



**INDUSTRIAS PEÑOLES, S.A.B. DE C.V.**

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## **ANNUAL REPORT OF THE BOARD OF DIRECTORS TO THE SHAREHOLDERS' MEETING CORRESPONDING TO FISCAL YEAR 2015.**

Dear shareholders:

As Chairman of the Board of Directors of Industrias Peñoles, S.A.B. de C.V., and on behalf of the Board, I present to you this report based on an analysis of the information provided by the Chief Executive Officer in his Annual Report on the Company's performance, the financial and operating results in the 2015 fiscal year and key developments in the period, as well as a report on the main activities of the Board of Directors.

We faced a difficult year in 2015. International economic conditions changed substantially for the mining industry, which has been particularly affected by the slowdown of the Chinese economy and its depressant effects on commodity markets. This had an adverse impact on the countries producing these materials.

Mexico has not been immune to international turbulence. Nonetheless, even though our country has enjoyed moderate growth and price stability, our industry is subject to economic cycles and a complex environment. In the fourth quarter of 2015, metal prices fell to levels similar to those of the 2009 crisis. In addition, the extraction and production of metals is subject to the interests and increasingly greater demands of various stakeholders, such as government institutions and non-governmental organizations, communities, workers, customers, suppliers and, of course, shareholders who risk their capital. Because of our long experience in mining, we always have the cyclical nature of this industry in mind; therefore we act prudently and without losing perspective in order to be successful in the long term.

In the face of the new realities, we do not lose our way: we always seek the competitiveness and safety of our mining, metallurgical and chemical operations by improving productivity, discipline, efficiency and cost control. We also generate good jobs and promote the self-development of communities. We continue to invest, but adjust the rates, keeping our current operations competitive and the course set with the long-term view, while at the same time preserving the financial soundness of the Company.

The flooding contingency in January 2015 at the Naica mine in Chihuahua was very unfortunate. Throughout the year, we conducted extensive efforts to recover and restore operations; however, having been unable to abate the water level to isolate the flooded area, the indefinite suspension of operations was announced last October.

In 2015, we thoroughly reviewed our “Vision 2020 – Growth Plan”, established in 2009 and contained within our Strategic Plan. As the Company’s operating budget and investments for this period reflected the tightened conditions of the industry, we made efforts to reduce costs and expenses to protect the financial health of the Company, and the pace of investment was deferred or reduced accordingly. Thus, despite significant changes in the environment and difficult circumstances in recent years, the strategic priorities set out in our Vision have been well executed, under the circumstances. Over the past six years we have increased milling capacity at the mining units, built and started up the Velardeña unit, one of Mexico’s major zinc mines; in addition, at Fresnillo plc, new gold and silver mines were built and commissioned, notably the two phases of Saucito, and at Herradura the dynamic leaching plant started up operation. We also expanded sodium sulfate production capacity to meet domestic demand and developed sources of renewable energy at lower cost.

Investments in exploration have replenished reserves at the mines, increased mineral resources and ore processed, and generated new operations. We are moving forward in strengthening our safety culture, modernizing production processes and upgrading administrative processes with better information systems and customer service, among many other actions. Investments in fixed assets and exploration over the past six years total approximately US\$5,700 million.

Safety and training for personnel have been and continue to be our priorities. In addition, we have strengthened relationships with communities and unions, and improved efficiency in all our operations. All of this is within a framework of ethics and values that we are reinforcing within the Organization.

Given the adverse circumstances of 2015, we took special care of liquidity and the use of working capital by reducing the rate of investment, and made special effort to reduce costs and expenses. This allowed us to sustain operations and continue developing strategic growth projects. In addition, US\$130 million of bonds issued five years ago on the Mexican Stock Exchange were amortized when they reached maturity in August.

During this period, construction advanced on two new mining units: the Rey de Plata polymetallic mine in the state of Guerrero, that will start up operations in late 2018 at a total investment of US\$296 million to produce zinc, silver, copper and gold in concentrates; and in the state of Chihuahua, Fresnillo plc’s San Julian silver and gold mine, with an investment of US\$515 million, whose first phase will begin operations in 2016. Important advances were made in the engineering of a new pyrites leaching plant to increase silver and gold recoveries from current and historical tailings, whose investment will be US\$155 million. Meanwhile, the project to expand production capacity of refined zinc by 120,000 tons per year, with an estimated investment of US\$327 million, will start up by the end of 2017. In terms of energy, a consumption agreement was signed with Electricidad de Portugal Renovables (EDPR) for the development of a wind farm with 180 MW of installed capacity in the state of Coahuila, which will supply our operations with clean energy at competitive costs.

Investments in fixed assets and exploration totaled \$14,409 million pesos in 2015, 20.4% higher than in the previous year, and sufficient for the proper maintenance of operations and the disciplined execution of projects in line with our long-term Vision.

Our commitment to communities is permanent and we maintain close, respectful, harmonious and mutually beneficial relations. Through educational, social, athletic and cultural programs, we actively support their development and promote health and wellness. During this year, social investment totaled \$118 million pesos.

Also, we made significant progress in the various exploration projects in Mexico and South America. A preliminary economic assessment was conducted for the Racaycocha copper-gold project in Peru, copper and molybdenum mineral resources were evaluated at Águila, acquired last year, and studies are underway to determine their economic potential. In addition, Fresnillo plc made significant findings that increased the mineral resources at San Julián, Guanajuato, Fresnillo Sur and Juanicipio.

