



INDUSTRIAS PEÑOLES, S.A.B. DE C.V.

ANNUAL REPORT OF THE BOARD OF DIRECTORS TO THE SHAREHOLDERS' MEETING CORRESPONDING TO THE 2016 FISCAL YEAR.

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 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 obtained in 2016, and key developments in the period, as well as a report on the main activities of the Board of Directors.

Global trade saw moderate growth and low dynamism during 2016. The fear of a new economic downturn was allayed by the slight increase in growth, particularly in China and the United States that we saw mid-year. With this, industrial metals prices –except for copper– improved over the previous year, and the ruling prices for precious metals –traditionally used as a safe haven investment– profited from a fair boom.

Furthermore, the new federal taxes for mining companies that took effect a couple of years ago have reduced their competitiveness and discouraged the rhythm of investment.

Because of all this, it is clear that additional tax burdens, such as the so-called *green tax* that was approved late in 2016 in the state of Zacatecas, would be both excessive and unjustifiable, and would lead to a loss of additional competitiveness for an industry that supports hundreds of thousands of Mexican families and is key in our country's development and growth. The state of Zacatecas invaded the sphere of federal allocations, forcing the mining industry to seek protection from the federal courts.

In its 130 years of existence, Industrias Peñoles has proven to be a solid company committed to Mexico's development: we invest constantly to improve productivity and have clean, safe, efficient and sustainable operations that will benefit existing and future generations; we create decent jobs and offer permanent support to the communities; we contribute to the supply chain to build mutually-beneficial relationships; and we produce high-quality, renowned products for the international market.

The volatile environment of 2017, forces us to maintain our focus in the careful management of resources and the strict control of costs. Our financial position has enabled us to pursue our operations and advance in the development of strategic growth projects. During this period, the

first stage of Fresnillo plc's silver and gold San Julián mine –which will require a total investment of \$515 million dollars– start operations. In addition, we advanced in the construction of the new Rey de Plata polymetallic unit in the state of Guerrero, which will begin producing zinc, silver, copper and gold in concentrates in late 2018, with a total investment of \$296 million dollars. There were other important developments in the engineering phase of a pyrite concentrate leaching plant to increase silver and gold recovery from existing and old tailings –involving a \$155 million dollar investment– and a second \$110 million dollar dynamic leaching plant in Herradura to increase gold production starting in 2018. The project to expand the production of refined zinc by 120,000 tons per year, estimated at \$327 million dollars, is underway and should begin tests and operations in January 2018. Optimization projects in the Sabinas, Tizapa and Velardeña mines received approval to increase milling, processing and metal production capacities.

Investments in fixed assets and exploration in 2016 reached \$837.5 million dollars, equivalent to \$15,754 million pesos, 9.3% higher than the previous year and enough to sustain operations and continue with the disciplined execution of the projects underway, as per our long-term vision.

Meanwhile, we achieved significant developments in our various exploration projects in Mexico and South America. We carried out technical studies of the copper-gold-molybdenum project in Racaycocha, Peru, and of the disseminated copper project Los Humos, in the state of Sonora. In La Industria, Durango, we are performing technical studies for a potential satellite mining operation to the Velardeña zinc mine. Furthermore, Fresnillo plc made important discoveries in the districts of San Julián, Guanajuato and Fresnillo, and integrated the feasibility of the silver and gold Juanicipio project, in Zacatecas.

In 2016, our mining operations had a solid performance. We set a new annual record in the production of gold (971 thousand ounces) for the second consecutive year, and in the production of silver (58.1 million ounces) for the third consecutive year. In addition, we achieved a new record in annual production of zinc (286 thousand tons). Lead production was also higher than the previous year, and copper cathodes decreased due to slower recovery in the Milpillas unit. In terms of metallurgical operations, production volumes were lower than the previous year: Gold and silver due to lower content in concentrates and fewer purchases of rich materials, and lead due to lower bullion treated. Refined zinc production also saw a decrease due to operating failures in the electrolysis plant, which were ultimately resolved.

With regards to chemicals, we achieved a second consecutive record in annual production of sodium sulfate, which totaled 750 thousand tons, thanks to the operation of the new plant which has expanded the capacity by 150,000 annual tons since 2014.

