# Frutarom Industries Ltd.

Annual Report
2012

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## FORWARD-LOOKING STATEMENTS

**This report includes forward-looking statements as that term is defined in the Securities Law - 1968. Forward looking statements include details, forecasts, estimations and other information relating to future events or circumstances which occurrence is not certain and which are not solely in Frutarom's control. These forward-looking statements can be identified, among others, by the use of terms such as, "believes", "estimates", "intends", "expects", "plans", etc. Forward looking statements also includes discussions on strategy, plans, objectives, goals, projections, forecasts, future events and other matters.**

**These forward-looking statements are based on estimations and assumptions made by Frutarom's management on the basis of information available to it at the time of publication, and expectations as to any future events, conditions, performance or other matters.**

**By their nature, forward-looking statements are subject to various risks, uncertainties and other factors that could cause the actual results of Frutarom's activity, its financial state and the realization of its strategy to differ materially from those stated in such statements. These risks, uncertainties and factors include, but are not limited to: the effect of global economics; competition in the markets in which Frutarom operates; the ability of Frutarom to successfully identify future acquisitions and acquire additional companies and activities; the impact of laws, regulations and standards, especially in the areas of environment, health and safety; currency fluctuations; fluctuation in the prices of raw materials used by Frutarom for the manufacturing of its product and their availability and other factors details in Frutarom's annual reports.**

# SECTION A

## DESCRIPTION OF THE COMPANY'S BUSINESS

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The following terms will have the meaning ascribed to them:

| | |
|---|---|
| **“Aromco”** | Aromco Ltd. |
| **"CH"** | Christian Hansen GmbH and Christian Hansen A/S |
| **"CH Italy"** | Christian Hansen ITALIA S.p/a |
| **“Director’s Report”** | Report of the Board of Directors of the Company as at Dec. 31, 2012, attached as Chapter 2 to this report. |
| **"EAFI"** | East Anglian Food Ingredients Ltd. |
| **"Etol"** | ETOL Tovarna arom in eteričnih olj d.d. |
| **"Financial reports"** | The financial reports of the company as of December 31, 2012, attached as Chapter 3 to this report |
| **"Flavor Systems"** | Flavor Systems International Inc. |
| **"FSI"** | Flavor Specialties Inc. |
| **"GDRs"** | Global Depositary Receipts |
| **"Gewurzmuller "** | Gewurzmuller GmbH and Blessing Biotech GmbH |
| **"IFF"** | International Flavors & Fragrances Inc. |
| **"Mylner"** | Mylner Indústria E Comércio Ltda and its mother company, Vila Osório Participações s/a |
| **"Nesse"** | GewurzMühle Nesse GmbH and GewurzMühle Nesse Gebr. Krause GmbH |
| **"Oxford"** | Oxford Chemical Limited |
| **"Rieber"** | Rieber & Son ASA |
| **"Savoury Flavours"** | Savoury Flavours (Holding) Limited and its subsidiaries |
| **"Share"** | Ordinary share par value NIS 1.00 of the Company Frutarom Industries Ltd. |
| **The "Company"** | Frutarom Industries Limited |
| **The "Group" or** | |

| | |
|---|---|
| **"Frutarom"** | Frutarom Industries Limited, including its affiliated companies |
| **The "Companies Law"** | The Companies Law, 1999 |
| **The "Ordinance"** | Income Tax Ordinance (New Version) |
| **The "Securities Law"** | The Securities Law, 1968 |
| **"US$"** | United States dollar |

All financial data in this report is in US dollars unless stated otherwise.

## CHAPTER 1 – THE COMPANY'S BUSINESS AND DEVELOPMENT

### 1. The Group's Activity and Description of its Business Development

General

1.1. Frutarom was incorporated in Israel in 1995 as a private company under the name Frutarom NewCo (1995) Ltd. In 1996 the Company's shares were listed for trade on the Tel Aviv Stock Exchange, and the Company changed its name to Frutarom Industries Ltd.

1.2. Frutarom Ltd., a wholly owned subsidiary of the Company through which the Company operates and manages its business and production activity, was established in 1933 as Frutarom Palestine Ltd. Frutarom's operations initially consisted of the cultivation of aromatic plants and flowers for the extraction and distillation of flavor and fine ingredients materials and essential oils.

1.3. In February 2005 the Company raised capital from international and Israeli institutional investors by issuing shares and registering GDRs for trade on the London Stock Exchange Official List

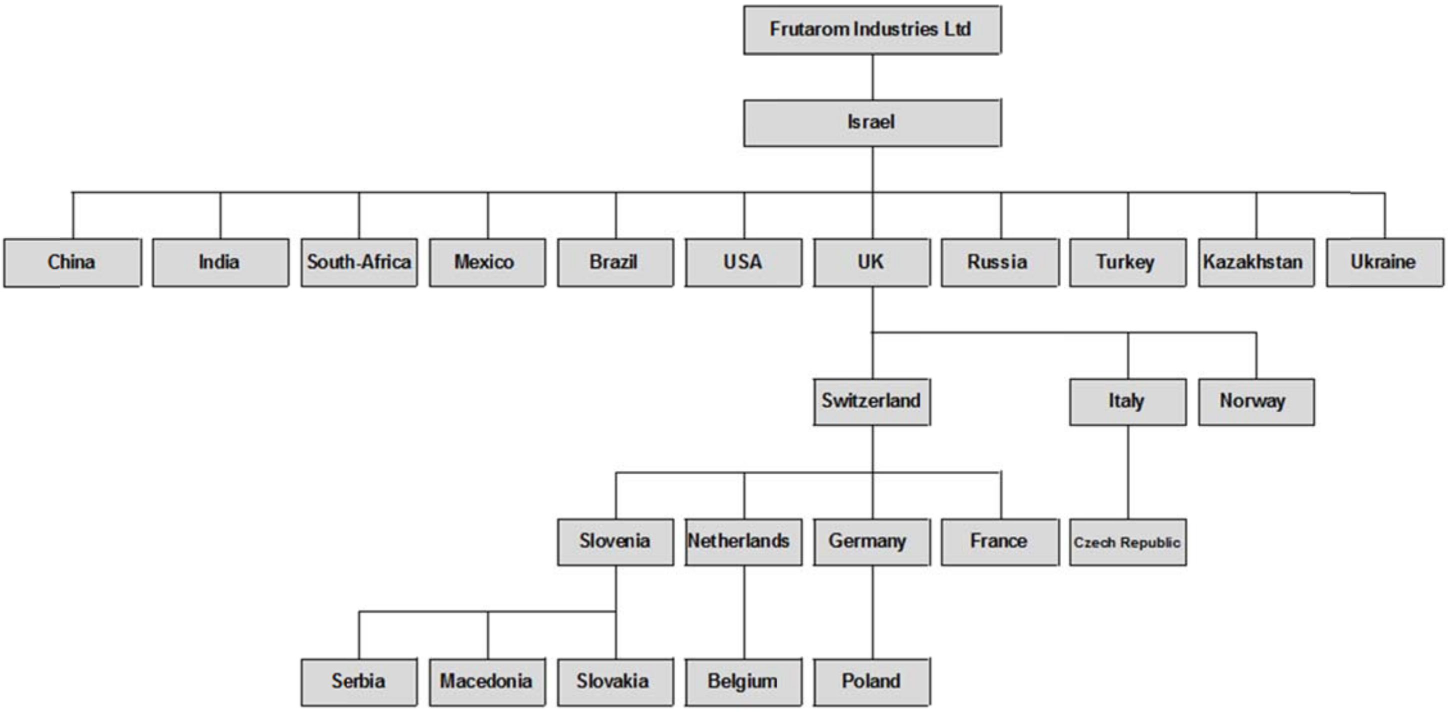
1.4. Today, Frutarom is a global company, one of the ten leading companies in the world in the fields of flavors and specialty fine ingredients. Frutarom is engaged in the development, production and marketing of flavors and specialty fine ingredients used in the production of food, beverages, flavor, fragrance, pharmaceutical/nutraceutical, and personal care products, among others. Frutarom operates production facilities in Europe, North America, Latin America, Israel and Asia that serve a customer base of over 14,000 in more than 140 countries. The Company markets and sells over 30,000 products and employs roughly 2,020 people throughout the world.

For additional information on the Company's growth strategy see section 39 of this report.

1.5. The Company's main shareholder is the ICC Group which, through ICC Industries Inc.[1], holds 21,406,922 shares as of the date of this report, representing approximately 36.71% of the Company's share capital and voting rights.

[1] ICC Industries Inc., through its subsidiaries, holds the abovementioned shares. 488,888 of these shares (approx. 0.08% of the Company's issued paid up share capital) are held by Dr. John J. Farber, the controlling member of ICC Industries Inc., who also serves as the chairman of the company's board of directors. His wife, Mrs. Maya Farber, and Ms. Sandra Farber, Dr. Farber's daughter, serve as directors of the company.

The Group Structure as of the date of publication of this report[2]:




[2] The structure of the group is presented according to countries. Except for the rate of holdings in the subsidiary in South Africa and one subsidiary in china, the rate of Frutarom's holdings in all the Groups main companies is 100%. For further details regarding Frutarom's subsidiaries, see Note 23 to the financial statements.

1.6. During the second half of the 1980s Frutarom came under new management and adopted a new business strategy which included material growth in the Company's international activities and establishing Frutarom as a major, global company in its field by substantially expanding the Company's Flavor activity, the Company's most profitable field of activity.

In the early 1990s, Frutarom's management decided to expand its global activity through the acquisition of companies and activities in the Company's fields of activity.

Since 2001, Frutarom has accelerated its growth by implementing a strategy combining profitable organic growth and execution of strategic acquisitions in order to expand its business opportunities in both emerging and developed markets. Frutarom has significantly increased its mergers and acquisitions activity over these years, and executed 23 acquisitions to date.

1.7. Details of key strategic acquisitions executed by the Company over the past three years are as follows:

1.7.1. **Acquisition of the Savory activity of Rieber** - On December 23, 2010, Frutarom signed an agreement for the acquisition of Rieber's Savory activity (the "**Rieber Activity**") in consideration for approximately US$4.3 million (approximately 25 million NOK). The acquisition was completed on February 1, 2011.

The Rieber Activity was part of an international food group of Rieber & Son ASA and includes the development, production and marketing of savory flavor solutions including flavors, seasoning mixes and functional ingredients used by the food industry, and in particular by the processed meat and fish and convenience food sectors.

The Rieber Activity has a wide customer base, which includes leading food manufacturers, mainly in the Scandinavian countries. The Rieber Activity is highly synergetic with Frutarom's activities in the savory field in Europe, which has grown substantially over the last few years following the acquisition of the savory activities of Nesse, Gewurzmuller and the German CH, acquired by Frutarom in 2006, 2007 and 2009, and the acquisitions of EAFI, Savory Activities of Rieber and of CH Italy in 2011 and the acquisition of Savoury Flavours in 2012.

Frutarom has integrated the Rieber activities, and at the end of 2011 completed transfer of production work to its plant in Germany, thus achieving efficiency and operational economy, leaving research, development, marketing and sales in Norway.

For further information regarding the acquisition of the Rieber Activity, see the Company's immediate reports dated December 26, 2010 and February 1, 2011.

1.7.2. **Acquisition of EAFI's activity and assets** - On January 20, 2011 Frutarom signed an agreement for the acquisition of the activity and assets of the **English** company EAFI in consideration for US$4.8 million (GBP 3 million). The acquisition was completed on January 31, 2011.

EAFI, founded in 1979, develops, manufactures and markets savory solutions including flavors, seasoning mixes and functional ingredients to the food industry in general, and to the processed convenience food, snacks and processed meat and fish industries in particular. EAFI has a wide customer base and a development, manufacturing and marketing site in the UK.

EAFI's activity is highly synergetic with that of Frutarom in the UK as well as with Frutarom's savory activity in Europe, which increased substantially in recent years as explained in section 1.7.1 above.

