Reconstruction Capital II Ltd

("RC2" or the "Fund")

Quarterly Report

30 June 2013

Investment Manager
New Europe Capital Ltd
33 Marloes Road
London W8 6LG
Tel +44 20 7244 0088
london@neweuropecapital.com

Investment Adviser Romania & Bulgaria
New Europe Capital SRL
Str. Tudor Arghezi nr.21, et.6
Bucuresti - Sector 2
Tel +40 21 316 7680
bucharest@neweuropecapital.com

Investment Adviser Serbia
New Europe Capital DOO
Francuska 12
11000 Beograd
Tel +381 11 715 1982
belgrade@neweuropecapital.com

Statistics

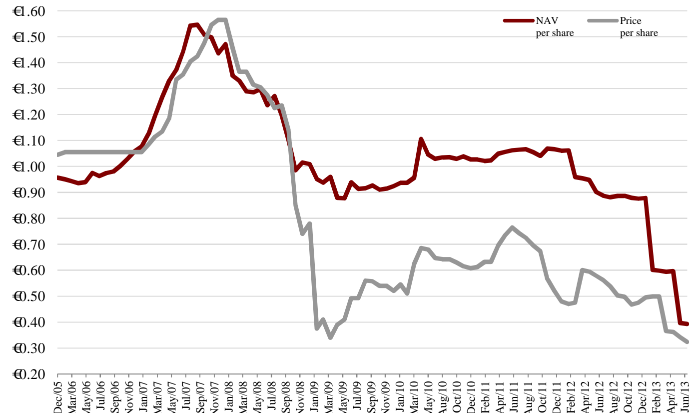
NAV per share (€)	0.3928
Share price (€)	0.3238
Total NAV (€m)	39.3
Mk Cap (€m)	32.4
# of shares (m)	100.0
NAV return since inception	-58.93%
12-month NAV CAGR	-55.73%
NAV annualized Return*	-11.19%
NAV annualized Volatility*	20.87%
Best month (NAV)	15.60%
Worst month (NAV)	-33.53%
# of months up (NAV)	46
# of months down (NAV)	44

**since inception*

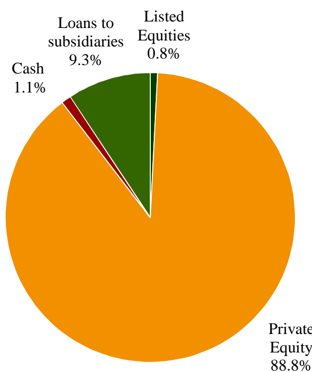
RC2 NAV returns

	2009	2010	2011	2012	2013
Jan	-5.65%	1.36%	-0.54%	0.11%	-31.58%
Feb	-1.51%	0.03%	0.24%	-9.68%	-0.50%
Mar	2.39%	2.07%	2.48%	-0.51%	-0.64%
Apr	-8.40%	15.60%	0.70%	-0.65%	0.29%
May	-0.26%	-5.42%	0.55%	-4.98%	-33.53%
Jun	3.08%	-1.57%	0.25%	-1.48%	-0.83%
Jul	1.08%	0.53%	0.13%	-0.73%	
Aug	0.23%	0.07%	-1.10%	0.61%	
Sep	1.20%	-0.62%	-1.25%	0.01%	
Oct	-1.79%	0.96%	2.63%	-0.81%	
Nov	0.46%	-1.15%	-0.25%	-0.38%	
Dec	1.08%	-0.06%	-0.49%	0.30%	
YTD	-8.38%	11.07%	3.32%	-17.17%	-55.28%

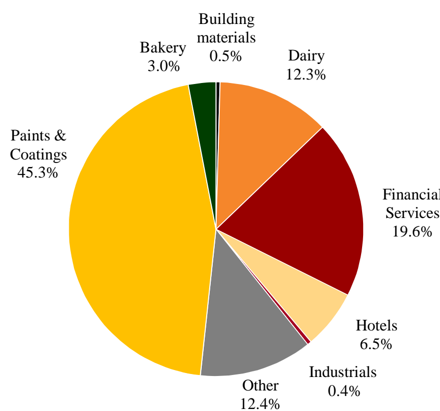
Share price / NAV per share (€)



Portfolio Structure by Asset Class

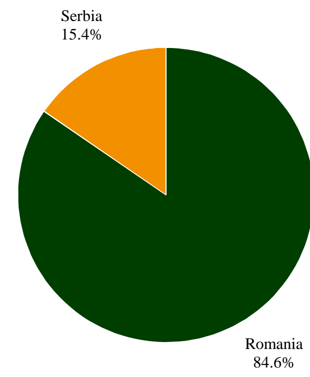


Equity Portfolio Structure by Sector



Note: EPH investment included under Other

Portfolio Structure by Geography



Note: EPH investment included under Serbia

Message from the Investment Manager and Advisers

Dear Shareholders

RC2's NAV per share fell by 33.9% over the second quarter, ending the period at €0.3928. This was mainly the result of the need to make substantial write-downs in the valuations of East Point Holdings and its subsidiaries, as well as, to a lesser extent, Policolor and Mamaia Resort Hotels.

