OUTLOOK

ECONOMIC FORECASTS CAUTIOUSLY OPTIMISTIC

The International Monetary Fund (IMF)[1] expects the pace of growth in the global economy to increase slightly: following an increase of 3.3 per cent in 2014 it is on course to expand by 3.5 per cent in 2015 and by 3.7 per cent in 2016.

Growth predictions for the eurozone and for key countries such as China, Russia and Japan have recently been revised downwards. In the latest forecasts, only the expectations for the USA have been revised upwards. For the industrialised nations, the IMF predicts growth of 2.4 per cent in 2015 (2014: 1.8 per cent). The eurozone economy is set to continue its recovery with a growth rate of 1.2 per cent in 2015, following 0.8 per cent in 2014. A further slight increase, to 1.4 per cent, is anticipated for 2016. The regional differences will remain, however. The German economy is expected to grow by 1.3 per cent in 2015, down slightly from 1.5 per cent in 2014. For the US, the predictions are for strong growth of 3.6 per cent in the current year and 3.3 per cent next year. In China the pace of growth will slow again, falling to 6.8 per cent in 2015 and to 6.3 per cent in 2016.

The business climate index[2] published by the ifo Institute of Economic Research was up for the third time in succession in January 2015. This index, which covers trade and industry in Germany, stood at 106.7 points compared with 105.5 points in the previous month. The ISM purchasing managers' index in the US stood at 53.50 in January 2015[3], a slight decline but still an indicator of expansion in economy activity.

DIESEL ENGINES MARKET

For construction equipment in 2015, we anticipate a flattening of the market in Europe and China and growth of between 0 and 10 per cent in North America. For agricultural machinery, we predict that the market in Europe will either remain at its current level or contract by up to 10 per cent. We also expect the Chinese automotive sector to remain static.

As a rule, the diesel engines market largely follows the applications and markets of the machinery and equipment in which the engines are installed. In 2014 our European customers bought advance-production engines ahead of the introduction of new emissions standards, so we are expecting demand from them to fall this year.

NEW ORDERS, UNIT SALES, REVENUE

Because of the effects of these advance-production engines, we are expecting a decline in engine sales this year that it will not be possible for our thriving business with new customers to offset. In the service business we are planning for slight growth. From a regional perspective, we forecast growth in North America and Asia but a decline in Europe.

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 increase at a faster rate than its unit sales. Furthermore, an especially large number of small engines with an output of less than 130kW were sold in 2014 due to the effect of advance-production engines mentioned above, which will also lead to a higher average unit price in 2015 compared with 2014.

Overall, we expect revenue to fall by around 10 per cent. In terms of segments, we expect a significant decline for DCE and moderate growth for DCS. 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. Although we have significantly improved our flexibility over the last few years, we will continue to work hard on increasing it still further.

EARNINGS

The focus this year – in addition to the production start-up of new engines, the successful implementation of new customer projects and the site optimisation process – is primarily on measures designed to increase efficiency and profitability.

We expect the EBIT margin before one-off items to rise to around 3.0 per cent, a moderate improvement on the previous year. Earnings will be boosted by the absence of exceptional items and the measures to reduce costs and raise efficiency in the DEUTZ Group. We believe there is potential to reduce warranty costs, while the first positive effects from site optimisation in Germany will not be seen until 2016. We are likely to benefit from the current movements in the US dollar exchange rate. However, the expected decline in revenue and the subsequent lack of economies of scale will have an adverse effect. We expect both our DCE segment and our DCS segment to achieve earnings growth.

As a result of the anticipated increase in earnings, we believe there will be a small year-on-year increase in return on capital employed (ROCE) in 2015.

[1] IMF World Economic Outlook, January 2015.
[2] ifo Institute of Economic Research, January 2015.
[3] ISM Institute for Supply Management, January 2015.

COMMODITIES, COLLECTIVE PAY AGREEMENTS

Commodity prices We expect to see primary markets remain flat during the year ahead, although there may be some slight upward movements in prices.

New collective pay agreement expected The collective pay agreement for Germany expired on 31 December 2014. We expect the negotiating parties to reach an agreement in the first quarter of 2015 that will be appropriate for the current economic climate in the metalworking and electrical engineering industries.

RESEARCH AND DEVELOPMENT EXPENDITURE

We expect expenditure on research and development to be slightly lower than in 2014. We expect the R&D ratio to be slightly lower than in 2014.

CAPITAL EXPENDITURE

We forecast that our capital expenditure in 2015 (excluding capitalisation of research and development expenditure) will be around €50 million. This includes capital expenditure on site optimisation.

JOINT VENTURES ACCOUNTED FOR USING THE EQUITY METHOD

We anticipate that the Chinese market will remain challenging and volatile in 2015. For our joint venture DEUTZ (Dalian) Engine Co., Ltd., we are expecting further growth in revenue and a slight increase in operating profit.

WORKING CAPITAL RATIO, FREE CASH FLOW AND EQUITY RATIO

Our objective is to achieve a working capital ratio of around 14 per cent as the quarter-end average. We forecast a positive free cash flow in 2015 in the low to mid-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

Flexible headcount adjustment We will continue to take on temporary employees and staff on employment contracts with a flexible term so that we can respond quickly and flexibly to future fluctuations in demand. In addition, our site-specific shift patterns and employees' individual working time accounts help us to increase or decrease capacity at short notice, where required.

Collective agreement on pre-retirement part-time employment
As in 2014, we will again use the 'Collective agreement concerning the flexible transition into retirement' in 2015. This gives employees who meet the necessary conditions the opportunity – within the collectively agreed quotas – to retire early by switching to pre-retirement part-time employment.

STATUTORY REGULATIONS, EXHAUST EMISSIONS STANDARDS

The most stringent exhaust emissions standards yet for diesel engines have now been introduced in all power output categories in the European Union, in the form of 97/68 Stage IV, and in the USA, with EPA Tier 4. Our TCD engines in the 2.9 to 7.8 litre cubic capacity range with a diesel particulate filter already meet Stage V, which is scheduled to come into effect in the EU in 2019[1)]. No further tightening of exhaust emissions limits in the USA is on the horizon at the time of the writing.

OUTLOOK FOR THE YEARS AHEAD

Following the decline in demand expected in the current year because of advance production of engines in 2014, we expect demand to normalise in 2016. In addition, we are expecting new customer business to provide a boost. We are also likely to experience further benefits from the price/mix ratio.

For 2016 we therefore expect revenue growth of more than 10 per cent as well as a sharp increase in the EBIT margin before one-off items, particularly in the DCE segment.

Global megatrends, such as increases in the world's population, advancing industrialisation in the agricultural sector and urbanisation, along with accompanying investment in infrastructure, are driving the further expansion of the global engine market. This will open up good opportunities for the continued advancement of the DEUTZ Group in the years to come. We plan to seize these opportunities in order to generate profitable growth.

[1)] EU Commission's proposal for EU Stage V published on 25 September 2014.

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.