

MANAGEMENT BOARD REPORT
ON THE ACTIVITIES
OF PROCHEM S.A. CAPITAL GROUP
IN THE FIRST HALF OF 2016

Warsaw, 31 August 2016

1. Principles of presentation of financial statements

Principles of preparation of the interim condensed consolidated financial statements of PROCHEM S.A. Capital Group for the first half of 2016 have been included in Explanatory notes to the financial statements.

2. Overview of basic economic and financial data disclosed in interim condensed financial statements and the presentation of development prospects of Capital Group of the Issuer until the end of 2016

In the first half of 2016 Capital Group achieved revenues from sale in the amount of PLN 79,73 million. They were by 2% lower than those achieved in the first half of 2015. In connection with the occurrence of unexpected problems technical and formal in the final stage of construction, as well as on the stage of start-up of the installation for the production of highly purified paraffin, oils and lubricants along with the extension of energy complex, what was implemented under an agreement with Mineral Wax Factory S.A. based in Belarus, in Swisłocz, with it is associated the necessity to shift the completion of the execution in first half of 2016 years, the Issuer has made significant adjustment of the gross margin in the long-term contract, which was implemented in Belarus. Gross margin at 31 December 2015 was estimated at 16.5%, and as at June 30, 2016 was adjusted to 7.2%. As a result of these events, there was an increase in the estimated costs of execution by approximately PLN 17.3 million, and an increase of an additional PLN 2 million due to possible penalties for delay in execution of the contract. Lowering of the estimated margin in the above mentioned contract as well as resulting from the downturn in the market of construction and assembly services, reducing the number of orders executed by the Issuer have a significant impact on the results of activity of the first half of 2016 which closed with a net loss of PLN 21.8 million.

On activities of the Capital Group of PROCHEM S.A. until the end of 2016 the macroeconomic environment will still have considerably impact, and in particular the level of ongoing and planned investments by enterprises, which according to data recently published by the CSO in the first half fell by above 7 %. Therefore, activities are carried out aiming at adapting operating costs to planned revenues. Also of great importance to the financial position of the Capital Group is consideration by the court of the appeal submitted by PERN SA from the judgment of 22 October 2015, in a result of which was adjudged amount (including interest for late payment) of about PLN 87 million in favour of a consortium with the participation of the Issuer. The Issuer's share in this amount is approximately 50%.

3. Description of significant risks, threats and untypical events affecting the activities of the Capital Group of the Issuer.

The companies from PROCHEM S.A. Capital Group in their operations are exposed to the following types of risks and threats:

3.1 Economic fluctuations on the investment market

Part of the companies belonging to Capital Group provides services to the investment market, which is characterized by a large scale of fluctuations in demand, which is strongly linked to general macroeconomic situation of the country. Methods used by the Company to reduce the negative impact of this factor on the financial results (the accumulation of financial reserves, diversification of services provided), may not fully neutralize this risk.

3.2 Dependence on the staff

The risk of dependence on the staff occurs particularly in the parent company. Raising the quality of services provided, undertaking the implementation of complicated technological projects, the use of modern information systems, and the work on behalf of the renowned clients require from workers the highest professional qualifications. Acquiring of such persons, especially in the situation of the liberalization of the European labor market can be difficult. The company is trying to minimize this threat by raising qualifications of the employed staff and using incentive programs associating employees with the company.

3.3 Exchange rate risk

Part of contracts (mainly of the parent company) for the sale of services is concluded with foreign companies in foreign currencies (EUR, USD). In the event of a significant strengthening of the domestic currency it can have an adverse effect on the Group's results. This risk is partially mitigated in a natural way through the purchase of equipment and services necessary for the execution of these contracts abroad, as well as through the purchase of the relevant financial instruments.

3.4 The risk of disadvantageous settling the litigation with PERN SA

In face of the substantial prolongation of legal proceeding in a dispute with PERN S.A. which begun in 2006, and currently is pending before the District Court in Warsaw concerning the accounting for the contract in the formula GRI concerning investment project under the name

of "Rurociąg w relacji ST-1 Adamowo - Baza Surowcowa Plebanka", which was interrupted on 10 of November 2005 PROCHEM S.A. was forced to fulfil their obligations to subcontractors concerning retained guarantee deposits before receiving them from PERN SA.

