

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

**CONSOLIDATED ANNUAL DIRECTORS' REPORT AND
CONSOLIDATED FINANCIAL STATEMENTS**

31 December 2016

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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General information

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 advisors

Law Firm „Lozanova and Groysman”
Radostina Krasimirova Yaneva

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

CONSOLIDATED 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.

1. Business program

1.1. Equity and loan resources

The share capital of the Group 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 Group including share capital, reserves and retained earnings altogether amounts to BGN 99 million.

In 2015 fund 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 112 million.

According to an Operational agreement between European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, signed on 30.05.2012, a contingent loan in the amount of BGN 24,600 thousand was granted for financing urban development projects under the JESSICA initiative. On 14.12.2015 a transfer and substitution agreement was signed between the EIB, MRDPW, FSUDS EAD and FLAG EAD, according to which, as of 01.01.2016, due to the expiration of the EIB's commitment to the JESSICA initiative in Bulgaria, all rights and obligations of the EIB under the Operational Agreement are transferred to MRDPW until the Fund manager of financial instruments in Bulgaria EAD starts functioning. In 2016 all available resource of FSUDS has been successfully invested through the implementation of 13 sustainable urban projects.

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 consolidated financial statements that provide a true and fair view on the financial position of the Group 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 consolidated 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 consolidated 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 Group has a core staff with appropriate qualifications and experience for the performance of its lending activity. 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 Group 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 selection 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 and MRDPW (MA of OPRD)**

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.

On 30 May 2012 an Operational Agreement was signed between the European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments - FLAG EAD for provision of contingent loan for financing of eligible urban development projects through Project funding agreements.

Amendment agreement №1 to the Operational Agreement was signed in 2014 under which the sanctions for breaching the first period for disbursement of funds to final recipients – 31.12.2013 are waived under condition. The Amendment was signed due to the inability for disbursement of the funds under the JESSICA initiative in the predetermined period. This was due to circumstances beyond the Fund's control. In particular, there was a six month delay in the signing of an Operational Agreement; another six months were needed for establishing the method for assessment of the state aid available for projects and the method for certification, through independent expert assessment, and selection of eligible experts to undertake the assessment. The volatile political situation and the frequent change of the governments, which deteriorated investors' confidence, as well as the innovative nature of the JESSICA financial instrument and the lack of experience in its application in Bulgaria, also played a role in delaying the investment process.

Under this additional agreement an "administration amount" of BGN 923 thousand was paid in exchange for future repayments by final recipients. The contingent loan was effectively reduced by this amount.

Amendment agreement №2 was signed on 18.12.2014. Under this agreement the period for disbursing funds under project funding agreements is extended to 31.12.2015 and the "administration amount" of BGN 923 thousand is specified as being deducted from the loan amount. The amount of the contingent loan is changed to BGN 23,685 thousand.

Amendment agreement №3 was signed on 10.07.2015 in relation to the changes in the criteria for selection of new partner bank of FSUDS. Under Amendment agreement №4 dated 11.12.2015, the final disbursement date for the funds provided under the Contingent loan was extended to 30.06.2016. The provision for reimbursement of the administrative amount withheld in line with Amendment agreement №1 is discarded. The amount of the Contingent loan remains BGN 23,685 thousand.

On 07.12.2015 FSUDS was informed that the Funding Agreement between Republic of Bulgaria and EIB will expire on 31.12.2015 and in line with the decision of the OPRD Managing Authority and the Investment Board, it will not be extended. On the basis of article 14.04B of the Operational Agreement, EIB assigns all of its rights, obligations and interests by way of novation to MRDPW (OPRD Managing Authority), which will take on its functions for a transition period until they are further transferred to the Fund Manager of Financial Instruments in Bulgaria EAD. A Transfer and Substitution Agreement was signed on 14.12.2015 between EIB, MRDPW, FSUDS and FLAG, where the transfer process and EIB's continuing obligations during the interim period are agreed.

Amendment agreement № 5 was signed on 08.07.2016. By virtue of this agreement, as of October 31, 2016 the amount of the overall "Co-financing" should be at least equal to the amount of the Contingent loan.

1.6. 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.

In 2016 continues the contract from 27.07.2015 between FSUDS and CiBank EAD for performing the functions of a partner bank.

