Analysis

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Bulgaria: Recent Developments and Market Opportunities

Introduction

Following a difficult political and economic transition, Bulgaria has become one of the most stable countries on the Balkan Peninsula. Over the past ten years, the country has maintained a balanced foreign policy with a **clear orientation towards democracy and a free market economy**. Although the transition process has faced difficulties and delays, the direction has been definitive and irreversible. Both the 2000 and 2001 European Union Progress Reports on Bulgaria presented a favourable appraisal, the latter noting that the country is on the point of achieving a **functional market economy**. The reports recommend the continuation of structural reforms, the acceleration of privatisation, and further development of the capital markets in order to achieve a fully operating and free market economy. It is now estimated that Bulgaria will be ready to join the European Union in 2007.

Political Situation

Following frequent government changes in the early '90s and a number of preliminary general elections, the country has enjoyed growing political stability during the last four years under the government of the United Democratic Forces. In July 2001, a new political force created and led by Simeon Saxe-Coburg-Gotha came into power, securing 50 percent of the seats in the Parliament. A new government has been formed based on a broad coalition, securing a majority of the parliamentary votes and ensuring its ability to govern.

The new government has announced its firm intention to speed up the economical and political reforms and achieve a visible increase in the standard of living within 800 days of its formation. **The government's primary objectives include further improvement of the investment climate, acceleration and completion of the privatisation process, and the support of business growth**. A series of new laws and regulations are being prepared and will strengthen investor confidence.

MACROECONOMIC OVERVIEW

In the last four years, Bulgaria has managed to achieve macroeconomic stabilisation. The Currency Board arrangement – first introduced in July 1997 – has fairly broad political and public support as the stabilisation results have become more perceptible to average citizens. Recent negotiations between IMF and the government were concluded successfully, though there were debates over the government's tax-cut plans and initiatives for improving the living standard of lower-income citizens. Bulgarian incomes are still relatively low, and higher prices for electricity, telecommunications, and other utilities introduced in October have had a negative impact on the government's popularity. This is despite increases in social benefits and the minimum wage.

The Bulgarian economy has grown in real terms every year since 1998. Inflation has decreased to below five percent a year, and real GDP has grown between 2.5 percent and 5 percent every year. The leva (BGN) is now tied to the euro and forex reserves have returned to acceptable levels. Steady improvements in tax collecting mechanisms and high budget revenues resulted in a general budget deficit of one percent in the year 2000, below the target for the year. The new government's fiscal policy should help to meet the lower 2001 inflation targets, although energy price liberalisation might adversely affect progress in this area. Bulgarian exports are negatively affected by the slowdown of the EU economy. Unemployment is predicted to decline from 2001, however, further privatisation and subsequent restructuring may cause additional joblessness in the short term.

Foreign direct investment is growing rapidly, reaching an accumulated total of almost US $3.2 billion for the last decade, despite having started from a relatively low base. Based on information from the Bulgarian National Bank, FDI amounted to US$1 billion in 2000 alone. Investments were roughly equally divided between green-field and privatisation, with the largest investors coming from Germany, Belgium, and Italy.

International investment ratings for Bulgaria are continuously improving. S&P's long-term credit rating was recently upgraded from BB- to BB. The country is rated B2 by Moody's Investors Service and B+ by Fitch.

Structural reform in Bulgaria has been slower than in most Central European countries, however, privatisation made considerable progress in 1999 and 2000. Although still underway, structural and ownership reforms have already led to the dominance of the private sector in overall economic output. In 2000, over 70 percent of GDP was generated from the private sector. About 75 percent of state-owned assets have been privatised, yet some of the "crown jewels" of the Bulgarian economy remain to be privatised.

