

Funkwerk AG, Kölleda

GROUP MANAGEMENT REPORT for the 2015 financial year

Basic principles of the group

Business model

Funkwerk is a leading technology company specialising in innovative communication, information and security systems. Funkwerk products deliver state-of-the-art technology to rail companies, the public transport sector, industrial businesses, energy and utility companies, authorities and correctional facilities, health institutions as well as municipalities and leisure facilities across the world. Our tailored concepts are designed to manage and streamline operations in transport, logistics and buildings. Funkwerk focuses on future markets with high growth potential.

The company operates with three strategic business units:

GSM-R Train Radio Systems

Funkwerk has developed and produced train radio systems for the international railway market since 1982. As a global leader Funkwerk offers customised solutions for voice and data communication over analogue and digital mobile radio networks (LTE, GSM-R).

Passenger Information Systems

Passengers rely on up-to-the-minute and dependable information for the complete travel process, from planning and booking through to travelling from one point to another. Funkwerk information systems are designed to provide real-time guidance on the journey, communicating schedule changes and suggesting alternative routes and transport – across all available information media.

Video Systems

Innovative technology combining video surveillance with security applications addresses the growing security concerns of individuals and businesses. Our sophisticated systems are end-to-end solutions developed for the specific purpose of improving the security of buildings, properties and persons in places such as central railway stations, local public transport, production facilities or major financial institutions such as the new headquarters of the European Central Bank, ECB, in Frankfurt. A further key application is our solution for hard shoulder release on motorways.

Our products and solutions are supported by a broad service portfolio, particularly engineering services and documentation, training, support, maintenance and servicing as well as equipment and system repair.

Corporate strategy and objectives

Funkwerk AG pursues a strategy of profitable growth through continuous advancement of its technological expertise, with concerted efforts to consolidate and further expand its shares in the market. Specific focus is given to securing our lead in particular sectors of the market (e.g. GSM-R train radio systems). To achieve these objectives, we dedicate ourselves to developing customised and software-rich solutions, but also to future markets with solid growth potential, investing specifically in key components. In view of the encouraging opportunities for overseas expansion, we are continuing to drive forward the internationalisation of our business, relying particularly on our extensive network of partners and customers.

Corporate structure

The majority sale of Funkwerk Security Communications GmbH and its subsidiaries, which together represented the security technology unit, was finalised in December 2015. The remaining 10% of shares in these companies remain either directly or indirectly with Funkwerk AG. This move was preceded by an asset deal in which the security technology operations were transferred before the shares were sold. To enable a forward-looking view of sales and earnings in the group, Funkwerk drew up a pro forma profit and loss statement for fiscal 2015 and the 2014 reference year, which excludes the sold unit. The relevant explanations provide a picture of the group as of 2016. The consolidated balance sheet still includes the security technology unit for the previous year, whereas the sold companies were deconsolidated as at 22 December 2015.

In the course of 2015, further corporate reorganisation measures were put in place with the approval of the shareholders' meeting. In a first step, the Kölleda and Karlsfeld operations, which were part of Funkwerk AG, were divested in two stages to the former Funkwerk Information Technologies Karlsfeld GmbH in Karlsfeld. The latter then changed its name to Funkwerk Systems GmbH and relocated its base to Kölleda. The company lease agreement between Funkwerk AG and Funkwerk Information Technologies Karlsfeld GmbH was terminated on grounds of a confusion of rights.

The table below provides a list of all group companies operating under the umbrella of Funkwerk AG as of 31 December 2015:

Direct subsidiaries	Registered office	Share in%
FunkTech GmbH	Kölleda, Thuringia	100
Funkwerk Technologies GmbH *	Kölleda, Thuringia	100

Indirect subsidiaries	Registered office	Share in%
Funkwerk Systems GmbH	Kölleda, Thuringia	100
Funkwerk Systems Austria GmbH	Vienna, Austria	100
Funkwerk Statkom GmbH	Kölleda, Thuringia	100
Funkwerk video systeme GmbH	Nuremberg, Bavaria	100

*The change of name and registered office of Funkwerk Information Technologies GmbH, Kiel, to Funkwerk Technologies GmbH, Kölleda, was effected in January 2016.

Corporate governance and control system

Specific responsibility for corporate governance rests with the Executive Board of Funkwerk AG. It sets up the corporate strategy and works on measures with senior management to ensure its implementation in the various business units. The Supervisory Board of Funkwerk AG advises and supervises the Executive Board in its management of the company.

The operating units are controlled both on the basis of strategic requirements and key performance indicators. These include specifically new orders, sales, operating income, balance sheet ratios such as working capital and liquidity. These management tools are used in the context of group-wide controlling and are extended where required. We also keep a close eye on various leading operational indicators such as market, economic and industry figures as well as on the trend of key commodity prices. Corporate management and controlling at Funkwerk further includes the analysis of our competitive position. To establish this, we regularly examine our market shares, the quality of our products, the sales contribution of new products, and development intensity. Customer satisfaction analyses as well as appraisal interviews and employee surveys are also taken into consideration for information.