The financial results presented below are expressed in millions of pesos and their percentage variation is based on a comparison with the previous year. Invoiced sales in 2016 (excluding hedging results) reached \$82,929, a 26.5% increase, due mainly to the rise in the average exchange rate for the US dollar, higher metal prices and an increase in sold volumes of zinc, gold and concentrates. Results from hedging metal prices and exchange rates recorded a \$787 opportunity cost. Because the increase in costs and expenditure were lower, gross profit was \$26,866 (100.6%), EBITDA was \$28,257 and operating income was \$18,450 (103.3% and 229.1%, respectively).

We must note that the application of the International Financial Reporting Standards (IFRS) – considering that the company’s functional currency is the dollar and the reporting currency is the peso– has caused the significant depreciation of the peso against the dollar to have a different effect between what happens to shareholders' equity, on one hand, and the year's results, on the other. This is evident in components of other comprehensive income amounted to \$9,236, the most significant of which is the result from currency conversion that increased the company's shareholders' equity by 17.6%, while related to this, a deferred tax of \$2,772 was generated, reducing the income for the year and increasing the effective income tax rate to 43.1%.

These currency fluctuations produce the effects described to every company that, like Peñoles, is subject to taxation in Mexico and whose functional currency is the dollars.

In addition, \$938 in dividends were declared. On the other hand, at year end, the debt-EBITDA ratio was 0.9 times, with sufficient cash reserves to cover operating, strategic and financial requirements.

One of our main attributes is our permanent commitment to the communities with which we have built productive relationships based on respect, co-responsibility and mutual benefit. We promote their self-development through education, sports, culture and community integration programs and their well-being through health promotion initiatives. To achieve all this, social investment in 2016 was \$117 million.

Industrias Peñoles was selected to be part of the new FTSE4Good Emerging Index of the London Stock Exchange, which includes public companies from more than 20 emerging countries that strongly commit to environmental, social and corporate governance best practices. Our employees are an essential part of our company's success and its most valuable asset; they bring our Vision to life day after day. That is why our business strategy prioritizes training programs and measures to increase health and safety in the workplace, as well as talent attraction, retention and development initiatives. Furthermore, we provide a constructive and harmonious work environment promoting communication and team work.

We maintain productive and respectful relationships with communities and unions, based on the ethical principles and values that we promote within society and with our customers and suppliers.

The Board of Directors has adhered to sound corporate governance practices. To perform its functions, the Board is supported by the committees recommended in the Code of Best Corporate Practices. The Board met four times in 2016. The following are among the topics discussed and approved at those meetings:

- Reinforcement of workplace safety and environmental programs
- Labor-management relations
- The metals hedging and exchange rate program
- Risk prevention program
- Review of the 2016 budget
- The analysis and approval of the financing and investment program
- Budget for 2017
- Approval of optimization projects in the Tizapa, Sabinas and Velardeña mines
- Review 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 from which comments herein are derived, as well as the main accounting policies and criteria used in the preparation of the financial information, were audited by the external auditors and included in the Annual Report. The company's Financial Statements were prepared in accordance with International Financial Reporting Standards, issued by the International Accounting Standards Board.

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 during 2016.

In accordance with policies, the performance of senior executives is evaluated annually. The Nomination, Evaluation and Compensation Committee must authorize any increase in salary and benefits. Salary increases are made annually and bonuses are determined based on the results of performance evaluations. The remuneration package of senior executives is comprised of a base salary and legal and other benefits common to the industry domestically.

We estimate that 2017 will be a year of global volatility and uncertainty. Our sector will not be spared from those circumstances. At Peñoles, we will continue to monitor the environment and manage our business prudently. We trust that our company, established 130 years ago, can weather the difficulties, as it has always done, based on its solid strategy and clear vision and its employees' commitment to excellence. As always, we will continue to improve our safety rates, invest with discipline and prudence, optimize our costs, increase our productivity and guarantee the efficient operation of our work centers. Moreover, we will strengthen our relationships with the communities and maintain our commitment to increasing our environmental leadership.

The year's results could not have been possible without the dedication, commitment to excellence and experience of our employees, to whom I am deeply grateful. I am also grateful to the Board of Directors, for their contributions and guidance, and to you, esteemed shareholders, for your continued trust.

Alberto Baillères
Chairman of the Board of Directors