For further information regarding the acquisition of EAFI, see the Company's immediate reports in the matter dated January 23, 2011 and February 1, 2011

1.7.3. **Acquisition of Savory assets and activities of CH Italy -** On May 26, 2011 Frutarom signed an agreement to acquire the assets and savory activity of Christian Hansen ITALIA in return for €25 million. The acquisition was completed on July 29, 2011.

CH Italy’s savory activity develops, produces and markets unique and innovative savory solutions including flavors, seasoning compounds and functional ingredients for the food industry, with special emphasis on processed meat and convenience food applications. The acquired activity is a leader in savory solutions with an extensive customer base comprised mainly of the leading Italian meat processors; the activity also has sales alignment in Russia, Ukraine, Poland, Czech Republic and France. The activity also included a state-of-the-art, high-capacity plant located in Parma, Italy that will enable Frutarom to increase its activities and to take advantage of operational synergies with its existing savory activities in Europe, and innovative R&D laboratories.

For further information regarding the acquisition of CH Italy, see the Company's immediate reports published on May 26, 2011, July 31, 2011 and November 23, 2011.

1.7.4. **Acquisition of Aromco -** On August 19, 2011 Frutarom signed an agreement to acquire 100% of the share capital of the UK company **Aromco** Ltd. for approximately USD 24.6 million (GBP 15 million). The acquisition was completed upon signing.

Aromco, founded in 1985, develops, manufactures, and markets flavors for the food and beverage industry. Aromco is mostly active in emerging markets with high growth potential in Eastern Europe, Africa and Asia as well as in the UK. Aromco operates a plant in Hertfordshire, England. Aromco's activities are greatly synergetic with Frutarom's activities in the UK, and with Frutarom's Flavor activities.

For further information regarding the acquisition of Aromco, see the Company's immediate reports published on August 21, 2011 and December 1, 2011.

1.7.5. **Acquisition of Flavor Systems -** On September 13, 2011 Frutarom signed an agreement to acquire 100% of the shares capital of Flavor Systems International Inc., a US company ("Flavor Systems") in return for the sum of US$45.3 million, (including the future earn out payment as noted below).. In addition, Frutarom paid US$6.5 million for real-estate assets owned by other companies held by the shareholders of Flavor Systems. The acquisition was **completed** on October 3, 2011In December 2012 the Company paid an additional US$10 million, according to the future earn out mechanism included in the acquisition agreement.

Flavor Systems, established in 1994, develops, manufactures, and markets sweet and savory flavors for the food and beverages industry. Flavor Systems owns a modern plant and R&D laboratories located in Cincinnati, in the Mid-West of the USA. The acquisition also included a new and advanced production site with a high production excess capacity. The site has allowed substantial expansion in areas, among others, where Frutarom has not yet operated until now, such as coffee and flavored shakes sold in convenience stores and in leading food chains throughout the US. Through this acquisition, Frutarom also entered the field of savory flavors, where it did not yet operate in the US prior to the acquisition. Frutarom is acting to utilize operational synergies between Flavor System and the flavors activity in North America, by integrating sites and activities. The modern plant in Cincinnati will serve as Frutarom's new flavors center in North America, and Frutarom is currently transferring its flavor activity from its plant in New Jersey to its new plant in Cincinnati.

For further information regarding the acquisition of Flavor Systems, see the Company's immediate reports published on September 13, 2011, October 4, 2011 and December 25, 2011.

1.7.6. **Acquisition of Savoury Flavours -** On January 4, 2012, Frutarom signed an agreement to acquire 100% of the share capital of the UK company Savoury Flavours (Holdings) Ltd. ("Savoury Flavours") for approximately US$5.8 million (GBP3.8 million), and additional consideration to be calculated based on performance, in accordance with the mechanism prescribed in the agreement, which in the **Company's** estimate will not exceed an amount equal to GBP0.3 M. The acquisition was completed upon signing. The Company paid a further GBP0.1 M for adjustment of working capital on the date of acquisition (US$0.2 M)

Savoury Flavours, founded in 1999, develops, manufactures, and markets savory taste solutions, including mainly flavors, seasoning compounds, marinades and sauces, specializing in snacks and convenience foods. Savoury Flavours has a development, manufacturing and marketing site in the UK, and a wide customer base including food manufacturers and private labels in the UK and in emerging markets.

Savoury Flavour's production site is located nearby the production site of EAFI, which also markets savory products. the geographic proximity between the sites, the complementary product portfolio and technologies of the two activities have enabled shared management of the two sites and integration of activities, creating significant synergies between the two activities and with Frutarom's growing activities in the UK and throughout the world, which have significantly increased over the past few years, as detailed in section 1.7.1 above.

For further information regarding the acquisition of Savoury Flavours, see the Company's immediate report published on January 5, 2012.

1.7.7. **Acquisition of Etol -** Over the first half of 2012, Frutarom purchased the entire share capital of the Slovenian public company ETOL for an overall sum of €35.4 M.

Etol, founded in 1924, develops, manufactures, and markets sweet and savory taste solutions, focusing on natural flavor products for the food and beverage industry. Etol also has great experience in the development and manufacture of fruit based flavors and products and food systems, specializing in local fruits of the region, as well as extensive activities in the growing area of bases for beverages, in which Frutarom intends to significantly invest and expand activities. Etol products are sold to a wide customer base in Central and Eastern Europe and in emerging markets, with a focus on Slovenia, Russia, Poland, Ukraine, Turkey, Croatia, Serbia, Slovakia, Belarus, Macedonia, Czech Republic, Kazakhstan and other developed countries including Switzerland, Germany and England. Etol's customers include leading food and beverage manufacturers in the countries it operates, including large multi-national food companies. Etol's activities are synergetic to Frutarom's activities.

Etol and its subsidiaries employ some 240 employees, including leading personnel in the areas of research and development and sales, and an experienced management team. Etol has a manufacturing and marketing site in Sofia Vas, Slovenia, in which it has invested extensively over the past few years, and has incorporated innovative technologies. Etol has additional real estate properties for future expansion. Frutarom is acting to integrate Etol's activities with its global activities in Flavors, including by the transfer of R&D and production activities to Etol, harmonization of raw materials and utilization of cross selling opportunities.

For further information regarding the acquisition of Etol, see the Company's immediate reports published on January 17, 18 and 26, 2012, from February 12, 2012, March 17, 2012, May 8, 2012, and from June 6 and 26, 2012.

1.7.8. **Acquisition of Mylner -** On February 7, 2012 Frutarom signed an agreement, to acquire 100% of the share capital of the Brazilian Mylner company in return for approximately

US$15.7 million (approximately BRL27.1 million). Frutarom paid a further BRL4.4 M for Mylner's cash balance. The acquisition was completed upon signing.

Mylner, founded in 1974, develops, manufactures and markets flavor solutions, focusing mainly on sweet flavors for beverages and baked goods, natural plant extracts and natural flavor products. Mylner has a modern development, production and marketing site near Sao Paulo, Brazil. Mylner's wide customer base includes leading food and beverage manufacturers mainly in Brazil and in other developing countries in Latin America.

For further information regarding the acquisition of Mylner, see the Company's immediate reports published on February 7, 2012.

1.8. The trend toward consolidation in the industry in which Frutarom operates is ongoing, and in recent years the number of active companies in the industry has dropped. Frutarom, which is one of the ten largest companies worldwide in the Flavors and Specialty Fine Ingredients industries, continues to be one of the leading and most active acquiring companies. Frutarom's management will continue to invest substantial resources in locating and pursuing potential new acquisitions which suit its strategy of rapid and profitable growth.

The Company estimates that its solid equity structure, the strong cash-flow achieved from its activities and the support from financial institutions will enable it to continue with its acquisitions strategy.

## 2. The Group's Fields of Operation

Frutarom is a global company that develops, manufactures, markets and sells flavors and specialty fine ingredients used in the production of food and beverage, flavors and fragrances, pharmaceutical/nutraceutical, personal care and other products. Frutarom has two main activities, each of which is a main field of activity and reported as a business segment in the Company's consolidated financial reports (see also Note 6 in the financial reports for 2012), as detailed below:

**2.1** **The Flavor Segment** – As part of the Flavor segment, Frutarom develops, produces, markets and sells sweet and savory flavor solutions, including flavor essences and product containing, in addition to flavor essences, fruit, vegetable and other natural components (food systems), used mainly by manufacturers of food and beverages and other consumer products. Frutarom develops thousands of different flavors for its customers, most of which are tailor-made, and develops new formulas and adapts them to changing consumer preferences and customers' needs.

The Flavor Activity, Frutarom’s most profitable activity, has experienced accelerated growth over the past few years. Flavor sales increased from US$26.5 M in 2000 to US$457.3M in 2012, constituting 74% of Frutarom’s total sales (compared with 33% in 2000).

This accelerated growth is the result of (a) the strategic focus on the fast growing area of natural and plant flavors; (b) the development of innovation-based unique solutions combining taste and health for the large multi-nationals; (c) the focus on mid-size and local customers (in emerging and developed markets), focusing in particular on the growing segment of private label manufacturers, providing them with customized services, including technological and marketing support, product development support, tailor-made products, and high level services, as are normally provided to large multi-national companies; and (d) as the result of Frutarom’s strategic acquisitions, which have and are being successfully incorporated with Frutarom's global activities.

**2.2** **The Specialty Fine Ingredients Segment** – As part of the Specialty Fine Ingredients activity, Frutarom develops, produces, markets and sells natural flavor extracts, natural functional food ingredients, natural pharmaceutical/nutraceutical extracts, aroma chemicals, essential oils, specialty citrus products, and natural gums. These unique specialty fine ingredients are sold principally to the food and beverage, flavor and fragrance, pharmaceutical/nutraceutical and personal care industries. Sales of Specialty Fine Ingredients have grown significantly from US$49 million in 2000 to US$140.8 million in 2012. The growth in the sales of the Specialty Fine Ingredients was mainly achieved by the development of new products, with special focus on natural products, by focusing on multinational, mid-sized and local customers and as a result of several strategic acquisitions successfully integrated with Frutarom's global activities. The relative portion of Frutarom's total sales deriving from the Specialty Fine Ingredients activity totaled 23% in 2012.

The majority of the fine ingredients produced by the Company are sold to third parties. However, some of the specialty fine ingredients are used by the Company as well, and there are few ingredients, such as in the citrus field and in the area of natural health products, which are used exclusively by the Company, for the development and creation of unique Flavor and Health solutions, giving Frutarom a competitive advantage.

**2.3** **Trade & Marketing Activity** – In addition to the Flavor and Specialty Fine Ingredients activities, Frutarom trades and markets various raw materials produced by third parties to customers in Israel and in central and Eastern Europe. This activity is not considered a core activity by the Company's management as volumes are low; it is therefore not reviewed separately in this report. In 2012, this activity totaled approximately US$22.3 million and its relative portion of Frutarom's total sales was approximately 4%.

**2.4** Frutarom's growth strategy is based on identifying major trends in the food and beverage markets and adjusting its activity accordingly, providing its customers solutions that speak to the forecasted demands of consumers. In recent years, leading food and beverage companies have increased the use of natural flavors and ingredients, with a special focus on functional foods (foods containing value-added nutritional ingredients) and on low-fat, low - sodium and low-sugar products and clean-label products perceived to be more nourishing, healthier and environmentally friendly. Consumers demand healthier products without compromising on stringent taste standards, despite the fact that many health ingredients also result in an aftertaste. Another trend arising in recent years is the number of hours the average consumer spends outside the home, resulting in increased demand for convenience food that is both tasty and healthy. This trend is supported by the rise in the scope of surplus consumer income, especially in emerging markets, and the willingness to increase spending on convenience products and other products perceived as healthier. In developed markets, we are witness to a continued trend of a consumer demand for more natural and healthy food. Frutarom has identified these trends and uniquely positioned itself as a solution supplier combining taste and health in response to consumer needs. Maximizing the synergy between its various activities enables Frutarom to offer its customers excellent science-based taste solutions and value-added health qualities with a special focus on the use of natural ingredients. The combination of its various activities also allows Frutarom to provide its customers with solutions for improving texture and prolonging the shelf life of their products (important qualities for processed food manufacturers in the production of convenience food) based on the combination of innovative, natural products.