Economic report

Economic parameters in 2015

In 2015 the German economy was marked by moderate growth. Based on preliminary figures published by the Federal Statistical Office, the gross domestic product (GDP) in this country rose in real terms by 1.7% on the previous year. A year earlier, the GDP had grown on a similar scale, by 1.6%. The measured rise was driven primarily by private consumer spending, whereas the weak global economy in a number of regions had a dampening effect.¹

According to the International Monetary Fund (IMF), global markets on the whole grew by 3.1% in 2015, with expectations softening significantly throughout the year. Growth in the industrialised nations was up by a slight margin, from 1.8% to 1.9%, whereas less developed countries and emerging markets saw a downturn of 4.0% for the fifth consecutive year. Russian GDP, as a matter of fact, contracted by a hefty - 3.7%, dipping the country into a recession. The regions in the Middle East, North Africa, Afghanistan and Pakistan registered growth of 2.5%, down from 2.8% in the previous year. The eurozone market outperformed the forecast, expanding by 1.5%, as a result of sliding oil price and weakness of the common currency.²

Sector environment

Whereas the German rail industry on the whole delivered a positive summary for the first six months of 2015, infrastructure business failed to show any gain in momentum. As stated by the German Rail Industry Association, VDB, the sector registered a sharp rise in orders for rolling stock and remained optimistic for the remainder of the year. By contrast, the demand for infrastructure equipment stagnated at EUR 1.6 billion in the first six months despite the fact that federal funding for replacement investments in Germany's existing rail network had been raised significantly. This failed to reflect in new orders for the rail industry, as Deutsche Bahn AG had once again pushed back urgently needed replacement projects. Rail associations have also called for measures to secure a solid financial basis for rail transit systems to end the current stagnation.³

Weak domestic demand meant that growth markets outside Germany continued to take on greater significance. Specific investments were made in the expansion of rail transport in Turkey, regions in Africa and the Middle East, as well as in Asian countries. The highly volatile political and economic environment in these countries increasingly necessitated reassessment of cultivating these markets. Investments in Russia, meanwhile, were discontinued completely at the onset of the political crisis in the Ukraine. The competitive conditions in the global market intensified acutely in 2015 – more so because of increased exports on the part of Chinese firms, which expanded their shares in the global market by a wide margin.⁴

¹ cf. DESTATIS; press release no. 56 of 23 February 2016

² cf. Wirtschaftswoche (<http://www.wiwo.de/politik/konjunktur/langsameres-wachstum-iwf-senkt-prognose-fuer-weltwirtschaft/11252214.html>)

³ cf. Verband der Bahnindustrie e.V.; press release of 20 October 2015

⁴ cf. Berliner Zeitung (<http://www.berliner-zeitung.de/wirtschaft/verband-der-bahnindustrie--da-darf-keine-unwucht-entstehen--22453546>).

A dominant feature in the video systems market was the growing concern of society for security, driven by the rising level of potential terror threats. Global demand for building and facility surveillance systems in the last year increased significantly. This, however, must be seen opposite a cautious investment attitude of the public sector in Germany. With a still small market share, Funkwerk believes that the global market continues to offer attractive growth opportunities.⁵

Funkwerk business trend at a glance and comparison with prior-year forecast

In the view of the Executive Board, Funkwerk AG delivered a sound performance over the preceding financial year, maintaining a solid financial position with steady cash flows. Good progress was made in a number of areas. Business for our continued units largely followed a positive trend, enabling us to stabilise the group's revenue and earnings performance as expected. Over and above this, we were able to reinforce our position as a leading technology supplier – particularly in the train radio segment, where our new product to prevent radio frequency interference with non-GSM-R networks met with keen interest. Our new technology was a significant factor that led to the rise in new orders. At the same time, we proceeded as planned with the implementation of our corporate reorganisation measures in 2015. This allowed us to press ahead with the consolidation of operations in the group, primarily in the interest of focusing on our core business, whilst also utilising existing tax loss carry-forwards from previous years.

Consolidated pro forma sales, adjusted for the sale of FSC shares in Salzgitter, rose by 3.5% to EUR 75.7m in 2015, which lies within the expected margins of EUR 75m to EUR 80m and moderately improved on the equally adjusted prior-year figure of EUR 73.2m.

Operating income in the group was positive across all continued business units and at EUR 4.8m (pro forma) was comfortably above the budget figure of around EUR 3m (2014: EUR 3.7m). Income from ordinary operations improved by 53.8% to EUR 3.9m (2014: EUR 2.5m). Net earnings after deduction of extraordinary income and taxes rose to EUR 12.3m in 2015 (2014: EUR 3.9m), primarily on account of the adjustment of deferred tax assets of EUR 4.7m and the income from the release of unused tax reserves for the now settled fiscal court case in Kiel. The deferred tax assets are a direct result of our corporate restructuring, which enabled the group to utilise existing loss carry forwards.

Total **orders** in the group rose equally as sharply in 2015, to EUR 82.0m, bettering the prior-year figure of EUR 70.1m by 17%. Orders on hand increased from EUR 42.7m at the close of 2014 to EUR 49.0m.

