

Bulgaria



Bank Lending To Small and Medium Sized Enterprises in Rural Areas; an Analysis of Supply and Demand

Study Supported Under the EBRD Technical Cooperation Balkan Region Special Fund



**Food and Agriculture Organization
of the United Nations**



**European Bank
for Reconstruction and Development**

BULGARIA

BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY	1
2. ASSESSMENT OF THE SUPPLY FOR CREDIT OF RURAL SMALL AND MEDIUM SIZE ENTERPRISES.....	9
2.1 Recent Developments in the Market for Loan Supply to Rural SMEs	9
2.2 Main Obstacles in the Supply of Credit to Rural SMEs	9
2.3 Use of Rural Assets as Collateral	11
2.4 Leasing.....	12
2.5 Main Institutions Involved in Financing and Developing SMEs in Rural Areas ...	13
2.5.1 Commercial Banks.....	13
2.5.2 Review of SME Assistance Programmes in Rural Areas.....	14
EU SAPARD Programme	15
EU PHARE Programme	16
2.6 Conclusions and Proposals to Improve Bank Lending to Rural SMEs.....	16
2.6.1 Use of Standardised Loan Appraisal Procedures	16
2.6.2 Training of loan officers.....	17
2.6.3 New Loan Product Development and Sequencing of Loans.....	18
2.6.4 Financing of New SMEs	20
2.6.5 Collateral Requirements	20
2.7 Marketing Strategies and Technical Advisory Services	21
3. ASSESSMENT OF THE DEMAND FOR CREDIT OF RURAL SMALL AND MEDIUM SIZE ENTERPRISES.....	24
3.1 Definition of Rural Areas and Sources of Information.....	24
3.2 Most Important Economic Sub-sectors Developed in Rural Areas	25
3.2.1 Overview	25
3.4 Investment Opportunities in Rural Areas.....	27
3.4.1 Overview of Potential Borrowers	27
3.4.2 Overview of Potential Credit Demand Across the High Priority Economic Sectors.....	30
3.4.2.1 Meat Processing	30
3.4.2.2 Milk Processing and Dairy Sector.....	32
3.4.2.2 Potential Risk Sharing Areas on Farm Level.....	34
3.4.2.3 Fruit and Vegetables Production and Processing and Wine	36
3.4.2.5 Tourism and Other Non-Farming Sectors	38
3.5 Main Conclusions of the Assessment of the Demand for Credit of Rural Small and Medium Size Enterprises	39

ANNEXES:

- 1. Analysis of the FAO Survey of Rural SMEs**
- 2. Survey of Bank Officers of 50 different Bank Branches in Ten Pre-selected Municipalities**
- 3. Review and Analysis of Programmes Focussed on SME Development**
- 4. Short Description of the Surveyed Municipalities**
- 5. Overview of Priority Subsector in Rural Areas**

Currency Equivalents (2005)

1 Euro = 1.95594 Bulgarian Lev (BGL)

1 US Dollar = 1.49800 Bulgarian Lev (BGL)

Abbreviations

BGN	Bulgarian Leva
EUR	Euro
GDP	Gross Domestic Product
GFP	Good Farming Practices
GPP	Good Production Practice
GOB	Government of Bulgaria
HACCP	Hazard Analysis and Critical Control Point
JOBS	Job opportunities through Business Support
MAF	Ministry of Agriculture and Forestry
NAAS	National Agricultural Advisory Service
NARDP	National Agriculture and Rural Development Plan
PM CRA	Private Mutual Rural Credit Associations
SAPARD	Special Accession Programme for Agriculture and Development
SFA	State Fund for Agriculture
SME	Small and Medium Enterprises
UNDP	United Nations Development Programme
US\$	United States Dollar

ACKNOWLEDGEMENTS

This report was commissioned by the European Bank for Reconstruction and Development (EBRD) and carried out by the Investment Centre of the Food and Agriculture Organization of the United Nations (FAO), under the co-operation agreement between the two institutions. The field missions took place between July and October 2004 and were composed of Vlaho Kojakovic (FAO), Ake Olofssen (FAO) and Anthon Slangen (Consultant). From EBRD side the work was coordinated by Blaise Philippe Chaumont, Associate Banker.

FAO would like to extend its warm thanks for the kind assistance it received from Antoaneta Simova (Consultant) for greatly contributing to the final report, conducting a survey and accessing additional primary data from the field, as well as for the logistical support and useful information provided during and after the field work.

FAO would also like to thank Pieter Zijlema (FAO) on his support during the finalisation of the report.

Finally, many thanks are extended to the representatives of all governmental and local authorities, commercial banks, companies and other institutions visited for their time and information provided.

1. EXECUTIVE SUMMARY

Background

1.1 Bulgaria's entry into the EU in 2007 will have a significant impact on the country's small and medium sized enterprises (SMEs) operating in rural areas and the banking sector servicing them. EU standards and regulations related to specific sectors of industry (particularly food industry) coming in place in the next two years, as well as expected competition from the EU market, will change dramatically the scene in which rural SMEs operate. New investments are needed in order for this transition process to be successful. Commercial banks operating in rural areas have a vital role in realising this goal.

More Attractive Sectors of Investments

1.2 Majority of the activities in the rural areas is focused on agricultural production and food processing. Much of the future demand for bank lending will therefore also come from this sector. However, the restrictive regulations and rules imposed by the European Union with regard to both quality and quantity of the produce as well as the hygienic concerns surrounding the food production and processing will, at the same time increase the demand for finance in order to restructure and modernise production sites, also lead to many businesses in the sector having to close down. It is believed though that the absorption capacity of those enterprises that will remain in business will be large. This section is trying to illustrate more attractive sectors for investments, describes investment needs those subsectors and lists the main risks.

1.3 Within the agriculture and food processing sectors, the **meat processing industry** is the fastest growing. Due to its specific production and processing characteristics, it is also the industry that mostly will need to conform to the new EU production and sanitary rules. The need for longer term investment loans is evident as a result as is the need for working capital loans. Much of the investment loans needed are in excess of €1m per processing plant, although some of the immediate demand is in the range of €20,000 – €30,000. In order to make an proper evaluation of the sector's demand for loans, banks will however have to seriously study and take into account the entire chain from cattle breeding through slaughter houses to processing factors and identify their respective loan absorption capacity.

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
MEAT AND LIVESTOCK				
Meat processing	<i>New EU regulations requiring large investments; ranging from food safety and quality requirements to investments in flooring, equipment, and physical lay out of facilities. Industry fairly consolidated and with a well developed market linkages.</i>	<i>Total investment needs vary according to different estimates from €75 million to €125 million.</i>	<i>Due to regulatory requirements imposed by EU a number of processing plants expected to be out of business in the three years.</i>	<i>Stable cash-flow due to stable domestic demand. Expected increased return due to capacity consolidation.</i>
Livestock for meat production	<i>EU-driven safety and hygienic regulations. Growing domestic demand.</i>	<i>Dairy farming and livestock production investment needs estimated at a total of €96 million.</i>	<i>Wide fluctuations in fodder cost (up to 70% of production cost)</i>	<i>Stable cash-flow due to stable domestic demand. Repayment should be agreed reflecting seasonal</i>

1.4 The **milk processing and dairy sector** will represent another potential client for loans from the banks. It is estimated in this report that the total investment needs for the industry in the next three years will be in a range of €42 million. Again, banks will have to consider the entire chain in order to identify the real effective demand for and use of borrowed resources. Although in need of investment loans to renew their facilities, many dairies are working under less than full capacity and it is therefore believed that much of the investment in the sector will have to go into the dairy farms in order to ensure sufficient raw material supply. Many investments at farm level will be of a size of €20,000.

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
DAIRY				
Dairy Processing	<i>New EU regulations requiring large investments; Better vertical integration of dairy farms with the milk collection centres, milk processors and the wholesalers and retailers.</i>	<i>Total investment needs estimated at €42 million.</i>	<i>EU mandatory industry-specific quality standards potentially forcing many smaller dairies out of business.</i>	<i>Frequent cash flow allowing regular and frequent loan repayment.</i>
Milk Production at the Farm Level	<i>EU-driven upgrade of on-farm infrastructure including cooling and milking equipment, sewage systems, animal buildings. Potential for risk-sharing arrangements with dairies. Continuous consolidation of farms. Relatively small investment sizes (animals, equipment).</i>	<i>Dairy farming and livestock production investment needs estimated at a total of €96 million.</i>	<i>Quality problems (EU standards). Oligopolistic market structures (low prices). Risk can be mitigated by lending to farmers who have off-take contract with a dairy.</i>	<i>Regular cash flow. Priority should be given to farmers who have off-take contract with a dairy.</i>

1.5 Although the pressure on the **fruits and vegetables processing sector** to meet EU standards is not as imminent as for the meat and dairy sectors, there is nevertheless an important need to renew the facilities in order to increase efficiency. Out of 57 operating canning factories, only five have new EU standard. All the rest should be doing the same if they plan to stay in business after 2007. In other words, only for the canning industry at least €13 million of investments is needed in the next three years.

1.6 The renewal of **old vineyards and orchards** is a must if Bulgaria wants to stay competitive in this sector. Investment needs of up to 10,000 €per ha have been identified, bringing the total investment needs in the sector to approximately €100 million.

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
AGRICULTURE				
Food & Vegetable Processing	<i>Same as other processing industry - large investments driven by new EU regulations - investments in food safety and quality upgrading of production facilities.</i>	<i>Financing of a minimum of EU-dictated safety regulations (HA CCP regulations) = €1.1million. Investment needs in canning industry estimated at a minimum of €13 million.</i>	<i>Due to regulatory requirements imposed by EU a number of processing plants expected to be out of business in the next few years.</i>	<i>Most of the canning industry export oriented = stable cash-flow. In some cases bank guarantees available from foreign partners. Well developed market linkages. Leveraged on inexpensive labor.</i>
Agriculture Production at the Farm Level	<i>Profitable at larger farms; orchards and herb growing increasingly profitable niche.</i>	<i>Estimated investments in orchards range from €10 to €13 million.</i>	<i>marketing problems</i>	<i>Good entry point: suitable in peri urban area; Working and investment loans (irrigation, transport)</i>
Wine growing sector	<i>Financing of upstream integration of wineries in grape-growing; Potential for risk-sharing arrangements with large wineries (e.g. Domaine Boyar) which are in great need of guaranteed raw material supply.</i>	<i>Total investment needs vary according to different estimates from €78 million to €110 million.</i>	<i>Cyclical price fluctuation; Capital intensive; Unfair competition from surrounding countries (Moldova).</i>	<i>Require long-term finance; May become viable in the medium term, especially with consolidation; Scope for seasonal finance.</i>

1.7 Other sectors than agriculture and food processing includes **tourism** and **textile production**. Profitable small and medium scale investment opportunities in rural tourism should at this stage not be overestimated though there might be a few instances where lending to this sector could prove to be efficient. The service sector in rural areas is generally demanding loans that are very small. Investment needs are presented in a table below.

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
TOURISM				
Rural tourism sector	<i>Investment in infrastructure for expansion of rural tourism activities.</i>	<i>Total investment needs vary according to different estimates. SA PA RD agency has €40 million of approved, but not yet financed investment projects. Further €13 million are needed for financing of EU-dictated HA CCP sanitary regulations.</i>	<i>Marketing and promotion dependent on the public support. Strong competition from the Black Sea resorts. Cyclical industry.</i>	<i>Require long-term finance; May become viable in the medium term, especially with MoAgriculture and MoTourism promoting rural tourism in the development strategy for rural areas.</i>
TEXTILE AND APPAREL				
Textile and apparel sector	<i>Investment in tools and machinery</i>	<i>Fastest growing industry in the last five years. More than 3,000 SMEs involved in textile assembly production, almost fully oriented to export.</i>	<i>Uncertain future for the industry due to increases competition from Asian countries and diminishing advantage of low labor cost.</i>	<i>Should be given access to working capital due to high turnover and secured cash in the short run. Difficult to justify long-term investments in infrastructure.</i>

More Prospective Regions

1.8 In terms of regions, the largest potential for lending is believed to be in municipalities where in the past many large state enterprises operated. In general, these areas benefit from better infrastructure, more favourable natural conditions and are also closer to larger cities and other important centres. More specifically, for the agricultural production and food processing, three regions have higher potential: Plovdiv, Veliko Turnovo and Haskovo. Plovdiv is most suitable for vegetables and fruit production and processing, while Haskovo has significant potential for livestock production and orchard growing. Veliko Turnovo is in livestock and crops production.

Banks' Approach to Lending to Rural SMEs

1.9 In order to serve their rural clients in a most effective way, the banks are developing capacity and adapting their procedures for lending to rural SME. The main aim to achieve low cost, efficient loan application procedures combined with standardised loan appraisal, including financial analysis, loan rating and credit scoring models which is improving and speeding up the loan decision process and guarantees the timely provision of credit to SMEs.

1.10 Some of the loan appraisal procedures are being delegated from headquarters to local level which is giving a responsibility to those who know potential clients from the first hand. In that way the motivation is also given to the local staff and, most importantly, decision making process is made shorter which is one of the most important prerequisites for good bank-client relationship, quoted many times by interviewed SMEs during FAO survey.

1.11 Many banks are taking on new staff with the necessary agricultural training and background in order to strengthen their rural lending operations. Ideally, staff is recruited from the target areas for rural loans. Loan officers without agricultural background undergo specific training in agricultural economics to become familiar with appraising the profitability and cash flow of agricultural enterprises and evaluating collateral. Specialised SME departments have been established in several banks with the aim of supporting and improving SME lending. This includes specialised and sector-specific technical training of SME loan officers operating in rural areas.

1.12 The usefulness of collateral to lenders is adversely affected by: (a) slow and uncertain legal procedures for foreclosure and sale of collateral and (b) thin markets for rural assets such as agricultural land, houses in the villages, farm machinery. However, in order to increase outreach towards the rural clients, banks are starting to "rethink" the way collateral is valued, particularly rural real property and movable assets (in addition to structuring the loan repayment schedule so as to match it as much as possible with the business cash flow which could then replace part of the collateral as a security for future repayment of loan).

Types of Loans

1.13 Loan products tailored to meet the specific needs of SMEs operating in rural areas and standardised products are starting to be developed. Depending if the banks are lending to existing or to new clients, the range of products offered is/should be different. Products may range from short-term loans for working capital requirements and immediate cash needs to investment loans. Sequencing of the introduction of the loan products is important, with short-term lending providing an opportunity to build up knowledge of the clientele (in the case of new clients), before proceeding with larger and longer-term loans. For the new clients it would be recommended to start with the short-term, working capital financing and with a time move towards more longer-term, investment type of lending.

1.14 A prudent strategy that banks would follow is to start with the provision of standardised short-term, **working capital loans** for SMEs operating in different pre-selected economic sub-sectors in rural areas. Short-term loans are the usual form of working capital loans or overdraft facilities, covering the costs of labour, fuel, seasonal inputs and unforeseen cash needs. This form of credit helps to build up the bank's knowledge of the client before consideration is given to provide larger and longer-term loans. It also allows the bank staff to

establish a close bank-client relationship and business partnership – an element quoted in interviews conducted by the FAO team. The table below illustrates a number of short term loan products that can be introduced by the banks for lending in rural areas, both to new and the existing clients:

SHORT TERM/WORKING CAPITAL LOANS						
Loan type	Targeted Subsectors	Maturity	Targeted clients	Main Aim	Size of Loans (Euro)	Potential Collateral
Inputs- purchasing loan: Working capital loan for purchase of seasonal inputs.	Agriculture, Wine and Orchard production	One to three months	Agricultural and livestock producers, wine and orchard owners (allows borrowers to take advantage of month-to-month price differences in some key inputs)	Covering costs of labor, fuel, seed inputs and seasonal chemical inputs; hedging against the input price fluctuations	10,000 – 30,000	Movable assets (machinery, transport vehicles)
Storage loan: working capital loan aimed at financing of storage of agricultural produce to be sold out of the peak season (price higher up to 50% outside season)	Agriculture	One to six months	Agricultural producers (particularly crop producers)	Covering costs of storage	20,000 – 50,000	Warehouse receipts
Emergency Loan: working capital loan aimed at financing of farmers, traders and service industry who are temporarily in financial distress, due to adverse physical events or price changes; might be offered as overdraft facilities.	Agriculture, Trade, Service	One to six months	Agricultural and livestock producers, food and meat processors, traders and services in rural areas	Hedging against the price fluctuations; seasonality and reductions in yields and profitability of production. For the livestock production seasonal loans to enable fodder to be bought at harvest, at minimum price.	30,000 – 50,000	Moveable and immovable assets
EU Food Standards Loan: aiming at fulfilling EU mandatory industry-specific quality standards coming into effect in 2005 for meat and dairy industry and 2006 for F&V processing industry	Food Processing	Three to twelve months	Meat, Dairy, Fruit and Vegetable processing, Canning industry	Covering costs of introducing the EU HACCP* standards; EU imposed specific industry standards related to improvements in safety and quality of production	20,000 - 50,000	Movable and immovable assets
Textile and Apparel Working Capital Loans	Garment and apparels	Up to one year	SMEs involved in textile production	Working capital, currently one of most competitive industries, almost 100% oriented to foreign markets	100,000 - 300,000	Moveable and immovable assets

1.15 Once the bank is familiar with the business and the financial history of its clients, it may gradually expand its lending portfolio and move from short-term to **medium- and long-term loan products**.

1.16 Long-term loan needs for investments in Bulgaria are, in particular, important for the restructuring and upgrading of the production and workplace facilities and equipment in the agro-processing sector (meat, dairy, canning, and wineries), wood processing and textile production in view of the forthcoming entry into the EU. Enterprises that will not comply with the strict EU regulations and norms regarding hygienic and sanitary conditions and health and safety regulations will in fact have to be closed shortly after 2007. Currently, SAPARD constitutes a main source of grant matching funding for restructuring investments. Co- and pre-financing SAPARD's approved viable investment projects in agro-processing as well as in other economic sectors is a profitable niche. However, many of the profitable SMEs interviewed during the FAO survey were not SAPARD recipients. In the same time, those enterprises were in great need of long-term investment loans for expansion and growth of their business.

1.17 Examples of **medium and long-term term loans** appropriate for the business in rural areas can be found in the table below. Most of these loans are aimed at the SMEs expanding or diversify the current scale of their production operations, upgrading production facilities, machinery and equipment in light of new EU regulations or consolidation of enterprises.

<i>Investment Loans</i>						
<i>Loan type</i>	<i>Targeted Subsections</i>	<i>Maturity</i>	<i>Targeted clients</i>	<i>Main Aim</i>	<i>Size of Loans (Euro)</i>	<i>Potential Collateral</i>
<i>Medium-term Investment Loans: loan aimed at medium term financing of agricultural producers involved in improvement and upgrading of equipment and machinery</i>	<i>Agriculture, Wine and Orchard production, Wood Processing</i>	<i>Two to five years</i>	<i>Agricultural producers and small processors, medium-sizes wood processors</i>	<i>Clients whose operations are being intensified and business expanding; in dairy industry investments in cooling equipment on-farm and improvement of equipment in collection centers; in meat industry upgrading of certain processing lines; replanting of orchards and wines</i>	<i>50,000 – 250,000</i>	<i>Moveable and immovable assets</i>
<i>Processing Industry Investment Loan: long-term investment loans for upgrading of processing facilities</i>	<i>Processing Industry: Dairy, Meat, Food and Wood Processing</i>	<i>Seven to ten years</i>	<i>Meat, Dairy, Fruit and Vegetable processing, Canning industry, Wood Processing</i>	<i>Upgrading of facilities and equipment in dairies, meat and vegetable processing and canning plants; Renovation of buildings and sewage-water cleaning systems; Investment in machinery and renovation of wood processing plants</i>	<i>250,000 – 1,000,000</i>	<i>Moveable and immovable assets</i>
<i>Rural Tourism Investment Loan: long-term investment loans aimed at agritourist enterprises</i>	<i>SMEs involved in tourist industry</i>	<i>Seven to ten years</i>	<i>SMEs involved in tourist industry</i>	<i>Investment in infrastructure</i>	<i>50,000 - 500,000</i>	<i>Movable and immovable assets</i>

1.18 In each of these cases, the banks' innovative approach to collateral and the costs (currency nomination and lending rates) and the extended maturity of investment loans, together with some **technical assistance component** that can be developed in cooperation with partners such as described below suggest a comparative advantage, and can be exploited.

Marketing and Technical Assistance– Attracting Desirable Clients

1.19 Marketing and assistance on the final borrowers level can be done in cooperation with the National Agricultural Advisory Service (NAAS) and UNDP-funded JOBS centres positions throughout the country (28 regions of the country have a regional centre of NAAS, while there are 37 JOBS business centres/incubators). These provide a first contact mechanism for information about existing bank loan products and for the understanding of the specific demand of potential rural SME bank clients. NAAS offices already display posters and distribute other publicity material for commercial companies selling inputs and farm machinery. They could handle information and promotion material from the banks in a similar manner.

