

**FUND FOR LOCAL AUTHORITIES AND  
GOVERNMENTS IN BULGARIA – FLAG JSC**

ANNUAL DIRECTORS' REPORT AND  
INDIVIDUAL FINANCIAL STATEMENTS  
31 December 2016

## FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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**General information**

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**Board of directors:**

Dobromir Prodanov Simidchiev - Chairperson  
Plamen Todorov Iliev – member  
Malina Valentinova Krumova - member  
Larisa Manastirli - member  
Nadya Yordanova Dankinova – member and Executive director  
Maria Blagoeva Lazarova– member  
Yulia Petkova Tsolova–Ilieva – member

**Registered address**

Sofia, 17-19 St. Saint Cyril and Methodius Street

**Business address**

1 Sixth September Street, Fourth Floor, Sofia

**Legal advisor**

Law Firm „Lozanova and Groysman”

**Servicing banks**

Unicredit Bulbank AD  
CiBank EAD  
DSK Bank EAD

**Auditor**

Baker Tilly Klitou and Partners OOD  
1612 Sofia  
104 Akademik Ivan Geshov Blvd, Seventh floor

## ANNUAL REPORT

### on the principal activities of Fund for Local Authorities and Governments in Bulgaria – FLAG JSC in 2016

This Report has been drawn up in compliance with the requirements laid down in Article 23 of the Regulation laying down the rules for exercising the rights of the government in state-owned commercial undertakings and the Commercial Act.

#### Mission

Fund for Local Authorities and Governments in Bulgaria – FLAG JSC is created on the basis of Ordinance № 4 of Council of Ministers of Republic of Bulgaria dated 7 March 2007 as an instrument of Government policy for Regional development.

The mission of the Fund is to support the efforts of Bulgarian municipalities, associations of municipalities (including associations of Water suppliers), companies with municipal or mixed state-municipal participation in the process of preparation and successful implementation of projects under the Operational Programmes, Programme for Rural Development, Cross Border Cooperation programmes, Financial mechanism of the EEA, the Norwegian financial mechanism, the Bulgarian-Swiss cooperation programme to reduce economic and social disparities within the enlarged European Union, Fund „Solidarity“ and National Trust Ecofund, which are aimed at modernization and expansion of municipal infrastructure and at creating sustainable and modern communities.

FLAG grants credits to beneficiaries and/or their associates, who prepare or implement projects under the above mentioned programmes or other international programmes after an explicit decision of the Board of directors of the Fund.

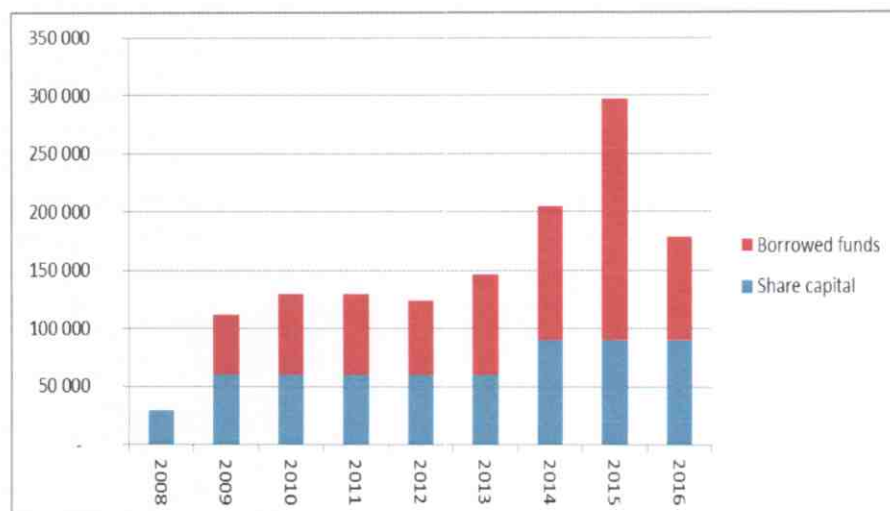
#### Development of the Fund

##### 1. Working capital and revenues

The table below reflects the changes in the capital of the Fund over the years. As it can be seen, in 2008 the starting share capital of the Company was paid-in and in 2009 began the utilization of funds from the Loan Agreement with the EBRD. The highest amount of working capital was registered in 2015. This is the year in which the portfolio of FLAG reaches the highest values. The reason is the end of the first programming period 2007 - 2013 and the need for all projects to be finalized and settled until 31.12.2016.

#### Working capital (BGN '000)

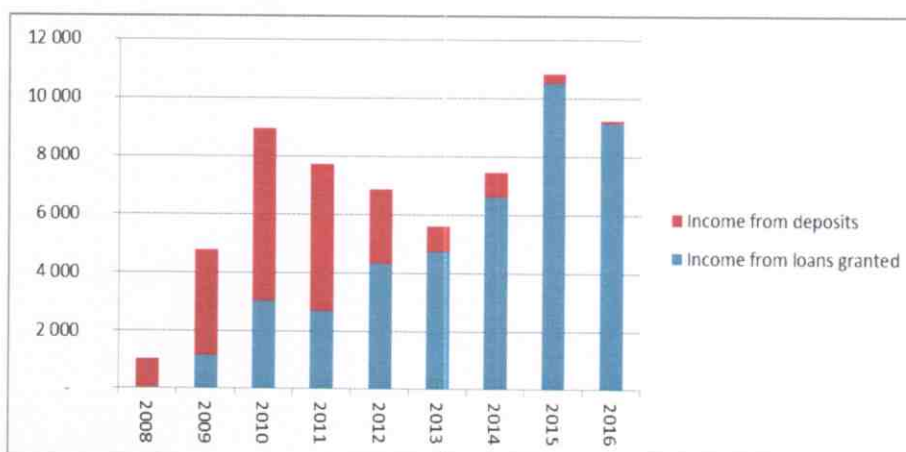
	Share capital	Borrowed funds
2008	30,000	-
2009	60,000	51,574
2010	60,000	69,133
2011	60,000	69,349
2012	60,000	63,675
2013	60,000	86,708
2014	90,000	114,389
2015	90,000	207,057
2016	90,000	88,178



The following table reflects the changes in the revenue structure of the company over the years. It is apparent that in the first years of operation the main part of the revenues of FLAG was from deposits. The reason is on one hand the availability of funds and on the other - the high interest rates on deposits. The gradual change in the market leads to a change in the structure of revenues – increase of the Fund's portfolio, reduction of available funds and respectively reduction of interest income from deposits.

