

# GRUPA LOTOS S.A. INVESTOR'S GUIDE

HOW TO READ FINANCIAL REPORTS  
OF AN OIL & GAS COMPANY

PART 3:  
CASH FLOW  
STATEMENT



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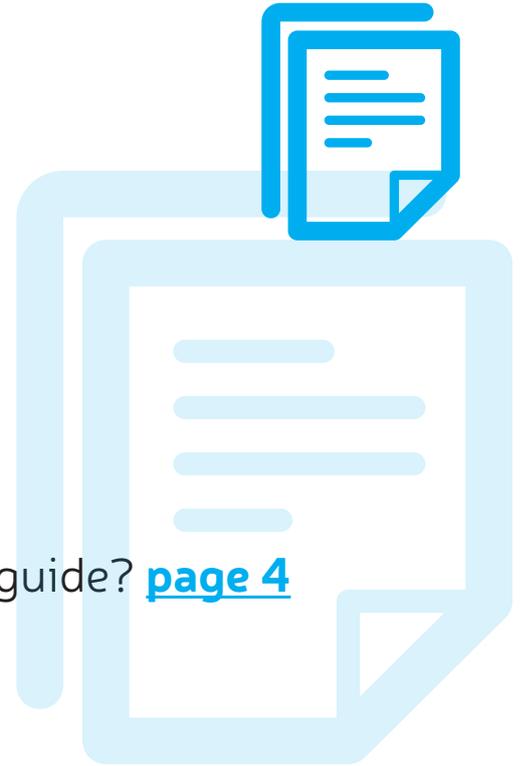
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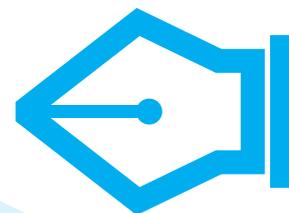
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# FOREWORD



## Dear Investor,

we present to you the third part of Grupa LOTOS Investor's Guide, intended as a manual for analysing the cash flows of oil companies.

We hope that the previous two parts have provided you with a useful insights into the peculiarities of the profit and loss accounts and statements of financial position of companies operating in our industry.

Our business is affected by a number of external factors, which tend to be highly volatile. Major impact factors include the prices of crude oil and petroleum products (e.g. gasoline and diesel oil), as well as USD/PLN exchange rates. As a result of their fluctuations, the financial performance of oil companies may vary significantly between reporting periods.

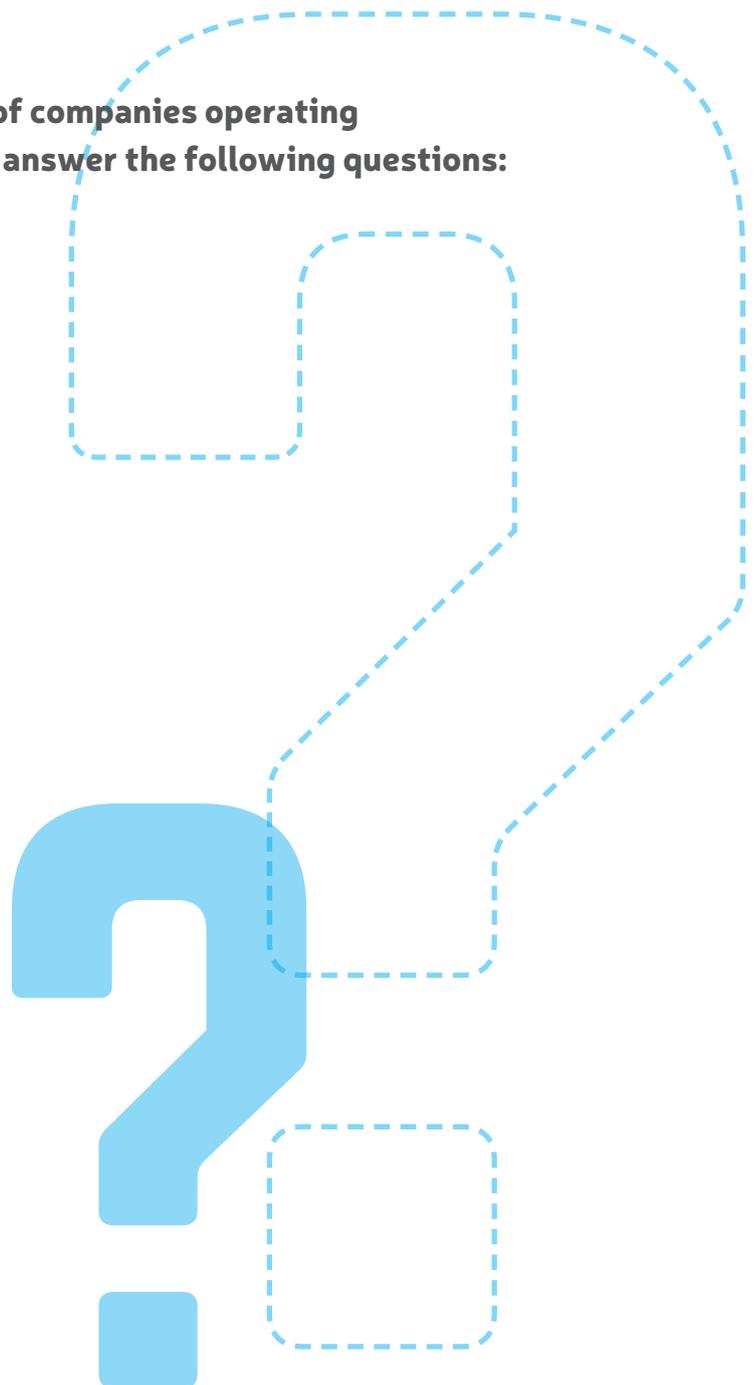
This third part of our guide is another stepping-stone in learning the financial analysis of petroleum industry operators. We hope to have been helpful in clearing up the main complexities, facilitating your decision to invest in shares of sector companies. We believe that, once you have read this edition, your investment decisions will be based on fundamental confidence stemming from an analysis of the selected company's cash flow statement.

