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The First "Brits in Bulgaria" Business Lunch

hosted by **His Excellency Jonathan Allen**, **Ambassador of Great Britain**

with Principal Speakers
Stefan Felstein, Country Manager, Citibank
Richard Clegg, Managing Partner, Wolf Theiss
David Archer, Managing Director, Melrose Resources
and chaired by **Vesey Crichton, Partner, Cleves**

Date: Wednesday, 7th November, 2012

Venue: British Ambassador's Residence, 36 Vasil Levski Blvd

Topics:

"Strengths and vulnerabilities of Bulgaria's banking system" *presented by Stefan Felstein*
"Bulgaria's impressive inbound & outbound M&A" *presented by Richard Clegg*
"Developing Bulgaria's Black Sea energy resources" *presented by David Archer*

In his welcoming remarks, the Ambassador noted the strong relationship between the Embassy and the BBCC and praised the new initiative as an opportunity to share experience, make connections and do business together. He thanked Vesey Crichton for establishing this initiative and was pleased to see the large number of participants in attendance.

The Ambassador requested feedback from the participants and welcomed further ideas for the expansion of the BBCC's activities.

"Strengths and vulnerabilities of Bulgaria's banking system" *presented by Stefan Felstein*

Stefan presented a brief overview of the Bulgarian Banking sector.

Bulgaria has a "standard" 2 tier banking system with a Regulator (BNB) which licenses, supervises and investigates all banks and non-banking financial institutions.

There are 31 banks operating in Bulgaria, broadly split into 3 groups – the 5 large banks, the middle sized local banks (the largest group) and the branches of international banks.

In H1 2012 the capital adequacy ratio (CAR) of the BG banking system was 16.7% compared to the 12% required by the BNB. The CAR represents a "buffer" which gives the bank the financial strength to weather shocks. Most countries have a limit of 8 – 9% for this ratio and most countries in CEE are well ahead of this, including Bulgaria, giving confidence in the resilience of the sector.

In H1 2012 the liquidity ratio in the Bulgarian banking system was 26.6%, on an upward trend for the last several years, which is a positive thing, creating more lending opportunities and more flexibility in the sector.

In H1 2012 the number of non-performing loans was 16.9%, also on an increasing trend. This is bad news. Much of it comes from the Real Estate sector and in addition, the Construction industry and non-collateralised loans in SMEs are increasingly non-performing. These trends are mitigated by the ability of the system to absorb this increase. There are 4 levels of classification of non-performing loans so the data is very subjective. So long as the banks have sufficient profit within their normal activities to absorb the impact of writing off these debts, then the system remains stable, but to the extent that they reduce profitability, these loans impair the flexibility in the system and reduce their ability and willingness to make further loans.

"Bulgaria's impressive inbound and outbound M&A" *presented by Richard Clegg*

M&A in Europe has declined since 2007 for obvious reasons. However, the share of CEE in M&A deal volumes has remained steady, meaning that the markets have not become relatively less attractive. Within the region, there is on average 250 – 300 deals monthly and in Bulgaria, the number of deals in 2011 was close to pre-crisis levels (although the value of deals remains depressed).

The macro-story for Bulgaria is not bad. Both Bulgaria and Romania are decoupled from the G7 economies which drag down the overall EU performance, but benefit from the EU framework and the BG tie to the Euro. Eastern Europe remains growing and in transition. It is now a safe place to do business.

There are four main trends in BG M&A:

1) family businesses, whose founders are now entering late middle age and looking for succession options
2) private wealth making direct acquisitions
3) blue chip industrials have shown an noticeable upturn since 2011 particularly looking for low cost manufacturing
4) Asian investors, particularly state owned companies seeking European assets

Major inbound deals to Bulgaria in 2011 were focused on the cash-generating sectors, manufacturing, energy and pharmaceutical. This is driven by the history of business in the region. In Western Europe and the US, family-owned businesses generally result in the strongest return on equity. However, in Eastern Europe, government involvement/ownership has supported development and hence driven returns, and now attracts investment interest.

Nevertheless, family firms in the mid-capitalisation range have done well because they were well-managed and unleveraged when the crisis hit and so remain very attractive "targets" for inward investment.

Both of these features mean that investments succeed best when positions are taken together with the existing owners to leverage their experience and relationships. "Locking in the founder" is a key issue and also offers lower entry costs and staged risk by the use of leveraged ratchet mechanisms.

These joint ownership structures require careful implementation over 3 key areas:

1) control structures
2) investment hurdles (earn out)
3) exit strategy/conditions

"Developing Bulgaria's Black Sea energy resources" *presented by David Archer*

Galata Field was discovered in 1993. A 25 year production concession was granted in 2003 and production started in June 2004 with a platform in 35m of water. Production is now suspended while the potential of storage is explored.

The platform was built in Varna. Local resources are key to the success. It is a small field (2 bcm of gas) and not interesting to a major player.

