

**JUSTIFICATION**  
**of the draft resolutions of the Annual General Meeting of Grupa LOTOS S.A.**  
**of June 2018th, 2018**

In connection with the Annual General Meeting of Grupa LOTOS S.A. convened for June 28th, 2018, the Management Board of Grupa LOTOS S.A. presents below the justification of the draft resolutions of the Annual General Meeting.

**Re: Item 12 of the agenda.**

*Allocation of the Company's net profit for 2017.*

The Management Board of Grupa LOTOS S.A. (the "Company") recommends that the net profit for 2017 shown in the separate financial statements, in the amount of PLN 1,419,501.109,93, be allocated as follows:

- PLN 184,873,362.00 be paid as a dividend to shareholders – PLN 1 per share; The proposed dividend record date is September 12th 2018 and the proposed dividend payment date is September 28th 2017,
- PLN 347,051,700.66 to cover the net loss for 2014 and 2015,
- PLN 887,576,047.27 to be transferred to the statutory reserve funds.

**Marked improvement in the financial condition of the LOTOS Group**

The principal objective to be achieved in accordance with Grupa LOTOS S.A.'s Strategy for 2017–2018, announced in late 2016, is to secure a stable financial position for the LOTOS Group companies in order to enhance their capacity to pay dividends, among other objectives.

An analysis of the Company's and its Group's financial statements clearly shows a significant improvement in financial performance over the recent years. The Group's consolidated net profit, which is the basis for calculating dividends for shareholders, grew rapidly in 2015, 2016 and 2017, from PLN -263m (net loss), through PLN 1,015m, to PLN 1,672, respectively. Consolidated LIFO-based EBITDA, used as a measure of the ability to generate cash flows, stood at PLN 2,156m, PLN 2,589m and PLN 3,051m in 2015, 2016 and 2017, respectively.<sup>1</sup> In those years, the Group's financial liquidity ratios also improved: the quick ratio (current assets net of inventories to current liabilities) rose from 0.69x in 2016 to 0.83x in 2017.

Over the last four years, the Group's bank debt has been consistently reduced, and its current level is safe. Net debt to LIFO-based EBITDA in 2015, 2016 and 2017 fell to 2.6x, 1.9x and 0.8x, respectively.

In conclusion, the LOTOS Group's consolidated financial results for 2017 are the best on record, and its economic performance in the first quarter of 2018 confirms that the trend is continuing, attesting to the dividend capacity of the Company.

**Funding for key growth projects secured**

Full funding has been secured for the Group's two principal CAPEX projects currently under way: (i) the EFRA Project and (ii) the launch of full crude oil production from the B8 field. The

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<sup>1</sup>adjusted for one-off events

Company's Management Board expects that no cash generated from the Group's day-to-day operations will need to be used to complete those projects.

### **Recommended dividend per share**

The Company is consistent with its commitment to building shareholder trust. In order to finance its key CAPEX projects, the Company has twice – in 2005 and 2014 – raised funds from its shareholders through new share issues on the Warsaw Stock Exchange.

Considering investors' expectations and the Company's financial capacity and needs, the Management Board has resolved to recommend to the General Meeting a dividend payment that will fulfil the shareholders' rights to profit distributions and further enhance their long-term trust in the Company and the growth policy it is pursuing.

Payment of dividend in two consecutive years would confirm the Company's business maturity and provide an undisputed proof of its stable financial position.

Having regard to the Company's requirements relating to:

- execution of further important CAPEX projects covered by the Strategy,
- fulfilling the financial obligations related to the Group's current external debt,
- the need to cover accumulated losses brought forward,

the Company's Management Board recommends that the dividend to be paid from profit for 2017 be the same as in 2016, i.e. PLN 1 per share (approximately PLN 185m in total).

The Company has sufficient financial resources that may be allocated to the payment of dividends to shareholders, and the payment in the proposed amount will not adversely affect the financing of the Company's day-to-day operations or constrain the capacity for financing the growth projects envisaged in the current strategy of Grupa LOTOS S.A.

