

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 "6" of the LPOS*

### 1. GENERAL INFORMATION REGARDING THE DEAL

#### 1.1. General Description of the Deal

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

The acquisition 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 Purchase 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 Purchase Deals are Korado-Bulgaria AD (the "**Company**"), as the Purchaser, and Korado, a.s., Czech Republic ("**Korado CR**"), as the Seller.

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 Purchase Deals.

By the Purchase Deals, the Company will acquire *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 Purchase Deals

In the course of trading of the own products, which it has manufactured, the Company has also developed a regional-coverage distribution network (Bulgaria, Ukraine, Romania, Hungary, Serbia, North Macedonia, Bosnia and Herzegovina, Greece and Turkey). The optimized workload of such network allows for the assumption by the Company of limited-scope and limited-risk distributor obligations with respect to products manufactured by other members of the Korado Group of Companies.

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

The following persons have been engaged with the preparation for obtaining corporate authorization of the Purchase 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 5 of the agenda of the Minutes of its regular session held on 22 July 2020. The Report represents a material under item 5 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 Purchase Deals.

The Report contains all of the essential elements of the Purchase 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 Purchase Deals.



In the absence of approval by the GM, the MB would not have the powers to consummate Purchase 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 Purchase Deals**

The parties to the Framework Agreement and the Purchase 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 Purchase 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). commercial earnings for the Company from the distribution of the Products across Central and Eastern Europe;
- (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 Purchase Deals and Description of the Products**

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

The Products are: (i). radiators of the whole-range product portfolio of Korado CR manufactured in finished form – designated for direct realization on the market of Central and Eastern Europe; (ii). materials for employment in the manufacturing of radiators; and (iii). spare parts for radiators. The radiators concerned by the Purchase Deals are finished (painted) tubular / bathroom radiators and specific categories of panel radiators. Their manufacturing follows technologies, which are not employed in the manufacturing process of the Company.

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 Korado CR's portfolio); quantity of the Products; unit price (based on Korado CR's price-list) and total value of the deal; and other terms and conditions of the deal.

#### **3.3. Timeline of the Purchase Deals**

The timeline of consummating the Purchase 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 Resale Price Method. That method will continue to apply until a different one 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 purchases 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:

final price for the customer decreased by the gross margin of the Purchaser stated in %
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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 selected *gross margin* 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**”). Minimally once per year, i.e. at the end of each calendar year, the actual *gross margin* will be reviewed and any deviations from the Target Margin will be compensated either to the Seller or to the Purchaser by a year-end adjustment.

For general orientation, the gross margin realized by the Company 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.

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 Purchase Deals

The maximum total value of any and all Purchase Deals will not exceed BGN 5 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 distributorship operations in the course of the Purchase Deals' timeline.

### 3.6. Assessment of the Value of the Purchase Deals against the Thresholds under the LPOS

Under the Purchase Deals, the Company will purchase Products, which will qualify as *acquisition of assets* in the meaning of Art. 114, Par. 1, item 1 of the LPOS. The total value of the Purchase 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 Purchase 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 Purchase 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 Purchase Deals

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

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

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

- *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 either FCA (warehouse of the Seller) or will be 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 purchase exclusively

from Korado CR

- *commitment to volume:* the Company is not bound by commitment to minimum volume of purchases
- *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 Purchase 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 level of margin 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 5 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 Purchase Deals and their allocation between the Company and Korado CR is, as follows:

###### *4.2.1. Market Risk*

As the Framework Agreement and the Purchase 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 Purchase Deals will undertake significant exchange rate risk related to the execution of the deals. The Purchase Deals will be consummated primarily in EUR.

###### *4.2.3. Inventory Risk*

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

###### *4.2.4. Product Liability and Intellectual Property Infringement Risks*

The Company will be entitled to indemnity from Korado CR against any product liability-type claims, including the costs of dealing with any warranty claims and infringement of intellectual property claims.

#### *4.2.5. Market Investment Risk*

Reasonable cost for entering a new market or maintaining and developing a market position will be borne by Korado CR by way of allocating the relevant obligations to it or entitling the Company to adequate reimbursement of expenses.

### **5. ECONOMIC BENEFIT TO THE COMPANY**

The factors, which determine the economic benefit of the Company from the Framework Agreement and the Purchase 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 (including, essentially, multi-use of trading channels)
- the Company will benefit from a higher load of its distribution network while earning a market-level margin
- the radiators, which the Company purchases from Korado CR, complement the Company's portfolio of its own manufacturing goods, thus the Company will be able to meet broader market demand
- the Company will realize return on its good practices in market monitoring and awareness of the regional specifics of consumer demand

#### **5.2. Commercial Benefits**

- absence of exclusivity of purchase from Korado CR
- absence of committed volume of purchase (freedom to place orders, as fits best with the distribution load of the Company)
- absence of committed prices
- the Company will assume normal risks for the limited-risk distributorship model (confirmed by the Local File of the Transfer Pricing Documentation)
- the level of the Company's gross margin will stay close to the median of the inter-quartile range

#### **5.3. Legal Benefits**

- the payment for the Products will not at any time precede their hand-over
- 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 purchase of radiators, materials for radiators and spare parts for radiators from Korado CR under Framework Agreement, subject to the following essential terms and conditions:

(a). *parties to the deals:*

Korado CR as Seller and Korado BG as Purchaser

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

The Framework Agreement and the deals are for the recurring (monthly, quarterly or yearly) purchases of the following 3 types of assets: (a). radiators for non-exclusive distribution by Korado BG on the territory of the countries of Central and Eastern Europe; (b). materials for employment in the manufacturing of radiators; and/or (c). spare parts for radiators, each individual deal of purchase 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 5 million per financial year (net of VAT and transaction costs).

(d). *timeline of the deals:*

The purchases 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 purchases 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:*

The transfer of title to the radiators, materials and spare parts shall occur upon full payment of their price.

The General Terms and Conditions of Delivery of Korado CR, as amended from time to time, shall apply to the purchases. The terms of delivery shall be either FCA (registered office of Korado CR) under Incoterms 2010 or otherwise 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 purchase exclusively from Korado CR.

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

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**