DEUTZ AG

The following remarks refer to the annual financial statements of DEUTZ AG. The annual financial statements of DEUTZ AG are prepared in accordance with the requirements of the German Commercial Code (HGB).

BASIC PRINCIPLES AND BUSINESS PERFORMANCE OF DEUTZ AG

DEUTZ AG is the parent company of the DEUTZ Group. At home and abroad, DEUTZ AG has various direct and indirect subsidiaries and equity investments. The subsidiaries include a production facility in Spain and several companies that perform sales and service functions. The Chinese production company – DEUTZ Engine (Shandong) Co., Ltd. in Linyi, China – is currently being wound up. In 2016, the sales and service company DEUTZ (SHANGHAI) INTERNATIONAL TRADE Co., Ltd. was established in Shanghai, China. DEUTZ AG holds 100 per cent of the voting shares in this company. In total, DEUTZ AG has a direct or indirect stake in 28 companies (2015: 27 companies). DEUTZ AG is also by far the largest production company of the DEUTZ Group and provides the head-office functions for the Group. For details of DEUTZ AG's equity investments, please see the list of shareholdings on page 119 of the annual report.

Because the business performance and financial situation of DEUTZ AG are essentially the same as for the DEUTZ Group, we make reference here to the ‘Business performance in the DEUTZ Group’ section on page 29 et seq. of this combined management report.

Because of the significance of DEUTZ AG within the Group, and its heavy interdependencies with other Group companies, the Group is managed at the level of DEUTZ AG. In addition to the key performance indicators used for management at Group level, the net income of DEUTZ AG, as the relevant variable in the payment of dividends, is also an element of the management system of the Company. The internal management system for the DEUTZ Group is described on page 27 et seq. of this combined management report. The DEUTZ Group’s net income in accordance with IFRS is reconciled to DEUTZ AG’s net income in accordance with the German Commercial Code (HGB):

DEUTZ AG: Reconciliation

€ million

DEUTZ Group net income (IFRS)	**16.0**
Consolidation of equity investments	10.5
DEUTZ AG income (IFRS)	**26.5**
Material differences due to different financial reporting standards	
Recognition of development expenditure	33.0
Measurement of provisions for pensions and other post-retirement benefits	–5.0
Recognition of deferred taxes	–8.6
Other differences relating to the financial reporting standards	–0.8
DEUTZ AG net income (HGB)	**45.1**

RESULTS OF OPERATIONS

Overview of DEUTZ AG’s results of operations

€ million

	2016	2015
Revenue	**1,151.8**	**1,120.8**[1]
Cost of sales	–998.3	–978.0[1]
Research and development costs	–45.0	–43.6
Selling and administrative expenses	–69.3	–70.3[1]
Other operating income	37.7	38.6[1]
Other operating expenses	–21.4	–35.9[1]
Net investment income	4.4	5.6
Operating profit (EBIT)	**59.9**	**37.2**[1]
Interest expenses, net	–5.7	–8.2
Income taxes	–8.6	–1.7
Other taxes	–0.5	–0.5
Net income	**45.1**	**26.8**

[1] Following the initial application of the German Accounting Directive Implementation Act (BilRUG) in the annual financial statements of DEUTZ AG for the year ended 31 December 2016, the prior-year figures have been restated to improve comparability.

Revenue In 2016, the revenue generated by DEUTZ AG amounted to €1,151.8 million, an increase of 2.8 per cent compared with 2015 (€1,120.8 million). This trend was primarily due to increased demand in our largest application segments, Construction Equipment and Agricultural Machinery. In the Construction Equipment application segment, revenue rose by 8.3 per cent to €346.0 million (2015: €319.4 million). Agricultural Machinery saw an even bigger increase of 12.3 per cent to €177.0 million (2015: €157.6 million). As a result of the initial application of the German Accounting Directive Implementation Act (BilRUG) in the annual financial statements of DEUTZ AG for the year ended 31 December 2016, items amounting to €1.8 million are reported under revenue that were previously recognised under other operating income. To improve comparability, the prior-year figure has been adjusted by €2.2 million.

