Letter to the Shareholders

Dear shareholders and business associates,

BAVARIA Industriekapital AG was established in 2003. This provides us with an opportunity, in addition to reporting on financial year 2012, to look back on 10 years of operating activities and to examine the sustainability of our business philosophy in greater detail.

We increased earnings significantly in financial year 2012. Consolidated earnings amounted to EUR 55.7 million (previous year: EUR 24.5 million), the net earnings from investments – adjusted for the write-down of the negative goodwill and the deconsolidation revenues – amounted to EUR 5.1 million (prior year: EUR -40.6 million). At EUR 11.6 million (prior year: EUR 2.4 million), series production achieved the main contribution to earnings, plant construction achieved a small positive contribution of EUR 0.5 million (prior year: EUR -25.9 million), while the Business Services segment achieved a loss of EUR -7.0 million (prior year: EUR -17.1 million).

Net liquidity (cash and cash equivalents minus bank liabilities including factoring of receivables) amounted to EUR 13.1 million at the end of 2012 (prior year: EUR 3.1 million).

We invested EUR 31.7 million in property, plant and equipment in 2012 – this equates to an investment ratio of 4.6% of consolidated sales of EUR 686.4 million. A dividend was not paid in 2012. By contrast, EUR 1.9 million was again spent buying back shares during the year. As long as the market capitalisation of BAVARIA Industriekapital AG remains below our estimate of its intrinsic value, we anticipate the continuation of buying back shares instead of paying a dividend. Our equity (including “bad-will” as a consequence of corporate acquisitions below book value) amounted to 32.5% in the Group and 88.6% in the holding company in 2012.

Series production remains our most successful area of business. Of the consolidated sales of EUR 686.4 million, EUR 476.6 million and consequently 68.1% was attributable to this area in 2012. Sales and net earnings in Series/Automotive have developed as follows in the last five years:

Mio. EUR	Serie/Automotive		
	Sales	Net results	Net margin
2008	327,9	-1,7	-0,5%
2009	259,3	-34,7	-13,4%
2010	345,4	1,1	0,3%
2011	480,6	2,4	0,5%
2012	467,6	11,6	2,5%

By contrast, the trend in sales and earnings in our engineering portfolio was more disappointing in the last five years:

Mio. EUR	Engineering		
	Sales	Net results	Net margin
2008	73,9	1,2	1,6%
2009	48,1	-0,3	-0,6%
2010	90,1	1,9	2,1%
2011	124,3	-25,9	-20,8%
2012	44,8	0,5	1,0%

The proportion of project business sales in consolidated sales only amounted to 6.5% in 2012.

The trend in sales and earnings in Business Services gives few grounds for optimism:

Mio. EUR	Business Services		
	Sales	Net results	Net margin
2008	83,2	-7,2	-8,6%
2009	96,2	-1,0	-1,1%
2010	202,9	-3,0	-1,5%
2011	145,0	-17,1	-11,8%
2012	174,0	-7,0	-4,0%

In the early years, lack of capital (the company was established with a share capital of EUR 50,000) meant that we only acquired loss-making companies at symbolic purchase prices and consequently built up our capital stock successfully. The two capital increases at the end of 2005/beginning of 2006 totalling EUR 14 million were not necessary from a financial perspective: in the three subsequent years, shareholders received EUR 65 million alone in the form of dividends and share buybacks. The recent trend in earnings in Business Services shows that the purchase of companies at no charge does not generate income that would justify the substantial management expenditure. At any rate not outside our series production. One reason for this may be found in the fact that industrial markets have trended sideways if anything since the crisis in the fourth quarter of 2008 and price pressure has increased significantly in many sectors.

Earnings in the holding company

If the earnings in the holding company in the last ten years are considered, no clear trend is discernible:

Holding										
(in EUR Mio.)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Net results	0,0	0,0	2,1	13,8	23,2	13,9	8,2	5,1	6,9	11,0

Net earnings fluctuated significantly because of the revenues from the sale of investments, write-downs on investments and the sales crisis.

Earnings from operating investments

By contrast, net earnings from investments (excluding the negative goodwill) have risen in recent years:

Portfolio companies								
(in EUR Mio.)	2005	2006	2007	2008	2009	2010	2011	2012
Net results	-13,3	6,0	-13,4	-7,7	-36,0	-0,1	-40,6	5,1

The loss-making companies led to a loss usually being reported in net terms in the early years, the annual surplus was also positive in net terms in 2012 for the first time since 2006.

