BULGARTABAC HOLDING
INDUSTRY: TOBACCO

KEEPING UP THE PUFF

BUY
ONE YEAR PRICE TARGET: BGN 93.74
CURRENT PRICE: BGN 46.99

66% REVENUE CAGR OVER THE PAST SIX YEARS. BULGARTABAC HAS STABILIZED ITS DOMESTIC MARKET POSITION AND IS HEADING FOR A HECTIC RIDE INTO THE LOW REGULATION HIGH GROWTH EMERGING MARKETS EXPECTED TO LEAD THE EUROPEAN TOBACCO INDUSTRY BACK ON THE GROWTH TRACK OF 4%-5% CAGR.

SOLID EXPORTS GROWTH
After being privatized in 2011, Bulgartabac revealed its true earnings power. The Company has skillfully replaced eroding domestic market with exports with the latter tripling during the last 5 years. Exports already account for 83% of Group's revenues, coming mainly from low regulation, high growth regions as the Middle and Far East. The Group is also heading for expansion into Africa, Asia and the Balkans, with first realized sales in the Philippines, selling agreements in Kenya, Egypt and India.

DIVERSE PRODUCT PORTFOLIO
10+ well-diversified cigarette brands portfolio with Victory as most recognized and second in sales brand in Bulgaria and another three brands among the top 15 most sold brands in the country.

STABILIZED LEADING DOMESTIC POSITION
Stabilized leading domestic position at 30% market share. Even though prices of local and international cigarette brands have almost converged, Bulgartabac's cheaper brands to soothe any major shocks on the market. Recently, launched and aggressively marketing another low price brand - Global.

VERTICALLY INTEGRATED COMPANY
Operating two modern cigarette producing factories and a renovated tobacco sourcing and processing facility. Both lines are underutilized despite the increase in operations in the last few years. The available free capacity to sustain additional revenue growth.

ATTRACTIVE MARKET VALUATION
Trading at a highly attractive market multiples e.g. trailing P/E 5.9x which is well below Bulgarian market average and global tobacco industry average. Reasons: stock selloff in mid June 2014 provoked by factors outside the Company's performance potential.

VALUATION/RISKS
VALUATION: Our one year price target is BGN 93.74 per share, 99% higher than the current price. We base our valuation on a mix of discounted cash flow and relative valuation methods. We incorporate a likely base and very unlikely worst case scenarios to encompass any likely potential development.

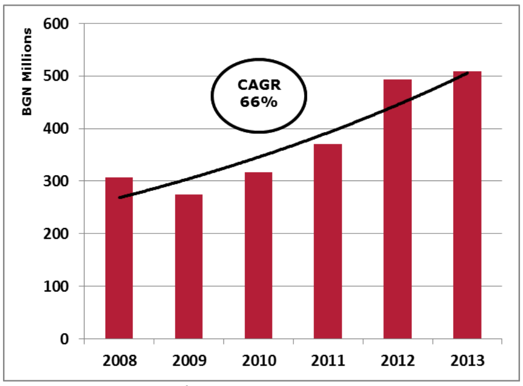
RISKS: Under political influence due to undisclosed real owner; Poor corporate governance; Unclear dividend policy; Operates in a highly regulated industry; Increased political and financial instability in conjunction with inefficient government institutions may delay needed structural reforms and slow the Bulgarian economy down;

EXCHANGE RATES
EUR/BGN (FIXED): 1.95583
USD/BGN: 1.5324

MARKET DATA

Shares Outstanding:	**7.37m**
Share Capital:	**7.37m**
Free-float:	**1.93%**
Market Cap.:	**BGN 346.2m**
Avg. Daily Vol.:	**BGN 15,000**
52 Weeks Range:	**BGN 44 – 106.69**
BSE Ticker	**57B**
Bloomberg Ticker	**57B BU**

REVENUE GROWTH

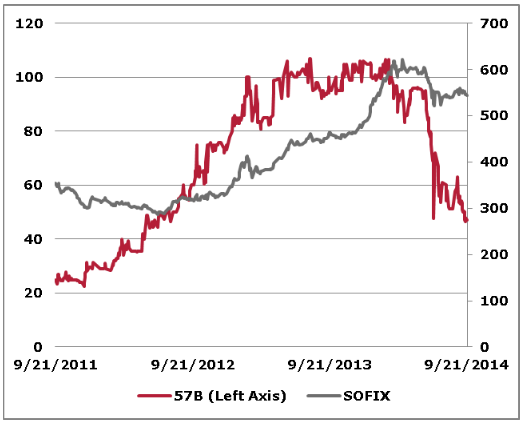


Source: Company data

BASE CASE Financial Performance

in kBGN, excl. ratios	2013	2014F	2015F	2016F
REVENUES	508,892	483,447	497,951	512,889
EBITDA	115,284	48,345	92,121	120,529
NET PROFIT	67,722	13,053	56,766	85,653
EQUITY	354,145	356,530	427,043	536,854
ROE	19.12%	3.66%	13.29%	15.95%
ROA	9.40%	5.33%	3.45%	8.23%
EBITDA MARGIN	22.65%	10.00%	18.50%	23.50%
NET PROFIT MARGIN	13.31%	2.70%	11.40%	16.70%
EPS	9.19	1.77	7.71	11.63
DEBT/EQUITY	0.38	0.35	0.29	0.13
P/E	11.42	26.52	6.10	4.04
P/B	2.18	0.97	0.81	0.64
EV/EBITDA	7.76	9.24	4.70	3.11
PAYOUT RATIO	640%	n/a	n/a	n/a
DIVIDEND YIELD	8.93%	n/a	n/a	n/a

PRICE PERFORMANCE



Source: Bloomberg

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EXECUTIVE SUMMARY

WE INITIATE COVERAGE OF BULGARTABAC WITH A BUY RECOMMENDATION WITH AN ONE YEAR PRICE TARGET OF BGN 93.74 OR A 99% RETURN IN THE NEXT 12 MONTHS.

THE COMPANY

Bulgartabac Holding (the Company, the Group, Bulgartabac) is the leading cigarettes company in Bulgaria with the largest market share (30%) in terms of volumes sold in the country. It produces one of the most well recognized and second in sales cigarette brands in the country –Victory. It is also a structurally significant company for the Bulgarian economy being one of the largest excise taxpayers. The Company pays on average BGN 600m in excise taxes which is approx. 15% of all excise tax revenues in the country and about 3% of all state budget revenues.

Operations: The Group has a diversified portfolio of 10+ cigarette brands. Four of the Groups' brands are among the top 15 most preferred brands in the country. Its 30% market share in Bulgaria, currently, results in about 17% of the Group's revenues.

The Group's management strives to position Bulgartabac as a leading producer competing with top international tobacco conglomerates. During the last six years the Group has skillfully replaced the eroding local market with fast growing exports in emerging markets. Currently, it exports more than 80% of its products to emerging markets in the Far and Middle East and Africa, thus focusing on the high growth low regulation tobacco markets. Recently, it started sales in Russia and the Philippines, finished selling negotiations in Kenya, Egypt and India. The Company also set foot in the Central European Free Trade Agreement (CEFTA) markets (i.e. the Balkan countries of Albania, Serbia, Bosna and Herzegovina, Macedonia, Montenegro and Kosovo). In the end of 2013 it acquired a cigarette producing facility in Bosna & Herzegovina, thus it will be able to gain momentum on high growing markets in the trade agreement by taking advantage of the relaxed trade regulations between them.

Ownership: The Group has been privatized in the autumn of 2011 by BT Invest GmbH, Austria – a VTB Capital SPV. It paid EUR 100.1 m for a 79.83% stake. This was the fifth and last privatization procedure for the Company during the last decade. The Groups' strategic importance both economically for the budget and politically for the local tobacco farmers have been major factors for the failures of the previous four privatization procedures. In February 2014, VTB Capital exited Bulgartabac by selling BT Invest to a Dubai based entity (TGI Middle East FZE) with an undisclosed individual as an owner. However, since the privatization, Bulgartabac was under the control of the small but highly influential political party in Bulgaria - the Movement for Rights and Freedoms (MRF), in partnership with the influential banking group of Corporate Commercial Bank (6C9 BU, CCB), according to local media publications with no official confirmation. CCB is the 4th largest bank in Bulgaria. A conflict between its owner- Mr. Tzvetan Vassilev, and the MRF representatives led by the MRF MP Delyan Peevski, that became public in mid June 2014, led to a major politico-economic transformation in Bulgaria. First, the CCB was placed under conservatorship due to liquidity problems. Second, the government fell and third, it has been said that the MRF supposedly took full control over Bulgartabac. The MRF is known to be the "small partner" that no ruling party can avoid if it wants to run the country. Its electorate consists mainly of local Turkish tobacco growing minority.