### **Re: Item 15 of the agenda.**

*Consent to the planned subscription and payment for shares in the increased share capital of LOTOS Upstream sp. z o.o.*

With a view to expanding the upstream operations of the LOTOS Group, on May 29th 2018 the Management Board of Grupa LOTOS S.A. passed Resolution No. 15/X/2018 to increase the share capital of LOTOS Upstream sp. z o.o., a wholly-owned subsidiary of Grupa LOTOS S.A., subject to the General Meeting's approval. The share capital of LOTOS Upstream sp. z o.o. is planned to be increased by way of a single increase or a series of successive increases by a maximum total amount of PLN 330,000,000.00 (three hundred and thirty million złoty) and subscription of no more than 3,300,000 (three million, three hundred thousand) new shares in LOTOS Upstream sp. z o.o., with a par value of PLN 100 (one hundred złoty) per share, to be paid up in cash.

To effect the share capital increase, the Management Board of Grupa LOTOS S.A. is required to obtain the consent of the Company's General Meeting pursuant to Art. 9.13 of the Articles of Association of Grupa LOTOS S.A., which provides that:

- 13) acquisition of or subscription for shares in another company where the value of such shares exceeds:
  - a) PLN 100,000,000, or

- b) 10% of total assets within the meaning of the Accounting Act of September 29th 1994,  
as determined based on the most recent approved financial statements (i.e. 10% of approximately PLN 1.58bn-worth of assets).

On May 29th 2018, the Supervisory Board of Grupa LOTOS S.A. passed Resolution No. 85/X/2018 approving the request made by the Management Board of Grupa LOTOS S.A. to the Company's General Meeting to increase the share capital of LOTOS Upstream sp. z o.o.

In view of the foregoing, the Management Board of Grupa LOTOS S.A. requests that the General Meeting of Grupa LOTOS S.A. approve the action described herein.

## Plan for partial deleveraging of Grupa LOTOS's upstream segment



## Introduction

Grupa LOTOS S.A. is a vertically integrated oil company operating in oil exploration, production and processing, as well as in sale and distribution of a wide range of petroleum products. The Company has been listed on the Warsaw Stock Exchange since 2005. Its major shareholder is the Polish State Treasury.

In the last 12 months, Grupa LOTOS S.A. carried out a capital restructuring of its upstream segment. The process led to the establishment within the LOTOS Group of a dedicated company whose main objective is to separate management and operational functions within the upstream segment and to create a platform for further development of upstream operations within the LOTOS Group structure. To date, the share capital of LOTOS Upstream has been increased to PLN 576m. The funds thus raised allowed LOTOS Upstream to acquire from LOTOS Petrobaltic the following companies: LOTOS E&P Norge AS, AB LOTOS Geonafta, Baltic Gas sp. z o.o., and Baltic Gas sp. z o.o. i Wspólnicy sp.k. In addition, a portion of the funds was allocated for a capital contribution to LOTOS E&P Norge, and then for repayment of some of that company's debt.

The current make-up of the Upstream segment has evolved through acquisitions and restructuring processes. One of the key sources of funding for the upstream operations were intra-group loans. As a result, a number of financial links were created between the individual companies of the Group. Following the completion of the restructuring process carried out at the LOTOS Group, a clear-cut structure of the upstream segment was established, separating the management and operational functions.

As defined in the LOTOS Group's 'Stability and sustainable growth' strategy for 2017–2022, activities in the upstream area are aimed at building a balanced and diversified portfolio of assets. LOTOS intends to pursue more new field development projects, gradually increase the importance of exploration activities in its portfolio, and reduce the share of licences covering mature fields. Apart from organic growth, LOTOS plans to actively exploit investment opportunities offered by the market and supplement its portfolio by acquiring attractive new assets.

Areas of the North Sea, both within the Norwegian Shelf and the British Shelf, as well as the Baltic Basin region (Baltic Sea, onshore licences in Poland and Lithuania) will be the key growth direction for the upstream business.

Total capital expenditure provided for in the Grupa LOTOS S.A. Strategy for the development of its upstream segment in 2017–2022 is PLN 3bn. Additionally, the Strategy provides for an option to allocate additional funds from the pool of PLN 3.3bn to be distributed among the segments for new development projects in the 2018+ perspective.