4. Description of capital group organization, indicating the entities subject to consolidation

PROCHEM S.A. Capital Group (hereinafter referred to as „Capital Group”, „Group”), in addition to the data of the Parent Company comprises the following subsidiaries directly and indirectly:

Subsidiaries covered by full consolidation:

- Prochem Inwestycje Sp. z o. o. seated in Warsaw – subsidiary directly (100.0%);
- PRO-INHUT Sp. z o. o. seated in Dąbrowa Górnicza – subsidiary indirectly (93.2%);
- Pro-Organika Sp. z o. o. seated in Warsaw – subsidiary directly (91.4%);
- Przedsiębiorstwo Konsultingowo-Inżynieryjne Predom Sp. z o. o. seated in Wrocław – subsidiary indirectly (81.1% of share in capital and profit, 71.4% of votes);
- Prochem Zachód Sp. z o. o. seated in Warsaw – subsidiary directly (80,0%);
- ELPRO Sp. z o. o. seated in Kraków – subsidiary indirectly (92.7%, including 85.4% in the 50% share of Elektromontaż Kraków);
- Elmont Inwestycje Sp. z o. o. seated in Kraków – subsidiary indirectly (92.7%, including 85.4% in the 50% share of Elektromontaż Kraków);
- Elektromontaż Kraków S.A. seated in Kraków – subsidiary indirectly (85.4%), including 73.0% of the capital and right to vote belongs to Prochem Inwestycje subsidiary in 100%. Company Elektromontaż Kraków S.A. prepares consolidated financial statements, which contains data of the subsidiary in 100%: ELMONT-POMIARY Sp. z o. o. seated in Kraków and two associated companies ELPRO Sp. z o. o. and Elmont-Inwestycje Sp. z o. o.;
- IRYD Sp. z o.o. seated in Warsaw – subsidiary indirectly 100%;
- ATUTOR Integracja Cyfrowa Sp. z o. o. seated in Warsaw – subsidiary indirectly (87.3% of share belongs directly to Prochem Inwestycje Sp. z o. o. subsidiary in 100%);
- Prochem RPI Sp. z o. o. seated in Warsaw – subsidiary in 100% (including 3.3% of capital and voting rights belongs to Prochem Inwestycje).

Jointly-controlled entities and associated entities valued using the equity method:

- ITEL Sp. z o. o. seated in Gdynia – 42.0% of share (18.7% of voting rights and capitals

- belongs directly to PROCHEM S.A., and 23.3% belongs to PROCHEM RPI Sp. z o. o. subsidiary in 100%);
- Irydion Sp. z o. o. seated in Warsaw – 50% of share;

5. Effects of changes in the structure of the Capital Group, including the results of merger, acquisition or sale of the issuer's group, long-term investments, division, restructuring and discontinued operations

In the first half of 2016 subsidiary Elektromontaż Kraków bought back 11 434 of own shares for redemption for a total amount of PLN 263 thousand.

In the first half of 2016 subsidiary Prochem Inwestycje acquired 10 000 of shares in company Elektromontaż Kraków S.A. for a total amount of PLN 370 thousand. In the result of these transactions Parent Company increased its share in the capital of Elektromontaż Kraków to 85.42 %.

6. The Management Board's position concerning the possibilities of accomplishment of previously published results forecasts for the given year, in the light of the results presented in the interim report in relation to forecasted results

The company PROCHEM S.A. did not publish any forecasts of financial results neither of the company nor of PROCHEM S.A. Capital Group for 2016.