The controlling stakeholders' conflict and the CCB being temporarily closed urged Bulgartabac to refinance most of its debt financing which in the last couple of years was coming mainly from the CCB. This increased the Group's debt levels in 2013 andH1 2014. Major new lenders with more favorable terms became the state owned Bulgarian Development Bank and other local banks. Thus, we expect the Company's debt levels to come down to 2012 level fast.

Bulgartabac is among the biggest public companies in Bulgaria, traded on the Bulgarian Stock Exchange (BSE). Up to September 2014 it was part of the BSE blue chip index SOFIX. We consider the company to be well managed but with poor corporate governance due to lack of transparency. Currently, the Company's dividend policy is unclear after paying a record high dividend in 2013 of BGN 9.46 per share. We expect Bulgartabac to restart dividends after controlling stakeholders resolve their conflict.

THE COUNTRY AND THE MARKET

Bulgaria is under a Currency board and the Lev is pegged to the Euro at fixed rate of 1.95583. We expect a modest economic growth in 2014 (1.4% of GDP), as it will be negatively affected by the ongoing political instability.

The 2nd parliamentary elections in the last 2 years took place Oct. 5th. Results reveal it will be difficult to form a government with unusually high number of political parties (i.e. 8) joining parliament. The leading center-right GERB won 32.7% of the voters followed by the Socialists with 15.4% and the MRF with 14.8%. All parties show commitment to long -term economic and political stability but disagree on major issues including how to solve the imminent problems in the banking, energy and judiciary sectors. The former will put significant pressure on the 2014 and 2015 fiscal position both increasing budget deficits and public debt level.

The tobacco industry is highly price elastic and dependent on economic development and fluctuations in consumers' disposable income. It is also heavily regulated in developed countries. Nevertheless, the industry is expected to grow at a 4-5% CAGR in the coming years with an emerging markets impetus which are still less regulated.

THE VALUATION

We use the DCF model together with peer group comparison to value Bulgartabac. All calculations are based on the consolidated results of the Group that include the production of cigarettes and the processing of tobacco.

We value the stock of Bulgartabac at BGN 93.74 per share or 99% above the current market price.

SOME RISKS

Politically dependent; High political uncertainty;

Pressure on the state's fiscal position could lead to an abrupt cigarette excise hike which would immediately translate into higher cigarette prices, higher illicit trade and lower legal cigarette market;

Slow recovery of the Bulgarian economy would lead to lower disposable income; slower economic growth in emerging markets

COMPANY OVERVIEW

Vertically integrated group strongest in production, good processing potential

Bulgartabac is a vertically integrated holding company which operates three main business lines: cigarette production, tobacco sourcing and processing and cigarette distribution. It is the biggest cigarette producer in Bulgaria and a market leader in terms of pieces sold.

The Group produces cigarettes in two modern factories, one in the southern Bulgarian city of Blagoevgrad and the other in the capital of Sofia, called Blagoevgrad BT and Sofia BT, respectively. The former can produce 25+ bn sticks annually and the latter 15+ bn sticks, but have almost equal contribution to the Group's results. In the end of 2013, the Company also acquired a cigarette factory in Bosna & Herzegovina to tap the import tax friendly CEFTA markets.

The main tobacco processing facility of the Group, Pleven BT, is located in the northern village of Yasen. It has a 14K tons capacity and processes 5K to 6K tons per annum for Bulgartabac's production needs mainly.

In general, the cigarette producing subsidiaries pay a royalty fee to Bulgartabac for distributing their products. The Group uses distribution subsidiaries it has established in a couple of countries with the major product flow for emerging markets passing through the Dubai distribution company.

Sold its domestic newspaper and cigarette kiosks chain in 2014

On 27th of March 2014 the Group sold its subsidiary Tabac Market. The latter is a retail chain of a few hundred newspaper and cigarette kiosks all over Bulgaria under the brand of Lafka. The Group invested BGN 120m+ in developing the chain during 2012 and 2013 with the aim to monopolize the retail market. However, the methods used to execute the plan led to high societal discontent with the project. Unable to achieve the planned economies of scale and the social discontent urged Bulgartabac to sell the company.

Exhibit 1: Main business lines with key subsidiaries

Bulgartbac Holding

Processing		Production		Distribution	
Pleven BT	100%	Blagoevgrad BT	97%	Bulgartabac Trade - Dubai, UAE	60%
Shoumen Tabac	86%	Sofia BT	98%	Bulgartabac Philipinnes	60%
Asenovgrad Tabac*	83%	Fabrika Duvana - Banja Luka, B&H	88%	Bulgartabac Logistics, Russia	97%
Haskovo Tabac*	93%			Global Tobacco Trading, Spain	97%
				Global Tobacco Trading, Romania	97%

*In liquidation

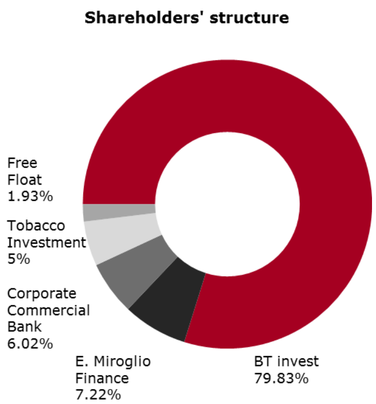
SHAREHOLDERS' SRUCTURE

The Company's registered capital is distributed among 7 367 222 number of shares.

The Austrian company BT Invest GmbH owns 79.83% of the capital which it acquired during its fifth and final privatization procedure in the autumn of 2011. The end owner of BT Invest is a Dubai based company that in itself is owned by an undisclosed individual. Bulgartabac's CEO Ventsislav Cholakov represents BT Invest.

There are three large minority shareholders with 5%+ stakes in Bulgartbac which currently are also in conflict with the majority shareholder. These are E. Miroglio Finance SA with 7.22%, Corporate Commercial Bank (CCB) with 6.02% and Tobacco Investment with 5%. Bulgartabac has revealed that the former and the latter have option agreements with the CCB. With the current conservatorship of the bank, however, this presents an opportunity for these stakes to come on the market. The future of CCB, opening up or liquidation, will determine the future of the CCB stake in Bulgartabacas well.

This leaves 1.93% of the capital as freely traded on the market with more than 1000 local and foreign institutional and individual investors.



POTENTIAL CATALYSTS

Growing tobacco market: The revival of the tobacco market is already in progress as emerging markets are expected to lead the way. Moody's expects 4% to 5% CAGR of the European tobacco industry in the coming years due to emerging markets exposure. Bulgartabac has doubled its exports in lcc value during the last five years with majority of revenues already coming from developing regions.

Highly attractive Valuation: Due to external to the Company's operations factors the stock has seen massive selloff and is currently trading at highly attractive multiples of trailing P/E 5.9x when industry average is 20x earnings. Strong fundamentals.

INDUSTRY OVERVIEW

GLOBAL TOBACCO INDUSTRY

4%-5% CAGR in Europe expected in the coming years

The global tobacco industry has been showing stable single digit growth in the past decade due to the booming emerging markets, especially in Asia, Middle and Far East, and Africa. The latter have compensated for the sector's declines in developed countries where governments have put harsh restrictions on consumption including through taxation and direct bans on smoking and higher standards of living have encouraged consumers to live healthier lives. However, the industry is expected to continue growing with Moody's estimating a 4% to 5% CAGR of the European tobacco industry in the coming years due to the emerging market momentum.

As Euromonitor International points out, "growing smoking populations in China and other large population developing markets, plus the pricing strength of international brands, have kept the global tobacco market robust in spite of falling cigarette volumes in many developed markets". Any slowdown in emerging markets, however, will put considerable pressure on the industry.

Additional tobacco products such as roll your own (RYO) tobacco and innovative healthier substitutes as e-cigarettes, are also expected to transform the industry but their impact is still very small, less than 2%, and is expected to stay this way in the foreseeable future.

