Letter to the Shareholders

Dear shareholders and business associates,

European economic performance has declined sharply since the financial crisis in 2009. Despite interest being at a historical low of below 1% and money supply being expanded, the economy is stagnating. Why? The bursting of the property bubble in the Southern European countries and Ireland resulted in households and industry in the periphery countries becoming savers. For example, in Spain before the financial crisis private households and industry took on new debts each year of approximately 10% of the gross national product. Together they now save 8% of economic performance. This 18% decline of private demand in Spain alone resulted in economic performance across the periphery countries declining sharply. While gross national product in the euro zone in 2014 was at the level of 2003, industrial production was at the level of the early 1990s. The expanded money supply and the announcement of further injections of liquidity (Draghi's statement "we do whatever it takes") did at least result in calming the liquidity crisis in Europe. However, contrary to expectations, high ECB bond purchases and the resulting increase in the money supply combined with low interest rates have not resulted in impulses spurring economic growth The expected upturn in demand for further loans has not taken place. The patent recipe which worked before the credit bubble burst of reviving the economy on the back of low interest rates does not work anymore. All households and industry have become savers so as to replenish reduced equity levels. For example, in Ireland property prices quintupled within a period of a few years. To 2014, they had already halved. An Irish person who financed his house with a loan in 2008 – the peak of the property bubble – now is facing a situation where his debts exceed his assets by 40% as a result of house prices halving. He will thus spend the next years reducing his level of debt by saving – it will take so much longer the lower interest rates are! Unfortunately what is the only right thing for each individual, combined results in an meltdown of demand at the national economy level, which cannot be compensated for by a higher level of exports ("increasing international demand"). It is not possible to transfer the example of Germany, which compensates its private savings ratio of 10% with an export ratio of 7% (foreign demand) and national debt of 3%, to the whole of the euro zone. Even the largest European trade partners USA, Japan and increasingly China are finding themselves in more or less a similar situation where saving is required, driven by the balance sheet recession after their own property bubbles burst. Even the level of the German export surplus – at almost EUR 275 billion it is almost exactly at the level of the export surplus of the entire euro zone with all third countries – shows that the German model cannot be copied!

The only solution would be more public spending to stimulate demand. However, this is unfortunately prevented by the Maastricht rules (no deficit above 3%). The structural reforms in neighbouring countries demanded by the German government will result in stimulating the economy with rising exports on the back of an improved competitive position only after a few years. (Even the Agenda 2010 introduced by the German Chancellor Schröder resulted in a considerable improvement of the competitive position only after more than ten years.) The structural adjustments (for example by making dismissals easier) increase unemployment in the short term, thus creating an additional drag on private demand. A further expansion of money supply is accompanied with risk (for example by creating new bubbles on stock markets or excessive international debt of developing countries) and is difficult to reverse when private demand for loans finally starts to rise again. There is the risk of a sudden explosion of the money supply as a result of the accelerated cash conversion cycle (via the money multiplier) and the resulting inflationary risks. There were examples of successfully increasing government spending to compensate the lack of private demand e.g. after the huge depression in the 1930s, higher US defence spending in the Second World War, which ultimately resulted in full employment in the USA. The huge expansion of state spending in China after 2008 prevented a collapse of the Chinese economy, after demand in the most important export markets in Europe and the USA suddenly collapsed.

Inflation threatens only when excess private demand is additionally fuelled by public spending or if less efficient public spending displaces sensible private investments – a danger which in a time of too low demand does not currently exist. Via what is called “”fiscal multipliers”[1]. higher public spending results in a stronger rise in economic performance which allows private households to replenish their equity. This reduces the debt burden in line with the stronger upturn of economic performance. When private demand finally rises, it is important that the state drastically reduces its spending again, i.e. time limits on spending are best. There should be sanctions against an infringement of the 3% debt rule if a country in the euro zone does not rein in public spending after a resurgence in demand. Before the outbreak of the crisis all countries except Greece (which even in the good times before 2009 had deficit levels exceeding 9%) remained within the 3% public deficit limit.

How does the European debt crisis impact BAVARIA?

In our acquisition activities we benefit from the fact that there are some companies battered by crises which can be bought for nothing. In 2014, we bought one profitable company and two companies at a symbolic purchase price. Unfortunately, many of the companies which are offered to us for purchase have excessive debt burdens in relationship to declining sales and thus are not interesting for us. The policy of accommodating monetary policy results in prices for company acquisitions remaining at a high level. Stock prices are also at a high level, which makes it difficult for us to achieve our target of a return above 10%. Thus our realised and unrealised profits on financial assets of EUR 48.9 million at year-end were only EUR 4.0 million (5.8% p.a.). With lower economic performance, it is even more difficult for our portfolio companies to generate sales growth. Thus sales at the companies we have held from 2010 to 2014 developed from EUR 241.0 million to only EUR 268.0 million – an upturn of only 2.9% p.a. Fortunately, we managed to achieve a better improvement in results on the back of enhanced efficiency.

Net earnings in our segments improved against the previous years as follows: Serial Production/Automotive EUR 9.5 million (EUR 7.1 million), Project Business EUR 0.6 million (EUR -1.2 million) and Business Services EUR -6.3 million (EUR -16.0 million). With EUR 0.2 million in 2014, the Holding generated net operating profit only at break-even level, while in the previous year the extraordinary sale of the K+S Group contributed EUR 94.4 million to net profit.

Our aim is to increase the overall value of our investee companies and financial assets. According to our calculations, the enterprise value increased by 18% in the last year. The table below shows how the enterprise value developed:

	2013	2014	%
Investee companies	98.2	153.9	57
Financial assets[2]	126.9	111.4	-12
Total	225.1	265.3	18

[1] Explanation on “fiscal multiplier” - with a savings ratio of 10% an increase of public spending by 100 results in gross national product rising by 1,000 (90% of 100 extra income will be spent again, which results in extra income of 90, of which 81 will be again spent, etc.) i.e. a multiplier of 9.

[2] Cash holdings and financial assets included not proven book profits.

The basis of the estimate is the EBIT of the profitable investee companies, multiplied by 7 plus the (interest-bearing) net funds of these investee companies. This figure is also the basis for calculating Executive Board bonuses. With financial assets it should be taken into account that in 2014 we spent EUR 18.6 million for various non-recurring items, including EUR 3.8 million for share repurchases, EUR 5.0 million for purchase of investee companies and EUR 6.3 million which also included non-recurring payments in connection with the sale of K+S.

In conclusion, it should be pointed out that in the 2014 financial year, we again made donations for social causes of EUR 100,000.00. This includes a donation to the Against Malaria Foundation. We followed the suggestion of givewell.org which assesses foundations according to the efficiency of their spending and made an allocation proposal.

We are very confident about the further development of BAVARIA Industries Group AG in the current year. Here we depend on good working relationships and trust. We remain open to suggestions and proposals for improvement or pointers towards new transactions.

Yours sincerely

Reimar Scholz	Harald Ender
Spokesman for the Board	Director Operations