Letter to the Shareholders

Dear shareholders and business associates,

In the financial year 2013 we were able to generate a significant increase in profits. Our holding company achieved a net result of EUR 94.4 million (prev. year EUR 11 million), enabled primarily by the sale of the K+S Group. Group profits rose to EUR 89.2 million (prev. year EUR 55.7 million).

Group cash and cash equivalents amount to EUR 129.5 million (prev. year EUR 44 million), of which EUR 9.2 million are held by the holding company (prev. year EUR 4 million). Minus bank and factoring liabilities, total net liquidity for the Group stands at EUR 106.1 million (prev. year EUR 13.1 million). A further EUR 20 million are on a escrow account due for release in two lump sums, one in April 2014, the other in February 2015. At the balance sheet due date of 2013 financial investments and loans to subsidiaries totalled EUR 21.1 million in net terms (prev. year EUR 4 million), EUR 17.1 million of which were invested in shares and/or funds. We currently have short to medium-term access to EUR 150 million for further acquisitions that could consequently be made without incurring debts.

Overall our investments in tangible assets totalled EUR 43.2 million last year (prev. year EUR 27.7 million). Of that sum, EUR 20.5 million went into plant and equipment and EUR 17.9 million (prev. year EUR 0.3 million) into financial investments. These significantly exceeded depreciations, totalling 149%. In general we invested more than we lost through depreciations, most notably in series production, where investments reached EUR 18 million, or 56.2% more than the value depreciation of our tangible assets.

Net results and returns on sales for the three business areas were as follows:

Net income (return on sales)

	With K+S				Without K+S			
	2012		2013		2012		2013	
Serial Production/ Automotive	11,6	2,5%	7,1	1,9%	-0,7	-0,3%	6,6	2,0%
Plant Engineering & Construction	0,5	1,0%	-1,2	-1,5%	0,5	1,0%	-1,2	-1,5%
Business Services	-7,0	-4,0%	-16,0	-10,0%	-7,0	-4,0%	-16,0	-10,0%
Others	-10,3		188,4		-10,3		188,4	
Consolidation	60,9		-89,1		60,9		-89,1	
Group	55,7	8,1%	89,2	14,5%	43,4	8,9%	88,7	15,5%

As usual series production was the greatest contributor to earnings, generating EUR 6.6 million without the K+S Group (prev. year EUR -0.7 million).

Our weakest performer was our Business Services segment, which generated EUR -16 million. Figures were impacted by two one-off factors: the deconsolidation of GRISET S.A.S (EUR -6.5 million) and the first consolidation of the ASTERION Group (EUR -5.8 million). These two factors are of importance in accounting terms but not in cash terms. Without them net earnings would have amounted to EUR -3.7 million.

Earnings development at Group level was influenced in 2013 by two special factors in 2013, both of which were instrumental in the rise. The first was an accounting profit of EUR 4.5 million generated by the EUR 5.5 million part-payment of the EUR 10 million earn-out for the

acquisition of TriStone. The second is a dissolution of negative goodwill with the ASTERION Group of EUR 6.4 million, which does not constitute a cash-inflow. Negative goodwill occurs when investments are acquired under book value, allowing losses to be neutralised or profits to be made at a later stage by dissolving these “reserves”. This provides a convenient buffer to absorb operating losses. Many a listed holding company thrives on this principle, in fact, delivering ever greater profits for as long as they are able to continue acquiring businesses. Equity issues then provide an opportunity to collect money!

For us, however, our primary goal is the long-term development of our companies, and we are reluctant to part with successful investments. So why did we part with the K+S Group?

Under our auspices profits at the K+S Group have developed as follows:

	2007	2012
Turnover	237.3	199.4
Net earnings (return on sales)	6.8 (2.9%)	12.2 (6.1%)

Based on the net profit we made on the sale, we would have achieved a return of 11% if we had kept the K+S Group. Nonetheless, in our view there were several reasons to sell:

- Risk concentration
  As the strongest earner within the BAVARIA Group, the K+S Group was heavily dependent on a small number of customers. Their wind energy business, for example, depended on two companies. One of those now produces largely in-house; the other, which currently has its own problems to deal with, hardly ordered any more generators from the K+S Group in the six months before it was sold.
- Lack of growth opportunities
  We, the Management, believe growth opportunities in Europe are largely exhausted. Under us, at least, the K+S Group underwent no significant growth. Moreover, investments overseas seemed risky, given the significant capital expenditure involved and the intense competition.
- The option of using earnings to buy into greater profits
  Ultimately, however, the key factor influencing our decision was our view that the money earned from the sale of the Group would allow us to buy into greater profits. It also seemed practicable, given our expertise in increasing the profits that businesses generally achieve under or ownership.

By the way, in Germany the choice between selling and keeping is neutral in terms of taxation. For our Group, effective (“minimum”) taxes on proceeds from the sale are about 1.5% - the same rate as applies for dividends (K+S Group was already paying 30% taxes on profits).

