

The dark red is still here

October made another record on the downside. The main market index SOFIX lost 37.9% and currently is more than 50% below its end-August level. This is proof that the market moved much more than a healthy correction requires. The index SOFIX fell to the levels that were last seen in the summer months of 2004. We agree that the risks of recession in Europe will hurt the export of Bulgarian industrial companies and the tight credit conditions could raise the interest costs. However, the valuation didn't play any role in investors' decisions nowadays. The liquidity is more important as stocks of large companies could be sold much easier. That should be the reason for the significantly better performance of M+S Hydraulic for the month and all small-caps in BG40.

SOFIX's Components in October

Stock	Last Price	Change
Albena	36.03	-30.58%
Bulgarian-American Credit Bank	18.30	-54.12%
Central Cooperative Bank	1.31	-54.51%
Chimimport	2.76	-48.89%
Corporate Commercial Bank	65.50	-23.84%
Elana Opportunity Land Fund	1.09	-28.57%
Enemona	7.80	-42.08%
Euro Ins	3.05	-32.18%
First Investment Bank	3.84	-21.17%
Holding Roads	8.00	-46.31%
Industrial Holding Bulgaria	2.94	-42.35%
Kaolin	4.00	-22.33%
Lead and Zink Complex	11.16	-44.63%
M+S Hydraulic	5.83	-16.76%
Monbat	6.00	-33.55%
Neochim	66.90	-10.80%
Orgachim	93.01	-30.06%
Sopharma	2.23	-23.79%
Sparky Eltos	3.50	-41.67%
Toplivo	8.14	-41.42%

Banks were the worst performing stocks in October. Even the lower liquidity of Bulgarian-American Credit Bank didn't help the stock which fell 50% for the month. Financial stocks, including large holdings with subsidiaries in the insurance and banking sectors, are under selling pressure and will be influenced by all negative news from abroad. SOFIX of 2008 is very different from SOFIX of 2004. However, the components of the index are not far from their 2004 levels and

we can say that SOFIX represents the true scale of the market slump. The decline is three to four times faster than the rise, which is usually the case for the falling markets.



Declaring a bottom is too premature. The market capitulation is not over; although it is also unknown whether it will happen at the way it is common for a developed market. The possibility of long period of underpriced stocks is rising. The companies with sound balance sheets and diverse markets should outperform during the next several quarters.

The earning season

It became obvious in September that the quarterly reports will not alter the market bias this quarter. The everyday talk about the financial crisis that is evolving into global economic recession has its implications not only to foreign investors but also to individual and institutional investors. In this market conjunction the trailing valuation ratios are not important for the investors' decisions. The earnings didn't provided some dramatic change in the corporate results as only several sectors had been hurt from the slumping prices of base metals or are facing lower demand for their products. Most other companies performed well during the third quarter and it is possible to announce good annual results too. Some of the interesting stocks are discussed later in the research.

There are several important conclusions from the earning season. The banks are growing in terms of assets and profits. Largest Bulgarian banks, mainly foreign owned, made

huge profits. The sector is well capitalized and the bad loans are not yet showing signs of increase. However, the banks are decreasing their loans, especially for construction, and are focusing their attention to deposits. There are not any reasons to expect that lending activities for large companies will be restrained but small and starting companies in Bulgaria are already facing difficulties obtaining credits.

Higher interest rates are not the main problems for Bulgarian companies as they managed to improve their balance sheets during the last several years. The inflation is rising and the labor costs are soaring even faster. Some sectors and companies have problems finding skilled workers. Labor costs jumping 20% are usual picture for Bulgarian public companies. This won't continue as some sectors are already reporting job cuts.

The positive news from the reports came from the companies that invested in energy efficiency. They have lower energy costs and better profit margins. Most companies continued to announce growing revenues. The slowdown of their sales should be more severe during the first quarter of 2009. Moreover, it is seasonally the weakest period due to the winter and this year it will coincide with the lower demand of industrial goods and base metal prices.

