

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

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

31 December 2014

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General information

Board of Directors:

Dobromir Prodanov Simidchiev - Chairperson
Yana Nikolova Georgieva - member
Emil Rumenov Savov - member
Susan Marie Goeransson - member
Nadya Yordanova Dankinova – member and Executive director
Denitza Plamenova Nikolova - member
Yulia Petkova Tsoleva–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 Atanasov”

Servicing banks

UniCredit Bulbank AD
Raiffeisenbank EAD

Auditor

Baker Tilly Klitou and Partners Ltd
1612 Sofia
104 Akademik Ivan Geshov, Seventh Floor

CONSOLIDATED REPORT
on the principal activities of
Fund for Local Authorities and Governments in Bulgaria – FLAG JSC in 2014

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

Share capital of the Group is BGN 90,000 thousand, and it is paid on four instalments in 2008, 2009 and 2014. During 2014 the Government increased the share capital of FLAG with BGN 30,000 thousand.

The contracted long-term credit resource amounts to EUR 70,000 thousand as negotiated in two Loan contracts dated 22 December 2008 and 31 October 2013 with the European Bank for Reconstruction and Development. The total amount of principal payable to EBRD as of 31.12.2014 amounts to EUR 58.3 million. During 2014 FLAG increased its utilisable loan resources with additional BGN 40 million, which the Group received under the form of revolving credit facility, included as an additional function during public procurement tender for choice of Managing bank. As of 31.12.2014 the loan is not utilized.

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. As at 31.12.2014 the unutilized amount of BGN 15,225 thousand, intended for sub-loans, has been deposited into the special account.

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 2014 thirteen 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 15 April 2014 with Protokol № T3-21/31.03.2014 the Minister of Regional Development, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister of Regional Development released Daniel Bryan Berg as a member of BoD and elects on his place Iliyana Dimitrova Tsanova as a member of BoD.

➤ On 19 September 2014 with Protokol № T3-60/01.09.2014 the Minister of Regional Development, in his capacity of representative of Government as a sole shareholder, conducted changes in BoD. The Minister of Regional Development released Iliyana Dimitrova Tsanova and Yoanna Vladimirova Hristova as members of BoD and elects on their places Susan Marie Goeransson and Yana Nikolova Georgieva as members of BoD.

➤ On 26 September 2014 with Protokol № T3-70/12.09.2014 the Minister of Regional Development, in his capacity of representative of Government as a sole shareholder, conducted changes in BoD. The Minister of Regional Development released Snezhina Slavcheva Petrova as a member of BoD and elects on her place Radoslav Rusev Rusev as member of BoD.

➤ With Protokol № T3-104/16.12.2014 the Minister of Regional Development, in his capacity of representative of Government as a sole shareholder, conducted changes in BoD. The Minister of Regional Development released Radoslav Rusev Rusev as member of BoD and elects on his place Denitza Plamenova Nikolova as a member of BoD. As of 31 December 2014 the change is not reflected in the Commercial register.

As of 31 December 2014 the Board of Directors has the following members: Dobromir Simidchiev – Chairperson, Radoslav Rusev – Deputy Chairperson, Yana Georgieva – member, Emil Savov - member, Yulia Tsoleva – member, Susan Marie Goeransson – member and Nadya Yordanova 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 2014, 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

The Fund's staff has the appropriate qualifications for performing the lending activities in 2014. The structure and number of staff are presented in the table below.

Position	Approved number of personnel for 2014	Number of personnel as of 31.12.2014
Directors of Departments "Projects and monitoring", "Finance and Risk management" and "Lending"	3	3
Senior experts in Departments "Projects and monitoring", "Finance and Risk management" and "Lending"	3	1
Experts in Departments "Projects and monitoring", "Finance and Risk management" and "Lending"	8	8
Director of Department „General administration“	1	-
Experts in Department „General administration“ including office manager in this number	1	1
Chief accountant	1	1
Internal auditor	1	1
Total	18	15

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

1.4. External auditor for 2014

On BoD meeting dated 26 August 2014 BoD approved the results from public tender for external auditor for 2014 and 2015 and approved „Baker Tilly Klitou and Partners” OOD. Subsequently this choice has been confirmed with Protokol T3-67/04.09.2014 from the Minister of Regional Development, in his capacity of representative of Government as a sole shareholder.