**Income from interest (BGN '000)**

	Income from loans granted	Income from deposits
2008	-	1,067
2009	1,215	3,570
2010	3,065	5,870
2011	2,708	5,016
2012	4,353	2,511
2013	4,739	881
2014	6,605	858
2015	10,527	306
2016	9,133	92



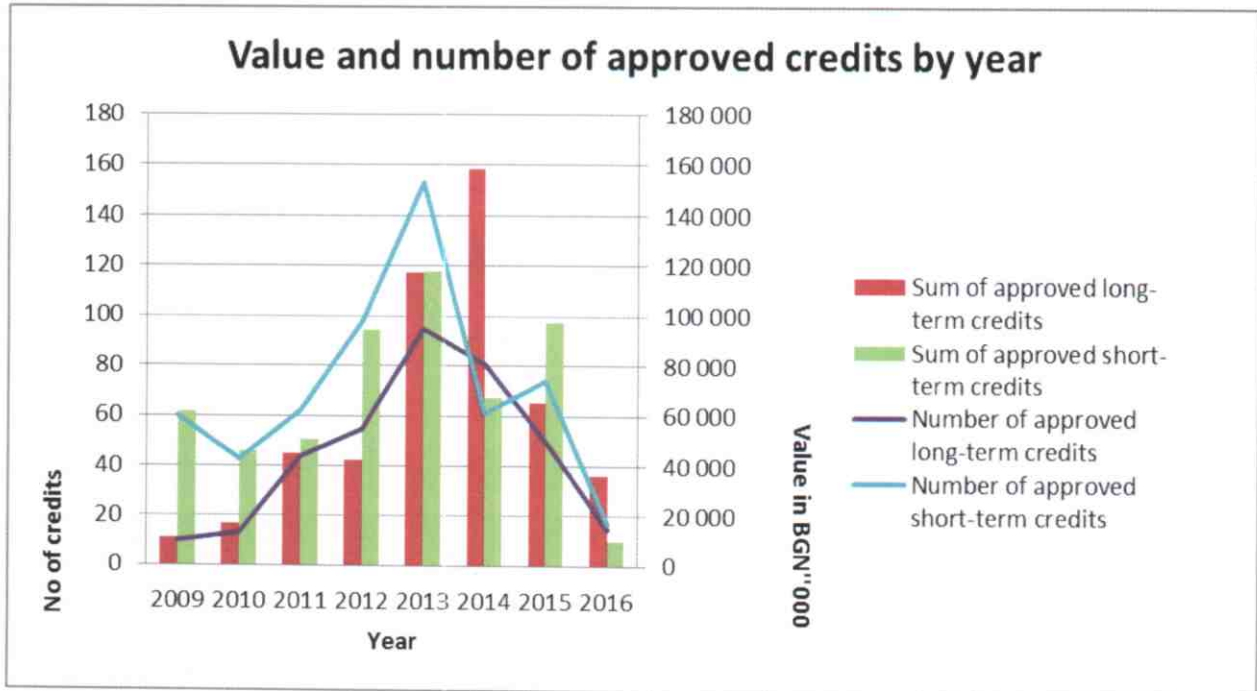
**2. Approved credits**

The table below shows the development of the activity of FLAG since 2009 when the application for credits started up until the end of 2016. Typical for the company's activity is that it is closely linked to the progress of the Operational programmes – the overall slowdown of activities related to grants led to a peak in the demand for resources in 2014 and 2015 when the projects which were implemented had to be successfully finalized. The reason is that the eligibility of expenditures under the programming period 2007 - 2013 was until the end of 2015.

The total number and amount of approved loans are the highest in 2013. The highest value of approved long-term loans was reached in 2014, with loans actually being utilized in 2015 as well, which is visible from the level of the working capital.

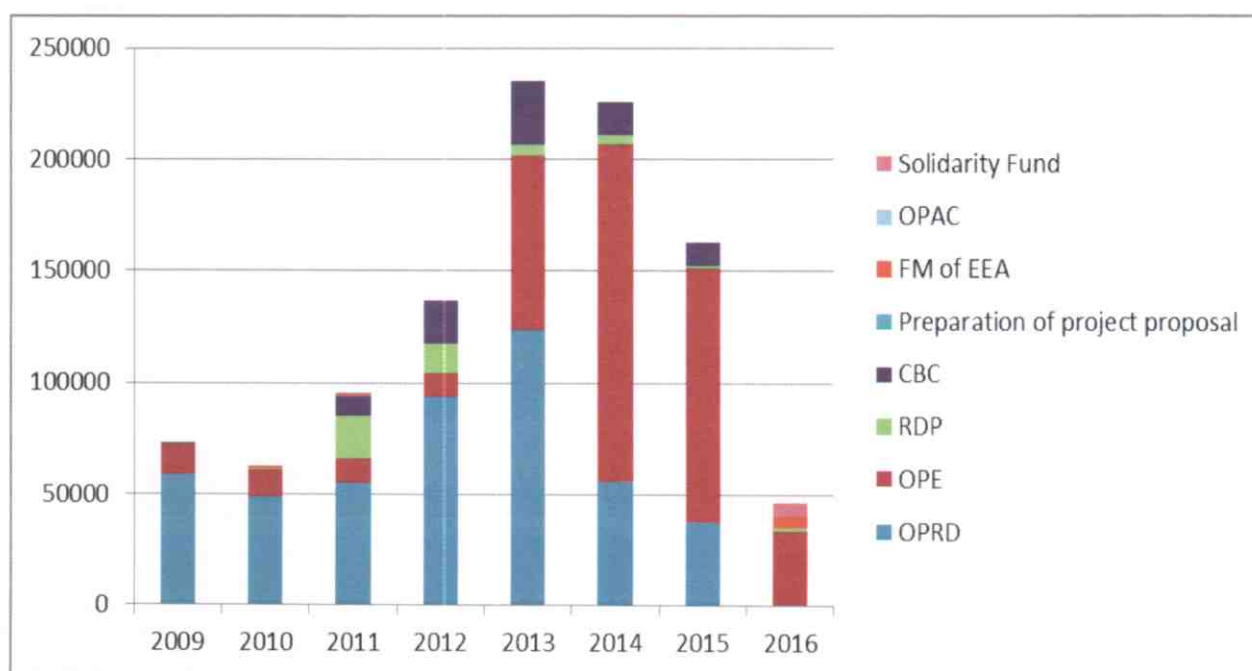
**Approved credits – value (BGN '000) and number**