## 3. Investments in the Company's Capital and Transactions in its Shares

**3.1** To the best of the Company's knowledge, no material investments were made in the company’s capital and/or material transactions made during the years 2011- 2012 in Company shares outside the stock exchange by any interested party in the Company.

**3.2** For further information regarding self-purchase of the Company’s shares as part of the compensation plan for Company employees, see Note 12b to the Company’s financial reports.

## 4. Distribution of Dividends

**4.1** In the last two years, the Company declared and distributed dividends to its shareholders as detailed in the following table:

| Year | Dividend Per Share in NIS | Total Sum NIS ,000 | Total Sum US$ ,000 | Distribution Date |
|---|---|---|---|---|
| 2011 | 0.20 | 11,565.3 | 3,380 | May 5, 2011 |
| 2012 | 0.20 | 11,565.3 | 3,029 | May 6, 2012 |

The stated dividends did not require court approval.

**4.2** As of December 31, 2012 the distributable retained earnings amount to US$318,807 thousand. Upon approval of the financial reports for the period ended December 31, 2012, the Board of Directors resolved to distribute a cash dividend in the amount of NIS 0.24 per share. An increase of 20% versus last year.

**4.3** The Company does not have a policy regarding distribution of dividends. The Company's decisions regarding distribution of dividends depend on several factors including but not limited to the level of the Company's profitability and its investment and strategic acquisitions plans. The Company intends to continue distributing dividends to its shareholders in the future. However, there is no guarantee that any dividend will be declared and distributed in the future, and any dividend distributed in the future will not necessarily be in accordance with the above.

**4.4** On February 16, 2012 the Company took upon itself the distribution of a dividend, as part of the adjustment of its financial covenants, under which it is entitled to distribute:

(A) 50% of the balance of surplus accumulated up to December 31, 2011, as this figure appears in the Company's balance sheet relating to 2011.

(B) 50% of the Company's annual profits for each calendar year, as this figure appears in the Company's financial statement for the calendar year in which these profits were accrued.

For further information, see the Company's immediate report dated February 16, 2012.

## CHAPTER 2 – OTHER INFORMATION

### 5. Financial Data Regarding the Company's Fields of Activity

5.1. In 2012, Frutarom's sales grew in dollar terms by 19.2%, achieving a yearly high of US$618 million, compared with US$518.4 million in 2011. The weakening of European currencies and the Israeli shekel against the US dollar detracted 5% from dollar sales. For further information regarding Frutarom's sales according to fields of activity, see section C to the Board of Directors' explanations to the state of the corporation's affairs in the Board of Directors' Report (Results of Activities in 2012).

5.2. The following tables show the Group's financial information for the years 2010 through 2012, broken down by fields of activity (in US$ 000)[3]:

**2012**

| | | Field of activity | | Adjustment to consolidated | Consolidated |
|---|---|---|---|---|---|
| | | Flavors | Fine Ingredients | | |
| **Income** | From external | 457,341 | 138,318 | 22,342 | 618,001 |
| | From other fields of activity | - | 2,445 | (2,445) | - |
| **Total Income** | | 457,341 | 140,763 | 19,897 | 618,001 |
| Expenses | Expenses that are income of other fields of activity | 2,445 | - | (2,445) | - |
| | Expenses that are not income of other fields of activity | 395,419 | 128,385 | 21,349 | 545,153 |
| **Total Expenses** | | 397,864 | 128,385 | 18,904 | 545,153 |
| **Operating Profit** | | 59,477 | 12,378 | 993 | 72,848 |

3 The profit from normal activities of all subsidiaries is attributable to the Company.

## 2011

| | | Field of activity | | Adjustment to consolidated | Consolidated |
|---|---|---|---|---|---|
| | | Flavors | Fine Ingredients | | |
| **Income** | From external | 369,894 | 142,176 | 6,373 | 518,443 |
| | From other fields of activity | — | 2,832 | (2,832) | — |
| **Total Income** | | 369,894 | 145,008 | 3,541 | 518,443 |
| Expenses | Expenses that are income of other fields of activity | 2,832 | — | (2,832) | — |
| | Expenses that are not income of other fields of activity | 320,251 | 133,263 | 6,265 | 459,779 |
| **Total Expenses** | | 323,083 | 133,263 | 3,433 | 459,779 |
| **Operating Profit** | | 46,811 | 11,745 | 108 | 58,664 |

## 2010

| | | Field of activity | | Adjustment to consolidated | Consolidated |
|---|---|---|---|---|---|
| | | Flavors | Fine Ingredients | | |
| **Income** | From external | 306,374 | 139,267 | 5,425 | 451,066 |
| | From other fields of activity | | 2,273 | (2,273) | |
| **Total Income** | | 306,374 | 141,540 | 3,152 | 451,066 |
| Expenses | Expenses that are income of other fields of activity | 2,273 | — | (2,273) | — |
| | Expenses that are not income of other fields of activity | 257,833 | 124,727 | 5,524 | 388,084 |
| **Total Expenses** | | 260,106 | 124,727 | 3,251 | 388,084 |
| **Operating Profit** | | 46,268 | 16,813 | (99) | 62,982 |

**5.3** Significance of adjustment to consolidated – The intercompany trade and marketing activity and the intercompany sales and purchases are cancelled in the framework of the adjustment to the consolidated report.

**5.4** Explanation of developments – For an explanation of developments that occurred in the data shown above, see the explanation in the Directors Report for the year ended December 31, 2012.

**5.5** The allocation of the joint costs of the Flavor and Specialty Fine Ingredients activities is made on the site level where joint resources for both fields exist, based on relevant loading criteria for each of the joint resources. Any change to the loading criteria requires advance management approval. In recent years there were no significant changes in the criteria for allocation of joint costs.

## 6. Market Environment and Influence of External Factors on the Company's Activity

Market Environment – Global Flavor and Fragrance Industry

Frutarom operates in the global flavor and specialty fine ingredients markets.

**6.1** The global flavors, fragrances and fine ingredients market in 2012 was estimated at approximately US$23 billion[4]. Frutarom does not operate in the market for fragrance compounds, but does operate in the markets for functional food ingredients (which is not included in the above estimation). Accordingly, the Company believes that the global market in which it operates is valued at approximately US$18.5 billion. Based on Leffingwell & Associates' data, Frutarom is ranked globally as one of the top ten companies in the field of flavors and fragrances.

**6.2** In 2011 IAL Consultants[5] estimated that global sales in industrialized nations (the USA and Western Europe) in the flavors market in which the Company operates would grow at an annual rate of between 3% and 3.4% during the years 2013-2015. The Company estimates that the volume of sales in these countries in the fine ingredients market in which the Company operates will increase at a similar annual rate during the same period. In accordance with these estimations, the growth rate in emerging markets in which Frutarom operates, such as Asia, Central and South America, Eastern Europe and Africa is expected to be significantly higher as a result of changes in consumers' preferences in these markets and the shift to processed foods, and may reach average annual rates of 4% to 7.1% from 2013 to 2015.

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11 ,Leffingwell & Associates, IAL Consultants October 2011October 2011
5 IAL Consultants October 2009.

**6.3** The manufacturers of the flavor, fragrance and fine ingredients markets can be divided into three main groups: (i) large multinational companies, (ii) mid-size companies, and (iii) local and small companies.

Large multinational manufacturers generally operate globally and have revenues in excess of US$1 billion. There are five such manufacturers in the global flavor and fragrance markets approximately 61% sales in the flavor, fragrance and fine ingredients markets (excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts), according to Leffingwell & Associates. These multinational manufacturers focus primarily on customers who are large multinational food and beverage producers.

Local and small companies generally have revenues of less than US$100 million (the greater part of these are much smaller and sell up to only several million dollars' worth). The Company estimates that there are approximately 700 companies in the global flavor and fragrance markets that represent approximately 20% of the value of the flavor, fragrance and fine ingredients market (excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts. These companies generally focus on smaller local customers and have limited service, research and development and innovation capabilities.

Mid-size companies, such as Frutarom, have revenues between US$100 million and US$1 billion. In the global flavor and fragrance markets there are eight such mid-size companies. According to the estimation of Leffingwell & Associates these companies represent approximately 19% of the value of the flavor, fragrance and fine ingredients market (excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts). Some of these mid-size players focus heavily on specific geographic markets (such as the USA, France and Japan).

**6.4** The flavor and fine ingredients market in which the Company is active is characterized by high entry barriers, such as:

- Long-term relationships – The market is characterized by long-term relationships between manufacturers and their customers, which include mostly the food and beverage, flavor and fragrance and pharmaceutical/nutraceutical industries. In these industries, reliability, quality of service and the manufacturers' knowledge and understanding of the customers' needs is of great importance.
- Research and development – End user preferences are dynamic, creating a competitive customer market (usually in

food or beverage). The market is characterized by an abundance of new and innovative products. Accordingly, manufacturers must invest heavily in research and development in order to offer a wide range of innovative products. Sometimes this investment is undertaken at the initiative of the flavor manufacturer while at other times it is the customers' initiative (food/beverage manufacturers) in collaboration with the flavor manufacturer.

- Compliance with quality and regulatory standards – Flavor and fine ingredients products are principally designated for the food and beverage and pharmaceutical/nutraceutical industries, which are subject to strict quality and regulatory standards. As a result, manufacturers are required to meet the same strict standards. In recent years quality and regulatory standards have become increasingly stringent, often intensifying the burden on competitiveness on small flavor manufacturers and increasing entry barriers for new players.
- The importance of flavors in the final product – Flavors play a major role in determining the taste of the end product and are often a vital element in determining success. Flavors cannot be precisely replicated and as they represent a relatively small percentage of the final product's overall cost, food and beverage manufacturers will usually avoid replacing the flavor and its manufacturer.
- Investment in production capabilities– In the fine ingredients field, considerable capital investment is required to build manufacturing facilities and/or increase existing production capabilities. These investments serve as a significant entry barrier for new manufacturers in the industry.

In light of the entry barriers described above, penetration of new manufacturers into the market is mainly through mergers and acquisitions. In general, the market is characterized by a trend of consolidation and a decrease in the number of players.

## CHAPTER 3 – DESCRIPTION OF THE COMPANY'S BUSINESS BY FIELDS OF ACTIVITY

**6.5** Frutarom is a global company that develops, manufactures, markets and sells flavors and specialty fine ingredients used in the production of food and beverage, flavors and fragrances, pharmaceutical/nutraceutical, personal care and other products. Frutarom operates principally in two activities, each of which constitutes a main field of activity[6] - the Flavors activity and the Specialty Fine Ingredients activity.

**6.6** The two Company activities are to a great extent complementary. This synergy may be observed in a number of areas:

- Sales and marketing – Frutarom's sales and marketing policy requires that a single dedicated salesperson work with each customer, providing sales services for the full range of Frutarom products. Specialty Fine Ingredients activity products intended for the food and beverage industry are sold through the Flavor activity's sales personnel.

- Research and development – The field personnel of the Flavor activity possess special knowhow and familiarity with the needs of food and beverage customers. This supports the development and production (benchmarking) of innovative specialty fine ingredients that meet customer needs.

- Operations – A number of Frutarom's production sites are shared between the two activities, thereby sharing resources.

- Fine ingredients – Most of the specialty fine ingredients produced by Frutarom are sold to third parties. Some of the fine ingredients are used by Frutarom's own Flavor Activity and some are produced solely for Frutarom, for the production of unique flavors that give Frutarom a unique competitive advantage in the market.