The example figures shown here are based mainly on the LOTOS Group's actual performance figures, with references to relevant pages of our 2017 Financial Statements.

# HOW TO READ FINANCIAL REPORTS OF AN OIL & GAS COMPANY

In this part, we focus on cash flows (CFs) of companies operating in the petroleum downstream industry, to answer the following questions:

- ⇒ WHAT ARE CFs CATEGORIES?
- ⇒ WHY ARE CFs CALCULATED?
- ⇒ HOW ARE CFs CALCULATED?
- ⇒ WHAT DO CFs VALUES IMPLY FOR THE COMPANY?



# ESSENCE OF THE CASH FLOW STATEMENT



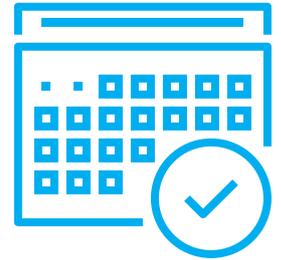
Cash flow statement is prepared by comparing the company's two successive statements of financial position: at the beginning and at the end of the reporting period.

Additionally, some supplementary data and certain items from the profit and loss account are also used.

A cash flow statement shows changes – both increases and decreases – in the cash balances that occurred in a given reporting period. It is therefore a statement giving a dynamic picture of the company. The information it provides is expressed in cash terms.

A balance sheet, on the other hand, presents values that provide a static picture of the company's assets and sources of their financing at a certain point in time, while a statement of profit or loss shows the cumulative effects of business processes taking place at the company in a given period.

# FUNCTION OF THE CASH FLOW STATEMENT



Profit generated by a company is not the measure of its existence. In the end, profit shown in the financial statements is only a so-called 'paper profit'. Profit generation is not the only condition for a company's efficient operation – more important are the flows of cash that determine its solvency and liquidity.

A cash flow statement shows the actual cash receipts (inflows), i.e. the sources from which cash was generated, as well as cash disbursements (outflows), i.e. uses to which the generated cash was put. It therefore shows a cash surplus or shortage generated by the company as a result of its activities. The cash flow statement allows an investor to evaluate the company's ability to self-finance its operations or, in other words, an ability to cover its current liabilities exclusively with self-generated, internal funds.



# CASH FLOW CATEGORIES



## CASH FLOWS FROM OPERATING ACTIVITIES

This category presents cash originating from or relating to the company's principal business activity as defined in its articles of association. Operating cash flows are directly associated with production, trade or provision of services, and include cash receipts from sales, and cash used to cover the costs of purchase of raw materials and other inputs used in the production process, salaries, rents, etc. Net cash from operating activities is a key indicator of the business entity's ability to generate cash needed to settle trade accounts, repay financial debt, maintain operational capacity, pay dividends and make new investments without having to seek external financing.

Net operating cash flows are primarily the result of transactions and events that ultimately determine whether the company earns a net profit or makes a net loss. They are calculated by deducting cash outflows from cash inflows. There are two methods of computing cash flows: the direct and the indirect method. Grupa LOTOS, like most companies, uses the indirect method of cash flow calculation.