By far the largest contract received in the reporting year came in for **GSM-R Train Radio**, where we lead the global market with a share of around 75%. The order was placed in early 2015 by leading Dutch telecommunications and ICT provider Royal KPN N.V. to modernise the Dutch railways by installing digital train radio systems with innovative filter technology. All train radio systems (some 1,400) will be supplied to NS Reizigers, the Dutch railway division responsible for passenger transport in the Netherlands, from April 2016. Funkwerk has been sub-contracted by KPN Netherlands, as the prime contractor responsible for the overall project management. While the order will not be reflected in sales until the 2016 financial year, initial payments on account were made in the reporting year. Our special technology is designed to block radio signals that may interfere with communication on the train, which is quite a common

⁵ cf. Schwitz; Offen in eine sichere Zukunft, in Protector, 7-8/2015, p. 26 ff.

occurrence, as the GSM-R frequency bands are also used by public networks. Foreign activities in this segment focus primarily on South Africa, Mexico, Israel and Uzbekistan.

Business with **Passenger Information Systems** failed to meet our targets in 2015. Detrimental factors were the discontinuation of our Russia business as well as the persistent investment reluctance of Deutsche Bahn AG, which impacted primarily on hardware component sales. We are increasingly focusing here on integrated software systems for mainline passenger information control, which we are continuously refining. We are already in an excellent position in the DACH region (Germany, Austria, Switzerland), holding majority shares in these markets. As well as this, we were able to consolidate our position in other European markets, specifically in the Scandinavian countries, Luxembourg and the Baltic States. Meanwhile, we are making headway in tapping the markets in Turkey and the Middle East, where we have yet to reach our targeted level, as progress was hampered not least by the political situation.

Business with **Video Systems**, where we hold a share of almost 20% in the German market, came up to our expectations. Our solution for hard shoulder release on motorways has given us a good lead in our home market. Modern Funkwerk cameras with pan-tilt head, in combination with special software, enable temporary use of the hard shoulder as an additional lane. Once more, key customers such as the ECB in Frankfurt/Main tapped into our trusted expertise in network technology. Our contract here involves full video surveillance for the interior and exterior of the ECB as well as the networking of all security-relevant components and ongoing servicing. Follow-up and maintenance contracts relating to the equipment of German railway stations, airports and other public facilities helped to secure our core business. In terms of video systems, the focal point of our international expansion efforts, driven forward across the Funkwerk group through strategic cooperation and partnerships, is on the Scandinavian countries, Austria, Switzerland, Italy, the Netherlands, Luxembourg and Middle Eastern countries.

Financial performance, position, and cash flows

Sales and earnings

Sales in the Funkwerk group, before adjustment for the sold business units in 2015, rose by a slight margin to EUR 95.1m (2014: EUR 94.1m). Gross profit increased by 4.4% to EUR 57.6m (2014: EUR 55.1m), translating into a gross profit margin of 60.5% (2014: 58.6%). Operating income came to EUR 5.1m, after EUR 1.4m in the previous year, while earnings from operations improved from EUR -0.9m to EUR 3.0m. Unadjusted net income in the group amounted to EUR 7.5m in 2015, up from a deficit of EUR 1.8m in the previous year.

The following explanatory notes of the group's earnings primarily expand on the pro-forma disclosures for the years 2014 and 2015, which were adjusted for the Security Technology BU sold in the reporting year so as to provide a forward-looking view of the group's sales and earnings trends as of 2016.

Table: Comparative pro-forma view of the financial performance

	2015 € k	Pro- forma 2015 € k	Pro- forma 2014 € k	Changes 2015 v 2014 Pro-forma %
Sales revenues	95,115	75,720	73,156	+3.5
Increase/decrease in finished goods	-2,814	-2,595	-4,057	+36.0
Other own work capitalised	1	1	0	
Other operating income	4,553	3,467	2,928	+18.4
Total operating performance	96,855	76,593	72,027	+6.3
Cost of materials	39,292	33,179	31,384	+5.7
Gross profit	57,563	43,414	40,643	+6.8
Personnel expenses	36,565	25,902	26,212	-1.2
Depreciation	3,178	2,667	1,306	+104.2
Other operating expenses	12,734	10,016	9,443	+6.1
Operating result	5,086	4,829	3,682	+31.2
Financial result	-2,104	-951	-1,161	+18.1
Profit/loss from ordinary activities	2,982		2,521	+53.8
Extraordinary profit/loss	-3,910	-82	-682	
Earnings before taxes	-928	3,796	1,839	+106.4
Taxes on income	-8,451	-8,499	110	
Other taxes	41	39	35	
Consolidated net income	7,482	12,256	1,694	

Consolidated sales at the continued units increased by 3.5% to EUR 75.7m in the preceding financial year (2014: EUR 73.2m), due in the main to the satisfactory capacity utilisation at our Köllda site. Including the decrease in finished goods inventories and work in progress, which came to EUR -2.6m in the reporting year (2014: EUR -4.1m), and other operating income of EUR 3.5m (2014: EUR 2.9m), total operating performance rose from EUR 72.0m in 2014 to EUR 76.6m. The increase in other operating income results from the retransfer of a reserve set up in connection with the lawsuit of Funkwerk video systeme GmbH in Algeria.