1.20 Business Sector Associations: The Branch Associations of food and agro-processors are well organized and structured. They have offices in the regional centres and publish newsletter containing useful information regarding legislation, imports, exports, taxation, etc. of the specific activity of their members (meat processing, milk processing, etc.). Moreover, these associations organise regular meetings for their members which could be used as a hub for the dissemination of information about relevant banking products for rural areas or as a forum for direct presentation of the bank products to potential clients.

2. ASSESSMENT OF THE SUPPLY FOR CREDIT OF RURAL SMALL AND MEDIUM SIZE ENTERPRISES

2.1 Recent Developments in the Market for Loan Supply to Rural SMEs

2.1 The Bulgarian financial system is dominated by the Commercial banks that held about 93 % of the total assets of the financial system. The sector of non-banking financial institutions is experiencing significant growth but in the near future will continue to have a minor role.

2.2 Despite the recent positive developments in the banking sector, the legacies of the 1997 banking crisis still influence the way in which the Bulgaria financial system functions. This is reflected in conservative bank lending policies towards rural SMEs and very severe collateral requirements for this market segment. Although credit to SMEs has increased, at the end of 2003 SME borrowing accounted for less than 5% of all outstanding loans (predominantly in urban areas), although SMEs account for 98% of all the enterprises in the country and provide 50% of the jobs.

2.3 Until recently, loans below €50,000 were rarely provided to rural SMEs and collateral worth more than 250% of the loan amount was generally required. However, there are signs that this situation is beginning to change. Conservative lending policies that were needed in the aftermath of the severe financial crisis in order to ensure safety and security are slowly disappearing with the progress towards EU accession. In the next few years, increasing competition, decreasing margins and demand for better services and for quality loan products will impact on banks' behaviour and reshape their business thinking. Confining themselves to "cherry picking" and seeking to service only a limited number of large corporate customers will not be a rewarding strategy for the banks to follow. Instead, most of them will have to turn their attention to lending to SMEs, which are expected to generate the urgently needed economic upswing.

2.4 Despite these positive trends, the outreach of most of the banks involved in financing rural SMEs is still low: Their presence is limited to certain regions and to SMEs in urban areas. Moreover, the range of loan products offered is narrow: Most banks focus on short-term, working capital loans; few offer medium term investment loans. Although it seems that most banks are changing their collateral policies, collateral requirements and evaluation of collateral are still conservative; in most cases rural property and land are not accepted as collateral and movable assets are evaluated at a third of their market value.

2.2 Main Obstacles in the Supply of Credit to Rural SMEs

2.5 Banks' reluctance to lend to rural SMEs is due to several factors. These include the external and internal banking procedures related to collateral, perceived high risk of the sectors in which rural SMEs operate and lack of knowledge and motivation of bank staff. The most important of the three is the issue of rural collateral, which is discussed in detail under 2.4 below.

1. External and internal banking procedures and regulations related to collateral include the following:
 - Restrictive banking regulations concerning lending to SMEs include high loan loss provisions and high collateral requirements. Moreover, only first class collateral (bank deposits, urban real estate) are accepted. Most rural assets such as houses, agricultural land, buildings and machinery are rejected by banks on grounds that seized assets are of little value and/or would be difficult to sell.
 - Requirement in terms of credit history of borrowers - most of the SMEs operating in rural areas have inadequate credit history and do not hold financial accounts.
 - While most banks have internally agreed delegation of loan approval authority, standardised documentary requirements and standardised applications for larger loans, this is not the case with smaller loans requested by SMEs;
 - Weak banks' rights coupled with slow procedures related with foreclosure and the selling of seized collateral in case of loan default, due both to legal constraints and lack of selling and purchasing markets for repossessed assets such as equipment and land in rural areas (according to interviewed banks, the foreclosure of collateral may take up to two years and local courts often decide in favour of the borrowers);
2. Perceived high risk of the areas, in particular agriculture, in which rural SMEs operate:
 - Most SME's activities in rural areas are related to agriculture and agribusiness, cash flow is seasonal and transaction costs are high;
 - Often there are problems with the legal aspects of the assets proposed as collateral – for example, in case of machinery, invoice of purchase is missing; in case of buildings, construction permits are missing/non-existent;
 - Many banks impose up to two times higher collateral than in the urban areas; Banks justify this with the fact that rural assets are not valuable and markets for these assets are not developed. The biggest problem with agricultural land is fragmentation of land ownership;
 - Lack of bank branches and the often poor infrastructure in rural areas imply high transaction costs related to on-site inspection of farms, appraisal of collateral and supervision of borrower.
3. Lack of sector knowledge, in particular agricultural, and motivation among bank staff.

- Lack of sector knowledge prevents loan officers from adopting a more flexible and dynamic approach towards loan appraisals based on cash flow evaluation and towards appropriate loan product design, as the majority of farm income from agricultural and related activities is seasonal, limiting the ability of borrowers to make frequent periodic repayments in equal instalments.
- Unskilled staff takes the same approach to evaluating loan applications for SMEs in rural areas as they do for evaluating loan applications from SMEs and larger enterprises in urban areas.

2.3 Use of Rural Assets as Collateral

2.6 As elaborated above, probably the biggest constraint for banks' lending in the rural areas is absence of suitable collateral. Many rural assets have a low collateral value and are difficult to monitor, foreclose and liquidate. Furthermore, banking legislation encourages banks in their conservative attitude towards collateral. More detailed description of use of rural assets as collateral and various innovative approaches are described below:

2.7 **A Mortgage Bond Law**¹ was passed in September 2000 to enhance the range of financial instruments and increase the access of banks to long-term sources of finance². However, only urban real estate can be used to secure bonds. The first mortgage of a property must be at least 125% of the loan amount. According to Regulation 8 on the Capital Adequacy of Banks, loans secured by first mortgages carry a risk weight of 50% and are included in the risk component of the balance sheet at an amount equal to half of their nominal value. Loans secured with other physical assets carry a risk weight of 100%.

2.8 Normally, banks charge a one-time fee for loan appraisal (including the collateral). Collateral is normally insured against risks which could cause destruction or depreciation of its market value. However, the mortgage law excludes agricultural land.

2.9 The government has recently introduced a number of legal and institutional reforms aiming at enhancing the use of rural assets as collateral and streamlining the processing and foreclosure of claims. For example, the foreclosure provisions of the Code of Civil Procedure have been amended in order to reduce delays in enforcement of valid claims. Following amendments to the Law on Registered Pledges, a central registry has been created where pledges can be registered at low cost and with few administrative hurdles. Since 2000 there is a registry in which the contracts for lease or rental, signed for a period of at least two years, are listed.

2.10 The land restitution process is completed and most agricultural land is now privately owned³, although the problem of scattered ownership among numerous heirs resulting in fragmentation of land further remains. Immovable assets are registered in the Real Estate Property Registers. Establishment or transfers of property right to real estate are performed by the regional

¹ FAO Report on Bulgaria, Expanding ProCredit's Operations in Rural Areas, January 2004.

² The Law gives every licensed bank the right to issues mortgage bonds backed by its portfolio of loans secured by first ranking mortgages over real property. The potential buyers of these mortgage bonds are pension funds, life insurance companies and investment companies and individual investors.

³ In 2000, 98% of the land has been returned to its legal owners who have received legal documents of ownership (Nikolova 2001).

notaries. According to the state officials interviewed inquiries can be made relatively easily in one of the computerised registers, either by the owner's name or by land title¹.

2.11 Despite these improvements, agricultural land is normally not accepted as collateral, mainly because of the low levels of sales transactions on rural land markets and low prices for agricultural land. This is starting to change with the perception that agricultural land will increase in value with the EU accession, as that was the case in other central European countries. The government is trying to stimulate land markets by establishing a market information system.

2.12 *Moveable assets* are accepted by some financial institutions as collateral, but are valued at very low prices (interviewed entrepreneurs were claiming that banks' valuation of movable assets was at a level of one third of the market value). In the event the assets are seized, the problems of using moveable assets also relate to the lengthy legal procedures during which their value may deteriorate considerably.

2.13 The large number of cows and other animals on small and medium sized farms suggest that many farmers might be in a position to offer these as loan collateral. However, only registered herd book animals have significant collateral value (e.g. dairy cows BGN 1.200 – 2.000). Moreover, prices for animals fluctuate considerably and repossession might be difficult. Livestock insurance is available, but premiums are high, about 8-9% of the value of the animal.

2.14 The *system of warehouse receipts*, pursuant to the Grain Storage and Trade Act, provides an alternative in short-term lending to grain producers, traders and processors by using stored grain as collateral. The warehouse receipts, issued by private licensed warehouses, constitute an effective mechanism for stored grain to be used as collateral for short-term loans. By using their grain as collateral, grain producers and processors thus enjoy greater flexibility in choosing the best time of sale. Using warehouse receipts makes the sales transactions much easier and faster, as there is no necessity to transfer the grain physically. Financial institutions accepting warehouse receipts as collateral have the advantage of high security ensured by professional management of the licensed warehouse and continuous control by the supervising agency.

2.4 Leasing

2.15 According to the Bulgarian law, there are two types of leasing: operating and financial. Any company may act as leasing company (lessor). There are no licensing requirements. According to the Law on Banks, such a company should be registered with the BNB as a non-bank financial institution. In 2001, 25 leasing companies were registered. But, there are also companies operating as leasing companies without being registered with BNB. Their number is difficult to estimate. Currently, there is no legal base for control of the leasing companies' activities.

2.16 The main advantage of leasing is the less complicated appraisal procedures: the time for evaluation of an application and signing the contract takes on average half as long as the completion and approval of loan applications. Usually, the lessee must make a down-payment of 30%, but no additional collateral is required. Leased assets are usually insured against the most common risks such as fire and theft.

¹ Officials in Statistical Office of the MAF.

2.17 Banks are avoiding leasing as a form of financing. This is partly due to the unfavourable tax treatment since leasing is VAT taxable. Moreover, important impediments for repossession of the leased item exist in Bulgaria. In case of default, the lessor cannot foreclose on the asset if the lessee does not agree. Repossession in case of default requires action by the local police backed by a court order. Local courts do not always fully understand the principles of leasing which puts timely repossession at risk. This reduces the incentives for financial institutions to offer leasing. Moreover, supply chain and support structures (repair shops, spare parts, etc.) are not always readily available. This increases the risk of default due to breakdown of leased equipment and of accelerated depreciation due to lack of proper maintenance. Finally, as mentioned above, markets for second-hand machinery are limited.

2.5 Main Institutions Involved in Financing and Developing SMEs in Rural Areas

2.18 There are three main types of stakeholders providing finance to SMEs in rural areas:

- (i) Commercial banks, providing commercial credit.
- (ii) State and EU-funded programmes: EU SAPARD programme; EU PHARE programme (including Rural Credit Cooperatives) and State Fund Agriculture (SFA).
- (iii) Donors and international NGOs providing Technical Assistance to SMEs.

2.5.1 Commercial Banks

2.19 Commercial bank interest in lending to SMEs is increasing. Market leaders among the banks with a wide branch network are in the process of setting up specialised SME departments. These banks are beginning to adopt a more active attitude and introduce new instruments aimed at rural SMEs combined with a more flexible approach to collateral.

2.20 During the two mission visits, both in Sofia and in the regions, management and loan officers of five bigger banks with an extended branch network in rural areas were interviewed.

2.21 The mission found that the market leaders in lending to SMEs in general are also the most interested in participating in the EBRD rural SME lending facility. Banks visited which stand out as being the most promising judging from their track record of lending to SMEs, expressed interest in the rural sector, sound lending procedures and their network of bank branches in rural areas. Furthermore, they are ready to start adopting more aggressive lending strategies towards the rural SME sector and are prepared to undertake training of their loan officers in order to efficiently reach new target groups in this sector.

2.22 The mission conducted a survey among 50 banks in ten different municipalities, the results of which are presented in Annex 2. Some of the highlights include the following:

- Majority of interviewed banks (89%) indicate that business environment and SME's economic performance is improving.

- Most of the banks are still focusing on providing working capital loans (56 on average per bank); while average number of investments loans is under 20.
- Average size of working capital loan is BGN36,000, while the average for investment loan is BGN106,000.
- Banks perceive food trade and retail, and textile as the most profitable sectors at the moment (42% each).
- When evaluating a loan, profitability of the company (45%) and available collateral (34%) are given priority in the evaluation process.
- Less than half of the bank branches interviewed had any lending approval authority.
- Most of the banks stated that the successful appraisal and due diligence of the company depends heavily on the trust between the bank and the client.

2.23 Finally, some banks are pioneering innovative and more flexible approaches to collateral, approaches that are being closely monitored by others that wish to enter into this largely unexploited market. At the same time, many banks are still in the process of building up their skills in loan appraisal, risk assessment and project monitoring techniques as essential components of an effective credit policy towards SMEs.

2.5.2 Review of SME Assistance Programmes in Rural Areas

2.24 According to the review of external assistance for SME development in Bulgaria conducted by the Bulgarian Chamber of Commerce and Industry¹ in 2003 and 2004, the total disbursements for SMEs for the period 1998 - 2003 accounted to more than €400 million. Out of this amount 49% was disbursed as credit through financial institutions, while the balance was used for various form of technical assistance direct to SMEs.

2.25 The leading multilateral and bilateral donors include EBRD, the USA, EU, Germany and the IFC.

2.26 Most of SME initiatives do not distinguish between urban and rural SME, however there are two programmes which are aimed at SMEs in rural areas: EU SAPARD programme and EU PHARE programme of credit cooperatives. Both programmes are described in more detail below, while the other programmes, institutions and donors supporting them are described in more length in Annex 3.

¹ Review and all the data quoted in the Annex 4 obtained from the Bulgarian Chamber of Commerce and Industry.

EU SAPARD Programme

2.27 The SAPARD Programme (Special Accession Programme for Agriculture and Rural Development) is mainly to prepare the agricultural sector and rural areas in candidate countries for European Union membership. In Bulgaria, SAPARD supports the National Agriculture and Rural Development Plan (NARDP). The specific aims of the SAPARD programme in Bulgaria are to develop efficient and sustainable agricultural production and raise food processing standards to EU levels through new technology, better market structure and strategic investment and to achieve sustainable rural development, based on alternative employment opportunities and best environmental practice.

2.28 SAPARD is implemented through ten specific measures as well as through technical assistance. For Bulgaria, the annual indicative SAPARD allocation amounts to €53,026 million (at 2000 prices) and is supplemented with public funds. In 2001, the European Commission conferred management of SAPARD funds to the Bulgarian authorities for the three main measures of the programme. These are: investments in agricultural holdings; improvement in the processing and marketing of agricultural and fisheries products; and development and diversification of economic activities and incomes. The three measures account for 61% of the total amount available for Bulgaria.

2.29 State Fund Agriculture (SFA) was nominated by the SAPARD Competent Authority (Minister of Agriculture and Forestry and Minister of Finance) to elaborate the procedures for the implementation of the SAPARD Programme and to be accredited as SAPARD Implementing agency. SFA functions as the implementing and disbursing entity.

2.30 The evaluation data show that the SAPARD beneficiaries were relatively big companies. It is believed that the underdeveloped agricultural credit market and the complexity of SAPARD implementation arrangements have skewed the distribution of funds towards larger agricultural holdings and food processing companies and to projects with a shorter investment cycle.

2.31 The SAPARD application form and business plans are rather complex and a vast majority of the current beneficiaries relied on external assistance for their preparation. Many beneficiaries considered that the price of external consultancy for business plan preparation is high. The complexity of the application form and related documentation is likely to deter a large number of potential applicants from applying to SAPARD.

Table 1: Investments in Agriculture Assisted Projects by the SAPARD Programme as of June 25, 2004

Measure	Approved projects (in BGN)		Completed projects (in BGN)	
	Number of projects	Committed funds	Number of projects	Investment amount
Investments in agricultural holdings.	744	335, 252, 505	439	156, 492, 335
Dairy farms	9	4, 266, 362	4	1, 243, 188
Meat	50	56, 004, 686	17	13, 671, 709
Orchards	159	52, 773, 670	69	14, 553, 995
Orchards, vegetables, essential oils herbs	524	219, 782, 950	349	127, 023, 444
Eggs	2	2, 424, 837	0	0

Source: Ministry of Agriculture and Forests

EU PHARE Programme

2.32 The total disbursements under EU project and programmes in 1998 - 2004 are €99 million. Most EU projects were in the sector "Assistance to SME support services". One of the PHARE sub-programmes which has great influence on disbursing funds in rural areas is a network of 33 Credit Cooperatives (PMRCAs) established in 1995, described below.

Credit Cooperatives	
<p>The Credit Cooperatives were established under the Agricultural Credit Fund Scheme, which has been financed by PHARE and GOB. They are authorised under paragraph 17 of the Transitional and Final Provisions to the Law on Banks to undertake lending activities without being licensed as banks. The Credit Cooperatives have received an initial capitalisation of €7 million from the EU and BGN 3 million from GOB, with later additional funding.</p>	
<ul style="list-style-type: none"> • The Credit Cooperatives provide short term loans of up to two years duration. Around 75% of the loans have maturities up to twelve months for working capital purposes, the remainder finances investments in farm machinery, equipment, land, greenhouses, livestock, etc. Loan amounts can not exceed €20,000. • Collateral requirements are more flexible than requirements of banks: Loans up to BGN 3,000 can be secured by a co-guarantor; larger loans require the pledging of moveable assets or mortgaging of real property. Farm machinery, rural houses and – in some cases - cows are accepted as collateral⁶. • More than 6,000 active borrowers, mostly rural-based small entrepreneurs 	<ul style="list-style-type: none"> • The main problem that the Credit Cooperatives face is the legislative environment in which they operate. Since 1999, the Credit Cooperatives are governed by a Memorandum of Understanding (MOA) between the Government of Bulgaria (GOB) and the European Union (EU), which will expire by the end of 2005. In 1999, the Law on Cooperatives was enacted. This Law stipulates that the provision of financial services by cooperatives should be governed by an additional Law which should be enacted and allow the cooperatives to receive deposits and expand their client base. It is expected that the final draft for the new Law on Credit Cooperatives will be submitted to the Council of Ministers for approval by the end of this year

2.6 Conclusions and Proposals to Improve Bank Lending to Rural SMEs

2.33 This chapter identifies measures that the banks could use in order to improve their lending to rural SMEs under the new EBRD facility. Some proposed measures are listed below:

2.6.1 Use of Standardised Loan Appraisal Procedures

2.34 When building up their capacity and procedures for lending to rural SMEs, banks should develop appropriate loan application forms and simplify documentation requirements taking into account the specific features of rural businesses.

⁶ Normally this is confined to high quality breeding cows which have to be properly insured.

2.35 Low cost, efficient loan application procedures combined with standardised loan appraisal, including financial analysis, loan rating and credit scoring models would improve and speed up the loan decision process and guarantee the timely provision of credit to SMEs.

2.36 SMEs interviewed from several regions clearly indicate the need for quick, simple and efficient procedures for loan application and assessment and prompt follow-up approval and disbursement. A surprisingly high number of SMEs expressed a willingness to pay higher interest rates in order to obtain better access to loans.

2.37 Streamlining loan review and approval procedures and using simplified loan application forms for SME lending would substantially reduce the required appraisal and decision time, both at headquarters and local branches of banks. In particular, banks should delegate the loan appraisal procedures from headquarters to local level. Both SMEs and managers/loan officers of local branches interviewed by the mission strongly suggested that bank headquarters should delegate loan approval decisions up to certain limits to their local branches. This would give responsibility to those who know potential clients the best, giving motivation to local staff and, most importantly, speed up the decision making process for clients. Current time required for the processing of SME loan applications in most banks is longer than six weeks. It was felt that this time could be halved.

2.6.2 Training of loan officers

2.38 Specialised SME departments established by several banks with the aim of supporting and improving SME lending need also to include specialised and sector-specific technical training of SME loan officers operating in rural areas.

2.39 Loan officers without agricultural background would require specific training in agricultural economics to become familiar with appraising the profitability and cash flow of agricultural enterprises.

2.40 Strengthening rural lending will require banks to take on new staff with agricultural training and background. Ideally, staff should be recruited from the target areas for rural loans. This would help the bank to understand better the specific local conditions and characteristics of the rural population. It would also strengthen the possibilities for the bank to establish long-term bank/client relationships in rural areas, even if such efforts have to be supported by providing incentives for the staff. Staff in rural branches should be equipped with standardised tools including cash-flow analysis instruments, credit scoring models and risk management techniques which should be adapted to the specifics of the local rural business with the assistance of technical advisors who are familiar with the sector⁷.

2.41 Agricultural loan officers would also have to be trained in evaluating the different types of collateral that exist in rural areas. Background data on farm and non-farm assets of the rural population can be obtained from sources such as the UNDP rural survey (UNDP, 2003) and the Ministry of Agriculture and Forestry (MAF) census (published in May 2004).

⁷ FAO Report on Bulgaria, Expanding ProCredit's Operations in Rural Areas, January 2004.

2.6.3 New Loan Product Development and Sequencing of Loans

2.42 Standardised loan products tailored to meet the specific needs of SMEs operating in rural areas need to be developed. Products may range from short-term loans for working capital requirements and immediate cash needs to investment loans. Sequencing of the introduction of the loan products will be important, with short-term lending providing an opportunity to build up knowledge of the clientele (in the case of new clients), before proceeding with larger and longer-term loans.

