



BULGARTABAC
OPEN TO THE FUTURE

MANAGEMENT REPORT
OF THE BOARD OF DIRECTORS
ON THE ACTIVITY OF BULGARTABAC GROUP
IN THE THIRD QUARTER OF 2016

prepared in accordance with Art. 100o, para. 4, i.2 of Public Offering of Securities Act (POSA)

1. General information about the Company

Bulgartabac-Holding AD (the “Company”), controls, directly or through its subsidiaries, Bulgartabac Group - a Bulgarian manufacturer of tobacco products and leader on the Bulgarian market that has a presence on international markets and offers a broad range of products.

The Group’s production capacity comprises three cigarette factories and one tobacco-processing enterprise, all of which comply with the international standards, have contemporary equipment and use industry’s state-of-the-art technology.

The Group manufactures all tobacco blends in various formats of products. Depending on the market, different types of packing are offered, containing different number of cigarettes. The most popular brands, produced by the Group, are Victory, E♥A, MM, GD, Prestige.

Object of activity

The object of activity of **Bulgartabac-Holding AD** includes share participation and financial resources management; foreign and domestic trade; research and development, engineering and manufacturing activities; participation in Bulgarian and foreign companies and in their management; intellectual property transactions.

The Company has an unlimited permit for industrial processing of tobacco No. 1011 dated 21 December 2004 issued by the Council of Ministers.

The object of activity of **the subsidiaries** includes the following types of transactions and deals:

- Buying-up, industrial processing, preparation for export and trade in tobacco;
- Production, preparation for export and trade in tobacco products;
- Distribution of tobacco products;
- Trade in tobacco products.

2. Development of the activity and status of the group companies in the third quarter of 2016

Important events, which have occurred during the reporting period

In March 2016, management of Bulgartabac announced that as a result of the reduction in orders, as also in order to prevent any more significant business risks, a decision was passed to discontinue the manufacture and sales of products to the Middle East Region as of 1 April 2016.

As a consequence, the Group’s management of believes that there are certain risks and uncertainty with regard to the future income, expenses and financial results from the Group companies’ activities. The Group’s management analyses the occurred and potential consequences of the above circumstances and the necessary measures to reduce and neutralize their effects on business of the Group companies.

During the period 01 January – 30 September 2016 Bulgartabac-Holding AD and the main Group subsidiaries, Sofia Bulgartabac AD, Blagoevgrad BT AD and Pleven BT AD, continued their business activities and measures had been taken to optimise the economic indicators in light of the individual circumstances.

In order to overcome the negative consequences from the above-described events, management actively seeks opportunities for penetrating into new markets and increasing the presence in the other markets in which the Group operates. In the process, the focus has been placed on the development or building upon trade relations directed towards achieving sustainable and long-lasting results. It is not possible to assess the effect / effects of the actions taken as at the date of preparation of this report due to the long-term goals set.

Retained earnings in the statement of financial position have been adjusted by the sum of trade receivables originating from 2015. The adjustment has been made in these financial statements, as at the date of preparation of the financial statements for 2015, in view of the existence of a high level of uncertainty as to the business development and the effects of lots of factors different in their direction and intensity, and based on information available at that moment, the best estimate of management was that there were not sufficient grounds to recognize the liabilities.

Tobacco buy-up, industrial processing and trade in tobacco

Tobacco of crop 2015 was bought up by the subsidiary Pleven BT EAD. The buy-up campaign for this crop 2016 ended in April 2016.

In November the buy-up campaign for tobacco, crop 2016, commenced.

For the needs of cigarette production tobacco of the variety Virginia and Burley, tobacco stems of the variety Virginia and Burley, and reconstituted tobacco of foreign origin are imported / supplied. 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, Malawi, Argentina, and India. Besides, tobacco of other origin, such as Kenya, Uganda, Guatemala, Italy, etc, is purchased as well. Tobacco stems and reconstituted tobacco with good quality characteristics are bought from different countries and regions.

Manufacture and sale of tobacco products

Bulgartabac-Holding AD will continue to pursue an active policy of developing and improving the existing cigarettes brands and creating new ones with modern design and high quality, compliant with the latest achievements in the sphere of cigarette manufacturing for the domestic market and for exports.