In terms of regions, revenue in the Asia-Pacific region rose by a substantial 17.2 per cent to €132.6 million. We also saw growth in our largest region, EMEA (Europe, Middle East and Africa), where revenue advanced by 3.1 per cent to €835.9 million. By contrast, revenue in the Americas region decreased by 5.5 per cent to €184.2 million.

Earnings performance In 2016, DEUTZ AG generated an operating profit (EBIT) of €59.9 million (2015: €37.2 million). The year-on-year increase of €22.7 million was mainly due to lower expenses resulting from the interest-rate-related adjustment to provisions for pensions and other post-retirement benefits, as well as the reversal of impairment losses recognised on our receivables from the equity investment Ad. Strüver KG. By disposing of the building lease for a plot of land that was no longer used for production purposes, Ad. Strüver KG improved its liquidity significantly, which means the receivables became recoverable again. The earnings of DEUTZ AG also benefited from the increased volume of business and lower cost of materials.

Earnings before interest, tax, depreciation and amortisation (EBITDA) at DEUTZ AG amounted to €105.6 million in 2016, compared with €93.5 million in 2015.

Cost of sales DEUTZ AG's cost of sales came to €998.3 million in 2016 (2015: €978.0 million). The year-on-year increase of €20.3 million was mainly attributable to the volume-related rise in the cost of materials. The gross margin improved from 12.7 per cent to 13.3 per cent. As the prior-year figure for revenue has been restated due to the initial application of the BilRUG, the prior-year figure for the cost of sales has also been adjusted upwards by €1.6 million in order to improve comparability. Correspondingly, selling expenses and general and administrative expenses have been reduced by €1.6 million.

Research and development costs Research and development costs rose only slightly year on year, by €1.4 million, to reach €45.0 million (2015: €43.6 million). Research and development costs largely comprised staff costs and cost of materials. Investment grants received and capitalised development expenditure were deducted. Unlike the development expenditure in the DEUTZ Group, which is recognised in accordance with IFRS requirements, the development expenditure in DEUTZ AG is recognised in accordance with HGB provisions and only expenditure relating to projects that started after initial application of the German Accounting Law Modernisation Act (BilMoG) at DEUTZ AG is capitalised.

Selling and administrative expenses Selling and administrative expenses in 2016 came to €69.3 million, a small decrease of €1.0 million compared with the previous year (2015: €70.3 million). This decrease was mainly the result of one-off transition costs in 2015 that were incurred in connection with the switch of IT service provider. When measured as a proportion of revenue, selling and administrative expenses also fell year on year, from 6.3 per cent in 2015 to 6.0 per cent in 2016. To improve comparability, the prior-year figure for selling and administrative expenses has been reduced by €1.6 million following the initial application of the BilRUG.

Other operating income Other operating income fell by €0.9 million year on year to €37.7 million (2015: €38.6 million). This decline was mainly the result of lower exchange-rate gains and the absence of the income in connection with the disposal of the shares in WEIFANG WEICHAI DEUTZ DIESEL ENGINE CO., LTD. in Weifang, China, that had been recognised in the previous year. These effects were offset by the reversal of impairment losses recognised on our receivables from the equity investment Ad. Strüver KG. As a result of the initial application of the BilRUG in the annual financial statements of DEUTZ AG for the year ended 31 December 2016, items that were previously recognised under other operating income have been reported under revenue. To improve comparability, the prior-year figure for other operating income has been adjusted by €2.2 million.

Other operating expenses Other operating expenses fell by €14.5 million year on year to €21.4 million (2015: €35.9 million). This decrease was predominantly caused by the much lower expenses relating to the interest-rate-related adjustment to provisions for pensions and other post-retirement benefits, as well as by foreign-currency transactions. The year-on-year reduction of €10.4 million in this interest-rate effect was due to using the ten-year average interest rate instead of the seven-year average interest rate to discount pension liabilities in 2016 for the first time following the implementation of new legal requirements.

As a result of the initial application of the BilRUG in the annual financial statements of DEUTZ AG, other operating expenses for 2016 include the annual addition of the difference of €2.3 million in provisions for pensions and other post-retirement benefits caused by the transition to the BilMoG. This was previously recognised under extraordinary expenses. To improve comparability, the prior-year figure has been adjusted.