In light of the considerable synergy that exists between the two activities and Frutarom's commitment to providing comprehensive solutions combining flavor solutions with specialty fine ingredients - some of which possess health qualities - and ingredients which are meant to assist in the creation of texture and richness of the food product, it is not always possible to separate the fields of activity.

[6] In addition to its Flavor and Specialty Fine Ingredients activities, Frutarom, through its subsidiaries in Israel and in Slovenia, also imports and markets various raw materials to customers in Israel and in central Europe. This activity is not considered a core activity and in 2012 totaled approximately US$ 22.3 million or 4% of Frutarom's total activity. As this activity is not significant for Frutarom, it is not dealt with separately in this report, although it is reported as a separate business segment in the financial reports.

## Flavors Market

### 7. Overview of the Flavors Market

General

**7.1** Flavors are the key building blocks that impart taste in processed food and beverage products and, as such, play a significant role in determining consumer acceptance of the end products in which they are used.

**7.2** According to an estimate by IAL Consultants, an industrial and market research company[7], 2011 global sales of flavors for the industry amounted to approximately US$8 billion. Flavor products are sold primarily to producers of prepared food, beverages, dairy, bakery, processed meat and fish products, confectionery, oral hygiene, pharmaceutical products, animal feed and tobacco products

**7.3** The global market for flavors has expanded rapidly over the last 60 years, primarily as a result of an increase in demand for, as well as an increase in the variety of, consumer end products containing flavors. The demand for consumer goods containing flavor products has increased as a result of rapid population growth and consumer preferences resulting from various factors such as increases in personal income, leisure time, health concerns and urbanization. These factors have led to an overall increase in food and beverage products containing flavors and to rapid growth in demand for convenience food and foods with healthier and more natural content.

**7.4** The following table sets forth 2011 flavor sales by region and the projected annual growth rate in these geographic regions[8]:

| Country | **Estimated world consumption in 2011 (US$ million)** | **Average growth expected in 2011-2015** |
|---|---|---|
| Western Europe | 1,668 | 3.0% |
| Eastern Europe | 573 | 4.0% |
| North America | 2,394 | 3.4% |
| South America | 528 | 7.1% |
| Asia | 2,554 | 5.8% |
| Middle East and Africa | 565 | 4.4% |
| **Total** | 8,282 | **4.5%** |

[7] IAL Consultants October 2011
[8] Estimates based on IAL Consultants 2011.

**7.5** According to the above projections, Flavors' sales in North America and Western Europe in 2011 accounted for approximately 49% of global flavor sales in 2011 although the population in these countries account for less than 10% of the world's population. Demand for flavor products in developed countries is expected to grow moderately, with more rapid growth expected in emerging markets such as Asia Central and South America, Central and Eastern Europe and Africa. Sales in these emerging markets are expected to grow as a result of changes in consumer preferences and a shift to processed food. Frutarom is constantly acting to enhance its growth in these markets through a variety of approaches including a focused strengthening of the research and development, production, marketing and sales infrastructure in the important target countries and continued exploration of options for strategic acquisitions.

**Characteristics of the Flavors Market**

**7.6** Reliable, quality service – Food and beverage producers, the principal customers of flavor manufacturers, expect reliable, high-quality service to meet their needs in terms of support and lead time, while maintaining high quality, regulatory and safety standards. These requirements encourage the formation of long-term relationships between flavor producers and their customers. As a result large multinational customers, and increasingly also mid-sized customers, have reduced the flavor suppliers that they will work with to a select few named on their "core lists", creating an entry barrier for small flavor manufacturers.

**7.7** Research and development – The development of flavor products in general and of new flavor extracts in particular is a complex, creative and technological process that calls for depth of knowledge and skill on the part of a flavor manufacturer's research and development personnel. Effective research and development is critical in order to ensure a continuous stream of innovative products and to maintain profitability and growth for any flavor manufacturer. The initiative for the development of new flavor products can be spurred by the flavor manufacturer or by a customer in need of a specific flavor to be used in a newly developed end product. As such, in order to anticipate market demands, a flavor manufacturer's research and development personnel are required to be familiar with and benchmark the taste preferences of various end product types and target markets. In addition, as most flavors are tailor made for specific customers, a close collaborative relationship with the customer is essential, but customers are also less likely to change suppliers for such flavor products during the course of the end products' life cycle. These flavor formulas are commercial secrets and usually remain the property of the flavor manufacturer. As most flavor products are tailor made for specific customers, customers will usually refrain from changing suppliers for the lifetime duration of the final product.

**7.8** Low price sensitivity – Since flavor products play a major role in determining the flavor of the end product, they are a vital element of its success. Flavor products cannot be precisely matched and their cost, compared to the total cost of the end products, is negligible. When selecting a flavor supplier, a customer will generally place a greater emphasis on the reputation, innovation, service, quality and consistency of the supplier than on the price of its flavors. The demand for flavors is therefore generally less sensitive to changes in price.

**7.9** Production processes – Flavor products in general and flavor extracts in particular typically contain a variety of ingredients (typically over 30 per flavor), which are blended using unique formulas created by a manufacturer's flavorists. The production processes involved in the manufacture of flavor products are less complex and capital intensive compared to those of fine ingredients. However, the production process for flavor products requires skill and knowhow to achieve the required consistency and quality.

**7.10** High and relatively stable profitability – As the flavors market tends to be characterized by long-term relationships and high customer loyalty, combined with relatively low price sensitivity and simple production processes, it generally benefits from high and stable margins. This is true also in comparison to the fine ingredients industry.

**7.11** Entry barriers – for explanations regarding entry barriers characterizing the flavor market, see section 6.4 above.

**Characteristics of the Food and Beverage Market**

**7.12** Flavors are sold primarily to food and beverage producers; therefore the flavor market is generally driven by trends characterizing the demands of food and beverage consumers. According to Data Monitor, global sales in the food and beverage market amounted to US$4,650 billion in 2012. Frutarom estimates that over 60% of such total global sales are generated by mid-sized, local and small food and beverage producers. Although there has been a general trend towards consolidation in the food and beverage industry, Frutarom estimates that mid-sized (annual revenues of between US$100 million and US$1 billion) and local and small (annual revenues of below US$100 million) food and beverage producers will continue to play a significant role in the market, and that new mid-sized, local and small producers will continue to emerge.

**7.13** The large multinational flavor manufacturers often focus on large multinational food and beverage producers, offering their customers a high level of service and tailor-made product development. Frutarom believes that these flavors producers focus to a lesser extent on mid-sized and local customers, offering these customers limited service, and do not invest much resources in the development of tailor-made flavors for their needs. However, the Company believes that mid-sized and local food and beverage producers require the same level of service and tailor-made products as their larger counterparts, and also require short lead times and manufacturing flexibility. Small, localized flavor producers often do not have the product variety and service capabilities to support the variety of these customers' needs. A specific example of this type of customer is the private label customer (see section 7.14 below). This situation creates a business opportunity for mid-sized flavor producers to service this segment. For details regarding Frutarom's flavor activity with medium-sized food and beverage producers, see clause 8.3 below.

**7.14** The following are the main trends in the consumer market for food and beverages which in turn drive the flavors market:

- Local and global tastes – Taste preferences vary by geographic location and different cultures. Flavor manufacturers must have thorough knowledge of local tastes in each of the countries in which they are active. It is also important for a global flavor manufacturer to have a physical presence in its key target markets in order to facilitate direct contact with customers, to better understand local tastes and to be able to respond quickly and efficiently to changes in consumer preferences. Additionally, the trend toward globalization now characterizes the flavor industry as multinational food and beverage customers are now launching global brands in many different markets simultaneously, often by changing the taste profile to meet the preferences of the respective populations worldwide. For details regarding Frutarom's geographic reach and its familiarity with local flavors, see clause 8.2 below.

- Preference of natural products – There has been a general increase in consumer demand for food and beverage products containing natural ingredients and having dietary values (reducing fat, salt, sugar, etc.). Natural products are generally perceived by consumers as being of higher quality, healthier and more environmentally friendly. Similarly, there is growing demand for 'clean label' and organic products. As a result, natural food and beverage products are viewed as specialty, premium products that can command higher prices. This trend has created new opportunities for flavors' manufacturers to develop new and innovative natural flavor products. Frutarom focuses on developing and producing natural products and currently its products consist of more than two thirds natural products. In developed markets, the main growth derives from a shift in consumerism to products considered healthier and more natural, and a willingness, even in times of economic slowdown, to continue to purchase these products.

- Private label – private label food manufacturers, which tend to be mid-sized, local or small food manufacturers, are a growing customer segment in the flavor industry. Over the last decade food product consumers have become increasingly price conscious, increasing sales of private label products in comparison to the branded food and beverage industry. This trend, accelerated in 2009 as a result of the economic crisis, continued into 2010 and 2012 as well, and is expected to continue over the coming years. Consumers, who have tried and had a positive experience with private label products, tend to continue using these. In addition, the increasing power of grocery retailers and their determination to increase their activity margins have lead these to take action in order to strengthen private label product offerings, by allocating greater shelf space and increasing the range of products, among other things. In markets where private labels are especially strong, such as in the UK, private label market share has reached a high of 50%[9]. Furthermore, Supermarket chains and other retailers have also placed greater importance on developing their own brand image. The demand from supermarket chains and retailers for private label products that mimic existing branded products as well as unique premium products has provided the flavors industry with new opportunities for growth. Frutarom has increased and will continue to increase its market share in the private label market.

- Continuously growing consumption of convenience food – There is an increase in the demand for processed foods with greater convenience (consumed both inside and outside of the home)such as "ready to eat" meals, fresh pasta; ready-to-cook, fresh seasoned or marinated meat or poultry; salads; sauces in liquid form. This has created new opportunities for flavor manufacturers in the savory flavors and functional fine ingredients fields which are responsible for the creation of food texture and its extended shelf life, to develop and market flavors and unique fine ingredients products for this large market segment.

[9] Symphony IRI Group, December 2012

Emerging markets – In recent years, certain emerging markets, such as Asia, Central and South America, Central and Eastern Europe and Africa have experienced above-market-average growth in demand for flavors products. Further, these markets have been characterized by a trend towards increased consumption of processed foods, which in turn has driven the emergence of mid-sized, local and small food companies, creating new market opportunities for flavor manufacturers. The Company expects that the continued shift to processed foods and changes in consumer needs in these markets will bring about a continued growth in these markets, at a rate higher than the growth rates expected in developed markets.

Key Success Factors in the Flavor Division

**7.15** The Company's management estimates that the key success factors in the Flavors division are:

- Long-term relationships – Long-term relationships with customers and collaboration in the development of new products.

- Global and local presence in target markets – Knowledge of the various flavor preferences in the different markets and the ability to provide global and local support to customers. For details regarding Frutarom's broad global spread, see section 8.2 below.

- Superior and reliable service – The ability to provide a high level of service and the reliability of a flavors manufacturer in providing service are critical for mid-sized, local customers and multinational customers.

- Presence in emerging markets – Emerging markets grow at considerably higher rates than developed markets. Presence in these key regions, along with knowledge and understanding of their unique needs and the ability to provide support to local manufacturers, is a critical success factor.

- Innovation in research and development – The ability to develop innovative products both at the initiative of the flavor manufacturer and in collaboration with customers is of extreme importance.

- Compliance with strict quality, regulatory and safety standards – Since the flavors are intended principally for the food and beverage and pharmaceutical markets, they must comply with strict quality, regulatory and safety standards.

- Purchase of raw material - There is a growing importance to allocating resources to focused purchase in countries which serve as important sources of many natural raw materials, such as China, India and Brazil, while expanding the choice of suppliers, maximizing the potential to reduce costs through global purchase strengthening relations with raw material manufacturers, processers and growers, mainly natural raw materials, in order to guarantee continuous and reliable supply over time and for improved purchase costs.

