

MANAGEMENT REPORT

of CIECH S.A., with its registered office in Warsaw (CIECH or Company), prepared on 22 June 2011 in connection with increasing the Company's share capital and acquiring a new issue of the Company's shares in exchange for in-kind contributions (Report)

PURPOSE AND LEGAL BASIS OF THE REPORT

This Report has been prepared in accordance with Article 311, in connection with 431 § 7 of the Commercial Companies Code Act of 15 September 2000 (J.L. No. 94, item 1037, as amended) (CCC), in connection with the planned increase of the Company's share capital (**Share Capital Increase**) by issuing 1,699,909 (in words: one million six hundred ninety-nine thousand nine hundred nine) series E ordinary bearer shares with a nominal value of PLN 5.00 (in words: five zloty 00/100) each and a total nominal value of PLN 8,499,545 (in words: eight million four hundred ninety-nine thousand five hundred forty-five zloty 00/100) (**New Issue Shares**).

The Company plans to offer all New Issue Shares for acquisition to the State Treasury of the Republic of Poland (**State Treasury**) by way of a private subscription referred to in Article 431 § 2 item 1 CCC, fully excluding the pre-emptive right to the New Issue Shares.

Given that the New Issue Shares are to be fully paid by the State Treasury with in-kind contributions (described in Part II of this Report), the Company's Management Board is obliged to prepare this Report according to Article 311, in connection with Article 431 § 7 CCC.

IN-KIND CONTRIBUTIONS

1. Description of in-kind contributions

The New Issue Shares will be paid with in-kind contributions (**In-kind Contributions**), including:

- 1) 571,826 (in words: five hundred seventy-one eight hundred twenty-six) series A ordinary bearer shares with a nominal value of PLN 2.30 (in words: two zloty 30/100) per share and with a total nominal value of PLN 1,315,199.80 (in words: one million three hundred fifteen thousand one hundred ninety-nine zloty 80/100) of Zakłady Chemiczne Alwernia S.A., with its registered office in Alwernia (later referred to as **Alwernia** and **Alwernia's Shares** respectively), and
- 2) 762,224 (in words: seven hundred sixty-two two hundred twenty-four) series A ordinary registered shares with a nominal value of PLN 10.00 (in words: ten zloty 00/100) per share and a total nominal value of PLN 7,622,240 (in words: seven million six hundred twenty-two thousand two hundred forty zloty 00/100) of Zakłady Chemiczne ZACHEM S.A., with its registered office in Bydgoszcz (later referred to as **Zachem** and **Zachem's Shares** respectively), and
- 3) 429,388 (in words: four hundred twenty-nine three hundred eighty-eight) series A ordinary registered shares with a nominal value of PLN 10.00 (in words: ten zloty 00/100) per share and a total nominal value of PLN 4,293,880.00 (in words: four million two hundred ninety-three thousand eight hundred eighty zloty 00/100) of Zakłady Chemiczne Organika-Sarzyna S.A., with its registered office in Nowa



Sarzyna (later referred to as **Organika-Sarzyna** and **Organika-Sarzyna's Shares** respectively).

Alwernia's Shares, Zachem's Shares and Organika-Sarzyna's Shares (later jointly referred to as **State Treasury Shares**) are fully paid, and free from any encumbrances and rights of third parties.

2. Information on companies whose shares are In-kind Contributions

Alwernia

Alwernia is CIECH's subsidiary. The Company holds 1,686,047 of Alwernia's shares, which account for a total of 73.75% of Alwernia's share capital and are vested with a total of 73.75% of votes at Alwernia's general meeting.

Alwernia's share capital amounts to PLN 5,258,168 (in words: five million two hundred fifty-eight thousand one hundred sixty-eight zloty 00/100) and is divided into 2,286,160 (in words: two million two hundred eighty-six thousand one hundred sixty) series A ordinary bearer shares, numbered 000 000 001 to 002 286 160, with a nominal value of PLN 2.30 (in words: two zloty 30/100) each.

Zachem

Zachem is CIECH's subsidiary. The Company holds 13,659,026 of Zachem's shares, which account for a total of 92.29% of Zachem's share capital and are vested with a total of 92.29% of votes at Zachem's general meeting.