Net investment income Net investment income was down on the previous year, declining by €1.2 million to €4.4 million (2015: €5.6 million). This was primarily because the prior-year figure for net investment income had been boosted by an exchange-rate gain in connection with the winding-up of the equity investment DEUTZ Engine (China) Co., Ltd. in Linyi, China.

Net interest expense Net interest expense amounted to €5.7 million in 2016 (2015: net expense of €8.2 million). This year-on-year improvement of €2.5 million was mainly attributable to reduced interest expenses for pensions and lower utilisation of credit lines.

Income taxes Income taxes came to €8.6 million in 2016 (2015: €1.7 million). Of this total, current tax expenses accounted for €6.0 million (2015: €2.7 million) and deferred tax expenses for €2.6 million (2015: deferred tax income of €1.0 million). The main reason for the rise in current tax expenses is the improvement in results of operations.

Net income Owing, in particular, to the much better level of operating profit, the net income for the reporting year increased significantly, rising by €18.3 million year on year to €45.1 million (2015: €26.8 million). At the start of 2016, we had predicted a year-on-year decrease in net income, which means we exceeded our forecast. One of the main reasons why we did better than the forecast was the reversal of impairment losses recognised on our receivables from the equity investment Ad. Strüver KG. Another reason was the change in the period, from seven years to ten years, used to determine the average interest rate for measuring pension liabilities. The contribution to earnings of €10.4 million from the positive effect arising from determination of the average interest rate cannot be distributed as a dividend.

In view of the positive level of net income, the Board of Management and Supervisory Board propose using €8.5 million of the accumulated income for the financial year to pay a dividend of €0.07 per share.

FINANCIAL POSITION

Overview of DEUTZ AG's financial position

€ million

	2016	2015
Cash flow from operating activities	50.7	88.7
Cash flow from investing activities	–44.5	–41.0
Cash flow from financing activities	–23.1	–23.9
Change in cash and cash equivalents	–16.9	23.8
Free cash flow	6.0	46.7
Cash and cash equivalents at 31 Dec	80.8	97.7

Free cash flow: cash flow from operating and investing activities less net interest expense.

Financial management in the DEUTZ Group is one of the core functions of the Group, and DEUTZ AG holds responsibility for this function. The basic principles and objectives of financial management at DEUTZ AG are therefore largely the same as those of the Group, as is the funding of DEUTZ AG. In this regard, please refer to the relevant sections on page 38 et seq. of this combined management report.

Liquidity Cash flow from operating activities amounted to €50.7 million last year (2015: €88.7 million). The sharp year-on-year fall of €38.0 million was mainly due to the higher volume of current receivables from affiliated companies and the change in working capital. Whereas there had been a marked decrease in working capital in 2015, the level of working capital fell only slightly in the reporting period. Another significant reason for the fall was the rise in income tax payments.

The cash flow from investing activities in 2016 was minus €44.5 million (2015: minus €41.0 million). This change was primarily due to lower cash receipts in connection with disposals of investments. In 2015, following the winding-up of DEUTZ Engine (China) Co., Ltd., headquartered in Linyi, China, an amount of approximately €5.0 million had been withdrawn from the additional paid-in capital of the holding company, DEUTZ Engine China GmbH, and repaid to DEUTZ AG.

Cash flow used for financing activities in 2016 totalled €23.1 million (2015: €23.9 million). This decrease was primarily due to lower interest expense. As in the previous year, cash flow used for financing activities included a dividend payment to shareholders of €8.5 million.

Free cash flow decreased year on year, falling by €40.7 million to €6.0 million (2015: €46.7 million). This was due, above all, to the significant reduction in cash flow from operating activities.

Capital expenditure After deducting investment grants, DEUTZ AG's capital expenditure in 2016 amounted to a total of €52.1 million (2015: €52.9 million). As in 2015, spending primarily related to property, plant and equipment, with €41.2 million being spent on these assets after deducting grants (2015: €42.2 million). The investing activities relating to property, plant and equipment focused on the construction of the shaft centre in Cologne-Porz, where production was progressively ramped up from mid-2016 onward. There were also additions in connection with replacement investments in machinery and tools. Capital expenditure on development projects totalled €7.5 million (2015: €6.1 million) and mainly related to the development of the new TCD 2.2 and TCD 5.0 engine series.