Operating performance in 2015 was solid. In mining, a new annual record was set for gold production (799 thousand ounces) and for the second consecutive year for silver production (54.5 million ounces). Other metal contents remained at similar levels to the previous year, with the exception of lead whose volume declined due to the lack of production at Naica. However, several of the mining operations, especially base metals, operated with very low operating margins due the prices at year-end; however, their integration with Metalúrgica Met-Mex contributed to the Company.

In the metallurgical operations, the volume of refined gold production grew due to the increase in the treatment and content of rich materials, while volumes of silver and lead were slightly lower due to lower ore grades in the concentrates received. The production of refined zinc, meanwhile, was similar to the previous year.

In chemicals, sodium sulfate reached an annual production record of 733 thousand tons, driven by the operation of the new plant whose capacity increased at the end of last year by 150 thousand tons per year. Magnesium sulfate also achieved record production and sales volumes. For the remaining varieties of this product range, production was adjusted in line with the needs of the various markets that consume them.

Separately, two years ago, in order to focus on core businesses, we began the process of divesting in companies related to the commercial operation and treatment of water. This year, we concluded that process with the sale of our interest in companies in that sector located in Mexico City. Also, at the end of the year, we sold our minority stake in S.A. Sulquisa, a sodium sulfate producer in Spain.

The financial results below are expressed in millions of pesos and the percentage change is compared to the previous year. Gross sales in 2015 (excluding hedging results) totaled \$65,562, 7.4% higher, which was primarily due to the higher average exchange rate of the peso against the US dollar and higher volumes sold of gold and sodium sulfate, which more than offset the impact of the decline in metal prices. Results from metal price and exchange rate hedging had an opportunity cost of \$666. Gross profit was \$13,396 (-16.7%), EBITDA was \$13,901 and operating income totaled \$5,605 (-7.8% and -34.4%, respectively).

The application of IFRS accounting standards –considering that the functional currency of the Company is the dollar and reporting currency is the peso– and the substantial depreciation of the peso against the dollar, led to disparate effects on shareholders' equity on the one hand, and on financial results on the other. That is to say, on the one hand there was a very significant

increase in Company's shareholders' equity in the amount of \$5,988, for this concept alone; while on the other hand, and linked to the above, a significant deferred tax charge of \$1,989 was generated, an amount exceeding pre-tax income, which led to record a net loss in the year of \$866. The combination of these results does not signify either the deterioration of performance or the financial health of the Company.

To the extent that major currency fluctuations are recorded, all companies subject to tax in Mexico and whose functional currency is the dollar will experience such effects.

We declared \$600 of dividends in the year. The debt to EBITDA ratio was 1.7 times at year-end, with sufficient cash reserves to cover medium-term operational, strategic and financial needs.

Without a doubt, our employees are the most valuable resource we have, and they are our greatest responsibility and key pillar of our Vision. We have and will continue to strengthen the training and safety programs for our personnel and contractors, as well as the processes to attract and develop talent, and to care for their health and safety. We also work to maintain a constructive and harmonious labor environment.

The Board of Directors adheres to sound corporate governance practices. To carry out its functions, the Board has the support of the committees recommended by the Code of Best Corporate Practices. The Board met four times during the 2015 fiscal year. Among the topics discussed and approved at these meetings, the most important were:

- Strengthening workplace safety and environmental programs
- Labor relations
- The metals and exchange rate hedging program
- The risk prevention program
- Revisions to the 2015 budget
- Analysis and approval of the investment program
- The basis for the 2016 budget and its revisions
- The flood contingency at the Naica mine
- The revision of the Strategic Plan

Pursuant to the provisions of the Securities Market Law, the Audit and Corporate Governance Committee prepared its Annual Report, which is presented to this Shareholders' Meeting.

The Financial Statements of the Company were prepared in accordance with International Financial Reporting Standards, issued by the International Accounting Standards Board. The preceding comments arose from these Financial Statements, as well as from the main accounting policies and criteria followed in the preparation of the financial information, which were audited by the external auditors and included in the Annual Report.

Submitted herein for the consideration of this Shareholders' Meeting is a report on the main accounting policies and criteria that serve as the basis of preparation for the Financial Statements, and which include, among others: the basis of presentation, consolidation, significant accounting policies and new accounting pronouncements, which were audited by the external auditors and made part of this Report.

In the opinion of the Board of Directors, the Report presented to this Shareholders' Meeting by the Chief Executive Officer reasonably reflects the financial position and results of the Company, as well as the key developments of the business in the 2015 fiscal year.

In accordance with policy, the performance of senior executives is evaluated annually. Any increase in salary and benefits must be authorized by the Nomination, Evaluation and Compensation Committee. Salary increases are made annually, and bonuses are determined based on the results of performance evaluations. The remuneration package of senior executives consists of a base salary, and legal and other benefits common to the domestic industry.

The expectation for 2016 is that conditions in the sector and the global economy will continue to be difficult. Our strategy is to remain cautious and manage the business with financial prudence. Our course of action is clear: to improve safety rates, make ongoing, prudent and disciplined investments, reduce costs, increase productivity, ensure sustainable operations and generate long-term growth opportunities, working in harmony with communities and caring for the environment. We can adapt to the changing environment without losing our long-term perspective. I once again express my confidence in the future of Peñoles and of our country.

I reiterate my appreciation to the team for their enormous effort, commitment and dedication to facing adversity during this year of great challenges. I also appreciate the members of the Board of Directors for their valuable contributions and, of course, to you, dear shareholders, for the continued confidence in us.

Alberto Baillères  
Chairman of the Board of Directors