

TO
the Extraordinary General Meeting of Korado-Bulgaria AD
scheduled for 16 September 2020

SUBSTANTIATED REPORT OF THE MANAGEMENT BOARD OF KORADO-BULGARIA AD

pursuant to Art. 114a, Par. 1 of the Law on Public Offering of Securities

Reference: Expediency and Terms and Conditions of Realisation of Deals in Accordance with Art. 114, Par. 1, item 1, letter "б" of the LPOS

1. GENERAL INFORMATION REGARDING THE DEAL

1.1. General Description of the Deal

The deal represents series of sales of: (a). radiators; and/or (b). materials for the manufacturing of radiators; and/or (c). spare parts for radiators, such sales being, in any and all cases, subject to specific orders and confirmations ("**Sale Deals**" and "**Products**", respectively). From legal perspective, each order and its confirmation will constitute a separate agreement for the sale of Products, such separate agreement following a pre-determined framework of general terms and conditions ("**Framework Agreement**").

The transfer of Products (as *assets* in the meaning of Art. 114, Par. 1, item 1 of the *Law on Public Offering of Securities* - the "**LPOS**") occurs by way of entering into the Sale Deals, therefore, corporate authorization is sought for them, where their value exceeds the statutory thresholds specified in that provision of law (not for the entering into the Framework Agreement, of itself).

The parties to the Framework Agreement and the Sale Deals are Korado-Bulgaria AD (the "**Company**"), as the Seller, and Korado, a.s., Czech Republic ("**Korado CR**"), as the Purchaser.

The Company and Korado CR qualify as *related parties* pursuant to §1, item 13, letter "a" of the Additional Provisions to the LPOS. Korado CR exercises control over the Company, such control qualifying under §1, item 14, letter "a" of the Additional Provisions to the LPOS and being manifested in the direct holding by Korado CR of 82.15% of the share capital of the Company.

With regard to the above, being a holder of more than 25% of the votes in the General Meeting of the Company, and pursuant to Art. 114, Par. 7 item 2 of the LPOS, Korado CR qualifies as an *interested party* with regard to the Framework Agreement and the Sale Deals.

By the Sale Deals, the Company will transfer *assets*, the total value of which exceeds 2% of the lower of the values of the Total Assets on the last two prepared Balance Sheets of the Company, at least one of which has been audited and both of which have been publicly disclosed in accordance with Art. 100r of the LPOS.

1.2. Economic Substance of the Sale Deals

The Korado Group of Companies has achieved full harmonisation of the corporate, technical and business processes amongst its members. Being such member, the Company traditionally has a significant role as a key manufacturer of the main products from the group's portfolio. Such role is manifested in the Sale Deals, which have been in place since the Company joined the group and whose value will exceed in 2020 the thresholds requiring authorization by the General Meeting of the Company.

As shown in the Management Report for 2019, the strategy of the Company assumes full utilization of the benefits available from the membership in the Korado Group, including, among others, Korado CR's continuation to be a key client of the Company.

1.3. Management and Officers of the Company and External Advisors Engaged with the Sale Deals

The following persons have been engaged with the preparation for obtaining corporate authorization of the Sale Deals:

Management Board of the Company consisting of 3 members: Ing. Jiří Řezníček, Silviya Stefanova and Jana Havlová

Investor Relations Director of the Company: Snezhana Baycheva

Attorneys-at-law Providing Advice on the Approval of the Deal: Ivan Lyaskov attorney-at-law and Konečná & Zacha Law Firm

Responsible for Valuation of the Products: Management Board of the Company relying on information provided by the Czech Transfer Pricing Department of PriceWaterhouse Coopers (with support from their Bulgarian department)

1.4. Information with Regard to the Approval of the Report

This present Substantiated Report (the “**Report**”) is approved by the Management Board of the Company (the “**MB**”) by resolution on item 4 of the agenda of the Minutes of its regular session held on 22 July 2020. The Report represents a material under item 4 of the agenda of the Extraordinary General Meeting of the Company scheduled for 16 September 2020 (the “**GM**”).