The cigarette manufacturing is secured with tobacco, tobacco stems and reconstituted tobacco, including technological documentation updates and technological projects implementation.

The Group companies focus their efforts on improving the effectiveness of the production processes, as also on the quality of products, modernization of the assortments and other trademarks, with the aim to preserve the Group's leading position on the Bulgarian and other regional markets.

Domestic market

The policy pursued by Bulgartabac-Holding AD with respect to the domestic market is entirely consistent with the market conditions and is subject to the aim of increasing the volumes sold in the domestic market and achieving a growth in the company's market share, and preserving the good image of the Company.

Diverging movements in the domestic sales compared to the various comparable periods have been observed over the third quarter of 2016. The volume of finished products sold in the third quarter of

2016 is by about 10% higher than that sold in the second quarter of 2016; however, there is a decline by about 8% compared to the third quarter of 2015. For the nine months of 2016, there is a decline by 5% compared to the comparable period of 2015.

The falling domestic sales of the Group are a result of the total decline in sales in Bulgaria. Main reason for drop in sales is the implementation of the requirements of *Directive 2014/40/EU of 3 April 2014 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products* (also known as “TPD”).

In the third quarter of 2016 the Company’s market share has dropped by 1.5 percentage points compared to the previous quarter. If compared to the comparable period of 2015, the market share remains lower by 2.4 percentage points. The decrease in the market share is due to the early introduction of consumer packs bearing mandatory health warnings compared to those of the competitors.

During the reporting period, the usual fluctuations in the separate months have been observed. The market of tobacco products has remained very dynamic throughout the quarter and depended on a number of objective factors which have a direct impact on the sales of cigarettes in the domestic market:

Pricing policy and competition

In 2016, the selling prices of some of the cigarette brands were increased by 10-20 stotinki. There is a very high activity in support of the cigarettes positioned in all price segments, by both the foreign and local companies.

Bulgartabac continues its active marketing policy (within the applicable statutory regulations) by supporting its trademarks positioned in all price segments. The enlarged portfolio within the *Exclusive by Victory* family gives the expected positive results and the same applies to the results of Victory Code. The results of the extremely successful trademark EVA remain stable as well.

Unregulated trade

At the beginning of 2016 the levels of the unregulated trade in tobacco products continued to decline. According to data of an independent marketing agency, it is expected that the increase of the banderol cigarette market observed in 2015 will continue in 2016 as well.

Financial and economic situation

Due to the increase in consumption of products bearing excise stamps, some of the stores experience difficulties in forecasting the exact levels of orders and ensuring cash for the purchase of larger volumes of cigarettes, which quite often results in stores running out of stock.

Due to the large number of brands offered in the market, the small retailers experience difficulties in ensuring the full range of products due to limited financial resources. Only the best-selling brands are supplied in limited quantities to the shops with lower levels of turnover.

There have been initial signs of growth in consumption of FMCG. The decreased purchasing power of the population in certain regions, the unemployment, the shrank households’ expenses, as also the reducing or even quitting smoking as a result of the ban on smoking in public areas, continue to be limiting factors affecting the rate of increase of consumption in 2016 as well.

Distribution

The brands of Bulgartabac Group have a sustained nation-wide presence and in almost all points of sale, regardless of their size and importance. As before, Bulgartabac continues to work with one logistics partner with a national coverage.

Exports

Thanks to its long-term experience and traditions, the products of Bulgartabac Group are well known in the markets of the Balkan countries. The developed solid presence in these regions enables us to sell products of high quality at prices that guarantee a constant net income.

Due to the constantly growing competition of multinational companies and the changing factors at macro- and micro-level, Bulgartabac - Holding AD has devoted considerable efforts to enlarging its market presence. Based on an analysis of the consumption patterns in the markets in which it operates, the Group has developed and launched new assortments of tobacco products.

During the second quarter, the Group changed its approach regarding its presence on the markets of Russia and the former CIS countries. Following that change, the operations of the subsidiary Bulgartabac Logistics have been limited and the proceeds from licence fees have increased considerably.