DOMESTIC TOBACCO INDUSTRY

We expect 2% to 3% CAGR of the domestic industry in the coming years

The domestic tobacco industry has seen dramatic drop (48%) in legal sales both in volumes and revenues in the last decade due mainly to the drastic change in the local tax regulation with a sharp excise tax increase in 2010. The ban on smoking in public places enforced in mid-2012 had a negligible effect on consumption.

With the EU accession in 2007 Bulgaria is obliged to enforce the minimal tobacco excise tax burdens in Europe. However, it is allowed to do this gradually over time with the first target date in 2010 and the second in 2018. So far instead of raising the excise gradually, the country did it sharply in the last moment as in the case of 2010 target minimum. In 2010 the state raised excises by 50% from EUR 50 to EUR 75 per 1000 sticks of cigarettes. This immediately led to a reciprocal decline in the legal market and doubled illicit trade.

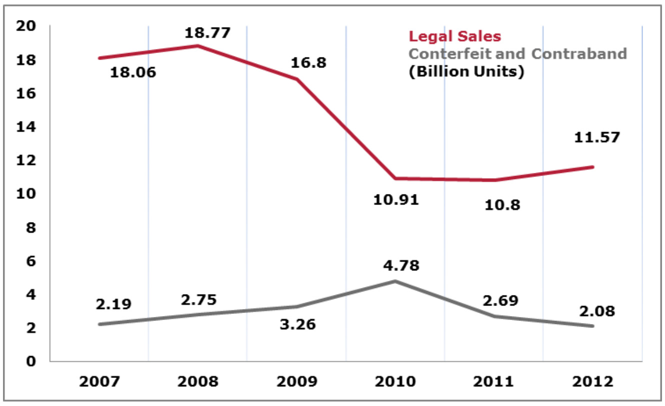
New cigarettes excise hike would push prices further up

The following four years from 2010 until 2013 the domestic industry stagnated in terms of volumes sold. Only small increases in cigarette prices in anticipation of the next excise tax hike has supported the industry's revenues at a single digit growth over the years.

Currently, the market stagnates at 11.5 bn pieces of legally sold cigarettes with a 16% to 18% illegal market, according to the European Commission and company data. We do not expect local volumes to start rising in the near future. However, the expected excise increase (the tax should increase by another 15% by 2018, according to EU regulation) would additionally push cigarette prices up, although negated by rising personal income. We believe that the industry players will be able to reap some fruits from higher prices before cigarette demand is able to adjust. Thus, we expect a 2% to 3% CAGR in revenues in the next couple of years.

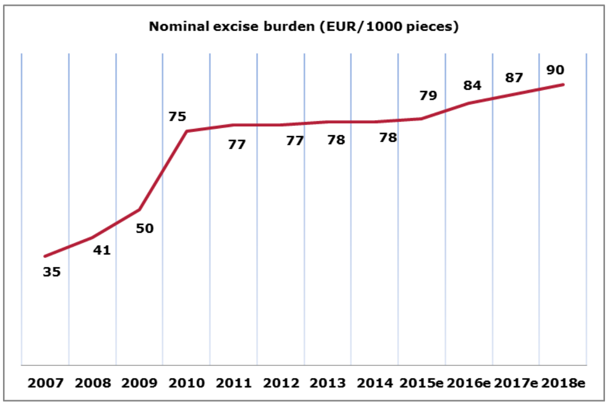
Additionally, even though prices of local and international brands have almost converged, with an average price of BGN 4.75 per 20 piece pack, Bulgartabac still offers some lower priced and well positioned brands. It should be able to benefit more from any price increase compared to international competitors' whose cigarettes are still more expensive.

Exhibit 2: Legal and illegal market dynamics



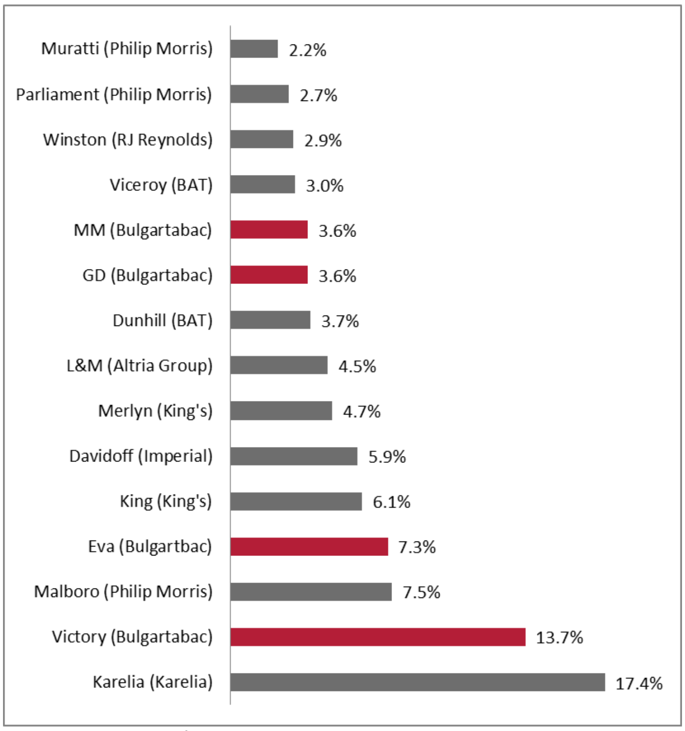
Source: KPMG Project Star 2012 Report

Exhibit 3: Cigarette excise tax to rise by 15% by 2018



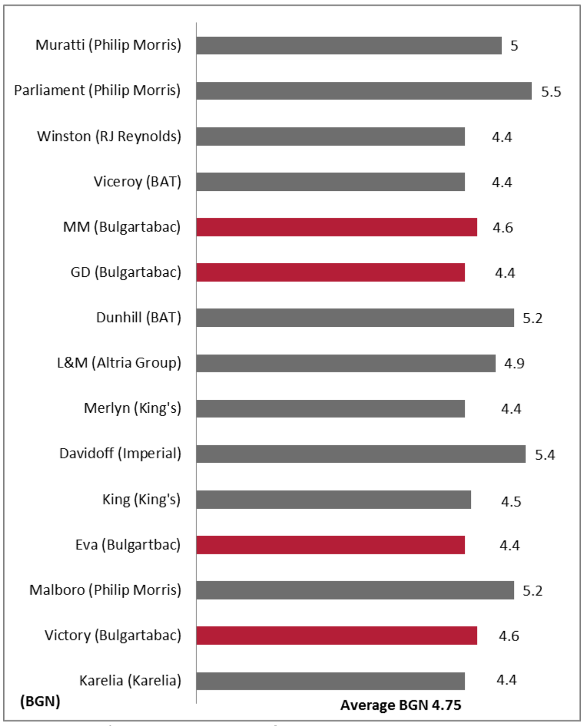
Source: European Commission, Bulgarian Ministry of Finance

Exhibit 4: Domestic market share by brands as of Dec. 2013



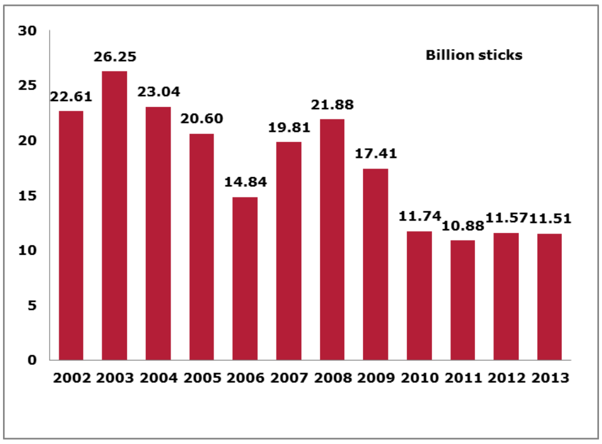
Source: Company data

Exhibit 5: Current retail price per 20-piece pack



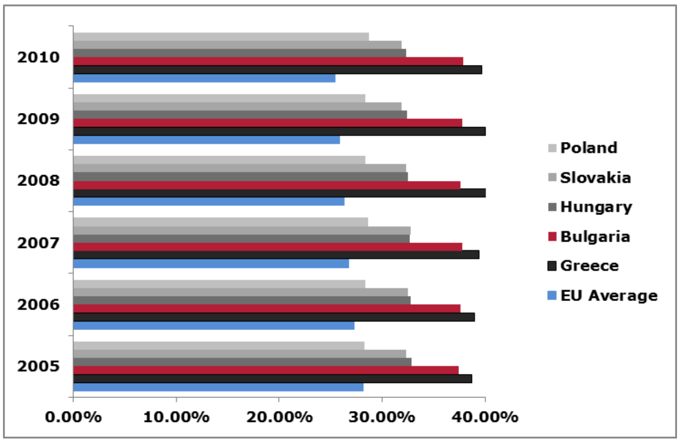
Source: Bulgarian Ministry of Finance

Exhibit 6: Cigarettes released for consumption in Bulgaria



Source: European Commission

Exhibit 7: Top 5 smoker countries in the EU (% of population)



Source: : EU Executive Agency for Health and Consumers

BULGARTABAC'S MARKET PRESENCE

The Group has a 30% market share in Bulgaria in 2014

Bulgartabac is the leading tobacco company in Bulgaria with a 30% market share as of May 2014 in terms of volumes sold, according to industry data. However, it has steadily been losing position due to four major reasons: the stagnating domestic market, aggressive competition, converging average price per pack of cigarettes and the high percentage of illegal sales.