Cost of materials rose from EUR 31.4m to EUR 33.2m. Overall, the cost of materials in the group had a heterogeneous composition. Whilst we were able to expand the less material-intensive operations at our Karlsfeld site, which are based on software solutions and services, the rise in material intensity was due to higher volume of business at Funkwerk Systems GmbH in Köllda, resulting in an increase in absolute terms. Gross profit in the group was up by 6.8% to EUR 43.4m (2014: EUR 40.6m), the gross profit margin improved from 55.6% to 57.3%.

Personnel expenses in the group reduced by 1.2% to EUR 25.9m, due primarily to optimised efficiency resulting from the decision not to replace outgoing employees. After deduction of depreciation, which rose to EUR 2.7m (2014: EUR 1.3m) owing to higher depreciation of the SAP system as well as unscheduled depreciation of Algerian cash at bank, and other operating expenses of EUR 10.0m (2014: EUR 9.4m), adjusted operating income in the Funkwerk group improved to EUR 4.8m, in contrast to EUR 3.7m in the previous year. Allowing for the financial result of EUR -1.0m (2014: EUR -1.2m), profit from ordinary activities climbed from EUR 2.5m to EUR 3.9m.

Extraordinary expenses came to EUR -0.1m, after EUR -0.7m in the previous year, which still accounted for restructuring costs of EUR 0.6m. This translates into pro-forma earnings before taxes of EUR 3.8m, up from EUR 1.8m a year earlier.

In view of the restructuring implemented in 2015, which enabled the utilisation of tax loss carry-forwards, deferred taxes in the total amount of EUR 4.7m (2014: EUR -0.5m) were recognised in net income. Following the final settlement of the long-running legal dispute with the Kiel tax office in 2015, Funkwerk paid income taxes plus default interest in the amount of around EUR 1.7m in the reporting year. The unused portion of the tax reserves, EUR 4.4m, was carried as tax revenue. Overall, fiscal 2015 showed a positive tax effect of EUR 8.5m after expenses of EUR 0.1m in the previous year. Consolidated net income generated by the continued business units rose from EUR 1.7m to EUR 12.3m. The aforesaid effects of the retransfer of tax reserves and the recognition of deferred tax assets on loss carry-forwards are one-off effects which are subject to a pay-out block where deferred taxes are carried as assets.

Cash flows

As financial management targets, Funkwerk AG seeks to secure the group's liquidity, optimise its financial expenses and income, and control the interest risks. Current liquidity requirements in the group are met by way of a guaranteed credit of up to EUR 20.0m, which Hörmann Holding GmbH & Co. KG made available to us for an indefinite period. In addition to this, Funkwerk has a factoring agreement with Hörmann Finance GmbH, a subsidiary of the Hörmann group, for the purchase of trade accounts receivable.

Cash flows in 2015 continued to stabilise. Working capital decreased from EUR 28.0m to EUR 16.6m, not only as a consequence of the special items relating to the sale of our Security Technology BU. Payments on account were increasingly instrumental in improving the working capital in relation to our financing requirements. As explained earlier, the long-running tax dispute at our former Kiel site could finally be settled in 2015. This resulted in tax liabilities of EUR 1.7m that were paid almost fully in the reporting year. The funds for this came from a short-time loan that was made available to Funkwerk AG by Hörmann Finance GmbH. This liability was paid off fully in January 2016. At the balance sheet date, the loan is recognised in the short-term liabilities due to affiliated companies.

Cash flow trend

	2015	2014
	€ k	€ k
Cash flow from operating activities	5,122	4,977
Cash flow from investing activities	-2,305	42
Cash flow from financing activities	-332	-5,800
Cash and cash equivalents at beginning of period	3,722	4,503
Cash and cash equivalents at end of period	6,207	3,722

Cash flow from current operations is improved by a slight margin in 2015, up from EUR 5.0m in the previous year to EUR 5.1m. After income tax refunds of around EUR 0.5m in the previous year, the group reported a cash outflow of approx. EUR 1.0m for income taxes. The drastic change particularly in accruals (EUR -10.6m) as well as in inventories, accounts receivable and other assets (EUR +8.7m) was due to the sale of our Security Technology BU. A further positive factor bearing on the group's liquidity in 2015 was the management of advances for major contracts.

Cash flow from investing activities totalled EUR -2.3m in the reporting year (2014: EUR 0.0m). Spending on investments in tangible assets and intangible assets reduced from EUR 2.8m to EUR 1.6m, which was due essentially to the acquisition of the ERP system. Inflow from the sale of affiliated companies was insignificant in the reporting year, whereas outflow from extraordinary items in this context amounted to EUR 0.8m. Extraordinary items in the previous year involved inflow from the sale of business units of EUR +2.8m, opposite restructuring related outflow of EUR -0.2m. Free cash flow (after investments) therefore totalled EUR 2.8m, compared to EUR 5.0m in the previous year.