### INDIRECT METHOD:

+ NET PROFIT

+ TOTAL ADJUSTMENTS:

DEPRECIATION AND AMORTISATION

FOREIGN EXCHANGE GAINS (LOSSES)

INTEREST AND PROFIT DISTRIBUTIONS (DIVIDENDS)

GAIN (LOSS) ON INVESTING ACTIVITIES

---

= NET CASH FROM OPERATING ACTIVITIES



## CASH FLOWS FROM INVESTING ACTIVITIES

They represent changes in cash reflecting capital expenditures incurred by the company to expand its assets and capital resources to generate future profits, and include cash used to acquire property, plant and equipment, intangible assets and other non-current assets, as well as proceeds from sale of such items. Any cash used to purchase a non-current asset is classified in its entirety under cash flows from investment activities.

### INDIRECT METHOD:

- + PROCEEDS FROM DISPOSAL OF INTANGIBLE ASSETS AND PROPERTY, PLANT AND EQUIPMENT
  - + PROCEEDS FROM DISPOSAL OF INVESTMENT PROPERTY AND INTANGIBLE ASSETS
    - + FINANCIAL ASSETS (DIVIDENDS, PROFIT DISTRIBUTIONS, REPAYMENT OF LONG-TERM LOANS ADVANCED, INTEREST, OTHER)
    - + OTHER CASH PROVIDED BY INVESTING ACTIVITIES
  - PAYMENTS TO ACQUIRE INTANGIBLE ASSETS AND PROPERTY, PLANT AND EQUIPMENT
  - PAYMENTS ON INVESTMENT PROPERTY AND INTANGIBLE ASSETS
    - PAYMENTS ON FINANCIAL ASSETS (ACQUISITION OF FINANCIAL ASSETS, LONG-TERM LOANS ADVANCED)
    - OTHER CASH USED IN INVESTING ACTIVITIES
- 
- = NET CASH FROM INVESTING ACTIVITIES

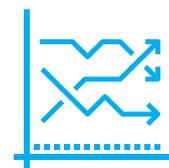
# CASH FLOWS FROM FINANCING ACTIVITIES

This category includes proceeds from issues of shares, bonds or other financial instruments and bank borrowings. Financing outflows typically include payments for buy-back of shares, dividends pay-outs and other payments associated with profit distribution, repayment of borrowings or finance lease payments.

## INDIRECT METHOD:

- + NET PROCEEDS FROM ISSUE OF SHARES OR OTHER EQUITY INSTRUMENTS, AND CONTRIBUTIONS TO EQUITY
    - + PROCEEDS FROM BORROWINGS
      - + PROCEEDS FROM ISSUE OF DEBT SECURITIES
      - + OTHER CASH GENERATED BY FINANCING ACTIVITIES
    - PAYMENT FOR BUY-BACK OF SHARES
    - DIVIDENDS AND OTHER DISTRIBUTIONS PAID TO OWNERS
    - DISTRIBUTIONS FROM PROFIT OTHER THAN DISTRIBUTIONS TO OWNERS
      - REPAYMENT OF BORROWINGS
      - REDEMPTION OF DEBT SECURITIES
      - PAYMENT TOWARDS OTHER FINANCIAL LIABILITIES
        - FINANCE LEASE PAYMENTS
        - INTEREST
    - OTHER CASH USED IN FINANCING ACTIVITIES
- 
- = NET CASH FROM FINANCING ACTIVITIES

# CASH FLOWS AT LOTOS GROUP



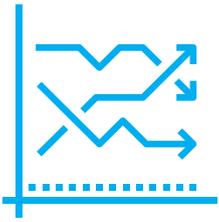
The LOTOS Group prepares its statement of cash flows using the indirect method.

## CONSOLIDATED STATEMENT OF CASH FLOWS

	Note	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
<b>Net profit</b>		<b>1,671.8</b>	<b>1,015.2</b>
<b>Adjustments:</b>		<b>1,804.9</b>	<b>1,708.8</b>
<b>Income tax</b>	10,01	775.9	564.2
Share in net profit/(loss) of equity-accounted joint ventures	14	(3.2)	(2.9)
Depreciation and amortisation	9,01	844.3	1,067.9
Foreign exchange (gains)/losses		72.3	37.6
Interest and dividends		146.2	175
(Gain)/loss on investing activities		8.6	12.8
Impairment losses on property, plant and equipment and other intangible assets	9,04	83.6	156.4
Settlement and measurement of financial instruments	9,5; 9,6	(314.1)	33.5
(Increase) in trade receivables		(425.3)	(671.9)
Decrease/(Increase) in other assets		160.1	(126.8)
(Increase) in inventories		(230.9)	(126.5)
<b>Increase in trade payables</b>		<b>483.5</b>	<b>457.7</b>
Increase in other liabilities and provisions		194.8	130.1
Increase in employee benefit obligations		9.1	1.7
<b>Income tax paid</b>		<b>(350.2)</b>	<b>(70.1)</b>
<b>Net cash from operating activities</b>		<b>3,126.5</b>	<b>2,653.9</b>