NET ASSETS

Overview of DEUTZ AG's net assets

€ million

	31 Dec 2016	31 Dec 2015
Non-current assets	494.4	493.4
Current assets	410.1	408.0
Prepaid expenses	1.6	1.8
Deferred tax assets	83.7	86.3
Total assets	**989.8**	**989.5**
Equity	508.8	472.2
Provisions	254.3	269.4
Liabilities	226.2	247.5
Deferred income	0.5	0.4
Total equity and liabilities	**989.8**	**989.5**
Working capital (€ million)	63.2	67.7
Working capital ratio (31 Dec, %)	5.5	6.1
Equity ratio (%)	51.4	47.7

Working capital: inventories plus trade receivables less trade payables.
Equity ratio: equity / total equity and liabilities.

Non-current assets Non-current assets at 31 December 2016 amounted to €494.4 million (31 December 2015: €493.4 million). The small year-on-year increase was primarily the result of the higher volume of internally generated intangible assets. Unlike the development expenditure recognised in the consolidated financial statements in accordance with IFRS, development expenditure in DEUTZ AG's annual financial statements is only capitalised if it relates to projects that began after the initial application of the BilMoG at DEUTZ AG. For this reason, only development expenditure on new engine projects that are still at the development stage is capitalised. As these development projects cannot yet be depreciated or amortised, the additions were not offset by depreciation or amortisation.

Current assets As at 31 December 2016, current assets amounted to €410.1 million. This increase of €2.1 million compared with twelve months earlier (31 December 2015: €408.0 million) mostly resulted from the higher volume of receivables from affiliated companies and other assets as at 31 December 2016. Decreases in inventories and in cash and cash equivalents largely offset the overall increase in current assets.

Working capital Working capital as at 31 December 2016 was €63.2 million (31 December 2015: €67.7 million), a small year-on-year decrease of €4.5 million. The main factor in this reduction was the lower level of raw materials and consumables and of bought-in parts at the end of 2016. Consequently, trade payables also declined. Trade receivables fell only slightly. The working capital ratio decreased to 5.5 per cent as at the balance sheet date[1] (31 December 2015: 6.1 per cent) owing to the reduction in working capital coupled with the increased volume of business.

Deferred tax assets Deferred tax assets contracted by €2.6 million year on year to €83.7 million (31 December 2015: €86.3 million). This reduction arose, in particular, from temporary differences between the carrying amounts in the tax accounts and in the financial statements under HGB for internally generated intangible assets. Whereas development expenditure is capitalised in the financial statements under HGB, this is prohibited in the tax accounts. The resulting deferred tax liabilities were offset against deferred tax assets as far as possible.

Equity ratio Owing to the positive level of net income, equity advanced by €36.6 million to €508.8 million (31 December 2015: €472.2 million). The rise was partly offset by the distribution of a dividend to the shareholders of DEUTZ AG of €8.5 million for 2015. The equity ratio increased slightly to reach 51.4 per cent (31 December 2015: 47.7 per cent).

Provisions At 31 December 2016, provisions stood at €254.3 million (31 December 2015: €269.4 million). This year-on-year decrease of €15.1 million was primarily attributable to the reduction in provisions for potential warranty claims in the future, as well as to lower provisions for pensions and other post-retirement benefits and lower provisions for income taxes.

Liabilities As at 31 December 2016, liabilities had fallen by €21.3 million to €226.2 million (31 December 2015: €247.5 million). The main factor here was the decline in liabilities to banks, which were scaled back as planned. Moreover, there was a year-on-year decrease in trade payables as at the balance sheet date due to a reduction in orders of raw materials and consumables.

EMPLOYEES

As at 31 December 2016, a total of 2,864 people were employed by DEUTZ AG. This meant that the number of employees had fallen by 79 year on year (31 December 2015: 2,943 employees). We also had a further 159 people on temporary employment contracts as at 31 December 2016, compared with 124 a year earlier. Employing temporary workers enables us to respond flexibly to any fluctuations in demand.

[1] Working capital ratio as at the balance sheet date: ratio of working capital (inventories plus trade receivables less trade payables) at the end of the reporting period to revenue for the preceding twelve months.