Competition has been very aggressive in the country coming first from the other bigger local producer - King's Tobacco International (KGI) and second by regional and international competitors. KGI entered the market in 2008 after acquiring one of Bulgartabac's cigarette factories in the city of Plovdiv. It quickly introduced two lower priced brands on the market – King and Merlyn, and started aggressive marketing. In three years KGI managed to eat up almost 12% of Bulgartabac's domestic market share.

At almost the same time, the Greek Karelia Tobacco has aggressively stepped into the market and in six years took over Bulgartabac's Vicrory 1st position on the market with its brand Karelia. Currently, Karelia is the top sold cigarette brand in the Bulgaria.

Bulgartabac has faced this trend by introducing although much later a lower priced brand – Global, which has been gaining momentum since its launch in the beginning of 2014. As of June 2014 Bulgartabac reports 0.4% market share for Global.

Nevertheless, we expect the negative trend of competitors eating up Bulgartabac's market share to fade away as the market is showing saturation.

83% of sales are export to Middle and Far East, Africa, EU and the Balkans

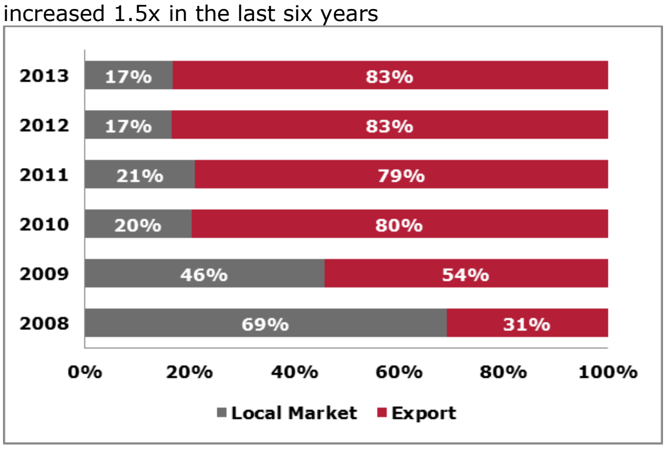
We also expect the domestic market to offer fewer prospects for growth compared to the booming emerging markets. With the declining local market, Bulgartabac has skillfully managed to restructure its sales from mostly domestic to almost entirely export. Currently, Bulgartabac exports 83% of its production mainly to low regulation high growth regions as the Middle and Far East, and Africa. The Group, however, does not provide the geographic breakdown of its sales by country which we see as a shortcoming and poor corporate governance. Management does mention it has started selling cigarettes in countries as Russia and the Philippines and finished negotiations in Kenya, Egypt and India as of H1 2014.

The Group has also opened up its Balkans markets i.e. the CEFTA markets via the Banja Luka factory acquisition. Thus, it will be able to tap on these markets with locally produced less taxed cigarettes.

Bulgartabac is also the main consumer of Bulgarian grown tobacco. It purchases on average up to 5K tons of domestic tobacco, mainly of the Virginia, Burley and Oriental varieties (i.e. Basmas and Kuba Koulac). Bulgaria is among the top tobacco growing countries in the EU after Italy and Greece. It is estimated that it grows approx. 40K tons per year which is about 16% of all tobacco grown in Europe.

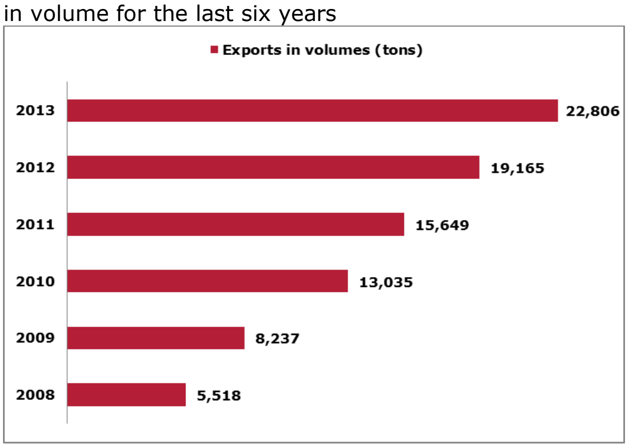
Bulgartabac also imports tobacco to sustain its needs for higher quality raw material as Bulgarian tobacco is perceived to be lower quality. The company's tobacco imports averaged 12K tons in the last three years.

Exhibit 8: Bulgartabac's exports share of total revenues increased 1.5x in the last six years



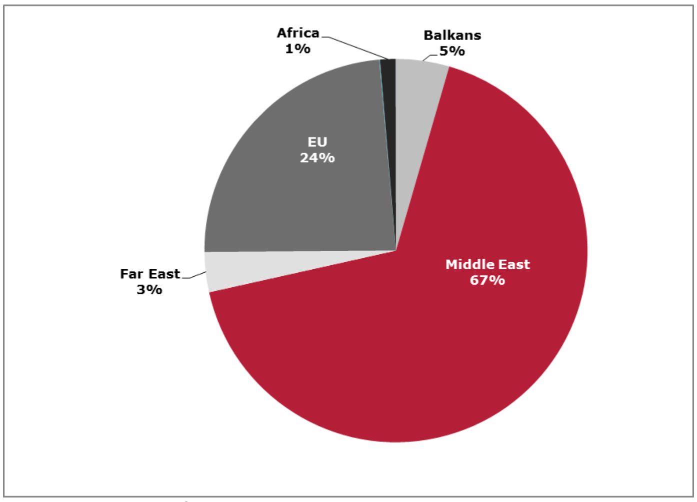
Source: Company data

Exhibit 9: Bulgartabac' s exports quadrupled in volume for the last six years



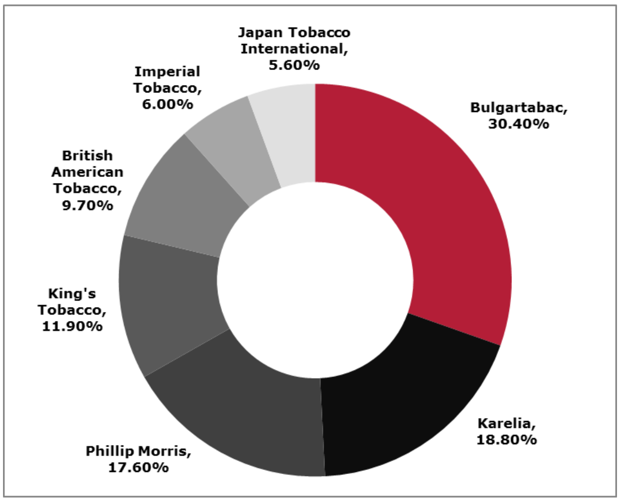
Source: Company data

Exhibit 10: Sofia BT's export markets in 2013



Source: Company data

Exhibit 11: Domestic cigarette market as of May 2014



Source: Capital weekly, Company data

FINANCIAL ANALYSIS AND VALUATION

Emerging markets exposure and stabilizing domestic market should support both top and bottom line

On the one hand, Bulgartabac's repositioning into exports to emerging and frontier markets gives it an opportunity to tap on lower regulation higher growth markets which will support both top and bottom line as well as cash generation. The Group's stabilizing domestic market position will help it soothe any market shocks (i.e. abrupt excise hikes in the coming years) while the vertical integration and the free capacity in both cigarette production and tobacco processing should additionally add to top and bottom line.