Cash flow from financing activities involved interest payments in the amount of EUR -0.3m (2014: EUR -0.7m). Since all long-term loans had been repaid in 2014 (EUR -5.1m), the prior-year outflow was without a comparative figure for 2015. Application of the guidelines in German Accounting Standard DRS 21 meant that the short-term loan from our majority shareholder was accounted for in cash and cash equivalents.

Total funds flowing into the group in fiscal 2015 amounted to EUR 2.5m, after outflows of EUR 0.8m in the previous year. As a result, cash and cash equivalents rose from EUR 3.7m in 2014 to EUR 6.2m in the preceding financial year. This amount factors in the deduction EUR 1.9m for the short-term loan from Hörmann Finance GmbH, which was repaid in the first quarter of 2016.

Financial position

The consolidated balance sheet of Funkwerk AG as at 31 December 2015 does not account for the sold assets and liabilities of FSC, Salzgitter, and its subsidiaries, which are still included in the prior-year figures. This makes it impossible to draw a full year-on-year comparison with the previous year.

Consolidated total assets as at the end of 2015 contracted to EUR 50.5m (31 December 2014: EUR 56.4m) as a result of the above deconsolidation. On the assets side, fixed assets decreased from EUR 11.7m to EUR 10.0m, with tangible assets reducing most notably, from EUR 9.5m to EUR 8.1m. Intangible assets totalled EUR 2.0m (31 December 2014: EUR 2.1m).

Current assets lessened from EUR 43.6m to EUR 35.1m, largely because of the sale of FSC group stocks, which saw inventories plummet from EUR 20.3m to EUR 9.3m. Accounts receivable and other assets reduced simultaneously due to tighter receivables management, down from EUR 19.6m in the previous year to around EUR 17.7m.

On the liabilities side, equity improved to EUR 17.8m in consequence of consolidated net income of EUR 10.3m, translating into an equity ratio of 35.2%, after 18.2% at the close of 2014.

Liabilities largely remained at prior-year level. Accounts payable, down from EUR 6.9m to EUR 5.2m, were counterbalanced by higher amounts due to affiliated companies, up from EUR 0.3m to EUR 2.1m, which resulted from the loan made available by Hörmann Finance GmbH in the reporting year, and which Funkwerk AG repaid in January 2016.

At EUR 23.9m accrued liabilities decreased by quite a margin on the previous year (EUR 36.5m), with significantly lower provisions for pensions and taxation. The primary factors responsible for this drop were the settlement of the fiscal court case in Kiel as well as the sale of the Security Technology BU.

Non-financial performance indicators:

Research and development

Intensive research and development activities (R&D) at Funkwerk aim to secure and consolidate our lead in the markets with state-of-the-art rail technology. Focus is given to designing customised and innovative products as well as system specific solutions, while at the same time continuously improving the efficiency of our production processes. In 2015 R&D spending in the group totalled around EUR 8.8m, translating into a share of sales of 11.6%.

In the GSM-R train radio segment efforts centred on developing new application solutions for existing products to reinforce our lead in this field. We are also working on new technologies that will supersede the current European GSM-R standard in the mid to long term. In terms of information systems, development efforts concentrated primarily on the further enhancement of our passenger information management system, while our video management system is consistently refined and adapted to specific customer requirements as well as new technical applications.

Production

Production in the Funkwerk group is focused at our Köllda facility, which was working to full capacity in 2015. In October the site started operating on a three-shift basis in all production areas to meet the keen demand. Centralising productions at one site enables us to pool our resources within the group and to optimise the use of space. Reducing throughput times and improving production efficiencies are integral components of our business understanding.

Procurement

The sourcing of raw materials and supplies and of components is largely centralised at Funkwerk to ensure consistent management of the group's purchasing volume and, with it, the relevant suppliers, as well as to facilitate a strictly need based procurement. Our raw materials and supplies are sourced from different suppliers worldwide, preferably based on framework contracts. This allows us to offset price fluctuations in individual regions and to secure optimum purchase prices.

Employees

As at 31 December 2015, Funkwerk as a group employed 439 people (including trainees), compared to 589 at the close of 2014. Adjusted for the sold Security Technology BU, the total number of employees at 31 December 2014 would have been 433.

The marginal rise in personnel was due to additional recruitments for our Passenger Information BU at the Karlsfeld site. Funkwerk staff in other countries totalled 7 (2014: 8) in the reporting year.

Personnel development in the preceding year focused on the professional and personal advancement of our employees as a key factor in ensuring consistently high quality standards. In addition to this, we endeavour to offer our staff a motivating and health promoting work setting. We therefore promote healthy and safe working conditions, provide a number of employee advancement programmes and ensure the compatibility of work and family. The various incentive systems in place and our collaboration

with universities of applied sciences and of cooperative education as well as working increasingly with university graduates are focused measures to secure competent and motivated junior staff for Funkwerk.