Short-Term, Working Capital Loans

SHORT TERM/WORKING CAPITAL LOANS						
Loan type	Targeted Subsectors	Maturity	Targeted clients	Main Aim	Size of Loans (Euro)	Potential Collateral
Inputs- purchasing loan: Working capital loan for purchase of seasonal inputs.	Agriculture, Wine and Orchard production	One to three months	Agricultural and livestock producers, wine and orchard owners (allows borrowers to take advantage of month-to-month price differences in some key inputs)	Covering costs of labor, fuel, seed inputs and seasonal chemical inputs; hedging against the input price fluctuations	10,000 – 30,000	Movable assets (machinery, transport vehicles)
Storage loan: working capital loan aimed at financing of storage of agricultural produce to be sold out of the peak season (price higher up to 50% outside season)	Agriculture	One to six months	Agricultural producers (particularly crop producers)	Covering costs of storage	20,000 – 50,000	Warehouse receipts
Emergency Loan: working capital loan aimed at financing of farmers, traders and service industry who are temporarily in financial distress, due to adverse physical events or price changes; might be offered as overdraft facilities.	Agriculture, Trade, Service	One to six months	Agricultural and livestock producers, food and meat processors, traders and services in rural areas	Hedging against the price fluctuations; seasonality and reductions in yields and profitability of production. For the livestock production seasonal loans to enable fodder to be bought at harvest, at minimum price.	30,000 – 50,000	Moveable and immovable assets
EU Food Standards Loan: aiming at fulfilling EU mandatory industry-specific quality standards coming into effect in 2005 for meat and dairy industry and 2006 for F&V processing industry	Food Processing	Three to twelve months	Meat, Dairy, Fruit and Vegetable processing, Canning industry	Covering costs of introducing the EU HACCP* standards; EU imposed specific industry standards related to improvements in safety and quality of production	20,000 - 50,000	Movable and immovable assets
Textile and Apparel Working Capital Loans	Garment and apparels	Up to one year	SMEs involved in textile production	Working capital, currently one of most competitive industries, almost 100% oriented to foreign markets	100,000 - 300,000	Moveable and immovable assets

2.43 A prudent strategy for tapping into the rural SME market comprises starting with the provision of standardised short-term, working capital loans for SMEs operating in different pre-selected economic sub-sectors in rural areas. Short-term loans would be the usual form of working capital loans or overdraft facilities, covering the costs of labour, fuel, seasonal inputs and unforeseen cash needs. This form of credit helps to build up the bank's knowledge of the client before consideration is given to provide larger and longer-term loans. It also allows the bank staff to establish a close bank-client relationship and business partnership – an element repeatedly mentioned to the mission. Short-term lending, particularly for well-defined working capital needs, is a good entry-level product for lending to agricultural and agriculture-related SMEs, as it offers a learning curve for loan officers.

2.44 For short-term loans the avoidance of bureaucratic and lengthy documentation could constitute an important advantage. In agricultural production, the main working capital needs are for timely seasonal farm operations and the supply, at the best possible trade terms, of essential agricultural inputs. Physical and economic risks are high in agriculture and adversities may occur due to unfavourable weather conditions and cyclical reductions in yields (common with some tree crops), sharp rises in the cost of input (e.g. animal fodder) and decline in product prices. Product price drops tend to be cyclical, even when over time price levels are such that they permit profitable operations.

Long-Term Loans

<i>Investment Loans</i>						
<i>Loan type</i>	<i>Targeted Subsections</i>	<i>Maturity</i>	<i>Targeted clients</i>	<i>Main Aim</i>	<i>Size of Loans (Euro)</i>	<i>Potential Collateral</i>
<i>Medium-term Investment Loans: loan aimed at medium term financing of agricultural producers involved in improvement and upgrading of equipment and machinery</i>	<i>Agriculture, Wine and Orchard production, Wood Processing</i>	<i>Two to five years</i>	<i>Agricultural producers and small processors, medium-sizes wood processors</i>	<i>Clients whose operations are being intensified and business expanding; in dairy industry investments in cooling equipment on-farm and improvement of equipment in collection centers; in meat industry upgrading of certain processing lines; replanting of orchards and wines</i>	<i>50,000 – 250,000</i>	<i>Moveable and immovable assets</i>
<i>Processing Industry Investment Loan: long-term investment loans for upgrading of processing facilities</i>	<i>Processing Industry: Dairy, Meat, Food and Wood Processing</i>	<i>Seven to ten years</i>	<i>Meat, Dairy, Fruit and Vegetable processing, Canning industry, Wood Processing</i>	<i>Upgrading of facilities and equipment in dairies, meat and vegetable processing and canning plants; Renovation of buildings and sewage-water cleaning systems; Investment in machinery and renovation of wood processing plants</i>	<i>250,000 – 1,000,000</i>	<i>Moveable and immovable assets</i>
<i>Rural Tourism Investment Loan: long-term investment loans aimed at agritourist enterprises</i>	<i>SMEs involved in tourist industry</i>	<i>Seven to ten years</i>	<i>SMEs involved in tourist industry</i>	<i>Investment in infrastructure</i>	<i>50,000 - 500,000</i>	<i>Movable and immovable assets</i>

2.45 Once the bank is familiar with the business and financial performance of its clients, it may gradually expand its lending portfolio and move from short-term to medium- and long-term loan products.

2.46 Long-term loan needs for investments in Bulgaria are particularly important for the restructuring and upgrading of facilities and equipment in the agro-processing sector (meat, dairy, canning and wineries) in view of the forthcoming entry into the EU. Enterprises that will not comply with the EU regulations and norms regarding hygienic and sanitary conditions, will have to close. Currently, SAPARD constitutes a main source of grant funding for restructuring investments. Banks may decide to use the new EU/EBRD SME Rural Credit Facility to co- and pre-finance viable investment projects of rural SMEs engaged in agro-processing as well as in other economic sectors.

2.47 Examples of medium term loans which could be funded by the EBRD Rural SME Lending Facility include investments to expand or diversify the current scale of production operations, for example to upgrade production facilities, convert buildings, improve machinery and equipment or consolidate enterprises. In each case, the banks' approach to collateral and the costs (currency nomination and lending rates) and the maturity of the EBRD funds together with a presumed accompanying EU technical assistance component to the banks, suggests a comparative advantage, and can be exploited.

2.6.4 Financing of New SMEs

2.48 A typical and not surprising pattern that emerges from the case studies is that all successful SMEs used their own funds⁸ (often complemented with credit from family and friends, "commercial credit" from suppliers and micro-credit from international NGOs/Micro Finance Institutions) to finance initial investments. They may later have sought bank loans in order to expand the business. Initial investments based on debt financing received from banks, many of which were related to pre-financing of SAPARD grants, later failed due to difficulties in marketing their products, in turn due to the lack of sector knowledge and major problems in the supply chain and the company's cash-flow pattern.

2.49 On the other hand, entrepreneurs that started their businesses with their own funds usually developed necessary skills and business sector experience within a period of one year, but had no experience with and were not successful in accessing bank loans. It is important that in similar cases banks take into account the technical skills and business sector knowledge as a guarantee for a future dynamic bank/client relationship and support the growth of the business of these clients.

2.6.5 Collateral Requirements

2.50 Collateral should be redefined in the case of rural SMEs particularly with regard to rural real property and movable assets, (in addition to a second major need for structuring the loan repayment schedule so as to match it as much as possible with the business cash flow). As described in 3.1, collateral is a major obstacle for potential SME borrowers operating in rural areas, since banks normally focus on urban property and exclude most items that are of value to

⁸ These may come from other businesses, sale of assets or of businesses, through restitutions, etc.

rural people and that they are in a position to offer. Thus, collateral requirements need to be reviewed to include rural property and agricultural equipment and other types of collateral.

2.51 Although it was repeatedly claimed by all the banks that rural land is difficult or sometimes even impossible to market and for that reason is not accepted as collateral, SMEs in several regions painted a different picture. A land market exists and land is being bought and sold on a daily basis. Even more, the demand for agricultural land has increased during the last year and it is expected that this trend will continue towards 2007. All interviewed representatives of SMEs and individual entrepreneurs dealing with agriculture and agro-processing were aware of similar trends in other Central European countries that joined the EU in May 2004.

2.7 Marketing Strategies and Technical Advisory Services

2.52 Technical advisory services to rural SMEs are a major prerequisite for granting loans. FAO experience shows that advising/coaching SMEs, and particularly those involved in agricultural business activities, is a very demanding exercise which requires considerable human and financial resources. Advice is particularly needed in general management, business plan preparation, financial management and, in particular, cash flow management. Introducing basic management tools would help SMEs to make better choices in a more rational way and act more successfully in obtaining financing from the banking sector, this will lead to a higher demand for loans.

2.53 Few SMEs are aware of the financial products that banks offer and most of them are unfamiliar with products that are specifically aimed at rural SMEs. Also it was pointed out during many of the interviews that commercial banks have a negative image in rural areas, mainly because of their bureaucratic and non-transparent procedures that lead to high transaction costs and long delays for loan applicants.

2.54 In order to win new clients among rural SMEs banks should have products which are based on their real needs; conditions for loans which are in line with existing types of collateral and cash flows of agricultural/rural business, as well as speed and friendliness in dealing with loan applicants.

2.55 The banks should consider organisations described below for promoting new products and for establishing training programmes for potential borrowers.

National Agricultural Advisory Services (NAAS)	Job Opportunities through Business Support Project (JOBS)
<ul style="list-style-type: none"> • The National Agricultural Advisory Service (NAAS) is the biggest advisory agency for small and medium- sized farm enterprises operating in rural areas. It has 28 regional centres (i.e. one in each administrative region, working in close collaboration with the regional offices of the MAF and the SFA) and a head office in Sofia. Each regional centre is staffed with three to five extension workers, including one agronomist, one zootechnician, one mechanisation specialist, one economist, and one specialist in a field related to the region's agricultural production specialisation. The agency has 166 staff in total. • FAO recently implemented a technical cooperation project related to capacity building of farmers and entrepreneurs operating in the agricultural sector. The project objective was to strengthen the capacity of NAAS staff and to provide market and business advice to allow integration of agricultural producers and SMEs into the market economy. The project developed training support materials related to the special needs of small and medium-sized enterprises and agricultural private-sector business operators (e.g. costs calculations, gross margin analysis, investment analysis, collection and dissemination of market information). 	<ul style="list-style-type: none"> • JOBS is a successful public-private partnerships project initiated by UNDP and the Ministry of Labour and Social Policy aiming at the promotion of entrepreneurship by supporting micro- and SMEs and agricultural producers. The project started in 2000 with a total budget of US\$ 7 million. Following the successful first three years of operation, the project received additional funding from several donor countries including Switzerland, United Kingdom and Norway. • To date, the JOBS network has established 37 Business Centres across the country, including 11 Business Incubators and three Business Information Centres. Business Centres provide information and consulting services in business planning, training, financial services and advise on access to existing micro and SME financing. • JOBS clients in rural areas include SMEs operating in the following six economic sub-sectors that have been identified as being the most competitive: <ul style="list-style-type: none"> ▪ Apparel and textile (300 companies) ▪ Wood processing and furniture (200 companies) ▪ Handicrafts (700 artisans) ▪ Herbs and spices (100 companies) ▪ Tourism (more than 200 companies in 37 regions) ▪ Organic agriculture (50 companies)

2.56 Other possible channels of marketing banks' loan products to SMEs include the following:

- **Business Sector Associations:** The Branch Associations of food and agro-processors are well organized and structured. They have offices in the regional centres and publish newsletter containing useful information regarding legislation, imports, exports, taxation, etc. of the specific activity of their members (meat processing, milk processing, etc.). Moreover, these associations organise regular meetings for their members which could be used as a hub for the dissemination of information about relevant banking products for rural areas or as a forum for direct presentation of the bank products to potential borrowers.

- Municipal authorities and regional administration centres: Municipal authorities could provide suitable entry points for carefully crafted publicity campaigns, once a core rural loan product range has been established.
- Fairs: There are two big agribusiness fairs in Bulgaria: Plovdiv fair, which takes place in the middle of March and Dobrich fair, held in August. They are of a similar size and have a similar number of visitors. Entrepreneurs operating in the agricultural production and agribusiness sectors have a tradition of visiting these fairs and they present a good marketing promotion tool for banks to advertise themselves and to establish contacts with agricultural producers and processors and input/equipment suppliers.
- Special TV/Radio Programs: TV programs have by far the largest audience. The state TV has the longest running agricultural programme, aired every Sunday at midday. Nova TV, a private television station, has also an agricultural programme called “Agrobusiness” on Sundays, at 13.15 hours. Radio stations with national coverage do not have agricultural programmes. However, local radio stations have agricultural programmes during weekday mornings and on Sundays. Banks should advertise through those programmes.

3. ASSESSMENT OF THE DEMAND FOR CREDIT OF RURAL SMALL AND MEDIUM SIZE ENTERPRISES

3.1 Definition of Rural Areas and Sources of Information

3.1 The demand for credit by rural SMEs is examined below from two aspects: the most important sub-sectors developed in rural areas, and; description of the potential borrowers.

3.2 The term “rural areas” is something new to Bulgaria. In the centrally planned economy most of the official statistics were classified on the basis of units of towns (urban) and villages (rural). Universally, the most common definition of “rural area” continues to overlap with the term “village” in its sense of a territorial unit. The Bulgarian statutory definition of “rural regions” is however broader than the perceptions of citizens and covers almost all the municipalities with the exception of larger cities and district centres. In order to implement some of the SAPARD measures, Bulgaria had to give a definition of the rural areas in 1999/2000 when the National Plan for the development of agriculture and rural areas was in the negotiation process with the EC. Lacking expertise in the territorial aspects of a rural development policy, the Ministry of Agriculture and Forestry (MAF) decided to define as rural all Bulgarian municipalities on whose territory there are no cities with over 30,000 people and whose population density is less than 150 inhabitants per sq. km. As a result, 231 out of 264 Bulgarian municipalities are at present identified as being rural. They cover 81% of the national area, account for about 83% of both arable and forest land, and contain about 44% of the population.

3.3 Some enterprises are registered in urban areas in order to have easier access to government and local authorities, financial institutions and other support services, but operate in rural areas. Similarly some companies are registered as rural but operate in an urban areas since companies registered in under-developed regions and municipalities with high unemployment enjoy substantial tax reductions, or may avoid supervision from the regulatory bodies like tax authorities, sanitary services etc. that are often insufficient in the rural areas. The first category of companies, legally registered, albeit in urban areas, and operating according to the Bulgarian law, should be considered as falling under the category of rural SMEs since they contribute to the rural economy by employing local people and paying taxes to the municipality/state_

3.4 The implementation of SAPARD, however, revealed some shortcomings in the accepted definition. Some typically rural areas were banned from support because they are situated on the territory of a non-rural municipality whilst some other municipalities where the majority of the Gross Domestic Product (“GDP”) is produced by economic sectors other than agriculture (i.e. mining of coal or production of cement) could still benefit from the SAPARD support. This has sparked strong criticism from local authorities and development institutions monitoring and adjusting SAPARD implementation rules. It is the main reason why the MAF should better delineate the rural areas of the country in a near future.

3.5 The assessment of the demand for rural credit is based on several sources of information: quantitative surveys composed of individual interviews (entrepreneurs residing in rural municipalities or in the villages of some urban municipalities), case studies developed during

the field trips to two districts – Stara Zagora and Pleven, official statistical data of the National Statistical Institute and MAF and information provided by different professional associations. The first round of 45 interviews among rural SMEs was carried out in 8 rural municipalities. Following the inception report, the team undertook a further assessment of the effective demand for credit among SMEs through an additional survey covering 50 entrepreneurs in 10 municipalities. 80 % of these municipalities were rural. The entrepreneurs from the urban municipalities that were interviewed were all resided in the villages.

3.6 According to the Human Development Index from 2003, the surveyed municipalities were ranked in the way shown in Table 1. Whilst not statistically representative, the surveys cover areas with diverse geographic, social and economic conditions. More details about the characteristics of the selected municipalities are given in Annex 4.

Table 2: Human Development Index of the Surveyed Municipalities

Municipality	Overall ranking (1-262)	GDP per person PPP \$ 2001	GDP rank (1-262)	Enrollment rank (1-262)	Literacy rank (1-262)
Targovishte	45	5 914	37	83	80
Samokov	63	5 303	44	167	179
Sliven	100	5 642	41	215	208
Razlog	102	2 823	211	37	35
Devin	125	2 885	208	54	61
Aitos	190	3 759	120	197	202
Sungurlare	201	3 470	147	228	228
Nova Zagora	245	3 140	185	245	252
Dulovo	257	2 567	232	256	259
Kotel	262	2 539	235	261	261

3.2 Most Important Economic Sub-sectors Developed in Rural Areas

3.2.1 Overview

3.7 The businesses that once constituted the economic production base of Bulgarian rural communities in the centrally planned economy such as manufacturing and commercial farming organized in large cooperatives, or the trade sector of developed economies are almost totally missing.

3.8 At a national level, the largest number of operating companies in the rural areas (excluding the micro enterprises with less than 10 employees) can be found in the food processing industry, trade, machine building and agriculture (see table 3).

Table 3: Number of Operating Companies in the Different Economic Sectors of the Rural Municipalities in Bulgaria in 2004

Sector	Operating companies	%
Food processing industry	262	15
Trade	242	13
Machine building	216	12
Agriculture	163	9
Textile and apparel	138	8
Transport	134	7
Construction	125	7
Wood processing	104	6
Chemicals production	79	4
Other sectors	73	4
Finances and insurance	72	4
Electro-technical industry	65	4
Tourism	53	3
Production of building materials	53	3
Paper and cellulose	19	1
Total	1 798	100

Based on FAO calculations based on the data provided by the rural municipalities regarding the number of the non-micro firms operating on their territory

3.9 Undoubtedly the most important of the sectors is the food processing industry. Since 1990, this industry has undergone a process of privatization and restructuring, following a very substantial downturn in activity and throughput with the loss of much of the former Soviet bloc market, coupled with a downturn in demand in the domestic market due to lower per capita incomes. Lack of investments during the 1990s has left the majority of the plants with outdated equipment and inefficient processing techniques. However, over the last two years, most companies reported stabilization of their financial status and market availability making food industry one of most dynamic in the country. Major factors that contribute to this are inexpensive labour, inexpensive raw material and good management ability.

3.10 According to the MAF⁹ survey of SMEs in the food industry sector, 99 % of the industry is currently in private hands. 95% are small, 2% medium and 3% large enterprises, respectively. There are 209 large processing plants of which 147 are newly established, with more than 8,000 small processors active in the sector of which 1,343 have food production as their major line of business. Food processing accounts for 25% of total industrial production employing more than 18 % of the labour force employed in the manufacturing sector as a whole¹⁰.

⁹ Ministry of Agriculture and Forestry.

¹⁰ It should be noted that the high share of food processing industry is partly due to the fact that other economic sectors in the country are less developed and alternative employment is scarce. During the first years of the transition, industrial input declined substantially in Bulgaria. The fall in output was very pronounced in agriculture (and especially for livestock products), but since some other sectors almost collapsed, the share of agriculture in the GDP increased and reached its peak in 1997 (26.6 %). With the post 1997 economic growth, the share of agriculture in GDP relative to other sectors started to fall and declined to 13.6 % in 2001. The most pronounced contribution to the overall economic growth was, however, that of the services

3.11 Over the period 2000-2004, food sales registered an average annual growth of 7.5% and totalled more than two billion US\$ in 2003¹¹. The meat processing industry is the fastest growing industry, expanding by 17% per year in the period 1999-2003, followed by bakery/cereal manufacturing (15%). Growth was also registered through industry consolidation and new investment. Due to Bulgaria's future accession to the EU, modernization of major local facilities according to EU requirements is under way. In order to be competitive within the EU market, the major challenge for the food industry is to reach full compliance with the sanitary, hygiene, food safety standards and quality management systems of the EU. If the industry is to comply with those standards and remain competitive after 2007, large amounts of additional funding will be required, part of which could be met through EBRD financing.

3.12 A detailed overview of the important economic sub-sectors can be found in Annex 5 of this report.

3.4 Investment Opportunities in Rural Areas¹²

3.4.1 Overview of Potential Borrowers

3.13 The FAO survey of SMEs in rural areas and the field trips of the mission showed that there is a considerable demand for investment and working capital loans in rural areas and that SMEs would have the capacity to absorb the planned EBRD lending facility.

3.14 Local branches of commercial banks in the municipalities visited during the field trips confirmed this conclusion. The "demand" assessment conducted by the banking sector itself coincides almost fully with the business sector evaluation regarding the most dynamic industries, the size and the types of the potential investments, and the requirements of the potential borrowers regarding the terms of the bank loans.

3.15 The table below summarises the main characteristics of borrowers in selected areas by using two different measures for rural areas, up to 30.000 - and up to 100.000 inhabitants.

and not of the industries. As a result the share of food processing in total industrial production remains very high.

¹¹ USDA Report on State of Agriculture in Bulgaria, March 2004.