On the other hand, the stock is currently traded well below average multiples on the Bulgarian Stock Exchange. This is mainly due to the sharp selloff of the stock after the Group's controlling parties conflict that became public in mid June 2014.We believe this to be an external to the company's operations factor but we want to see next few quarter results to be able to conclude if it will have a lasting effect on the Company's performance.

Bulgartabac is also trading way below average peer group multiples and having in mind the emerging market exposure of the big four cigarette players in the world, we also consider peer comparison in our valuation of the stock.

Thus we base our valuation on both the future cash flow generating ability of the Company in a base and a worst case scenarios and the peer review comparison.

	2012	2013	TTM	2014E
Last Price	78.00	105.00	46.99	46.99
Number of Shares	7,367,222	7,367,222	7,367,222	7,367,222
Market Capitalization	574,643,316	773,550,943	346,185,762	346,185,762
Net Profit	87,050,000	67,722,000	59,055,000	13,053,000
P/E	6.60	11.42	5.86	26.52
Equity	360,873,000	354,145,000	375,603,000	356,530,000
P/B	1.59	2.18	0.92	0.97
Sales	493,150,000	508,892,000	494,862,000	483,447,000
P/S	1.17	1.52	0.70	0.72
EV	565,377,000	894,488,000	452,242,000	446,806,000
EBITDA	122,229	115,284	86,360	48,345
EV/EBITDA	4.63	7.76	5.24	9.24
ROE	24.12%	19.12%	15.72%	3.66%
ROA	14.12%	9.40%	8.23%	1.65%

FINANCIAL PERFORMANCE ANALYSIS

Real earnings power revealed in 2011-2013

Bulgartabac has showed a tremendous improvement in its financial performance both in terms of revenues and profit margins since its privatization in 2011. We attribute this to the Company's real earning power revealed by the new owners. Sales showed 60% CAGR averaging to 15% in terms of continuing operations. Operating profit touched the 20% margins which is much closer to the peer group performance than previously reported.

These were achieved via aggressive exports and lower operating expenses e.g. lower labor and external services costs. The former quadrupled in terms of volumes and tripled in terms of lcc revenues during the last six years. Only for the two years after privatization exports increased by 46% in volumes and 35% in lcc revenues.

At the same time, debt levels started climbing, peaking in 2013 due to the financing provided by the Corporate Commercial Bank which until that point was the main financing institution of the Company. However, with the closing of the bank and the main stakeholders' conflict, Bulgartabac started a debt refinancing program from other local banks. The newly assumed debt is on more favorable terms coming mostly from the state owned Bulgarian Development Bank. Also, most of the debt is for short-term working capital needs due to the CCB problems. Nevertheless, we expect the current higher debt levels to be only a temporary event as the Company generates enough cash to quickly repay it.

9% dividend yield in 2013

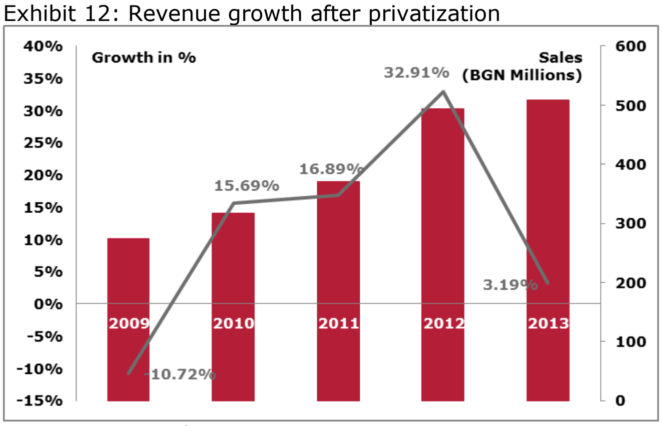
On the other hand, we also believe that the dramatic decrease in the quick ratio of the Group to be a temporary event as it is mainly due to the extraordinary high dividends distributed in 2011 and 2013. The Company distributed nearly BGN 53 m (BGN 7.19 per share) in 2011 as part of the privatization arrangement with the Bulgarian state and another BGN 70 m in cash (BGN 9.46 per share) in 2013 among the new private owners.

As a state company up to 2011 Bulgartabac was required by a government decree to distribute dividends and thus had a policy distributing approx. 40% of individual profits. However, as a private company and with the latest controlling stakeholders' conflict the company will not pay a dividend in 2014 and we believe it will renew its dividend payout only after a considerable change in the minority shareholders structure. Thus, any additionally generated cash shall be left within the company to support average annual CAPEX of about BGN 25m.

2013 and H1 2014 results were also distorted by another onetime item. At the end of 2013 the Group decided to sell its retail chain for cigarettes and newspapers in Bulgaria - Tabac Market. The sale should be effective as of 27th of March 2014, however, the subsidiary was classified as a discontinued operations since 2013. Thus, the Group's results from continuing operations in 2013 and H1 2014 no longer include the subsidiary's performance in its top line. This means BGN 36 m and at least BGN 18 m less in revenues from continuing operations for Bulgartabac, respectively. Also, Tabac Market was generating significant losses BGN 14.8 m and BGN 4.7 m which explain the decrease in the Group's net income both in 2013 and H1 2014.

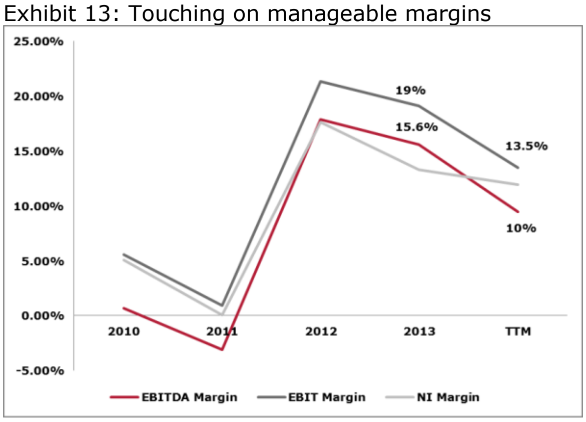
Additionally, it must be noted that Tabac Market's sale already generated some cash for the Group but the increase in receivables suggests the deal should bring additional cash to the Company which we should to see in the coming quarters. However, the increase in receivables is an issue that should be closely monitored.

Exhibit 12: Revenue growth after privatization



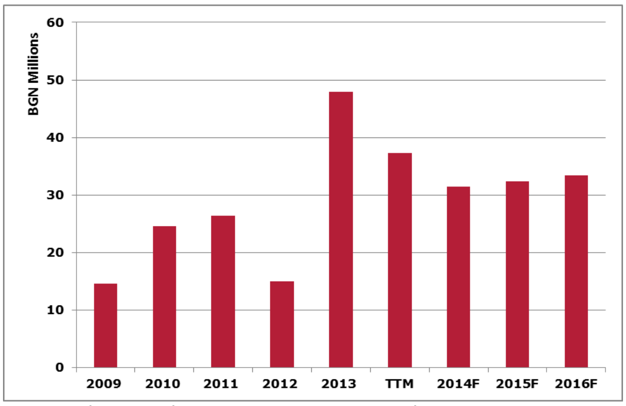
Source: Company data

Exhibit 13: Touching on manageable margins



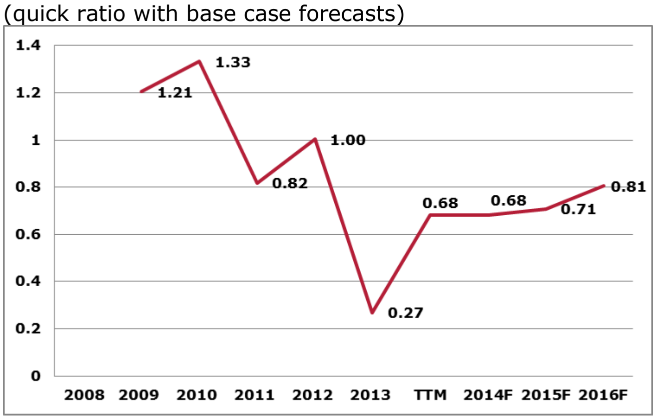
Source: Elana Trading estimates, company data