## 8. Products and services in the Flavor Activity Segment

Frutarom's Flavor Activity, the most profitable of Frutarom's activities, has undergone accelerated growth since 2000. Flavor sales grew from US$26.5 million in 2000 to US$457.3 million in 2012. This growth in sales is principally the result of (a) the strategic focus on the fast growing area of natural food flavors; (b) the development of innovation-based unique solutions combining taste and health for the large multi-nationals; (c) the focus on mid-size and local customers (in emerging and developed markets), with special emphasis on private label companies, providing them with customized services, including technological and marketing support, product development support, tailor-made products, and high level services, as are normally provided to large multi-national companies; and (d) as the result of Frutarom's strategic acquisitions, which have and are being successfully incorporated into Frutarom's global activities.

**8.1** The relative portion of the Flavors Activity out of Frutarom's overall activities grew from 33% in 2000 to 74% in 2012.

**8.2** As the success of many of the flavors developed by Frutarom depends on knowledge of local tastes, in the Flavor's segment, Frutarom maintains approximately 25 local research and development laboratories and 41 sales and marketing operations in close proximity to its customers in the target markets. In addition, Frutarom's global presence enables it to introduce new tastes to local markets. Frutarom's global reach also provides it with the means to service the needs of food and beverage producers launching global brands in many markets simultaneously.

**8.3** Frutarom's Flavor Activity provides an efficient, high quality response to the accelerated growth of private label products, providing assistance and support in developing and marketing the products. Private label manufacturers tend to be mid-sized, local food and beverage producers. Frutarom offers these customers technological support, assistance with the development of products, marketing assistance and a comprehensive product offering, with personalized services suited to each customer's unique needs and flexibility in terms of minimum quantities and lead times Frutarom’s acquisitions over the last few years considerably expanded Frutarom's product offering to private label manufacturers, and expanded its global spread, allowing Frutarom to be nearer to its customers.

**8.4** Frutarom's Flavor Activity offers a wide variety of flavor products designed to enhance or create new tastes and/or to mask certain tastes in processed foods and beverages.

**8.5** Most flavor products consist of numerous raw materials (typically more than 30 raw materials per flavor) combined according to formulas developed in the Frutarom’s laboratories by the research and development team of the Flavor activity. The development of a new flavor is undertaken either at Frutarom's own initiative or according to the specific requirements of its various customers and in close collaboration with them.

**8.6** Frutarom's flavor products can be divided into different categories: by application (beverage, dairy, snacks, confection, processed meat and fish, etc.), by source of raw materials (natural/ organic/artificial), by taste (sweet, savory), by medium (liquid/ powder/ emulsion/ granulated/ paste), and more.

**8.7** Applications – The flavors produced by the Company are used primarily as ingredients in consumable goods manufactured by food and beverage producers and are suited for different types of applications such as soft drinks and juices, dairy and ice cream products, pastries, confectionery, chewing gum, and a variety of savory foods including snacks, soups and salad dressings, as well as processed meat, meat substitutes. Pharmaceuticals and pet food.

**8.8** Source – Frutarom offers natural, organic, nature-identical and artificial flavors. The natural compounds are produced only by natural ingredients including natural extracts and essential oils. The nature-identical and artificial compounds are produced also using synthetic ingredients. Some of Frutarom's flavors products contain unique ingredients manufactured by the Company's Specialty Fine Ingredients activity exclusively for the Flavor activity.

**8.9** Taste – Frutarom produces both sweet and savory flavors. The sweet flavors are used primarily for beverages, dairy products, ice creams, pastries and confections. The savory flavors are used primarily in the production of snacks, salty pastries, processed meat and fish and convenience food. Additionally, Frutarom produces unique seasoning mixes and functional ingredients for meat, poultry and fish processors, as well as a variety of flavors of meat substitutes designed to help impart meat flavor in vegetarian preparations.

**8.10** Medium – Frutarom sells its flavor products in stable liquid, paste, powder, emulsion and granulated form and sometimes bundled with stabilizers and emulsifiers (ingredients which alter texture and other properties of the products to which they are added).

**8.11** Composition - Frutarom produces both flavors which do not include fruit, vegetables etc. components, as well as a wide variety of food systems products which do include, among other things, fruit, vegetables and other natural ingredients along with a combination of flavors. The food systems also include sweet and savory sauces such as pizza sauces and salad dressings, ready-to-eat fillings for pasta and other types of ready-to-eat meals, and other preparations made from fruit, vegetables and other natural ingredients used in a wide range of food products, such as dairy (yogurts, ice cream, chilled desserts, butter and cheese), sweet and savory baked products, ready-to-eat meals and other convenience food products. Frutarom's capabilities in the food systems business allows it to combine several fields of its core expertise, as food systems often are produced using flavors, natural flavor extracts and increasingly, natural functional food ingredients manufactured under the Specialty Fine Ingredients activity, allowing it to provide customers with comprehensive, tailor-made solutions.

## 9. Segmentation of the Income and Profitability of Products and Services

The following are the Group's sales (in US$ thousands) for the years 2009 through 2011, showing Flavor Activity sales and their percentage of the Group's total income:

| | **2012** | **2011** | **2010** |
|---|---|---|---|
| *Group's total income* | 618,001 | 518,443 | 451,066 |
| *Income from Flavors division* | 457,341 | 369,894 | 306,374 |
| *% of Company's total income* | 74.0% | 71.3% | 67.9% |

The strengthening of the US dollar against the European currencies and the NIS detracted from Frutarom's activities in US dollar terms in 2012 (in 2011 the weakening of the dollar contributed to an increase in activity, and in 2010 the strengthening of the dollar offset the increase in Frutarom activities).

## 10. New Products

As part of its Flavors activity, Frutarom is constantly developing a variety of new products. New products are generally developed in cooperation with and adapted to the needs of specific customers. No new product developed by the Company is significant in terms of expected sales turnover and/or development costs.

## 11. Customers

**11.1** The flavors manufactured by Frutarom are sold to an extensive customer base comprised of thousands of large multinational, mid-sized, local and small customers. The customers are primarily food and beverage manufacturers and they are located in over 120 different countries worldwide.

**11.2** The Flavors activity does not have any one customer whose purchasing turnover constituted over 10% of Frutarom's sales turnover (over the last few years there have also been no customers whose scope of purchase was more than 3% of Frutarom's sales turnover). The management of the Company estimates that it has no dependency on any one of its customers.

**11.3** The majority of sales are made to permanent customers since, as previously discussed, the flavor segment is characterized by long-term relationships and customer loyalty. As is customary in the flavor market, there are no long-term supply contracts.

## 12. Orders Backlog

As is customary in the flavor market, orders are received on an ongoing basis, close to the supply date and therefore there is no issue of significant order backlogs.

## 13. Competition

**13.1** In the flavors market, Frutarom's competitors are large global manufacturers, mid-sized companies and smaller, local manufacturers. Competition is based to a large extent on innovation, product quality, the ability to provide the customer with added value and establish and maintain long term customer relationships, value added services, reliability and development of products which are tailor made for the customers' needs and the future market directions. As the cost of flavors accounts for only a small percentage of the total cost of an end product, this market tends to display low price sensitivity. Flavor manufacturers must differentiate themselves by maintaining close collaborative relationships with customers, thorough knowledge and understanding of target markets, innovative abilities, effective research and development, establishing reputation for consistent, reliable and effective service, product supply and quality, and the ability to supply products on short notice and with short lead time.

**13.2** Large multinational flavor manufacturers are established, experienced companies with a global presence and established technical and commercial capabilities, focusing primarily on large multinational customers. The large multinational flavors producers with whom Frutarom competes include Givaudan, Firmenich, IFF Inc., Symrise and Takasago.

**13.3** The midsized flavors manufacturers with whom Frutarom competes focus on both large multinational food and beverage producers as well as and primarily on mid-sized and smaller food and beverage producers who tend to operate in smaller geographical regions. Mid-sized flavor manufacturers with whom Frutarom competes include Sensient, Mane, Robertet, Kerry Ingredients; Wild and Dohler.

**13.4** The Company estimates that there are over 700 small and local flavor manufacturers with more limited research and development capabilities who focus on narrow market segments and local customers. In recent years there has been a trend towards consolidation in the flavor manufacturing industry, resulting in increased market concentration.

**13.5** For further information regarding manufacturers acting in the taste and aroma market, and Frutarom's place among these, see section 6.3 above. For details regarding the influential factors on the position of the Group in the flavors market, see section 7.15 above ("key success factors in the flavor market").

## 14. Production Capacity

Production processes in the Flavor segment are relatively simple and do not require significant capital investment, therefore production capacity is not a significant factor nor a restriction on the Company's ability to meet its customers' demands or on its ability to grow in the Flavors Activity. For more production capacity information see section 26 of this report.

## Specialty Fine Ingredients Market

## 15. Overview of the Fine Ingredients Market

General

**15.1** The specialty fine ingredients market in which the Company operates produces ingredients for a variety of industries. Frutarom's Specialty Fine Ingredients activity is focused mainly on developing, producing and marketing natural fine ingredients for the food and beverage, flavor and fragrance, pharmaceutical/nutraceutical and personal care industries. Fine ingredients are often sold directly to food and beverage manufacturers who use them in the manufacture of consumer end products. Flavor and fragrance manufacturers use fine ingredients products as the building blocks for the flavor and fragrance compounds they manufacture.

**15.2** Frutarom operates in the following fields of the specialty fine ingredients market: natural flavor extracts, natural functional food ingredients, natural pharmaceutical/nutraceutical extracts, specialty essential oils and citrus products, aroma chemicals, and natural gums.

**15.3** According to an estimate by Koncept Analytics[10], the sales of specialty fine ingredients in the flavor and fragrance industries in the USA and Western Europe are expected to grow at an annual rate of 1.9% to 3.2% during the years 2012 – 2014, while the growth rate in emerging markets such as Central and Eastern Europe, Asia, and Central and South America is expected to be much higher, reaching an annual average of 3.9% to 6.0% between the years 2012 – 2014.

## Characteristics of the Fine Ingredients Market

**15.4** Research and development – Innovation is a key success factor in the fine ingredients market. Research and development of new fine ingredients products is a sophisticated process that requires a high level of expertise, experience and investment. In many cases, the development of new fine ingredients products takes longer than that of flavor products. Some of the natural fine ingredients are tailor-made to customer needs and require long-term relationships with the customers and collaborative development efforts.

**15.5** Production – The production of fine ingredients tends to be more sophisticated and complicated than the production of flavors, requiring extensive knowhow. In addition, the production of fine ingredients requires greater capital investment in the construction of manufacturing facilities, as well as in increasing production capacity when required. The production of fine ingredients must also comply with stricter environmental and regulatory standards.

**15.6** Supply chain – Customers are increasingly seeking to optimize their inventory level, therefore requiring fine ingredients manufacturers to meet shorter lead times and to keep local stocks in main markets. In addition, mid-sized and local customers purchase hundreds of fine ingredients in variable, relatively small

[10] Koncept Analytics, November 2010

quantities. The large multinational fine ingredients manufacturers often have strict policies of minimum quantity and standardized packaging, while small fine ingredients manufacturers generally do not have the operational flexibility and the required global supply chain to meet the needs of many mid-sized customers. This has created a market opportunity for mid-sized fine ingredients producers.

**15.7** High entrance barriers – An established reputation and brand recognition, which can only be developed over time are key success factors for manufacturers in the fine ingredients market. Food and beverage producers require a high degree of reliability and consistency, and once an ingredient is incorporated into a product, producers rarely risk replacing the fine ingredients supplier in order to avoid an adverse effect on the quality of that product. In addition, building a competitive advantage of a multinational fine ingredients manufacturer requires compliance with stringent supervisory, regulatory and environmental demands as well as strong research and development, production and global supply chain capabilities, including capital investments in construction of production facilities and increasing the production capacity when and if necessary. These factors create significant entry barriers.

