

Overview of 2016

Fundamental features of
the Group

Internal control system

DEUTZ AG

DEUTZ Compact Engines

- Liquid-cooled engines of up to 8 litres cubic capacity

DEUTZ Customised Solutions

- Air-cooled engines
- Liquid-cooled engines of more than 8 litres cubic capacity

MARKET AND COMPETITIVE ENVIRONMENT

DEUTZ manufactures diesel engines for professional applications used in countries with stringent emissions standards, in particular EU Stage III A, III B and IV (as well as the equivalents in the US and other countries). These technically sophisticated applications include construction equipment, agricultural machinery, lifting and material handling equipment, pumps, gensets, medium-duty trucks and buses. The market for DEUTZ engines is therefore separate from the market segments for diesel engines used in passenger cars and small commercial vehicles up to a permissible gross weight of 3.5 tonnes. Engines that rely on outdated technology and that are intended for use in applications in countries or application segments with only very low requirements in terms of product quality, emissions and fuel consumption also do not feature in our target market. The market for technically sophisticated diesel engines can be divided into the captive segment and the non-captive segment. The captive segment comprises equipment manufacturers who produce their own engines; some of these manufacturers are also active as engine suppliers in the market. The non-captive segment is made up of equipment manufacturers who for the most part do not produce their own engines and who, therefore, buy in engines from suppliers. It is in this non-captive market that DEUTZ sells high-value engines with outputs between 25 kW and 520 kW around the globe.

We have attained a good position as one of the biggest suppliers in the non-captive market. We face competition from rival engine suppliers in western Europe, North America and Asia, but none of these competitors can offer an identical product range to DEUTZ in terms of the power outputs and application segments that they cover.

Main competitors

Application segments	Applications	Main competitors (in alphabetical order)
Construction Equipment	Excavators	Cummins, USA
	Wheel loaders	Isuzu, Japan
	Pavers	Weichai, China
Material Handling	Mining equipment	Yanmar, Japan
	Forklift trucks	Cummins, USA
	Telehandlers	VW, Germany
	Lifting platforms	Yanmar, Japan
Agricultural Machinery	Ground support equipment	Zhejiang Xinchai, China
	Tractors	Deere, USA
	Harvesters	Kubota, Japan
Stationary Equipment	Gensets	Cummins, USA
	Pumps	Kubota, Japan
	Compressors	Perkins, UK
Automotive	Rolling stock	Yanmar, Japan
	Special vehicles	Cummins, USA
	Trucks	Fiat Powertrain, Italy
	Buses	MAN, Germany
		Mercedes, Germany

INTERNAL CONTROL SYSTEM

RESPONSIBLE CORPORATE MANAGEMENT
BASED ON TRANSPARENT PERFORMANCE
INDICATORS

The DEUTZ Group defines its budget targets and medium-term corporate targets using selected key performance indicators (KPIs). In order to increase profitability and achieve sustained growth, we manage the Group on the basis of the following financial performance indicators:

		2016	2015
Revenue growth	%	1.0	-18.5
EBIT margin (before exceptional items)	%	1.9	0.4
Working capital ratio ¹⁾ (average)	%	17.9	17.6
ROCE (before exceptional items) ¹⁾	%	3.1	0.6
R&D ratio	%	4.0	3.3
Free cash flow ¹⁾	€ million	4.7	35.0

¹⁾ These KPIs are alternative performance measures that are not defined in the International Financial Reporting Standards (IFRS). A reconciliation of these KPIs to the amounts recognised in the financial statements is provided below.

Revenue growth Steadily increasing revenue is the basis for the profitable growth of the Company. The level and growth of revenue is determined on a monthly basis, broken down by product group, application segment and region. This data is provided to senior management promptly so that it can react quickly to changes as they materialise.

