

on an ongoing basis during the preparation of monthly financial statements. Data is reported to the Group head office using a standard reporting tool that has been implemented throughout the Group. Additional control mechanisms covering the risks in the main processes, thereby guaranteeing a reliable accounting and reporting system, are normally set up locally at departmental level. Where necessary, we also use external service providers, such as independent assessors of pension liabilities. The Group accounting department ensures that these requirements are adhered to across the Group.

Information relevant to accounting is shared on an ongoing basis with the Head of Finance, Accounting and Compliance and passed on to the Chief Financial Officer in regular meetings.

Besides discussing the single-entity and consolidated financial statements, the Audit Committee set up by the Supervisory Board regularly discusses the quarterly financial reporting. In addition, the Audit Committee's monitoring function includes the ICS set up by the Board of Management as well as the accounting process itself.

The internal audit department prepares a risk-based audit plan and verifies whether the statutory regulations and the DEUTZ Group's internal guidelines for its entire control and risk management system are being complied with. As part of its monitoring function it reviews whether the defined controls are functioning effectively. The findings of these reviews are reported directly to the Board of Management and allow us to eliminate any deficiencies that have been identified and ensure that the ICS is continually refined.

OPPORTUNITIES REPORT

In the fast-paced, dynamic markets in which the DEUTZ Group operates, there are, in addition to the aforementioned risk factors that can negatively impact on the attainment of the business objectives, also opportunities that can have a positive effect on the business objectives of the Group for 2017 and beyond. Identifying and harnessing these opportunities is the responsibility of the individual operating segments of the Group. Unlike risks, opportunities are not collated and assessed centrally.

Unless otherwise stated, the opportunities described below refer to 2017 and relate to the DCE and DCS segments.

Economic situation in relevant markets Developments in the global economy have a major effect on the financial position and financial performance of the DEUTZ Group. If our expectations regarding the macroeconomic situation in our most important markets of Europe, the USA and Asia are exceeded, and in view of the measures we have already taken to boost efficiency (particularly the optimisation of our network of sites in Germany), we may perform significantly better than we predicted.

Research and development Increasingly stringent emissions standards and general technological progress are placing huge demands on our entire industry. We are one of the innovation leaders and have a very strong competitive position thanks to our proven expertise, our many years of experience and our efficient processes in the research and development of diesel engines and other drive systems. The development of gas engines with a capacity of up to 4 litres and the expansion of our portfolio of products with a capacity of over 4 litres will enable us to reinforce this strong competitive position.

Production and quality The digital transformation of manufacturing, referred to as Industry 4.0, is exploring new approaches to production. The first projects in the service business are due to start soon. In combination with projects to improve quality and the introduction of the zero-error strategy, this may lead to substantial efficiency increases and greater customer satisfaction in the short to medium term.

OUTLOOK

ECONOMIC FORECASTS REMAIN UNCERTAIN

The International Monetary Fund (IMF)¹⁾ has confirmed its forecasts for the next few years, anticipating a stronger rate of growth in industrialised countries as well as in developing countries and emerging markets. Following growth of 3.1 per cent in 2016, the IMF predicts that the global economy will expand by 3.4 per cent in 2017 and by 3.6 per cent in 2018.

The economy of the eurozone is likely to generate growth of 1.6 per cent, compared with 1.7 per cent last year. Germany's growth rate will probably be slightly lower, remaining unchanged at 1.5 per cent. The US economy is expected to receive further stimulus, growing at a rate of 2.3 per cent in 2017 and 2.5 per cent in 2018, compared with 1.6 per cent in 2016. The IMF also anticipates slower growth rates for China: having risen by 6.7 per cent last year, GDP is predicted to rise by 6.5 per cent in 2017 and 6.0 per cent in 2018.

¹⁾ IMF World Economic Outlook Update, January 2017.

The business climate index¹⁾ published by the ifo Institute of Economic Research, which covers trade and industry in Germany, dropped from 111.0 points to 109.8 points in January 2017. Although companies were more satisfied with their current business position, they were feeling slightly less optimistic about the coming months. The ISM purchasing managers' index²⁾ in the USA made a surprising jump to 56.0 points as at 1 February 2017 – its highest level since November 2014.

DIESEL ENGINES MARKET

For construction equipment in 2017, we anticipate that unit sales in North America will move within a range of –5 per cent to +5 per cent while the European market will expand by between 0 per cent and 5 per cent and the Chinese market by between 5 per cent and 10 per cent. We expect growth in the material handling market to be between 0 per cent and 10 per cent in Europe, whereas the North American and Chinese markets are likely to remain within a bandwidth of –5 per cent to +5 per cent. We also predict that the agricultural machinery market in Europe will remain fairly static within a range of –5 per cent to +5 per cent. In China, we expect the light and medium-duty truck sector to generate slight growth of between 0 per cent and 5 per cent.

As a rule, the diesel engines market largely follows the applications and markets of the machinery and equipment in which the engines are installed.

UNIT SALES, REVENUE

Although, as already said, we anticipate that the market will stagnate, or perhaps grow slightly, we can already see early signs of a potential improvement in the market. Last year, many of our European customers largely used up the inventories that they had built up in 2014 in anticipation of the new emissions standard. This provides a very strong base effect for us. Production for a number of projects with new customers is still being ramped up, which should also have a beneficial impact. We believe the service business's revenue will continue to go up.

Owing to the increasing proportion of higher-value engines to meet the new emissions standards in Europe and America, the value of the diesel engines market will continue to increase at a faster rate than its unit sales.