**15.8** Growing demand for natural products – The rise in consumer demand for natural products has in turn increased demand that a variety of fine ingredients, such as natural flavor extracts and natural specialty essential oils, be used in such products. Natural fine ingredients tend to be more unique and less interchangeable, resulting in greater customer loyalty. Many of the natural extracts and specialty essential oils are tailor-made to customer needs. Frutarom focuses on the development of natural products, providing a solution to this growing global consumer trend. For further details, see section 16.5 below.

**15.9** Growing demand for functional food ingredients – Functional food is food with certain added ingredients which provide, or are perceived as providing, health benefits, such as juices or milk products with health additives. Changing consumer preferences lean towards food with health advantages, leading to increasing demand for functional food. The end user markets of the functional food industry exhibiting the highest growth are the dairy and beverage markets. Many of the active ingredients used in functional foods are derived from plants and herbs using similar production processes as those used in the production of flavor extracts. Functional food ingredients manufacturers are often required by food and beverage producers to provide a scientific basis for the health claims attached to such functional food ingredients, such as clinical studies.

**15.10** Regulatory, health safety and certification – The fine ingredients used in the food, beverage and pharmaceutical/nutraceutical industries are increasingly subject to strict health and safety regulations. At the end of 2006, REACH regulations were published in the EU detailing the registration arrangements, assessments, certifications and restrictions on all chemicals produced in or imported into the European market. In December 2008 the EU adopted a new regulation prescribing definitions, labeling requirements and maximum quantities of BAP's (Biologically Active Principles), which came into force on January 20, 2011. In January 2009 the European Union adopted regulation 1334/2008 on the matter of flavors, defining natural products and the manner of labeling such. This regulation went into effect on January 20, 2011.

Customers of raw materials in general and specialty fine ingredients in particular often require their manufacturers to provide certification that their products meet strict regulations and standards. In addition, there is increasing demand for products with certain proven qualities, such as genetically modified organism free ("GMO-free") or products that are pesticide free. Kosher and Halal certified products are also increasing in demand by a wider demographic customer base. As a result, fine ingredients manufacturers are increasingly required to document their manufacturing processes and to adhere to strict standards in order to ensure compliance with such certification requirements. Lastly, fine ingredients manufacturers are expected to be approved by various manufacturing standards such as ISO 9001, Swiss GMP, ISO 22000 and BRC Version 6 (British Retail Consortium).

Frutarom's specialty fine ingredients comply with strict health, safety and quality standards. For further details, see section 16.4 below.

**15.11** Sourcing – in order to maintain a high level of product quality and consistency and to ensure the availability of raw materials used for the production of the specialty fine ingredients, as and when needed for production, long term relationships with suppliers, growers and/or producers of raw materials are of crucial importance to the specialty fine ingredients manufacturers. This is the case particularly for natural raw materials, which are mostly crop-related goods and are often subject to seasonality in supply.

**15.12** Production of high volume of fine ingredients with low margins – during recent years, there has been an increase in the production of certain fine ingredients, in certain countries such as China and India, where the cost structure is lower for manufacturers. A large number of these manufacturers tend to have less technical sophistication and research and development capabilities, and they focus more on higher volume, lower margin fine ingredient products. In addition, they tend not to have global sales and marketing capabilities, brand recognition or approved supplier status. This has led certain fine ingredients' manufacturers to set themselves apart from these low-cost manufacturers, by developing close, collaborative relationships with customers, providing higher added-value products and services, and investing in research and development in order to develop higher margin, specialty fine ingredients products.

## Key Success Factors in the Fine Ingredients Division

**15.13** The Company's management estimates that the key success factors in the Fine Ingredients division are:

- Positioning and reputation as a reliable supplier – it is extremely important to have reliable service and to build up a reputation as a supplier in the market.

- New, innovative and comprehensive product portfolio – in the fine ingredients market, it is very important to have new, innovative, added-value products that satisfy consumer demand.

- Innovation in research and development – suppliers must have strong research and development and innovation competencies to supply innovative products such as functional food ingredients, and to adapt products, mainly natural, to customer needs.

- Compliance with quality, regulatory and safety standards – since fine ingredients are intended for the food and beverage and pharmaceutical/nutraceutical markets, which provide health benefits apart from taste, they must comply with strict quality, regulatory and safety standards.

- Raw material procurement – there is a growing importance to allocating resources to focused procurement in countries which serve as important sources of many natural raw materials used for the production of specialty fine ingredients, such as China, India and Brazil, while expanding the choice of suppliers, maximizing the potential to reduce costs through global purchase and strengthening relations with raw material manufacturers, processers and growers, mainly natural raw materials, in order to ensure continuous and reliable supply of raw materials over time and improvement of purchasing cost. Locating quality raw materials and the right timing for the purchase of these is the key to maintaining timely and stable supply for customers and for keeping up with the changing demands in quantity and quality.

- Wide geographic reach to support and service multinational customers – The wide geographic reach of the Company providing multinational customers support and ongoing assistance during working hours, in the language of the customer and its location, is imperative.

## 16. Products and Services in the Fine Ingredients Division

**16.1** Under the Fine Ingredients activity, Frutarom develops, manufactures, markets and sells natural flavor extracts, natural functional food ingredients, natural pharmaceutical/nutraceutical extracts, specialty essential oils and citrus products, aroma chemicals, natural gums and more.

**16.2** Specialty Fine Ingredients sales grew substantially from US$49 million in 2000 to US$140.8 million in 2012. The growth in Specialty Fine Ingredients sales results mainly from the development of new and innovative products focus on both multinational customers and mid-sized local customers and from the strategic acquisitions successfully executed. The portion of Specialty Fine Ingredients sales out of Frutarom's total sales totaled 23%in 2012. Specialty Fine Ingredients are sold primarily to the food and beverage, flavor and fragrance, pharmaceutical/nutraceutical and personal care industries.

**16.3** Frutarom has an established reputation in the market for fine ingredients, with a broad customer base of multinational, mid-sized and local customers supported by Frutarom's sales and marketing team and efficient global supply chain. The Company has local warehouses in Europe, USA, Central and South America and Asia allowing it to supply its products to its customers in a timely manner, in most cases, within several days. Although the majority of the fine ingredients produced by the Company are sold to third parties (including competing flavor manufacturers), a portion of Frutarom's fine ingredients production is used for its Flavor activity, and some unique raw materials, such as citrus products and natural health products, are used solely by the Company for the development and creation of unique flavor and health solutions, giving Frutarom a competitive advantage.

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**16.4** Frutarom's specialty fine ingredients meet strict health, safety and quality standards, such as Swiss GMP, British BRC and ISO 9000 standards. Frutarom's fine ingredients are also generally

GMO-free and pesticide free, and satisfy a variety of Kosher and Halal certifications.

**16.5** Frutarom focuses on the development of natural products, providing a solution to the growing global consumer trend of natural products consumption, which is considered healthier. Frutarom's management believes that the Company is one of the world leaders in this market and successfully uses its experience of over 80 years of research, development and production of natural and unique specialty fine ingredients, allowing it to offer a wide variety of products based on a global, efficient supply chain. Frutarom's in-depth knowledge of the flavors market and its knowledge of customer demand in the food industry, and of specialty fine ingredients, places Frutarom at a unique meeting point allowing it to provide solutions combining both flavor and health.

**16.6** Frutarom believes that its relationship with and understanding of food and beverage markets provide it with a competitive advantage in the functional food ingredients market. This is complemented by Frutarom's research and development capabilities, proprietary production technologies and clinical study capabilities.

As stated, Frutarom's Specialty Fine Ingredients division is divided into several main categories:

**16.7** **Natural Flavor Extracts** – Frutarom is a leading manufacturer of a wide variety of natural flavor extracts which are extracted from fruit, plants and other botanical materials Frutarom's main customers for natural flavor extracts are food and beverage producers, flavor and fragrance companies (including the Company's own Flavors activity) and, to a lesser extent, tobacco companies. The natural flavor extracts are generally tailor made products and the Company works in close collaboration with customers to create the exact flavor extract required.

**16.8** **Natural Functional Food Ingredients** – The Company offers a variety of standardized natural extracts used as raw materials in the manufacture of functional food. Functional foods are foods which include additional specialty fine ingredients which provide health benefits. Functional food ingredients are subject to different requirements, but at the same time are subject to less restrictions than pharmaceutical/nutraceuticals. The main customers for the Company's functional food ingredients are food and beverage producers.

**16.9** **Natural Pharmaceutical/Nutraceutical Extracts** – Frutarom manufactures a variety of standardized natural extracts with certain medicinal and health benefits used in the manufacture of prescription drugs, over the counter pharmaceutical products and natural dietary supplements. The main customers of the pharmaceutical/nutraceutical extracts are pharmaceutical companies, nutraceutical and dietary supplement producers.

**16.10 Specialty Essential Oils and Citrus Products** – Frutarom produces a wide range of specialty essential oils and is a leading producer of specialty citrus products. Specialty essential oils produced by Frutarom include citrus (such as orange, grapefruit and lemon), mint (peppermint and spearmint), floral, seasoning, herb and woody oils. These products are used in food and beverages, flavor and fragrance applications, pharmaceutical products, cosmetics and other wellness and personal care applications.

The Company's management estimates that Frutarom is the global leader in specialty citrus products used to infuse citrus flavors into food, beverages, fragrances and other personal care products. Frutarom has been active in the production of citrus specialties since 1933. The Company continuously invests in innovative and unique technologies for processing, extraction and distillation of specialty citrus products. The Company is an approved supplier of citrus specialty products to large multinational and mid-sized flavor manufacturers. Specialty citrus products manufactured by Frutarom include orange, grapefruit, sweetie (a citrus variety derived from hybridization of pomelo and white grapefruit), lemon, lime and mandarin ingredients. A number of Frutarom's citrus specialty products are reserved for the exclusive use of the Flavors activity and are not sold to third party flavor manufacturers, providing the Company with a competitive advantage in the production of citrus flavors.

**16.11 Aroma Chemicals** – Frutarom produces over 600 different types of aroma chemicals used in the manufacture of flavor and fragrance compounds, food, animal feed, cosmetics, oral hygiene products and other applications. Frutarom is a leading global player in the field of unique aroma chemicals, focusing on research and development, manufacturing and selling of high-added-value specialty aroma chemicals, with a continuous trend in product mix towards low volume, high margin products. Frutarom's range of aroma chemicals used in flavor and fragrance applications includes diketones and pyrazines, used to create roasted and toasted aromas. In addition, Frutarom manufactures unsaturated aldehydes, cooling agents designed to impart a cool sensation when orally consumed or applied to the skin, used in the manufacture of candies, chewing gum, skin care products and oral hygiene products, among others.

**16.12 Natural Gums** – Frutarom offers a range of natural water soluble gums and stabilizers derived from a variety of botanical sources, including certain types of gum trees, seeds, seaweed and beet sugar. The natural water soluble gums and stabilizers are used in the production of food, beverages, pharmaceuticals and cosmetics. The main customers are producers of food, beverages and flavors, and pharmaceutical companies.

## 17. Segmentation of the Income and Profitability of Products and Services

The table below presents data on the Company's sales (in US$ millions) for the years 2010 through 2012 deriving from the Specialty Fine Ingredients division and from the Aroma Chemical products, and its portion of the Group's total income:

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Group's total income | 618,001 | 518,443 | 451,066 |
| Income from Specialty Fine Ingredients division | 140,763 | 145,008 | 141,540 |
| Income from aroma chemicals | 48,170 | 48,133 | 50,071 |
| % of income from Specialty Fine Ingredients | 22.8% | 28% | 31.4% |
| % of income from aroma chemicals | 7.8% | 9.3% | 11.1% |

The strengthening of the US dollar against the European currencies and the NIS detracted from Frutarom's activities in US dollar terms in 2012 (in 2011 the weakening of the dollar contributed to an increase in activity, and in 2010 the strengthening of the dollar offset the increase in Frutarom activities).