2. ADDRESS TO THE SHAREHOLDERS AND THE VOTE-HOLDERS

Dear Shareholders and Vote-Holders,

The Report is prepared on the grounds of Art. 114a, Par. 1 of the LPOS and has the contents required by Art. 46 of *Ordinance No. 2 dated 17 September 2003 on the Prospectuses for Public Offering and Admission to Trade at a Regulated Market of Securities and on the Disclosure of Information by Publicly-Traded Companies and Other Issuers of Securities*, issued by the Financial Supervision Commission, as follows:

- (i). description of the proposed deal, including its subject-matter, value, beneficiaries, as well as of the other essential elements of the deal, which are necessary to provide complete information and avoid misleading of the shareholders;
- (ii). the trade names of the parties to the proposed deal;
- (iii). the trade names of the parties, which qualify as *interested parties* under Art. 114, Par. 7 of the LPOS, the reasons to qualify as such and the grounds of their interest in the deal;
- (iv). the market valuation of the proposed deal under Art. 114a, Par. 5 of the LPOS; and
- (v). description of the economic benefits of the Company from the proposed deal.

The Report aims to present to the attention of the shareholders and vote-holders of the Company the essential terms and conditions and the expediency of the Framework Agreement and the Sale Deals.

The Report contains all of the essential elements of the Sale Deals, which are necessary for the taking of an informed and substantiated resolution by the GM with regard to the authorization of the MB on the entering into the Sale Deals.

In the absence of approval by the GM, the MB would not have the powers to consummate Sale Deals in excess of the statutory thresholds of value. In the event that such deals had anyway been concluded absent such approval, then the deals would have been null and void pursuant to Art. 114, Par. 12 of the LPOS.

3. ESSENTIAL TERMS AND CONDITIONS OF THE DEAL

3.1. Parties to the Framework Agreement and the Sale Deals

The parties to the Framework Agreement and the Sale Deals qualify as *related parties* and Korado CR qualifies as an *interested party* with respect to such deals. The interest of Korado CR in the Framework Agreement and the Sale Deals arises from its capacity of a majority shareholder of the Company and is manifested in:

- (a) successful implementation and maintenance of the business model of the Korado Group;
- (b) efficient realization on the market of the products manufactured by the Company;
- (c) maintenance of the stable financial condition of the Company; and
- (d) optimisation of the cash-flow of the Company.

3.2. Subject-Matter of the Framework Agreement and the Sale Deals and Description of the Products

The Framework Agreement and the Sale Deals contemplate non-exclusive supply of Products manufactured by the Company for subsequent realization on the market using the distributorship network and other resources of Korado CR.

The Products comprise the following 2 main categories:

- (i) radiators of the whole-range product portfolio of the Company manufactured in finished form – designated for direct realization on the market (“**Radiators for Distribution**”); and
- (ii) steel tubular radiators without surface treatment – designated for processing to final form and resale (“**Pre-Finished Radiators**”),

and the following 2 auxiliary categories:

- (i) materials for employment in the manufacturing of radiators; and
- (ii) spare parts for radiators.

Each order for Products and its confirmation will constitute a separate sale-purchase agreement, where case-by-case arrangements will be in place as to: type of the Products (from the Company’s portfolio); quantity of the Products; unit price (based on the Company’s price-list) and total value of the deal; and other terms and conditions of the deal.

3.3. Timeline of the Sale Deals

The timeline of consummating the Sale Deals will not go beyond 31 December 2025.

3.4. Unit Prices of the Products

The unit prices of the Products are determined by amount in accordance with Transfer Pricing Documentation obtained by the Company, which is subject to periodic adjustment (typically annual, unless

the alignment with the Arm’s Length Principle requires more frequent). The determination is done on the basis of the following methods:

- (i). Resale Price Method – for the Radiators for Distribution; and
- (ii). Cost Plus Method – for the Pre-Finished Radiators.

Each of these methods will continue to apply to the respective type of the Products until a different method is deemed more appropriate by the management of the Company on the basis of advice from the qualified tax counsel.

The Resale Price Method is universally acknowledged as the most adequate in the case of sales for subsequent direct distribution. The method requires the employment of a pricing model plus annual benchmarking adjustable at least once a year to keep an arm’s-length-aligned level of the gross margin of the Purchaser (distributor).

The gross margin of the Purchaser is calculated, as follows:

$\text{final price for the customer decreased by the gross margin of the Purchaser stated in \%}$

The gross margin of the Purchaser is defined, as follows:

Sales by the Purchaser of the Products purchased from the Seller	
minus	
purchase price of the Products purchased from the Seller (including costs for transport from the plant of the Seller to the premises of the Purchaser)	
equals	the absolute gross margin of the Purchaser
divided by	Sales by the Purchaser of the Products purchased from the Seller
equals	the gross margin of the Purchaser in %

The Cost Plus Method is universally acknowledged as the most adequate in the case of sales for subsequent processing into final form before resale. The method uses the cost base of the Seller, to which is added a mark-up falling within the inter-quartile range determined on the basis of a study of comparable uncontrolled deals.