¹² This section draws on a number of sources, primarily surveys and interviews conducted by FAO team among SMEs and interviews with sectoral associations conducted during the visits to the country, but also on the reports from MAF and National Agriculture and Rural Development Plan, 2000-2006, GoB (version 27 May 2003).

Highlights from the FAO Survey of rural SMEs¹³

Using up to 30.000 inhabitants to define rural areas, the potential borrowers are characterised by:	Using up to 100.000 inhabitants to define rural areas, the potential borrowers are characterised by:
<ul style="list-style-type: none"> • Predominance of agricultural (48%) and local services (33%) activities. • While micro-enterprises (up to 10 permanent employees) predominate in rural areas, the main focus of the Facility will be on small and medium-sized enterprises with higher educational levels and appropriate business and marketing skills of their managers and newer, if possible, diversified enterprises to reduce the high risks in agriculture. • The low access to bank credit is mainly due to lack of collateral, high interest rates and reliance on own capital with a reluctance to incur debts. Obviously, this is also related to the scarcity of profitable investment opportunities in rural areas. • In the case of bank credit, the predominance is for working capital purposes (53%). With the Facility this trend can be converted to term lending for viable investments or simultaneous term and working capital lending. The current small loan size floor and ceiling (from €18,000 to €144,000) could be almost doubled under the Facility. • Bank credit under the Facility should aim to co-finance with the SFA and, in particular, with SAPARD projects. 	<ul style="list-style-type: none"> • A much more diversified economic structure (agriculture and food processing activities account for only 23% and 9%). 25% of the entrepreneurs have more than one main activity. • Much less micro-enterprises (Only 8%) and predominantly limited liability companies. • A relative old age of enterprise (52%) established between 1990 and 1996. • Asset value higher than €100,000. • High market and profit orientation. Profits are a main source for capitalisation. Domestic markets are dominant (89%), but export markets are much more dynamic. • Good loan repayment records of current borrowers - only 12% stated that they had faced some problems. • 84 % of the entrepreneurs intend to borrow from banks with an emphasis on term loans for renovation, equipment, renewal of orchards. • Highest potential economic areas: food processing (meat and dairy), construction, wood processing, tourism • Desired terms of loans: long maturity, less strict collateral requirements, better repayment schedules considering the cash flow situation.

Overview

3.16 The re-structuring of the agro-processing industry requires substantial investment to improve quality of output and to enable the production of the sector to be marketed effectively.

3.17 Scale is clearly an issue. Larger enterprises have already attracted foreign investment (e.g. Danone in dairy processing/marketing). This is likely to continue, and to involve investment in consolidation of enterprises. However, SMEs are still potentially a most viable segment of the industry. Many of SME enterprises need to borrow for working capital purpose and, much more in the next two years, for the investment purposes in order to meet EU criteria.

3.18 It is expected that the majority of demand for credit in the next two years would come from the meat and dairy industries, as well as from specific agricultural production sector activities¹⁴. The majority of the SMEs surveyed (84 %) have intentions to apply for a bank loan within the next six months to a year. Out of those, almost 90 % intend to apply for investment

¹³ Full analysis of the survey of rural SMEs can be found in Annex 1.

¹⁴ Detailed sector analysis can be found under 3.4.2 below.

loans and only 10 % are in need of working capital. Types of investment needs are varied – ranging from construction of new or renovation and upgrading of the existing buildings (32 %) to purchase of new machinery and equipment (78 %) to renewal of orchards and vines (7 %). The need for complementary working capital is existent for almost all the enterprises surveyed with the exception of those which have a regular daily cash flow (for example the dairy farms and restaurants).

3.19 The respondents who expressed the intention of applying to the bank for an investment loan stated that they would like to see the present terms of lending changing in the following way: a) the time of repayment should be expanded to at least 7-8 years (100 % of the respondents); b) the collateral requirements should not be so rigid (97 %) and c) the repayment schedule should be based on the cash flow particularities (29 %).

3.20 According to FAO survey analysis, SMEs interviewed have a good repayment capacity. Among those that had borrowing history, only 12 % have had some difficulties in repaying the credits. 20 % of the respondents have never taken a bank loan for operational or investment purposes. The main capital source for the companies is their profit. By diversifying their activity some of the companies will become more flexible and can transfer funds from one enterprise to another. Risk mitigation is the main reason for diversification for 90 % of the companies which operate in more than one sector.

3.21 The survey confirmed that private sector growth is greatest in food processing (particularly meat and dairy), construction, tourism and wood processing. The majority of companies (89%) sell mainly on the domestic market. A major concern for almost all of those enterprises producing for the home market is the low purchasing power of the Bulgarian population and the large variation in agricultural commodity prices. Export-oriented enterprises which are more dynamic and economically viable will continue to develop and if they invest in the infrastructure on time for 2007 accession, will be well placed to meet EU competition.

3.22 Textile and apparel industry have a less bright longer-term future although their current situation is protected with quotas and subsidies which will be eliminated at the start of 2005.

3.23 Although these companies are currently almost fully export oriented their market and competitive advantage (based on cheap labour) is disappearing due to strong competition from Asian countries including China. All the respondents from this sector expressed their concern about the expected liberalization of the markets and uncertainty about their future. Also most apparel companies work with cheap and second-hand equipment which is not attractive as collateral for the banks.

3.24 Other relatively risky sectors are agriculture and bakery. 40 % of the companies in agriculture have either never applied or have applied unsuccessfully for bank loans. The main reasons for this high percentage are lack of collateral, liquidity problems and unstable produce prices.

3.25 The issue of investment choice in marketing/processing is very important. Currently, the investment returns are higher in processing than in the production of raw materials. The government tries to compensate for this by the different support measures and mainly through the SAPARD program. Yet the interest to invest in the food industry is higher than in farming and

other non-farming activities: in the period 2001-2004 contracted investments under the SAPARD program in the processing industry amounted to €288 million, in agriculture they were €168 million and in other non-farming sectors €45 million.

3.4.2 Overview of Potential Credit Demand Across the High Priority Economic Sectors

3.4.2.1 Meat Processing

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
MEAT AND LIVESTOCK				
Meat processing	<i>New EU regulations requiring large investments; ranging from food safety and quality requirements to investments in flooring, equipment, and physical layout of facilities. Industry fairly consolidated and with a well developed market linkages.</i>	<i>Total investment needs vary according to different estimates from €75 million to €125 million.</i>	<i>Due to regulatory requirements imposed by EU a number of processing plants expected to be out of business in the three years.</i>	<i>Stable cash-flow due to stable domestic demand. Expected increased return due to capacity consolidation.</i>
Livestock for meat production	<i>EU-driven safety and hygienic regulations. Growing domestic demand.</i>	<i>Dairy farming and livestock production investment needs estimated at a total of €96 million.</i>	<i>Wide fluctuations in fodder cost (up to 70% of production cost)</i>	<i>Stable cash-flow due to stable domestic demand. Repayment should be agreed reflecting seasonal</i>

3.26 Within the agriculture and food processing sectors, the meat processing industry is the fastest growing. Due to its specific production and processing characteristics, it is also the industry that mostly will need to conform to the new EU production and sanitary rules. The need for longer term investment loans is evident as a result as is the need for working capital loans. Much of the investment loans needed are in excess of €1m per processing plant, although some of the immediate demand is in the range of €20,000 – €30,000. In order to make an proper evaluation of the sector's demand for loans, banks will however have to seriously study and take into account the entire chain from cattle breeding through slaughter houses to processing factors and identify their respective loan absorption capacity.

3.27 Major investment areas include the following:

- Renovation of facilities and equipment to meet EU standards.
- Improving food safety and quality by introducing Hazard Analysis and Critical Control Point standards, or "EU standards".
- Measures, including construction and equipment, to deal with pollution at processing plants.
- Promotion and market development for specialty meat products.

3.28 Considerable investments are needed in order to conform to the wide range of requirements regarding flooring, equipment, and physical layout of facilities. An increasing number of companies have already started investments in improved food safety and quality. The need for renovation and restructuring in this sector is so urgent that the Ministry of Economy decided to allocate one million BGN to local meat processors for the introduction of EU standards. All the operating plants are required to introduce the EU standards by the end of 2006. The average cost for adopting this system is about €20,000. Meat processing is the first part of the food industry to adopt these standards, due to be completed by December 2005. Despite this government assistance and the EU pre-accession funds, the bulk of the required capital will have to come from the owners themselves. Another factor that will increase the demand for investment capital is the adoption of EUROP meat grading standards.

3.29 Some experts believe that a small number of larger plants meeting EU standards will be able to produce enough meat to satisfy domestic demand and to allow for export. Bulgaria has negotiated a three-year transition period following accession, during which plants, which do not fully meet EU standards, can continue to operate and sell on the domestic market. This gives the chance to many small enterprises located mainly in the rural areas to continue to operate after 2007. However without considerable investments for acclimatisation of the premises, walls that can be easily washed and anti-bacterial floors and high-quality steel equipment those enterprises will have to close.

3.30 Slaughtering and processing capacities considerably in excess of current production of animals by local farmers. The meat processors try to compensate this lack of supplies from the domestic market through imports from abroad. Duty free quotas for cattle and pigs have been completely taken up. With the accession to the EU in 2007 the access to raw material within the Union will increase and the underutilization of their installed production capacities should no longer be a problem for the processors.

3.31 There is strong need for vertical integration between production and processing in this sector with further investments needed for both pig and dairy commercial farms for improvement of their breeds in order to produce better quality and compete more effectively with imports after the accession. The pressure to modernize is enormous, because this industry is still heavily protected by import duties, but this protection is going to disappear completely from the date of accession to the EU.

3.4.2.2 Milk Processing and Dairy Sector

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
DAIRY				
<i>Dairy Processing</i>	<i>New EU regulations requiring large investments; Better vertical integration of dairy farms with the milk collection centres, milk processors and the wholesalers and retailers.</i>	<i>Total investment needs estimated at €42 million.</i>	<i>EU mandatory industry-specific quality standards potentially forcing many smaller dairies out of business.</i>	<i>Frequent cash flow allowing regular and frequent loan repayment.</i>
<i>Milk Production at the Farm Level</i>	<i>EU-driven upgrade of on-farm infrastructure including cooling and milking equipment, sewage systems, animal buildings. Potential for risk-sharing arrangements with dairies. Continuous consolidation of farms. Relatively small investment sizes (animals, equipment).</i>	<i>Dairy farming and livestock production investment needs estimated at a total of €96 million.</i>	<i>Quality problems (EU standards). Oligopolistic market structures (low prices). Risk can be mitigated by lending to farmers who have off-take contract with a dairy.</i>	<i>Regular cash flow. Priority should be given to farmers who have off-take contract with a dairy.</i>

3.32 The milk processing and dairy sector will represent another potential client for loans from the banks. It is estimated in this report that the total investment needs for the industry in the next three years will be in a range of €42 million. Again, banks will have to consider the entire chain in order to identify the real effective demand for and use of borrowed resources. Although in need of investment loans to renew their facilities, many dairies are working under less than full capacity and it is therefore believed that much of the investment in the sector will have to go into the dairy farms in order to ensure sufficient raw material supply. Many investments at farm level will be of a size of €20,000.

3.33 Major investment areas include the following:

- Upgrading of facilities and equipment in dairies in order to meet EU hygienic standards.
- Renovation of sewage-water cleaning systems and equipment modernization.
- Investments in cooling equipment on-farm and improvement of equipment in collection centres.

3.34 The most important stages in the chain of dairy products are the dairy farms, the milk collection centres, milk processors and, finally, the wholesalers and retailers. At the milk processing level the accent of future investments should be put on the renovation of the buildings and sewage-water cleaning systems. Smaller investments will be needed in equipment modernization, because the existing dairies, even those in group II, already meet the basic

requirements (like the cooling equipment for fresh milk). Mass veterinary inspection in the beginning of 2003 resulted in the closure of almost a quarter of dairies, the major causes for this being the lack of cooling equipment, poor hygiene, excess water content in milk, and shorter than required ageing period of milk products.

3.35 The table below presents the investment needs of the milk processing plants differentiated by the level of compliance with the EU hygienic standards and the size of the milk processor. Unfortunately, there are no data available on the production capacity of each processor and thus it is not possible to calculate exactly the total investment need for all milk processors. If we consider, however, only the so-called “industrial” processors (almost one half of all the processors) and assume that they have reached a good and medium level of harmonization with EU norms and have an average annual capacity of 10-20 million litres, then the total investments needs for all milk processors will be about €42 million.

Table 4: Assessment of Investment Needs at the Milk Processing Level

Harmonization level	Size of processors (million l/year)	Number of milk processors	Investment purpose			
			Reconstruction of buildings ('000 EURO)	Modernization of pasteurizing equipment, establishing controllable cleaning system ('000 EURO)	Sewage water cleaning system ('000 EURO)	Total investment needs per processor ('000 EURO)
good	<1	29 big and medium sized and 5 dairy workshops	2	5	1	8
	1-5		4	9	2	15
	5-10		6	13	4	23
	10-20		16	29	11	56
	20-50		35	35	23	92
	50-100		53	42	32	127
	>100		58	51	35	144
medium	<1	181 big and medium size and 93 small	9	18	6	33
	1-5		15	35	10	60
	5-10		24	52	17	93
	10-20		65	115	44	225
	20-50		138	138	92	369
	50-100		212	169	127	508
	>100		234	203	138	575

FAO calculations based on experts' evaluations

3.36 As in meat processing, excess production capacity is characteristic of the milk processing sector. Many dairies, including the most efficient ones, compete for milk supplies and operate at less than full capacity. This gap between raw material supplies and processing capacity is a much bigger problem for the industry, because unlike the meat sector, raw milk cannot be imported from abroad. The future development of dairy farming is therefore crucial for the smooth functioning of the milk production/processing and marketing chain of dairy products.

3.37 The assumptions about the needed investments in dairy farming are made on the basis that only medium and large-size farms invest in new buildings, milking facilities and cooling facilities and that all of the operating farms are at a medium level of compliance with the EU sanitary and hygiene regulations (which is rather the exception than the rule), in which case they will need on average 50% of the capital reported in Table 5. With these assumptions the minimum amount of investments needed in the dairy farming sector amounts to €6 million.

Table 5: Specific Investments Needed to Establish Dairy Farms Compliant with the EU by Size (in EURO)

Number of cows	Number of farms	Buildings	Milking equipment	Cooling equipment	Total investment per farm	Total investment for the country
3-9	17, 082	3, 846	1, 477	1, 815	7, 138	121, 931, 316
10-19	2, 385	6, 923	3, 938	3, 077	13, 938	33, 242, 130
>20 (≈60)	1, 237	15, 385	8, 000	6, 154	29, 539	36, 539, 743
Grand total investment						191, 713, 189

Source: “Animals in Bulgaria by Nov.1, 2003, Bulletin of the Ministry of Agriculture and Forests”, April 2004 and FAO calculations based on experts’ evaluations

3.38 All livestock farming, including dairying will need considerable investment if they are to comply with the code of the good farming practices in order to obtain direct and investment subsidies after 2007¹⁵. Currently, the so called “good farming practices” (GFP) principles the adoption of which will be a prerequisite for getting all kinds of assistance under the EU agricultural policy are almost non-existent in Bulgaria¹⁶

3.4.2.2 Potential Risk Sharing Areas on Farm Level

3.39 For commercial banks, the main risks associated with lending to the dairy farms are related to **the level of milk prices and their fluctuations**. A prerequisite for any further discussion would therefore be the conclusion of acceptable **off-take agreements between candidate borrowers and reputable dairies**. It is acknowledged that milk prices could not realistically be fixed for the whole duration of a medium-term credit. However, off-take contracts committing the dairy to (i) provide specific technical assistance to the farm and (ii) buy all quantities of milk produced (at specified quality standards) would already constitute an important risk-mitigating element in the eyes of the bank. Annual renewable agreements on milk prices should be concluded in addition to the long-term off-take contract.

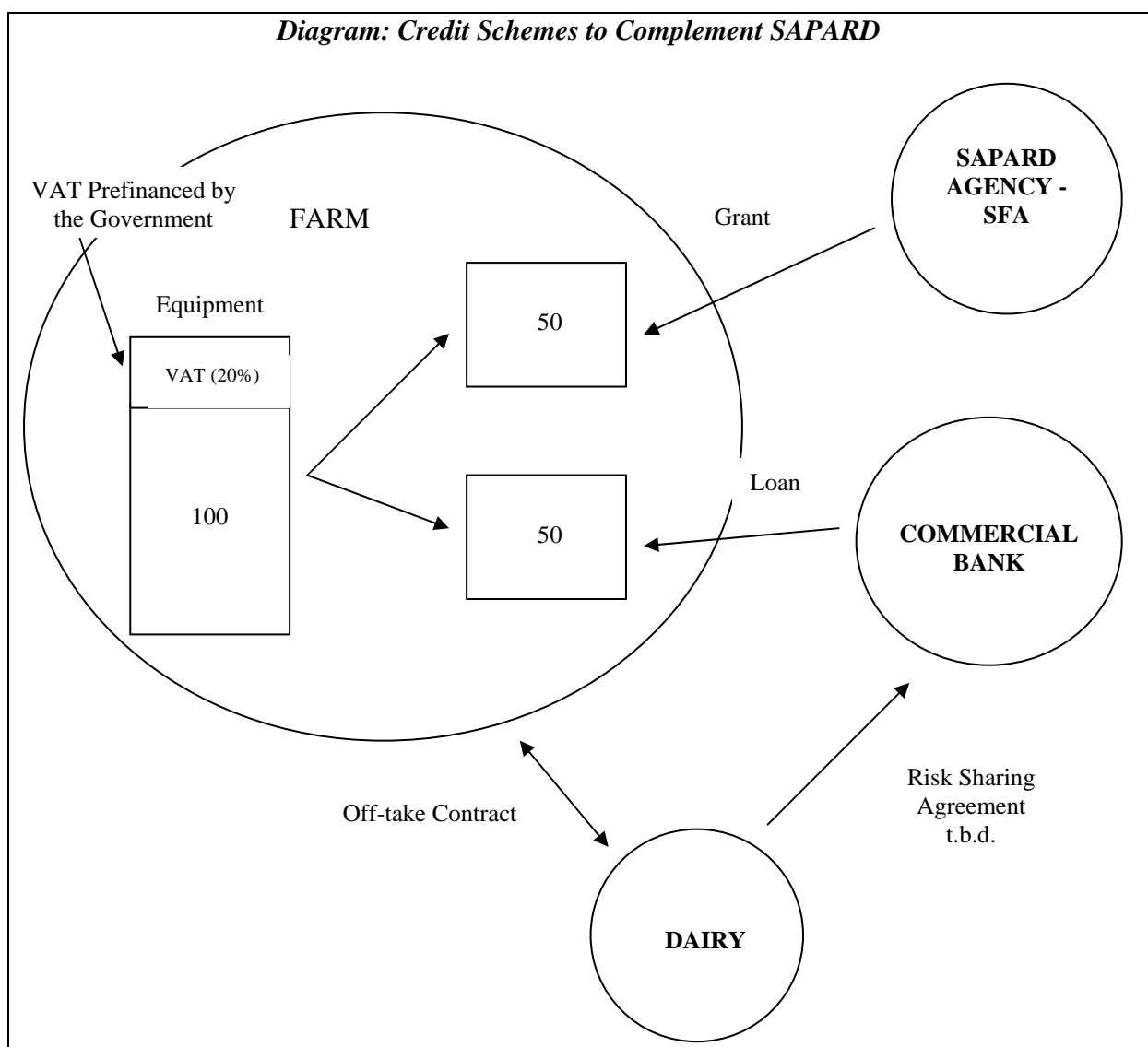
¹⁵ GFP in Bulgaria has been adopted in the internal legislation under the name of “Code on the requirements in the field of environment protection, hygiene, human treatment of animals, veterinary and phyto-sanitary requirements of the agricultural farms”.

¹⁶ Farmers must comply with many EU legal standards even without receiving any compensation. The EU Nitrate directive is an example of such a basic standard. According to it the application of livestock manure should be limited to 170 kg N/ha. The collection, storage and handling of wastes will be one of the biggest challenges on many Bulgarian farms. It is very difficult to calculate on national level the total costs to adopt environmentally sound practices, because this varies widely among farms depending on climate, soils, crops, and proximity to environmental resources.

3.40 Technically, the repayment of the credit should be captured through the dairy. The dairy would pay the debt obligations of the farmers directly to the bank, deducting them from its milk payments to the farm. The seasonality of cash flow generation at the farm level (due to the fluctuations of milk production) could be addressed through semi-annual instalments and/or the creation of a reserve account.

Potential Credit Schemes to Explore to Complement SAPARD

3.41 As mentioned earlier, it is strongly recommended that the cofinancing of SAPARD projects be examined in a realistic way, in parallel to the SAPARD grant process, even if grant sources and credit sources are kept separate. One possible solution could be presented as follows:



3.42 The nature of the risk participation of the dairy has to be discussed. Again, the selection of borrowers by the dairy is an important aspect for the bank. Some dairies have established steady commercial relationships with supplying farmers and are in a good position to

make a judgement on the creditworthiness/reliability of the candidates. An off-take agreement between the farm and the dairy, committing the dairy, would be a very important element of risk-mitigation in the eyes of the bank.

