



## **ANNUAL REPORT OF THE BOARD OF DIRECTORS TO THE SHAREHOLDERS' MEETING, CORRESPONDING TO THE 2017 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 2017, and key developments in the period, as well as a report on the main activities of the Board of Directors.

2017 was a year of contrasts. From the economic point of view, we witnessed greater growth, increased momentum in global commerce, and an emerging upturn in investment, which drove demand for industrial metals and prices recovery.

Mexico was subject to external pressures, driven in particular by the North American Free Trade Agreement renegotiation process and the policies under the new administration in the United States. Our economy experienced moderate growth and a volatile exchange rate of the peso against the dollar.

Natural disasters that struck the country this year were unfortunate, especially the earthquakes that affected Mexico's central and southern regions in September. Once again, Mexicans showed the world our tremendous solidarity in the face of disaster. Peñoles actively joined in the search and rescue efforts. We were able to collect and distribute 320 tons of aid to the victims, mainly in the communities surrounding our operations in Oaxaca. Likewise, as part of our social commitment, we helped –along with other companies of *Grupo BAL* – to donate \$120 million pesos that will be assigned to rebuild public schools. Fortunately, our facilities suffered no significant damage as a result of these events.

In 2017, Peñoles celebrated its 130<sup>th</sup> anniversary. We are proud of our contribution to the economic, social and industrial development of Mexico. Working together, we have been able to face the difficulties and overcome adversity. Therefore, on the occasion of this significant anniversary, we reaffirm our commitment to operate responsibly, continuously invest in growth, efficiency, productivity, technology, training and development, in addition to supporting the communities. All these efforts with the prudence, sustainability, and long-term vision that are the hallmark of the company.

During this period, operations began at the flotation plant in the San Julián silver-gold mine operated by Fresnillo plc; the construction of this mining unit required an investment of \$515 million dollars. Significant construction progress was also made on the project to expand the refined zinc production capacity by 120,000 tons per year at our Torreón refinery. Operational testing of the facilities began and will continue during the first quarter of 2018. Thanks to these new facilities, Peñoles is positioned as the sixth-largest zinc producer worldwide, with an installed capacity of 350,000 tons per year. Progress was also made in the construction of the polymetallic mine Rey de Plata, in Guerrero. The mine is scheduled to start up production of zinc, lead, silver, copper, and gold in concentrates by mid-2019. Investments in these latter two projects will be \$327 and \$303 million dollars, respectively. During this period, construction began on a new leaching plant for pyrite concentrates to recover gold and silver contents from the current and older tailings in Fresnillo and Saucito; with an investment of \$155 million dollars. Likewise, a second dynamic leaching plant was installed at the Herradura site, with an investment of \$110 million dollars. Optimization works were also carried out at the Tizapa, Sabinas, Velardeña, Ciénega, and Fresnillo mines in order to increase milling capacities and metallic contents production. Related investments amount to \$151 million dollars.

In terms of exploration, important progress was made in various projects located in Mexico and South America. Technical and economic feasibility studies are underway for the disseminated copper project in Los Humos, Sonora, and for the copper-gold-molybdenum project in Racaycocha, Peru. Drilling work identified mineral intersections at Reina del Cobre, close to the Velardeña zinc mine, Durango, and in the Bismark area of influence in Chihuahua. In addition, Fresnillo plc reported important findings in the districts of San Julián, Guanajuato, and Fresnillo.

The investments in fixed assets and exploration during the year totaled \$1.141 billion dollars, equivalent to \$21.453 billion pesos. This amount was 36.2% higher than the previous fiscal year. In the last five years alone, we have invested \$4.912 billion dollars into these categories, allowing us to strengthen the integration of our mining-metallurgical business with new operations, capacity expansions, and updated technology. As a result, we have generated thousands of decent, well-paying jobs.

We have also made significant progress in terms of energy self-sufficiency. In April 2017, operations began at Eólica de Coahuila, municipality of General Cepeda, with a 25-year supply agreement. This wind farm has an installed capacity of 200 MW to supply our operations with the electricity produced at competitive costs, and will allow us to continue advancing in the use of renewable energy sources as part of our company's commitment to environmental stewardship. In addition, we signed agreements to acquire electricity from a wind farm in Tamaulipas, with 306 MW installed capacity, and from an efficient co-generation plant in Coahuila, with 60 MW. Both facilities will begin operations in 2020.

In the performance of mining operations, silver production record improved to 66.4 million ounces for the fourth consecutive year, while zinc maintained similar volumes to the previous year, at 285.1 thousand tons. Gold production totaled 951.8 thousand ounces, and lead was 78.8 thousand tons –both slightly below the previous year– due to slower recovery and lower ore grades, respectively. Copper concentrates, for their part, increased due to improved recoveries; in contrast, copper cathodes posted lower volumes due to the slow recovery process at the Milpillas unit.