**Income tax and income tax paid** – the former is an item of a statement of profit or loss, representing the tax amount that has been calculated as payable. The latter item represents the amount of tax that has actually been paid.

**Increase in trade payables** – the large movements in this item reflect mostly payments for crude oil and their postponement.



## CONSOLIDATED STATEMENT OF CASH FLOWS

	Note	2017	2016
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Dividends received – equity-accounted joint ventures		2.1	-
Dividends received from other entities		1.7	2.0
Interest received		11.3	11.4
Sale of property, plant and equipment and other intangible assets		4.3	28.4
<b>Purchase of property, plant and equipment and other intangible assets</b>		(1,439.2)	(1,243.6)
Cash contributions – equity-accounted joint ventures	14	(5.4)	(24.4)
Cash earmarked for the EFRA Project		-	433.4
Bank deposits		(8.0)	-
Security deposit		25.3	(26.4)
<b>Funds for future costs of decommissioning of oil and gas extraction facilities</b>		(42.9)	(187.2)
Security deposit under EPCM contract for the offshore production unit in the B-8 field		-	10.6
Settlement of derivative financial instruments		2.8	(7.4)
Other cash used in investing activities		(0.7)	-
<b>Net cash from investing activities</b>		<b>(1,448.7)</b>	<b>(1,003.2)</b>

**Purchase of property, plant and equipment and other intangible assets** – this item is not always equivalent to capital expenditure made by the company, because cash booked does not always entail a cash movement.

**Funds for future costs of decommissioning of oil and gas extraction facilities** – this is one of key items in our industry determining the economic viability of projects.

## CONSOLIDATED STATEMENT OF CASH FLOWS

	Note	2017	2016
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from bank borrowings	22,1	925.8	379.3
Proceeds from non-bank borrowings	22,2	-	1.2
Issue of notes	22,3	296.1	-
Repayment of bank borrowings	22,1	(1,223.4)	(1,499.5)
Repayment of non-bank borrowings	22,2	(12.8)	(11.6)
Redemption of notes	22,3	(160.2)	(19.2)
Interest paid		(203.3)	(203.7)
Dividends paid	12	(184.9)	-
Finance lease payments		(36.8)	(31.2)
Settlement of derivative financial instruments		116.8	183.3
<b>Net cash from financing activities</b>		<b>(482.7)</b>	<b>(1,201.4)</b>
<b>Total net cash flow</b>		<b>1,195.1</b>	<b>449.3</b>
Effect of exchange rate fluctuations on cash held		(5.3)	3.4
<b>Net change in cash</b>		<b>1,189.8</b>	<b>452.7</b>
<b>Cash at beginning of period</b>		<b>730.8</b>	<b>278.1</b>
<b>Cash at end of period</b>	17	<b>1,920.6</b>	<b>730.8</b>