EBIT margin (before exceptional items) The main key performance indicator that we use to manage the Company's operating performance is the EBIT margin before exceptional items. This is based on the Group's earnings before interest and tax (EBIT). The EBIT figure is then adjusted for exceptional items and calculated as a percentage of revenue. We define exceptional items as significant income generated or expenses incurred outside the scope of the Company's ordinary business activities that are unlikely to recur. There were no exceptional items in 2016 or 2015. Adjusting for exceptional items enables a more accurate comparison of the Company's operating performance over time. The EBIT margin before exceptional items is, like revenue growth, calculated monthly and presented to senior management as part of internal reporting.

Working capital ratio (average) We manage the Company's tied-up capital using the average working capital ratio. This is the ratio of average working capital over the past four quarters to revenue for the preceding twelve months. Working capital comprises inventories plus trade receivables less trade payables. Along with revenue growth and the EBIT margin, this key figure is calculated monthly and presented to senior management.

ROCE (before exceptional items) The return on the capital employed in the Group is measured and managed on an annual basis using the key figure ROCE (before exceptional items). This is calculated as follows:

ROCE

€ million

	2016	2015
Total assets	1,059.7	1,088.1
Cash and cash equivalents	-91.8	-112.5
Trade payables	-162.3	-169.5
Other current and non-current liabilities	-57.3	-49.0
Capital employed	748.3	757.1
Capital employed (average for the year)	752.7	792.7
EBIT (before exceptional items)	23.4	4.9
ROCE (before exceptional items)	3.1%	0.6%

R&D ratio As a technology-focused company, we consider the R&D ratio to be one of the most significant performance indicators in our internal management system. It is the ratio of research and development expenditure (after reimbursements) to revenue in the period in question. The R&D ratio is calculated at least once a quarter and is reported to senior management.

Free cash flow The DEUTZ Group uses free cash flow as its main performance indicator for managing liquidity. It comprises net cash provided by, and used for, the operating activities and investing activities of the Group during the period in question less interest payments in connection with financing activities. We can thus show what cash flow generated in the relevant year is available to the Company, e.g. for repaying liabilities or paying a possible dividend to shareholders. Free cash flow is reported to senior management at least once a quarter.

Based on these performance indicators, DEUTZ has set up an early warning system in order to be proactive and respond promptly. At the same time, we operate a sound system of causal analysis to ensure that we minimise risks and make the most of opportunities. Three times a year we produce an annual forecast for all key performance indicators. In this way, we ensure optimum transparency with regard to our business performance, benefiting both the Group and all our stakeholders.

In addition to the financial performance indicators which form part of the management system described above, we also employ a range of other parameters to measure our economic performance. These include, but are not limited to, new orders received, revenue and unit sales on the income side, the working capital as at the reporting date with regard to tied-up capital, and earnings before interest, taxes, depreciation and amortisation (EBITDA). Moreover, the Group net income and the DEUTZ AG statutory income in accordance with the German Commercial Code are significant factors for us as regards dividend payments.

CONTINUOUS OPTIMISATION OF THE CONTROL SYSTEM

Regardless of fluctuations in the economic cycle, one of the DEUTZ Group's overriding aims is the continuous optimisation of its management systems. This essentially involves the annual planning of all specified performance indicators. This planning is based on both internal estimates of future business and benchmark figures from competitors. Each organisational unit prepares detailed plans for its area of responsibility, which are then coordinated with the management strategy. Both the specific unit sales and revenue targets and the customer and product-related targets (EBIT margins) are aligned with the operating units each year, taking groupwide objectives into consideration. This means that they are available at the relevant hierarchical level for use in operational management.

We specify working capital targets for the individual companies in the DEUTZ Group in order to optimise the capital tied up in the business. These overall figures are then broken down and specific targets for inventories, trade receivables and trade payables are allocated to the relevant individual employees.

We are pursuing long-term growth objectives. In order to secure the financial basis for this, we have made the management of capital expenditure a central element in the management of tied-up capital: clearly specified budget figures set out the framework for the level of capital expenditure and development expenditure; actual requirements are derived from the medium-term planning of unit sales and the resulting requirements in terms of capacity and technologies. Annual budget meetings are held to coordinate individual projects, development expenditure and planned capital expenditure with the groupwide financial planning process and to record the outcomes. An additional detailed review is carried out before projects are actually approved. To this end, we use standard investment appraisal methods (internal rate of return, amortisation period, net present value, the impact on the income statement and cost comparisons). A project with an appropriate budget is only approved if there is a clear positive outcome from this investment appraisal.