Year	Sum of approved long-term credits	Sum of approved short-term credits	Total amount of approved credits	Number of approved long-term credits	Number of approved short-term credits	Total number of credits
2009	11,290	61,486	72,776	10	60	70
2010	17,043	45,742	62,785	13	43	56
2011	44,695	50,748	95,443	44	62	106
2012	42,398	94,162	136,560	55	98	153
2013	117,170	117,886	235,056	95	153	248
2014	158,399	67,158	225,557	81	61	142
2015	65,462	97,653	163,115	50	74	124
2016	36,306	10,318	46,624	15	17	32
<b>Total</b>	<b>492,763</b>	<b>545,153</b>	<b>1,037,916</b>	<b>363</b>	<b>568</b>	<b>931</b>



Approved credits per programmes (BGN `000)

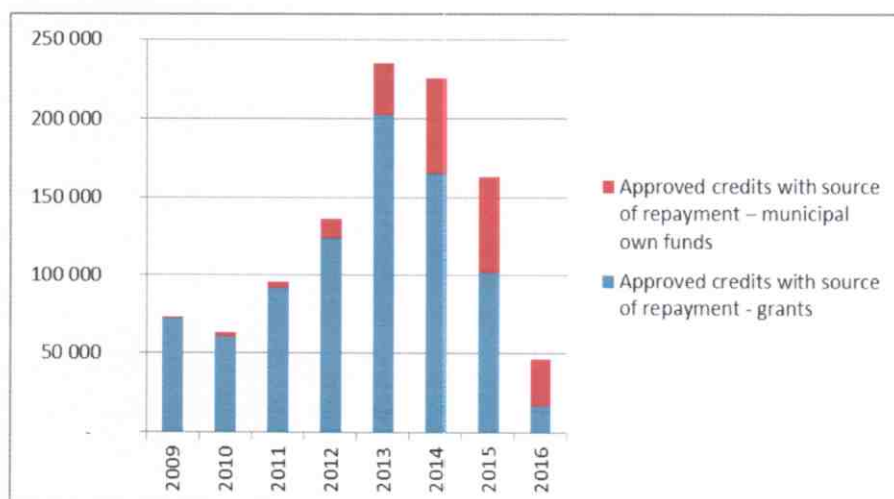
	OPRD	OPE	RDP	CBC	Preparation of project proposal	FM of EEA	OPAC	Solidarity Fund
2009	58,851	13,774	-	-	151	-	-	-
2010	48,881	11,992	425	-	-	1,487	-	-
2011	55,464	10,687	18,720	8,919	272	1,051	330	-
2012	93,781	10,899	12,723	19,157	-	-	-	-
2013	123,455	77,907	5,198	28,496	-	-	-	-
2014	55,795	150,866	4,321	14,575	-	-	-	-
2015	38,107	113,181	1,091	10,736	-	-	-	-
2016	250	33,248	2,095	-	-	4,703	-	6,328
<b>Total</b>	<b>474,584</b>	<b>422,554</b>	<b>44,573</b>	<b>81,883</b>	<b>423</b>	<b>7,241</b>	<b>330</b>	<b>6,328</b>



The structure of approved credits for the period is shown in the table below. It is obvious that at the beginning of the programming period there is not a great demand for loans to finance own participation. This is due to the fact that at the beginning of the programming period the majority of projects with beneficiary municipalities were with 100% grant. Gradually the need for co-financing arose, which the municipalities had undertaken to pay back until the end of the projects. Therefore a growing demand for this type of credits is observed from 2013 onwards.

Approved credits according to source of repayment (BGN `000)

	Approved credits with source of repayment - grants	Approved credits with source of repayment – municipal own funds
2009	71,846	930
2010	60,430	2,355
2011	91,384	4,059
2012	123,562	12,998
2013	202,468	32,588
2014	165,216	60,341
2015	101,936	61,179
2016	16,794	29,830
<b>Total</b>	<b>833,636</b>	<b>204,280</b>



## 1. REPORT ON ACTIVITIES

### 1.1. Equity and loan resources

The share capital of the Company is BGN 90 million, and it is fully paid in four instalments, two in 2008, one in 2009 and one in 2014. As of 31.12.2016 the total equity of the Company including share capital, reserves and retained earnings altogether amounts to BGN 98,6 million.

In 2015 FLAG increased its borrowings with three new loans of BGN 40 million from DSK Bank EAD; EUR 20 million from CiBank EAD and BGN 14 million from Municipal Bank AD. As of 31.12.2016 the loan from Municipal Bank AD is fully repaid, the current exposure of the loans from DSK Bank EAD and CiBank EAD is BGN 0 and EUR 4,8 million, respectively.

In 2016 after conducting a research on the interest rates, offered from banks, negotiations with the European Bank for Reconstruction and Development were held for decreasing the interest on the two existing Loan agreements – from 22.12.2008 and from 31.10.2013. After the failure to reach market interest rates a selection procedure was held to choose a financing institution to refinance the obligations of FLAG to EBRD. Two banks were chosen – Unicredit Bulbank AD and CiBank EAD, with loan facilities of BGN 40 million and EUR 20 million respectively. As of 31.12.2016 both loans are fully utilized.

As at 31.12.2016 the agreed long-term credit resource from the European Bank for Reconstruction and Development (EBRD) granted by two loan agreements - from 22.12.2008 and 31.10.2013 is fully repaid.



Total agreed long-term credit resource as at 31.12.2016 amounts to BGN 158 million.

Total borrowed capital as at 31.12.2016 amounts to BGN 88 million.

### **1.2. Management**

The affairs of the Fund are managed by a Board of Directors (BoD), which is composed of seven members and is responsible for all ongoing activities of the Fund. In 2016 fourteen board meetings were held.