The question that remains, of course, is: How high would our dividends have been if the K+S Group had indeed grown? With an investment ratio of about 5% of sales and net current assets totalling 15% of turnover, a 5% increase in turnover would have cost us EUR 2 million (20% of EUR 10 million) and brought in a net profit of EUR 0.6 million. That would have represented a return on investment of no less than 30% - but without factoring in risks and possible start-up losses. Owing to capital requirements, we would have had to reinvest part

of the net profit rather than paying it out if the company had grown. This would have caused its value to rise disproportionately (by EUR 7.2 million based on 5% growth and an assumed price-to-earnings ratio of 12), which would in turn have been the equivalent of a 260% return - based on a dividend renunciation of EUR 2 million. No wonder we like it so much if our companies invest in profitable growth!

Incidentally, in times of inflation the reverse happens. Assuming an inflation rate of 2%, net earnings would rise to just EUR 0.36 million when adjusted for inflation. The increase in the value of the company would have amounted to just 116% of the EUR 2 million capital invested. And when inflation-linked price rises are not possible, the turnover of capital employed cannot be increased (to generate more turnover from the same current and tangible assets) as inflation always causes the value of the company to fall because of the investments needed in current and tangible assets. The logical consequences of this are falling share prices against a backdrop of rising inflation and low price-to-earnings ratios in countries with high inflation.

The development of equity capital within the AG, group and per share is especially revealing. These figures show developments since our IPO in 2006:

(in EUR)	AG	Group	
	EUR million	EUR million	per Share
2006	28.8	70.4	10.65
2007	45.4	91.0	13.75
2008	37.5	128,1	20.04
2009	26.0	114.7	17.94
2010	21.1	124.5	20.21
2011	25.4	91.2	15.28
2012	34.5	116.0	19.97
2013	124.4	215.0	38.20
CAGR	23.2%	17.3%	20.0%

Owing to the share buyback programme, equity capital (book value) per share of 20% p.a. has risen more steeply than the company's own equity capital. At IPO 6.6 million shares were on offer, but by 31 December 2013 numbers had fallen by about 1 million to 5.6 million (-14.9%). In our view, the book value gives at least some idea of the value increases being achieved. In our early days, we made most of our first acquisitions at a considerable discount on the book value, (= equity capital including negative goodwill), which was certainly much higher than the actual ("intrinsic") value of the investment. In contrast, more recent years have seen us pay higher prices for our acquisitions as we seek to buy stakes in profitable businesses. In addition, the intrinsic value has in the meantime increased owing to stronger earnings and realised cash proceeds from the sale of companies.

Investors may be asking how we used our cash and cash equivalents:

At the balance sheet due date of 2013, our cash and cash equivalents were invested with appropriate returns in:

Bank and escrow accounts	109.4	0.3 (interest)
Share buybacks	4.5	1.9 (accounting profit)
Financial assets	17.1	0.9 (accounting profit and unrealized gains)
TOTAL	131.0	3.1 (2.4%)

The most profitable financial investment was our own share buyback. During the course of 2013 we repurchased 181,364 shares worth EUR 4.5 million in total. At the end of the year their book gain amounted to EUR 1.9 million based on a share price at the close of the year of EUR 34.91. However, the accounting profit on our financial investment was relatively disappointing, at 5.1%. During the course of the year we invested only gradually and too hesitantly. As a result we were unable to benefit in any meaningful way from the 22% rise in the DAX in the same period. Even if our aim remains to purchase entire companies wherever possible, we intend to continue growing the proportion of shares we hold. After all, share-price increases (including earnings from dividends) amount to on average 7-8% p.a. over the long term, which is far more than could be earned on a fixed-term deposit account. The Management Board remains committed to reinvesting our own funding and paying out no dividends. Why? Because we are the main shareholders and intend to spend our working time investing our liquidity as well as we possibly can, leaving our free time to be devoted to non-monetary issues. All other shareholders can benefit from our activities through rising share prices – without having to pay the performance fee, which, for traditional capital investors, can easily amount to between 20 and 25% of the total value increase. In addition, there is always the option of selling the shares they hold.

Our cash and cash equivalents generated opportunity costs (with interest rates well below inflation at present) as well as benefits (we can be ready to buy as soon as we have a deal). Unfortunately, valuations are very high at the moment, affecting publicly traded companies and – more severely – companies that are up for auction. We are patient people and have no intention of giving up the discipline we have shown so far with any of our investment decisions. Our objective remains to build up a portfolio of profitable and, ideally, growing companies. What matters to us is the quality of management and not so much whether we hold a majority stake or not.