The weak performance of East Point Holdings was primarily the result of limited access to trade finance for its copper business, as it has still not been able to finalize the entry of a new lender. The Group also suffered from weak demand for cables in Russia, and high operating costs at its Bakery division pending the opening of its new facility for which the permitting process in Serbia is still underway.

Although Policolor's performance was affected by delays in the reconstruction of its resins plant, and by the temporary closure of one of its solvent-based coatings plants to upgrade its anti-fire installation, the other Romanian investments had a strong performance. In particular, Top Factoring's EBITDA was 56% above budget due to strong collections on existing proprietary portfolios, while Albalact achieved exceptionally strong sales (up 23.2% on the same period last year), although its EBITDA was broadly unchanged due to increases in the cost of raw milk and higher marketing and distribution expenses. Mamaia Resort Hotels is expecting a strong summer season which should result in higher EBTIDA than the previous year.

Progress on exits over the first semester was slow due to the low level of interest in the region from strategic investors.

At the end of the quarter, the Fund had cash and cash equivalents of approximately €0.1m, compared to €0.3m at the end of the previous quarter. The Fund received €1.0m in dividends from Top Factoring over the quarter, and used €0.8m to reduce its debts. At the end of the quarter, the Fund's borrowings (excluding borrowings of investee companies) amounted to €4.2m, whilst overdue amounts owed to the Investment Manager and Advisers amounted to €3.8m.

Yours truly,

New Europe Capital

Policolor Group

Background

RC2 has a 40.0% shareholding in Policolor, the parent company of the Policolor Group ("Policolor" or the "Group"), the largest producer of coatings (architectural, automotive and industrial) in Romania and Bulgaria, and a producer of resins and specialty chemicals. The Group comprises Policolor SA, a Romanian company, and Orgachim AD, its 91% owned Bulgarian subsidiary. Both Policolor and Orgachim are unlisted.

Group Financial results

(EUR '000)	2011A*	2012A*	2013 B	1H12**	1H13A**	1H13B
Income statement (according to IFRS)						
Total operating revenues	**74,030**	**58,496**	**67,255**	**31,535**	**29,710**	**30,959**
Operating expenses	(74,618)	(58,079)	(64,884)	(30,010)	(29,796)	(30,405)
Operating profit	**(588)**	**417**	**2,371**	**1,525**	**(86)**	**554**
Operating margin	*-0.8%*	*0.7%*	*3.5%*	*4.8%*	*-0.3%*	*1.8%*
Depreciation	2,923	3,228	3,480	1,680	1,745	1,696
EBITDA	**2,335**	**3,645**	**5,851**	**3,205**	**1,659**	**2,250**
EBITDA margin	*3.2%*	*6.2%*	*8.7%*	*10.2%*	*5.6%*	*7.3%*
Financial Profit/(Loss)	(1,185)	(1,126)	(1,313)	(683)	(398)	(634)
Profit before tax	**(1,774)**	**(709)**	**1,058**	**842**	**(484)**	**(80)**
Income tax	(10)	(219)	(245)	(6)	(163)	-
Profit after tax	**(1,783)**	**(928)**	**812**	**836**	**(647)**	**(80)**
Minority interest	133	261	-	(186)	58	-
Profit for the year	**(1,650)**	**(667)**	**812**	**649**	**(589)**	**(80)**
*exchange rate (RON/EUR)****	*4.238*	*4.456*	*4.500*	*4.389*	*4.392*	*4.500*

** Audited financial statement ** Unaudited financial statements *** Average exchange rate*

Policolor's sales for the first half were slightly below those of last year and the budget, due to weak consumer paints markets and delays in re-starting the resins plants (which is now due to re-open in the fourth quarter of 2013), as well as the closure for a number of months of its solvent based coatings plant in order to upgrade its anti-fire installation.