During the reporting period the following changes in the composition of the BoD were made pursuant to a decision of the sole shareholder:

➤ On 09 March 2016 with Protocol № T3-24/09.03.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Emil Rumenov Savov as a member of the BoD and elected on his place Malina Valentinova Krumova.

➤ On 22 March 2016 with Protocol № T3-34/22.03.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Susan Mari Goranson as a member of the BoD and elected on her place Larisa Manastirli.

➤ On 28 July 2016 with Protocol № T3-73/28.07.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Asya Petrova Stankova as a member of the BoD and elected on her place Plamen Todorov Iliev.

As of 31 December 2016, the Board of Directors is comprised of: Dobromir Simidchiev – Chairperson, Plamen Iliev – member, Mariya Lazarova - member, Malina Krumova - member, Yulia Tsoleva - member, Larisa Manastirli – member and Nadya Dankinova – member and executive director.

According to the Bulgarian legislation, the Management is required to prepare annual financial statements that provide a true and fair view on the financial position of the Company as at the year end, its financial results and cash flows.

Management confirms that adequate accounting policies have been consistently applied in preparing the annual individual financial statements as of 31 December 2016, and reasonable and prudent judgments, assumptions and estimates have been made.

Management also acknowledges that it has applied the existing accounting standards and the individual financial statements have been prepared under the going concern principle.

Management is responsible for the proper keeping of accounting records, for the appropriate asset management and for the undertaking of all necessary measures for avoidance and detection of fraud and other irregularities.

### **1.3. Human resources**

In 2016 the Fund has a core staff with appropriate qualifications and experience for the performance of its lending and other activities. The organizational structure includes 4 Directorates, as follows: „Lending and monitoring”, „Finance and financial instruments”, „Risk management”, „General Administration” and an Internal Audit Unit.

The approved number of personnel for 2016 is 21 employees. As of 31.12.2016 there are 4 vacant places for employees, and two employees are on maternity leave. The Company does not plan any significant changes to its human resources in 2017.

The legal services, as well as the maintenance of the computer network, are outsourced.

#### 1.4. External auditor for 2016

With a decision from 10 August 2016, Protocol № 139 the BoD approved the results from public tender for external auditor for 2016 and approved „Baker Tilly Klitou and Partners” OOD. Subsequently this choice has been confirmed with Protocol T3-77/24.08.2016 from the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder.

#### 1.5. Borrowed capital

##### ➤ **Loan agreements with EBRD**

During 2016 the Fund fully repaid its obligations to the European Bank for Reconstruction and Development. Summarized payments during the year are as follows:

- Principal payments – BGN 96,8 million
- Interest payments – BGN 2,9 million
- Fees – BGN 0,53 million.

Out of the above mentioned the payments made in connection with the early repayment to EBRD amounted to **BGN 80,5 million**.

##### ➤ **Managing bank**

In 2016 continues the contract from November 6, 2014 with "Unicredit Bulbank" AD only for carrying out the functions of managing bank. With regard to the provision of revolving credit in the amount of BGN 40,000 thousand the contract has been terminated because the loan was repaid in advance.

##### ➤ **Other loans**

With a decision of the Board of Directors from 24.10.2016 and approval by the sole shareholder Protocol № T3 - 95 / 07.11.2016 were approved the results of the public tender "Selection of financing institutions for the provision of long-term bank loans for refinancing existing debt of "Fund for local authorities and governments in Bulgaria-FLAG" EAD into four lots: Lot № 1 - Provision of a standard long-term bank loan for refinancing existing debt in the amount of BGN 40,000 thousand, Lot № 2 - Provision of a revolving long-term bank loan for refinancing existing debt in the amount of BGN 40,000 thousand, Lot № 3 - Provision of a standard long-term bank loan for refinancing existing debt in the amount of EUR 20,000 thousand and Lot № 4 - Provision of a revolving long-term bank loan for refinancing existing debt in the amount of EUR 20,000 thousand as follows:

Lot № 1 - Provision of a standard long-term bank loan for refinancing existing debt in the amount of BGN 40,000 thousand - for contractor is selected UniCredit Bulbank AD with a proposal for an annual loan management fee of 0.1% for the first three years of the contract and the cost of funding formed by the 3-month SOFIBOR and a margin of 0.99%.

Lot № 4 - Provision of a revolving long-term bank loan for refinancing existing debt in the amount of EUR 20,000 thousand - for contractor is selected CiBank EAD with a proposal for an annual loan management fee of 0.3% for the first five years of the contract term and the cost of funding formed by the 6-month EURIBOR and a margin of 1.07%.

As of 31.12.2016 the outstanding payables under these loans are as follows:

- Unicredit Bulbank AD – BGN 40,000 thousand
- CiBank EAD – EUR 20,000 thousand /BGN 39,116 thousand/

The total borrowed capital as of 31.12.2016 is BGN 88,178 thousand.

In connection with the contracts signed with Unicredit Bulbank AD and CiBank EAD for provision of loans for refinancing the liabilities of the Fund to EBRD, FLAG has an obligation to comply with the requirements in respect of certain financial ratios, which were laid down in the contracts. In this way the Fund will guarantee its financial stability and effective work. The ratios are:

- Ratio of overdue loans /loans past due 90 days or more/ to current exposure of all loans
- Debt coverage ratio - debt / equity
- Ratio of liquid to total assets /available cash and bank deposits with a remaining maturity of 90 days or less/

The table below presents the reported values of these ratios as of 31.12.2016.

No	Indicators	Requirements	Results as of 31.12.2016
1	<b>Ratio of overdue loans:</b> <i>the coefficient of the current exposure of loans past due 90 days or more in the portfolio of the Borrower no greater than 5% of the total current exposure on all loans in the portfolio.</i>	Not more than 5%	0%
2	<b>Ratio debt/ equity:</b> <i>"Debt" - financial debt of the Borrower; "Equity" - Capital of the Borrower.</i>	Not more than 2.5	0.89
3	<b>Ratio of liquid assets to total assets:</b> <i>Liquid assets - cash and cash in bank deposits (including in BNB) with a remaining maturity of 90 days or less.</i>	Not more than 5%	17.10%

#### 1.6. Main results from lending activities in 2016

In 2016 are received 33 credit requests from 27 municipalities for total value of BGN 48,032 thousand. In 2016 considered and evaluated are 34 loan applications from which approval received 32 requests, for total value of BGN 46,624 thousand, supporting the implementation of projects for BGN 411 million.

