



**ANNUAL REPORT OF THE BOARD OF DIRECTORS TO THE SHAREHOLDERS'
MEETING, CORRESPONDING TO THE 2018 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 2018, and key developments in the period, as well as a report on the main activities of the Board of Directors.

The global economy was complicated in 2018. Various geopolitical tensions and trade disputes led to a slowdown in the industrial activity in China and other emerging countries. In contrast, although the United States had a better performance throughout the year, growth slowed down toward the end of the period.

Market imbalances generated volatility and, since the middle of the year, put pressure on metal prices. Silver, which in 2017 represented one-fourth of our revenue, fell to levels from three years ago, while the rest of the metals, except for gold, suffered double-digit reductions compared to the previous year.

Undoubtedly, the mining industry has played an essential role in Mexico's economic and social development, as an important source of employment in remote areas, generating currencies and tax revenue. In 2017 alone, mining contributed 8.3% and 2.5% of the industrial and national GDP, respectively, and generated more than 2.2 million direct and indirect jobs.¹ Likewise, four years after entering into force, rights paid by companies in the mining sector (in addition to income tax) amounted to \$14.4 billion pesos. Of these resources, 77.5% were included in the Mining Fund, allocated to projects with social and environmental impact and for urban development, to the benefit of inhabitants in 199 municipalities with mining activity in 25 Mexican states.

¹ According to the *2018 Annual Report of the Mexican Mining Chamber*.

The Peñoles business strategy prioritizes support for the communities where we operate. Therefore, it maintains and reinforces its ties to these communities in order to build productive and harmonious relationships. Our social commitment includes educational programs for personal development, medical check-ups for health care, and fostering community well-being by promoting sports, culture and recreation, among other initiatives. Over the last four years, community investment, in addition to the payment of mining rights, totaled \$692.3 million pesos.

In an ever-changing environment, industry faces greater challenges in general, and mining, in particular: Lower ore grades in the deposits, higher environmental requirements, social pressure, delays in obtaining permits, and greater complexity in terms of site access. We are aware of the circumstances thus we lead our business with prudence, responsibility, and full respect to neighboring communities, the environment, and the rule of law.

During this period, we concluded construction of the project to increase the annual production capacity of refined zinc by 120,000 tons per year, thus reaching an annual capacity of 350,000 tons; this project required an investment of US \$327 million. Process testing was carried out in order to start operations at the beginning of 2019. Development also continued at Capela, a polymetallic mine in Guerrero, whose start-up is planned for the third quarter of 2019. This project will require an investment of approximately US \$303 million. Phase I operations also began at the new leaching plant for iron concentrates to recover silver and gold contents from tailings at Saucito. Furthermore, at the end of December, a second dynamic leaching plant began operations at Herradura to expand gold recoveries, with an investment of US \$110 million. Optimization works continued at the Tizapa, Sabinas, Velardeña, Ciénega, and Fresnillo mines in order to increase capacities for milling and metallic contents production. A project to improve silver recovery from zinc concentrates is also in progress.

In terms of exploration, important progress was made in various projects located in Mexico and South America. In addition, Fresnillo plc reported relevant findings in the districts of San Julián, Guanajuato, and Fresnillo. Discoveries were made in Durango close to the zinc mine at Velardeña, and in the area of influence at the Bismark mine.

Investments in fixed assets and exploration during the year rose to US \$1.262 billion, equivalent to \$24.323 billion (a variation of 13% compared to the previous year). In the last 10 years, investments totaled US \$7.437 billion in new mining operations, capacity expansions, process improvements, and technology updates, which translated into higher productivity and generated well-paid employment.

In mining operation performance, for the fifth consecutive year the silver production reached record levels, at 69.8 million ounces, while zinc reached a new high of 289.6 thousand tons. Gold production, at 963.4 thousand ounces, was similar to 2017, while lead

and copper cathodes posted increases. In turn, copper concentrates fell due to lower ore grades and recoveries.

Globally, the metal sector experienced a sharp decline in treatment charges in 2018. This led to lower volumes of gold, silver and lead production, and fewer purchases of materials from third parties. However, refined zinc experienced a slight increase.

In terms of chemical inputs, sodium sulfate broke a record for the fourth consecutive year at 780.6 thousand tons of production, reaching full capacity. Magnesium oxide performed reasonably well, considering market conditions.

Among our strategic objectives, we seek alternatives to increase the use of clean energy in our operations. In 2018, there was an increased supply of clean energy from the wind power plant Eólica de Coahuila, in operation since 2017. In addition, a third party is building a new wind power plant and an additional agreement was signed to develop another wind farm. These new power plants will be added to our electric power supply infrastructure at attractive prices.

In the financial results and their variations compared to the previous year (in millions of pesos), invoiced sales totaled \$84,151.8, a decline of 2%, as a result of reduced volumes sold and the fall in metal prices, especially silver. The results on hedging metal prices and exchange rates recorded a profit of \$135.9, which was favorable in comparison to the opportunity cost (-\$826.4) from the previous year. Costs and expenditure rose since the inputs experienced an increase above the national inflation, and there was higher consumption levels in operations, development works, and growth projects. The gross profit was \$24,811.7 (-23 %), the EBITDA was \$24,738.8 (-24 %) and operating income was \$13,592.8 (-39 %).

The average peso-US dollar exchange rate experienced a marginal change of 2 %, resulting in a foreign exchange loss of \$55.7. Therefore, net income for the year of \$6,005.4 was lower by 45 % from the previous year.

Dividends were declared at \$5,445.4, and at year-end we had short-term bank financing for US \$410 million. Of this amount, US \$300 million will be refinanced on a long-term basis to cover part of the growth investments; the remaining amount constitutes financing needs of working capital to start the zinc expansion.

At year-end, the debt-EBITDA ratio was 1.5 times. Despite the difficult year, the company's financial position remains solid and prudent, since we have maintained investment-grade credit ratings with a positive outlook.

As always, we recognize the dedication and talent of our employees. Our greatest commitment is to them: That is why we promote safe working conditions and a harmonious workplace environment that fosters productivity. In addition, we boost safety training for our employees and contractors, and increase health care actions.

The Board of Directors adheres to solid corporate governance practices. In the discharge of its duties, the Board relies on the support of the committees that are recommended in the Code of Best Principles and Practices for Corporate Governance. The Board met four times during the 2018 fiscal year. Among the topics covered and approved during those sessions, the most important were the following:

- Reinforcement of workplace and environmental safety programs
- Nurturing labor management relations
- Strategic Plan review
- Metal hedging and exchange rate program
- Analysis and approval of the investment program
- Authorization of company financing
- Budget for the 2019 fiscal year
- Approval of long-term agreements to supply electricity
- Approval of the audit firm for Basic Financial Statements and additional services

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 2018.

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 on a yearly basis 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.

The macroeconomic outlook for 2019 is complex, uncertain and volatile. We remain very cautious towards the evolution of global economy and the possible impacts that may affect our results. Peñoles will continue to maintain its prudent and conservative management practices. We reiterate our commitment to Mexico and to creating opportunities and wellbeing in a sustainable manner.

I want to express my gratitude to the members of the Board of Directors for their dedication, commitment and valuable contributions. I would also like to thank our employees for their hard work and dedication. I also extend my appreciation to you, our Shareholders, for your continued trust in us.



Alberto Baillères
Chairman of the Board of Directors