Looking at it by segment, DEUTZ Compact Engines employed 2,383 people as at 31 December 2016, 71 fewer than it had employed a year earlier. The number of employees at DEUTZ Customised Solutions was 481, which was eight fewer year on year.

OPPORTUNITY AND RISK REPORT

DEUTZ AG is integrated into the risk management system of the DEUTZ Group. As a head-office function, risk management for the Group is performed by DEUTZ AG. Information about the structuring and mechanics of the risk management system and of risk management with regard to financial instruments can be found in our notes on pages 57 et seq.

Because DEUTZ AG is closely integrated with the other Group companies, its risk and opportunities situation is essentially the same as that of the Group. Risks arising from subsidiaries may have an effect on DEUTZ AG because of the carrying amount of an equity investment, reduced dividend payments and the internal business relations. The risks and opportunities associated with the DEUTZ Group are described on pages 57 to 61 of this combined management report.

Information about DEUTZ AG's internal accounting-related control system and about risk management with regard to the use of financial instruments at DEUTZ AG can be found on page 60 et seq. of this combined management report.

OUTLOOK

DEUTZ AG performs the head-office functions of the DEUTZ Group and is the biggest production company within the Group by some margin. Because of DEUTZ AG's wide-ranging relationships with other Group companies and because of its size within the Group, the expectations presented in the Group outlook for 2017 are essentially the same as those for DEUTZ AG. We therefore anticipate that the revenue of DEUTZ AG will develop largely in line with the statements made for the DEUTZ Group. As the one-off effect resulting from the reversal of the impairment losses recognised on our receivables from Ad. Strüver KG in the reporting year will not be repeated, we expect net income in 2017 to be slightly lower than in 2016. Moreover DEUTZ AG's Board of Management decided in February 2017 to examine whether the Cologne-Deutz site can be sold quickly on attractive terms and has authorised the initiation of negotiations on selling the site. If the outcome of these negotiations is positive, DEUTZ AG may be able to generate a substantial one-off gain within a short period of time – and possibly recognise some of this gain in 2017 – depending on the specific contractual arrangements. Further information can be found in the outlook for the DEUTZ Group on pages 61 to 63.

CORPORATE GOVERNANCE DECLARATION PURSUANT TO SECTION 289A HGB

The corporate governance declaration pursuant to section 289a HGB is an integral element of the combined management report. We refer here to our remarks on pages 129 to 134 of the annual report.

DISCLOSURES PURSUANT TO SECTIONS 289 (4) AND 315 (4) HGB

Composition of the issued capital There were no changes to the issued capital (share capital) of DEUTZ AG in 2016. As at 31 December 2016, the issued capital amounted to €308,978,241.98 and was divided into 120,861,783 no-par-value bearer shares.

Direct or indirect shareholdings representing more than 10 per cent of voting rights Since 12 September 2012, AB Volvo of Gothenburg, Sweden, has held 30,246,582 shares in DEUTZ AG, giving it a voting share of 25.026 per cent.

Restrictions affecting voting rights or the transfer of shares According to the information available to us, the transferability of DEUTZ shares held by AB Volvo is restricted by a pre-emption right of the Same DEUTZ-FAHR Group S.p.A. of Treviglio, Italy.

Legal provisions and Statute provisions regarding the appointment and removal of members of the Board of Management and regarding changes to the Statutes According to articles 7 (1) and 7 (2) of the Statutes of DEUTZ AG:

"(1) The Board of Management shall comprise at least two members.
(2) The Supervisory Board shall determine the number of members of the Board of Management and the allocation of responsibilities. It may draw up and issue rules of procedure."

As far as the appointment and removal of members of the Board of Management are concerned, sections 84 and 85 of the German Stock Corporation Act (AktG) and section 31 of the German Codetermination Act (MitbestG) also apply.

According to article 14 of the Statutes of DEUTZ AG:

"The Supervisory Board may change the wording but not the spirit of the Statutes." Sections 179 and 133 AktG also apply in the case of changes to the Statutes.

Authority of the Board of Management, in particular with regard to share issue or buyback The authority of the Board of Management is derived from the legal provisions and from the rules of procedure laid down by the Supervisory Board.