

# 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

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## **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

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## 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>
<b>MEAT AND LIVESTOCK</b>				
<b>Meat processing</b>	<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>
<b>Livestock for meat production</b>	<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>
<b>DAIRY</b>				
<b>Dairy Processing</b>	<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>
<b>Milk Production at the Farm Level</b>	<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>
<b>AGRICULTURE</b>				
<b>Food &amp; Vegetable Processing</b>	<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>
<b>Agriculture Production at the Farm Level</b>	<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>
<b>Wine growing sector</b>	<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>
<b>TOURISM</b>				
<b>Rural tourism sector</b>	<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>
<b>TEXTILE AND APPAREL</b>				
<b>Textile and apparel sector</b>	<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:

<b>SHORT TERM/WORKING CAPITAL LOANS</b>						
<b>Loan type</b>	<b>Targeted Subsectors</b>	<b>Maturity</b>	<b>Targeted clients</b>	<b>Main Aim</b>	<b>Size of Loans (Euro)</b>	<b>Potential Collateral</b>
<b>Inputs- purchasing loan:</b> Working capital loan for purchase of seasonal inputs.	<b>Agriculture, Wine and Orchard production</b>	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)
<b>Storage loan:</b> 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)	<b>Agriculture</b>	One to six months	Agricultural producers (particularly crop producers)	Covering costs of storage	20,000 – 50,000	Warehouse receipts
<b>Emergency Loan:</b> 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.	<b>Agriculture, Trade, Service</b>	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
<b>EU Food Standards Loan:</b> 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	<b>Food Processing</b>	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
<b>Textile and Apparel Working Capital Loans</b>	<b>Garment and apparels</b>	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**<sup>1</sup> was passed in September 2000 to enhance the range of financial instruments and increase the access of banks to long-term sources of finance<sup>2</sup>. 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 owned<sup>3</sup>, 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

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

<sup>2</sup> 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.

<sup>3</sup> 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 title<sup>1</sup>.

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.

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<sup>1</sup> 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 Industry<sup>1</sup> 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.

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<sup>1</sup> 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
<b>Investments in agricultural holdings.</b>	744	335, 252, 505	439	156, 492, 335
<b>Dairy farms</b>	9	4, 266, 362	4	1, 243, 188
<b>Meat</b>	50	56, 004, 686	17	13, 671, 709
<b>Orchards</b>	159	52, 773, 670	69	14, 553, 995
<b>Orchards, vegetables, essential oils herbs</b>	524	219, 782, 950	349	127, 023, 444
<b>Eggs</b>	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.

<b>Credit Cooperatives</b>	
<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"> <li>• 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.</li> <li>• 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 collateral<sup>6</sup>.</li> <li>• More than 6,000 active borrowers, mostly rural-based small entrepreneurs</li> </ul>	<ul style="list-style-type: none"> <li>• 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</li> </ul>

## 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.

<sup>6</sup> 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 sector<sup>7</sup>.

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).

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<sup>7</sup> 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
<b>Inputs- purchasing loan:</b> Working capital loan for purchase of seasonal inputs.	<b>Agriculture, Wine and Orchard production</b>	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)
<b>Storage loan:</b> 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)	<b>Agriculture</b>	One to six months	Agricultural producers (particularly crop producers)	Covering costs of storage	20,000 – 50,000	Warehouse receipts
<b>Emergency Loan:</b> 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.	<b>Agriculture, Trade, Service</b>	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
<b>EU Food Standards Loan:</b> 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	<b>Food Processing</b>	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
<b>Textile and Apparel Working Capital Loans</b>	<b>Garment and apparels</b>	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 funds<sup>8</sup> (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

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<sup>8</sup> 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.