Market perspectives

The development of the activities of the Bulgartabac Group companies will be focused on overcoming the effects of discontinuance of the manufacture and sales of products to the Middle East Region, as well as achieving the strategic goals of the Group that remain unchanged.

Set out below are some of the factors that would have a direct impact on the environment, in which the company will operate in 2016:

- ✓ Reducing the volume of activities as a result of discontinuing exports to the Middle East Region.
- ✓ Measures for restructuring manufacturing and operating activities aiming at optimizing the expenses and cost in view of the new levels of load on machinery and equipment.
- ✓ Enhance marketing presence (in compliance with the regulatory restrictions) on the Bulgarian and the foreign markets on which the Group operates.
- ✓ Decline in the levels of offering contraband products on the domestic market thanks to the measures taken by the government authorities.
- ✓ Highly competitive domestic market environment.
- ✓ Legislative amendments imposing increasingly stringent regulations on the EU Member States with respect to production, promotion and sale of tobacco products. Legislative measures for restriction of tobacco smoking in closed public areas.
- ✓ Gradual increase over the period 2016 – 2018 of cigarette excise duties and their equalisation with the minimum rates provided for in the European law.
- ✓ Indications of an accelerating growth pattern in consumption of FMCG, still held back by the decreased purchasing power of the population, the relatively high levels of unemployment and shrank households' expenses.
- ✓ The dynamic economic, market and competitive environment will necessitate certain measures for optimizing and improving the effectiveness of work processes.

Investments

During the third quarter of 2016 the subsidiary Blagoevgrad BT AD concluded a contract for the acquisition of 22,563,500 shares of the capital of the associated company Tabac Market AD. As at 30 September 2016 the shareholding of Blagoevgrad BT AD in Tabac Market AD was 50%.

During the third quarter of 2016 the subsidiary Blagoevgrad BT AD concluded a contract for the acquisition of 50 shares of the capital of the associated company Express Logistics and Distribution OOD. As at 30 September 2016 the shareholding of Blagoevgrad BT AD in Express Logistics and Distribution OOD was 50%.

During the third quarter of 2016 the subsidiaries Sofia BT AD and Blagoevgrad BT AD exchanged their shareholding in associated companies of the Group. The structure of Bulgartabac Group was not changed as a result of this exchange.

Dividends

During the third quarter of 2016, Bulgartabac Holding AD and the Group's subsidiaries have not distributed dividends.

Liquidation procedures of subsidiaries

At the date of this report, the companies Haskovo Tabac AD and Asenovgrad Tabac AD are undergoing liquidation procedures.

Haskovo Tabac AD - in liquidation

The decision of the General Meeting for winding-up of the company and starting a liquidation procedure was entered by 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. Sale of the company's property was forthcoming for their settlement. At present, the term of completion of the company's liquidation is 18 months as of 11 July 2015.

Asenovgrad-Tabac AD - in liquidation

At the extraordinary General Meeting of Shareholders of Asenovgrad-Tabac AD, held on 1 September 2011, the following decisions were passed: winding up and announcing the company's liquidation, discontinuing the powers of the Board of Directors, setting a term to complete the liquidation – one year as of the date of announcing the invitation to the creditors to request their receivables, and appointing a liquidator. The invitation to the creditors to claim their receivables was registered with the Commercial Register on 26 October 2011. At present, the term of completion of the company's liquidation is 18 months as of 22 June 2015.

Risk factors

Within the framework of their activities, the individual Group companies are exposed, in general, to two main groups of risk factors: ***General and Specific***.

Information about the general risk factors is disclosed in i.3 of this Report and in the notes to the annual consolidated financial statements of the Group.

Risks inherent to the industry in which the Group operates are as follows:

Risks and uncertainties in the area of tobacco trade

In view of the full liberalization of the raw tobacco market, the future results of the activity “buy-up and industrial processing” will depend directly on the demand and supply of tobacco, including in the Bulgarian and in foreign markets.