2 further fields were found and developed - Kaliakra and Kavarna – both very small fields and developed with innovative decisions to manage cost and infrastructure for a resource with a short life, producing back to the main platform to sustain the overall field life. Melrose continues to prospect, starting with drilling in Kamchia.

The strategy is to continue to develop small surrounding fields to keep working the implemented infrastructure as far and as long as possible.

Regionally, Melrose comes ashore at Varna and enters into the Bulgargas distribution system. It also supplies a second, independent transmission company.

Melrose continued to seek opportunities to leverage its facilities and expertise (and the cost effectiveness) of its Varna resources onshore, building a production facility for pre-assembled plant now installed in Egypt and producing oil and gas, having been commissioned by the Bulgarian team. The core team of roughly 40 is a key asset to be leveraged and sustained.

Strong supplier relations are also key. Long term relations, particularly in transportation services have been key to their success. The British Embassy has also provided a very strong source of support.

Q & A session

How big is the shale gas story for Bulgaria and what will it mean for "BG PLC"?

David Archer: Shale gas is part of a process – the gas that is passing through the rock looking for a trap (the traditional "field") is extracted "early". In BG it is at least 10 – 15 years away. There is a potential here – Poland is already extracting it, although there is political resistance. But, as compared to the US, reserves are much deeper and therefore it is not such a cheap source. It's not a focus at this time.

There are a growing number of non-performing loans, presumably supported by reasonable assets. What will be the process for those to be sold on?

Stefan Felstein: The question is really "what is the collateral?" Much of these assets are in real estate and in the aftermath of the bubble bursting, what are reasonable values for these properties today?

There is no general information about who in fact has financial difficulties and what the value of their underlying assets is. The discrepancy between current and original valuations depends heavily on original deal date.

In the non-performing portfolio, there are a lot of loans which have no collateral at all.

Richard Clegg: The problem is that the buy side has been very slow. The NPL market may have now started driving M&A, but this is very recent. Hedge funds are starting to show interest in BG real estate. Unicredit and Wolf Theiss have established units for this kind of deal in 2012, but mostly banks chose to renegotiate with their borrowers and to try to wait out the situation.

Family businesses are a focus for M&A here, but sometimes it is less than clear where the money came from. How does this affect deals?

Richard Clegg: Patience is a real virtue, and forward planning. Cleaning up the business before sale is a key way of adding value and/or even achieving the sale. It is necessary to identify and if possible package the interesting assets from other parts of the group.

What would make BG a better environment for British businesses?

Richard Clegg: Big British manufacturing groups should be very attracted to BG where we have strong targets supported by government.

Costs in BG are now comparable to Asia, transport is easier and it is EU, so for British companies, BG should now be very attractive.

David Archer: Melrose has had extraordinary support from the Embassy and wants more of the same. Terms and conditions are as good as anywhere else in the world here. The problem is actually doing business. The amount of bureaucracy and documentation is enormous and there is no continuity between the different authorities.

Ambassador Allen: The Embassy will and does engage with specific investors to highlight issues through press conferences, events and sharing of experience to highlight UK activity and investment and build relationships. Bulgaria has the highest concentration of family businesses in the EU, the British Embassy has tried to encourage BG to work with UK to lobby together in Brussels to exempt micro-businesses from much regulation.

What should the future relations with Russia include?

Ambassador Allen: BG has enormous geographic potential through Russia and Turkey. Bulgaria is trying hard to ensure that substantial investments come from these geographical regions.

David Archer: we try to stay below the "Gazprom horizon". Nevertheless, Russia is a fact of life. They are remarkably good business people and you have to work with them and their impact on the markets, though Bulgaria benefits from being small and is not a focus for the major players which creates good niches.

Business is multilateral and Russian investors and businesses have strong ties with British and BG businesses, including BBCC members.

How will BG be impacted if Greece exits the Euro?

Stefan Felstein: It is too hard to forecast whether or not Greece will in fact stay or leave the Euro. However, without a forecast, what might happen to the BG banking system in the event of exit. Greek assets are about 22% of the banking asset base. Greece is the 3rd or 4th largest trading partner.

Considering only the Banking sector, how would we mitigate the collapse of Greek banking subsidiaries in BG? The BG subsidiaries are well capitalised (as the rest of the BG sector). The question is whether they can repatriate, which to be honest, has already happened, but it is important to note also that Regulation is strong in BG. The Greek banking subsidiaries in BG that remain are "the jewels in the crown" and they have ultimate value and a very likely option is that they will change ownership rather than collapse

In the light of the most recent turnaround at Citibank, what will be the consequences for the role Citibank plays in the banking system in Bulgaria?

Stefan Felstein: Nothing will change. Citibank is a large financial organisation and not dependent on one person. The new CEO has stated that the established strategy will remain unchanged.

Vesey Crichton thanked the speakers and the Embassy and also the participants, and invited everyone to join for lunch!