Consumer spending in Romania fell significantly, with the retail sales index falling by 3.1% in June alone (in Bulgaria, where sales performed better, the retail sales index was stable). Nevertheless, construction activity in both countries remained depressed.

The Group's profitability weakened due to weak profits at its non-core specialty chemicals (anhydrides) division, whose profitability is highly volatile based on prevailing market conditions; as well as increased marketing expenditure (+€0.35m) at its core architectural coatings division, as a number of brands were re-launched over the period.

Due to an improved working capital management, net bank debt fell from €15.9m at the beginning of the year to €14.3m as at 30 June.

Operations

The Group has a new management team in place, including a new Heads of Architectural Sales in Romania and Bulgaria, as well as a new manager for the Chemicals division. The Architectural Coatings division reacted to the weak consumer markets by launching new mid- and low-level brands, and by increased advertising spend on the premium brand. Furthermore, formulations have been optimized to improve the gross margin, whilst operating expenses have been kept low. The resins plant is now expected to re-open in late 2013, allowing it to be fully functional for the start of the new season in 2014.

Top Factoring

Background

Top Factoring ("Top Factoring") is a Romanian receivables collection company in which RC2 owns a 93% shareholding. The remaining 7% is owned by the Company's CEO. The debt purchase part of the business is undertaken by an SPV also 93%-owned by RC2 (Glasro Holdings Ltd) which sub-contracts the debt collection process to Top Factoring. Top Factoring and Glasro Holdings Ltd are together referred to as the "Group".

Group Financial Results

(EUR '000)	2011*	2012**	2013B	1H12**	1H13**	1H13B
Combined Group Income Statement						
Total Gross Operating Revenues	**5,549**	**8,787**	**10,107**	**4,387**	**4,401**	**4,639**
Debt portfolios (collections)	4,571	7,531	9,138	3,878	3,913	4,155
Agency contracts	978	1,256	969	509	488	483
Amortization and fair value adjustments of debt portfolios	(1,274)	(3,441)	(4,357)	(1,255)	(1,308)	(1,916)
Total Net Operating Revenues	**4,275**	**5,346**	**5,751**	**3,133**	**3,093**	**2,723**
Total Operating Expenses	**(2,940)**	**(3,689)**	**(3,393)**	**(1,660)**	**(1,704)**	**(1,850)**
Operating Profit	**1,335**	**1,658**	**2,357**	**1,473**	**1,389**	**873**
EBITDA	**1,398**	**1,745**	**2,463**	**1,514**	**1,443**	**926**
EBITDA margin	*32.7%*	*32.6%*	*42.8%*	*48.3%*	*46.7%*	*34.0%*
Financial Profit/(Loss)	(150)	(234)	(192)	(81)	(99)	(96)
Profit before Tax	**1,185**	**1,423**	**2,165**	**1,392**	**1,290**	**777**
Income Tax	(111)	(142)	(217)	(139)	(161)	(97)
Profit after Tax	**1,074**	**1,281**	**1,949**	**1,253**	**1,128**	**680**
Net margin	*25.1%*	*24.0%*	*33.9%*	*40.0%*	*36.5%*	*25.0%*
Avg exchange rate (RON/EUR)	*4.238*	*4.456*	*4.400*	*4.389*	*4.392*	*4.400*

Note: IFRS(audited, combined accounts), IFRS**(unaudited, combined accounts)*

The Group's 2013 first-half gross operating revenues of €4.4m were virtually flat year-on-year, and a bit below budget due to less new portfolio acquisitions, although EBITDA was strongly above budget due to collections on many of the existing portfolios being above budget in the first half of 2013, resulting in a write up adjustment of €0.4m when the quarterly impairment test on proprietary portfolios was performed as at 30 June 2013.

The debt purchase line accounted for 84% of net operating revenues, of which banking portfolios generated 54% (up from 22% in the first half of 2012). Agency contracts generated the remaining 16% of net revenues.

In 2013, the Group distributed €1.5m of its retained earnings as dividends, a total of €1.38m being paid up to RC2.

Operations

In June, the Group won an auction organized by a Romanian telecom player and acquired a portfolio of 48,000 cases with a total face value of €17m. Thus, the Group now owns 32 debt packages (twelve telecoms and twenty banking) made up of 800,000 cases with a total face value of €218m.