The policy of purchasing raw tobacco of foreign origin is a function and therefore is directly related to the policy of selling cigarettes – the purchases of tobacco, tobacco stems and reconstituted tobacco depend proportionately on the volumes of cigarettes planned for sale in the domestic and foreign markets. In connection with the above, Bulgartabac will continue to actively perform and implement a flexible trade policy in order to ensure constant supplies of raw tobacco for the needs of cigarette production and for sale of raw tobacco.

Risks and uncertainties inherent to the import and supply of tobacco, tobacco stems and reconstituted tobacco depend directly on the international demand and supply, the conjuncture of tobacco markets by regions, the economic development of the countries – tobacco manufacturers and exporters, and on a number of other factors, among which force majeure events and circumstances.

1. Financial risk management

In the course of their ordinary business activities, the Bulgartabac Group companies are 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 overall 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 products/services, provided by the companies, as also of the borrowings attracted by the companies, 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.

Currency risk

The Group companies perform their activities by trading actively with foreign contractors (clients and suppliers). They perform sales to foreign clients (tobacco products) and transactions with foreign contractors (tobacco, auxiliary materials and spare parts) contracted in USD. Therefore, the Group is exposed to an extent to currency risk to USD insofar the sales and supplies are affected directly by the exchange rate of USD to BGN. The other part of transactions is denominated in BGN, EUR and other currencies. In order to manage the currency risk and due to the centralized system for supply of imported tobacco, and respectively, export of tobacco and tobacco products, the import supplies, and respectively, the export sales, are planned on an on-going basis within Bulgartabac Group.

Interest rate risk

In general, interest-bearing financial assets are represented mainly, in the structure of the Group's assets, by cash bearing fixed interest rates. The Group's share of interest-bearing floating-rate assets is immaterial, and therefore, it is not exposed to significant cash flow risk with respect to these assets. At the same time, the Group is exposed to interest rate risk as regards the long-term and short-term loans utilized by it to finance its business activity. Therefore, the changes in interest rates are constantly monitored.

Price risk

The Group is exposed to a risk of possible adverse changes in the prices of raw materials and materials needed for the production of tobacco products, as also to possible adverse changes in the prices of products manufactured. In order to control the price risk, the Group monitors the market status and dynamics, and constantly monitors and analyses the trends, with the aim to effectively plan the supplies of raw materials depending on the estimated sales and to optimise the working capital engaged in inventories.

Credit risk

In the course of performing its activities, the Group companies are exposed to credit risk associated with the risk that one party to a contract will fail to discharge its obligations fully and within the normally prescribed terms. The Group's receivables are presented net in the statement of financial position, less of any accumulated impairment. Such impairments are made where and when there were events identifying losses due to uncollectability based on previous experience.

In order to manage its credit risk, the Group has adopted best practices for selection of trade contractors and contractual relationship control policies, which are of significant importance for preventing the risk of uncollectability of receivables.

Liquidity risk

Liquidity risk is the risk that the companies of Bulgartabac Group will encounter difficulties in meeting unconditionally its obligations within their maturity. The Group companies' liquidity management policies are conservative, as they maintain constant optimal liquid reserve of cash (own and borrowed) and good capability to fund their business activities. Currently, the maturity and timely settlement are monitored and controlled at two levels, by the parent company and by the respective units of the Group companies.

Capital risk management

The capital management objectives of the Group 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 - at the level of the individual Group company (incl. the parent company) and at the level of the Group (the consolidated equity).

The Group financed its operations by its own generated profits and by maintaining a certain level of trade and other short-term liabilities and bank loans.

Besides in this Report, detailed and systemized information disclosing the financial instruments employed by the Group companies and when it is important for assessing the assets, liabilities, financial position and financial performance, the financial risk management objectives and policies,

the exposure of the Group companies to price, credit and liquidity risk, and cash flow risk, is disclosed in Note 6 – Financial risk management to the interim financial statements for the third quarter of 2016.