Each of: (i). the selected *gross margin* for the distribution operations; and (ii). the selected *mark-up* for the processing and resale operations, is based on the Arms Length’s Principle. That renders, in result, a percentage within the inter-quartile range defined by a benchmarking study of independent companies and their results for at least 3 (three) seasons (the “**Target Margin**” and the “**Target Mark-Up**”, respectively). Minimally once per year, i.e. at the end of each calendar year, the actual *gross margin* and the actual *mark-up* will be reviewed and any deviations from the Target Margin and the Target Mark-Up will be compensated either to the Purchaser or to the Seller by a year-end adjustment.

In exceptional circumstances, the Seller and the Purchaser can agree on providing a significant discount and also on the way they will split the outcome, either a profit or a loss, resulting from the particular project. Exceptional circumstance can include: participation in a tender and/or penetration a market and/or acquiring a new customer or any other exceptional situations for providing significant discounts provided that they are mutually agreed by the Seller and the Purchaser, mainly due to strategic-business reasons.

3.5. Maximum value of the Sale Deals

The maximum total value of any and all Sale Deals will not exceed BGN 40 million (net of VAT and transaction costs) in any financial year. That quantification is determined by the management of the Company on the basis of historical data and projections for the size of operations in the course of the Sale Deals' timeline.

3.6. Assessment of the Value of the Sale Deals against the Thresholds under the LPOS

Under the Sale Deals, the Company will sell Products, which will qualify as *transfer of assets* in the meaning of Art. 114, Par. 1, item 1 of the LPOS. The total value of the Sale Deals is estimated to reach the thresholds, determined in the aforementioned legal provision in the year 2020.

Due to the affiliation between the Company and Korado CR and the interest of Korado CR with respect to the Sale Deals, the applicable threshold is the one under Art. 114, Par. 1, item 1, letter "6" of the LPOS, namely: 2% of the lower value of the assets on the last two prepared Balance Sheets of the Company, at least one of which has been audited and which have both been publicly disclosed following the order of Art. 100r of the LPOS.

As of the moment of the preparation of the Report, the last audited Balance Sheet of the Company is the one as at 31 December 2019 and the last prepared and publicly disclosed Balance Sheet of the Company is the one as at 31 March 2020. The value of the Total Assets on them is as follows:

	Balance Sheet as at 31 December 2019	Balance Sheet as at 31 March 2020
Value (BGN '000)	28,485	29,844

The lower of the two values is the one on the Balance Sheet as of 31 December 2019, of which 2% are equal to circa BGN 569.7 thousand.

From the comparison between the abovementioned threshold and the estimated value of the Sale Deals, it can be concluded that they fall within the scope of Art. 114, Par. 1, item 1, letter "6" of the LPOS, due to which they are subject to upfront approval by the GM.

In the present item of the Report the term "*Balance Sheet*" is used as a synonym of "*Statement of Financial Position*".

3.7. Beneficiaries of the Framework Agreement and the Sale Deals

The Framework Agreement and the Sale Deals will be consummated as beneficial to both parties.

3.8. Other Essential Terms and Conditions of the Framework Agreement and the Sale Deals

The MB considers the following as essential terms and conditions of the Framework Agreement and the Sale Deals, to which the shareholders of the Company should pay specific attention:

- *terms of payment:* the deadline for full payment is 60 (sixty) days from the date of invoice
- *transfer of title:* the title to the Products passes over from the Seller to the Purchaser upon full payment
- *terms of delivery:* the terms of delivery are agreed upon (including, but not necessarily, by reference to Incoterms 2010 or Incoterms 2020) on a case-by-case basis

- *exclusivity:* the Company is not bound by commitment to sell exclusively to Korado CR
- *commitment to volume:* the Company is not bound by commitment to minimum volume of sales
- *specific obligations of Korado CR:*
 - to procure for the distribution of the ready-for-market-realization radiators on terms, which Korado BG considers usual to the radiator market at the moment of the respective sale
 - to adequately protect any and all intellectual property rights of Korado BG over the radiators and support the legitimate business interest of Korado BG in the most beneficial market realization of the radiators
- *applicable law and resolution of disputes:* The framework terms and conditions of the deals shall be governed by the Czech law. The disputes arising from the deals shall be referred for solution to the Arbitration Court attached to the Economic Chamber of the Czech Republic and Agricultural Chamber of the Czech Republic.