The number of Funkwerk trainees at the close of 2015 was 27, compared to 30 a year earlier (adjusted). This translates to around 6% of our total workforce. Training opportunities offered at our Funkwerk sites focus on regular trade and industry occupations. Our Köllede site additionally offers the option to obtain a Bachelor of Engineering (BA) as part of a cooperative education course.

Quality assurance

The high quality of our products and the reliability of our systems are of paramount importance to us. For this reason, all relevant business processes are subjected to regular quality control and improvement. Quality management systems installed at our production facilities are continuously advanced. Individual facilities also undergo specific certification procedures to meet our customers' requirements.

In 2015 all our sites once again successfully completed the necessary certifications and reaudits. Compliance with the requirements of ISO 9001 as well as IRIS (International Railways Industrial Standard) has been a key component of the Funkwerk quality strategy for many years.

Sustainability and corporate social responsibility

As a corporation with international operations, Funkwerk takes responsibility towards its social, economic and ecological environment seriously. Consequently, we are committed to acting with a view to sustainability and take account of the requirements of all interest groups affected by our activities. Under ecological aspects, we endeavour to keep the effects of our activities on the environment to an absolute minimum, if not continuously reduce them. Our aim is to combine economic with ecological interests.

Events after the reporting period

In early January 2016 Funkwerk AG fully repaid a loan made available by Hörmann Finance GmbH in 2015 to pay tax liabilities in the amount of EUR 1.7m. These liabilities resulted from the long-running fiscal court case in Kiel that finally ended in a settlement in 2015.

In the first quarter of 2016 Prof. Dr. Gerhard P. Fettweis and Dr.-Ing. Manfred Egner duly resigned their seats on the Supervisory Board effective at the close of the annual general meeting on 28 June 2016.

Other developments by the end of the reporting period relate to the preliminary proceedings instituted in Algeria in 2010. Funkwerk video systeme GmbH (FVS) is involved in a joint venture under Algerian law (Groupement Funkwerk Contel plettac). In this context, a number of companies and individuals are investigated on suspicion of corruption and illegal price inflation. Those affected include the joint venture, the Algerian partner and FVS, but not its management or other employees in the Funkwerk group. In the course of these investigations, the accounts of the joint venture were frozen with the result that the money on these accounts totalling around EUR 3.3m, which had been duly paid after completion of work performed and which is due exclusively to FVS, still cannot be transferred to Germany. The cash value of these accounts due to FVS, less collection costs and a provisional write-down, totals EUR 1.8m and is included in other assets on the consolidated balance sheet.

Several days of hearing were held in Algiers in the preceding year and in January 2016, to which representatives of the former Funkwerk plettac, today Funkwerk video systeme GmbH, and the joint venture were summoned as witnesses. While the oral verdict was delivered on 2 February 2016, FVS had not yet received the written verdict as legally prescribed by the time the balance sheet was drawn up. In the oral verdict Funkwerk video systeme GmbH and other companies were charged with corruption and price inflation in Algeria and ordered to pay a penalty of around EUR 40k. An appeal was lodged against this verdict within the stipulated time and the seized accounts were released.

Aside from the above, no other events with a significantly detrimental effect on the financial performance, position and cash flows in the Funkwerk group occurred since the conclusion of the 2015 financial year up until signing of this report.

Risk report

Risk management system

Due to the international focus of operations in the Funkwerk group, we face similar opportunities and risks as any company in the global market. Targeted management of these variables is a key requirement for the long-term success of our company. Opportunity and risk management at Funkwerk therefore is a key priority and part of our corporate governance. The primary goal of our risk policy is to use opportunities that arise systematically but only take risks that promise a reasonable gain in earnings. Generally, we define risks and opportunities as potential future developments or events that may involve a positive/negative variance of our forecast or target.

In order to follow this principle, we have a centrally coordinated multistage risk management system in place as a firm component of our strategic business, planning and control processes. Risk management at Funkwerk is centrally coordinated, mandatory for all group companies and includes every division and department. This structure to our risk management system, which is maintained as part of our corporate planning, allows us to identify and analyse risks early on. Risks are assessed in terms of their probability of occurrence and expected effects on our financial performance, financial position and cash flows. Higher risk classes which exceed defined thresholds are monitored and assessed in our monthly reporting. Appropriate countermeasures are defined and their implementation monitored in cooperation with the Executive Board.

Individual risk report

The following describes the main risks that may have a detrimental effect on the financial performance, position and cash flows of Funkwerk over and above the usual uncertainties related to general business operations. With the disposal of the FSC group, risks emanating from subsidiaries reduced on the previous year. Further changes to our risk situation resulted from the settlement of the fiscal court case in Kiel.

Risk from the development of subsidiaries

Funkwerk AG generally anticipates a positive future for its subsidiaries. Deviations of business performance from the planning, occurring despite the restructuring and strategy optimisation measures implemented over the last years, may have a detrimental effect on the group's financial performance, position and cash flows.

Dependence on major customers

Funkwerk has an extensive customer base generating business of no more than 10% of total sales per customer. If several key accounts reduced their purchases from Funkwerk, the company would face considerable risks as a result of the reduced workload and loss of sales. This, however, is not currently the case at Funkwerk.