KEY BULGARIAN ECONOMIC INDICATORS

	1998	1999	2000	2001[f]	2002[f]
Real GDP Growth	3.5%	2.4%	5.0%	3.7%	3.8%
GDP per capita (US$)	1,538	1,570	1,570	1,835	2,089
Population (millions)	8.0	7.9	7.9	7.9	7.9
Consumer Price Inflation (average)	22.2%	0.4%	11.4%	8.5%	4.3%
Unemployment	12.2%	13.8%	18.1%	17.2%	15.8%
Short Term Interest Rate	12.2%	13.8%	18.1%	17.2%	15.8%
Trade Balance	3.5%	3.5%	4.5%	5.0%	6.0%
Current Account Balance (% of GDP)	-0.4%	-1.1	-1.2	-1.0	-1.2
Debt/GDP Ratio	80%	81%	85%	72%	63%
Foreign Direct Investments (% of GDP)	4.4%	6.0%	7.0%	6.9%	6.9%

[f] - Forecast

[1] - The spike in the CPI is largely due to increased energy prices. The core rate would be significantly lower and more stable

Sources: NSI, EBRD, EIU, Bulgarian Country Reports, Lazard Capital Markets Research, Bulgarian Equities: Investment Review, December 2000

RECENT DEVELOPMENTS

Among the first acts of the new Bulgarian government was a series of new laws and regulations supporting the transition towards an operating market economy. The initial steps towards accelerating privatisation, improvement of the general investment climate, elimination of corruption, and strengthening of the capital and land markets have been perceived positively by the investor community, as reflected in increased interest from foreign investors.

The new bill on privatisation and post-privatisation control was accepted by Parliament at first reading on November 8, 2001. The bill will provide for simpler and more transparent procedures for privatisation of the remaining state assets, thereby enabling the process to move more quickly and efficiently. The Privatisation Agency becomes the ultimate authority to deal with privatisation and handles all aspects of the process. Although privatisation strategies were revised, most processes initiated by the previous government were continued.

The first Bulgarian Eurobond issue was successfully completed in early November. The bonds were offered at a total value of EUR 250 million and were greatly oversubscribed, demonstrating the improved investment opportunities and increased attention paid to Bulgarian economic developments. Analysts point out that the high interest was largely prompted by the positive assessment of the new government's financial and fiscal policy by international financial experts.

INVESTMENT OPPORTUNITIES

The new government's commitment to continue with further liberalisation of the markets and the privatisation of the remaining major state-owned assets will create exceptional investment opportunities in Bulgaria, similar to those of Central Europe in the early 90s. Liberalisation and privatisation of the telecom and energy sectors is scheduled to continue in 2002.

KEY GROWTH SECTORS

The Bulgarian service sector, which represents slightly less than 60 percent of the GDP, has experienced the highest growth in recent years and is forecast to remain one of the most attractive to investors. The sectors that attracted the most investment were tourism, retail, financial services, and telecommunications. Primarily due to slow restructuring of the privatised chemical and metallurgical plants, the overall share of industry within GDP has been declining. The agricultural sector faces great difficulties, primarily because of the lack of a land market and uncertain transition policy.

Telecommunications

The telecom liberalisation process started with the introduction of the new Telecom Act in 1998, allowing some competition in certain areas. Full liberalisation – including voice service and leased lines -- will be completed in January 2003. The privatisation of the Bulgarian Telecom Company (BTC) is a priority for the new government following a failed attempt of the KPN and OTE consortium in August 2000. There are few local companies that could become competitors to BTC in a liberalised market, leaving a number of opportunities for new entrants in the alternative telecom providers' market. Bulgaria's mobile telecom penetration is now slightly above 12 percent, a figure far below the average for the region. With the recent launch of the second GSM operator and the expected issuance of a third license, this figure is expected to grow rapidly. Consolidation of the CATV market is also planned, and large financial investors have started investing into this segment.

A number of infrastructure modernisation projects have been introduced recently, including fibre-optic cable developments and improved international service. Internet service provision, including VoIP and other value-added services, could be another attractive area for investors. The privatisation of BTC may provide additional opportunities through spin-offs and encourage liberalisation of the market in general.

Financial Services

Major western investors (including AIG, Société Général, National Bank of Greece and

Allianz) have privatised five major local banks. Although this accounts for about 70 percent of the banking sector, there are still two major banks to be privatised. Both of these banks – DSK, the state savings bank, which ranks third in assets, and Biochim, which ranks fourth – are expected to be privatised in 2002.