We therefore anticipate a marked rise in revenue overall. The increase in revenue will be fuelled by the DCE segment, whereas we expect the DCS segment's revenue to decrease slightly. This is because the effects of the advance production of engines for the new emissions standard and the projects with new customers are predominantly in the DCE segment. Given the current environment, our forecasts are of course subject to great uncertainty. The flexibility of our business therefore remains a key factor in our competitiveness.

¹⁾ ifo Institute of Economic Research, January 2017.

²⁾ ISM purchasing managers' index, February 2017.

EARNINGS

We expect the EBIT margin before exceptional items to increase moderately. The margin will be boosted, above all, by better capacity utilisation and the positive effects of optimising our network of sites. However, unlike in 2016, we do not anticipate any licensing income this year. From this year, we reckon on annual efficiency gains of around €10 million from the optimisation of our network of sites, primarily in connection with the new shaft centre, the relocation of Xchange assembly activities to Ulm and the absence of costs from the Cologne-Deutz site. We already realised about half of this gain in 2016. We expect earnings to rise in both the DCE and the DCS segment.

Furthermore, we anticipate positive exceptional items from property transactions in the near future. Firstly, in 2016 we disposed of a building lease for a plot of land of our equity investment Ad. Strüver KG (GmbH & Co.), Hamburg, that was no longer being used for production purposes; this will result in a positive exceptional item of around €10 million this year. Secondly, DEUTZ AG's Board of Management decided in February 2017 to examine whether the Cologne-Deutz site, which covers an area of around 160,000 square metres and is no longer required for operational purposes following the successful optimisation of our site network, can be sold quickly on attractive terms. The Board of Management has authorised the initiation of negotiations on selling the site. If the outcome of these negotiations is positive, DEUTZ may be able to generate a substantial one-off gain within a short period of time, depending on the specific contractual arrangements. It may be possible to recognise some of this gain as early as 2017.

As a result of the anticipated slight increase in earnings – before positive exceptional items – we believe there will be a small year-on-year rise in return on capital employed (ROCE) before exceptional items in 2017.

COMMODITIES, COLLECTIVE PAY AGREEMENTS

Commodity prices We expect a further small rise in price levels in the primary markets this year, driven by slightly higher growth of the global economy.

No collective pay bargaining in 2017 The collective payment agreement from 2016 expires on 31 December 2017, and one of its key points is a 2 per cent pay increase with effect from 1 April 2017.

RESEARCH AND DEVELOPMENT EXPENDITURE

We predict that research and development spending will rise to between approximately €60 million and €70 million, of which up to €15 million will be capitalised. This is because of new engine projects in relation to the upcoming EU Stage V that will lead to the expansion of our engine portfolio.

CAPITAL EXPENDITURE

We forecast that our capital expenditure in 2017 (excluding capitalisation of research and development expenditure) will be around €70 million, of which up to €15 million for the planned project with Liebherr.

JOINT VENTURES ACCOUNTED FOR USING THE EQUITY METHOD

The market environment in China is likely to remain challenging in 2017. We expect the revenue and earnings of our joint venture DEUTZ (Dalian) Engine Co., Ltd. to improve slightly. Its performance will depend heavily on its capacity utilisation and thus on market conditions.

WORKING CAPITAL RATIO, FREE CASH FLOW AND EQUITY RATIO

Our prediction for the working capital ratio, measured as the quarter-end average, is for a slight improvement on the figure of 17.9 per cent as at 31 December 2016. In addition, we expect positive free cash flow to be at the same level as 2016. If negotiations on the sale of the Cologne-Deutz site are successful, we forecast that free cash flow will be in the mid- to high-double-digit million euro range.

We intend to maintain our equity ratio above 40 per cent, a level that it currently comfortably exceeds. The good level of equity reduces our dependency on capital markets in a volatile market environment.

EMPLOYEES

Optimisation of site network The measures to optimise our network of sites remain on schedule. Following the completion of the first stage of the relocation from Übersee to Ulm in 2015, the reconditioned exchange engine business went through a process of continuous improvement during 2016. The final stage of the relocation should be completed as scheduled on June 30, 2017.

Flexible employment So that we can respond appropriately to cyclical fluctuation in our industry, we will continue to make use of fixed-term and temporary contracts, even though the terms and conditions will change significantly as a result of the new German Labour Leasing Act (AÜG).

STATUTORY REGULATIONS, EXHAUST EMISSIONS STANDARDS

Regulation (EU) 2016/1628 on the introduction of Stage V from 2019 came into force on 6 October 2016. This will largely harmonise EU and US limits on gaseous emissions in all power categories. There will also be a limit on the number of particulates emitted by diesel engines for mobile machinery in the 19 to 560 kW power output range. Our TCD engines equipped with a diesel particulate filter in the 2.9 to 7.8 litre cubic capacity range already meet this new limit. Furthermore, our 'Stage V ready' label guarantees that the entire DEUTZ TCD engine range from 2.2 to 16 litres cubic capacity will meet EU Stage V without the need for modifications to customers' equipment. No further tightening of exhaust emissions limits in the USA is currently on the horizon.

Disclaimer This management report includes certain statements about future events and developments, together with disclosures and estimates provided by the Company. Such forward-looking statements include known and unknown risks, uncertainties and other factors that may mean that the actual performances, developments and results in the Company or those in sectors important to the Company are significantly different (especially from a negative point of view) from those expressly or implicitly assumed in these statements. The Board of Management cannot therefore make any guarantees with regard to the forward-looking statements made in this management report.