## 18. New Products

Frutarom develops new Specialty Fine Ingredients as part of its ongoing activity in order to strengthen its position and improve its product diversity while replacing low profit margin products with innovative, added-value products with higher profit margin. No single new product is significant from the aspect of forecasted sales turnover and/or development expenses.

## 19. Customers

**19.1** The Specialty Fine Ingredients manufactured by Frutarom are sold to a large customer base that includes many large multinational, mid-sized, local and small customers in the food and beverage, pharmaceutical/nutraceutical, flavor, fragrance and personal care industries.

**19.2** The Specialty Fine Ingredients activity has no one particular customer with a purchasing turnover exceeding 10% of the Group's sales turnover. (Over the last few years there have also been no customers whose scope of purchase was more than 2% of Frutarom's sales turnover). The Company's management believes that it is not dependent on any of its customers.

**19.3** Excluding a number of supply contracts for periods not exceeding one year, most sales are made on the basis of specific orders by customers and based on the Company's forecast. Sales are mainly to permanent customers with long-term relationships.

## 20. Order Backlog

As customary in the specialty fine ingredients market, orders are received on an ongoing basis close to the supply date and therefore significant order backlogs are not applicable. There are a number of supply agreements for periods not exceeding one year, none of which are significant relative to the Company's overall activity.

## 21. Competition

**21.1** In the market for specialty fine ingredients, competition varies by product category.

**21.2** In the natural flavor extract category, the Company's competitors are manufacturers that specialize in natural flavor extracts, such as Naturex, pharmaceutical/nutraceutical manufacturers and multinational and mid-sized manufacturers that produce specialty fine ingredients, mainly for internal use, such as Givaudan, IFF, Symrise, Sensient, Robertet and Mane.

**21.3** In the functional food ingredients and pharmaceutical/nutraceutical extracts category, Frutarom's competitors are mainly of specialized pharmaceutical/nutraceutical companies such as Naturex, Indena S.p.A., Martin Bauer GmbH & Co. and KG, as well as a number of smaller, innovative, start-up companies that concentrate on unique products or technologies.

**21.4** In the essential oils category, Frutarom's competitors include companies such as Treatt plc that focuses on the manufacture of essential oils, including specialty essential oils as one of their product offerings, and large multinational and mid-sized flavor manufacturers that produce specialty essential oils primarily for internal use. There are also growers and processors of essential oils, mainly in developing countries, represented by traders and distributors of specialty essential oils, also competing in the market for essential oils.

**21.5** In the aroma chemical category, the Company competes with large multinational flavor manufacturers who produce specialty aroma chemicals primarily for internal use. Additional competitors in this field are specialized aroma chemicals manufacturers such as Aromor, Fontarome and Bedoukian Research. Other manufacturers of aroma chemicals are generally low cost local producers, located mainly in Asia. These manufacturers have direct and limited sales and marketing infrastructures, and they are often reliant on traders for the purpose of marketing and selling their products. There are also large chemical companies that manufacture high volume aroma chemicals as part of their wider product offering but in most cases do not offer specialty aroma chemicals. For the most part, Frutarom does not compete with these low-cost producers as it focuses on higher profit margin specialty aroma chemicals whose scope is not substantial, with relatively high profit margins.

**21.6** For further information regarding manufacturers acting in the specialty fine ingredients market, see section 6.3 above. For details regarding the factors affecting the Group's position in the specialty fine ingredients market, see section 15.13 above ("Key success factors in the specialty fine ingredients market").

## 22. Production Capacity

For further information on production capacity see section 26 of this report.

## 23. Frutarom's Trade and Marketing Activity

**23.1** As stated above, Frutarom has additional activity in the field of importing and marketing of certain raw materials produced by third parties to the food, pharmaceutical, chemicals, cosmetic, and detergent industries in Israel and central and Eastern Europe.

**23.2** The raw materials sold and marketed by the Trade and Marketing activity are mainly raw materials that Frutarom imports for the manufacture of its specialty fine ingredients.

As Frutarom imports and purchases these materials in bulk or in large quantities, it is able to purchase these materials at attractive prices and sell them at a premium to third party companies.

**23.3** Trade and Marketing are not part of Frutarom's core activities and account for only a small portion of its sales and profit. In 2012 this activity totaled US$22.3 million, and its portion of Frutarom's overall activity totaled approximately 4%. In view of the fact that this activity is not significant to Frutarom, it is not dealt with separately in this report.

# CHAPTER 4 – DESCRIPTION OF THE COMPANY'S BUSINESS: MATTERS RELATING TO THE COMPANY'S OVERALL ACTIVITY

## 24. Marketing and Distribution

24.1 Frutarom maintains a global marketing, sales and customer technical support organization, with established local R&D, sales and marketing personnel in all of its key target markets. The Company estimates that its global presence provides it with a competitive advantage and is a key factor in the success of its growth strategy. On December 31, 2012, Frutarom had 671 professionals, approximately 50 sales and marketing offices and 31 research and development laboratories located in its target markets in close proximity to its customers, including in the US, Brazil, Costa Rica, Mexico, the UK, Germany, Switzerland, France, Italy, Slovenia, Norway, Denmark, Israel, Russia, Ukraine, Turkey, Kazakhstan, Romania, Czech Republic, China, Vietnam, Japan, Hong Kong, Indonesia, India, Nigeria and South Africa. The Company markets and sells its products primarily through its own sales personnel. In certain countries, Frutarom uses third party agents and distributors to sell its products.

24.2 Frutarom's global sales and marketing organization is a key component of its strategy to provide tailor-made specialized products and services and high quality customer support to both large multinational and mid-sized and local customers.

24.3 Frutarom differentiates itself from its major competitors by offering its mid-sized and local customers the same quality of service and tailor-made product specialization that it offers to its large multinational companies. Frutarom's sales and marketing personnel and its research and development personnel work equally closely with both large multinational and mid-sized and local companies to offer timely and responsive personalized development services, including custom flavors development and specialty fine ingredients tailor made to the customer's specific needs. The Company estimates that the mid-sized and local customer segment represents more than 60% of the global food and beverage market.

24.4 The Flavor and Specialty Fine Ingredients activities each have their own separate sales, marketing and customer support personnel. However, Frutarom assigns one dedicated salesperson to any customer purchasing the products of both activities. This single-sales person interface allows Frutarom to better respond to its customers' needs and to identify and realize cross-selling opportunities.

24.5 The Flavor activity's sales, marketing and customer support activities focus primarily on customers in the food and beverage industries, while the Specialty Fine Ingredients activity's sales, marketing and customer support activities focus the activities also on customers in the flavor, fragrance, pharmaceutical/nutraceutical and personal care industries.

24.6 Frutarom's marketing and sales team form an important link between Frutarom's customers and its research and development team. Working closely with customers is necessary in order to understand their specific needs while relaying this information in full cooperation to the research and development team, which, in turn develops tailor-made products for such customers' specific needs.

24.7 In certain cases, particularly in emerging markets, Frutarom offers its customers technological and marketing support in order to help them expand and improve their product offering and quality and their manufacturing processes. Frutarom believes that this approach further strengthens its relationships with these customers and helps to increase demand for its products.

24.8 The Group’s management estimates that it does not depend on any one of its marketing channels.

## 25. <u>Seasonality</u>

**25.1** The Company’s business is subject to seasonal fluctuations, generally with higher sales and profitability in the first half of a given year and lower sales in the second half of a given year (in particular, in the fourth quarter). A major part of the Company’s products are used by its customers in the manufacture of beverages and dairy products such as soft drinks, ice cream and yogurts, for which demand generally increases markedly during the summer months. As a result, sales of certain flavors and fine ingredients produced by Frutarom rise in the first half of the year, as manufacturers of beverages and dairy products re-stock their inventories and increase production in advance of rising demand during the summer months.

**25.2** Sales of the Company’s products slightly decrease in the third quarter as the summer ends and further in the fourth quarter as the weather cools, and many of Frutarom’s customer’s reduce production and inventory levels in advance of the year end and the holiday season.

The impact of seasonality on the Company's results has steadily decreased in recent years as the Company has increased its sales of products such as savory flavors, functional food ingredients and natural botanical extracts intended for the pharmaceutical/nutraceutical industry, generally less impacted by seasonality.

**25.3** The following is the quarterly profit and loss reports in the years 2011-2012:

| | Q4 2012 | Q3 2012 | Q2 2012 | Q1 2012 | Q4 2011 | Q3 2011 | Q2 2011 | Q1 2011 |
|---|---|---|---|---|---|---|---|---|
| **Income** | 144.9 | 157.1 | 164.8 | 151.2 | 131.6 | 135.3 | 130.6 | 121 |
| **Gross profit** | 51.5 | 58.1 | 61.8 | 54.9 | 46.8 | 47.7 | 48.5 | 45.7 |
| **R&D, Sales, Management & General expenses** | 37.8 | 38.5 | 40 | 37.1 | 34.6 | 34.8 | 31.5 | 29 |
| **Operating profit*** | 13.7 | 19.5 | 21.8 | 17.8 | 12.2 | 12.9 | 17 | 16.6 |
| **EBITDA*** | 20.7 | 26.3 | 28.5 | 25.0 | 18.1 | 18.6 | 22.2 | 21.5 |
| **Finance** | 1.4 | 0.6 | 4.3 | 0.9 | 3.2 | 2.6 | 0.8 | -0.9 |
| **Income before tax** | 12.3 | 18.9 | 17.5 | 16.9 | 8.9 | 10.3 | 16.2 | 17.5 |
| **Net profit** | 10.5 | 14.4 | 13.5 | 13.5 | 7.9 | 8.7 | 12.3 | 13.1 |

* One-time expenses in the amount of approximately US$1.5 million affected operational profit in 2012 (reorganization expenses of US$2.2 million, acquisition expenses of US$1 million and one-time income for a gain on a bargain purchase for the acquisition of ETOL of US$1.7 million)

Onetime expenses of US$1.9 M for the acquisitions performed in 2011 affected operating profit in 2011.

## 26. Fixed Assets, Facilities and Production Capacity

Frutarom has 28 production facilities around the world. The following table sets forth Frutarom's major production facilities and the activity at each of them:

| Country | Location | Field of Activity | Size ($m^2$) | Buildings Ownership/Lease | Land Ownership/Lease/Rent |
|---|---|---|---|---|---|
| Israel | Haifa[11] [12] | Flavors and fine ingredients | 35,490 | Ownership | Lease |
| Israel | Acco [12] | Flavors | 9,273 | Oownership | Lease |
| Switzerland | Wadenswil | Flavors and fine | 13,464 | Ownership | Ownership |
| Switzerland | Reinach | Flavors | 43,000 | Ownership | Oownership |
| Germany | Emmerich | Flavors | 19,000 | Ownership | Ownership |
| Germany | Nesse-Loxstedt | Flavors | 10,812 | Ownership | Ownership |
| Germany | Sittensen | Flavors | 10,001 | Ownership | Ownership |
| Germany | Stuttgart (Gewurzmuller) [13] | Flavors | 13,600 | Lease | Rent |
| UK | Teesside | Fine ingredients | 21,500 | Ownership | Ownership |
| UK | Hartlepool | Fine ingredients | 31,971 | Ownership | Ownership |
| UK | Wellingbourough | Flavors | 8,090 | Ownership | Ownership |
| USA | North Bergen (NJ) | Flavors and fine ingredients | 32,000 | Ownership | Ownership |

[11] Frutarom Ltd. owns land rights in Haifa Bay and Acco industrial areas. The net capitalized leasing fee for the land is in the amount of approximately US$ 1,141 as at December 31, 2012 (US$1,173K as at December 31, 2011). Land leasing rights are granted for a period of 49 years ending during the years 2032 – 2042. Frutarom Ltd has the right to extend the lease for an additional 49 year period. The land on which the Company's plant in Haifa is located is subject to long term lease agreements with the Israel Land Administration (excluding that stated in footnote 12 below). The capitalized lease fees are presented in the financial reports under fixed assets.