The municipality of Belovo and the municipality of Simitli withdrew their loan requests. The average percentage share of loans in the total budget of the financed project is 11.3% for 2016.

In 2016 the "typical" approved credit granted to municipalities for bridge financing averages BGN 884 thousand and is with an average maturity of 11 months. The average approved credit repaid with own funds is BGN 2,295 thousand with an average maturity of 86 months.

The average interest rate in 2016 is 3,993% with value of the 6-month EURIBOR of (-0,094%) for the months from January to July and 0% for the period from August to December and margin of FLAG at 1,78% as from 25.03.2016 and 2,078% for the period until 25.03.2016.

In 2016 the decree of the Council of Ministers for implementation of the compensation mechanism to assist municipalities in accessing funding from FLAG was not accepted. In this respect, the funding provided by the Fund is entirely on market principles in competition with commercial banks.

The table below presents information for credits approved in 2016 by type of credits and source of repayment of the principal.

Type of credits	Number of credits in 2016	Value of approved credits in 2016 (in thousand BGN)
Long-term	15	36,306
<i>Incl. Bridge financing</i>	2	6,476
<i>Incl. Own contribution</i>	13	29,830
Short-term	17	10,318
<i>Incl. Bridge financing</i>	17	10,318
<i>Incl. Own contribution</i>	-	-
<b>Total</b>	<b>32</b>	<b>46,624</b>

The following two tables present the structure of the lending operations of the Fund for 2016 on the basis of credits approved during the year by type of project, operational programme and source of repayment of the principal.

By Operational programme	Number of credits	Total amount in BGN thousand	Amount of credit in BGN thousand			Maturity in months		
			Min.	Max.	Average	Min.	Max.	Average
<i>OPRD</i>	<i>2 funded projects, part of framework agreements</i>	250	98	152	125	85	119	102
<i>OPE</i>	10	33,248	274	9,779	3,325	11	120	71
<i>RDP</i>	4	2,095	153	619	419	85	119	100
<i>FM of EEA</i>	13	4,703	143	1,477	362	6	20	11
<i>Solidarity Fund</i>	5	6,328	130	5,113	1,266	9	28	14

By source of repayment	Number of credits	Total amount in BGN thousand	Amount of credit in BGN thousand			Maturity in months		
			Min.	Max.	Average	Min.	Max.	Average
Operational programmes	19	16,794	130	5,113	884	6	20	11
Own contribution	13	29,830	153	9,779	2,295	28	120	86

In 2016 the funds utilised under credit agreements signed with third parties amounted to BGN 40,231 thousand, while the repayments amounted to BGN 167,941 thousand.

The reason for the reduced demand for credit resources, respectively reduced utilization of funds, is that 2016 is the first year of operation within programming period 2014 – 2020 solely. The delay in approval of the operational programmes and hence in opening up opportunities for application led to reduced demand for resources from the municipalities. As could be seen from the tables above the greatest demand is for the FM of EEA where the call for proposals was launched in 2014. In 2016 the projects are already in the phase of execution. Demand is observed also in relation to OPE, due to the so-called "phased projects" - these are projects that have started in programming period 2007 – 2013, which were in process of implementation, but due to delay failed to be completed in the first programming period. They have selected contractors, the projects are in process of execution and they would need a resource at short notice for the successful implementation of the projects.

In 2016 a total of 146 annexes were signed to credit agreements with third parties. The requests for annexes are mainly with the aim of extending the deadline for repayment - 68 requests, for extension of the deadline for utilization - 2, and for changing both periods - 2. The annexes leading to restructuring of credits granted mainly due to imposed financial corrections deducted from the final payment claim on the projects and the inability to repay the outstanding principal with own funds were 16. The number of annexes within the category "Other" is 58, these range from change of accounts, change in repayment schedule due to a smaller amount utilised or partial early repayment of co-financed credits and reduction of the risk premium.

Active credits as of 31.12.2016 are 170 amounting to BGN 136,216 thousand. Credits are split by types as follows:

- Bridge financing – BGN 21,349 thousand (16 % from active loans)
- Own financing – BGN 114,867 thousand (84 % from active loans)

**1.7. Credit line granted to “Fund for sustainable urban development of Sofia EAD – subsidiary company**

With contract dated 28.11.2012 FLAG granted credit line to FSUDS amounting to BGN 24,500 thousand for the purpose of investing in urban projects under JESSICA initiative.

As of 31.12.2016 BGN 24,284 thousand from the credit line has been utilized and BGN 1,261 thousand has been repaid. As of 31.12.2016 the principal payable by FSUDS to FLAG is BGN 23,023 thousand. With Additional agreement 3 from 24.06.2016 to the credit line agreement with FLAG the closing date for utilization of funds for co-financing is extended to October 31, 2016. Meanwhile, after the initial utilization FSUDS will be entitled to utilize new amounts under the credit line to the amount of repaid funds up until 31.12.2025. Fourteen project funding agreements are signed as of 31.12.2016, all of which are fully utilized. Twelve of the projects are completed, while two projects are in the final phase of implementation.

**1.8. Operational agreement between FSUDS, FLAG, EIB and MRDPW**

On 23.06.2016 the BoD of FLAG approved for signing Amendment agreement № 5 to the Operational agreement from 30 May 2012 between MRDPW (replacing EIB as of 01.01.2016), FSUDS and FLAG. The Amendment agreement was signed on 08.07.2016. This agreement extends the deadline for disbursement until 31.10.2016 and makes changes to the established targets.