1.7. 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/

1.8. 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.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

Consolidated Directors' Report

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 FLAG EAD 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>	-	-
Total	32	46,624

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
OPRD	<i>2 funded projects, part of framework agreements</i>	250	98	152	125	85	119	102
OPE	10	33,248	274	9,779	3,325	11	120	71
RDP	4	2,095	153	619	419	85	119	100
FM of EEA	13	4,703	143	1,477	362	6	20	11
Solidarity Fund	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 FLAG EAD amount 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 FLAG EAD. 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 of FLAG EAD as of 31.12.2016 are 170 amounting to BGN 136,216 thousand. Credits are split by types as follows:

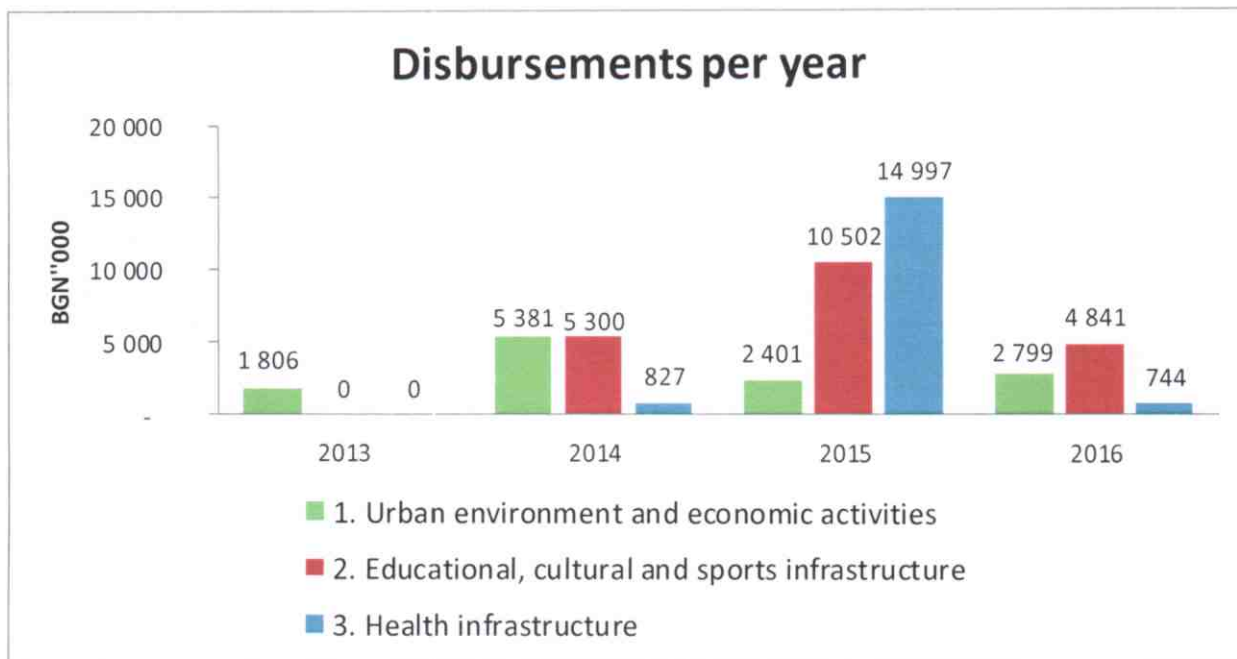
- Bridge financing – BGN 21,349 thousand (16 % from active loans)
- Own financing – BGN 114,867 thousand (84 % from active loans)

Regarding the subsidiary FSUDS, since the beginning of 2016, a total of 23 disbursements in the amount of BGN 8,384 thousand were made, of which disbursements under subloan MRDPW - BGN 2,535 thousand or 10.70% of the Contingent loan.

Since the beginning of the activity of FSUDS up to 31.12.2016 a total of 77 disbursements in the amount of BGN 49,294 thousand were made under the 13 contracts for project funding, of which the disbursements under subloan MRDPW are BGN 24,603 thousand. The difference of BGN 918 thousand is provided by the interest received on the special account. As of 31.12.2016 the total disbursements under all 14 approved urban development projects are 83 and their value is BGN 49,598 thousand.

The distribution of disbursements per sector for the period 2013 - 2016, in thousand BGN is as follows:

Sector/Year	2013	2014	2015	2016	Total
1. Urban environment and economic activities	1,806	5,381	2,401	2,799	12,387
2. Educational, cultural and sports infrastructure	-	5,300	10,502	4,841	20,643
3. Health infrastructure	-	827	14,997	744	16,568
Total:	1,806	11,508	27,900	8,384	49,598



At the end of December 2016, twelve projects are completed and two are in the final phase of implementation.

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. 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/Protocol №147 it was proceeded with registration of the share capital increase of FSUDS EAD from BGN 500,000 to BGN 5,000,000 in the Commercial Register. Meanwhile, changes to the Articles of association of FSUDS EAD related to the scope of its business activity and its name were also made.

1.11. 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.

In October 2016 the Executive Director of FSUDS took part in the event City Forum 2016, organized by the City Media Group, where the fund is an official partner. The main topic of the event was "Prospects for the development of Bulgarian cities".

A promotional event of FSUDS was held in November 2016, where the results of the Fund for the first cycle of investment were presented. In connection with this event a short film was produced presenting the projects funded by FSUDS. A presentation summarizing the results of FSUDS during the first cycle of investment was also prepared.

During 2016 representatives of FSUDS participated in numerous trainings, seminars and forums.