The following parameters are expected to be achieved by the Upstream segment following the implementation of the Strategy:

KPI	2017-2018 Perspective	2019-2022 Perspective
Annual EBITDA	PLN 0.6bn– 0.7bn	PLN 1.6bn– 1.8bn
Production	22,000 boe/day	30,000– 50,000 boe/day
2P reserves	60 mboe	> 60 mboe

To effectively deliver the pre-set strategic objectives, it is necessary to streamline the financing structure of the upstream segment. The restructuring process will be continued, with a plan to partially deleverage the upstream companies, which will also create a capital base for further growth of upstream operations.

### Description of the process:

The purpose of the request is to provide LOTOS Upstream sp. z o.o. with funds allowing a further debt reduction of the upstream business (including, in particular, provision of capital to LOTOS E&P Norge and repayment of some loans to LOTOS Petrobaltic S.A., and to create a capital base for growth of the LOTOS Group's upstream segment. The repayment of loan interest and principal will significantly reduce the CIT tax risk related to non-recognition of interest income on loans granted in previous years in the tax calculation. Moreover, the risk of thin capitalisation (classing borrowing costs as tax deductible) will be mitigated at some of the Group companies.

The basic assumption underlying the project is providing capital to upstream companies and using a portion of funds so obtained to repay the outstanding intra-group loans and the balance – as the equity for the implementation of development projects. Presented below are the steps planned to be taken as part of the process:

1. Grupa LOTOS S.A. increases the share capital of LOTOS Upstream sp. z o.o. by approximately PLN 300m<sup>2</sup> (in accordance with Art. 9.13 of the Articles of Association, subscription for shares with a value exceeding PLN 100m requires approval by the General Meeting of Grupa LOTOS). The Management Board of Grupa LOTOS S.A. has requested the General Meeting to grant its consent to subscribe for new shares in LOTOS Upstream sp. z o.o. with a value of up to PLN 330m. The maximum amount of the capital contribution includes a reserve of PLN 30m in case the planned PLN 300m increase proved insufficient due to changes in exchange rates;
2. LOTOS Upstream sp. z o.o. allocates the funds to increase the share capital of LOTOS E&P Norge AS;
3. LOTOS E&P Norge AS repays a portion of the debt outstanding under the intra-group loans received from LOTOS Petrobaltic S.A. and AB LOTOS Geonafta;

<sup>2</sup> The amount was calculated using the following exchange rates: USD 1 = PLN 3,66; NOK 1 = PLN 0,45; EUR 1 = PLN 4,3

4. AB LOTOS Geonafta repays the loans to LOTOS Petrobaltic S.A. (subject to approval by the lending bank);
5. Some of the funds received by LOTOS Petrobaltic S.A. are allocated for the repayment of loans to Grupa LOTOS S.A. and the balance may be allocated to support day-to-day operations and/or to financially support the B8 Project;
6. In accordance with the CIT prepayment mechanism applicable at the LOTOS Group companies, payment of tax on LOTOS Petrobaltic S.A.'s interest income will be delayed until March 31st 2019. At the other companies, the issue of tax on interest income will be immaterial.

### **Expected effects:**

LOTOS Upstream Sp. z o.o.

- ✓ Share capital will increase by PLN 300m, to PLN 876m;

LOTOS E&P Norge AS:

- ✓ increase in equity (reducing the risk of thin capitalisation);
- ✓ repayment of some of the intra-group loans (elimination of tax risk associated with interest accrued on the loans);
- ✓ increased ability to secure external financing for growth projects (field development, acquisitions);

LOTOS Petrobaltic S.A.:

- ✓ repayment of debt towards Grupa LOTOS S.A.;
- ✓ securing funds to supplement the Company's own contribution to finance the equity required for the completion of the B8 Project;

AB LOTOS Geonafta

- ✓ repayment of debt towards LOTOS Petrobaltic S.A.;

Once completed, the planned partial deleveraging will enable further financial streamlining of the Group's upstream segment and will create the basis for further growth of upstream operations.

Pursuant to Art. 1.1.k and Art. 1.3.2 of the Act on Tax on Civil Law Transactions, a share capital increase in a company, involving an amendment to the articles of association, is subject to tax on civil law transactions. The obligation to pay tax on civil law transactions lies with the company whose share capital is increased. The rate of tax on civil law transactions is 0.5% of the amount of the share capital increase.

The process is subject to confirmation that the above transactions are feasible at the companies which are parties to binding agreements for external financing and if there is a risk of subordination of the funds, the Companies will obtain relevant bank approvals.