1.5. Loan agreements with EBRD and EIB

In 2014 the credit resource under the Loan Agreement from 22 December 2008 with the European Bank for Reconstruction and Development amounting to EUR 35 million is fully utilised. During 2014, FLAG continued to repay the loan and two instalments were paid on 03.02.2014 and on 03.08.2014 amounting to BGN 5,704 thousand.

On 30 October 2013 a new Loan Agreement for the amount of EUR 35,000 thousand was signed with the EBRD. As of the end of 2014 the loan is fully utilised, and two repayment instalments were paid on 03.02.2014 and on 03.08.2014 amounting to BGN 5,711 thousand.

As at 31 December 2014 the Operational Agreement, concluded between the European Investment Bank, the Fund for Sustainable Urban Development of Sofia EAD and the Fund for Local Authorities and Governments - FLAG EAD on 30 May 2012, in respect of a contingent loan is still in force. The entire loan amount has been made available to the borrower while the unutilized amount intended for sub-loans to final recipients along with the interest accrued on the special account amount to BGN 15,225 thousand.

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 from BGN 24,608 thousand to BGN 23,685 thousand.

1.6. Managing bank

On a meeting dated 26 May 2014 Board of Directors of FLAG took decision to conduct public procurement procedure for choice of credit institution, which to execute functions and activities of Managing bank of FLAG EAD. The decision was taken due to expiry of contract with Managing Bank – „Unicredit Bulbank” AD on 22.12.2014.

In the public procurement procedure was added new function of Managing bank – provision of revolving credit facility in the amount of BGN 40,000 thousand, which to secure additional resources for financing municipal projects. After successful public tender, with Decision of BoD from 30 September 2014 and approval from sole shareholder Unicredit Bulbank AD was chosen as Managing bank and the contract with the bank was signed on 6 November 2014.

The agreement concluded between subsidiary company FSUDS and Raiffeisenbank Bulgaria EAD which is selected on the basis of a conducted tender under the Public Procurement Act by a decision of the Managing Board dated 19 June 2012 remains in force. A contract that contains special provisions on the bank accounts held with Raiffeisenbank Bulgaria EAD has been concluded in line with the requirements laid down in the Operational Agreement.

1.7. Results from lending activities during 2014

In 2014, 150 loan applications were received from 80 municipalities and one municipal owned company with total requested amount of BGN 294,010 thousand. During 2014 FLAG approved 142 loan with total value of BGN 225,557 thousand, supporting projects with value BGN 1,428,864 thousand.

During 2014 loan requests from Simitly municipality and Strumiyani municipality were denied. Varna municipality and municipal company "Trolleybusen Transport" EOOD withdrew their loan requests. For 2014 the average percentage of loan share in total budget of credited project is 15,8 %.

The „Typical” loan granted to municipalities for bridge financing is with average amount of BGN 1.8 million and with average maturity of 12 months. Average amount of loan repaid with Municipalities own funds is BGN 1.2 million, with average maturity of 73 months.

The table below presents information for loans granted in 2013 and 2014 by type of loans and source of repayment of principals of loans

Type of loans	Number of loans in 2013	Value of granted loans in 2013 (in thousand BGN)	Number of loans in 2014	Value of granted loans in 2014 (in thousand BGN)
Long-term	95	117,170	81	158,399
<i>Incl. Bridge financing</i>	49	85,613	30	98,058
<i>Incl. own contribution</i>	46	31,557	51	60,341
Short-term	153	117,886	61	67,158
<i>Incl. Bridge financing</i>	143	116,854	61	67,158
<i>Incl. own contribution</i>	10	1,032	0	-
Total:	248	235,056	142	225,557

The following two tables present the structure of the lending operations for 2014 by project type, operational programme and source of repayment of the principal.

