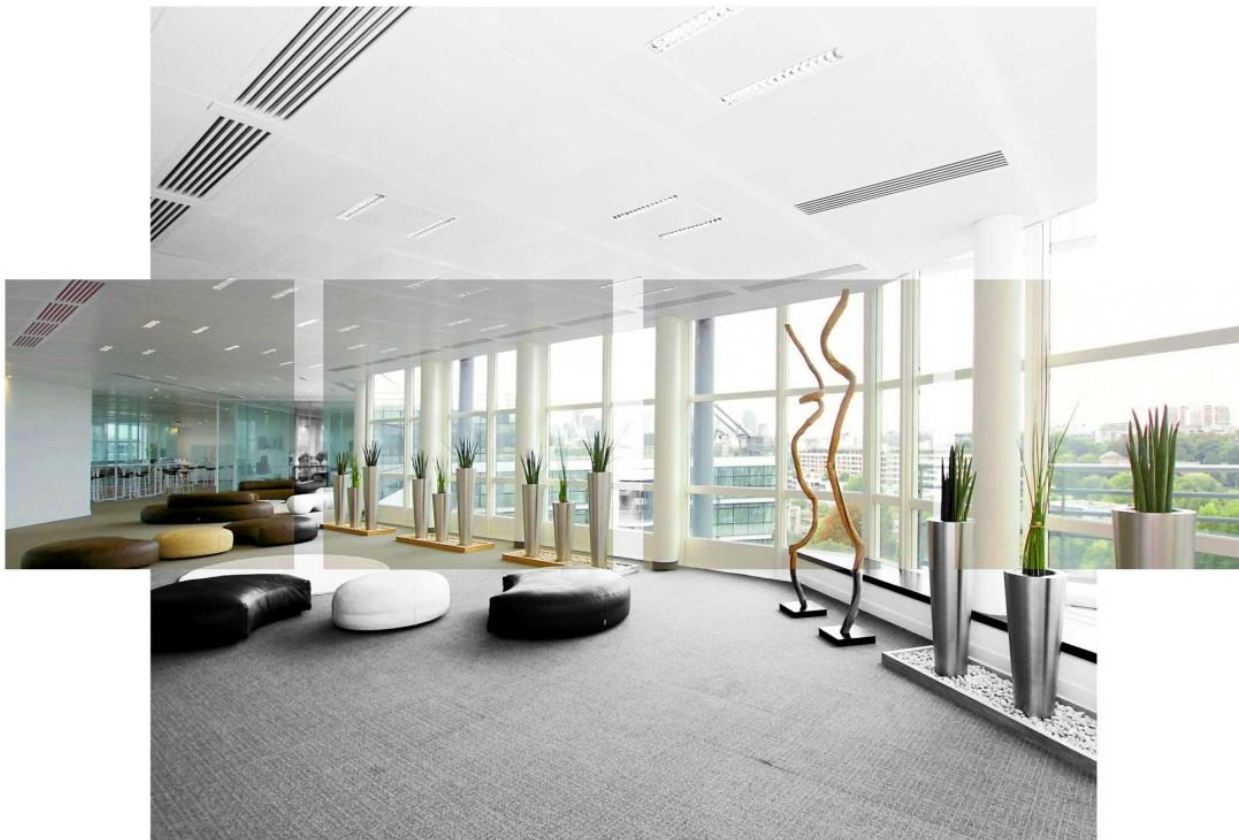
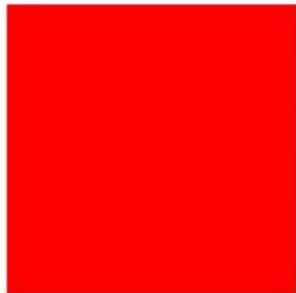




The summary of the LUG S.A. Management Board report  
about risk factors



## **4. RISK FACTORS**

The entities functioning within the LUG S.A. Capital Group actively manage operating and financial risks in order to optimise all business processes taking place inside the Group and maximise its market value. Each of the companies is charged only with selected types of risks, comprising together a comprehensive presentation of the risks faced by the LUG S.A. Capital Group, divided into two categories: risk factors connected with the surrounding and risk factors connected with activities. The most important risks are presented below.

