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.