2. Analytical review of the comparative data in the consolidated financial statements of Bulgartabac Group

Absolute and relative changes of key financial indicators

A. CONSOLIDATED INCOME STATEMENT

	30.09.2016 BGN '000	30.09.2015 BGN '000	Change	
			BGN '000	%
Revenue	226 918	368 682	(141 764)	(38,45)
Other operating gains and losses, net	4 295	7 195	(2 900)	(40,31)
Changes in stocks of finished products	(5 494)	(10 950)	5 456	(49,83)
Costs of materials	(123 577)	(175 087)	51 510	(29,42)
Personnel expenses	(39 044)	(48 095)	9 051	(18,82)
Depreciation / amortisation expenses	(16 170)	(16 587)	417	(2,51)
Costs of hired services	(29 212)	(39 367)	10 155	(25,80)
Book value of goods sold	(15 230)	(20 401)	5 171	(25,35)
(Accrued)/reversed impairment of assets	12 863	(25)	12 888	-
Other operating expenses	(5 189)	(7 781)	2 592	(33,31)
Operating profit	10 160	57 584	(47 424)	(82,36)
Investment gains and losses, net	2 754	68	2 686	3 950,00
Finance costs	(4 099)	(4 791)	692	(14,44)
Profit / (Loss) on investments measured under the equity method	761	(1 455)	2 216	(152,30)
Profit before income tax	9 576	51 406	(41 830)	(81,37)
Income tax expense	(2 561)	(5 432)	2 871	(52,85)
Net profit for the year	7 015	45 974	(38 959)	(84,74)
Attributable to:				
The equity owners of the parent company	6 724	45 345	-38 621	(85,17)
Non-controlling interest	291	629	-338	(53,74)

B. CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	30.09.2016 BGN '000	31.12.2015 BGN '000	Change BGN '000	%
ASSETS				
Non-current assets				
Property, plant and equipment, incl.	162 194	156 693	5 501	3,51
Intangible assets	46 357	48 939	(2 582)	(5,28)
Investment property	31 128	30 447	681	2,24
Investments in entities accounted for under the equity method	174 135	155 160	18 975	12,23
Investments available for sale	320	320	-	-
Deferred tax assets	7 338	7 412	(74)	(1,00)
Other non-current assets	806	7 828	(7 022)	(89,70)
	<u>422 278</u>	<u>406 799</u>	<u>15 479</u>	<u>3,81</u>
Current assets				
Inventories				
Receivables from clients and suppliers	43 303	83 588	(40 285)	(48,19)
Corporate income tax refundable	125 201	131 024	(5 823)	(4,44)
Other current assets	20	437	(417)	(95,42)
Cash and cash equivalents	22 338	5 427	16 911	311,61
	57 725	47 318	10 407	21,99
	<u>248 587</u>	<u>267 794</u>	<u>(19 207)</u>	<u>(7,17)</u>
Assets classified as held for sale	-	45	(45)	(100)
TOTAL ASSETS	<u>670 865</u>	<u>674 638</u>	<u>(3 773)</u>	<u>(0,56)</u>
EQUITY AND LIABILITIES				
Capital attributable to the equity owners of the parent company				
Share capital	7 367	7 367	-	-
Reserves	85 858	83 054	2 804	3,38
Retained earnings	187 887	180 361	7 526	4,17
	<u>281 112</u>	<u>270 782</u>	<u>10 330</u>	<u>3,81</u>
Non-controlling interest	<u>3 979</u>	<u>3 424</u>	<u>555</u>	<u>16,21</u>
Total equity	<u>285 091</u>	<u>274 206</u>	<u>10 885</u>	<u>3,97</u>
LIABILITIES				
Non-current liabilities				
Long-term payables to financial institutions	62 407	58 364	4 043	6,93
Long-term payables to clients and suppliers	15 387	-	15 387	-
Deferred tax liabilities	6 517	5 664	853	15,06
Retirement benefit obligations	5 098	4 931	167	3,39
Other non-current liabilities	-	1 125	(1 125)	(100,00)
	<u>89 409</u>	<u>70 084</u>	<u>19 325</u>	<u>27,57</u>
Current liabilities				
Payables to suppliers and clients	166 866	191 972	(30 627)	(15,95)
Short-term payables to financial institutions	24 144	23 456	688	2,93
Tax liabilities	88 106	85 068	3 038	3,57
Corporate income tax payable	2 937	1 184	1 753	148,06
Other current liabilities	14 312	28 668	(8 835)	(30,82)
	<u>296 365</u>	<u>330 348</u>	<u>(33 983)</u>	<u>(10,29)</u>
TOTAL LIABILITIES	<u>385 774</u>	<u>400 432</u>	<u>(14 658)</u>	<u>(3,66)</u>