By Operational programme	Number of loans	Total amount (in BGN thousand)	Amount of loan In thousand BGN			Maturity in months		
			Min.	Max.	Average	Min.	Max.	Average
Regional Development	66	55,794	67	3,500	845	8	120	26
Environmental	55	150,866	266	9,779	2,743	11	120	48
Rural Development	7	4,321	134	2,229	617	10	120	44
Cross-border Co-operation	14	14,576	169	4,300	1,041	10	22	14

			Amount of loan In thousand BGN			Maturity in months		
By source of repayment	Number of loans	Total amount (in BGN thousand)	Min.	Max.	Average	Min.	Max.	Average
Operational programmes	91	165,216	67	9,779	1,816	8	22	12
Own contribution	51	60,341	69	6,000	1,183	13	120	73

In 2014, the funds utilised under the concluded loan agreements amounted to BGN 158,389 thousand, while the repayments amounted to BGN 128,736 thousand.

During 2014 the Company reviewed requests for annexes to granted loans with the purpose of extension of maturity of contracts, for changes in bank accounts and other reasons. In 2014 the Company signed 216 annexes, from which seven are with change of source for repayment of principal with value of restructured principals amounted to BGN 4,040 thousand. One request for restructuring from Sliven municipality was approved, but the annex was not signed due to early repayment of principal from client. As of 31.12.2014 the Company has 6 restructured granted loans with change of sources of repayment of principal of BGN 3,400 thousand.

In 2014 148 loans with value of BGN 113,998 thousand are fully repaid.

As of 31.12.2014 there are 250 active loans with principal amounted to BGN 162,697 thousand.

As at the end of 2014 there are no loans, overdue more than 30 days.

A large-scale campaign promoting the JESSICA financial instrument and the opportunities that it provides was undertaken during 2014. Assistance was granted to potential beneficiaries with regard to the structuring of eligible projects. Dozens of bilateral meetings were held to discuss project ideas and the possibilities to finance them under the JESSICA financial instrument. As at 31.12.2014, approximately 25 projects with a total value of over BGN 193,4 million were submitted for review and assessment. The total loan financing sought under these projects amounted to BGN 142,9 million.

In 2014, eleven of the projects were reviewed and approved by the Investment Committee. The approved financing amounted to BGN 61,548 thousand, which represents 125% of the available funds. In 2014 the company signed agreements for financing 7 of the approved projects at the amount of BGN 23,513 thousand, representing 48% of the resources of the fund. The total amount of disbursements made in 2014 was BGN 11,508 thousand.

1.8. Changes in Lending and Pricing policy of FLAG

- 1 By decision 16.1 and decision 16.2 set out in Protokol 101/25.02.2014 BoD approves the following changes in pricing policy of fund: maintain all the components and methodology for composition of basic interest rate of FLAG and change the additional margin of FLAG from 1.715% to 2.078%;
2. By decision 17 set out in Protokol 101/25.02.2014 BoD approves lending to municipal investment projects, which are approved by Rural Development Program, measure 122, using the current rules for financing of projects;
3. By decision 19 set out in Protokol 101/25.02.2014 BoD approve increase in maximum limit for financing of commercial entities for 2014 from BGN 5 million to BGN 9 million.