Risk from outstanding project debt in Algeria (see also Events after the reporting period)

Funkwerk video systeme GmbH (FVS) is involved in a joint venture under Algerian law (Groupement Funkwerk Contel plettac). In connection with internal developments in Algeria, a preliminary investigation

was opened against a number of companies and individuals in early 2010 on suspicion of corruption and illegal price inflation.

In the context of the projects handled, Funkwerk AG furnished bank guarantees that were issued by Algerian banks based on appropriate counter-guarantee agreements with a number of German banks. As at the balance sheet date, all bank guarantees from German banks had been derecognised. To date, the client has yet to return the original guarantees of around EUR 8.4m of the bank guarantees issued. Based on the contracts with the client, FVS should no longer be at risk of claims as it fulfilled its supply and performance obligations, but also because of the expiry of the contractual warranties and the time limit of the guarantees, which explains why these guarantees have already been derecognised by the German banks. There is, however, a remaining risk involving the bank guarantees not yet returned in so far as the German banks have issued “real” counter-guarantees on first request to the Algerian banks.

Financial risks

The financing agreements with the Hörmann group provided Funkwerk AG with the required cash funds throughout the 2015 financial year. These agreements are still in place as is, with nothing to suggest that they will be amended or terminated. We therefore do not foresee any risks that may jeopardise the continued existence of the company. If the loan issued by the majority shareholder, which is subject to a notice period of six months, does not remain in place as is in the future, we will at once take appropriate steps. Opportunities to widen our financial scope depend on the development of our subsidiaries and second-tier subsidiaries and on any adjustment of group charges. A risk for the group would arise only if in the context of the aforesaid individual risks Funkwerk incurs financial liabilities of a magnitude that exceeds the credit facilities offered by the Hörmann group, which the Executive Board does not currently foresee.

Procurement risks

Funkwerk requires a wide variety of parts and components to manufacture its products. These are sourced from a limited number of suppliers. Some, primarily electronic components, are specially made for Funkwerk. If these components are no longer available from the supplier, Funkwerk may not be able to change early enough to components from other suppliers.

As well as this, if our key suppliers and other business partners run into financial difficulties, this could affect our own operations, as could unexpected price increase that impact on our earnings in the group. In an effort to avoid these scenarios, we periodically review the efficiency and performance of our business partners and select our suppliers very carefully. Wherever possible, we also agree long-term supply contracts to safeguard against fluctuations and avoid bottlenecks.

Risk report relating to the use of financial instruments

Primary financial commitments in the company as at the balance sheet date included financial liabilities, accounts payable and other liabilities. The main purpose of these financial commitments is to finance business operations in the group. Funkwerk AG has accounts receivable, due from affiliated companies, and other receivables as well as cash and short-term investments resulting directly from its operations.

The company is exposed to credit and liquidity risks. These risks are managed and controlled by Corporate Management. Corporate Management ensures that any activities in the Funkwerk group which involve financial risks are performed in accordance with relevant guidelines and that financial risks are identified, assessed and managed in agreement with these guidelines and in consideration of the company's risk appetite. Risk management also takes account of risk concentrations which may arise through individual transactions or group companies.

The guidelines on managing the risks described below are reviewed and decided by Corporate Management.

Default risk

Default risk refers to the risk that a business partner does not duly or correctly meet its obligations under a financial instrument or a basic customer contract and these results in financial loss. Operations in the Funkwerk group involve credit risks (specifically risks related to accounts receivable and loans) and risks resulting from financing activities, including deposits at banks and financial institutions, and other financial instruments.

Accounts receivable

The default risk on receivables concerns trade accounts receivable from business operations in the Funkwerk group. Customers are managed by the relevant business unit based on procedures and controls applied in the company for customer default risk management. Debt ceilings are specified for each customer based on internal risk classification characteristics. These risk classification characteristics are determined by sales limits and order frequencies over defined periods. Customers are principally divided into risk and non-risk customers. Outstanding receivables from customers are regularly monitored and reminders sent for overdue accounts. In specific cases, we take out bad debt insurances. We also agree reasonable advance payments on orders with our customers. The requirement for bad debt adjustments is analysed for each customer individually at each reporting date.

Financial instruments and investments

The default risk related to cash in banks and financial institutions is managed in accordance with our corporate strategy. This risk is generally seen to be low, as Funkwerk primarily works with commercial banks with excellent credit ratings.

Liquidity risk

Funkwerk responds to liquidity risks and potential short-term cash flow fluctuations with strict cash management whilst monitoring the risk of potential liquidity shortages using a periodic liquidity planning tool that is correct to the day for a short-term planning horizon, enabling us to respond quickly to cash flow fluctuations.

All other liabilities usually have a remaining term of less than one year.

Foreign exchange risk

The risk from foreign exchange transactions is seen as low on grounds of the fact that all major business is conducted in euros.

Interest change risk

The Executive Board does not currently see any significant risk of interest rate changes for short-term financing. Furthermore, any risk in this regard is managed through agreement of fixed interest rates, which includes contracts with affiliate companies. Currently low interest rates, which cannot be counteracted, pose the risk of increased additions to provisions for long-term pension liabilities.