**1.9. Changes in policies and internal regulations of FLAG**

- By decision set out in Protocol № 133 from 01.03.2016 the BoD of FLAG approves changes in the pricing policy associated with reduction in cost of the resource of the fund and accordingly its reflection on the „margin of FLAG” forming the underlying interest rate. As of March 25, 2016 FLAG’s margin is reduced from 2.078% to 1.78%.
- By decision set out in Protocol № 133 from 01.03.2016 the BoD of FLAG approves changes in the pricing policy through introducing a rule that when the 6-month EURIBOR is negative, the same would be assumed to be zero. This decision was dictated by the practice of the EBRD and comes into force on August 3, 2016.
- By decision set out in Protocol № 134 from 23.03.2016 the BoD of FLAG approves changes to the Methodology for evaluation and management of the operational risk of FLAG through the reduction of the premium for macroeconomic risk from 0.5% to 0.25%, as from the date of approval of the decision.
- By decision set out in Protocol № 138 from 23.06.2016 the BoD of FLAG approves new Internal rules for public tenders of "Fund for local authorities and governments in Bulgaria - FLAG" EAD and the related attachments. The rules have been changed to align with the new Public Procurement Act (PPA).
- By decision № 6 set out in Protocol 141/24.10.2016 the BoD of FLAG approves changes and additions to the Internal rules for public tenders of "Fund for local authorities and governments in Bulgaria - FLAG" EAD, creating new Section XI Policy for conducting public tenders for selecting a contractor for financial services in cases under Article 13, ph. 1, p. 8 or p. 9 of the PPA.
- By decision № 1 and 2 per Protocol 142/11.11.2016 the BoD of FLAG changes p.3 of the Pricing policy of the fund as follows:
  1. Removes the text: *The value of the margin of FLAG is constant for at least one year;*
  2. „The margin of FLAG“ is 1,083 %;The changes to the pricing policy are in force from 01.12.2016.

- By decision № 1 per Protocol 144/20.12.2016 the BoD of FLAG approves changes in The rules on signing contracts for deposits and other payment services of "Fund for local authorities and governments in Bulgaria - FLAG" EAD.
- By decision № 4 per Protocol 144/20.12.2016 the BoD of FLAG amends the Rules for the activity of FLAG. The amendment focuses on clarification of the functions and responsibilities of the various structures taking into account practical aspects of the links established between these structures, avoidance of duplication of functions and ensuring effective and efficient management of the fund. Also, an Internal Audit Unit was created in line with the changes in the Law on Internal Audit in the public sector.

#### **1.10. Management of temporary available funds**

In implementation of the internal rules for management of temporarily free funds in the first quarter of 2016 was held a procedure for the selection of a bank for providing deposit services. According to a decision from Protocol № 134/23.03.2016, all funds from the current account with preferential interest opened at "Unicredit Bulbank" AD together with the accrued interest were deposited, on the maturity date of 30.4.2016, in the current account opened at "Unicredit Bulbank" AD at preferential rates under the terms of "overnight deposit" at an annual interest rate of 0.15%.

A procedure for selection of a deposit bank was held in December 2016. With Decision № 2 from Protocol 144/20.12.2016 the Board of Directors of FLAG approved the results of the procedure as follows:

- Opening of bank account at CiBank EAD for one year closed deposit for BGN 10,000 thousand, with annual interest of 0.3%.
- The reserve account in UniCredit Bulbank AD with available funds amounting to BGN 10,150 thousand shall be closed on the maturity date - 21.01.2017.

As of 31.12.2016, the company has opened a current account in UniCredit Bulbank AD at preferential rate under "overnight deposit" terms at an annual interest of 0.15% and a reserve account in the form of a standard annual deposit with an annual interest of 0.45%.

#### **1.11. Share capital increase of the subsidiary of FLAG – FSUDS EAD**

With Decision № 8.1 and № 8.2 of Protocol 143/25.11.2016, the Board of Directors of FLAG proposed to the sole shareholder of FLAG to take a decision for the increase of the share capital of "Fund for sustainable urban development of Sofia" EAD from BGN 500,000 / five hundred thousand / to BGN 5,000,000 / five million /, divided into 5,000 (five thousand) ordinary shares with a nominal value of BGN 1,000 (one thousand) each, through the issue of 4,500 (four thousand and five hundred) new ordinary available registered shares, carrying voting rights, with a nominal value of BGN 1,000 (one thousand) each and issue price of BGN 1,000 (one thousand) per share.

The sole shareholder "Fund for local authorities and governments in Bulgaria - FLAG" EAD shall take up all of the newly issued shares. With Protocol T3-12 from 22 March 2017 the Minister of Regional Development and Public Works, as a representative, authorized FLAG to acquire long-term financial assets in the subsidiary "Fund for sustainable urban development of Sofia" EAD worth BGN 4,500,000, representing 4,500 new ordinary, available, registered shares with a nominal value of BGN 1,000 each. With this act and following a decision of the Board of Directors of FLAG from 28 March 2017 it was proceeded with registration of change and a corresponding increase in the share capital of "Fund for sustainable urban development of Sofia" EAD from BGN 500,000 to BGN 5,000,000.

#### **1.12. Information and publicity**

The information on the website of FLAG is maintained and updated regularly, and as of 31.12.2016 an entirely new design was made.

Fund representatives took part in meetings, discussion forums and training of the National Association of Municipalities in Republic of Bulgaria by presenting the policies of the Fund, opportunities for financing in the 2014-2020 programming period, as well as providing specific advice to municipalities' teams.

In order to present the main results of operations of the Fund in the 2007-2013 programming period an information leaflet was prepared, which was presented at the Nineteenth National Meeting of financial professionals of the municipalities. The meeting was held during 09 - 11 June 2016 in Pamporovo and FLAG was an official

sponsor of the event. During the meeting representatives of the fund presented funding opportunities and participated in discussion panels. Information stands were organized and individual consultations were held with representatives of municipalities.

FLAG took an active part in the Eleventh Annual meeting of the local authorities and the MUNICIPAL EXPO that was held in October 2016 in Albena. Over 600 representatives of the local authorities participated in the event including mayors, chairpersons of municipal councils and others. A special stand with promotional materials of the Fund was set up and there was opportunity for the participants in the event to hold individual meetings and consultations with experts of the fund. In two of the discussion forums was presented the progress of the fund in dealing with financial instruments and the vision of FLAG for expansion of its activity and participation in specialized municipal investment fund.

Fund representatives regularly participate in the work of the monitoring committees of the OP "Regional Development", OP "Regions in growth", and OP "Environment" as well as at meetings of the Managing Board of the National Association of Municipalities in Republic of Bulgaria.