4. MARKET VALUATION

4.1. Transfer Pricing Documentation

As required by Art. 114a, par. 5 of the LPOS, the Sale Deals, if approved by the GM and entered into by the MB, will be performed at prices of the Products equal to their fair market value. Such value will be determined, separately for each financial year, by an independent advisor from the group of PricewaterhouseCoopers – a leader in the area of providing professional tax advice, including transfer pricing matters. The value will follow from the levels of margin and mark-up set forth in a written study prepared under the requirements for Transfer Pricing Documentation.

Because the Transfer Pricing Documentation is not in the materials under item 4 of the agenda of the GM, it will be made available to the shareholders of the Company, who would like to get acquainted with it, by the Investor Relations Director of the Company at the following contacts:

5150 Strazhitsa
 28, Gladstone St.
 tel: ++359 6161 42 45
 e-mail: info@korado.bg

4.2. Functional Analysis

The description of the risks related to the Sale Deals and their allocation between the Company and Korado CR is, as follows:

4.2.1. Market Risk

As the Framework Agreement and the Sale Deals do not bind either party to volumes of sale / purchase or to the making of any order / confirmation, their terms and conditions would not shift the market risks, which will continue to lie over the parties as manufacturer and distributor, respectively.

4.2.2. Exchange Rate Risk

Neither of the parties to the Framework Agreement and the Sale Deals will undertake significant exchange rate risk related to the execution of the deals. The Sale Deals will be consummated primarily in EUR or BGN.

4.2.3. Credit Risk

Neither of the parties to the Framework Agreement and the Sale Deals will undertake significant credit risk related to the execution of the deals. Korado CR has excellent credit record, so all collection risks for the Company have been mitigated to the highest possible extent.

4.2.4. Inventory Risk

The inventory risks lying over each of the Company and Korado CR would not be affected by the Framework Agreement and the Sale Deals.

4.2.5. Risk related to Quality

The Company, being the manufacturer of the Products, will bear the usual business risk with regard to the quality of the Products. The parties will agree on a de-minimis rule with respect to value of defects raised by customers in any calendar year (typically EUR 50,000).

4.3. Rate of Gross Margin of Korado CR on Radiators for Distribution

For general orientation, the gross margin realized by Korado CR on deals done in 2018 (the latest one to date, for which final transfer-pricing documentation is available) was 18.80 %. The inter-quartile range for the preceding 3-year period averages the following:

Minimum	12.7 %
Lower Quartile	15.1 %
Median	18.4 %
Upper Quartile	21.6 %
Maximum	37.5 %

In their consistent practice, the Bulgarian tax authorities tend to accept as market-level any % of gross margin, which falls within the inter-quartile range, depending on the allocation of functions and risks between the parties to the deal. Levels of margin, which do not deviate significantly from the median, are common for limited-risk distributorships.

4.4. Rate of the Mark-Up of the Company on Pre-Finished Radiators

In the period of initial input for the Transfer Pricing Documentation, the Target Mark-Up used to range within 56.7 – 93.5%. That range is not, for any subsequent period, binding on the Company and/or Korado CR and will see adjustment on an annual basis.

5. ECONOMIC BENEFIT TO THE COMPANY

The factors, which determine the economic benefit of the Company from the Framework Agreement and the Sale Deals, are the following:

5.1. Strategic Benefits

- the Company will take a share of the usual synergies, which arise in the group business models, typical for the manufacturing sector (including, essentially, centralized trading)
- the Company will get avail of Korado CR's higher market realization resources at a market price
- having a global distributorship solution will allow the Company to better target and dedicate resources to manufacturing and R&D, in which operations the Company is of particular importance to the group