### **4.1. Risk factors connected with the Issuer's surrounding**

#### **4.1.1. Risk connected with macroeconomic and sector trends**

Development of the lighting branch and activities of the LUG S.A. Capital Group are directly correlated with economic trends in Poland and abroad. In order to minimise the negative impact of market trends, while supervising activities of the subsidiary companies, the Issuer takes actions aimed at lowering the costs of its activities, improvement of effective functioning and optimisation of all business processes taking place in the LUG S.A. Capital Group. Besides, the Issuer strengthens its position on the current markets and enters new markets, ensuring geographical diversification of revenues and increasing its share in the sold production of the international lighting industry.

#### **4.1.2. Risk of changes in the legal surrounding**

Legal regulations, their interpretations and legal practice, are still changing relatively often in Poland. Such changes may have positive or negative impact on commercial activities. The highest risk is related to such areas as: tax law, public procurement law, construction law, employment and social insurance law, trade law and provisions concerning public trade with securities.

In particular, frequent changes occur in the Polish tax system, where many regulations have not been formulated in a sufficiently precise way and there are no clear interpretations. Interpretations of tax regulations are subject to frequent amendments. The practices of tax authorities and court case-law in the domain of taxation are not consistent.

In order to prevent possible discrepancies and ambiguities in interpretation of legal provisions, the LUG S.A. Capital Group employs professional consultants and law firms.

#### **4.1.3. Risk connected with licensing policy for the LED technology**

One of the international corporations functioning in the lighting sector requested Polish manufacturers to participate in the so called LED Licensing Programme, which works on the basis of license agreement in return for the possibility of using technological solutions protected by patents in Poland and other European countries. Justification of such claims is currently being analysed by the Office for Competition and Consumer Protection. The decision process in this case has been suspended pending the outcome of any legal doubts. Only after the outcome, will be possible to estimate the level of this risk and its full impact on activities and financial results of the Issuer's Capital Group, as well as take actions aimed at its minimisation.

### **4.2. Risk factors connected with the Issuer's activities**

#### **4.2.1. Risk connected with seasonality of sales**

Lighting fixtures are used at the final stage of the investment process and seasonality is a factor characteristic for the entire construction sector. The entities from this branch recognise the lowest revenues in the first half of the calendar year and significantly higher in the second half. The employment policy taking into account seasonality and the model of managing components and finished products warehouse minimise the results of this type of risk. A positive factor that reduced

this type of risk in 2013 and at the beginning of 2014 was a mild winter, which did not cause additional delays in the implementation of the investment resulting from weather conditions. The LUG S.A. Capital Group strives to increase the share of export production in the sales structure, which may decrease the impact of seasonality on the financial results of the Issuer's Capital Group upon appropriate management of the exchange rate change risk. Additionally, prevention of this type of risk may include increasing foreign sales and exporting products to the markets characterised with different construction cycle or entirely immune to the seasonality of this cycle.

#### **4.2.2. The risk of changes in market tendencies**

The possibility of changes in market tendencies and trends with respect to professional lighting makes the Issuer's Capital Group exposed to the risk of decreasing the sales results. In order to minimise this risk, the entity conducts surveys concerning preferences of the customers, the results of which are combined with knowledge and experience of the sales department employees and the management staff. The employees responsible for introducing new products to the Group's offer participate in the most important fairs, symposia and meetings concerning the lighting sector issues. Besides, modern, automated machine park allows flexible adjustment of production orders to the orders from the customers and production of short series of fixtures, as well as the so called customisation, that is adjustment of specific lighting solutions to the requirements of an individual customer. Those factors mean that the LUG company introduces lighting solutions corresponding to the newest trends and is always a step before the competitive companies offering its customers innovative values within the framework of the Flash DQ brand.