East Point Holdings Ltd

Background

East Point Holdings Ltd ("EPH" or the "Group") is a Cyprus-based holding company which operates along the following main business lines: Copper Processing, Cable Production, Bakeries, Milling and Real Estate. RC2 acquired a 21.3% shareholding in 2008. In April 2010, RC2 increased its shareholding to 42% in exchange for waiving certain claims against EPH's other shareholders for zero consideration. At the same time, Darby, the private equity arm of Franklin Templeton Investments, exchanged a mezzanine loan for 24.7% of EPH's equity. Over 2011, RC2 increased its shareholding from 42.0% to 59.0%, pursuant to an asset swap agreed with EPH's founding shareholders, whereby the founding shareholders of the business were due to exit the business completely by early 2012 in exchange for non-core assets. In February 2012, RC2 completed the final phase of the asset swap, increasing its shareholding in EPH from 59.0% to 63.0%. In March 2010, RC2 acquired a direct 11.1% shareholding in Klas DOO ("Klas"), the holding company for EPH's Bakeries business, for €2.7m.

Introduction

EPH has agreed to reschedule €57m of its local debt with a number of local banks. No principal repayments were due in 2013. However, debt repayments are due over a five year period starting in 2014. In 2014, the Group is also due to invest a further €3.5m in Novkabel, as part of its privatization contract with the Serbian state.

EPH and its subsidiaries had approximately €2.5m deposited at Laiki Bank (of which approximately €1.4m was used to back up a performance bond issued in favour of the Serbian Privatization Agency) when the Cyprus government announced that uninsured deposits at the bank in excess of €0.1m per depositor would be used to bail-in the bank. EPH has managed to exclude the deposit backing up the performance bond from the bail-in. Of the remaining €1.1m, EPH also managed to recover €0.3m in May. EPH is therefore at risk of losing the balance of €0.8m, or of recovering only a fraction of it.

Copper Processing (EPM)

(EUR m)	2011A	2012	2013B	1H12	1H13	1H13B
Income Statement						
Net Sales	219.4	181.7	200.3	94.0	68.8	99.0
EBITDA	4.8	5.8	8.5	3.3	0.7	4.0
EBITDA margin	2.2%	3.2%	4.2%	3.5%	1.0%	4.0%
Profit after Tax	(4.9)	(1.0)	2.4	0.4	(1.8)	1.0
Net margin	-2.2%	-0.5%	1.2%	0.4%	-2.6%	1.0%

Note: unaudited management accounts

EPH's copper processing division continued to experience difficulties in the second quarter, mainly due to inadequate trade financing, as existing providers continued to cap the availability of their lines. This, coupled with decreased demand on western European markets and in Russia, resulted in an 18.1% year on year fall in volumes sold. Consequently, the EBITDA margin fell from 3.5% in 1H2012 to 1% in 1H2013. EPH is actively attempting to access new trade finance facilities, and is currently negotiating with several financial institutions, although no breakthrough has yet been achieved.

Cable Production

(EUR '000)	2011A*	2012A*	2013B	1H12**	1H13**	1H13B
Income Statement						
Net Sales	36,779	32,385	36,890	15,705	10,838	15,604
EBITDA	(387)	(162)	286	(197)	(1,753)	(710)
EBITDA margin	-1.1%	-0.5%	0.8%	-1.3%	-16.2%	-4.6%
Profit after Tax	(387)	(1,466)	(1,019)	(3,661)	(3,623)	(1,362)
Net margin	-1.1%	-4.5%	-2.8%	-23.3%	-33.4%	-8.7%

*Note: *audited; **unaudited management accounts*

Due to reduced purchases from Russian oil and gas companies, the largest and most profitable export market for Novkabel, EPH's cable sales continued to fall in the second quarter of 2013. This resulted in a 26.2% year-on-year decrease in volumes sold over the first half of 2013 and a dramatic increase in Novkabel's losses, with the EBITDA margin falling from -1.3% in 1H2012 to -17% in 1H2013. Sales in EU countries and on the domestic market were in line with the budget. Management expects a significant increase in sales on the Russian market in the second half of 2013, as the company received fresh inquiries from several large customers.

Milling

(EUR '000)	2011A*	2012A*	2013B	1H12**	1H13**	1H13B
Income Statement						
Net Sales	13,687	12,437	12,680	6,004	6,092	5,392
EBITDA	2,873	2,275	1,252	1,156	612	492
EBITDA margin	21.0%	18.3%	9.9%	19.3%	10.0%	9.1%
Profit after Tax	1,782	1,696	1,069	1,107	552	441
Net margin	13.0%	13.6%	8.4%	18.4%	9.1%	8.2%

*Note: *audited; **unaudited management accounts*

Zitomlin, EPH's flour mill, achieved a 1.5% year-on-year increase in turnover during the first half of 2013, despite a 17.9% fall in volumes, mainly due to a strategy of not compromising on prices. However, due to a very good harvest and the consequent reduction in wheat prices in the second quarter, the gross margin for 1H2013 came in at 17%, lower than the 20% originally budgeted. In spite of this, EBITDA over the first half of 2013 came in at €0.6m, or 24.3% above the budgeted €0.5m, due to tight cost controls.