TOTAL EQUITY AND LIABILITIES	670 865	674 638	(3 773)	(0,56)
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Analytical review

Income statement:

The changes in the financial indicators of the Income statement are due to the combined effect of the following main factors observed during the period:

- The registered decline in income relates to the decrease in export revenue. Expenses by nature and movements in finished products follow the general trends, although they decrease at different speeds depending on the specifics of the activity.
- The largest decrease has been noted in the costs of materials, which depend almost entirely on the developments in production and stocks of finished products.
- Costs of hired services decrease more slowly, as far as a considerable part of these expenses relate to marketing and other activities that do not depend directly on the volume of production.
- Costs of personnel decrease more slowly due to expenses on measures taken in order to optimize the activity.
- The decrease in the book value of goods sold is a consequence of the change made in business processes on some of the foreign markets.

The combined effect of these factors results in a significant drop in profits for the period.

Statement of financial position:

The movements in the main balance sheet items as at the end of the reporting period compared to the end of 2015 are as follows:

- The cost of the Group's non-current assets grows, mainly as a result of the increase in the participation in associated companies.
- The available quantities of inventories have been optimized considerably, which in the group of current assets is partially compensated by the growth in other current assets and cash (usually, changes in cash relate to the economic situation).
- It may be noted that in the liability side of the balance sheet, as part of the measures for effective management of financial resources, the Group has transformed part of its current liabilities into non-current liabilities.

3. Important events which have occurred after the date of preparation of the consolidated financial statements

No significant events have occurred after the end of the reporting period, which have not been disclosed in the interim consolidated financial statements for the third quarter of 2016.

4. Additional information

- 1. Value and quantitative information about major categories of goods, products and/or services rendered, together with their share in sales revenue of the Group as a whole, and any changes occurred throughout the reporting period*

SALES REVENUE

Sales revenue	30.09.2016 (BGN'000)	Relative share	30.09.2015 (BGN'000)	Relative share
Domestic market	66,378	29.25%	67,016	18.18%
Foreign markets	160,540	70.75%	301,666	81.82%
Total	226,918	100.00%	368,682	100.00%

Sales revenue– domestic market	30.09.2016 (BGN'000)	Relative share	30.09.2015 (BGN'000)	Relative share
Tobacco and tobacco products	64,826	97.66%	66,277	98.90%
Other	1,552	2.34%	739	1.10%
Total	66,378	100.00%	67,016	100.00%

Sales revenue– foreign market	30.09.2016 (BGN'000)	Relative share	30.09.2015 (BGN'000)	Relative share
Tobacco and tobacco products	151,800	94.56%	295,008	97.79%
Retail trade – goods	8,557	5.33%	6,221	2.06%
Other	183	0.11%	437	0.15%
Total	160,540	100.00%	301,666	100.00%

- 2. Information about large transactions and transactions of significant importance to the Group companies' activities.*

Transactions of significant importance or having a material effect on the activities have not been concluded during the third quarter of 2016, except for those disclosed in paragraph **Investments** in item 2 above.

- 3. Information about the transactions concluded between the issuers and its related parties during the reporting period, proposals for conclusion of such transactions, as well as transactions going beyond its ordinary activity or significantly different from market conditions, where to either the issuer or its subsidiary is a party, by indicating the transaction amount, the nature of relationships and any other information that is needed to assess the impact on the financial position of the issuer*

Information about the related party transactions is provided in the notes to the interim consolidated financial statements for the third quarter of 2016.

This report was approved by a decision of the Board of Directors dated **28 November 2016**.

Vladimir Zhekov
Executive Director
of Bulgartabac-Holding AD

Radoslav Rahnev
Executive Director
of Bulgartabac-Holding AD