Letter to the Shareholders

August 2015

Dear shareholders and business associates,

We have been investing in equities as well for around two years. How have we done and what have we learned from this?

In total, as at 30 June 2015, we have invested EUR 66.8 million in investment securities (not including company acquisitions); unrealised profits contributed EUR 3.6 million and realised profits EUR 7.2 million to this in the first half of 2015. This means a total return in the first half of the year of 16%. By comparison, the DAX rose by 12% over the same period.

However, we are still a long way from our goal of building up a core portfolio of around ten positions. Given the very high market valuations currently prevailing, the question arises of how much of the cash and cash equivalents currently held in the holding company (and intermediate holding company) we would like to invest in equities (our cash rate is currently 44%). Apart from these investments in key equities that we wish to hold in the long term for fundamental reasons, we have acquired a whole series of equities with a low EBIT multiple (< 8) that we will most likely sell when we achieve fair values – depending on the estimated growth and return on equity. We will also sell all equities that have consistently disappointed us in their earnings performance (if only for tax reasons).

We only buy our equity investments at a discount of 30% to 50% on what we estimate to be their fair value. In doing so, we make no distinction between shares and wholly owned equity investments. How exactly do we calculate this value?

In the developed industrial nations, the long-term return (100 years and more; dividends and price increases) on all equities is around 7%. This naturally fluctuates depending on forecasts for future interest rates. However, the higher the interest on fixed-income securities, the lower the price-earnings ratio. A company with no growth prospects is usually only valued at around 14 times its earnings. This gives investors a target return of 7% (100/7=14). The company's net liabilities are deducted from this.

If the company is growing, it is a question of how much capital has to be invested for this. The average additional capital employed for all companies (in the form of working capital, capital expenditure and possibly start-up losses) is again only 7%. Growth therefore generates no actual value, it is merely a consequence of the decision of how to use funds, namely to reinvest them rather than to distribute them. Often companies will seek to grow at any price. They will pursue marginal projects that reduce the return on investment to less than 7%. They thus destroy their own value.

The companies that are interesting are those with good growth opportunities coupled with a consistent return on investment. Both of these are usually subject to erosion as a result of increasing competition:

No economic moat will remain impregnable and protected against erosion for all time. Assuming that, a company manages to grow for 10% p.a. for five years with a return of 25%. How high would a fair P/E ratio be?

Year	1	2	3	4	5
Net Profit	10	11	12	13	15
Equity (=Book value)	40	44	48	53	59
Dividend	6	7	7	8	15
Fair Value	181	188	195	202	208
Dividend yield	*3%*	*4%*	*4%*	*4%*	*7%*
Stock Price Increase	*4%*	*4%*	*4%*	*3%*	*0%*
Total Return	*7%*	*7%*	*7%*	*7%*	*7%*
P/E	18	17	16	15	14

If we assume that net debt in the first year is zero and that the free cash flow is distributed in the form of dividends (other variants would be buying back own shares or reducing own debt), the fair value of its shares in the first year would be around 18 times its earnings. The opportunity to invest in growth has a value measured by the amount of capital employed!

The stock market rightly assigns a higher P/E ratio to companies with growth potential than to those that are treading water. But investors are frequently overly optimistic in terms of how long high growth will last, or they underestimate the costs of growth in relation to the return on equity. This then leads to overvaluation and corresponding corrections when growth slackens. Ultimately all the excess profits vanish again as competition rises, if there is open competition. If an investment in a new branch generates a return of more than 7% (e.g. in a new coffee shop or a rubber hose factory), investment will continue until the excess return disappears. A further requirement is that the state allows plant closures or dismissals, or at the very least does not overly restrict them. Generally there is a reversion to mean in both directions.

The net earnings of our portfolio companies developed as follows year-on-year:

	1st HY 2014	1st HY 2015
Serial Production/Automotive	6,108	6,179
Plant Engineering & Construction	-1,713	-3,263
Business Services	-3,678	-11,721
Others	572	16,900
Consolidation	273	-6,137
Group	1,562	1,957

Compared to the first half of last year, the net earnings of all equity investments declined from EUR 0.7 million to EUR -8.8 million. The main reason was high seasonal losses in one of our participations in the calendar business. Consolidated earnings were EUR 2.0 million (previous year EUR 1.6 million).

We estimate that enterprise value increased by 6% in the first half of the year. The following table shows how this development is measured:

1 st Half-Year	1-12/2014	07/2014 - 06/2015	%
Investee companies 1)	153,9	156,0	1%
Financial Assets 2)	111,4	126,0	13%
Total	265,4	282,0	6%

According to estimates, equity investments climbed by 1% securities (including hidden reserves) by 13%. In the first half of 2015 we spent EUR 0.4 million to buy back shares (previous year EUR 1.6 million).

We are very confident about the further development of BAVARIA Industries Group AG in the current year. Here we depend on good working relationships and trust. We remain open to suggestions and proposals for improvement or pointers towards new transactions.

Yours sincerely

Reimar Scholz

Spokesman for the Board

Harald Ender

Director Operations

[1] This estimate is based on the actual last 12 months operating earnings of the profitable equity investments (EBIT), multiplied by 7 plus the (interest-bearing) net funds of these equity investments – this also forms the basis for calculating directors' bonuses.

[2] Cash holdings and financial assets included not proven book profits.