#### **4.2.3. Risk connected with competition**

The financial results of the Issuer's Capital Group may be affected by lowering the prices of the offered products or even dumping prices applied by the competitive companies. Presently, almost all important international lighting companies are present in Poland, which increases competition on the market of lighting sources and fixtures. It should be noted that growth of the demand for lighting products increases the competition, which results in price manipulation and therefore decrease in the margins on sales.

An additional element of the risk connected with competition is expansion of the companies from the Far East, among which it is very common to copy the European solutions and introduce products usually characterised by low quality and therefore also low price. The Company limits the risk connected with competition by continuous development of the offer by lighting fixtures that are technologically advanced and have attractive patterns. Higher quality of the products is also guaranteed by investments in the Development Department at LUG Light Factory Sp. z o.o.

#### **4.2.4. Risk connected with repayment of receivables by the contractors**

Financial liquidity of the LUG S.A. Capital Group is closely related to timely repayment of receivables by the contractors, so the Issuer's Management Board tightened the debt collection policy and took a number of actions aimed at minimisation of the risk connected with timely repayment of the receivables:

- insuring the receivables arising from all contracts with local and foreign receivers,
- covering the key contractors of the LUG S.A. Capital Group with a partial factoring agreement up to the amount of granted insurance,
- if it is impossible to insure a given contract, the Group uses the order performance system based on advanced payments.

#### **4.2.5. Risk connected with fines for non-performance or delayed performance of the orders**

In connection with activities of the Issuer's Capital Group in the lighting branch, the Group may be exposed to the risk connected with fines for delayed performance of the orders. The LUG S.A. Capital Group protects itself against this risk by carefully analysing the agreements with the contractors and preferring long-term cooperation with the suppliers of components based on the appropriate contracts. The companies from the Group do not conclude agreements containing unfavourable supply terms. Occasionally, the companies conclude agreements containing contractual penalties for failure to perform or delayed performance of the deliveries.

#### **4.2.6. Risk of increases in prices of raw materials and components**

The costs of manufacturing lighting fixtures depend on the prices of raw materials, which are determined based on the indexes of international commodities exchanges (aluminium, steel, glass, copper, crude oil - namely raw materials used for production of plastics and powder paints) and also various types of electronic and electric components used during production. Extensive demand from quickly developing economies, including Asia, as well as geopolitical situation in resource abundant countries, increase the risk of raising the prices of raw materials and components. In order to minimise that risk, the Issuer monitors the levels of prices for strategic raw materials. It also applies the system of suppliers qualification under ISO procedures and cooperates with the suppliers of components based on long-term purchase plans specified at the moment of supply completion. Besides, the LUG S.A. Capital Group holds component stocks corresponding to the needs, which is also translated into the size of warehouse stocks.

#### **4.2.7. Risk of reputation deterioration and loss of trust of the customers**

The key role in establishing permanent relations with the customers based on attachment to the product is played by quality and good image of the manufacturer. Deterioration of the organisation's reputation and loss of trust of the customers towards LUG's products may result in lower sales and, as a consequence, have negative impact on the results of the LUG S.A. Capital Group. In its everyday activities, the Issuer minimises the risk connected with reputation deterioration, responsibly managing its relations with all stakeholders and observing the recommendations included in the document entitled "Good practice for the companies listed at the NewConnect".

#### **4.2.8. Risk connected with financing using foreign capital and changes of interest rates**

The companies included in the LUG S.A. Capital Group, while carrying out development projects, use among others financing from bank loans based on variable interest rates. Similarly as other entities, the Issuer is exposed to the risk of changes of interest rates. In order to minimise this risk, the companies use long-term planning and all investments are preceded with detailed financial analyses. Considering the financial results of the Issuer's Capital Group and proper levels of indebtedness indicators, the risk of making the loan liabilities immediately due is not very probable.

#### **4.2.9. Risk of reaching strategic targets**

Exposure of the LUG S.A. Capital Group to the risk connected with reaching strategic targets is related to failure to achieve the assumed growth parameters and lack of the expected results in the case of reaching the targets or reaching the targets based on wrong analyses and forecasts of the macroeconomic situation or development trends in the sector. In both cases, non-refundable expenditures for completion of wrongly specified targets may deteriorate the financial status of entities included in the LUG S.A. Capital Group.