Exhibit 14: CAPEX over the years with base case forecasts



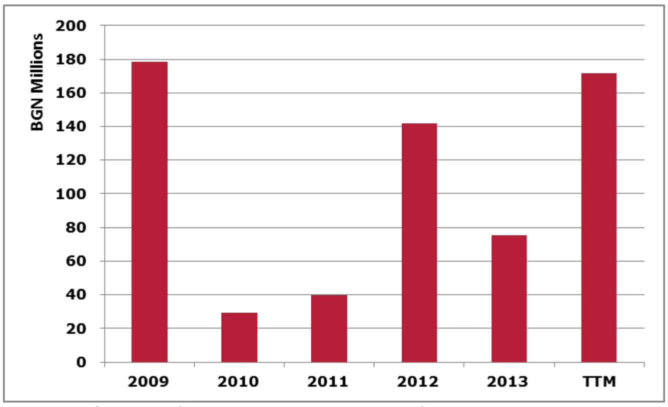
Source: Elana Trading estimates, company data

Exhibit 15: Serious fluctuations in the cash position (quick ratio with base case forecasts)



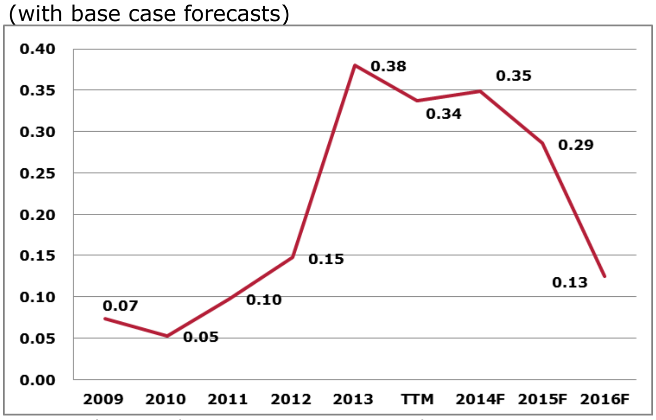
Source: Elana Trading estimates, company data

Exhibit 16: Building up receivables



Source: Elana Trading estimates, company data

Exhibit 17: Debt-to-equity ratio peaking in 2013 (with base case forecasts)



Source: Elana Trading estimates, company data

Valuation

Two scenarios for the Company's development

We believe the controlling parties' conflict will have a temporary effect on the Group's performance and once the one-off effects clear out the Group should return to normal earnings growth. Nevertheless, we have developed two scenarios for the Group's development: a more likely (60% weight in final valuation) base case scenario and less likely worst case scenario (10% weight in final valuation).

Our base case scenario incorporates our view for the temporary effect of the controlling parties' conflict and a long term growth of the Company within the industry averages. For our 2014 forecasts we take into account the Tabac Market effect. In the following years we expect the Company to experience additional positive effects of its emerging markets exposition. During the first half of the current year it has reported 19% increase in exported volumes. We do expect this growth to go on in the short term and to be able to offset any negative impact from the domestic operations. Thus, we have incorporated a conservative 3% revenue growth rate in 2015 and 2016 followed by a 2% sustainable long term growth. In terms of profitability, once the one-off effects fade away, we expect it to average at 20% EBIT margin and 18% to 23% EBITDA margin which is close to the company's norm achieved after its privatization.

The worst case scenario incorporates 1% negative CAGR over the next 5 years together with lower profitability at 7% EBITDA margin and 6% EBIT margin due to low economic growth both on domestic and export markets and concentration of the Group's sales to its Dubai subsidiary. The lack of sufficient information on the exports geographical distribution as well additional market insights urges us to be cautious when seeing a potential one distribution point, which the Group does not fully own.

When discounting the Company's results we assume a 3.05% risk free rate for 2014 which is the current yield on the Bulgarian government's long term debt. However, with the current political and financial uncertainty in the country we expect its financing costs to increase. Thus, we assume higher risk free rates in later years.

For the cost of equity calculation we also incorporate a beta on Bulgartabac's stock of 1.00 as we expect the stock to move in line with the market. However, due to the stock's lower liquidity and smaller free float in the past few months we incorporate a liquidity discount to our final DCF intrinsic value. In terms of cost of debt we believe the Group will be able to get debt financing at relatively good levels around 5% but with the increase in Bulgaria's risk free rate we assume a small increase in the Group's financing costs as well.

Thus, the intrinsic value of Bulgartabac's stock is BGN 111.61 based on the base case scenario and BGN 22.50 based on the worst scenario. We also provide sensitivity analysis on the price per share, based on a fixed WACC for the period and floating terminal growth.

WACC Calculation

	2014	2015	2016	2017	2018
Risk free rate	3.05%	3.15%	3.20%	3.50%	3.50%
Equity risk premium	8.00%	8.00%	8.00%	8.00%	8.00%
Beta	1.00	1.00	1.00	1.00	1.00
Cost of equity	**11.05%**	**11.15%**	**11.20%**	**11.50%**	**11.50%**
Cost of debt	4.28%	4.49%	6.11%	5.67%	5.26%
Effective tax rate	10%	10%	10%	10%	10%
After-tax cost of debt	**3.85%**	**4.04%**	**5.50%**	**5.10%**	**4.73%**
Weight of equity	74%	78%	89%	89%	89%
WACC	**9.19%**	**9.57%**	**10.57%**	**10.79%**	**10.75%**

Base Case Assumptions

BGN'000	**2011**	**2012**	**2013**	**2014F**	**2015F**	**2016F**	**2017F**	**2018F**	**Terminal Year**
Sales	371,037	493,150	508,892	483,447	497,951	512,889	523,147	533,610	544,282
Growth y-o-y	*16.89%*	*32.91%*	*3.19%*	*-5.00%*	*3.00%*	*3.00%*	*2.00%*	*2.00%*	*2.00%*
EBITDA	18,569	122,229	115,284	48,345	92,121	120,529	122,940	125,398	127,906
EBITDA margin	5.00%	24.79%	22.65%	10.00%	18.50%	23.50%	23.50%	23.50%	23.50%
Depr. & Amorization	15,018	17,017	17,942	19,338	17,428	17,951	18,310	18,676	19,050
% of Sales	*4.05%*	*3.45%*	*3.53%*	*4.00%*	*3.50%*	*3.50%*	*3.50%*	*3.50%*	*3.5%*
Investments	26433	14928	47968	31,424	32,367	33,338	31,389	32,017	27,214
% of Sales	*7.12%*	*3.03%*	*9.43%*	*6.50%*	*6.50%*	*6.50%*	*6.00%*	*6.00%*	*5.0%*
EBIT	3,551	105,212	97,342	29,007	74,693	102,578	104,629	106,722	108,856
EBIT margin	0.96%	21.33%	19.13%	6.00%	15.00%	20.00%	20.00%	20.00%	20%

Base Case DCF

BGN'000	2014F	2015F	2016F	2017F	2018F	Terminal Year
EBIT	29,007	74,693	102,578	104,629	106,722	108,856
EBIT(1-T)	26,106	67,223	92,320	94,166	96,050	97,971
Add: D&A	19,338	17,428	17,951	18,310	18,676	19,050
Less: Investments	31,424	32,367	33,338	31,389	32,017	27,214
Less: Change NWC	17,385	15,846	17,430	19,173	21,091	(17,006)
FCF	**-3,365**	**36,439**	**59,503**	**61,914**	**61,619**	**106,813**
PV FCF	-3,220	31,771	46,289	43,256	38,923	
Sum of PV FCF	157,019					
PV of Continuing Value	771,270					
Total PV Free Cash Flows	928,289					
Less: Outstanding Debt	126,879					
Plus: Financial Assets	20,823					
PV of Equity	822,233					
Price Per Share	**111.61**					

Worst Case Assumptions

BGN'000	2011	2012	2013	2014F	2015F	2016F	2017F	2018F	Terminal Year
Sales	371,037	493,150	508,892	483,447	478,613	473,827	469,089	464,398	459754
Growth y-o-y	*16.89%*	*32.91%*	*3.19%*	*-5.00%*	*-1.00%*	*-1.00%*	*-1.00%*	*-1.00%*	*-1.00%*
EBITDA	18,569	122,229	115,284	48,345	47,861	45,014	44,563	41,796	41,378
EBITDA margin	5.00%	24.79%	22.65%	10.00%	10.00%	9.50%	9.50%	9.00%	9.00%
Depr. & Amorization	15,018	17,017	17,942	19,338	19,145	16,584	16,418	13,932	13,793
% of Sales	*4.05%*	*3.45%*	*3.53%*	*4.00%*	*4.00%*	*3.50%*	*3.50%*	*3.00%*	*3.0%*
Investments	26433	14928	47968	14,503	14,358	14,215	14,073	13,932	13,793
% of Sales	*7.12%*	*3.03%*	*9.43%*	*3.00%*	*3.00%*	*3.00%*	*3.00%*	*3.00%*	*3.0%*
EBIT	3,551	105,212	97,342	29,007	28,717	28,430	28,145	27,864	27,585
EBIT margin	0.96%	21.33%	19.13%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%