Zachem's share capital amounts to PLN 148,000,000 (in words: one hundred forty-eight million zloty 00/100) and is divided into 14,800,000 (in words: fourteen million eight hundred thousand) series A registered shares, numbered 000 000 001 to 014 800 000, with a nominal value of PLN 10.00 (in words: ten zloty 00/100) each.

Organika-Sarzyna

Organika-Sarzyna is CIECH's subsidiary. The Company holds 7,900,147 of Organika-Sarzyna's shares, which account for a total of 93.05% of Organika-Sarzyna's share capital and are vested with a total of 93.05% of votes at Organika-Sarzyna's general meeting.

Organika-Sarzyna's share capital amounts to PLN 84,900,000 (in words: eighty-four million nine hundred thousand zloty 00/100) and is divided into 8,490,000 (in words: eight million four hundred ninety thousand) series A registered shares, numbered 000 000 001 to 008 490 000, with a nominal value of PLN 10.00 (in words: ten zloty 00/100) each.

NUMBER AND TYPE OF SHARES TO BE ISSUED IN EXCHANGE FOR IN-KIND CONTRIBUTIONS

In exchange for the In-kind Contributions, CIECH will issue 1,699,909 (in words: one million six hundred ninety-nine thousand nine hundred nine) series E ordinary bearer New Issue Shares E with a nominal value of PLN 5.00 (in words: five zloty 00/100) each and a total nominal value of PLN 8,499,545 (in words: eight million four hundred ninety-nine thousand five hundred forty-five zloty 00/100).

The New Issue Shares will be issued as bearer shares, according to Article 336 § 3 CCC, considering the Company's and the State Treasury's intention to apply for and introduce the New Issues Shares to trading on the regulated market – the main market run by the Warsaw Stock Exchange (**WSE**), and the related dematerialisation of the New Issue Shares.

ISSUE PRICE AND ITS JUSTIFICATION

The issue price for the New Issue Shares has been set at PLN 26.06 (in words: twenty-six zloty 06/100)

per each New Issue Share.

The total issue price of the shares issued by CIECH in connection with the Share Capital Increase in exchange for the In-kind Contributions will amount to PLN 44,299,628.54 (in words: forty-four million two hundred ninety-nine thousand six hundred twenty-eight zloty 54/100). The difference between the total issue price of all New Issue Shares and their nominal value is a share premium, which will be appropriated to the Company's supplementary capital according to Article 396 § 2 CCC.

The issue price of the New Issue Shares has been determined with a market-based approach, using an average historic price of CIECH's shares on the public market (WSE). The average price is the arithmetical average of daily average prices of CIECH's shares weighted by the volume for the last three months, ending 30 April 2011, i.e. as of the calculation date of the value of In-kind Contributions. Applying the average price for the above three-month period was intended to adopt a period identical with the one adopted for calculating the average market price of shares paid by investors when taking control over companies traded on the regulated market. The above procedure limits the effect of short-term trends and random share price fluctuations on estimating a fair market price.

As a result of the conclusion on 22 June 2011 of an Addendum to the Understanding between the State Treasury and CIECH of 26 May 2011 (referred to as **Addendum** and **Understanding** respectively), the issue price of a New Issue Share was determined based on the average share price for a three-month period instead of the average price for a six-month period, which was originally planned in the Report prepared on 27 May 2011. BRE Corporate Finance S.A., with its registered office in Warsaw (**Financial Consultant**), was commissioned by the Company to determine the issue price of a New Issue Share based on the above criteria.

The number of the New Issue Shares was determined using the following formula:

$$L_{ANE} = \frac{WA}{CE_{ANE}}$$

where:

- L_{ANE} number of New Issue Shares (if L_{ANE} is not an integer, it will be rounded down to the nearest integer)
- WA value of State Treasury Shares
- CE_{ANE} issue price of New Issue Shares

ENTITIES MAKING IN-KIND CONTRIBUTIONS

The In-kind Contributions to cover the New Issue Shares will be fully paid by the State Treasury.

In exchange for the In-kind Contributions, the State Treasury will acquire all New Issue Shares.

The acquisition of the New Issue Shares and the transfer of the State Treasury Shares as an in-kind contribution to pay for the New Issue Shares will be based on an agreement (or agreements) concluded between CIECH and the State Treasury.

