

„BANJALUČKA PIVARA“ AD
BANJA LUKA
- Management Board -
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Report on Business Operations in 2016

Introduction

2016 was an extremely challenging year for Banja Luka Brewery. The most important theme of the year was beer excise tax. First because on 1st January 2016, the Company lost the classification as a small brewery for the purpose of calculating excise, and with it the 20% reduced rate that we enjoyed in 2015. This means that the Company pays 0.50 KM additional excise tax + value added tax (VAT) on every crate into the future. This total cost to the Company was 2.8 million KM in 2016 of additional taxes. Second, throughout the year, the Company was actively lobbying against a further 1.50 KM + VAT increase in excise per crate of beer that was proposed by the entity governments. This is still unresolved, but until today has not been adopted.

The impact of this change in status was strongly felt in the Company's finances, because we were unable to pass on all the tax increase in the form of price increases. As a result, net revenues per hectolitre fell and margins also fell. On the positive side, the low oil price helped us to reduce direct costs but not enough to offset the revenue reduction. The Company continued to increase sales volumes, achieving 474 thousand hectolitres, an increase of 3% over 2015, however operating profit (EBITDA), fell 9% to 13.3 million KM.

The final result for 2016, benefited from a reduction of 1.5 million KM in depreciation and a saving of 0.5 million KM in interest charges. The final result - profit before tax - rose by 11% to 7 million KM. For the first time, after a number of years of losses, the Company paid full tax on profit, leading to a final result after tax of 6.1 million KM, roughly where it was previous year. We can conclude that the state institutions are the winners in 2016 raising over 3.7 KM million additional taxes from this successful Company.

The Beer Market in 2016

The total beer market in BiH appears to have been fairly stable in 2016. Within the year, there were some significant swings. The summer started very slowly, with wet and cold weather in Q2; fortunately, the second half of summer was warm and dry, which helped to redress the losses of the first half. The competitive landscape on the BiH beer market continues to become more intensive. Our key competitors Molson Coors (Jelen) focused a large portion of its investment on Banja Luka in 2016. In particular, they attempted to drive Nektar out of distribution in leading bars and restaurants in the region by offering inflated sales incentives and capital investments. To a very large degree, thanks to the loyalty of Nektar

consumers, they have not been successful in this endeavour. Nonetheless, we were again obliged to increase our level of spend in HoReCa and leading retailers to maintain our presence.

In eastern Republic of Srpska, the level of competitive intensity is rising. Heineken have entered the market with Zaječarsko, a very successful brand from Serbia, and more recently added Laško to their portfolio, thanks to the acquisition of the company in Slovenia. Laško group brands sell around 130,000 hectolitres of beer in Bosnia and Herzegovina, which will give important additional weight to their portfolio here. This now means that there are four important brands of mainstream beer on the market, which will inevitably lead to continuous discounting to gain market share.

Among the local breweries, Sarajevo brewery was notable for a strong re-launch of their core brand Sarajevsko. This was accompanied by a more price driven strategy and an effective cut of around 15%, which now means that beer prices across the whole of BiH are fairly similar, whereas in the past FBiH beer prices were 15-20% higher than in the RS. Nonetheless, the regional differences in the beer market persist, making it extremely important to develop detailed plans for each region.

Investments in Production

An increasing burden for the Company is the need to continuously keep up with the evolution of hardware and software used in manufacturing technology. This year we undertook a major upgrade of our main filling line, to bring all the electronics up-to-date. This project was successfully implemented in May, with a major planned stoppage during the season. This would not have been possible without the many improvements that have been achieved in stock management and planning in recent years. The next round of investment in this area in 2017 will be in our cellaring and fermentation systems which are also becoming out of date.

The filling machine on our PET line has long been a weakness, working slowly and inefficiently. This year we purchased a new filling machine, which has enabled us to double the speed of the line and make important efficiency savings. We also replaced the main air compressor, which was close to the end of its useful life with a new more energy efficient model. The process of gradually upgrading our filling lines will involve some important further investments in the next few years.

Over the last two years, the Company has been working on a variety of measures to measure and track product longevity. The general goal is to maximise the long term freshness and shelf life of our products. In order to facilitate this, the team have implemented new quality control measures, and cleaning practices and the Company has invested in the latest laboratory equipment.

Sales and Marketing

In April, the Company launched the biggest prize game that we have ever participated in. The main prizes were three dream cars an Audi, a BMW and a Mercedes. The campaign was heavily promoted on TV and other media. The level of positive response and participation surprised us all, with over 150,000 envelopes and 600,000 codes via internet which were sent in for the prize draw, that took place on Trg Krajina in Banja Luka in July.

The Company made long term commitments to three important music festivals, Demofest, OK Fest and Fresh wave, which are the centre piece of our wide ranging event and activation program. Other than these three leading events, during the year we participated in over 400 individual events from music festivals, to sports, culture, the Banja Luka half marathon and many other manifestations.

The impossible task of meeting the ever growing demands of café and bar owners for investments and equipment, was a big theme in 2016. This was largely thanks to a sustained campaign by Molson to drive Nektar out of distribution through big investments. The Company reacted to this pressure by increasing investments, but we try at all times to maintain a balanced long term view and spend intelligently. Certainly this problem will dominate our budget discussion over the coming years.

Prices and Margins

Increase in excise costs has put a lot of pressure on the Company pricing during 2016. In fact, we were forced to cut the prices of some products in order to reduce the impact of the excise increase. There is also a general trend towards non-returnable, convenient products in new retail stores which is stimulating the proportion of sales in less profitable packages such as cans and PET. As a consequence of these two factors and despite some cost savings on direct costs margins fell slightly.

Human resources

The process of improving management processes has continued, with a focus upon clearer responsibilities throughout the business, with greater accountability. A number of changes were made to structure and a reduction of complexity in some of our processes. Our management aim is to build strength in depth throughout the Company. The Company is committed to its employees, and in particular the long term stability of the workforce, recruiting and maintaining good skills and experienced employees. The Company also seeks and supports young, dedicated and ambitious talents in all areas of its operations, and is fully supportive of continuous development of its employees' skills.

Corporate Governance - Application of Standards

Commitment of the Brewery management to transparency of its operations and application of recognised Standards of corporate governance (adopted by the Republic of Srpska Securities Commission) is unchanged. The Standards Governing Joint Stock Companies (applying to companies enlisted on the official stock exchange) are applied in daily practices of the Company. Banjalučka pivara has its own Code of Conduct and Management, and Banjalučka pivara continues to further develop its corporate website, to include all relevant, timely available investor information - company financials, the most important information on business operations, its governing bodies and members of the management team, etc.

In addition to this, Banjalučka pivara is fully implementing various imperative norms, regulated and sanctioned by various laws (Law on Enterprises, Law on Securities Market, Law on Accounting and Audit,

etc.) and acts of the Commission for Securities and Stock Exchange Rules, incorporated in the Brewery's Articles of Association, Rulebook on Procedures of the Assembly and other acts of the Company.

Conclusion

2016 was a challenging year of transition from our tax status as a small brewery to a large brewery competing on the same terms as the global beer companies, who are more than a hundred times our size. The Company made a successful transition and will continue to be proud of its achievement as the largest independent brewery in the region. However, thanks to this change, the Company suffered a drop in operating profitability, which will hamper our future operations. Future growth opportunities are hard to see in our home market, without a general economic improvement and increase in consumer power in BiH. Future growth will demand that we expand our geographical coverage in the region and launch new products.

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