Bakeries

(EUR '000)	2011A*	2012A*	2013B	1H12**	1H13**	1H13B
Income Statement						
Net Sales	20,260	16,826	16,823	8,688	7,778	7,200
EBITDA	(438)	(1,308)	(73)	(602)	(931)	(552)
EBITDA margin	-2.2%	-7.8%	-0.4%	-6.9%	-12.0%	-7.7%
Profit after Tax	(1,286)	(6,852)	(2,416)	(1,348)	(2,265)	(1,612)
Net margin	-6.3%	-40.7%	-14.4%	-15.5%	-29.1%	-22.4%

*Note: *audited; **unaudited management accounts*

Due to delays in obtaining an operating permit for the new state-of-the-art plant on the outskirts of Belgrade, and the consequent delays in relocating production, EPH's bakery division continued to experience severe difficulties in the second quarter of 2013. This, coupled with government controls of bread prices, resulted in a negative EBITDA margin of -12% in 1H2013, compared to -6.9% in 1H2012. However, the 2013 margin includes €0.2m of extraordinary expenses for redundancies. In early August, the Serbian authorities finally issued a fire protection permit for the new plant. Consequently, the issuance of the operating permit remains a formality at this point, and is expected in the following weeks. Management plans to finalize the relocation of equipment and start operations at the new factory in September. They believe the relocation will generate annual savings of €1.2m.The new manager, hired in April, has also initiated several restructuring measures, including discontinuing unprofitable or low volume products, optimizing inventories, and improving the bread packaging.

Albalact

Background

Albalact SA ("Albalact" or the "Company") is a Romanian dairy company quoted on the RASDAQ section of the Bucharest Stock Exchange in which RC2 owns a 25.4% stake under its Private Equity Programme. A local entrepreneur and his family own 45%, with the remaining 29.6% representing the free float. With Albalact's market capitalization increasing by 0.5% over the quarter, the value of RC2's shareholding was slightly up at €5.3m as at 30 June.

Financial results

(EUR '000)	2011A*	2012*	2013B	1H12**	1H13**
Standalone Income Statement					
Sales Revenues	**79,814**	**77,164**	**87,374**	**37,800**	**46,577**
Other operating revenues	2,267	192	(594)	782	136
Total Operating Revenues	**82,081**	**77,356**	**86,780**	**38,582**	**46,714**
Total Operating Expenses	(79,842)	(74,946)	(83,411)	(37,106)	(45,249)
Operating Profit	**2,238**	**2,410**	3,369	**1,475**	**1,465**
Operating margin	*2.7%*	*3.1%*	*3.9%*	*3.8%*	*3.1%*
Recurring EBITDA	**3,598**	**5,655**	**6,065**	**2,858**	**2,915**
EBITDA from non-recurring sale of non-core assets	1,412	(429)	-	-	-
Total EBITDA	**5,009**	**5,225**	**6,065**	**2,858**	**2,915**
EBITDA margin	*6.1%*	*6.8%*	*7.0%*	*7.4%*	*6.2%*
Financial Profit/(Loss)	(632)	(450)	384	(504)	(280)
Profit before Tax	**1,607**	**1,960**	**3,753**	**972**	**1,185**
Income Tax	(246)	(317)	(600)	(156)	(174)
Profit after Tax	**1,361**	**1,643**	**3,152**	**815**	**1,011**
Net margin	*1.7%*	*2.1%*	*3.6%*	*2.1%*	*2.2%*
Avg exchange rate (RON/EUR)	*4.238*	*4.456*	*4.400*	*4.389*	*4.392*

*Note: * RAS (audited), ** RAS (unaudited)*

Albalact's 2013 first half sales grew by 23.2% in euros over the same period last year, helped by higher sales of fresh milk, yoghurts and cheese. The sales growth is extremely positive, given the overall decline in dairy consumption, according to the press statements of other important local players. The higher cost of raw milk, as well as increased marketing and distribution expenses in order to generate the higher sales, resulted in a 21.9% year-on-year increase in operating expenses, and unchanged EBITDA of €2.9m. The unrealized foreign exchange loss generated by the revaluation of the Company's euro denominated loans amounted to €165,000. Overall, the net profit came in at €1.0m, up from €0.8m over the same period the year before.