In the metallurgical operations, production volumes increased for silver as a result of higher input of rich materials, and for zinc, due to an increase in concentrates treated with better grades. Refined gold had lower production because there were lower purchases of rich materials, while lead production was similar to the previous year.

In terms of chemical inputs, despite facing various operational and market challenges, sodium sulfate broke a record for the third consecutive year since the expansion, with 753,000 tons of production. Magnesium oxide had an important recovery, thanks to higher demand from the refractory sector; and magnesium sulfate also reached a production record.

Financial results for the 2017 fiscal year were favorable. Unless otherwise stated, the figures presented below are expressed in billion pesos, and their percentage variation is year-over-year. Invoiced sales (excluding hedging results) reached \$86.238 billion, an amount that grew by 4.0%, mainly due to the increased prices for industrial metals, the higher average parity of the peso, and the increase in volumes sold for silver, concentrates, and chemical products. Hedging results of metals prices and exchange rates, recorded an opportunity cost of \$826 million. Given that the costs and operating expenses increased to a lesser degree, the gross profit was \$32.127 billion (+19.6 %), the EBITDA of \$32.396 billion (+14.6 %) and operating income of \$22.292 billion (+20.8 %).

The average peso-US dollar exchange rate experienced a marginal change of 1.5%, but closed below its corresponding 2016 level (-4.5%), which caused to post a foreign exchange loss of \$590 million. On the other hand, there was a financial expense resulting from the ineffectiveness of the hedges (mainly options) whose accounting record, like the exchange effect, did not affect cash flow. Net profit in 2017 was \$10.892 billion, a figure 89.6% higher than the previous year.

Dividends declared were \$4.325 billion, and we obtained a line of credit for \$94.5 million dollars under favorable conditions, of which \$66.8 million was made available during the period. The funds will be used to finance part of the projects for zinc expansion and improved silver recovery.

At year-end, the debt-EBITDA ratio was 0.9 times. The cash flow generated has been healthy, allowing the Company to hold enough cash reserves to cover operational

requirements, medium-term strategic and financial investments, while maintaining a solid and conservative financial position.

Our social commitment has been, and will continue to be, a priority. This is why we strengthened outreach actions to benefit the communities whom we support on a permanent basis through educational programs that contribute to their development. We also foster their well-being through initiatives that promote health, sports, culture, and recreation. In 2017, we invested \$217 million in these categories. In addition to these resources, through our payment of mining rights (\$706 million this year), we contribute to the Fund for the Regional Sustainable Development of States and Municipalities for distribution among investments that produce social and environmental impact and urban development, pursuant to the applicable legislation.

Our people are undoubtedly an essential part of Peñoles' success and make up our most valuable asset. Our highest responsibility is to ensure their health and integrity, and to provide a safe and harmonious work environment that fosters productivity. That is why year after year we boost safety training for our employees and contractors, as we increase health care actions. Similarly, in order to have the best-trained and prepared workforce, we strengthen our processes to attract, retain, and foster the development of the people who have the greatest talent and potential.

We also promote ethical behavior among our team members, in accordance with the institutional values set out in our business vision, and extend them to our unionized personnel, contractors, customers, and suppliers.

The Board of Directors adheres to solid corporate governance practices. To perform its duties, the Board relies on the support of the committees that are recommended in the Code of Best Business Practices. The Board met four times during the 2017 fiscal year. The following are among the topics discussed and approved at those meetings:

- Reinforcing workplace and environmental safety programs
- Nurturing labor management relations
- Strategic Plan review
- The metals hedging and exchange rates program
- Risk prevention program
- Review to the 2017 budget
- Analyzing and approving the investment program
- Authorizing company financing
- Budget for the 2018 fiscal year
- Approval of two long-term agreements to supply electricity

Pursuant to the provisions in 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 2017.

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 domestic industry.

Challenges are foreshadowed for 2018. As Mexicans, we must be united during this election year and lend our enthusiastic participation to the crucial decisions that will define our country's course. In the face of external turmoil, we must remain calm, work hard, with loyalty and commitment, for our beloved nation.

At Peñoles, we will continue executing our strategy with discipline, as we always have, managing the business in a prudent, sustainable manner with a long-term vision.

I want to express my gratitude to our people for their work, commitment, and dedication. I also wish to extend my appreciation to the Board of Directors for its valuable contributions and guidance, and to you, our Shareholders, for your continued trust in us.

Alberto Baillères  
President of the Board of Directors