4. By decision 11 set out in Protokol 102/25.03.2014 BoD approve changes in rules for signing of contracts for deposits and other cash equivalents of FLAG, resulting in change of level of credit ratings, which banks should have to be eligible for presenting of offers for services. The level of credit rating is changed from BB+ to BB for the rating agencies Fitch и Standarts and Poor's and from Ba1 to Ba2 for the rating agency Moody's.
5. By decision 1 set out in Protokol 103/28.04.2014 BoD of FLAG postpone approval of loan applications, related to loan contracts financing OPE projects until restoration of payments of grants, which are collateral of those loans. BoD of FLAG temporarily postpone absorption of funds by loan contracts, related with OPE projects until restoration of payments for grants.
6. By decision 15 set out in Protokol 104/26.05.2014 and in relation to decision of BoD of FLAG № 1.2 set out in Protokol 103/ 28.04.2014, BoD decides not to accrue commitment fee to signed loan contracts for execution of OPE projects, by which there is absorption request from the date of request until restoration of grant payments. Commitment fee will not be accrued only for absorption requests, which can not be fulfilled.
7. By decision 11 set out in Protokol 105/24.06.2014 BoD of FLAG approved new Rules for financing of projects from FLAG EAD.
8. By decision 1 set out in Protokol 109/26.08.2014 BoD of FLAG restores absorption of loan contracts related to OPE projects. BoD of FLAG restores reviewing of loan requests related to OPE projects, from the date of publication of the Decree of the Council of Ministers for for restoration of OPE payment from State budget. Requests will be considered in order of their entry in the Fund and will be approved subject to the signing of contracts to the extent of available resources, which the fund has.
9. With decision 18 set out in Protokol 112/28.11.2014 BoD of FLAG approves addition to Internal rules for public procurement orders of FLAG, by adding in the rules new Section VIII Buyer Profile.

1.9. Information and publicity

It is a tradition for representatives of the Fund to participate in major events of the municipalities organized by the National Association of Municipalities in Republic of Bulgaria, on which the Fund represents itself and conducts consultations with municipalities. During the year Fund representatives actively participated in national and regional events relating to the new programming period and in meetings of the Regional Development Councils. FLAG maintains a website and updates the information published on the site on a regular basis.

Representatives of the Fund participated in the work of the Monitoring Committees of OP Regional Development and OP Environmental as well as in monthly local meetings of the Managing Authorities with representatives of the municipalities.

One of the highlights in the operations during the year was the effort to present and promote the activity of the Fund, the participation in training events, workshops and forums. A website setting out relevant information is updated on a regular basis. A booklet and a number of materials intended to inform potential final beneficiaries have been published.

More than 30 eligible urban development projects have been identified and meetings with the potential final beneficiaries have been held to aid the structuring of project ideas and assist with other pre-financing activities.

2. Financial position

2.1 Consolidated structure of revenue and expenses of the Group

i. Consolidated statement of income and expenditure

EXPENDITURE, BGN '000		5,884
1	Remuneration	598
2	Social securities	71
3	Accounting and audit services	22
4	Legal and consulting services	196
5	Other hired services (hardware and software maintenance, translation, insurance)	15
6	Rent	56
5	Communication services	7
6	Expenses for materials	16
7	Other costs (cleaning, maintenance, car wash, subscription)	54
8	Depreciation charge	16
9	Bank fees	874
10	Interest expense on EBRD loans	3,108
11	Impairment	851

REVENUE, BGN '000		8,447
1	Income from interest	6,617
2	Default interest income	63
3	Fee income	847
4	Interest on deposits, accrued but not received in 2014	4
5	Interest on deposits, accrued and received in 2014	864
6	Income from evaluation of projects	52

DEPOSITS, BGN '000		10,629
1	Unicredit Bulbank	10,629

ii. Structure of expenses

Group of expenses	Amount in BGN thousand	Share in total expenditure in %
Maintenance Costs	126	2%
Hired services	240	4%
Depreciation expense	16	0%
Remuneration of staff, BoD	669	11%
Unicredit Management fee, other bank fees	874	15%
EBRD loans – interest	3,108	53%
Impairment	851	15%
	5,884	100

iii. Revenue

Total revenues for the period are BGN 8,447 thousand, and are presented split by types below:

Revenue in BGN '000	2014	Share
Interest and fees on loans and other income	7,579	90%
Interest on deposits	868	10%
Total	8,447	100

- ✓ **Revenue from granted loans** – Around 90% of revenues are from lending activity with average interest rate of 4.924%, including interest income; management fee and commitment fee amounting to BGN 7,579 thousand and 10% of revenues are from management of temporary free funds.
- ✓ **Management of temporary free funds** – As of 31.12.2014 FLAG has signed contract for reserve account for the purpose of servicing of loan agreements with EBRD and contract for current account with preference rate. Total revenue from management of temporary free funds amounts to BGN 868 thousand, distributed by following sources:

Source	Paid in 2014 BGN '000	Accrued as at 31 December 2014 BGN '000	Total BGN '000
Unicredit Bulbank	274	1	275
Unicredit Bulbank – Reserve account	119	3	122
MKB Unionbank	389	-	389
Raiffeisenbank	82	-	82
Total	864	4	868

2.2 Results from current period

The Group's profit before tax for 2014 is BGN 2,563 thousand and net profit is BGN 2,308 thousand.

2.3 Dividends and distribution of profit

In 2014, the Board of Directors approve allocation of 10% from the profit from 2013 amounted to BGN 268 thousand to "Reserve Fund", and from the rest of the profit for 2013 distribute 70% dividend to the Government amounting to BGN 1,687 thousand, which are fully paid during the year.

2.4 Subsidiary company

As of 31 December 2014 FLAG EAD is the sole shareholder in the "Fund for Sustainable Urban Development of Sofia" EAD (FSUDS), which was registered in the Registry Agency on 23 April 2012. As of 31.12.2014 FSUDS has 8 loan contracts for financing of urban projects, under which BGN 13,314 thousand have been disbursed.

3. Foreseen development of the Group in 2015

The 2015 Business Plan has been drawn up on the basis of:

- The loan agreements concluded in 2014 and previous years that will remain active in 2015;
- Expected parameters of loan applications, which are submitted and processed as at the end of December 2014;
- Indicatives lists and repayment schedules of OPRD and OPE, information about RDP, meetings with representatives of the Managing Authorities of OPE and OPRD, and a study conducted in 264 municipalities to estimate the demand for FLAG loans.
- A set of assumptions, based on FLAG's accumulated experience for the period 2009-2014.

3.1 Overall assessment of loan demand

The Table below sets out a summary estimate of the expected new loans in 2015 in BGN milion.

Programmes/type of loans	Bridge financing in million BGN	Municipal co-financing in million BGN	Total in million BGN
Operational Program Regional Development (OPRD)	68	9	77
Operational Program Environmental (OPE)	119	83	202
Rural Development Program (RDP)	2	-	2
Cross Border Cooperation (CBC)	2	-	2
Total:	191	92	283

To provide the necessary credit resources the fund in 2015 will seek additional financing in the form of revolving loans with up to total amount of BGN 80 million.

According to the business plan of subsidiary company FSUDS for 2015, 100% of the available funds (i.e. BGN 23,685 thousand of the funds provided under the Operational Agreement with the European Investment Bank and BGN 24,500 thousand of the credit line available from FLAG) are expected to be contracted. It is planned that 14 projects at the total amount of BGN 50,000 thousand to be financed under project funding agreements.

3.2 Financial proceeds and results

The total expected revenue from operations for 2015 is estimated at a total value of BGN 10.7 million, 93% of them being the expected interest income on loans granted to municipalities

3.3 Information as per article 187 d and article 247 of the Commercial Act

In 2014 by decision of Minister of Regional Development number T377/07.10.2014, share capital of the fund is increased from BGN 60 million to BGN 90 million distributed in to 90 thousand shares with nominal value of 1000 BGN per share, by emission of 30 thousand new shares with nominal value and emission value of 1000 BGN each. New shares issued are 100% owned by the sole shareholder of the Company - the Government, represented by the Minister of Regional Development.

3.4 Branches and subsidiaries of the Company

In 2012, the Company has established a subsidiary - "Fund for Sustainable Urban Development of Sofia" JSC, 100% owned by the "Fund for Local Authorities and Governments - FLAG" JSC with a capital of BGN 500 thousand. As at 31 December 2014, the capital of the company remains BGN 500 thousand. The capital has been fully paid up.

As of 31 December 2014 and 31 December 2013 there are no branches.

Prepared by: Nadya Dankinova – Executive Director

19 May 2015.