DETERMINING THE VALUE OF IN-KIND CONTRIBUTIONS AND VALUATION METHOD APPLIED

The value of the In-kind Contributions was determined based on the valuation of the State Treasury Shares (**Valuation**) performed by the Financial Consultant commissioned by the Company.

For the purpose of the Valuation, the following valuation approaches were used:

- 1) Income approach – discounted cash flow method
- 2) Comparative approach – market multiplier method.

The income approach is based on valuating the forecast free cash flows for the holders of own and third party equity, transformed into present value using an average weighted capital cost after tax. This method concentrates on future cash flows generated by a company, reflecting the company's potential and the characteristics of the market where it operates. The method takes account of the valuated company's specific characteristics, i.e. factors which shareholders consider when deciding on the purchase of shares and the offered share price. The Valuation uses long-term financial forecasts and a capital cost that is adequate to a company's risk.

Valuating a company with the comparative approach involves determining relations between market valuations (stock exchange prices) of comparable companies and their financial parameters, and applying these relations (multipliers) to the valuated company's financial parameters. The comparative approach uses typical market multipliers based on sales revenue, operating result before amortisation/depreciation, operating result, net financial result and equity. The comparative method reflects the situation on the capital market and the investors' expectations with regard to companies from a given industry, i.e. factors which shareholders consider when deciding on the purchase of shares and the offered share price. Subject to the analysis were historic multipliers, current multipliers and forecast multipliers for domestic and foreign entities.

Presented in the tables below are the Valuation results.

- 1) Measured total value of State Treasury Shares (rounded up/down as appropriate):

in PLN '000,000 for share stakes	<u>Alwernia's Shares</u>	<u>Zachem's Shares</u>	<u>Organika-Sarzyna's Shares</u>
Income approach	18.3	5.9	19.0
Comparative (multiplier) approach	19.0	7.3	20.1
Average valuation based on two approaches	18.6	6.6	19.5

- 2) Measured value of individual shares as part of State Treasury Shares (rounded up/down as appropriate):

PLN per share	<u>Alwernia's Shares</u>	<u>Zachem's Shares</u>	<u>Organika-Sarzyna's Shares</u>
Income approach	32.0	7.8	44.1
Comparative (multiplier) approach	33.2	9.6	46.9
Average valuation based on two approaches	32.6	8.7	45.5

Considering the economic circumstances of the transaction described in this Report under *Rationale behind the planned transaction*, based on comparing the Valuation results and the value of the State Treasury Shares according to the provisions of the Understanding, the Financial Consultant, in its letter of 20 June 2011 (**Financial Consultant's Recommendation**), proposed to the Company's Management Board to determine the value of the In-kind Contributions in accordance with the provisions of the Understanding. In the opinion of the Financial Consultant, the prices of the State Treasury Shares resulting from the Understanding do not deviate from the fair value established during the Valuation. The Financial Consultant's Recommendation forms **Annex 1** to this Report.

Based on the Valuation and the Financial Consultant's Recommendation, the Company's Management Board set the total value of the In-kind Contribution in the form of the State Treasury Shares at 44,299,635.84 (in words: forty-four million two hundred ninety-nine thousand six hundred thirty-five zloty 84/100), including:

- 1) the total value of Alwernia's Shares was determined at PLN 18,332,741.56 (in words: eighteen million, three hundred thirty-two thousand seven hundred forty-one zloty 56/100), i.e. at PLN 32.06 (in words: thirty-two zloty 06/100) per Alwernia's Share;
- 2) the total value of ZACHEM's Shares was determined at PLN 6,494,148.48 (in words: six million four hundred ninety-four thousand one hundred forty-eight zloty 48/100), i.e. PLN 8.52 (in words: eight zloty 52/100) per ZACHEM's Share;
- 3) the total value of Organika-Sarzyna's Shares was determined at PLN 19,472,745.80 (in words: nineteen million four hundred seventy-two thousand seven hundred forty-five zloty 80/100), i.e. PLN 45.35 (in words: forty-five zloty 35/100) per Organika-Sarzyna's Share.