7. Shareholders having directly or indirectly through subsidiaries, at least 5% of the total number of votes at the General Meeting of the Issuer at the date of the quarterly report, including the number of owned shares, their percentage of the share capital, the number of votes from them and their percentage share in the total number of votes at the general meeting, and changes in the ownership of large blocks of shares of the Issuer since the previous quarterly report

According to the Company's knowledge at the date of this report, the following shareholders hold at least 5% of votes at the general meeting of shareholders:

Item No.	DESCRIPTION	NUMBER OF SHARES HELD (IN PCS)	% OF VOTES IN TOTAL NUMBER OF VOTES	% OF SHARE CAPITAL
1.	Porozumienie PHC, including:	1 173 561	30.15	30.13

	Steven Tappan	510 000	13.09	13.09
2.	Legg Mason Parasol Fundusz Inwestycyjny Otwarty („Legg Mason Parasol FIO”), Fundusz Własności pracowniczej PKP Specjalistyczny Fundusz Inwestycyjny Otwarty i Legg Mason Akcji Skoncentrowany Fundusz Inwestycyjny zamknięty. Total above mentioned Funds, including: - Legg Mason Parasol Fundusz Inwestycyjny Otwarty („Legg Mason Parasol FIO”)	560 549 284 054	14.39 7.29	14.39 7.29
3.	QUERCUS Parasolowy SFIO, QUERCUS Absolute Return FIZ, QUERCUS Absolutnego Zwrotu FIZ. Total above mentioned Funds, including: QUERCUS Parasolowy SFIO	399 715	10.26	10.26
4.	Otwarty Fundusz Emerytalny PZU „Złota Jesień”.	387 521	9.95	9.95

Since the submission of the annual report for 2014 the Company received the following information about the change in shareholding:

- on 11 June 2016 roku at the General Meeting of Shareholders the Group received information about the decrease in the number of shares held by Porozumienie PHC by 5 922 pcs. of shares, what resulted in a decrease in the total number of votes by 0.15%. On the date on which the information was received by the Issuer, Porozumienie PHC had 1 173 561 shares of the Issuer, representing 30.13% of the share capital and 30.15% of the total number of votes at the General Meeting.

- on 11 June 2016 at the General Meeting of Shareholders the Group was informed about the change in number of shares held by QUERCUS Towarzystwo Funduszy Inwestycyjnych S.A. – QUERCUS Parasolowy SFIO, QUERCUS Absolutne Return FIZ and QUERCUS Absolutnego Zwrotu FIZ – has increased (through Common funds) share in the total number of votes in the company PROCHEM S.A. by 4 752 pcs of shares. On the date on which the information was received the Funds together hold 399 715 shares of the Issuer, representing 10.26% of the share capital and 10.26% of the total number of votes at the General Meeting.

8. Statement of changes in ownership of the issuer’s shares or rights to them (options) by the managing persons and by the supervisory authorities of the issuer, according to Issuer’s knowledge in the period from the last report

As at the date of this Report the following members of the Management Board and Supervisory Board of the Company held shares of PROCHEM S.A.:

- Jarosław Stępniewski – 80,943 pcs.
- Marek Kiersznicki – 70,393 pcs.
- Krzysztof Marczak – 43,700 pcs.
- Andrzej Karczykowski – 115,186 pcs.
- Marek Garliński – 86,900 pcs.
- Michał Suflida- 48,500 pcs. together with related person.

In connection with the resolutions of the General Meeting from June 11, 2016, there were the following changes in the composition of the Supervisory Board:

- 1) have been dismissed from the Supervisory Board:
 - Steven Tappan, who held 510 000 of shares in the Company,
 - Wiesław Kiepiel.
- 2) have been appointed to the Supervisory Board:
 - Michał Suflida, who with related person holds 48,500 pcs of shares
 - Karol Żbikowski.

9. Proceedings pending before the court, competent authority for arbitration or public administration including information on:

- a) proceedings relating to liabilities or receivables of the issuer or of its subsidiary, which value is at least 10% of the equity of the issuer, with the specification of: the subject of the case, the amount in dispute, date of initiation of proceedings, the parties to the proceedings and the position of the issuer,
- b) two or more proceedings relating to liabilities and receivables with a total value respectively of at least 10% of the Issuer's equity, with determining total value of proceedings separately in the group of liabilities and group of receivables, with the position of the issuer in this case, and in relation to the most significant proceedings in the group of liabilities and the group of receivables – an indication of their subject, the amount in dispute, date of initiation of proceedings and the parties to the proceedings.