From a general perspective, we believe our business success is founded on:

- De-centralised structures
- Operational excellence
- Price discipline in acquisitions
- Rigorous payback controls on all of our investments
- Share buybacks rather than dividends

De-centralised structures

Once we have decided on the best manager we can find to take on the role of business director (after we have assessed whether the incumbent one should continue or we need a new recruit), we leave them (all males so far!) the greatest possible freedom to act. All the while, however, we keep a close eye on every investment decision and monitor operational developments closely. This enables us to correct any errors quickly. Essentially, when it comes to “how” things are done, our managers have free rein, acting purely on their initiative. We expect them to run the business as though it were their own. Extreme cost consciousness and continuous striving to improve are in our opinion the most important factors for success.

Operational excellence

Our BAVARIA Operating System helps establish continuous process improvement firmly within companies. Its objective is to fix costs and contribution margin targets for every process and underpin them with three to five measures each.
But before the question of “how” comes that of “what”. In other words: What’s our decision with regard to putting our cash and cash equivalents to good use? The main way of increasing the value of a company is through:

Price discipline in acquisitions

The key point here is to ensure that the purchase price leaves enough of a safety margin – not least because the seller always knows more than the buyer (If they didn’t, they wouldn’t be selling, would they?). A business that is essentially failing to grow – or does so only with the help of considerable funding – is worth no more than its capital cost, which for the sake of simplicity we always estimate at 10%, i.e. no more than ten times net earnings. Based on a 30% tax rate, this amounts to a multiple of seven on operative earnings before tax (EBIT). So with a safety margin of 20-30%, we generally pay a maximum of five to six times the EBIT for a business that is in a steady state. Higher multiples are paid only for companies with significant potential to grow and improve. In our view, the EBIT is the best approximation of a company’s free cash flow, and we do not base our evaluations on operating earnings before interest, taxes, depreciation and amortisation (EBITDA), unlike many other organisations. We work on the basis that investments will be needed to get the company running over the longer term. So it makes no difference in our view whether we are acquiring a company in part (e.g. via the stock market) or entirely. When completing a transaction, we always use checklists to ensure nothing important is overlooked in the heat of the moment.

Payback controls

The same principle applies for investments in tangible assets and new recruits, which are made by the directors we appoint. We expect investments in efficiency to pay back after two years, or possibly three years for projects like a new branch or investments in company software. Market developments are too unpredictable to work with a longer timeframe.

Share buybacks

For us, share buybacks are an important way of instilling discipline, and they are an option only for those who focus on intrinsic values and how to increase them. Over the last seven years, we have repurchased 987,015 shares with a total value of EUR 14.9 million – the equivalent of 14.9% of the shares outstanding at IPO. Buybacks have several important advantages over dividends for our shareholders:. First, they can decide for themselves whether to opt for a growing share in the company's profits or whether they would prefer to sell shares in the equivalent proportion to the buy-backs to generate a "dividend". The second advantage is that shareholders themselves can determine by setting their own sell date when their investment will be taxable and when to increase their liquidity. They also benefit from accumulated interest. If a shareholder invests their dividend and achieves an average return of 8% on their shares, their capital will actually only increase by 6% p.a. because earnings are taxed at 25% a year. If the company invests the same amount, they will receive the full 8% return because it is not liable to dividend tax. After ten years, the first of these scenarios will have generated a profit of 80%. The second will have delivered 115%. As a general rule, we buy back our shares only when their price has fallen below the estimated intrinsic value of our company (and we have the necessary cash to do so), which means earnings per share for all the remaining shareholders will rise. The following table compares earnings per share since our IPO in January 2006 with and without our share buybacks:

	2006	2013	CAGR
Net earnings per share without buyback	4.77	13.49	16.02%
Actual net earnings per share	4.77	15.85	19.73%

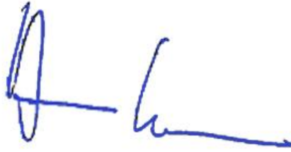
Because we reduced our share capital by about 1 million shares, average earnings per share amounted to 19.7% rather than the 16% that would have been the achieved without a share buyback. In addition, if shareholders take into consideration the dividends of EUR 7.50 per share that were paid out in the early years (before we reconsidered our strategy!), they will see that their shares have generated returns of more than 20% since our IPO.

Over the years we have learned a lot about business management and capital allocation. In the beginning, we made use of every instrument one would expect as an inexpert listed company attempting to keep its share price buoyant, from stock splits and option issues to using a PR agency. Not until our shares were valued at below the intrinsic value we estimated did we re-think what we were doing.

Our management board has invested more than 90% of its assets in BAVARIA shares and has no intention of selling. On the contrary, both Board members (and their families) increased their stakes since the IPO from some 45% to 80%. And finally, allow us to mention that we have once again made donations to non-profit organisations. In 2013 we donated EUR 100,000 to the social venture fund Alterra. (To find out more, visit www.alterraimpactfinance.com)

For the current year we view the continued development of BAVARIA Industries Group AG with some optimism. Good collaborations and trusting relations are two of the most important assets on which we can build. But we always keep an open mind to new ideas and suggestions that might help us improve and for information about possible new acquisitions.

Yours sincerely



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