually represents an established mortgage of real estate(s);

- regarding the remaining agreements, which are not secured in advance, the following common actions are undertaken in cases of overdue payment by the debtor company - setoff of payables to the company against overdue receivables and where the payable amount is not sufficient to cover the receivable of Bulgartabac-Holding AD, then other out-of-court options are searched to settle receivables (deals related to purchases of assets - tobacco and fixed assets, ownership of the debtor - which are settled by setoff).

In the Company, the current servicing of receivables, the reasons for being past due and the changes in the financial abilities of debtor companies are currently monitored and analysed, and the status and quality of collateral provided is controlled.

Regarding the other clients, the Company's policy is that deferred payments (credit sales) are offered as an exception only to clients having long account of business relations with the Company, good financial position and no history of credit terms violations. Receivables are controlled jointly by the trade and financial departments in the Company by following the established common practice and monitoring the observance of contractual terms and conditions. Sales to the other clients are mainly performed through prepayment (in part or in full) or payment on the date of the transaction.

Liquidity risk

Liquidity risk is the adverse situation when the Company encounters difficulties in meeting unconditionally its obligations within their maturity.

The liquidity management policy of the Company's is conservative maintaining a constant optimal liquid reserve of cash and a good capability for funding its business activities, continuous control monitoring of the actual and forecasted cash flows by periods ahead and matching maturity profiles of assets and liabilities. The Company usually maintains optimal quantity of available cash so that it is able to meet its obligations at any time pursuant to their maturity. The Company generates and has sufficient working capital and does not need borrowed credit resources to finance its operating activities.

Maturity analysis

The Financial and the Accounting Departments monitor currently the maturity and the timely payments by maintaining daily information on the cash available and analysis of forthcoming payments. Free cash is invested usually in short-term deposits with commercial banks.

Capital risk management

The capital management objectives of the Company are to build and maintain capabilities to continue its operations as a going concern and to provide return on the investments of shareholders and economic benefits to other stakeholders and participants in its business as well as to maintain an optimal capital structure to reduce the cost of capital.

The Company currently monitors the availability and structure of its capital. It is a characteristic feature that it traditionally funds its activities from its own generated profits and working capital.

Fair values

Fair value is generally the amount for which an asset could be exchanged, or a liability settled in an arm's length transaction between independent, willing and knowledgeable parties. The Company's policy is to disclose in its financial statements mostly the fair value of these assets and liabilities for which market quotations are available.

The fair value of financial instruments, which are not traded in active markets, is determined through valuation methods based on various valuation techniques and management assumptions made in accordance with the market circumstances as at the balance sheet date.

The fair value concept presumes realization of the financial instruments through sales. However, in most cases especially with regard to trade receivables and payables as well as provided loans and deposits, the Company expects to realize these financial assets also through their total refund or respectively, settlement over time. Therefore, they are presented at their amortised cost which is accepted as being close to their fair value.

In addition, the large part of the financial assets and liabilities are either short-term in their nature (trade receivables and payables) or are presented in the balance sheet at market value (deposits placed with banks) and therefore, their fair value is almost equal to their carrying amount. The available-for-sale investments for which there are neither markets nor objective conditions for a reliable fair value measurement form an exception to this rule. Therefore, they are presented at acquisition cost (cost), which could be accepted conservatively as not materially different from their fair value.

As far as no sufficient market experience, stability and liquidity exist with regard to purchases and sales of certain financial assets and liabilities, still no adequate and reliable quotes of market prices are available thereof. The Company's management has judged that the estimates of the financial assets and liabilities presented in the balance sheet are as reliable, adequate and trustworthy as possible for financial reporting purposes under the existing circumstances in Bulgaria.

5. Information about large-scope transactions concluded among related parties

During **the second quarter of 2011** Bulgartabac-Holding AD did not conclude any contracts for large-scope transactions with related parties.

On the grounds of Art.100o, para.7 of POSA we hereby inform that the interim financial statements as at 30 June 2011 of Bulgartabac-Holding AD have not been certified and audited.

Ivan Bilarev
Executive Director
Bulgartabac-Holding AD