Operations

Fresh products (milk, sour cream and yoghurts) were the largest contributors to Albalact's first half sales (77%), followed by butter (13%) and cheese (10%). In particular, yoghurt sales increased by 75% year-on-year, bringing their share of total sales to 16%, up from 11% during the same period last year.

Following its entry in the fresh cheese segment in May 2012, the share of this category in the Company's total sales was 10%, up from the 8% achieved over 2012.

Mamaia Resort Hotels

Background

Mamaia Resort Hotels SRL (the "Company") is the owner and operator of the Golden Tulip Mamaia Hotel (the "Hotel"), which is located at Mamaia, Romania's premium seaside resort next to Constanta. In March 2008, RC2 acquired 63% of the Company, with the remaining 37% being owned by a Romanian private individual.

(EUR '000)	2011A*	2012A*	2013B	1H12**	1H13**	1H13B
Income Statement						
Sales Revenues	**1,664**	**1,744**	**2,021**	**436**	**485**	**490**
Other operating revenues	7	81	26	10	16	23
Total Operating Revenues	**1,671**	**1,825**	**2,047**	**446**	**501**	**513**
Total Operating Expenses	(1,563)	(1,598)	(1,662)	(688)	(659)	(637)
Operating Profit	**108**	**227**	**385**	**(241)**	**(158)**	**(124)**
Operating margin	*6.5%*	*12.4%*	*18.8%*	*neg.*	*neg.*	*neg.*
EBITDA	**437**	**457**	**601**	**(108)**	**(53)**	**(16)**
EBITDA margin	*26.2%*	*25.0%*	*29.4%*	*neg.*	*neg.*	*neg.*
Financial Profit/(Loss)	(153)	(172)	(120)	(121)	(126)	(111)
Profit before Tax	**(45)**	**55**	**265**	**(362)**	**(283)**	**(235)**
Income Tax	-	-	-	-	-	-
Profit after Tax	**(45)**	**55**	**265**	**(362)**	**(283)**	**(235)**
Net margin	*neg.*	*3.0%*	*12.9%*	*neg.*	*neg.*	*neg.*
Avg exchange rate (RON/EUR)	*4.238*	*4.456*	*4.400*	*4.389*	*4.392*	*4.400*

*Note: * IFRS (audited), ** RAS (unaudited)*

The Hotel was only open for corporate events between January and April 2013 in order to keep operating costs at a minimum during the low season. Consequently, the Hotel generated revenues of only €55,000 up to the 1st May, which is the official opening of the Summer season on the Romanian seaside. Revenues over the first half of the year were €0.5m, up 12% year-on-year and in line with the budget. Accommodation revenues were flat year-on-year and accounted for 44% of revenues, while the Food & Beverage department generated revenues of €255,000 (up 31% year-on-year), or 51% of total sales. The increase in revenues from the Food & Beverage department is the consequence of an increased focus on its performance in 2013. The six-month EBITDA loss of €53,000 is half the loss over the same period last year. As at the end of June, the Company's total indebtedness amounted to €2m.

Operations

The Company generated enough cash in 2012 to take it through the low season and to make investments of €50,000 to improve the Hotel and its services. 100 of the Hotel's 290 rooms were redecorated and the pool area was improved. Importantly, in May the Company was awarded a 10-year concession to operate the beach in front of the Hotel, following which it invested €20,000 in beach furniture to arrange the beach for its clients.

The occupancy rate was 15.8% over the first half of 2013, an increase on the 13.8% recorded over the same period last year. Management expects the occupancy rate to reach 70% in July, and 83% in August, while the September rate is expected to fall to 50%.

Capital Market Developments

BET-EUR, SOFIX and BELEX-15: 1 year performance

Commentary

During the second quarter, stock markets in the region had a mixed evolution, with the Romanian BET-EUR and the Serbian BELEX-15 indices falling by 7.7% and 18.3%, respectively, while the Bulgarian SOFIX index rose 15.5%, all in euro terms.

Over the past year, the BET-EUR index gained 15.8%, the SOFIX 51.5%, and the BELEX-15 12.2%, all in euro-terms. By comparison, over the last year, the MSCI Emerging Market Eastern Europe index lost 6.1%, the MSCI Emerging Market index lost 2.4%, while the FTSE100 index was up 5.1% and the S&P index was up 14.7%, all in euro terms.