On 26 May 2011, the statutory auditor, i.e. PKF AUDYT Sp. z o.o. (**Statutory Auditor**), issued an opinion on the fair value of the In-kind Contributions in the form of the State Treasury Shares (**Auditor's Opinion**), according to which the value of the State Treasury Shares adopted in this Report by the Company's Management Board corresponds to their fair value. The Auditor's Opinion forms **Annex 2** to this Report.

RATIONALE BEHIND THE PLANNED TRANSACTION

Contributing the State Treasury Shares to pay for the New Issue Shares is a part of the performance of the transaction agreed between the Company and the State Treasury, in consideration of the following circumstances:

- 1) Under agreements concluded by CIECH on 29 March 2006 with Nafta Polska S.A., with its registered office in Warsaw (**Share Sale Agreements**), CIECH purchased from Nafta Polska S.A. (i) 11,840,000 shares in ZACHEM with a nominal value of PLN 10.00 each, accounting for a total of 80% of ZACHEM's share capital, and (ii) 6,792,000 shares in Organika-Sarzyna with a nominal value of PLN 10.00 each, accounting for a total of 80% of Organika-Sarzyna's share capital;
- 2) According to the Share Sale Agreements, CIECH submitted to the State Treasury irrevocable offers for the acquisition of all remaining ZACHEM's shares and all Organika-Sarzyna's shares held by the State Treasury (**Share Acquisition Offers**). The State Treasury has the right to accept the Share Acquisition Offers by their expiry date, i.e. 20 December 2016.
- 3) On 5 January 2010, CIECH and the State Treasury concluded understandings under which the Share Acquisition Offers were modified by revaluating the price for CIECH's acquisition from the State Treasury of ZACHEM's and Organika-Sarzyna's shares by determining a revaluation rate for prices in the event that the Share Acquisition Offers are accepted, and the price revaluation was effected in a period ending 20 December 2010. Next, on 28 December 2010, CIECH and the State Treasury concluded understandings under which the revaluation period was extended to 20 December 2011;
- 4) Acquiring the New Issue Shares in exchange for the in-kind contribution in the form of ZACHEM's Shares and Organika-Sarzyna's Shares is an alternative to CIECH's acquisition from the State Treasury of ZACHEM's Shares and Organika-Sarzyna's Shares under sale agreements which could be concluded (irrespective of CIECH's intention) if the State Treasury accepted the Share Acquisition Offers.
- 5) CIECH's binding with the Share Acquisition Offers results in uncertainty for the Company and its shareholders with regard to the acceptance probability and date when the State Treasury accepts the Share Acquisition Offers, and leads to financial consequences, such as CIECH's payment of the sale price for the shares. As a result of the Share Capital Increase and the payment for the New Issue Shares with the in-kind contribution in the form of the State Treasury Shares, the Company will no longer face uncertainty and CIECH will not be obliged to pay in cash the price for ZACHEM's

Shares and Organika-Sarzyna's Shares;

- 6) In addition, in connection with the State Treasury's intention to sell Alwernia's Shares and in connection with CIECH's divestment from Alwernia, as part of which CIECH allows for a temporarily greater commitment to Alwernia, the Parties made arrangements according to which it was decided to issue the New Issue Shares in exchange for the in-kind contribution in the form of Alwernia's Shares. The in-kind contribution of Alwernia's Shares to CIECH will give CIECH nearly a 100% share in Alwernia's share capital, allowing it to make decisions on the company's operations or to manage its shares.

Considering the above circumstances and the fact that the value of the State Treasury Shares adopted by CIECH's Management Board in the course of the valuation does not deviate from their fair value established by the Statutory Auditor in the Auditor's Opinion, the in-kind contribution of the State Treasury Shares to CIECH to pay for the New Issue Shares is justified.

Therefore, based on Article 312¹ § 1 item 2), in connection with 431 § 7 CCC, CIECH's Management Board, on 22 June 2011, plans to adopt a resolution on abandoning the audit of this Report by the statutory auditor referred to in Article 312 § 1 et seqq., in connection with Article 431 § 7 CCC.

Signatures of the members of CIECH S.A.'s Management Board:

1. Ryszard Kunicki – President of the Management Board


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2. Andrzej Bąbaś – Member of the Management Board


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3. Artur Osuchowski – Member of the Management Board


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4. Rafał Rybkowski – Member of the Management Board


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