3.43 As mentioned earlier, other important conditions would be:

- the cash flow is captured at the dairy level;
- the piece of equipment is pledged as a guarantee;
- in case of default, the dairy has the responsibility to recover and dispose of the asset (for the realisation of the guarantee by the bank).

3.44 Finally, if such schemes were explored, it should be done in close collaboration with the SAPARD agency. In particular, grant and credit application procedures should be co-ordinated. Furthermore, in case of default - i.e. if the piece of equipment had to be recovered and sold to another party, it seems that, according to EU rules, SAPARD would claim back the total amount of the grant plus some interests based on the national reference rate and a penalty of 10%. This aspect would have to be discussed with other risk-takers, i.e. the main creditors.

3.4.2.3 Fruit and Vegetables Production and Processing and Wine

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
AGRICULTURE				
Food & Vegetable Processing	<i>Same as other processing industry - large investments driven by new EU regulations - investments in food safety and quality upgrading of production facilities.</i>	<i>Financing of a minimum of EU-dictated safety regulations (HA CCP regulations) = €1.1million. Investment needs in canning industry estimated at a minimum of €13 million.</i>	<i>Due to regulatory requirements imposed by EU a number of processing plants expected to be out of business in the next few years.</i>	<i>Most of the canning industry export oriented = stable cash-flow. In some cases bank guarantees available from foreign partners. Well developed market linkages. Leveraged on inexpensive labor.</i>
Agriculture Production at the Farm Level	<i>Profitable at larger farms; orchards and herb growing increasingly profitable niche.</i>	<i>Estimated investments in orchards range from €10 to €13 million.</i>	<i>marketing problems</i>	<i>Good entry point: suitable in peri urban area; Working and investment loans (irrigation, transport)</i>
Wine growing sector	<i>Financing of upstream integration of wineries in grape-growing; Potential for risk-sharing arrangements with large wineries (e.g. Domaine Boyar) which are in great need of guaranteed raw material supply.</i>	<i>Total investment needs vary according to different estimates from €78 million to €110 million.</i>	<i>Cyclical price fluctuation; Capital intensive; Unfair competition from surrounding countries (Moldova).</i>	<i>Require long-term finance; May become viable in the medium term, especially with consolidation; Scope for seasonal finance.</i>

3.45 There is a need for investments in the fruit and vegetable processing industry, the pressure for them to meet the EU standards is rapidly increasing towards 2007. The majority of the enterprises are generally inefficient, incurring high costs because of the use of outdated technology. All the operating plants are required to introduce the EU standards by the end of 2006. The average cost for adopting this system is about €20,000. In order to introduce this system however the plant must have first adopted Good Production Practice (GPP) principles. In the canning industry only 5 out of 57 companies have already adopted these principles and only 10 canning factories have renovated their production and store facilities and so will need the minimum amount of investments for the introduction of EU standards. The remaining 47 companies will need at least €250,000 each in order to introduce the GPP first and then the EU standards. That means that only for the canning industry at least €13 million of investments are needed in the next 2 years.

3.46 It is expected that the orchards and vineyard sub-sector will have to consume a large amount of investments if it is to survive in the EU after 2007. If we assume that only 10 % of the existing vineyards are replanted and the average cost per ha varies between €6,000 and €10,000, the investments needs for the sector are between €78 and €110 million. Similar calculations for the orchards (new plantations on 10 % of the current areas) suggest that between €10 and €13 million investments will be needed. Currently, interest in orchard renewal and especially raspberries, sour cherries, cherries and apples has been increasing, although because of fragmentation of land ownership the potential investors face a lot of difficulties when they buy or rent land for a long period of time.

3.47 Major investment areas include the following:

- Upgrading of facilities and equipment in order to meet EU hygienic standards.
- Improving of food safety and quality by introducing EU standards.
- Renewal/upgrading of equipment for market-led product lines.

3.4.2.5 Tourism and Other Non-Farming Sectors

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>APPROXIMATE TOTAL INVESTMENT NEEDS</i>	<i>CONSTRAINTS/ RISKS</i>	<i>REPAYMENT CAPACITY</i>
TOURISM				
<i>Rural tourism sector</i>	<i>Investment in infrastructure for expansion of rural tourism activities.</i>	<i>Total investment needs vary according to different estimates. SA PARD agency has €40 million of approved, but not yet financed investment projects. Further €13 million are needed for financing of EU-dictated HA CCP sanitary regulations.</i>	<i>Marketing and promotion dependent on the public support. Strong competition from the Black Sea resorts. Cyclical industry.</i>	<i>Require long-term finance; May become viable in the medium term, especially with MoA agriculture and MoTourism promoting rural tourism in the development strategy for rural areas.</i>
TEXTILE AND APPAREL				
<i>Textile and apparel sector</i>	<i>Investment in tools and machinery</i>	<i>Fastest growing industry in the last five years. More than 3,000 SMEs involved in textile assembly production, almost fully oriented to export.</i>	<i>Uncertain future for the industry due to increases competition from Asian countries and diminishing advantage of low labor cost.</i>	<i>Should be given access to working capital due to high turnover and secured cash in the short run. Difficult to justify long-term investments in infrastructure.</i>

3.48 The majority of the rural SMEs in industries other than those mentioned above are in sectors with a low level of capital intensity. These would require bank loan demands too small to qualify for the Facility and are, thus, not analyzed in more detail in this report.

3.49 Some investment requirements can be expected from people engaged in agri-, eco- and other forms of alternative tourism. This sector is still at its early stage of inception. The government understands the fact that the state should invest in infrastructure, while the private sector would bear the cost of investment in hotels, restaurants and tourist attractions. A number of projects with such purpose have already been initiated by the Ministry of Agriculture (under the SAPARD programme for the development of rural tourism) and the Ministry of Economy (for a project on cultural tourism and one on eco-tourism). By its nature, the alternative tourism business is likely to be an SME. This gives an opportunity for local tour operators which have been almost completely pushed out of the mass Black Sea tourism by the big foreign operators. Because of the growing interest in alternative tourism even big operators like TUI and Thomas Cook have been

considering to include eco- and agri- tourism packages for their clients. Both companies recently opened their first countryside hotels in Tryavna, Central Bulgaria

3.5 Main Conclusions of the Assessment of the Demand for Credit of Rural Small and Medium Size Enterprises

3.50 In order to ensure an as efficient use as possible of additional sources for lending to Small and Medium Sized Enterprises in the rural areas, the concept rural would have to be interpreted in a rather broad manner. Too many attempts to define clear parameters in terms of population, population density, relative distance to larger towns and similar should be avoided. Nor should an attempt be made to align strictly with the definition that was developed by the Ministry of Agriculture and Forestry in order to facilitate the implementation of the SAPARD measures. A too severe definition may result in enterprises with the largest potential being excluded. Most of the banks, in particular those who indicated a serious interest in expanding their lending to this sector do furthermore not, as a matter of fact, distinguish so willingly between rural and urban.

3.51 The questionnaires revealed that many of the interviewed entrepreneurs set-up and developed their businesses either with entirely their own resources or with resources borrowed from other sources than banks, in particular from relatives. This does however not mean that a pronounced demand for bank loans from the sector does not exist but only that the climate for lending and in particular for banks and entrepreneurs to enter into a proper dialogue was at the time not as favourable as it is today. The over establishment in the banking sector will necessarily force banks to look for new sectors in order to expand and diversify their lending portfolio. However, far from all enterprises will make it after the completion of the European Union accession process, especially those operating in the agriculture and related sectors, and banks will therefore also in the future have to critically assess loan demands from the sector.

3.52 Despite the call for diversification, much of the activities in the rural areas will for a foreseeable future continue to focus on agriculture production and the processing thereof. Much of the future demand for bank lending will therefore also come from this sector. However, the restrictive regulations and rules imposed by the European Union with regard to both quality and quantity of the produce as well as the hygienic concerns surrounding the food production and processing will, at the same time it will increase the demand for finance in order to restructure and modernise production sites, also lead to many businesses in the sector having to close down. It is believed though that the absorption capacity of those enterprises that will remain in business will be large enough to match the level of the envisaged EBRD lending facility.

3.53 Within the agriculture and food processing sectors, the meat processing industry is the fastest growing. Due to its specific production and processing characteristics, it is also the industry that mostly will need to conform to the new EU production and sanitary rules. The need for longer term investment loans is evident as a result as is the need for working capital loans. Much of the investment loans needed will, due to their size, have to come from sources other than the EBRD lending facility but some of the demand could be accommodated within this instrument. It is estimated that loans in the range of 20,000 – 30,000 € could be extended to entrepreneurs in the sector from the EBRD lending facility. In order to make an proper evaluation of the sector's demand for loans, banks will however have to seriously study and take into account

the entire chain from cattle breeding through slaughter houses to processing factors and identify their respective loan absorption capacity.

3.54 The milk processing and dairy sector will represent another potential client for loans from the EBRD lending facility. Again, banks will have to consider the entire chain in order to identify the real effective demand for and use of borrowed resources. Although in need of investment loans to renew their facilities, many dairies are working under less than full capacity and it is therefore believed that much of the investment in the sector will have to go into the dairy farms in order to ensure sufficient raw material supply. Many investments at farm level will also be of a size that they could be covered by the EBRD lending facility.

3.55 Although the pressure on the fruits and vegetables processing sector to meet EU standards is not as imminent as for the meat and dairy sectors, there is nevertheless an important need to renew the facilities in order to increase efficiency. The amounts needed are in general rather high and may therefore fall outside the realms of what could be considered under the EBRD lending facility. Introducing EU standards which is valued at the cost of approximately 20,000 € could however be considered from these resources.

3.56 The renewal of old vineyards and orchards is a must if Bulgaria wants to stay competitive in this sector. Investment needs of up to 10,000 € per ha have been identified and are well suited to be funded under the EBRD lending facility.

3.57 Other sectors than agriculture and food processing includes tourism and services. Profitable small and medium scale investment opportunities in rural tourism should at this stage not be overestimated though there might be a few instances where lending to this sector could prove to be efficient. The service sector in rural areas is generally demanding loans that are very small and that therefore fall below the intended minimum level of the resources provided by EBRD. A couple of specialised so called micro finance institutions are instead expected to cater for this segment.

3.58 In terms of regions, the largest potential for lending is believed to be in municipalities where in the past many large state enterprises operated. In general, these areas benefit from better infrastructure, more favourable natural conditions and are also closer to larger cities and other important centres.

3.59 In some cases, successful use of borrowed capital can be ascribed to the strong commitment of the local government to encourage economic growth by facilitating privatization, licensing procedures and improving infrastructure.

ANNEX 1

ANALYSIS OF THE FAO SURVEY OF RURAL SMEs

1. In order to identify some of the main characteristics of credit demand in rural areas, the FAO survey was carried out in two stages, surveying a total of 95 rural SMEs. Survey was conducted on the basis of a specifically designed questionnaire for this purpose which can be found in the attachment to this Annex.

Results from the First Stage of the Survey of Rural SMEs

2. First part of the survey was conducted among 45 SMEs in eight municipalities from three regions in Bulgaria – Sofia, Plovdiv and Shumen. 75% of the municipalities were rural, while almost all of the remaining potential borrowers, although from urban municipalities, were living in small towns (up to maximum 30,000 inhabitants) or in villages. According to the Human Development Index from 2003 the surveyed municipalities are ranked in the following way:

Municipality	Overall ranking (1-262)	GDP per person PPP \$ 2001	GDP rank (1-262)	Enrollment rank (1-262)	Literacy rank (1-262)
Plovdiv	9	7 470	21	11	14
Shumen	39	5 824	38	48	43
Veliki Preslav	113	2 216	93	157	145
Elin Pelin	135	4 258	82	247	241
Novi Pazar	139	3 850	110	144	137
Parvomai	169	2 750	219	106	114
Kaspichan	175	3 417	154	233	225
Sadovo	213	2 563	233	115	142

3. The data-set consists of a random set of 45 respondents with the following profile:

Rural economic sectors

Production of

-agricultural raw materials	22 %
-foods	18 %
-other products	8 %

Services 33 %

More than 1 activity 9 %

Legal type of the business:

Limited liability companies	55 %
Sole traders	27 %
Physical persons	18 %

Starting year of operation

1990-96	53 %
1997-00	29 %
2000-04	18 %

Number of employees (permanent plus seasonal)

Up to 10	46 %
11-50	33 %
51-100	11 %
More than 100	4 %

Assets owned

Up to 10 000 EURO	35 %
10 000 – 50 000 EURO	14 %
50 000 – 100 000 EURO	16 %
More than 100 000 EURO	35 %

Summary of results:

4. Statement of credit applications and credit transactions by potential borrowers refer to their most recent loans in the period 2001-04. The following **conclusions** can be made on the basis of the respondents' answers:

- The empirical results suggest that the majority of the respondents (58 %) do not have access to the credit market. This access has however increased significantly during the last two years when the commercial banks became more liquid and started competing among each other for clients on the domestic market.
- Non-price rationing and particularly the lack of collateral was pointed out as the main constrain by those who applied and received a loan and those who applied but were rejected.
- Among those who have been rejected or who have not applied after the lack of collateral (25 % of the respondents), the next most frequent credit constraints are: the high interest rates (24 %) and reluctance to get into debt (22 %). 16 % of the respondents who have not received a credit during the past three years declare that their own income resources are sufficient and do not need a credit, while for 8 % of them the bureaucratic application process is a serious constraint.
- In order to detect eventual wealth biases, the respondents were divided in three main groups according to the number of people employed: up to 10, 11-50 and more than 50. Bank application seems to be biased towards more affluent potential borrowers, since the share of non-applicants or rejected applicants among the micro enterprises is 65 %, among those employing between 11 and

50 people – 60 % and among those with more than 50 people – only 33 %. The average approved applicant employs 47 people compared to non-applicant or rejected applicant with 26 people.

- On the basis of the grouping made above one can conclude that affluent borrowers are less constrained than less affluent. In the first group of respondents (up to 10 people) 41 % are discouraged to apply, while in the third group (more than 50 people) there is no one discouraged and almost all of them are unconstrained.
- Having in mind the big need for reconstruction of the majority of the processing plants more affluent potential borrowers would probably also be constrained to obtain bigger credits for both investment and operational purposes in the future, because if the bank requirements for collateral do not change, they will not have enough guarantee for credits they want to obtain. A large number of respondents did not or could not provide information about the market value of their assets, but the majority of them did not dispose of assets bigger enough to be used as collateral for both working and investment capital.
- The average size of the loans obtained by borrowers with up to 10 employees is 18,000 EURO, by those who employ between 11 and 50 people – 144,000 EURO and for those with more than 50 people – 484 000 EURO.
- A larger share (53 %) of the respondents of those who have received a credit during the last three years, used it for operational purposes, a smaller share - 32 % obtained long term credits, while only 15 % received credit for both working and investment capital.
- There is a big demand for both operational and investment credits in rural areas. From the potential borrowers, 15 % need a short term credit, 18 % - a long term credit and 67 % - both operational and investment credit.
- Although the interest rates in Bulgaria are comparatively higher than in other western European countries, the majority (60 %) of the respondents would like to borrow more at the current interest rates. Of the remaining 40 % who does not need a credit, 55 % declare that they have their own financial resources while the remaining 45 % do not generate enough profit in order to repay the credit and the interest rates.
- Despite the popularity of the government and EU programs for subsidized credits and grants, they are not of sufficient size to serve more of the entrepreneurs living in rural areas. For example only 33 % of the farmers and no one from the processors have applied and have been approved to get a grant or a subsidized credit from SAPARD or from State fund “Agriculture”.
- Although the impact of government and EU programs (and especially investment programs like SAPARD) on credit market is not big, some of the respondents suggested that the subsidies are given to “unsuitable” businessmen

who are not connected with agriculture at all, but have the political connections or the money to bribe the evaluation committee. That suggests that several projects under SAPARD are financed at the moment that would have dropped out under fully commercial interest rate or without any grant.

- Rural non-farm sector cannot be thought of as a homogenous one: it includes self employment, micro and small and medium enterprises, traders. Here are incorporated jobs which range from these requiring significant access to assets and credits (farming, food industry) to self employed activities of low assets requirement (retail trade, repairs, small services).
- The majority of the respondents (80 %) keep financial statements. Among the remaining 20 % can be found both self employed people and rural businessmen who employ more than 50 people. The latter group of respondents operate in the grey sector and are employed mainly in agriculture.

Results from the second stage of the survey of rural SMEs

5. Following the results and analysis of the first part of the survey and initial visit to municipalities by FAO team, a number of other municipalities was selected (10) in cooperating with the UNDP office. The selection procedure aims to ensure 1) representation of municipalities with different economic and social profile and 2) comparison of different SME and their investment intentions. Municipalities were selected in order to insure a presence of a variety of rural activities in selected municipalities, representation of municipalities with different economic and social profile and geographical position. Following this selection criteria, FAO team of national consultants carried out a second survey on a sample of 50 rural SMEs.

6. 80 % of the selected municipalities were rural, while almost all of the remaining potential borrowers, although from urban municipalities, were living in small towns (up to maximum 30, 000 inhabitants) or in villages. According to the Human Development Index from 2003 the surveyed municipalities are ranked in the following way:

Municipality	Overall ranking in 2003 (1-262)	GDP per person PPP \$ 2001	GDP rank (1-262)	Enrollment rank (1-262)	Literacy rank (1-262)
Targovishte	45	5 914	37	83	80
Samokov	63	5 303	44	167	179
Sliven	100	5 642	41	215	208
Razlog	102	2 823	211	37	35
Devin	125	2 885	208	54	61
Aitos	190	3 759	120	197	202
Sungurlare	201	3 470	147	228	228
Nova Zagora	245	3 140	185	245	252
Dulovo	257	2 567	232	256	259
Kotel	262	2 539	235	261	261

Profile of the respondents:

Rural economic sectors

-agricultural raw materials	23 %
-food processing	9 %
-wood processing	9 %
-trade	10 %
-textiles and apparel	9 %
-services	7 %
-other industries	6 %
-tourism	4 %
-more than one activity	23 %

Legal type of the business:

Limited liability companies	74 %
Sole traders	26 %
Physical persons	0 %

Starting year of operation

1990-96	52 %
1997-00	34 %
2001-04	14 %

People employed (permanent plus seasonal)

Up to 10	8 %
11-50	72 %
51-100	12 %
More than 100	8 %

Assets owned

Up to 10 000 EURO	0 %
10 000 – 50 000 EURO	10 %
50 000 – 100 000 EURO	14 %
More than 100 000 EURO	76 %

Main Sectors and Activities

- The survey covered a wide range of SME operating in almost all the sectors of agriculture, industry and services. Almost every fourth enterprise (23 %) is engaged in more than one activity – this is especially true about the enterprises in agriculture and

processing industry. Through such a diversification the businessmen reduce the risk and prolong the production year.

- The majority of enterprises surveyed are medium size companies. 72 % of them employ between 11 and 50 people and 76 % possess assets for more than 100 000 EURO.

Income Sources and Repayment Capacity

- The main income source for the companies is the profit. By diversifying their activity some of the companies are more flexible and can transfer financial means from one enterprise to another. The risk mitigation is the main reason for diversification for 90 % of the companies which operate in more than one sector.
- The repayment capacity of the companies interviewed is very good. Only 12 % of the respondents, who have taken a bank loan, have had some difficulties in repaying the credits. 20 % of the respondents have never taken a bank loan for operational or investment purposes.

Integration in Markets

- All the surveyed companies are market oriented. The majority of them (89%) sell mainly on the domestic market. A major concern for almost all of those producing for the home market is the low purchasing power of the population and the big variation in purchasing prices (for the enterprises in agriculture).
- There are sectors that are almost entirely oriented to international markets – the most typical example is the textiles and apparel. While the export oriented companies are in general more liquid, this is not the case for the apparel industry which works mainly on the basis of CMT system.

Where to Start Rural Lending

- The survey confirmed that the private sector growth is greatest in textiles and apparel, food processing (and especially meat and dairy), construction, tourism and wood processing. Those sectors are most likely to continue to develop, at least until 2007, when they will meet the competition of the EU producers.
- In general export oriented enterprises are the most dynamic and economically viable. There are however exceptions, connected with the textile and apparel industry. The future of this industry is not very sure because of the elimination of quotas from the beginning of 2005 and the prospects for increased competition from some Asian countries. All of the respondents from this sector shared their concern about the expected liberalization of the markets and their uncertainty about their future. On the other hand the majority of the apparel companies work with comparatively cheap and second hand equipment which is not attractive collateral for the banks.

- Other relatively risky sectors are agriculture and bakery. 40 % of the companies in agriculture have never applied or have applied, but not received a bank loan. The main reasons for this high percentage are the lack of collateral, liquidity problems and unstable purchasing prices.
- It is not accurate to choose selected regions in which it would be more recommended to invest than in others. Certainly the investment needs of rural areas vary because of their different specialization. From this point of view the municipalities in which there are more enterprises from the fastest growing sectors (tourism, wood processing, meat industry etc.) are more likely to become potential bank clients for lending operations than others with a narrower or less advantageous specialization (mainly in agriculture or in other stagnating sectors). In our survey such unattractive municipalities are the municipality of Dulovo and Samokov for example.