Macroeconomic Overview

Overview

	RO	as of:	BG	as of:	SRB	as of:
GDP Growth (y-o-y)	2.1%	3M13	0.4%	3M13	2.1%	3M13
Inflation (y-o-y)	5.4%	6M13	2.6%	6M13	9.8%	6M13
Ind. prod. growth (y-o-y)	-1.2%	May-13	-6.0%	May-13	4.2%	May-13
Trade balance (EUR bn)	-2.2	5M13	-1.0	5M13	-2.1	5M13
y-o-y	*-40.5%*		*-46.4%*		*-21.7%*	
FDI (EUR bn)	0.4	5M13	0.5	5M13	0.3	5M13
y-o-y change	*-36.9%*		*-45.8%*		*n/a*	
Total external debt/GDP	70.2%	May-13	91.0%	May-13	79.1%	Apr-13
Reserves to short-term debt	159.7%	May-13	143.6%	May-13	3703.7%	Mar-13
Loans-to-deposits	110.9%	Jun-13	89.6%	Jun-13	107.1%	Apr-13
Public sector debt-to-GDP	38.3%	Mar-13	18.1%	Apr-13	57.4%	Jun-13

Commentary

Romania

Between January and May 2013, the trade deficit continued to improve, having shrunk by 40.5% compared to the same period last year (from €3.7bn to €2.2bn) due to exports growing by 5.7% year-on-year, whilst imports fell by 1.9%. The improvement in the trade balance, together with an €800m positive balance of services (compared to a negative €18m over the same period last year), resulted in a positive current account balance of €0.3bn, compared to a deficit of €2.3bn over the first five months of 2012. FDI flows amounted to only €0.4bn, down 37% year-on-year. Intra-group loans accounted for 79% of total FDI flows, with equity investments accounting for the balance of 21%.

After falling 2.8% against the euro over the first five months of 2013, the Romanian leu recovered in June, resulting in a slight overall decline of 0.7% over the first six months.

Although Romania's annual inflation rate increased from 5.0% at the end of 2012 to 5.4% at the end of June, the National Bank of Romania lowered its key interest rate from 5.25% to 5.00% in July, due to its confidence in a falling trend in the inflation rate which is projected at 3.2% for 2013.

Over the first half of 2013, the budget deficit came in at €1.5bn, down 2.4% year-on-year and equivalent to 1.1% of GDP, as revenues increased by 4.8% year-on-year while expenses fell by 4.3%. The Romanian Government has revised the 2013 budget deficit target to 2.3% of GDP (up from the 2.1% of GDP set at the beginning of the year). Positively, the EU funds' absorption rate was 15.3% from accession to the end of June, up from 11.5% at the end of 2012, and 5.5% at the end of 2011, respectively. Romania was allocated €19.7bn of EU funds available for the period 2007-2013 on its accession to the EU.

Romania's total external debt was €100.0bn at the end of May, up 1% year-to-date. Public sector debt was €57.2bn at the end of March, up 4.8% year-to-date and equivalent to 38.3% of GDP. The increase in public debt is mainly triggered by Romania successfully placing USD 1.5bn of 10-year US Dollar denominated bonds at a yield of 4.5% in February. The NBR's foreign reserves (excluding gold) amounted to €33.4m at the end of July, up from €31.2bn at the end of 2012. Over the first seven months of 2013, Romania repaid €2.2bn of the €12.4bn loan it was granted by the IMF in March 2009, with €2.9bn remaining to be paid by the end of the year.

Total domestic non-governmental credit (which excludes loans to financial institutions) amounted to €50.2bn at the end of June, down 0.9% year-to-date in local currency. In spite of the falling loan stock, the deposit base grew by 5.8% year-on-year in local currency terms, and amounted to €45.3bn at the end of June. Accordingly, the loan-to-deposit ratio improved from 114.5% at the end of 2012 to 110.9% at the end of June 2013. Overdue loans accounted for 14.5% of the total loan stock at the end of June, compared to 13% at the end of 2012.

A joint IMF and EU mission, which visited Romania at the end of July, reached a new 24-month stand-by agreement with the Romanian government which replaces the previous €5bn precautionary agreement signed in 2011, which expired in June. The new agreement provides for €4bn, equally split between the IMF and the EU, which will be treated as precautionary by the Romanian authorities. Following the visit, the IMF improved its 2013 GDP growth forecast for Romania from 1.6% to 2%, on the grounds of improved exports. The increase in exports was supported by a positive evolution in industrial production, which increased by 5.4% year-on-year over the first five months of 2013.