The valuation

As mentioned above, the forward multiples are more important due to the economic uncertainties. Our worst case scenario for selected blue chips is presented in the next table:

	P/E	P/S	P/B
Albena	8.74	1.47	0.50
Sparky Eltos	9.11	0.82	0.54
Industrial Holding Bulgaria	12.56	0.81	0.64
Kaolin	10.99	0.75	0.68
M+S Hydraulic	27.19	0.96	1.61
Monbat	8.77	1.39	1.79
Neochim	9.08	0.59	1.42
Odessos	18.59	2.42	1.53
Orgachim	10.17	0.38	0.59
Lead and Zinc Complex	neg.	0.56	1.47
Sopharma	11.48	0.62	1.08
Toplivo	8.56	0.14	0.39

*calculated with the expected financial data for 2009
Prices as of 11 November

This scenario is based on the declining revenues next quarter and mainly next year. Profit margins will also suffer but is expected to remain above their levels of 2004-2005.

The valuation ratios of those companies in the worst case scenario are less attractive than the trailing multiples. However, they remain very low when comparing to the average for the last several years. Large investors entered the Bulgarian market in 2004 at very close prices than the current. Their investment horizon was for three to five years. The valuation ratios were similar than current but the EPS of many companies are far better. Same story for revenues and balance sheets – Bulgarian stocks worth more today than the last four-five years.

The growth perspectives before the EU accession were also several years in the future. It is likely that the global economy will be in much better condition three years from now. This is the reason for positive long-term outlook as the valuation is still good, the financial situation in Bulgaria is stable and both domestic and export-oriented companies will resume their growth next year or in early 2010.

Stocks in focus:

The huge drop of prices sent the valuation ratios at historically low levels. We already commented the overall picture in the financial reports and the possible decrease of sales and profits.

Orgachim (5ORG) was mentioned in previous bulletin as a company with very low market capitalization. The report for the third quarter was a bit below our estimations for the similar performance during the previous period. The market reaction to the report was negative, which is more consequence of the negative sentiment toward the future problems in the residential construction than the lower sales growth and the weaker quarterly profit.

The financial result for the same period last year was heavily influenced by one-time items. Thus the P/E ratio of Orgachim became negative despite that the profit so far this year is BGN 4.4 million which corresponds to P/E ratio of 11. This is higher than the average for the market but the share

currently trades at EV/EBITDA of 6.5 and 4.3 times EBITDA. Those levels are attractive in long-term perspective but some weakness is anticipated.



The non-consolidated report showed a bit higher revenues than the second quarter. Costs of materials are rising and the write-off of assets also contributed to the lower profit margins. Orgachim used the period to increase its inventories whereas the materials in the balance sheets decreased.

Odessos (5ODE) will again be among the stocks with special attention along with Industrial Holding Bulgaria (4ID). Both companies are working in a very difficult market conjuncture for the maritime transportation. Odessos is repairing ships, whereas the main asset of Industrial Holding Bulgaria is Varna Shipyard. So far this year the problems of the transportation industry don't transfer to the two companies. On the contrary, lower prices of materials could support the profits for the fourth quarter but 2009 should be bleak.

Transportation charges are falling to very low levels and the number of free ships in the Black sea is very high. The revenues of the shipping companies are so low that they cannot afford to cover their leasing payments and will likely shrink the repair to the operational minimum. Our expectations for Odessos and Industrial Holding Bulgaria for 2009 are for 15-20% decrease of revenues. Cost will also shrink and for the market should be more important the profit margins and not the lower sales.

Industrial Holding Bulgaria



Another sector with imminent danger of shrinking revenues is the production of hydraulic elements and other machine parts. Two companies are producing hydraulic elements M+S Hydraulic (5MH) and Hydraulic Elements and Systems (4HE). Many other companies are producing machine parts and will be affected seriously by the lower demand of capital goods.

M+S Hydraulic, on the graph, is also 70% down from its peak. However, it trades at higher forward P/E than other blue chips.



The risks of global recession should raise cautious for companies in those sectors along with the production of metals and chemicals. They should underperform in the next two or three quarters and lag the recovery.

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Market Perform	Market performance, +/-5% as compared to SOFIX and BG40
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For more information, please contact:

Research analyst
Tsvetoslav Tsachev
Tamara Becheva

Phone:
+359 2 810 00 23
+359 2 810 07 23

E-mail:
tsachev@elana.net
becheva@elana.net

Internet:
www.elana.net
www.elana.net