# SUMMARY

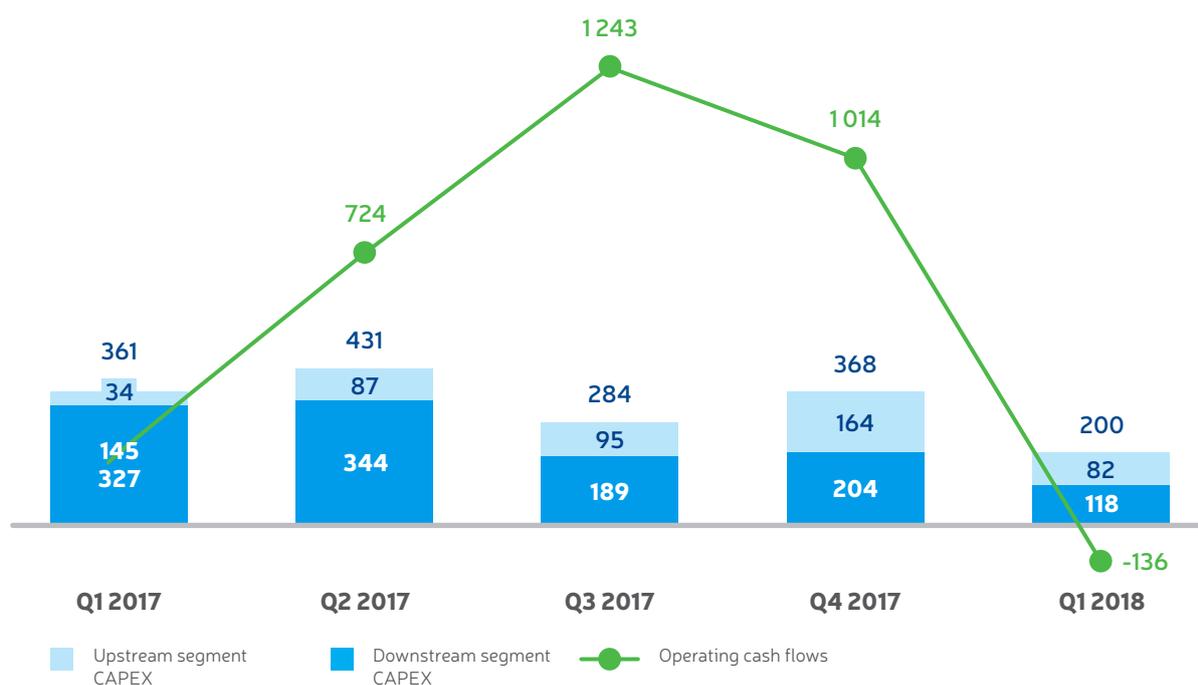


At Grupa LOTOS net cash from operating activities is positive, approximating a key performance metric used in its management reports, namely normalised LIFO-based EBITDA, such situation confirms that Grupa LOTOS is an efficiently operating business.

A company that is unable to generate positive net cash from operating activities in the long term is probable to fail. Negative net cash from operating activities is primarily an indication of low profitability of the company's business.

An exemplary situation is when net cash from operating activities is high enough to cover any negative net cash from investing activities. What negative net cash from investing activities usually implies is that a company is incurring capex to replace its non-current assets (which is expected to ensure future generation of operating cash flows).

Regular replacement of its assets should be a company's policy, and high amounts of cash used on investing activities are characteristic to enterprises that constantly grow and develop. In recent years, Grupa LOTOS has been reaping the benefits of its earlier investment programmes (e.g. 10+ and EFRA), allowing it to comfortably deleverage its business, as shown in the chart below. The green line runs high above the bars – the difference between the operating cash flows and capital expenditure is applied to reduce financial debt.

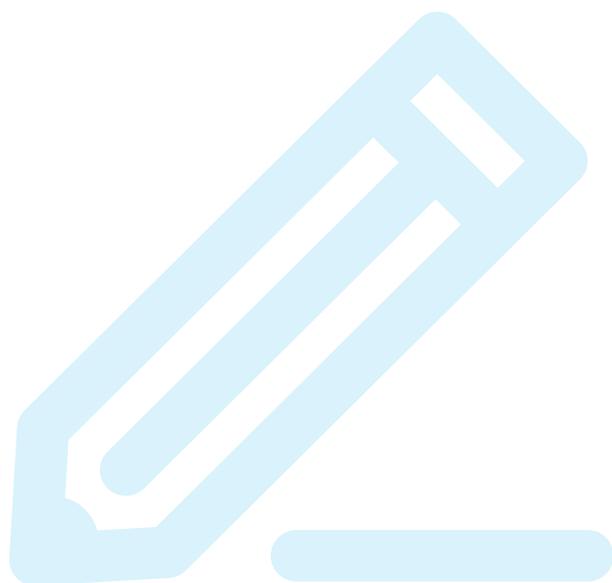


**Net cash from financing activities may be positive or negative.**

If a company is growing fast, it has to rely on external sources of financing in addition to self-generated cash to finance its expanding operations. As a part of financing activities, a company may raise funds in a number of ways, for instance by borrowing from banks, contracting loans from other entities, or issuing bonds.

The aggregate of net cash from operating, investing and financing activities may be called a **net cash profit from the company's operations**. By aggregating it with cash held by the company at the beginning of a financial year, we arrive at the amount of the company's cash at the end of the period.

Cash flow analysis is an important element of fundamental analysis used to evaluate potential investment opportunities in stocks, since discounting of excess cash is one of the methods through which investors arrive at a company's value. Publicly traded company's valuation methods will be discussed in a greater detail in the next, fourth edition of our guide.



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