Worst Case DCF

BGN'000	2014F	2015F	2016F	2017F	2018F	Terminal Year
EBIT	29,007	28,717	28,430	28,145	27,864	27,585
EBIT(1-T)	26,106	25,845	25,587	25,331	25,077	24,827
Add: D&A	19,338	19,145	16,584	16,418	13,932	13,793
Less: Investments	14,503	14,358	14,215	14,073	13,932	13,793
Less: Change NWC	(42,757)	4,916	5,162	5,420	5,691	33
FCF	**73,698**	**25,715**	**22,794**	**22,257**	**19,387**	**24,794**
PV FCF	70,529	22,421	17,732	15,550	12,246	
Sum of PV FCF	138,478					
PV of Continuing Value	133,314					
Total PV Free Cash Flows	271,792					
Less: Outstanding Debt	126,879					
Plus: Financial Assets	20,823					
PV of Equity	165,736					
Price Per Share	**22.50**					

SENSITIVITY ANALYSIS

Exhibit 18: BASE CASE Terminal growth

WACC	1%	1.5%	2%	2.5%	3%
8%	137.75	147.81	159.55	173.43	190.08
9%	121.39	129.03	137.75	147.81	159.55
10.75%	100.85	105.92	$\boxed{111.58}$	117.93	125.09
11%	98.50	103.32	108.68	114.66	121.39
12%	90.17	94.14	98.50	103.32	108.68

Source: Elana Trading estimates

Exhibit 19: Worst Case Terminal growth

WACC	-3%	-2%	-1%	0%	1%
8%	23.73	25.66	28.02	30.97	34.77
9%	22.12	23.73	25.66	28.02	30.97
10.75%	19.86	21.07	$\boxed{22.49}$	24.18	26.20
11%	19.59	20.75	22.12	23.73	25.66
12%	18.57	19.59	20.75	22.12	23.73

Source: Elana Trading estimates

To come to the true fair value of Bulgartabac's stock we also consider international peers with emerging market exposure and presence on the Bulgarian tobacco market. In this way we believe peers are exposed to the similar market risks as Bulgartabac.

When considering the peer group we take into consideration three multiples: P/E, EV/EBITDA and EV/Sales. We weighted them by giving highest weight to EV/EBITDA as we consider it more fairly valuing the current market environment then the other two metrics. Lastly, we include give a 30% weight of the relative valuation value in our final valuation of Bulgartabac's intrinsic value.

MULTIPLES

Company	Country	Market Cap. (EUR)	P/E	EV/EBITDA	EV/Sales
Bulgartabac Holding	**Bulgaria**	**177 m**	**5.86**	**5.24**	**0.91**
Philip Morris International	US	104.13 bn	15.5	11.2	5.3
British American Tobacco	UK	82.27 bn	18.08	12.68	5.25
Japan Tobacco International	Japan	51.93 bn	14.7	9.45	3.08
Imperial Tobacco Group	UK	32.53 bn	37.3	10.14	2.58
KT&G Group	South Korea	9.24 bn	25.01	11.38	4.59
Karelia Tobacco	Greece	612.72 m	14.54	5.36	1.86
Phillip Morris CR	Czech Republic	997.67 m	12.32	8.58	2.1
Industry Median			**15.5**	**10.14**	**3.08**
Industry Average			**19.6**	**9.8**	**3.5**

PEER MUTIPLES Valuation	**P/E**	**EV/EBITDA**	**EV/Sales**
Average Peers' Multiples	19.6	9.8	3.5
Market Capitalization ('000 BGN)	1,159,587	460,205	1,750,398
Price	**157.40**	**62.47**	**237.59**
Weight	20%	60%	20%
Current Price	46.99		
Price per Share	**116.48**		
Premium (Discount) to Current Price	148%		

FINAL VALUATION	**Fair Value per Share**	**Weight**
DCF Base Case	111.61	60%
DCF Worst Case	22.50	10%
Relative Value	116.48	30%
FINAL FAIR VALUE	**104.16**	
Liquidity Discount of 10%	**93.74**	
Market Cap (BGN)	690,614,663	
EV (BGN)	796,670,663	

Recommendation and Price Target

Several factors support the long-term positive trend of Bulgartabac's price per share: perspectives for growth with solid growth in emerging markets, stabilizing domestic position, highly attractive valuation (trailing P/E of 5.9x) and 99% higher intrinsic value than the current price per share. Therefore, we issue a **BUY** recommendation with price target that is more than 20% higher than the current. The risk of underperformance of Bulgartabac's shares as compared to other Bulgarian industrial stocks is low but poor corporate governance and stakeholders' conflict currently make it volatile.

Recommendation: BUY
Target Price: BGN 93.74
Upside potential: 99%

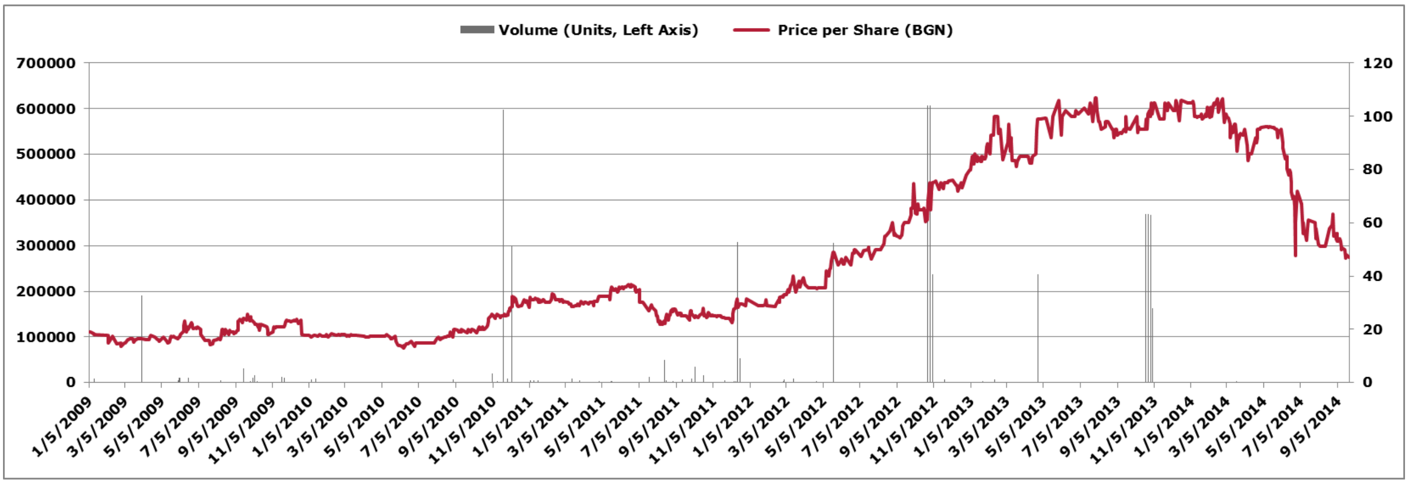
Therefore, we consider the stock suitable for:

- Institutional investors with a long term investment horizon with low to mid dividend return and high capital appreciation return expectations. Potential for investor activism.

In terms of significant investors involved in the stock market, we share the following observations:

- Bulgarian institutional investors are not active currently on the buy side. However, they are expected to maintain their present portfolio and will not provide excess volumes in following months
- Domestic individual investors view the stock as stable in the long term but highly volatile currently for due to external factors.