### 1.13. Monitoring

In 2016 continued the intensive communication with the Managing Authorities of OP "Regional Development", OP "Environment" and State Fund Agriculture on the implementation of projects for which requests for financing have been submitted, as well as the status of problematic projects with already disbursed loans from FLAG. There is a regular exchange of information about payments and verification checks, for identified irregularities and others.

Ongoing review of the portfolio and analysis of the financial position of the clients is conducted in order to undertake the necessary actions for regular servicing of loans and avoiding overdue payments.

At the end of December there are three loans with past due monthly installments of over 30 days. All three loans are of the municipality of Karlovo, respectively credit agreements № 596, 753 and 777.

## 2. FINANCIAL PERFORMANCE

### 2.1. Structure of revenues and expenses

The expenses of the Company for 2016 are BGN 6,607 thousand, from which BGN 747 thousand are expenses for impairment of loans granted. Total revenues are BGN 9,570 thousand. Breakdown of revenues and expenses is presented in the table below:

		BGN '000
	<b>EXPENSES</b>	<b>6,607</b>
1	Remunerations	526
2	Social securities	73
3	Audit services	11
4	Legal and consulting services	7
5	Other hired services	30
6	Rent and office maintenance	57
7	Communication services	6
8	Materials	17
9	Other expenses (cleaning, subscription, representative expenses, etc.)	72
10	Depreciation charge	20
11	Bank fees	2,387
12	Interest expenses EBRD - loan 1	901
13	Interest expenses EBRD - loan 3	963
14	Interest expenses on other bank loans	786
15	Exchange rate differences	4
16	Impairment expense	747

BGN '000

	REVENUE	9,570
1	Interest on loans	9,093
2	Penalty interest on loans	40
3	Fees on loans granted	282
4	Interest on deposits	92
5	Dividend income	47
6	Other income	16

#### Structure of expenses

	Group of expenses	Amount in BGN thousand	Share in total expenses in %
1	Maintenance Costs	152	2.30%
2	Hired services	48	0.73%
3	Depreciation	20	0.30%
4	Remunerations - staff, BoD (incl. social securities)	599	9.07%
5	Bank fees including Managing bank fees	2,391	36.18%
6	Interest expenses	2,650	40.11%
7	Impairment expense	747	11.31%
	<b>Total expenses</b>	<b>6,607</b>	<b>100%</b>

#### Structure of revenues

	Group of revenue	Amount in BGN thousand	Share in total revenue in %
1	Interest on loans	9,093	95.02%
2	Penalty interest on loans	40	0.42%
3	Fees on loans granted	282	2.95%
4	Interest on deposits	92	0.96%
5	Dividend income	47	0.49%
6	Other income	16	0.16%
	<b>Total revenue</b>	<b>9,570</b>	<b>100%</b>

- **Revenue from lending activities** – Over 98% of total revenues of the Company are from lending activities
- **Revenue from management of temporary free funds** – Only 1% of revenues are from management of temporary available funds.

#### 2.2. Results from the current period

The profit before tax for 2016 is BGN 2,963 thousand and the net profit is BGN 2,672 thousand.

#### 2.3. Dividends and distribution of profit

In 2016 with a decision of the BoD the Company formed a “Reserve fund” with 10% of the net profit for 2015 amounting to BGN 266 thousand and after that it distributed dividends to the Government amounting to BGN 1,245 thousand, which were fully paid during the year.



#### **2.4. Investments**

As of 31 December 2016 FLAG EAD is the sole shareholder in the "Fund for Sustainable Urban Development of Sofia" EAD (FSUDS), which is registered in the Registry Agency on 23 April 2012. As of 31.12.2016 FSUDS has signed 14 loan contracts, all of which are fully utilized, and twelve of the projects are completed. Two projects are in the final phase of implementation. The company has fulfilled the objectives set in the Operational agreement and as of 31.12.2016 it has invested BGN 24,603 thousand of the contingent loan.

#### **2.5. Information under Art. 187 d and Art. 247 from the Commercial Act**

In 2016 shares of the Company have not been issued, acquired or transferred.

The remuneration of key management personnel in 2016 amounted to BGN 124 thousand.

As of 31.12.2016 the members of the Board of Directors have the following participation within the meaning of Art. 247, ph. 2, p. 4 of the CA:

- Nadya Yordanova Dankinova – executive director and member of the Managing Board of "Fund for sustainable urban development of Sofia" EAD;
- Larisa Manesterli - member of the Supervisory Board of "Galleria Burgas" AD;
- Dobromir Simidchiev – executive director and member of the Board of Directors of "HIDROLIA" AD, shareholder in "TYUBOR" OOD with 33% share;
- Malina Krumova - shareholder in "Zanimavki" OOD with 40% share, sole owner of "Espira" EOOD.

#### **2.6. Branches and subsidiaries**

In 2012, the company has established a subsidiary - "Fund for sustainable urban development of Sofia" EAD, 100% owned by "Fund for local authorities and governments in Bulgaria - FLAG" EAD with share capital of BGN 500 thousand.

With Decision № 8.1 and № 8.2 of Protocol 143 / 25.11.2016, the Board of Directors of FLAG proposed to the sole shareholder of FLAG to increase the share capital of "Fund for sustainable urban development of Sofia" EAD from BGN 500,000 /five hundred thousand/ to BGN 5,000,000 /five million/.

As of 31.12.2016 there is no decision of the sole shareholder of FLAG.

As of 31.12.2016 the company has no branches.

#### **2.7. Financial risk management and financial instruments**

The main financial liabilities of the Company include interest-bearing loans and borrowings, and trade and other payables. The main purpose of these financial instruments is to provide financing to the Company. The Company holds financial assets such as loans granted, cash and short-term deposits, which arise directly from its operations.

In 2016 as in 2015 the Company does not own and does not trade with derivative financial instruments.

The main risks arising from financial instruments of the Company are interest rate risk, liquidity risk, currency risk and credit risk. The policy that the Company's management applies to manage these risks is summarized below.

##### *Interest rate risk*

The Company is exposed to risks from changes in market interest rates, mainly regarding its long-term financial liabilities with variable (floating) interest rate. The Company's policy is to manage interest expenses by providing loans with floating interest rates.

*Liquidity risk*

The effective management of the Company's liquidity presumes that sufficient working capital will be available mainly through maintaining a given amount of money on deposit. A cash flow movement plan is prepared based on short-term budgets as well as based on long-term planning.