BUSINESS PERFORMANCE IN THE DEUTZ GROUP

ECONOMIC ENVIRONMENT

Global growth rate at prior-year level Worldwide economic growth remained at a moderate level last year. The International Monetary Fund (IMF)¹⁾ is expecting global economic growth of 3.1 per cent for 2016 as a whole, compared with 3.2 per cent in 2015.

The economy of the eurozone grew by 1.7 per cent in 2016, which was slightly weaker than the increase of 2.0 per cent in 2015. Germany's economy stepped up the pace of growth slightly, expanding by 1.7 per cent year on year (2015: growth of 1.5 per cent). The Spanish economy again performed very encouragingly with a growth rate of 3.2 per cent, which was the same as in 2015. France was also on a par with the previous year with growth of 1.3 per cent. Italy's growth increased slightly from 0.7 per cent in 2015 to 0.9 per cent in 2016.

The US economy expanded by 1.6 per cent (2015: 2.6 per cent). This slowdown in the pace of growth was due to declining levels of capital investment. The economy in China held steady over the course of the year thanks to more expansionary economic policy. Gross domestic product (GDP) rose by 6.7 per cent over 2016 as a whole, compared with 6.9 per cent in 2015. The Russian economy remains in recession; South America's performance was weaker than originally anticipated.

¹⁾ IMF World Economic Outlook Update, January 2017.

Overall, the economic environment was characterised by a variety of risks and uncertainties in 2016, such as the vote for Brexit in the United Kingdom, and these will continue to have an impact this year. China is in a state of transition with a lower growth rate than in previous years and a shift away from the strong export model. The economic effects of the outcome of the US election cannot yet be gauged.

Mixed picture in DEUTZ's customer industries The situation varied significantly across DEUTZ's main customer markets in 2016. According to DEUTZ's own estimates, demand for construction equipment rose by around 5 per cent in both Europe and China. However, unit sales of construction equipment fell by approximately 5 per cent in North America. The European agricultural machinery sector contracted again, with demand declining by 5 per cent in 2016.²⁾ Unit sales of light and medium-duty trucks in China improved by around 7 per cent according to DEUTZ's own estimates.

IMPACT OF ECONOMIC CONDITIONS ON BUSINESS PERFORMANCE

Uncertainties hold back investment activity Overall, the economic environment was characterised by a variety of risks and uncertainties in 2016 that will continue to have an impact this year. The tendency is therefore for a wait-and-see stance as far as investment activity is concerned. Moreover, prices for oil, commodities and agricultural goods were again at a very low level in 2016, although they did rise over the course of the year. However, higher prices would encourage investment in the relevant areas – and thus would benefit business at DEUTZ.

While the global economy grew by 3.1 per cent in 2016, revenue at DEUTZ rose by 1.0 per cent. The economy in the eurozone expanded by 1.7 per cent in the year under review. Against this backdrop, the situation varied significantly across DEUTZ's main customer markets in Europe. Whereas demand for construction equipment rose, there was a decline in the agricultural equipment sector. Nevertheless, DEUTZ was able to increase its unit sales of engines for agricultural equipment applications because demand in the previous year had been very low due to customers using up their inventories. In 2014, they had purchased significant volumes of engines ahead of a new emissions standard. DEUTZ's revenue in its largest market, EMEA (Europe, Middle East and Africa), rose by 3.3 per cent in 2016.

Economic growth in the United States slowed to 1.6 per cent in the reporting year (2015: 2.6 per cent). DEUTZ's revenue in North America fell by 13.0 per cent. This was largely caused by declining unit sales of engines for construction equipment in North America and by rental companies' reluctance to invest.

Momentum in China, our key international market, slowed again, with economic growth of 6.7 per cent (2015: 6.9 per cent). However, the markets for construction equipment and for light and

²⁾ Konjunkturbulletin of the German Engineering Federation (VDMA), February 2017.