In order to minimise this type of risk, implementation of any strategy is always preceded by an analysis of consequences of business decisions from the point of view of the risk level. If the risk level is found to be acceptable, it is followed by specification of the methods of its management. Using the indicated procedures, the Issuer's Management Board identifies and eliminates the areas constituting possible threat for development of the LUG S.A. Capital Group.

#### **4.2.10. Risk of becoming dependent on the suppliers**

The Issuer and its subsidiary companies apply the components purchase policy based on diversification, so the exposure to the risk connected with becoming dependent on a supplier is limited. For every component, the Group has at least two independent, proven suppliers. Minimisation of the risk is also conducted by means of regular monitoring of the components market, which allows observation of the trends and early identification of possible risks. Besides, the Issuer's Management Board, to make the companies from the LUG Group independent from the suppliers, in 2013 expanded the existing factory by 700 sq. m. and launched the production line of electronic components LEDs. This investment is going to enable the Issuer to independently manufacture the SMD plates, eliminating the risk of becoming dependent on the suppliers.

#### **4.2.11. Exchange rate risk**

The exchange rate risk is an inseparable element of operation of any company concluding transactions in foreign currencies. Because of large share of export sales in the revenue structure of the Issuer's Capital Group, it is particularly exposed to the risk connected with exchange rates. The Issuer minimises the impact of the risk of exchange rate differences on the financial results using the available financial instruments. In 2013 those were forward contracts used only to secure the payments, without being used in speculative game. Besides, the exchange rate risk is minimised by balancing purchases and export of finished products.

#### **4.2.12. Risk connected with withdrawing production batches from the market**

In the case of withdrawing a product offered on one of the European Union markets, it may be necessary to withdraw that product from other markets of the European Union, which is connected with additional costs, including costs of transport, surveys and examinations, court proceedings and possible fines. This type of risk is minimised by means of the quality management system ISO 9001:2001 and by means of subjecting fixtures and electronic components to the safe use tests. The tests include also thermal conditions, tightness of fixtures (IP level), resistance to mechanical damage responsible for wear and tear of plastics (IK level), as well as all electric parameters. The quality of the Group's products is confirmed by certificates such as ENEC, GOST.

#### **4.2.13. Risk connected with temporary suspension of production as a result of failure, damage or loss of property**

In the case of failure, damage or loss of tangible fixed assets or current assets, the production may be temporarily suspended, which is followed by prevention of timely completion of the orders placed by the customers. In order to limit this risk, the Group applies the appropriate investment policy concerning the machine park and concludes appropriate service agreements. Besides, the Group holds insurance of the entire assets and insurance against loss of profits for the period of six months after the incident. Therefore, this period is sufficient to restore production.

#### **4.2.14. Risk connected with environment protection**

The LUG S.A. Capital Group is obliged to observe a number of regulations from the local and the European law with respect to environment protection. Infringement of those regulations is punished with various fines, separately specified in each of the regulations. In its activities, the Issuer's Capital

Group observes all requirements concerning environment protection specified in the applicable regulations.

**4.2.15. Risk connected with court, arbitration and administrative proceedings**

Within the scope of disputes, the companies from the Issuer's Capital Group conduct only debt collection proceedings. Because of the value of disputes, they do not significantly affect financial liquidity of the Group. In 2013, there were no other court, administrative or tax proceedings in course against the Issuer or its subsidiary companies, which could affect functioning of the LUG S.A. Capital Group and constitute a potential threat.

**4.2.16. Risk of losing key employees and management staff**

Changes in the staff composition are charged with the risk of losing know-how of the experts and deterioration of the results generated by the Issuer in all its areas of functioning. In order to minimise this risk, the Management Board of LUG S.A. gradually implements the bonus system in the company divisions based on motivating the employees in the context of achieving one common target of the entire organisation. The system based on a number of elements forming motivational working environment. Its element is the annual process called "Evaluation of employee."