Equity management

Equity comprises the equity attributable to the shareholders of Funkwerk AG.

The primary purpose of equity management in the company is to maintain an appropriate equity ratio as the central control element of our equity management. The equity ratio is a key indicator for third parties, meaning that a negative trend could result in appropriate risks.

Overall risk assessment

The settlement of the long-running fiscal court case against a subsidiary in Kiel enabled us to make considerable headway in reducing our overall risk profile in the reporting year. In addition to this, we were able to improve the financial position and revenue basis of the group, thereby further stabilising our business. On the whole, the risks which Funkwerk takes are acceptable for our type of activities. If, however, the projected positive earnings momentum fails to materialise in the Funkwerk group and losses arise, there is a risk that current results on balance will lead to a deficit not covered by equity.

Forecasting report

General economic setting in 2016

The International Monetary Fund projects global growth at 3.4% in 2016, a slight pickup on 2015. Growth in emerging market and developing economies is expected to increase to 4.3%, and to 2.1% in advanced economies. Russia is predicted to remain in recession, albeit at a somewhat more moderate level than in 2015, whereas the Eurozone countries could expand by 1.7%. Risks to the global outlook are believed by the IMF to relate primarily to the ongoing slowdown in China, the tightening monetary policy in the USA in conjunction with the strong dollar, and a potential escalation of the geopolitical tensions in various regions. Additionally, the persistent drop in oil prices continues to affect the economy in oil producing countries.⁶

The weakness in global economic activity along with lower oil prices also weigh on the sentiment in the German market. Even so, the IMF and Federal Government expect GDP growth in the order of 1.7% in 2016.⁷

Sector trend

The change in strategy announced by Deutsche Bahn AG is expected to buoy the German rail industry, opening up numerous opportunities for Funkwerk AG. The DB programme aims to bring about a significant improvement in rail services, offering passengers even higher quality travel with upgraded information systems. Over and above this, the plans include the modernisation and maintenance of tracks, switch points and bridges as well as an increase in rolling stock for long-distance transport. Total spending on the track modernisation programme is expected to come in at about EUR 28 billion by 2019.

At international level, experts continue to be optimistic for the rail sector. Countries such as Turkey and the Middle East are expected to invest particularly heavily in rail transport. Developments in Russia depend on the further progress of the Ukraine conflict.

The demand for video systems will rise in line with global security concerns. Significant growth rates are predicted particularly for software-based networks to protect facilities and likewise for solutions and equipment for traffic supervision, though network consulting and services is also expected to pick up.

Development in the Funkwerk group

Based on the opportunities and risks described for the activities continued in the group, Funkwerk expects sales in the 2016 financial year to remain steady at prior-year level, with a further shift in our revenue mix towards higher software content with good margins. Earnings in fiscal 2016 are projected to reach at least EUR 4m, after exceeding our targets for 2015 by quite a significant margin as a result of

⁶ cf. IMF; press release of 19 January 2016.

⁷ cf. IMF; press release of 19 January 2016.

one-time factors. The group's financial position and cash flows should continue to stabilise, with an investment volume of around EUR 1.6m targeted primarily at replacements and the expansion of productive capacities at our operating units.

Strategic orientation and opportunities report

Over the next few years Funkwerk AG will focus on growing its revenue with an eye on profitability whilst scaling up efforts to strengthen its competitive position in the continued segments. Specific priority will be given to our strategy designed to drive the sale of full-service solutions across world markets so as to establish Funkwerk consistently as a supplier of advanced software systems, and to enhanced efficiency in the group.

As well as advancing our technical expertise, we will continue to focus our efforts on increased internationalisation of our operations through strategic cooperation and partnerships. We will also address ourselves to consistent cost optimisation in the group. This involves reducing the diversity of hardware and instead strengthening our service activities. Whilst boosting customer retention, it will help us increase our expertise as a system provider. Additionally, it means that standardised management software across all departments and divisions will help to improve our profitability.

A further strategic priority is the advancement and long-term retention of qualified personnel in the group. As a technology company we constantly seek new talent whilst keeping existing staff by offering attractive incentive programmes and interesting training and advancement options.

Along with software business, specific opportunities for Funkwerk are seen to arise primarily from filter technology for GSM-R train radio systems. This new development not only strengthened our market position, but also enabled us to demonstrate once more our technological edge in this field. Our innovative technology also met with keen interest at the UIC ERTMS World Conference in Paris, the leading trade exhibition for GSM-R technology. We expect other international rail operators to follow suit and switch over to this technology.

Summary view of future development

In consideration of the aforesaid opportunities and risk situation, the Executive Board expects the revenue basis in the Funkwerk group to stabilise in 2016, with positive operating income and sustained margins. Over the longer term, Funkwerk aims to achieve a group EBIT margin of over 5%. Whilst corporate finances are secured through financing agreements with the Hörmann group, we plan to maximise free cash flow in the medium term to meet our requirements.

Kölleda, 15 April 2016

The Executive Board

Kerstin Schreiber