The insurance sector opened for competition in 1997. Although small compared to other countries in the region, both the life and general insurance segments have excellent potential for rapid growth. DZI is the largest market player, still state-owned and due to be privatised in early 2002. DZI's privatisation started in year 2000, but was not completed by the previous government. Bulstrad, the second largest player, was privatised last year by a consortium that involved EBRD. There are another 22 insurance companies in the country, including some owned by AIG, Allianz, MunichRe, and other foreign investors.

Pension and health services have undergone ambitious reform in recent years, and the benefits to the financial services sector are now becoming visible. The implementation of a three-pillar pension model is under way with a few funds already operating.

FMCG & Food Processing

An increasing number of the leading multinational FMCG companies are establishing themselves in Bulgaria, replacing the system of third-party wholesalers and importers. The local production of these goods is also on the rise. Opportunities exist for both financial and strategic investors in this area.

Although EBRD estimates show that as much as 30 percent of all FDI went to this sector, Bulgarian food processing is still in a difficult transition period. The sector operates at roughly half of its capacity despite the fact that Bulgaria has a long history of food processing and traditional export markets for its products. To date, major investments have been made in the confectionery (Nestle, Kraft Jacobs Suchard), dairy (Danone), wine (EBRD), soft drink (Coca-Cola and Pepsi Co.), and brewery (Interbrew and Brewinvest/Heineken) industries. Turkish and Greek investors have made smaller investments in the bakery, dairy, and ice cream sectors. The growing disposable income of Bulgarians and demand for better quality products create new opportunities for investors in this area.

Retail & Distribution

Retail has been one of the most visibly changing sectors in the past few years. Despite the appearance of some major western strategic investors, the Bulgarian retail landscape is still highly fragmented and far behind CE countries in terms of chain retail outlets. Super- and hypermarkets and discount stores are almost non-existent. To date, Metro and Billa are the only two major western investors in the segment. The two companies have invested a total of US$55 million and continue to expand. A few Greek and Turkish investors present in the market have announced ambitious expansion plans as well. Nevertheless, there is a significant opportunity for a strong new entrant to acquire a dominant market share relatively inexpensively.

Most multinational FMCG companies are present in the Bulgarian market directly or through distributors. However, no professional logistics companies are yet established. Demand for hauling and professional distribution services is expected to grow with the increase of the penetration of chain stores.

Energy

The new Energy and Energy Efficiency Act provided the legal and regulatory framework for the liberalisation and privatisation of the energy sector. In 2000, the National Electricity Company (NEK) was transformed into separate legal entities for generation, transmission, and distribution (seven regional companies). A number of smaller hydropower companies were successfully privatised in 2000. Electricity prices are expected to reach full recovery costs in 2002 and market liberalisation should be 30 percent by the beginning of 2003. The privatisation of electricity distributors and some major power generation companies is planned for 2002, and this should result in major opportunities for strategic investors as well as significant government reciepts.

Tobacco

After a failed attempt last year, the privatisation of Bulgartabac Holding, one of the largest European cigarette producers, is again under way. Creditanstalt has remained the sale-side advisor. Major international strategic investors and a number of financial investors have expressed interest in the company. The privatisation strategy has not been officially announced yet, and contradictory expectations abound. Political lobbying in protection of the large Bulgarian tobacco-growing industry further complicates the process.

Travel & Tourism

Tourism is one of the most dynamically growing sectors in Bulgaria. However, despite investments from several major Swiss, Austrian, and German groups, tourism ranks relatively low in FDI compared to other sectors. Bulgaria has exceptional natural and historical attractions, including a number of good winter and summer resorts. The government is initiating projects for further development of mainstream tourist destinations. Attractive investment opportunities exist both in developing and upgrading infrastructure and restaurants, for example, the upcoming opening of a winter resort in the Pirin Mountains.

CONCLUSION

Overall, the Bulgarian economy is on a decisively upward trend. This economic growth, together with the government's firm commitment to rapidly completing privatisation and structural reform, creates unique investment opportunities across a number of sectors in the short and medium term.

CET is prepared and ready to assist its clients in their pursuit of the opportunities in Bulgaria.

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