PROCHEM S.A. continues to be a party to the proceedings before the court concerning the settlement of the contract which was interrupted on 10 November 2005, for the construction management of an investment project under the name "Pipeline in a section from the ST- 1 Adamowo - to raw material base Plebanka" concluded with PERN S.A. PROCHEM S.A. filed a lawsuit to the court for payment of PLN 41, 301 thousand under the final settlement of the contract, of which PLN 17,364 thousand is recognized in the statement of financial position as a receivable from seized guarantee deposit, and the remaining amount is the contingent receivable. On 18 January 2008 District Court in Warsaw issued a

judgment in this case considering claim of PROCHEM S.A. as to be right in principle, while stating that this obligation is not yet due.

On 26 August 2008 the Court of Appeal in Warsaw issued a final judgment on the appeal lodged by PROCHEM S.A. from the a/m judgment of the District Court, recognizing in it that the claim filed by PROCHEM S.A. regarding accounting for the contract is not premature, and at the same time has ordered that the District Court will make the accounting for the contract mentioned above pursuant to the provisions of the contract. This finding is in compliance with position in a case of PROCHEM S.A.

On 12 August 2010 the hearing was held before the District Court in Warsaw, where the Court decided to appoint an expert – Warsaw University of Technology – Department of Civil Engineering, who according to the recommendations of Court of Appeal will make an ultimate accounting for in relation to the disputed contract. In April 2011, the case file was forwarded to the expert witness, who in an opinion published in May 2012 confirmed the amount of the claim of PROCHEM S.A. By order of May 31, 2012, the District Court granted the Warsaw University of Technology a remuneration for opinion in the case, in relation to which the defendant PERN lodged a complaint. According to PERN SA the prepared opinion could not be the basis of the findings of facts of the case for the Court, because it is contrary to the thesis of the Court in which was determined the basis and scope of the opinion.

The Court of Appeal in Warsaw, I Civil Division has cancelled the decision of the District Court which was contested by PERN SA and the request for remuneration of an expert for the drafting of an opinion has submitted to the District Court for reconsideration.

On 5 February 2013 before the District Court in Warsaw, a hearing was held with the participation of experts, after which the court decided to oblige the parties to submit the pleadings in which the final conclusions of evidence to complement the expert opinions will be clarified, and postponed the hearing until 16 May 2013.

By order dated February 25, 2013, the District Court in Warsaw XXVI Economic Department upheld the previous decision of the Court, and finally has awarded a remuneration for the expert for drafting the opinion. In grounds for the judgment the Court determined that, at the hearing on 5 February 2013, the certified expert has carefully explained the methodology that has been adopted for the preparation of the legal opinion and it is not inconsistent with the thesis of the Court, and there are no legitimate grounds to complaint that the methodology adopted by the experts is not correct.

On 14 May 2013, the Issuer received a notice from the District Court in Warsaw of revocation hearing scheduled for 16 May 2013 and the next date of hearing has not been appointed yet.

On 9 August 2013, the Issuer received from the District Court in Warsaw, the decision as of 1 August 2013, from closed session of the Court. At the meeting, the Court decided to admit evidence of a supplementary opinion of research institute - Warsaw University of Technology in Warsaw, in the circumstance of determining the value of services, supplies, and other liabilities made by PROCHEM

S.A. and directly related to the implementation of the agreement that have been made after the date of withdrawal from the contract on the basis of commitments contracted prior to the withdrawal from the contract. In November 2013 the experts appointed by the court have started the work associated with the preparation of the supplementary opinion.

On 25 February 2014, the Court received the supplementary opinion that confirms the amount of the claim of PROCHEM S.A.

On 24 October 2014 the court suspended of its own motion the hearing until the removal of formal obstacles that have now been removed and on February 6, 2015, a request was made to continue the proceedings and set a date for the next meeting.

On 4 March 2015 the District Court in Warsaw has scheduled a hearing for 30 April 2015.

At the hearing on 30 April 2015, the Regional Court in Warsaw has pledged experts to supplement the opinion.

On 6 May 2015 in relation to the doubts raised against some aspects of the expert's opinions and in the interest of a faster conclusion of the case, PROCHEM limited the action for payment by the amount of PLN 139 thousand to the amount of PLN 41 162 thousand, along with statutory interest.