*Currency risk*

The Company has no purchases, sales and lending in foreign currencies and the loans received are denominated in EUR or BGN. Since the exchange rate BGN / EUR is fixed at 1.95583, the currency risk arising from Company's exposures in EUR is not significant.

*Credit risk*

Credit risk is the risk that the clients / counterparties will not be able to pay in full the amounts due to the Company within the envisaged / agreed deadlines. As at the end of 2016 the remaining liability of municipalities to the Company amounts to BGN 136,339 thousand, and at the end of 2015 it was BGN 264,185 thousand. As of 31.12.2016 the Company has receivables on loan granted to related parties amounting to BGN 23,338 thousand (31.12.2015: BGN 17,960 thousand).

Credit risk management in 2016 is carried out by the "Lending and monitoring" Directorate and is monitored simultaneously by the Executive Director and the Board of Directors. The credit risk management function is to ensure the implementation of an appropriate investment policy in respect of the funds available and respectively, the compliance of this policy with the related procedures and controls for current monitoring of the respective loan, deposit or receivable.

The credit risk exposure is managed through a current analysis of the ability of the counterparties / servicing banks to comply with their contractual obligations to pay interest and principal, as well as through setting appropriate credit limits. Cash deposits are placed with first-class banks having good reputation at the Bulgarian market. In compliance with the adopted internal rules for contracting cash deposits, invitations to submit an offer are sent only to banks that have the right to operate in the territory of the Republic of Bulgaria and have an assigned and not withdrawn (valid at the time of offer submission) credit rating not lower than a) BB assigned by the rating agencies Standard and Poor's or Fitch, b) Ba2 assigned by Moody's or c) BBB- assigned by BCRA.

Furthermore, subject to current monitoring is also the existence of concentration of receivables from a particular counterparty, and if such is identified – the respective counterparty is subject to special current supervision. The impairment of loans granted as of December 31, 2016 is on a portfolio basis, while there are also impairments of specific exposures.

**2.8. Research and development activity**

In 2016, the Company has not been engaged in research and development activities.

**2.9. Significant events after the reporting period**

With Protocol T3-12 of 22 March 2017 the Minister of Regional Development and Public Works, as a representative authorizes FLAG to acquire long-term financial assets in the subsidiary "Fund for sustainable urban development of Sofia" EAD worth BGN 4,500,000, representing 4,500 new, ordinary, available, registered shares with a nominal value of BGN 1,000. With this act and the following a decision of the Board of Directors of the Fund from 28 March 2017 is proceeded with the registration of the change and a corresponding increase in the share capital of "Fund for sustainable urban development of Sofia" EAD from BGN 500,000 to BGN 5,000,000.

There have been no other significant events after the reporting period that could have an effect on the information presented in these individual financial statements.

### 3. FORESEEN DEVELOPMENT FOR 2017

The business plan for 2017 is based on:

- The credit agreements signed in 2016 and previous years that will remain active in 2017;
- The indicative lists and scheduled payments of OPRD and OPE, information about the RDP and the FM of EEA, meetings with representatives of MA of OPE, OPRD and CBC, telephone conversations and surveys with municipalities and the stated need for financial resources, information from UMIS;
- A set of assumptions based on the experience of FLAG accumulated during the period from 2009 to 2016;
- A survey in late 2016 and early 2017 for projected demand for resources and schedules and results from the announced procedures for programming period 2014 - 2020 and new programmes under which the municipalities can be beneficiaries.

#### 3.1 Overall assessment of loan demand

2017 is the second effective year of the second programming period and is characterized by an initial phase of the projects, including approval of project proposals by the Managing Authorities, the selection of contractors for the projects through announcement of public procurement procedures, receiving advances and commencing the implementation of projects from programming period 2014 – 2020.

The demand for financing in 2017 will be relatively limited - mainly for bridge financing and own contribution per "phased projects" /second phase of projects for construction of water supply infrastructure, the implementation of which has started under OPE 2007 – 2013/ and per "advanced projects" /projects that have been withdrawn from OPE 2007 - 2013 and will be implemented during the current programming period/, projects with short deadlines for implementation of activities under OPRD and CBC.

Summary assessment for the expected new credit resource in 2017 in BGN thousand is presented in the table below:

Programs	Bridge financing	Co-financing	Total
OPRD	3,500	3,300	6,800
OPE	6,000	21,500	27,500
CBC, FM of EEA and NFM, RDP	750	1,320	2,070
<b>Total</b>	<b>10,250</b>	<b>26,120</b>	<b>36,370</b>

The Fund has the necessary financial resources to meet the expected demand for funding in 2017.

#### 3.2 Financial income and result

The forecast for interest income on loans is based on the structure of the portfolio in 2016, which is expected to remain relatively the same in 2017. This is due to the following objective reasons: at the end of 2016 the company's portfolio includes mainly long-term loans (about 75% of total number of loans) - these credits will be active in 2017 and will continue to form the main part of the portfolio; reduced demand for resources is expected in 2017 given the initial phase of the programming period.

The total expected income from operations is BGN 4,000 thousand, 98.8% of which is expected to be comprised of income from lending and 1.2% - income from management of temporarily free funds.

The phased repayment and subsequent utilization of the revolving loans provided by commercial banks will continue in 2017, depending on the needs of the Fund. During the year there are no plans for assuming new debt except renegotiation of the loan from DSK Bank, which will be reflected in reduced fees. The nature of the three revolving and the one standard commercial loans allows the fund to be flexible in terms of management of available resources and therefore no great availability of free funds to occur which in the current market situation does not generate income.

Directors' Report

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On the basis of assumptions, analysis of operations and estimates of income and expenditure for 2017, an operating profit (profit before tax and impairment loss) in the amount of BGN 1,632 thousand has been projected. The profit is comparatively lower than the levels achieved in 2016, because of the effect of the following major factors: decrease in interest rates, in order to maintain market presence, risk of early repayment of part of the loans related to refinancing by the commercial banks, reduction of the portfolio, renegotiation of the interest rates on part of the loans in order to retain customers and to provide competitive market terms.

Prepared by: Nadya Dankinova – Executive director  
28 March 2017