<b>National Agricultural Advisory Services (NAAS)</b>	<b>Job Opportunities through Business Support Project (JOBS)</b>
<ul style="list-style-type: none"> <li>• 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.</li> <li>• 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).</li> </ul>	<ul style="list-style-type: none"> <li>• 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.</li> <li>• 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.</li> <li>• 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"> <li>▪ Apparel and textile (300 companies)</li> <li>▪ Wood processing and furniture (200 companies)</li> <li>▪ Handicrafts (700 artisans)</li> <li>▪ Herbs and spices (100 companies)</li> <li>▪ Tourism (more than 200 companies in 37 regions)</li> <li>▪ Organic agriculture (50 companies)</li> </ul> </li> </ul>

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	%
<b>Food processing industry</b>	<b>262</b>	<b>15</b>
<b>Trade</b>	<b>242</b>	<b>13</b>
<b>Machine building</b>	<b>216</b>	<b>12</b>
<b>Agriculture</b>	<b>163</b>	<b>9</b>
<b>Textile and apparel</b>	<b>138</b>	<b>8</b>
<b>Transport</b>	<b>134</b>	<b>7</b>
<b>Construction</b>	<b>125</b>	<b>7</b>
<b>Wood processing</b>	<b>104</b>	<b>6</b>
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
<b>Total</b>	<b>1 798</b>	<b>100</b>

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 MAF<sup>9</sup> 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 whole<sup>10</sup>.

<sup>9</sup> Ministry of Agriculture and Forestry.

<sup>10</sup> 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 2003<sup>11</sup>. 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 Areas<sup>12</sup>**

#### **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.

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

<sup>11</sup> USDA Report on State of Agriculture in Bulgaria, March 2004.

<sup>12</sup> 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 SMEs<sup>13</sup>

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"> <li>• Predominance of agricultural (48%) and local services (33%) activities.</li> <li>• 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.</li> <li>• 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.</li> <li>• 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.</li> <li>• Bank credit under the Facility should aim to co-finance with the SFA and, in particular, with SAPARD projects.</li> </ul>	<ul style="list-style-type: none"> <li>• 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.</li> <li>• Much less micro-enterprises (Only 8%) and predominantly limited liability companies.</li> <li>• A relative old age of enterprise (52%) established between 1990 and 1996.</li> <li>• Asset value higher than €100,000.</li> <li>• High market and profit orientation. Profits are a main source for capitalisation. Domestic markets are dominant (89%), but export markets are much more dynamic.</li> <li>• Good loan repayment records of current borrowers - only 12% stated that they had faced some problems.</li> <li>• 84 % of the entrepreneurs intend to borrow from banks with an emphasis on term loans for renovation, equipment, renewal of orchards.</li> <li>• Highest potential economic areas: food processing (meat and dairy), construction, wood processing, tourism</li> <li>• Desired terms of loans: long maturity, less strict collateral requirements, better repayment schedules considering the cash flow situation.</li> </ul>

### 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 activities<sup>14</sup>. 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

<sup>13</sup> Full analysis of the survey of rural SMEs can be found in Annex 1.

<sup>14</sup> 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>
<b>MEAT AND LIVESTOCK</b>				
<b><i>Meat processing</i></b>	<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>
<b><i>Livestock for meat production</i></b>	<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>
<b>DAIRY</b>				
<b>Dairy Processing</b>	<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>
<b>Milk Production at the Farm Level</b>	<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
<b>Grand total investment</b>						<b>191, 713, 189</b>

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 2007<sup>15</sup>. 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 Bulgaria<sup>16</sup>