5.2. Commercial Benefits

- absence of exclusivity of distribution or prioritization of Korado CR
- absence of committed output (freedom to reject orders without cause, as fits best with the production load of the Company)
- absence of committed prices (price-list becoming applicable to Korado CR, subject to prior notice)
- the legal compliance with labelling, marketing and realization requirements for the Products (import, certification of origin, cross-border clearance, etc.) will be allocated to Korado CR
- waived obligation of the Company to redeem products or to compensate goodwill upon termination
- agreed *de-minimis* rule for claims for the Company's manufacturer warranty
- 60-day post-invoicing payment terms are Seller-friendly for the present-day market environment in Bulgarian manufacturing
- the Company will not suffer any reduction of the risks borne by Korado CR below the standard-commercial risk level for limited-risk distributorships (confirmed by the Local File of the Transfer Pricing Documentation)
- the level of Korado CR's gross margin (realized on the sales of the Radiators for Distribution) will stay close to the median of the inter-quartile range
- by applying a market-level mark-up (on the sales of the Pre-Finished Radiators), the Company will at all times have a guaranteed level of profit, regardless of the fluctuations in the market environment (which can be a key benefit given the overall predictions for economic decline across European consumer markets in short-term perspective)
- via Korado CR's distribution network the Products will have better access to the markets of Western and Central Europe, which see higher consumer prices and lesser impact of the COVID-19 pandemic on demand.

5.3. Legal Benefits

- title to products will go away from the Company only upon receipt of full payment
- flexible right of the Company to terminate (without case, subject to advance notice)

6. DRAFT RESOLUTION

With regard to the abovementioned, the MB proposes to the GM to take the following resolution, as contained in the invitation to the GM:

Draft-resolution: The General Meeting, on the grounds of 114, Par. 1, item 1 in relation to Art. 114a, Par. 7 of the Law on the Public Offering of Securities, authorizes the Management Board of Korado BG to perform deals of sale of radiators, materials for radiators and spare parts for radiators to Korado CR under Framework Agreement, subject to the following essential terms and conditions:

(a). *parties to the deals:*

Korado BG as Seller and Korado CR as Purchaser

(b). *subject-matter of the deals:*

The Framework Agreement and the deals are for the recurring (monthly, quarterly or yearly) sales of the following 4 types of assets: (a). radiators manufactured by Korado BG, which are ready for market realization; (b). radiators manufactured by Korado BG, which have not undergone surface treatment; (c). materials for employment in the manufacturing of radiators; and/or (d). spare parts for radiators, each individual deal of sale being subject to written order and confirmation.

(c). *value of the deals:*

The unit prices of the radiators, materials and/or spare parts shall be determined on an annual basis in alignment with the Transfer Pricing Documentation of Korado BG for the respective calendar year, as updated.

The aggregate price of the radiators, materials and spare parts shall not exceed BGN 40 million per financial year (net of VAT and transaction costs).

(d). *timeline of the deals:*

The sales of radiators, materials and spare parts, which have been hereby authorized and/or confirmed by the General Meeting, commence upon the entering into written Framework Agreement/s for such sales and end at the date of expiry or termination of such agreement/s, but not later than 31 December 2025.

(e). *beneficiaries of the deals:*

Korado BG and KORADO CR

(f). *other essential terms and conditions of the deals:*

Korado CR shall pay for the radiators, materials and spare parts sold not later than 60 (sixty) days from the date of invoice. The transfer of title shall occur upon full payment.

The terms of delivery shall be agreed upon (including, but not necessarily, by reference to Incoterms 2010 or Incoterms 2020) on a case-by-case basis.

Korado BG shall not be bound by commitment to sell exclusively to Korado CR.

Korado BG shall not be bound by commitment to minimum volume of sales.


Korado CR shall assume the following obligations: (a). to procure for the distribution of the ready-for-market-realization radiators on terms, which Korado BG considers usual to the radiator market at the moment of the respective sale; (b). to adequately protect any and all intellectual property rights of Korado BG over the radiators and support the legitimate business interest of Korado BG in the most beneficial market realization of the radiators.

The framework terms and conditions of the deals shall be governed by the Czech law. The disputes arising from the deals shall be referred for solution to the Arbitration Court attached to the Economic Chamber of the Czech Republic and Agricultural Chamber of the Czech Republic.


7. NOTICE OF ABSENCE OF VOTING RIGHTS OF THE INTERESTED PARTIES

The shareholder Korado CR is hereby notified that pursuant to Art. 114a, Par. 4 of the LPOS that shareholder shall not be allowed to vote on the proposed draft-resolution by reason of its capacity of an *interested party*, on the grounds of Art. 114, Par. 7, item 2 of the LPOS.

Members of the Management Board of Korado-Bulgaria AD:



Jiří Rezníček



Jana Havlová



Silviya Stefanova