Investment and Financial Intentions

- The majority of the surveyed enterprises (84 %) have intentions to take a bank loan in the next couple of years or months. From them, 90 % intend to invest and 10 % want the credit for operational purposes only. The range of long term investment intentions is very wide – construction of new or renovation of existing buildings (32 %), purchase of new equipment (78 %), creation of orchards and vines (7 %). The need for operating capital is existent for almost all the enterprises with the exception of those which have a regular cash flow (for example the dairy farms and the restaurants).
- Those who do not intent to borrow investment or operating bank credits range the reasons for this decision in the following way: 1) use firm credits (27 %), 2) have modern buildings and equipment and do not need to make investments (25 %), m 3) do not have a profitable business and will probably close down (25 %) and 4) do not want to expand in the near future, neither need an operational capital (23 %).
- The respondents that expressed an intention to take an investment loan stated that they would do it only if the present terms of lending change in the following way: 1) the time of repayment should be expanded to at least 7-8 years (100 % Of the respondents); 2) the collateral requirements should not be so severe (97 %) and 3) the repayment schedule should depend on the cash flow particularities (29 %).

ANNEX 1

Appendix 1

Questionnaire for the Evaluation of SME Activity, Size and Investment Intentions

SURVEY QUESTIONNAIRE

Date: _____ / 2004 Starting time: _____ Ending time: _____

Surveyor: _____

Region: _____

Municipality: _____

Distance from the nearest commercial centre: _____

Banks present in the nearest commercial centre: _____

Respondent's name: _____

Position in the enterprise: _____

Profile: _____

Type Family business Company/Firm Cooperative Farm Other

1. GENERAL INFORMATION

1.1. Description of the enterprise

Legal status:

- Sole traders
- Partnership
- Registered Company; type: _____

What is the management structure of the company (describe):

Subscribed (Paid-in) Capital (in Euro or local currency):

Year when started activities: _____

Financial history:

- What type of records company has:
 - Balance sheet? Y / N
 - Income statements? Y / N
 - Annual reports? Y / N
 - Business plan? Y / N
- Have the accounts been audited by external/internal auditors (choose one): External / Internal
- If audit was done externally, which is the firm that audited those accounts (put name):

- For how many years back have accounts been audited (put number of years):

Number of permanent employees: _____

Number of seasonal employees: _____

Main activities:	
Agro-Processing

Agricultural production	Cereals
	Cereals for fodder
	Oil crops
	Wine
	Fruits
	Vegetables
	Dairy products
	Meat
Agri-Tourism	
Manufacturing
Textile
Services (hairdressers, garages...)
Other	

2: ASSETS OWNED

How many of the following assets does the company own?

Info collected from questions

Asset Owned	Value when acquired / Purchase Price (Euro):	Replacement Value:	How was the item acquired? 1 = cash 2 = credit 3=other	If credit, what was the source of the loan? 1=supplier 2=relative or friend 3=money lender 4=trader 5=financial institution: 6=other:	Time Period of Loan (months)
1. Land					
2. Buildings					
3. Plant(s)					
4. Equipment/ Machinery _____ _____ _____ _____					
5. Motor vehicles _____ _____ _____ _____					
6. Shop/Workshop					
2. Farm equipment (if enterprise is farm)					
Tractor					
Trailer/cart					
Plough					
Weeder					
Harrower					
Other (Specify) _____					

3. LOAN HISTORY

Please provide information on loan applications by company during the past three years.

It would be particularly interesting to know if they applied and if they already benefited from any support from any of EU-funded credit lines (in case of agri-sector, particularly SAPARD programs).

YEAR	Institution that was approached? 1= commercial bank (name of the bank) 2=moneylender 3=other financial institution (name)	For what purpose was the loan intended? 1= working capital investment (<12 months) 2= longer-term investment (>12 months) 3=repay other debt	What was the size of the loan?	What was the interest rate of the loan?	Repayment schedule / term of repayment	Collateral used by the bank
2004						
2003						
2002						

3.1 If no applications are listed above, why not?- please circle as many as necessary

- 1 = Own income sources sufficient (do not really need loans)
- 2 = Reluctant to get into debt
- 3 = Interest rates too high
- 4 = Term too short
- 5= Do not have enterprises that would make a sufficient profit to repay the loan
- 6= Did not satisfy collateral requirements imposed by the bank
- 7= Not aware of the application process; do not know how to apply
- 8 = Application process too time consuming or bureaucratic
- 9= Do not believe loan application would be approved (no collateral, do not trust the financial institution)
- 10= Other (specify)

.....

3.2 If one or more loans have been received from the same source, please complete the following table:

.1.1 loan	Size of Initial Loan (R)	Has the borrower since taken out more loans of the same type? 1=yes 2=no	If yes, what was the size of the most recent loan? (R)	To what use was the initial loan put?	To what use was the most recent loan put?

Repayment

3.2.1. Have there been any events that made it difficult for the borrower(s) above to maintain loan repayments? Yes / No

3.2.2. If yes, what? _____

3.2.3. What were collateral requirements: _____

SECTION 4: SUGGESTIONS FOR IMPROVEMENTS OF FINANCIAL SERVICES

4.1. What have been the main problems with your present sources of financing?
.....
.....

4.2. Is there interest/demand for more/different kind of loans (long-term, short-term/working capital etc.) in the banks? Yes/No;

4.3. If yes, for which purpose?.....

4.4. How/from which income source would you repay an additional loan?
.....

4.5. How should loans be improved to better suit your needs:

Frequency of repayment.....

Term.....

Collateral.....

Interest.....

Technical assistance in preparation of loan applications and business plans
.....

Other.....

ANNEX 2

SURVEY OF BANK OFFICERS OF 50 DIFFERENT BANK BRANCHES IN TEN PRE-SELECTED MUNICIPALITIES

Questions Addressed to the Banks

- How many current SME and micro enterprises borrowers do you have in portfolio and what is their growth rate over the last years?
- How many investment and working capital loans were disbursed? What are the average loan sizes, ceilings, and other financial conditions by enterprise size?
- Provide main economic sub-sectors ranked by profitability and cash flows of investment opportunities.
- Describe main borrowers' requirements: banking records and credit history, collateral type/loan value ratios, profitability, marketing and cash flow perspectives.
- What are lending approval authority thresholds for branch bank staff?
- Describe lending procedures used for micro, small and medium size enterprises and various economic sectors.

Main Results

1. Average number of business clients per bank:

Companies with up to 10 employees	82
Range	1-350
Companies with more than 10 employees	6.4
Range	1-50

2. Banks' observation on the growth rate of the clients:

General economic and clients' economic performance improving	89 %
General economic and clients' economic performance improving not changing	11 %
General economic and clients' economic performance improving deteriorating	0 %

3. Number of working capital loans:

Average per bank	56
Range	0-460

4. Number of investment loans:

Average per bank	19
Range	0-90

5. Average size of the working capital loans:

Average per bank	36,000 BGN
Range	12,000-120,000 BGN

6. Average size of the investment loans:

Average per bank	106,000 BGN
Range	15,000-500,000 BGN

7. Most attractive sectors according to sector profitability and cash-flow:

<i>Sector profitability</i>	
Food trade and retail	42 %
Textile and apparel	42 %
Wood processing	10 %
Agriculture	2 %
Transport	1 %
Repairs	1 %
Construction	1 %
Tourism	1 %

<i>Regular cash flow</i>	
Retail trade with food	42 %
Repairs	17 %
Textiles and apparel	5 %
Transport	5%
Milk Processing	5 %
Construction	5 %
Trade with petrol products	5 %
Meat processing	5%
Bakery/Confectionary	5 %
Tourism	4%
Other	2 %

8. Most important factor when disbursing a loan:

Profitability	45 %
Collateral type and size	34 %
Cash flow perspectives	15 %
Good credit history	6 %
Marketing skills	3 %

9. Lending approval authority thresholds for branch bank staff:

Number of banks with any lending authority	45 %
Number of banks without lending authority	55 %

10. Average threshold per bank with lending authority:

Average	53,000 BGN
Range	20,000-200,000 BGN

11. Lending procedures used for micro, small and medium size enterprises and various economic sectors:

Differ	0%
Are the same	100 %

12. 100 % of the banks interviewed stated that the successful appraisal and due diligence of the company in loan valuation process depends heavily on the trust between the bank and the client and not on the size or the type of the business.

ANNEX 3

REVIEW AND ANALYSIS OF PROGRAMMES FOCUSED ON SME DEVELOPMENT

1. According to the review of external assistance for SME development in Bulgaria conducted by Bulgarian Chamber of Commerce and Industry¹ in 2003 and 2004, the total disbursements for SMEs for the period 1998 - 2003 accounted to more than 400 million Euro. Out of this amount 49% was disbursed as loans through financial institutions, while the balance was used for various form of technical assistance direct to SMEs. These include assistance for the establishment of legal framework and state policy support, export competitiveness and internationalisation and assistance in providing export promotion. The source of financing SME support is formed by a group of 26 donors composed of 16 bilateral and 10 multilateral donors in the reviewed period.

2. This review shows that more than 160 external assistance programmes and projects were either completed or in the process of implementation to the benefit of SME development.

Multilateral Donors

3. The leading multilateral donors includes EBRD, United States of America, European Union, Germany and IFC.

4. European Union's assistance is provided mainly through EU Phare Programme. The disbursements under the Programme's projects amounted to 10.8 million US dollars in 2000. They were increased by 9.3% in 2001 and reached 11.9 million US dollars, but in 2002 they amounted to 4.8 million US dollars only (for 2003 and 2004 there is only preliminary data available). The total disbursements under EU project and programmes in 1998 - 2002 was 54.6 million US dollars. Most EU projects were in the sector "Assistance to system of SME support services". EU had a substantial contribution in the other sectors and in almost each and every sector and sub-sector there were important EU programmes aimed at creating prerequisites of strategic importance, instrument and institutions of sustainable SME support. Among them are the projects for strengthening the national network of business centers and incubators for SMEs and for certification under ISO quality standard, which were considered of great importance for Bulgarian SMEs. These programmes and projects proved the strong EU commitment to support effectively SMEs in the period of Bulgaria's preparation for membership in the Union.

5. The disbursements under projects of the International Finance Corporation (IFC) from the World Bank group amounted to 26.3 million US dollars during the period under consideration. By its share of 6.9% of the total disbursements, it was the fifth donor contributor to SMEs in Bulgaria. All its projects were in the sector "Facilitation of SME financing". They include significant investments in two venture capital funds and in a leasing company.

6. The International Bank for Reconstruction and Development (IBRD) support to the Bulgarian Fund for Regional Initiatives made it the seventh important donor supporting SME development in Bulgaria. The disbursements under its projects amounted to 8.6 million US dollars or 2.3% of the overall disbursements under donors' assistance to SME development in 1998-2002.

¹ Review and all the data quoted in the Annex 4 obtained from the Bulgarian Chamber of Commerce and Industry.

7. The United Nations Development Programme (UNDP) was also among the important donors that supported traditionally SME sector in Bulgaria. Disbursements under its projects amounted to 8.2 million US dollars in 1998 - 2002. It is however necessary to stress that UNDP was executing important projects financed by other donors. Its assistance was in three subsectors: "SME training support"; "SME consultancy support" and "SME support services institutions".

8. The European Investment Bank (EIB) - by providing a specialized credit line for SMEs long-term lending in Bulgaria, became also an important donor. With disbursements of 8.0 million US dollars and a share of 2.1% of the total disbursements under external assistance, the Bank ranks ninth among all donors.

9. Among the other multilateral donors, that supported SMEs in Bulgaria were the Council of Europe Development Bank (CEDB); United Nations Industrial Development Organization (UNIDO) and United Nations Education Science and Culture Organization (UNESCO).

Bilateral Donors

10. Major bilateral donors include USA, Germany, The Netherlands, Switzerland and the UK.

11. The United States of America is the largest donor among the bilateral and the second among all donors supporting SME development in Bulgarian in the reviewed period according to the level of disbursements. US share of the total disbursements amounted to 84.4 million US dollars. US assistance to SME sector is provided mostly through the United States Agency for International Development (USAID) activities. US offers a comprehensive support to SME development and to the private sector in general. The assistance was provided in all sectors and sub sectors. There were 7 USAID projects with important role for establishing legal framework and raising public support to SMEs in Bulgaria at national and local levels. USAID provided financial and expert assistance to four important projects aimed at strengthening the system of SME support services as well as four projects in facilitating SME financing and two projects on increasing sector's competitiveness.

12. Germany provided a diversified support directly aimed at SMEs need. With a total disbursements of 43.9 million US dollars, Germany was the second largest bilateral donor and fourth among all donors supporting SME development in Bulgaria in 1998 - 2002. Among the 33 projects implemented with German support there were 20 important projects aimed at strengthening the system of SME support services. Six projects were aimed at facilitating SME financing and two - at improving export competitiveness and SME internationalization. Another two projects were implemented in support of the establishment of legal framework and state policy regarding SMEs.

13. The Netherlands is sixth among the donors supporting SMEs in Bulgaria with disbursements of 8.7 million US dollars. A substantial part of its assistance was aimed at strengthening the system of SME support services and their export competitiveness.

14. Switzerland was the tenth biggest donor supporting SME in Bulgaria with total disbursements of 7.9 million US dollars. The Swiss support to SMEs was provided mostly for the

improvement of export competitiveness and SME internationalization and for strengthening the system of SME support services. Significant part of the Swiss support was concentrated in selected regions through comprehensive and practically oriented programmes.

15. UK disbursed 6 million US\$. Important project was implemented with UK support for strengthening the system of SME support services, for export promotion and improvement of state policy to SME development.

16. Total disbursements under projects, supported by Japan were 5.9 million US dollars during the period under consideration. Support provided by the Japanese assistance programme was significant in improving the services to SMEs and strengthening state institutions capacities to support SMEs.

ANNEX 4

SHORT DESCRIPTION OF THE SURVEYED MUNICIPALITIES¹

TARGOVISHTE

2. The municipality of Targovishte is situated in the eastern part of the Danube valley and is part of the Northeastern-planning region. The city of Targovishte is the administrative center of the municipality and of the district. The total population of the municipality is 61,241 people, distributed in 41 settlements (1 city and 40 villages). Two thirds of the population lives in the City of Targovishte (40,775). The age structure of the municipality population is a little bit better than the country average.
3. The total territory is 69,159 ha, of which about 46 thousand ha agricultural lands and 16,630 ha – forests. The relief consists predominantly of plains and hills. The climate is temperate continental. There are strong northeast winds in winter, and summers are hot and dry.
4. The municipality of Targovishte has a very convenient geographical location. The city of Targovishte is situated on the two banks of the Vrana River. It is a crossing of the roads leading to the cities of Sumen and Razgrad and the towns of Popovo and Kotel.
5. Targovishte municipality falls in the group of the medium developed municipalities in the country. In terms of HDI it ranked 45th and in terms of GDP Index – 37th.
6. The number of the active non-financial non-budget enterprises is 1,501 and the company density is 24.5 companies per 1,000 inhabitants, which is lower than the country average. About 99 % of the active non-financial non-budget enterprises employ below 100 persons. The share of large companies in the total number of business is just 0.9 %.
7. Manufacturing enterprises create about half of GVA. Another sector, playing an important role is trade, contributing 12-15 % of the GVA. The GVA created in agriculture accounts for 9-10 % of total GVA. The average agricultural land per capita is 0.63 ha, which is above the average for the country. The number of the agricultural producers registered in the municipality is 210. Grain production is leading on the territory of the municipality – wheat, barley and maize are sown on 48 % of the managed arable lands. Sunflower is also grown, taking 12 % of the total arable land. Perennials are planted on part of the remaining agricultural lands, where vineyards are predominant.
8. Manufacturing plays the leading part in terms of employment creation. Second in importance to the local employment is the trade sector, which provides between 20 and 25 % of the total number of jobs in the separate years. Agricultural sector is ranked third in terms of employment creation, contributing to about 15 % of the local employment. Although the number of large companies is small, they employ a significant part of the local labor force. Small and medium sized companies gradually increase their importance to the level of employment.

¹ Data in the annex based on the “Baseline surveys on economic development potential” of selected municipalities in Bulgaria, study carried out by the Ministry of labor and social policy and UNDP under the Project “Job Opportunities through business support” (JOBS), Sofia , 2001.

9. Targovishte municipality is one of the regions with the highest level of unemployment, registered in the country. In 2002, the difference between the levels of local unemployment and the country average was 12.4 percentage points. In 2002 and 2003 the number of unemployed decreased, mainly due to the active measures for employment promotion of the Ministry of labor.

10. Targovishte municipality has a good potential for economic development. Its good geographical location and fertile soil allow for the development of agriculture, manufacturing and trade.

SAMOKOV

11. Samokov municipality is located in Sofia district, covering 19 % of its territory (1,303.6 sq. km). Its strategic geographical location combines with a mountainous relief, which restrains the development of intensive farming, while creating excellent opportunities for year-round tourism and winter sports. High quality drinking waters and spa centers present another valuable asset for tourism development. Samokov municipality also shelters the Rila National park – one of the largest protected natural territories in Bulgaria. The town of Samokov is rich with cultural and historical traditions.

12. The total population is 42,431 people. Due to its mountainous relief, the municipality is comparatively sparsely populated – 32.6 persons per sq.km. The negative population dynamics resulted in unfavorable age structure and aging population.

13. The last couple of years witnessed a boom of newly company registrations, mainly in trade and healthcare. Almost all the companies are SMEs. The number of large enterprises is only 7.

14. Manufacturing and tourism dominate the economy. Manufacturing has a significant share in the local GVA. The leading local industries include textiles, metal processing, and the production of machinery, equipment and electro-technical devices.

15. Total agricultural land amounts to 49.5 thousand ha, or about 1.1 ha per capita of the population. Arable land accounts for about 40 % of the total agricultural land, and forests take 59.5 thousand ha.

16. Prior to the reforms, crops accounted for 57 % of the local agricultural output. Fodder crops (43 %) had a major share in the crop mix, followed by cereals (38 %) and vegetables (14 %). Potato growing earned a significant share of the agricultural revenues in the municipality, since the local varieties are well accepted on the domestic market. The transition brought a significant change in the crop mix with a reduction of yields and land under cultivation. Potatoes and wheat gradually took over and became the staple crops for the municipality.

17. Manufacturing has the highest share of the total employment in the enterprise sector, having engaged almost half of the employed. Hotels and catering are the second biggest sector in terms of employment generation, occupying 20 % of total employment. Samokov municipality employs 2.3 % of the entire hotel and restaurant personnel in Bulgaria.

18. In contrast to other municipalities, agriculture and trade do not post a substantial employment contribution. That is determined by the low level of agricultural development, while the modest employment in trade results from the good employability of other local industries like manufacturing and tourism.

19. The level of unemployment is higher than the country average. It remained high even after 2000, affecting 42 % of the population.

20. Samokov municipality is situated at convenient distance from the capital Sofia and the internationally famous tourist resort Borovetz. Combined with the local natural and economic conditions, these assets cumulate a good potential for development.

SLIVEN

21. Sliven municipality is situated in the Southeastern region of Bulgaria and covers 1,367 sq. km. It has a population of 137,073 persons and is one of the ten biggest municipalities in Bulgaria. It consists of 48 settlements – 2 towns and 46 villages.

22. According to the HDI Sliven municipality is one of the medium developed municipalities in Bulgaria. In the last couple of years it started to gradually recover part of its economic potential.

23. The number of the active non-financial non-budget companies is 3,947. The company density is 25.8 per 1,000 inhabitants, which is quite close to the country average. Like in most municipalities in Bulgaria, about 99 % of the active non-financial non-budget enterprises are small and medium-sized. The number of the large companies is continuously decreasing and they represent only 0.8 % of the total businesses. All the large companies, except one, are registered in the town of Sliven.

24. The agricultural land amounts to 70,960 ha. The territory of the municipality includes 51,544 ha of arable agricultural land and approximately 45,800 forestry land. About 33 % of the arable land is under irrigation. The average arable land size per capita is 0.2 ha, which is well below the country average. The number of agricultural producers, registered on the territory of the municipality, amounts to 390 persons.

25. Grain crops are leading in the plant growing sector, sown on 41 % of the managed arable land, where wheat, barley and sunflower are the leading crops. Perennials are planted on part of the remaining agricultural lands where vineyards and peaches are predominant. As far as animal breeding is concerned, poultry, sheep, goats, pigs and cattle are bred on the territory of the municipality.

26. The sector with the highest share in the employment is manufacturing. It employs 39 % of the employed in the non-financial non-budget sector. Second in importance to the employment is trade. The relative share of the employed in the commercial companies is 23 %. This high percentage is a result of the decreased employment in some leading sectors, like agriculture, manufacturing, electricity, heat, gas and water supply and the increased employment in trade. Other sectors, which registered growth in employment, are transport and communication, and financial services (other than banks and insurance companies). The average employment in

Sliven municipality marked a gradual decline in the transition period. The average employment per enterprise is 5.8 persons.