Net earnings fell sharply in the financial crisis but have risen significantly since then. TriStone and the K+S Group were the most important sources of earnings in 2012:

TriStone

The purchase price for the TriStone Group, which was acquired from Trelleborg in June 2009, amounted to some EUR 35 million including the BAVARIA loan to strengthen the company's equity – part of which in the form of an earn-out linked to certain conditions (which we have not fulfilled so far). At first glance, we certainly paid a great deal at the time and offered predominantly for the potential to increase the Group's earnings. Net earnings of the TriStone Group have developed as follows since then:

in Mio. EUR	TriStone Group	
	Sales	Net results in %
2010	79,7	-3,7%
2011	179,8	-0,8%
2012	168,7	1,5%

(before reversal of negative goodwill)

It is notable that earnings in 2012 are depressed by the construction of two new plants in Mexico and China, which will – it is hoped – lead to a higher contribution to earnings in subsequent years. At all events, incoming orders in 2011 (EUR 69.2 million) and 2012 (67.7 million) support this hope.

We have concluded from this that, in line with our core competence, we shall continue to invest in companies with the potential for improvement, albeit increasingly in profitable companies in sectors with the potential to increase sales in future.

K+S Group

In February 2013, we signed a contract to sell the profitable K+S Group. As expected, the sale was completed in March 2013. The amount of the net sales proceeds will lead to our also investing in listed companies to a limited extent. Since our purchase in 2006, the net earnings and return on sales of the K+S Group have developed as follows:

in Mio. EUR	K+S Group	
	Sales	Net results in %
2007	237,3	3,1%
2008	219,3	3,5%
2009	143,2	-7,9%
2010	182,0	5,3%
2011	231,0	5,1%
2012	199,4	6,3%

It is clear that we increased the return on sales - with the exception of the crisis-riven 2009 – significantly. We spent a long time considering whether we should sell or continue to draw regular dividends. For us, the decisive factor behind the decision to sell was the Group's lack of sales growth and the consideration that growth in other markets would be associated with very substantial investment (approximately three times as much as for the TriStone Group).

When we reflect on the foundation stones of our success and contemplate our previous errors critically, the following picture emerges:

A key factor for our success are the selection and monitoring of the management teams at individual companies based on a system of financial indicators, which - derived from the Toyota Manufacturing System - links operating indicators with the improvement in earnings (e.g. the reduction in the scrap quota leads to savings on materials procurement and consequently to an improvement in the gross margin). Over the course of time, we have developed a better instinct for who and what will generate earnings and whether the management makes sufficient use of its room for manoeuvre.

However, as is always the case when acquiring investments, the actual art lies in making the right purchase. In principle, in our transactions we attach value to the protecting our downside, i.e. to ensuring that we cannot lose any money - in accordance with the motto: "protect your downside, the upside takes care of itself". We also follow a strict due diligence process, document all answers and, in principle, carry out the examination ourselves to exploit the few moments of truth, which sellers usually grant us (e.g. in the form of meetings with the management team). In addition, we pursue current earnings and incoming orders intently to question every deviation and, if necessary, use them as an argument to reduce the purchase price. It is striking that too much is paid for many companies and transactions frequently jeopardise the parent company.

We try to follow the following basic principles to avoid paying too high a purchase price:

- We only buy at a discount to fair value. If, for example, leading automotive manufacturers are traded for eight times net earnings on the stock market, this roughly equates to five times EBITDA and six times EBIT – an average discount of 33% compared with other listed companies. Whether this equates to the real “fair value”, this naturally depends on one's own assessment of the potential to increase profits.
- We do not negotiate over the purchase price internally and escalate it in the process but concentrate on talking to the seller. The art does not lie in concluding a deal at all costs but in negotiating a good one.
- Each earn-out or each seller's loan, which still has to be paid, even if it is only linked to a positive performance, reduces the enterprise value. This equates to the sum of positive and negative scenarios regarding future performance. Therefore, if the upside is restricted, the balance of all possible disbursement scenarios is reduced and consequently the enterprise value as well.

Unfortunately, however, errors do occur in acquisitions. When we examine the reasons, we have often underestimated the need for working capital, wrongly assessed the order position and overlooked the amount of equity that would be sufficient. We were not always sufficiently critical towards sellers. And of course we have also made mistakes and thrown good money after bad. And we have given certain guarantees that it would have been better for us not to have given. 2011 was a sharp setback for us in this respect. We had to write down almost EUR 17 million then, which we have lost in three transactions (one of these was an inherited burden from 2004). The model of buying undervalued companies is a game involving probabilities, meaning that errors are also possible in future. However, we must ensure that we never wager the company and accept that it is better to make ten small bets than one large one.

The majority of BAVARIA Industriekapital AG is family owned and consequently adopts a long-term focus in its investments. We supported the “Deutschland rundet auf” foundation with EUR 50,000 in 2012. - The foundation supports the rounding up of monetary amounts at retail points of sale, the proceeds of which support various children’s foundations in Germany. The founder, Mr Christian Vater, is a prime example of socially committed entrepreneurship in Germany.

We should like to thank all 5,106 employees for their work. We assure our shareholders and business associates that we are confident in our assessment of the future development of BAVARIA Industriekapital AG.

In particular, the development potential of our existing investments gives us grounds for optimism. This is also true of the opportunities to acquire new investments on attractive terms, meaning that we have already concluded another takeover in France in the first quarter of 2013.

We would like to express our thanks for the trust you have shown in us. 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