Bulgaria

An IMF mission visiting Bulgaria at the end of June restated its forecast for Bulgarian GDP growth in 2013 of 1%. This slight growth is expected in spite of a high unemployment rate and domestic political turmoil, as the street protests against the new government formed after the May parliamentary elections continue.

Inflation continued its downward trend, with Bulgaria's CPI falling from 4.2% at the end of 2012 to 2.6% at the end of June. Bulgaria's current account balance was a positive €28.7m, or 0.1% of GDP, compared to a deficit of 2.6% over the same period in 2012. The improved current account balance was the result of a shrinking trade deficit, which fell from €1.9bn over January - May 2012 to €1.0bn over the same period this year. FDI inflows were €0.5bn over the period, down from €0.9bn over the same period in 2012.

Bulgaria's budget deficit over the first half of 2013 was €3.9m, compared to a surplus of €32m over the same period in 2012. Although small, the budget deficit over the first half of 2013 reveals a fall in tax revenues, which accounted for 77% of total budget revenues over the first semester, compared to 83% over the first quarter. The Bulgarian government has revised its 2013 budget deficit target from 1.3% of GDP as approved by the parliament in December 2012, to 2%. The worsening budget prospects are the result of falling economic growth expectations for 2013. Bulgaria's public sector debt was 18.1% of GDP at the end of April, one of the lowest levels in the EU.

The Bulgarian banking system's total loans-to-deposits ratio was 90% at the end of June, virtually flat year-to-date. Whilst loans to non-financial institutions fell from €27.2bn to €26.9bn (-1.3%), the deposit base increased by 2.4% from €29.3m to €30m. Overdue loans accounted for 23.1% of total loans at the end of June, up from 22.4% at the end of 2012.

Serbia

Serbia's GDP grew by 2.1% in the first quarter of 2013, after having contracted for four consecutive quarters. This was mainly the result of strong growth in industrial production, driven by the start of serial production of cars at the new FIAT's factory in Kragujevac, the re-opening of the upgraded Pancevo oil refinery, and an increase in the production of pharmaceutical products. Accordingly, industrial production rose by 4.2% year-on-year over January - May, as a result of high growth in motor vehicles production (+225% year on year), refined petroleum products (+42% y-o-y) and pharmaceutical products (+35% y-o-y). The National Bank of Serbia (NBS) is now projecting 2% overall GDP growth in 2013, mainly due to strong exports and a good agricultural season.

The budget deficit for the first five months of 2013 amounted to €0.8bn, or 5.3% of GDP, well above the level planned by the fiscal consolidation measures enacted in October 2012. This came mainly as a result of weaker than planned tax collections. In early July, the Serbian parliament adopted a 2013 budget revision bill, in order to bring the budget deficit down to 5.2% of GDP by year-end. These measures include limiting the growth of public wages and pensions to 0.5% in April 2014, and to 1% in October 2014 (instead of 3.6% and 2.4%, respectively).

The CPI continued its downward trend in the second quarter of 2013, coming in at 9.8% in June. This was mainly the result of a fall in the prices of agricultural products, due to a good agricultural season. As a result of weakening inflationary pressures, the NBS reduced its key policy rate by 50 bps and 25 bps in May and June, respectively, lowering it to 11%. However, the announced 10-12% electricity price hike for August, and a weakening of the dinar (-2.2% against the euro in the second quarter), are expected to fuel inflationary pressures in the second half of the year.

FDI reached €0.3bn over the first five months of 2013. The European Commission's recommendation on opening EU accession talks with Serbia in late June could increase the inflow of FDI in the second half of 2013, as many announced investments were waiting for the Commission's decision on the start of accession negotiations.

During the first five months of 2013, exports grew by 20.9% year-on-year, mainly as a result of growing car and pharmaceutical exports, while imports grew by 2% over the same period. Consequently, the trade deficit fell to €2.1bn, a 21.7% year-on-year decrease.

In April, the Russian government signed a USD 500m budget support loan for Serbia, with a 10-year maturity, a two-year grace period, and a fixed annual interest rate of 3.5%. The Russian government transferred USD 300m to Serbia in June, while the remaining USD 200m will be transferred after the IMF adopts the economic programme for Serbia, which is focussed on limiting the growth of public wages and a pension freeze, along with considerable cuts in other public spending programmes.

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