27. The unemployment rate in 1997-2001 was 16-19 % and was higher than the country average. This was due to the industrial decline and to unfavorable features of the local labor force which have low entrepreneurial skills. The potential of the municipality is connected with its good location, favorable soils and traditions in a number of industries – textile, food processing, machine-building etc.

RAZLOG

28. Razlog municipality is situated in the southwestern Bulgaria in the Razlog valley along the Mesta river basin in the foothills of the mountains Pirin, Rila and Rhodope. The municipality covers an area of 375.8 sq. km and comprises a stretch of the Pirin national park and the Rila national park. The municipality is also the site of the largest Bulgarian biosphere reserve.

29. The population of the municipality is 22,197 people. The density is 59.06 persons per sq. km, which is lower than the country average. The number of population has been relatively stable in the last years. Inside the municipality the number of population in the villages has even grown, as opposed to a decrease in the urban population. This can be explained by the increased migration towards the villages.

30. According to the HDI Razlog municipality ranks 102th among the other municipalities and in terms of GDP Index it ranks 211th, which is much lower than the country average.

31. 1,500 companies are registered in the municipality. Yet less than one third report results on their activity. The company density, based on the active enterprises, is 21 companies per 1,000 inhabitants, which is a comparatively good indicator for the rural municipalities. Company size structure is similar to that in other small municipalities in the country. SMEs comprises about 98.5 % of the active companies in the region.

32. The prevailing part (45 %) of the active companies operates in trade. The company concentration in manufacturing (19.5 % of the active enterprises in the region) and hotels and catering (16.8 %) is relatively high. The share of manufacturing in the sector GVA is 63 %. Forestry and wood processing are typically well developed, as well as food processing and ready-to-wear industries. In contrast to other rural regions, the hi-tech sector is comparatively well developed. Two US companies made relatively big investments in the production of telemetric equipment and electro-mechanical devices.

33. The natural resources favor the development of agriculture and forestry. Arable land accounts for 9.1 ha and forest lands cover 24,000 ha of the municipal territory. Potatoes, beans, tobacco, cereals and fodder crops are the main agricultural crops.

34. The high concentration of labor is another typical feature of Razlog municipality. 25 of the largest enterprises in the municipality create about three quarters of local employment and 10 of them, with the highest employment, comprise 56 %.

35. Almost 60 % of the employed in the municipality work in manufacturing. Construction and trade are next in importance. The minor share of employment in the service sector illustrates its underdeveloped position in the locale economy. The registered unemployment rate in Razlog municipality stands close to the country average.

36. The significant changes in the local economy over the last years, combined with the favorable natural conditions, the qualified labor force and the good cooperation between the local authorities and the business community prove that the municipality has big potential for economic growth.

AITOS

37. Aitos municipality is one of the biggest rural municipalities in Bulgaria. In terms of population it ranks 21st among all the rural municipalities in Bulgaria and 3rd – in the Southeastern planning region. The population amounted to 30,709. The population growth is negative, though the decline rate is lower than the country average.

38. There are 2,010 registered companies on the territory of the municipality, of which only 635 are active. The active companies' density is 21 companies per 1,000 inhabitants. The active companies are mainly micro- and small-sized and their share in the total number of companies is 98 %. The large companies are quite few, but they provide the majority of jobs.

39. Though the main share of registered companies is in the sector of services, the GVA is created mainly by the agricultural and industrial sectors. The importance of agriculture is higher than in the country and in the district, to which the Aitos municipality belongs.

40. The GDP per capita is much lower than the country and the district average. The structure of the local economy and the relatively lower efficiency of the local companies can explain this fact. The low labor productivity results in low wages and in low living standard of the local population.

41. Aitos municipality is a rural area depending mainly on agriculture as a source of employment and incomes. Cereals and technical crops account for the main part of the area under cultivation.. Second in importance are the perennials – vineyards, cherries and peaches. The specialization varies by the size of the agricultural holding – small farms specialize in vegetable production while large produce mainly cereals and oilseeds. The diversification of the agricultural production is small and farmers are vulnerable to fluctuation in prices. Land ownership is fragmented and agricultural holdings, cultivating less than 10 ha predominate. Land use is however concentrated and large agricultural holdings cultivate more than 95 % of land.

42. The unemployment rates in the municipality are higher than the country average. The vacancies are very limited and despite the active labor policy measures the pressure on the labor market is high.

43. Despite the stagnant current economic situation, the municipality has a potential for economic development. Local actors perceive that the most promising sectors are agriculture, food processing and light industry.

SUNGURLARE

44. The municipality of Sungurlare is one of the biggest, by territory, in the Bourgas district, Southeast Planning Region of Bulgaria. It is situated on an area of 824.4 sq.km.

45. The territory of the municipality is a rich combination of mountain, hilly and flat terrain. The climate is moderately continental. It is characterized by mild winter, early spring mild summer and warm autumn. The rainfalls are insufficient. The soils are predominantly forest maroon, which favor the viticulture, vegetable and tobacco growing and almost all kinds of grain crops.

46. There are 31 settlements in Sungurlare municipality, with a total population of 15,544. Of them, 3,717 people live in the administrative center – the town of Sungurlare. The population has been constantly decreasing. This is due both to the migration to the bigger cities and the poor natural growth indicators. The combined educational index is very unfavorable and this fact can be an obstacle for the further social and economic development of the municipality.

47. Sungurlare municipality is among the medium developed areas in the Bourgas district. In recent years the economic and social conditions in the municipality improved substantially. According to the overall HDI the municipality is ranked 201st among the municipalities in Bulgaria. In terms of the economic component of the index, the GDP index, the municipality is even in better position, ranking 147th.

48. The number of active non-financial non-budget enterprises in the municipality is 165, and the company density (10.1 per 1,000 inhabitants) is lower than the country average. The investment activity in the municipality is still quite low and substantial investments have been made in only one-two local companies. Vine growing is a sector with established traditions. The financial resources in the agricultural sector are however limited, as individual farmers dominate it.

49. The prevailing part (41 %) of the active companies in the municipality are from the trade sector, most of them being micro-companies. Second in importance in terms of company concentration the agricultural sector (28 %). Manufacturing companies account for 9 % of the active businesses. Other sectors with relatively high concentration are hotels and catering (11 %) and transport and communications (8 %), although none of those companies employed more than 10 people.

50. Manufacturing enterprises generates the major part of GVA in the municipality. Other sectors, playing an important role for the GVA generation are agriculture and trade. The agricultural sector generated between 10 % and 17 % of the local GVA in the separate years.

51. The arable land in the municipality is not much and accounts for only 35 %, as substantial part of the municipal territory is in the east Stara Planina Mountain.. This, however, allow the development of cattle breeding and vine growing in the area, which are the sectors dominating the agricultural activities. Between 25 % and 30 % of the active companies are from the stock-breeding and vine growing sectors. The number of registered agricultural producers is 24 and the number of the registered tobacco growers is 770 since tobacco growing is an important economic activity in the municipality. The only large company, giving the specific characteristics of the municipality, is “Vinex”, Slavianzi.

52. The level of unemployment is substantially higher than the country average. The unemployment issues occur as a result of the lack of large enterprises in the area. The other major reason is the low level of education and qualification of the local labor force.

53. Sungurlare municipality has good potential for economic development. The favorable soils, the hilly relief, the warm climate, the relatively long autumn are important conditions for the development of vine growing and wine production, vegetable and tobacco growing and for almost all grain crops.

NOVA ZAGORA

54. The municipality of Nova Zagora is a rural area located in the fertile Thracia Valley. It has a relatively well-developed infrastructure and good access to road and railway transport.

55. With its total population of 47,994, Nova Zagora ranks third largest among the rural municipalities in Bulgaria. The municipal center – Nova Zagora, is surrounded by 33 small settlements. The population density in the municipality is 55.2 people per sq. km. In the transition period the population suffered a decline determined mainly by the negative natural growth and outward migration. The population in the villages is aging, with a higher population drop in the smaller settlements. The share of the working age population in the municipality is below the country average.

56. There are 2,950 registered companies, less than 50 %, of which are active. The density of 28 companies per 1,000 inhabitants is comparatively low. The share of micro-companies has been increasing, accounting for about 94 % of all registered companies. Micro and small companies create about 60 % of the local employment.

57. The majority of the companies (80 % of all registered companies) operate in the service sector, predominantly in trade. Agriculture and manufacturing generate a bigger share of the GVA (respectively 60 % and 30 %). Agriculture creates most of the jobs (30 % of the employed).

58. The municipality has excellent natural conditions for the development of agriculture. The soils and the climate allow for the efficient growth of a large variety of agricultural products. Cereals and sunflower are the staple crops in the municipality, accounting for up 90 % of the arable land. Vineyards and fruits are also essential. Livestock numbers have considerably declined in the transition period. The size of agricultural holdings is larger than the country average.

59. The unemployment rates have been steadily increasing over the period 1997-2001. Very high is the share of unemployed under 30 years of age. In the same time one of the main problems of business community is the emerging deficit of qualified labor force.

60. In view of their good potential for development, agriculture and food processing have the capacity to boost local economic growth. The rate of development and the efficiency of these sectors will determine the overall development of the municipality.

DULOVO

61. Dulovo municipality is situated in the northeast part of the Danube valley. It is part of Silistra district, Northeast planning region. The territory of the municipality is 56,702 ha.

62. The relief is predominantly flat with height above sea level of 150-250 m. The climate is temperate continental. The territory of the municipality is largely opened to the north. The road transportation network is well developed, consisting mainly of forth grade inter-village roads. The first grade road Silistra-Shumen crosses the municipality.

63. The population is 30,712 inhabitants and includes 27 settlements. The municipal center is the only town and has a population of 7,108 inhabitants. The municipality has a relatively good age structure and the natural growth indicators of the local population are more favorable than the country average. The most numerous ethnic group in the municipality is that of ethnic Turks, comprising more than two thirds of the population.

64. Dulovo municipality is among the most underdeveloped areas in Bulgaria. According to the HDI the municipality is one of the most poorly developed economies in the last couple of years. The last HD index places Dulovo on 257th among the 263 municipalities in Bulgaria and the GDP index – to 232nd place among the municipalities.

65. The number of active non-financial and non-budget enterprises is 451 and the company density is 15 companies per 1,000 inhabitants, which is nearly as two times as low the country average. About 99 % of the active non-financial non-budget enterprises are SMEs, most of them being micro-companies, employing up to 10 persons. The number of the large companies is small and they operate predominantly in manufacturing.

66. Highest contribution to the GVA generated in the municipality, have the enterprises from manufacturing, followed by those from trade and agriculture and forestry. The economy of Dulovo is predominantly agrarian, with weakly developed industrial sector, and the service sector is limited to the scope of the municipality. The sector structure of the economy explains the low productivity.

67. The territory of the municipality includes 32,520 ha of arable land and approximately 800 ha of forestry lands. The arable land per capita is 1 ha, which is above the average for the country. The number of the agricultural producers registered on the territory of the municipality, amounts to 170 entities. Grain production is leading (wheat, barley and maize). Sunflower is also grown, as well as perennials but on significant smaller part of the land. Tobacco growing is well developed too. The number of the registered tobacco growers is 2,068.

68. Highest contributions to the municipal employment have the manufacturing companies. They employ more than 50 % of all employed in the company sector of the municipality. In the agricultural sector are employed 15 % of the total number of employed in the municipality. The data do not include however the individual agricultural producers who would substantially increase the importance of agriculture to the local employment level, as its share would exceed that of the manufacturing. Trade companies employ a little over 25 % of the employees in the local enterprise sector.

69. The level of registered unemployment in Dulovo municipality is close to the county average.

70. The future prospects for development are connected with the good geographic and climatic conditions and the abundant soil resources that facilitate the development of grain, technical cultures and fodder.

DEVIN

71. Devin municipality is located in the Southwestern Rgodopes along the Vacha river. It borders to the south on the republic of Greece. The relief is mountainous with steep slopes and deep river gorges. The municipality is rich in water resources –springs, rivers, dams and thermal spas. The mineral waters are drinkable and have curative effects. The soils in the municipality do not favor the development of agriculture. The forests, rich in game, are the biggest assets of the municipality. Three natural reserves have been established to protect the variety of species.

72. The technical infrastructure is not well developed. The high altitude and the steep slopes hamper its maintenance. The infrastructure is a serious constraint on the economic development of the municipality and the utilization of its natural resources.

73. The number of population is 15,094 persons. The density is much lower than the country average, owing to its peripheral border region location. The population dynamics is negative: the absolute population number is one on the decrease and this is due to the outward migration to other urban areas and emigration, mainly to Turkey. The outward migration to areas with better prospects for employment is rendering Devin into a gradually depopulating municipality. In the near future there might be serious problems with aging population and depopulation.

74. The number of companies registered in Devin municipality is 1,130. The company density is 75 per 1,000 persons. As per active companies, this density falls to 39 firms per 1,000 inhabitants. Over the past few years, the number of newly established companies has steadily decreased as a result of the decreased number of newly established enterprises in the field of trade, forestry, hotels and catering.

75. The economic transformations have brought about profound changes in the economic texture of the municipality. The closure of the small manufacturing enterprises that were spread in almost all the settlements in the pre-reform period, left little other opportunities for employment except agriculture and forestry. The local population whose mentality and values had been shaped by life in an isolated community had to adjust to the completely changed economic pattern of the municipality

76. Agriculture and tourism are perceived to be the most promising sectors in the region. The light industry (and mainly wood processing) has a good potential for development. Proximity to the border with Greece is also expected to dynamize the region in the future.

KOTEL

77. The municipality of Kotel is situated in Southwestern Bulgaria. The territory of the municipality is 858 sq.km. The relief is mountainous with height above sea level of 520 m. The highest peak is Razboina (1,128m). The region is famous for its karst forms [caves, waterfalls, springs, etc.], which make it quite interesting and beautiful, and attractive from a tourist point of view. The climate is middle continental and transcontinental with influence of the mountains – snow in the winter, nice summer, long and warm autumn.

78. The municipality of Kotel has relatively good density of the road network, close to the average of the country. The road of the first and second-class roads is limited [54.3 km] but the network of third- and fourth-grade roads is well developed. The only first class road is from the village of Mokren to the Petoluchka crossing, connecting the municipality with the main road E 773 Sliven-Burgas.

79. The municipality of Kotel consists of 27 settlements (1 town and 26 villages) and has a population of 22,000 people. Almost two-third of the population is grouped in three settlements: the municipal center [the town of Kote], the village of Gradets and Yablanovo village. In the period of the last three centuries, the population of the municipality has declined by about 9%. Nevertheless, municipal population has a relatively good age structure, which is due both to the better natural growth as compared to the country average and the specific ethnic composition of the local population.

80. The Educational index of Kotel municipality is 0,866, which gives it penultimate ranking 261st among the municipalities of Bulgaria. The high percentage of the ethnic Turks group and particularly of the group of ethnic Roma is likely responsible to a great extent for the bad education indicators. This will be a serious obstacle in the economic development of the municipality.

81. In the past years the municipality of Kotel has been continuously ranked last in terms of Human Development Index, calculated with the UNDP methodology. It is almost entirely located in the region of Stara Planina Mountain and the arable land in the municipality accounts for the modest 19% of its territory. The results are an underdeveloped agricultural sector, which could not provide alternative employment to the people made redundant after the substantial lay-off in the past decade.

82. The number of the active non-financial, non-budget enterprises in Kotel municipality at the end of 2001 is 313, and the company density is 12.9 companies per 1,000 inhabitants, which is more than two times as low as the country average. In 2001 the share of SMEs in the municipality is 99% and micro-companies is 94.9%, which means that the local economy is in fact driven by micro-companies, providing employment to the owner and his family members and in some case to two-three hired employees.

83. In the 1997-1999 period, manufacturing enterprises created nearly half of the gross value added in the area but in 2001 their share in GVA decreased to about 16%. In the last years, the main source of income in the municipality became forestry and the wood processing, followed by other agricultural activities, mainly stockbreeding and vine growing. The agricultural sector contributes to about 21% of the GVA, created in the municipality in 2001. Another sector, which marked an increase in terms of its share in GVA, was trade [about 20% in 2001] though that was

mainly a result of the shrunk activity of the other economic sectors. The capacity of the tourist sector was not utilised at all and the share of tourism in the GVA, generated in the area was only 2-3%. The sector has a high development potential and its development could contribute to the solution of the social and economic problems in the area.

84. The territory of Kotel municipality includes 17,064 ha of arable land and approximately 48,900 ha of forestry lands. The average agricultural land per capita in the municipality is 0,7 ha, which is closed to the average for the country. The number of the agricultural producers registered on its territory is barely 14 persons. Grain production is leading on the territory of the municipality, mainly wheat, barley, maize and sunflower/ Vegetable production is best represented by potato growing. Perennials are planted on part of the remaining agricultural lands, mainly vineyards and the tobacco variety "Iztochen Balkan". On the territory of the municipality are registered 180 tobacco growers.

85. The sector, playing a decisive role for the local employment in the last years is agriculture and forestry. In 2001 is employed over 22% of the employed in the municipality. Another sector with a substantial impact on the levels of local employment is trade. In the recent years the sector employed about 20% of the total number of parity. Moreover, only one industrial enterprise employed more that 50 people. Qualifying as a medium-sized company. All other companies are of small size. The only companies employing over 100 people in 2001 are the Employment Association, established under one of the active measures on the labor market, the municipal hospital and the state-owned wood processing and landscaping enterprises.

86. The level of registered unemployment in Kotel municipality is about two times as high as the country average. The average number of unemployed registered annually reached its peak in 2000 [3,629 people] but in the following two year the number of unemployed decreased so that in 2002 it was 3.404.

87. The decreased number of unemployed in the municipality is to a high extend as a result of active measures and programs for employment promotion, carried out by the MLSP. In 2000, Employment Association was registered in the municipality and in 2002 the program "From Social Assistance to Employment" was launched, which was focused on long-term employment with low level of education and qualification. Another instrument used to fight unemployment in the area were the program for temporary employment, although their scope has been gradually decreased during the past years.

88. The beautiful and preserved natural environment, the favorable conditions for the development of animal breeding and vine yard growing, the rich cultural and historical heritage give good potential for the development of Kotel municipality. About 780 culture monuments, including five architectural preserves (Kotel, Zheravna, Katunishte, Medven and Gradetz] and two natural reserves are situated on the territory of the municipality.

ANNEX 5

OVERVIEW OF PRIORITY SUBSECTOR IN RURAL AREAS

Main Subsectors

1. Food industry consists of 13 sub-sectors: meat and meat products; canned fruits and vegetables; fish/seafood; animal fats and vegetable oils; milk and dairy products; grains and cereal products; pet foods; bread milling, confectionery and other cereal products; sugar, chocolate and cocoa products; food additives; diet foods; alcohol: wine; beer and malt manufacturing; mineral water and soft drinks.
2. The largest number of registered companies is in the cereal food industry (439), meat processing (274) and beverages (186). The highest value of sales is registered by the bakery sector (27 % of the total food sales), beverage production industry (26 % of the total), and meat and fish industry (19 % of the total).
3. Major products include flour and other grain products, sunflower and other vegetable oils, dairy products, wine, tobacco, processed fruits and vegetables, essential oils, fresh and dried mushrooms and herbs. Major exported products are grains, sunflower, vegetable oils, dairy products, wine, tobacco, processed fruits and vegetables, essential oils and herbs. It is estimated that the local food processing industry sources (on average) 30 percent of its raw materials from imports.
4. Most export oriented sub-sectors are canned fruit and vegetables (32%), fish/seafood products (21%) and beer and malt manufacturing and other beverages (20%). For the remaining sub-sectors, less than 10 % of the production is export oriented. Local and international experts agree that the best opportunities for Bulgaria to compete in international markets, especially in European markets, exist in the area of fruit and vegetables and wine.
5. Parallel to the formal processing industry, almost half of the food companies are estimated to operate in the grey sector with the highest number being in the beverage and bakery industries.

Meat Processing

6. One of the most dynamic sectors in Bulgaria. Over the past four years, a large number of new companies have emerged in this sub-sector and the growth is the highest of all the food processing sub-sectors. Partly the reason for these recent developments is the increased consumption of ready and semi-ready convenience foods, and increase in purchasing power of local consumers..
7. Companies face frequent fluctuations in prices of raw meat, as well as lack of a constant and reliable meat supply. Raw meat supply to the processing industry is closely related to price and quality of raw meat sold in the retail market. Usually, when local meat has a high price, processors prefer to use imported meat.
8. New EU's sanitary and hygiene standards that were adopted in 2003 and started to be implemented in 2004 are inducing a major transformation and restructuring of the sector whereby

a number of producers and processors are forced to close their businesses under a heavy scrutiny of the National Veterinary Service.

9. Out of a total of 607 meat processing plants (including those that are unregistered), operating in 2002, 150 have already been closed down. Of the remaining, only 20 processing plants fully meet the requirements of the national legislation and have EU approved facilities. These include four pig meat slaughterhouses in Svishtov, Vratza, Silistra, Shumen, nine poultry meat slaughterhouses and processors (mainly for ducks and geese) and five meat processing facilities for red meat. In addition, Bulgaria has two EU approved facilities for game meat and four seafood plant facilities (two for caviar and two for fish). Audits (inspections) carried out by the National Veterinary Service have made recommendations for improvements to be made in 492 plants. The facilities, which will not be able to meet the sanitary requirements, will be shut down in 2005 and 2006. This will increase unemployment in some rural areas, but is an inevitable step resulting from the commitments of the Bulgarian government to the EU during the accession negotiations.