In October 2016 the renovated website of FSUDS was launched. The Facebook page of the fund is also updated on a regular basis through news and photos.

In 2016 the JESSICA initiative continued to be promoted in Bulgaria through events organized by final recipients presenting the results of the projects.

2. 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.

3. Financial performance

3.1 Consolidated statement and structure of revenue and expenses of the Group

3.1.1. Consolidated statement of income and expenditure

EXPENSES, BGN '000		7,242
1	Remunerations	737
2	Social securities	84
3	Accounting and audit services	25
4	Legal and consulting services	32
5	Other hired services	94
6	Rent	57
7	Communication services	7
8	Expenses for materials	20
9	Other costs (cleaning, subscription, representative expenses)	29
10	Depreciation charge	22
11	Bank fees and exchange differences	2,429
12	Interest expenses	2,650
13	Impairment costs	1,056

REVENUE, BGN '000		10,510
1	Interest on loans	9,743
2	Penalty interest on loans	40
3	Fees on loans granted	618
4	Interest on deposits, accrued and received in 2016	92
5	Interest on deposits, accrued but not received in 2016	1
6	Other income	16

3.1.2. Structure of expenses

Group of expenses	Amount in BGN thousand	Share in total expenses in %
Maintenance Costs	106	1%
Hired services	158	2%
Depreciation expense	22	0%
Remunerations - staff, BoD (including social securities)	821	11%
Bank fees including Managing bank fees	2,429	34%
Interest expenses	2,650	37%
Impairment/provisions	1,056	15%
	7,242	100%

3.1.3. Revenue

Total revenues of the Group for the period are BGN 10,510 thousand, and are presented split by types below:

Revenue in BGN '000	2016	Share
Interest and fees on loans and other income	10,417	99%
Interest on deposits	93	1%
Total	10,510	100%

- ✓ **Revenue from lending activities** – around 99% from total revenues are from lending activities. The return includes interest, management and commitment fees.
- ✓ **Management of temporary free funds** – As of 31.12.2016 FLAG EAD has a contract for deposit account and a contract for a current account with a preferential interest.
Total revenue of the Group from management of temporary free funds amounts to BGN 93 thousand.

3.2 Results from the current period

The Group's profit before tax for 2016 is BGN 3,268 thousand and the net profit is BGN 2,942 thousand.

3.3 Dividends and distribution of profit

In 2016 with a decision of the BoD the Group formed a "Reserve fund" with 10% of the net profit for 2015 amounting to BGN 277 thousand and after that it distributed dividends to the Government amounting to BGN 1,245 thousand or 50% of the balance, which were fully paid during the year.

3.4 Subsidiary company

As of 31 December 2016 FLAG EAD is the sole shareholder in "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 for financing urban development projects, twelve of which 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.

3.5 Financial risk management and financial instruments

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

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

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

Interest rate risk

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

Liquidity risk

The effective management of the Group'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 Group 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 Group'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 Group within the envisaged / agreed deadlines. As at the end of 2016 the receivables on loans granted by the Group amount to BGN 182,375 thousand, and at the end of 2015 these were BGN 303,903 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.

4. Foreseen development of the Group 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.

4.1 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 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
Total	10,250	26,120	36,370

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

In relation to FSUDS, in 2017 the Fund plans to focus on the process of reinvestment of funds. The expected resource that will be available for investment in new sustainable urban development projects in the city of Sofia is approximately BGN 3 million per year until the deadline for reinvestment – 2025. In 2017 FSUDS also plans to participate in the competition for selection of future urban development funds, organized by the Fund manager of financial instruments in Bulgaria.

4.2 Financial income and result

The forecast for interest income on loans granted by FLAG EAD 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 portfolio of FLAG EAD 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 of FLAG EAD 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.

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) for FLAG EAD 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.

4.3 Information under Art. 187 d and Art. 247 from the Commercial Act

In 2016 own shares of the companies in the Group were not acquired and transferred.

Remuneration of key management personnel in 2016 amounts to BGN 295 thousand.

As of 31.12.2016 the members of the Board of Directors of FLAG EAD 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 Manastirli - 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.

4.4 Research and development activity

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

4.5 Significant events after the reporting period

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 EAD from 28 March 2017/Protocol №147 it was proceeded with the registration of the share capital increase from BGN 500,000 to BGN 5,000,000 in the Commercial Register. Meanwhile, changes to the Articles of association of FSUDS EAD related to the scope of its business activity and its name were aslo made. The changes in the Articles of association related to the scope of business activity, the name and the share capital increase were officially published in the Commercial register on 05.04.2017.

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

4.6. Branches and subsidiaries

In 2012, FLAG EAD 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. As at 31 December 2016, the share capital of the company remains BGN 500 thousand. The share capital has been fully paid in.

As of 31 December 2016 and 31 December 2015 there are no branches.

Prepared by: Nadya Dankinova – Executive director

19 May 2017