On 17 July 2015 the Company received a copy of the supplementary opinion expert, which in all cases had confirmed the position of PROCHEM S.A.

On 22 October 2015 the District Court in Warsaw, XXVI Commercial Division announced judgment in the above matter, in which:

- from the principal action, jointly and severally to the Issuer and a member of the consortium adjudged from PERN:
 - ✓ amount of PLN 35 086 589.26, with statutory interest from 23 March 2006 until the date of payment;
 - ✓ amount of PLN 4 879 883.58, with statutory interest from 22 March 2006 until the date of payment;
 - ✓ amount of PLN 126 400,4, with statutory interest from 16 January 2007 until the date of payment.
- in the cross action, dismissed the action of PERN entirely.

The Issuer's share in adjudged penalty is about 50%.

From the above judgment on 7 December 2015 PERN lodged an appeal. The term of consideration of the appeal has not been set yet.

On the end of June 2016 the Group presents the receivables from PERN SA under guarantee deposits seized during the execution of the contract worth PLN 17,364 thousand, which are the subject of a final settlement of the contract and the proceedings which is pending before the Court.

These receivables are not covered by write-down, because in the opinion of the Management Board there is the high probability of their recovery.

The remaining amount of the main claim of PROCHEM S.A. in the amount of PLN 2 682 thousand was recognized as a contingent asset, because at the reporting date, did not meet all the criteria for recognition as an asset in the understanding of IAS 37.

Furthermore, the total value of other proceedings separately for group of liabilities and as well as for group of receivables does not exceed 10% of the equity of the Issuer.

10. Information about the one or more transactions concluded by the issuer or by its subsidiary with related parties, if separately or jointly they are significant and were concluded on terms other than market terms:

- a) subject of the transaction,
- b) connections of the issuer or its subsidiary with the entity which is the party to the transaction,
- c) the material terms of the transaction with particular emphasis on financial conditions and indication of the specific conditions determined by the parties, characteristic of this agreement, in particular those which are different from those commonly applied for such contracts.

In the first half of 2016 there were no transactions concluded on other terms than market terms.

11. Information on granting surety of loan or borrowing or guarantee by the Issuer or by its subsidiary - jointly to one entity or to its subsidiary, if the total value of existing surety or guarantee is equivalent to at least 10% of the Issuer's equity

In the first half of 2016 no Company from the Capital Group advanced any sureties and guarantees.

12. Other information that in the issuer's opinion is essential to the assessment of the human resources, assets, financial position, financial results and changes in them, and information that is essential to assess the possibility of fulfilment the obligations by the companies from the Capital Group

In connection with loss on activity, which was noted in the first half of 2016 was carried out a detailed analysis of cash, financial assets, available mortgage protections, granted credit limits and possibilities for introduction of program of adapting the operating costs to planned revenues. Despite the breach of conditions of loan agreements what was described in note 10 of the financial statements The Management does not expect termination of banks' loan agreements and expects continuation of funding under existing contracts on the same or similar level for the next 12 months. The Management Board believes that despite the possibility of short-term tensions in the liquidity of the Issuer, there are no significant threat to continuing of operations at least in the prospect of the coming year. In addition, during the next six months is expected consideration by the court of appeal of PERN SA from the judgment of 22 October 2015, in a result of which was adjudged amount (including interest for late payment) of about PLN 87 million in favour of a consortium with the participation of the Issuer. The Issuer's share in this amount is approximately 50%. In the opinion of the Management Board there is high probability of a positive resolving.

13. Factors which in the opinion of the issuer will have an impact on financial performance of the Capital Group in the prospect of at least the subsequent quarter

The results in the next quarters will depend mainly on the possibility of obtaining by companies from the Capital Group of new contracts on sale of their services. Continuing of construction and commercialization of office centre Astrum Business Park in Warsaw as well as completion of execution of the contract in Belarus will have high impact on the results of the Capital Group of the Issuer.

Krzysztof Marczak

Vice President

of the Management Board

Marek Kiersznicki

Vice President

of the Management Board

Jarosław Stępniewski

President

of the Management Board