10. Cattle and pig inventories decreased sharply during transition as herds of the former state and cooperative farms were slaughtered or sold off. In the period 1990-1997 the number of cattle decreased almost three times. After the grain crisis from 1996-97 the livestock production stabilized and even started to grow, reaching 634,000 heads in 2001. The larger part of the cattle is of milk species and animals are used for the dual production of milk and meat. Although the percentage of combined breeds is growing, the predominant share of meat production comes from milk breeds. Approximately 60 % of the beef is produced on small and medium-sized farms. In most cases this meat is for self consumption and is not offered on the market. The lack of reliable supply of raw material from the point of view of quantity and quality is the main reason for the considerable share (about 40 %) of imported beef for the domestic consumption. The imported beef is used mainly for processing (Bulgarians do not have the habit to consume much beef, because pork has traditionally been the main meat consumed).

11. Although pork remains the mainstay in the diet of Bulgarian consumers, poultry has lately displaced it on the market because of lower and more constant prices and changes in the food habits of the population. As in the case of cattle breeding pigs are bred mainly for subsistence and on small farms. The number of animals fluctuates from year to year depending on the prices of fodder. There are two main reasons for the increasing share (about 30 %) of imported meat in the domestic consumption. The first is connected with the lower prices of pork in some other countries and the second with the low ability of the local farmers to deliver big lots of animals of uniform quality.

12. The enterprises in the meat industry tend to be much smaller than in Western Europe and more heavily concentrated on second stage meat processing, rather than on slaughtering. The annual capacity of a large Bulgarian meat processor (about 3,600 tons) for example is equal to the week output of only one of the 10 processing plants belonging to the Spanish company, Campofrio. The concentration and consolidation of the meat processing industry after 2007 is the only way to survive in the enlarged European Union according to the opinion of the experts in the branch.

13. The total investments in the meat processing sector in the next two years are estimated at 125 million Euro¹. This is the amount needed for the industry to invest in the processing facilities in order to reach the standards prescribed by the new legislation and comply with the EU sanitary regulations. Detailed analysis of the total demand for investment in the sector is provided in the main report.

Milk Processing and Dairy Sector

14. This is the other sector of the food industry that will have to quickly reshape to meet the EU standards which are gradually coming in force since 2002 or face closures which already started last year. The new EU hygiene and sanitary norms in the industry should be fully put into practice by 2010 according to agreements between the Government and EU. Dairies that will not meet EU requirements by 2007 will not be able to export their produce into EU, and 2010 they will have to face closure.

15. Only in 2003, mass veterinary inspections resulted in closure of 25% of mainly small dairies for not meeting the standards that are being harmonised with the EU standards. The main reasons for closure were lack of cooling equipment, excess water content in fresh milk, poor hygiene conditions and shorter than required ageing period for processed dairy products. It is expected that most of the remaining small dairies will close in the next five years.

16. As of August 2004, there were 318 dairy plants operating in the country: 213 of them with industrial capacity, while the remaining 105 are small processing units. Only 10% of the operating enterprises fully meet the national requirements; 181 big and 93 smaller processing dairy plants have been categorized by the National Veterinary Service in the second group, i.e. their production and store buildings might meet the sanitary norms by the end of 2005.

17. The sector is currently mainly oriented to the domestic market but traditional products like the feta cheese and the yellow cheese are well known on the international markets. Although only a 3% are licensed to export to the EU (10 dairies), in the last four years (2001-2004) the export of dairy products has increased by almost 80 % showing the good potential of the industry. The main markets are the USA (20 %), Greece (18 %), Germany (14 %), Lebanon (11 %) and Australia (10 %). However, these exporters also face difficulties related to the protection of their trade marks and brands. For example, Bulgarian exporters are not able to export under the label "Feta" for "Bulgarian white cheese" since these two appellations are already patented by Greek and Turkish parties.

18. The industry consists of two types of processors: small processing plants called 'mandras' with a low cost policy producing only a few varieties of long-lasting cheese (such as feta) and large, modern, processing plants (mainly with partial foreign ownership) which have the capacity to compete internally and in the wider EU market.

19. After the break up of the large co-operative state farms at the beginning of the 1990s and the consequent redistribution of co-operatives' assets, the majority (over 80%) of the milk production (total of 370,000 cows in 2002 .) has moved to small private farms with herds of less

¹ Estimate provided by the Union of Bulgarian Meat Processors; mostly for large investments close to one million Euro per investment, but the need for smaller, working capital investments and more specific investments is needed by the same processors.

than 10 animals. 48. Farms are characterized by an inferior production processes, technologically primitive breeding methods and a lack of mechanization. Cattle breeding is equally spread around the southern region of Bulgaria, but the most promising regions where more commercially-oriented farmers are emerging are the regions of Veliko Turnovo, Haskovo and Plovdiv. One of the biggest problems in the sector is the supply of quality raw milk. Still 60 -70 % of the supplies come from small and medium dairy farms with 1-2 cows which do not comply with the sanitary and hygienic requirements. However, during the survey it became apparent that the new breed of farmers who run medium size farms (10-30 cows) account for an increasing proportion of milk production. The number of these specialised farmers has increased over the last five years, particularly in the in regions of Veliko Turnovo and Haskovo. Farmers are usually young families, in some cases former workers of large state-owned co-operatives, with strong technical backgrounds and some agricultural education. In many cases these farmers rent or purchase buildings and machinery from the dismantled cooperatives at a very low price, which provides them with a good start for their future business. These farms have the biggest potential for the future as they have a capacity to produce a higher quality of milk providing them with the premium price and subsidies from the state. The banks should look at those farms and support them in growth of their business into "closing" the circle whereby they would move towards production and sale of cheese, yogurt and butter to the market directly, thus allowing them to increase their profits and production.

20. Bulgaria should be ready to fully meet the EU norms in the dairy industry by 2010. The dairies which can not adopt the standards by 2007 may continue to work for three more years but they can only sell products locally. After 2010, all working dairies must completely comply with the EU norms.

21. The most serious structural changes that are expected to occur after 2007 are in the field of dairy farms. It is certain that some of the existing medium-sized farms will expand at the expense of disappearing subsistence farmers (who will be able to use the raw milk only for their own consumption). The milk quota of almost 1 million liter which Bulgaria will be allowed to produce after its accession to the EU is not big, but still it will be hard to fulfill unless medium- and big-sized farmers will substantially expand (currently, 80 % of the cows are concentrated on subsistence farms). Otherwise, Bulgaria will become a consumer market of the EU dairy products.

22. The total investments needs for all milk processors will be about 42 million EURO. This is assuming only "industrial" processors (approximately half of the industry) where the investment would allow them to reach the sanitary regulations and standards of the EU.

Fruit and Vegetables Processing

23. This is the most export oriented sector of the processing industry. However, due to the transition to the market economy and the land fragmentation, the industry is facing difficult times. Installed capacities are able to process 761,000 ton of raw materials, but only about 40 % of this capacity is used. The main reasons for the decline of production was the collapse of the former markets (mainly ex-communist countries), lack of raw materials and lack of working and investment capital.

24. Currently, there are 57 operating canning factories. Some of them are mainly producing for the domestic market, while others are export oriented. Main international markets

are the EU, the US, Israel, Australia, and Russia. The majority of the operating companies apply modern marketing practices. They have their own trade mark or sell under an international distributors' label. The main obstacles that need to be overcome by the industry in the coming years are the difficulties in supplying big commercial lots, consistency in quality and quantity, and the promotion for the export markets.

25. The production facilities are concentrated mainly in southern Bulgaria in the districts of Plovdiv, Pazardjik, Stara Zagora and Iambol. In northern Bulgaria the highest concentration of canning plants is in the districts of Pleven and Veliko Tirnov. Detailed review of the fruit and vegetables processing sector can be found in Annex 6.

26. Out of 57 operating factories, only ten have renovated their production and store facilities in the last two years. It is expected that the remaining 47 companies will need to invest at least 13 million EURO in the next two years if they want to stay in business after 2007.

Wine and Orchard Sector

27. Bulgaria has a long history of vine cultivation and wine production. Natural conditions are good for the production of quality wines for both the domestic and export markets. The total area covered by vineyards in 2003 is somewhere between 96,000 ha and 110,000 ha¹. It is estimated that commercially cultivated vineyards totalled 71,500 ha (both table and wine grapes), while the balance is cultivated for non-commercial purposes.

28. There are around 270 wineries in Bulgaria owned by 96 enterprises of which 11 are large concerns that dominate the sector. The privatization of wineries started in 1993 and, in September 2003, all the wineries had been privatized. There is an increasing number of private, medium-sized wineries (around 50 at the moment) with new type of owners that are mostly Bulgarian entrepreneurs, not necessarily originating from the wine sector, but interested in investing in sector with good prospects of returns. It is estimated that, in 2002², most wineries made profits.

29. The sector is more than 80% export-oriented, and accounts for 30% of the export revenues of trade between Bulgarian food exporters and the EU³.

Table 1: Value of Wine Export

		1998	1999	2000
Total export	EURO (millions)	4,000	3,850	4,500
Value of wine export	EURO (millions)	118	70	55
Wine share in export	%	2.8%	2%	1.2%
Volume of wine export	Liters (millions)	169	101	76

¹ MAF, Wine Outlook Report, 2002.

² Vertumne, Etude de marche, Bulgarian Wine and Vine industry overview, 2002.

³ Bulgarian Wine Industry, J.E. Austin Associates, 2001.

30. The first major foreign private investment in the sector took place in 1998 when Agribusiness Team of EBRD signed EURO 2million equity investment and EURO 26 million long-term loan investment in Domaine Boyar, the biggest and most successful exported of Bulgarian wine. The investment was aimed at the enhancement of skills and technology and the strengthening of the competitive position of Domaine Boyar in export markets.

31. The main weakness and threat facing the industry are old and depleted vineyards (more than 70% are older than 25 years¹). However, above mentioned emerging medium-size private producers are in the process of establishing long term contracts with vineyard owners and encouraging new plantations of vine. They also provide extension services on vineyard management, cultivation practices, mechanization and advise on more profitable sorts of grapes. This process provides an investment gap for the banks who can explore financing of the grape producers through risk-sharing mechanism with the processors.

32. The southern central region is the biggest producer of grapes (28 % of the vineyards), followed by the northern eastern (18 %) and the southern eastern region (27 %). Only 7 % of the plantations are young. In the northern western region almost half of the vineyards have been abandoned because they were old or in a very bad agro-technical condition. The diminishing area of vineyards is very unfavorable for the wine industry which otherwise has good perspectives for development in the enlarged European Union. Because of the lack of enough and good raw materials the wine industry production decreased by 42 % in 2001 compared to 2000 and since then it has been stagnating around 1 million hectoliters per year. The development of the wine sector in the next couple of years will depend mainly on the size of investments in new vineyards

33. Two thirds of the orchards are concentrated in the southern central and in the northern central regions of the country and 65 % of the orchards are grown by cooperatives. The average size of their farms is 32 ha. Due to the structural reforms in agriculture and the collapse of the traditional international markets 24 % of the plantations have been abandoned. More than half of the cherry and apple trees are more than 20 years old. Only about 10 % of the cherry, plums, peach, apricots and apple orchards are new (under 10 years old). The age structure is better only for raspberries and sour cherry trees. The age structure of the orchards should also be renewed in the next two years.

34. In the past, commercially marketed wine was produced mainly by co-operatives. However, since land restitution there are a large number of privately owned vineyards with an average area of around 0.3 ha per farmer². Some of these growers have taken the opportunity to plant new vineyards with more profitable varieties of grapevines, and the performance of these rehabilitated enterprises is generally much better than that of those co-operatives which still exist. However, there are still very large areas of suitable land which have not been improved, constituting an opportunity for profitable investment.

35. Market opportunities for Bulgarian wine are potentially good, but much effort needs to go into key strategies in order to unlock this potential. Individual growers can re-plant in varieties for which there is a strong demand (unlike many currently grown in Bulgaria). Then, on a national basis, much can be done to promote quality Bulgarian varieties such as Mavrud, and to strengthen export demand for these by introducing a provenance of origin system, with associated

¹ Vertumne, Etude de marche, Bulgarian Wine and Vine industry overview, 2002.

² Investing in vineyards in Bulgaria, FAO, 1998.

controls and publicity. Coupled with this are the steps the Government of Bulgaria is now taking to implement a strategy for giving a stronger role to vine-growing associations. This will give more power and lobbying strength to these associations, and should result in fairer prices being paid to growers by wineries. Currently the biggest problems faced by growers are: price fixing (at low levels) by wineries, difficulties in obtaining credit for the rehabilitation of vineyards, including planting new varieties, and the lack of a balanced approach to marketing Bulgarian wine. These difficulties are strongly inter-connected, and remedial measures need to be harmonized.

36. Vineyard rehabilitation is a long term investment, and banks entering this field need to be prepared to structure loans accordingly. Many grape farmers will also need access to seasonal loans to meet the costs of labour and materials, especially in spring and early summer, for pruning, fertilization, weed control, spraying and irrigation. Labour costs at harvest, in the late autumn, can also be high, and in the case of some growers these will need to be credit-financed.

37. It is expected that the investments in vineyards and orchards in next two years will be substantial and if the investments needs are to be met, they could reach up to 130 million EURO.

Other Sectors which will Lend Themselves Most Readily to Credit Financed Investments

Wood Processing

38. 65 % of the wood processing companies in Bulgaria are micro-enterprises, 32 % are small and medium size and only 3 % are large enterprises. Some wood-processing companies in rural areas employ more than 10 persons and are connected with a large number of smaller firms providing carpentry and joiner products.

39. With rich natural resources (forests covering 33 % of the country's total territory), wood processing and furniture making industry has a good potential for development in some rural areas.

40. At national level wood processing accounts for only 1.4 % of the total industrial output. In the mountain regions of southern and central Bulgaria it is one of the traditional and most promising industries. In some areas like the region of Mesta, wood processing facilities are so many that a whole cluster of companies has emerged. Such clusters keep people and production activities tied together. Another advantage is the sharing of work between the small businesses guaranteeing flexibility and economic efficiency. Through such clusters small business companies networks managed to set up a structure necessary for making them known on the domestic and international markets.

41. 65 % of the wood processing companies are micro-enterprises, 32 % are SMEs and only 3 % - large enterprises. Some wood-processing companies in rural areas employ more than 10 persons and are connected with a large number of smaller firms providing carpentry and joiner products. The wood processing enterprises are connected also with the furniture making companies in bigger cities.

42. The majority of the enterprises in the sector have the most important woodworking equipment and well qualified and trained labor. With rich natural resources (forests covering 33 %

of the country's total territory), wood processing and furniture making industry has a good potential for development in some rural areas. Textile and apparel

43. The clothing sector has become one of the most competitive industries in recent years with considerable export and employment opportunities. The textile, knitting and clothing branches account for 7% of the total industrial output and 25% of the total exports. In the first half of 2004 Bulgarian companies have exported 1,031 billion BGN worth of goods, with 90 % of the exports realized to the EU – mainly Greece, Germany, USA, France and Italy.

44. The industry employs more than 150,000 people from both urban and rural areas and comprises some 3,000 enterprises with the facilities which in almost in every district. Their geographic concentration is, however, the biggest in Plovdiv, Tryavna, Veliko Tirnovo, Blagoevgrad, and Gotse Delchev. Rural areas are an attractive place to organize an apparel enterprise, because of the higher level of unemployment (and especially of female population), the low wages and the disciplined workers. With men unemployed or absent from the villages, women have been employed mainly in agriculture. Because agriculture labor is seasonal, apparel assembly absorbed the surplus labor in many rural areas.

45. The clothing sector has become one of the most competitive industries in recent years with considerable export and employment opportunities. The textile, knitting and clothing branches account for 7% of the total industrial output and 25% of the total exports. The clothing sector's growth significantly surpasses the average for the whole industry. In the period 1994-2003 the sales on international markets increased seven times. In the first half of 2004 Bulgarian companies have exported 1,031 billion BGN worth of goods, i.e. an increase of 25 % compared to the same period of 2003. 90 % of the exports are destined to EU – mainly Greece, Germany, USA, France and Italy.

46. The industry employs more than 150,000 people from both urban and rural areas and comprises some 3,000 enterprises. They are frequently SMEs created after privatization. Most are positioned in low value-added production due to their concentration on cut-make-trim (CMT) business. Some are developing full package production, but only a few have successfully introduced their own brands on international markets.

47. The primary reason for the dynamic growth of assembly production of apparel for international markets is the competitive pressure on productivity and the high costs in western economies. The first foreign investors in Bulgarian apparel sector have been Turkish and Greek contractors who organized their small enterprises in the mountain rural areas of South Bulgaria. Some of those enterprises have closed after having fulfilled the contract and re-opened in a neighboring village. As apparel enterprises became increasingly linked to larger international retail buying chains, the importance of such kinds of businesses gradually diminished and contractors stick to the national regulations for payments, social benefits and working time.

48. A big impact on the future development of this industry will have the increased competition as the world market is going to open up and phase out the quota system under the WTO in January 2005 and the textile industry of Bulgaria will be threatened by more competitive producers from China and India. It is expected that Bulgaria will maintain its competitiveness mainly in higher-grade apparel directed to European market segments.

Tourism

49. In the last two years Bulgarian rural areas have witnessed opening of a number of small family hotels offering many activities to their clients like mounting biking, adventurous sports, horse riding, hunting and fishing. The rural and eco-tourism is not attracting a large number of people, but it offers a possibility for additional income to rural population and those involved in other activities such as agriculture.

50. The total capacity of the members of the Bulgarian Association of Alternative Tourism is 560 beds. The majority of members are family hotels and guest houses, mainly in the mountain areas, but there are also some larger hotels. Experts estimate that in 2002 the alternative tourist products and services generated almost 550,000 EURO in the economy of villages and small towns.

51. Bulgaria has a strong tradition in tourism sector. Despite the stagnation of the market due to the terrorist threat, the number of tourists in Bulgaria has been increasing during the last couple of years. Until recently the tour agencies were concentrating their efforts mainly on mass Black Sea and mountain sport tourism. However eco and rural tourist initiatives have lately sprung up from many sources ranging from hotel owners and tour operators, to municipalities, national parks, branch associations and NGOs.

52. Most of the tourists visiting the rural areas in Bulgaria are foreigners. The middle class Bulgarian families do not have the tradition to spend their vacation in the countryside (with the exception of some mountain regions where they go to practice winter sports or to spend weekends in summer). A lot of Bulgarians have their own small holiday houses in the countryside or have relatives who live there, so a large domestic demand for an organized supply of rural tourist products does not exist. The nature and traditions in rural areas have a large potential but foreign tourists are not attracted alone by beautiful nature. Good accommodation and services are also required.

53. The rural and eco-tourism can not attract a big number of people and will not bring masses of tourists to rural areas, but they can offer a good means of living and occupation for the local people. Small family hotels are good places for higher income and senior-aged tourists who require not only bed and breakfast, but also a quiet and pleasant home atmosphere. In the last couple of years people who work in the sphere of rural tourism have started offering many other activities to their clients like mounting biking, adventurous sports, horse riding, hunting and fishing.

54. The total capacity of the members of the Bulgarian Association of Alternative Tourism is 560 beds. The majority of members are family hotels and guest houses, mainly in the mountain areas, but there are also some larger hotels. Experts estimate that in 2002 the alternative tourist products and services generated almost 550,000 EURO in the economy of villages and small towns, situated mainly in the interior mountain regions of Pirin, the Rhodopes, the Balkan range and Strandja as well as in the Dobrudja plain. More than 3,200 alternative tourists visited Bulgaria, paying tourist packages in the range of 800 to 1,000 EURO. If other services like tours and souvenirs are included, those tourists provide revenues to local people amounting to 1.2 million EURO. In addition, at least 12,000 foreign and local tourists use various services in the form of lunches or dinners in a Bulgarian village, Christmas or New Year celebration in a traditional village house, trips on horseback or on bicycle and guided mountain trips. At the

moment, rural tourism mainly provides additional income for rural families (as part-time activity particularly for the female population) and contributes to the development of multi-activities. In some least developed villages rural tourism may be the only economic activity with economic potential.

Other Non-farm Rural Activities

55. Other parts of industry and the tertiary services activities are under-developed in rural areas. There are however villages and small towns (mainly the peri-urban centers) in which the non-farming economy is quite diversified. For example, in one of the surveyed rural municipalities – Elin Pelin, situated at 25 km from Sofia enterprises in more than 10 sectors, i.e. food processing, packaging, construction, production of building materials, furniture, fiber glass, detergents, porcelain, pottery, scrap material processing, garden design, agriculture and agricultural services, golf and entertainment, sport hunting, and petrol trade, can be found. Such rural municipalities are, however, more an exception than the rule. Their dynamic growth is due mainly to their vicinity to the big cities, but also to the initiative of the local administration to attract outside investors.