#### 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.

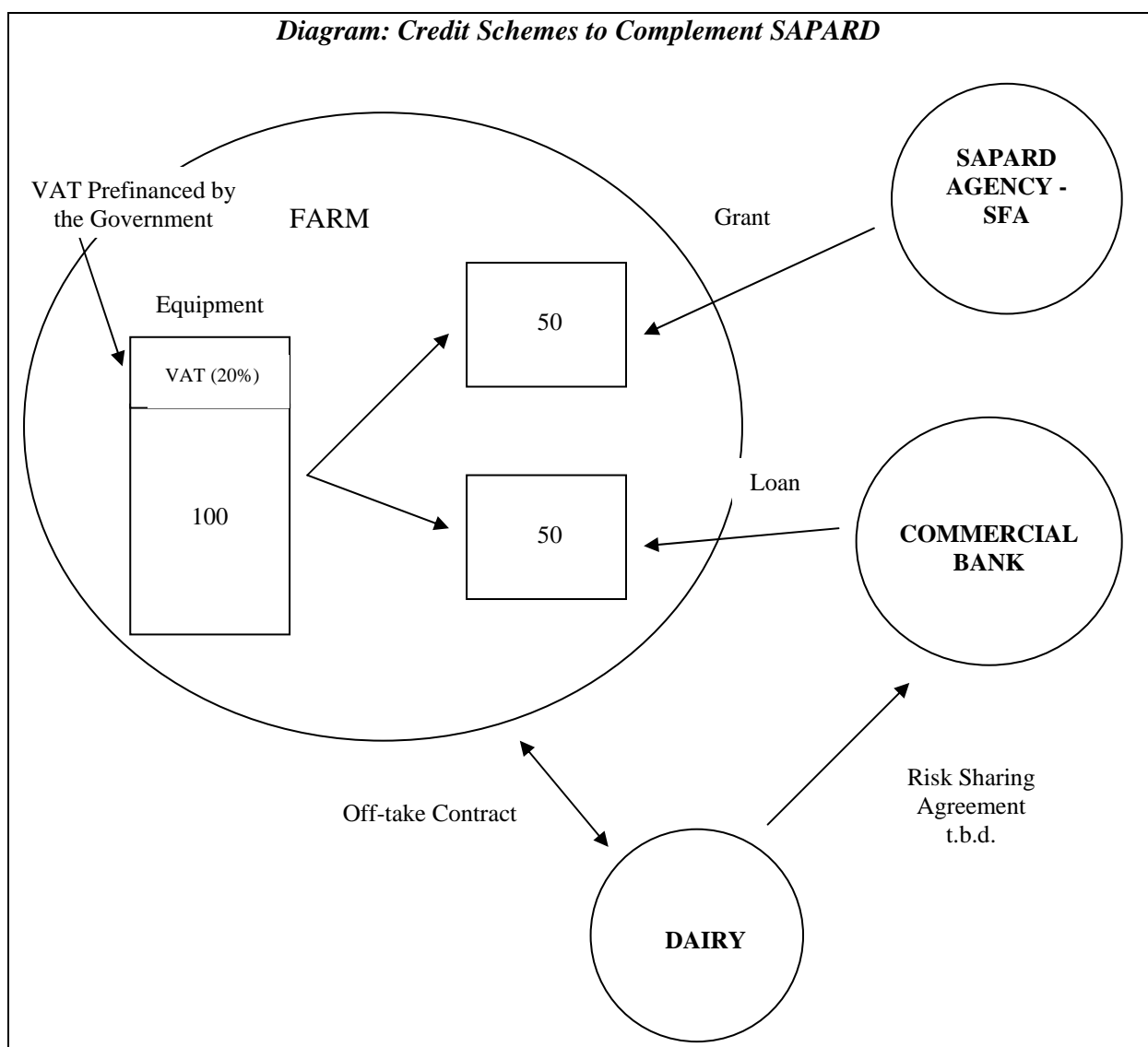
<sup>15</sup> GFP in Bulgaria has been adopted in the internal legislation under the name of “Code on the requirements in the field of environment protection, hygiene, human treatment of animals, veterinary and phyto-sanitary requirements of the agricultural farms”.

<sup>16</sup> 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>
<b>AGRICULTURE</b>				
<b>Food &amp; Vegetable Processing</b>	<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>
<b>Agriculture Production at the Farm Level</b>	<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>
<b>Wine growing sector</b>	<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>
<b>TOURISM</b>				
<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>
<b>TEXTILE AND APPAREL</b>				
<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.