Stock Price Dynamics



Financial Data (Audited, excl. semi-annual data)

Income Statement (in '000 BGN)	2011	2012	2013	TTM	H1 2013	H1 2014
Revenues from Cont. Operations	366,930	475,799	472,447	458,973	255,246	241,772
Other revenue	4,107	17,351	36,445	35,889	1,274	718
Total Revenues	**371,037**	**493,150**	**508,892**	**494,862**	**256,520**	**242,490**
Operating Expenses	(367,486)	(387,938)	(411,550)	(428,267)	(211,692)	(228,409)
Change in Inventories	20,087	(1,361)	(12,899)	446	(3,481)	9,864
Cost of Material	(246,257)	(237,049)	(268,485)	(281,905)	(146,508)	(159,928)
Cost of Labor	(75,842)	(72,594)	(67,128)	(71,280)	(34,176)	(38,328)
Cost of External Services	(26,966)	(48,357)	(32,845)	(39,120)	(14,948)	(21,223)
Depreciation and Amortization	(15,018)	(17,017)	(17,942)	(19,765)	(8,799)	(10,622)
Net Book Value of Assets Sold	(1,311)	(2,619)	(1,143)	(4,187)		(3,044)
Other Costs	(22,179)	(8,941)	(11,108)	(12,456)	(3,780)	(5,128)
EBIT	**3,551**	**105,212**	**97,342**	**66,595**	**44,828**	**14,081**
Financial revenues	**5,710**	466	997	23,294	346	22,643
Financial expenses	**(7,662)**	(1,790)	(6,717)	(10,074)	(2,458)	(5,815)
Interest expense	(834)	(1,382)	(6,206)	(7,568)	(2,237)	(3,599)
EBT	**826**	**103,888**	**91,622**	**79,815**	**42,716**	**30,909**
Income Tax Expense	(386)	(10,134)	(6,663)	(3,933)	(3,984)	(1,254)
Income Before XO Items	**440**	**93,754**	**84,959**	**75,882**	**38,732**	**29,655**
Extraordinary Loss Net of Tax On Discontinued Operations		(3,962)	(14,824)	(14,735)	(4,801)	(4,712)
Minority Interests	261	2,742	2,413	2,092	533	212
Net Income	**179**	**87,050**	**67,722**	**59,055**	**33,398**	**24,731**
Earnings per share in BGN	**0.02**	**11.82**	**9.19**	**8.02**	**4.53**	**3.36**

Balance Sheet (in '000 BGN)	2011	2012	2013	TTM	H1 2013	H1 2014
Cash and near cash items	123,595	62,509	13,865	20,823	29,277	20,823
Short-term investments	0	0	0	0	228	0
Accounts and notes receivable	39,598	141,736	75,543	171,789	177,231	171,789
Inventories	159,349	159,702	196,223	179,859	138,703	179,859
Other current assets	584	2,761	189,188	4,555	3,418	4,555
Total current assets	**323,126**	**366,708**	**474,819**	**377,026**	**348,857**	**377,026**
LT investments and LT receivables	4,959	25,160	884	74,874	22,442	74,874
Net fixed assets	220,479	215,885	224,881	242,607	244,642	242,607
Other long-term assets	792	8,698	19,678	23,252	10,303	23,252
Total long-term assets	**226,230**	**249,743**	**245,443**	340,733	**277,387**	**340,733**
Total assets	**549,356**	**616,451**	**720,262**	**717,759**	**626,244**	**717,759**
Accounts payable	182,131	172,925	166,125	153,145	132,944	153,145
Short-term borrowings	13,619	28,445	125,405	95,624	114,177	95,624
Other short-term liabilities	3,694	2,353	4,607	33,999	3,609	33,999
Total current liabilities	**199,444**	**203,723**	**333,746**	**282,768**	**250,730**	**282,768**
Long-term borrowings	13,149	24,798	9,397	31,255	25,617	31,255
Other long-term liabilities	22,549	15,425	15,526	17,271	16,270	17,271
Total long-term liabilities	35,698	40,223	24,923	48,526	41,887	48,526
Total liabilities	**235,142**	**243,946**	**358,669**	**331,294**	**292,617**	**331,294**
Total preferred equity	0	0	0	0	0	0
Minority interest	39,403	11,632	7,448	10,862	7,382	10,862
Share capital & APIC	7,367	7,367	7,367	7,367	7,367	7,367
Retained earnings & other equity	267,444	353,506	346,778	368,236	318,878	368,236
Total equity	**274,811**	**360,873**	**354,145**	375,603	**326,245**	**375,603**
Working capital	549,356	616,451	720,262	**717,759**	626,244	717,759

Number of shares:	**7,367,222**	**7,367,222**	**7,367,222**	**7,367,222**	**7,367,222**	**7,367,222**
Price in BGN - period end:	**31.40**	**78.00**	**105.00**	**46.99**	**102.00**	**72.00**
Market cap in BGN - period end:	**231,330,771**	**574,643,316**	**773,550,943**	**346,185,762**	**751,456,644**	**530,439,984**

CASH FLOW STATEMENT (IN '000 BGN)	2011	2012	2013	TTM	H1 2013	H1 2014
NET INCOME	179	87,050	67,722	59,055	33,398	24,731
DEPRECIATION & AMORTIZATION	(15,018)	(17,017)	(17,942)	(19,765)	(8,799)	(10,622)
OTHER NON-CASH ADJUSTMENTS	60,398	(160,870)	(62,839)	(95,482)	(1,055)	(50,863)
CHANGES IN NON-CASH CAPITAL	(62,200)	39,303	(21,912)	0	(42,946)	(3,869)
CASH FROM OPERATIONS	13,395	(17,500)	913	(16,662)	(1,804)	(19,379)
DISPOSAL OF FIXED ASSETS				0		
CAPITAL EXPENDITURES	105	459	4	4	0	0
INCREASE IN INVESTMENTS	(26,433)	(14,928)	(47,968)	(37,311)	(38,592)	(27,935)
DECREASE IN INVESTMENTS	0	0	(10,533)	(10,745)	0	(212)
OTHER INVESTING ACTIVITIES	0	0	0	49,444	0	49,444
CASH FROM INVESTING ACTIVITIES	2,733	(31,347)	(3,570)	(815)	(2,726)	29
DIVIDENDS PAID	(23,595)	(45,816)	(62,067)	577	(41,318)	21,326
CHANGE IN SHORT-TERM BORROWINGS				0		
CHANGE IN LONG-TERM BORROWINGS	(58,244)	(679)	(70,907)	(255)	(70,689)	(37)
INCREASE IN CAPITAL STOCKS				0		
DECREASE IN CAPITAL STOCKS				0		
OTHER FINANCIAL ACTIVITIES	0	0	0	0	0	0
CASH FROM FINANCING ACTIVITIES	0	0	0	0	0	0
NET CHANGES IN CASH				0		
END-OF-PERIOD CASH	(49,714)	2,282	17,493	7,850	9,890	247
CASH PER SHARE	(59,914)	(61,034)	(43,661)	(8,235)	(33,232)	2,194

FINANCIAL AND PERFORMANCE INDICATORS	2011	2012	2013	TTM
VALUATION				
PRICE/EARNINGS (P/E)	>100	6.60	11.42	5.86
PRICE/BOOK (P/B)	0.84	1.59	2.18	0.92
PRICE/SALES (P/S)	0.62	1.17	1.52	0.70
PRICE/CASH PER SHARE	1.87	9.19	55.79	16.63
EV (IN BGN)	134,504	565,377	894,488	452,242
EV/EBITDA	n/a	6.41	11.27	9.66
PROFITABILITY				
RETURN ON COMMON EQUITY	0.07%	24.12%	19.12%	15.72%
RETURN ON ASSETS	0.03%	14.12%	9.40%	8.23%
RETURN ON TOTAL CAPITAL	-3.80%	21.30%	16.24%	9.32%
EBITDA MARGIN	-3.09%	17.88%	15.60%	9.46%
OPERATING MARGIN	0.96%	21.33%	19.13%	13.46%
NET INCOME MARGIN	0.05%	17.65%	13.31%	11.93%
DIVIDEND				
DIVIDEND YIELD	20.7%	n/a	8.9%	n/a
DIVIDEND PER SHARE	7.19	n/a	9.46	n/a
LIQUIDITY				
CURRENT RATIO	1.62	1.80	1.42	1.33
QUICK RATIO	0.82	1.00	0.27	0.68
CREDIT				
LT DEBT/EQUITY	0.05	0.07	0.03	0.08
TOTAL DEBT/EQUITY	0.10	0.15	0.38	0.34
TOTAL DEBT/TOTAL ASSETS	0.05	0.09	0.19	0.18
EBIT/INTEREST EXPENSE	4.26	76.13	15.69	8.80

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BUY	More than 5% higher as compared to SOFIX and BG40 performance
HOLD	Market performance, +/-5% as compared to SOFIX and BG40
SELL	More than 5% lower as compared to SOFIX and BG40 performance

Frequency of Recommendations: No schedule of recommendations is available. The frequency of recommendations depends on specific factors to individual companies and the opinion of the analyst(s) for the necessity of minor or major changes.

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