[12] The total size of the Haifa site is approximately 35.5 dunam including a rented space under an operating lease with a third party totaling 7.3 dunam until February 28, 2013. The annual leasing fee for 2011 is NIS 810,000 The annual leasing fee for 2012 is NIS 780,000 a year.

[13] The land and facilities of the Company's plants in Stuttgart are rented by the Company from a third party under a rental agreement for a period of 10 years ending on October 1, 2017. The annual rental fee is EUR 600,000 a year (EUR 544,000 for the GewurtzMuhle plant and EUR 56,000 for the plant in Blessing). According to the lease, the Company has a unilateral option to extend the rental agreement by another 5 years. If the option is realized, rental fees will be updated according to the amount customary in the market at the time being for the rental of similar assets, and the price will be adjusted to the changes in the German Consumer Price Index. At the end of the rental period, the agreement will be extended automatically by additional periods of two years each, until one of the parties notifies regarding termination of the agreement, at least one year in advance. The Company is entitled to terminate the contract by one years' advance notice.

| Country | Location | Field of Activity | Size ($m^2$) | Buildings Ownership/Lease | Land Ownership/Lease/Rent |
|---|---|---|---|---|---|
| USA | Corona (CA)[14] | Flavors | 14,000 | Rent | Rent |
| USA | Cincinnati (Ohio) | Flavors | 57,000 | Ownership | Ownership |
| China | Kunshan [15] | Flavors | 15,000 | Ownership | Leasing |
| Italy | Parma | Flavors | 7,500 | Ownership | Ownership |
| Slovenia | Škofja-Etol | Flavors | 65,000 | Ownership | Ownership |
| Brazil | Porto feliz/ Sao Paulo | Flavors | 8,000 | Ownership | Ownership |

The facilities and properties owned by the Group are presented in the financial reports as the Group's fixed assets in the section on land and facilities. All of the Group's lease agreements are defined as operational lease and are therefore not included and presented under assets.

The Company also has production facilities which are not significant in proportion to the Company's scope of activity. Following is a description of the Company's significant plants:

- **<u>Haifa, Israel</u>** – In the Haifa plant, the Company produces flavors and fine ingredients (specialty essential oils, specialty citrus products and aromatic chemicals). The plant also contains management offices.

  <u>Production capacity and shifts</u> – Flavor production is performed five days a week with one shift per day. The plant has additional potential production capacity of approximately 100%, assuming two shifts per day.

  Fine ingredients production is performed five days a week in three shifts.

- **<u>Acco, Israel</u>** – The Company produces flavor mixes (mainly savory flavors) at the plant in Acco.

[14]The property and the facilities of the Company's plant in Corona are rented by Company from a third party under a 6 year rental agreement ending on February 28, 2015. The annual rental fee is US$ 200,000. According to the lease, the Company has a unilateral option to extend the agreement by another 4 years for a rental fee that will be adjusted to the market price on March 1, 2014.

[15] An associated company in China has rights of use of land for a period of 50 years, ending in 2046. Net capitalized lease fees for said property are US$175 thousand as of December 31, 2012 (US$183 thousand as of December 31, 2011). Capitalized lease fees are presented in the statements as permanent assets

Production capacity and shifts – Production at the plant is performed five days a week in one shift. The plant has additional potential production capacity of 60% to 70% assuming two shifts per day.

- **Wädenswil, Switzerland** – At the Wädenswil plant the Company's Flavor activity produces flavors and natural extracts for the Specialty Fine Ingredients activity.

  Production capacity and shifts –The plant works five days a week in two shifts. The plant has additional potential production capacity of about 30%-40% assuming continuous production over seven days a week.

- **Reinach, Switzerland** – At this plant the Company's Flavor activity produces food systems as part of the Flavor activity.

  Production capacity and shifts –The plant works five days a week with one and a half shifts each day (14 out of each 24 hours). The plant has additional potential production capacity of about 20%-25% assuming continuous production in three shifts.

- **Emmerich, Germany** – At this plant the Company's Flavors activity produces food systems.

  Production capacity and shifts – The plant works five days a week in two shifts. The plant has additional potential production capacity of about 30%-35% assuming continuous production in three shifts.

- **Nesse-Loxstedt, Germany (Nesse)** – At this plant the Company's Flavor activity produces savory flavor mixes.

  Production capacity and shifts – The plant works five days a week with one shift. The plant has additional potential production capacity of about 60%-65% assuming continuous production in three shifts.

- **Sittensen, Germany (Nesse)** – At this plant the Company's Flavor activity produces savory flavor mixes and seasonings.

  Production capacity and shifts – The plant operates five days a week with two shifts (excluding Friday, when there is one shift). The plant has additional potential production capacity of about 30%-35% assuming continuous production in three shifts.

- **Stuttgart, Germany (Gewurzmuller)** – At this plant the Company's Flavor activity produces savory flavor mixes and seasonings.

Production capacity and shifts – The plant operates five days a week with one shift. The plant has additional potential production capacity of around 150% assuming continuous production in three shifts.

- **Wellingborough, UK (Belmay)** – At this plant the Company's Flavor activity produces flavors.

  Production capacity and shifts – The plant works five days a week with a 9 hour shift for flavor production. The plant has additional potential production capacity of 100% assuming multiple shifts.

- **Hartlepool, UK (Oxford)** – At the Hartlepool plant, the Company's Specialty Fine Ingredients activity produces aroma chemicals.

  Production capacity and shifts – The plant works five days a week with three shifts (24 hours a day). The plant has additional potential production capacity of about 25%-30% assuming continuous production 7 days a week.

- **Teesside, UK** – At this plant the Company's Specialty Fine Ingredients activity produces natural plant extracts for essential oils and aroma chemicals.

  Production capacity and shifts – The plant works five days a week in three shifts (24 hours a day). The plant has additional potential production capacity of 25%-35% assuming continuous production 7 days a week.

- **North Bergen, New Jersey, USA** – At this plant the Company produces natural plant extracts and natural gums.

  Production capacity and shifts – The plant works five days a week with two shifts (subject to the production department). The plant has additional potential production capacity of 35%-40% assuming continuous production with three shifts, 7 days a week.

- **Corona (CA), USA (FSI site)** – At the Company's plant in Corona (California), the Company manufactures flavor extracts for its Flavor activity and extracts from natural plants.

  Production capacity and shifts – The plant works 5 days a week (according to customers' orders) with 1 shift during most of the year and 1.5-2 shifts during the summer months. The plant has additional potential production capacity of approximately 60% - 70% assuming production in three shifts, 7 days a week.

- **Cincinnati, USA (Flavor Systems site)** - At this plant in Cincinnati, Ohio, the Company’s Flavor activity produces flavors.

Production capacity and shifts – The plant works 5 days a week, one shift during most months of the year, and one and a half to two shifts during the summer months. The plant has additional potential production capacity of about 60% - 70% assuming continuous production of three shifts 7 days a week.

- **Kunshan, China** – At this plant the Company's Flavor activity produces flavors.

  Production capacity and shifts – The plant works five days a week with one shift. The plant has additional potential production capacity of approximately 100% assuming production in shifts.

- **Parma, Italy -** At this plant in Parma, the Company's Flavor activity produces savory flavor mixes.

  Production capacity and shifts – The plant works 5 days a week, one shift. The plant has additional potential production capacity of about 200 % if it shifts to continuous production of three shifts seven days a week.

- **Škofja vas, Slovenia** - At this plant in Škofja vas, the Company's Flavor activity produces mainly flavors, beverage bases, food systems and savory flavor mixes.

  Production capacity and shifts – The plant works 5 days a week, 1.5 shifts. The plant has additional potential production capacity of about 40%-50%

- **Sao Paulo, Brazil -** At this plant in Porto Feliz, near Sao Paulo, the Company's Flavor activity produces flavors.

  Production capacity and shifts – The plant works 5 days a week, one shift. The plant has additional potential production capacity of about 100% in flavors if it shifts to continuous production of three shifts, seven days a week.

## 27. Research and Development

**27.1** Frutarom considers its research and development infrastructure to be one of its key competencies, and focuses and invests great resources in the research and development of new and innovative products. As at December 31, 2012, Frutarom employs about 280 research and development employees. Frutarom has over 80 years of experience in research and development in the field of flavors and specialty fine ingredients, particularly natural flavors and natural fine ingredients. Frutarom's research and development activities are crucial to its success, as many of its products, particularly natural products, are tailor-made to customers' specific needs.

As part of Frutarom's research and development activities and in order to broaden its offering of natural, innovative and unique products, Frutarom works to create collaborations with leading academic institutions, research institutes and start-ups throughout the world. Frutarom has created a number of such collaborations that strengthen and broaden the pipeline of new and innovative products it intends to launch in the coming years.

**27.2** The development of fine ingredients is in many cases Frutarom's own initiative, based on its assessment of market trends and needs while focusing on developing products with higher margins in order to continue and improve the Company's product mix and optimize production capabilities and capacity.

**27.3** The development of new and customized flavor products is a complex process calling upon the combined knowledge of the Company's scientists and flavorists. Scientists from various disciplines work in project teams that include flavorists to develop flavors with consumer preferred performance characteristics. The development of new flavor compounds is as much an art as it is a science, requiring in depth knowledge of the flavor characteristics of the various ingredients used and is, to a large extent, conducted as a trial and error process.

**27.4** As of the date on which this report was published, the Flavors activity has approximately 25 research and development laboratories. The main laboratories are located in the UK, Switzerland, Germany, the US, Slovenia, Israel, Italy, Turkey, China, Brazil and South Africa. In the Fine Ingredients field, Frutarom has approximately 9 research and development facilities located in Israel, the UK, Switzerland the US and the Netherlands.

**27.5** The Company recognized all research and development expenses at the time of occurrence as an expense in the financial reports. For details, see Note 2f (6) and Note 20(b) in the Financial Reports.

**27.6** For further information regarding the liabilities recognized in the financial reports as grants and amounts that were attributable to research and development expenses, see Note 2(f) (6) and Note 11 a.(2) of the Financial Reports.

## 28. <u>Intangible Assets</u>

**28.1** Frutarom’s intellectual property includes mainly of the formulas used to create its flavors and production processes for the development and production of fine ingredients. These formulas are not registered as patents but are highly confidential proprietary business information, available to a limited number of people within the Group. It is customary industry practice not to patent the formulas used in the production of flavors, as doing so would make the formulas publicly known and the protection and the patent protection would only be available to a given flavor producer for the life of the patent. Additionally, the Company has registered patents, mainly with regards to the production processes of ingredients that were developed by the Group and with regards to pharmaceutical/nutraceutical products. The Company also registers trademarks for some of its products in some of the countries in which it operates. The Company also relies, in part, on confidentiality and non-competition agreements as well as transfer of intellectual property rights with employees and consultants, and agreements with suppliers and customers. Frutarom believes that it is not materially dependent on any single intellectual property right, proprietary formula, patent or license.

**28.2** The Company has not registered the "Frutarom" trademark in all of the jurisdictions in which it currently operates. In certain such jurisdictions, a trademark substantially similar to "Frutarom" has already been registered by third parties. The Company's management estimates that not registering the "Frutarom" trademark in all the jurisdictions in which it operates does not constitute a significant risk to the Group and its activities.

**28.3** For details regarding amounts recognized as assets in the Financial Reports for intangible assets, see Note 5 and Note 8 of the Financial Reports.

**28.4** The reduction of intellectual property, representing know-how and formulas, is performed according to Group management's assessment regarding the length of time such know-how will be utilized, in light of the fact that most of the know-how and formulas have no technical or regulatory statute of limitations, and in light of the Group's experience regarding periods of use of the Group's know-how and formulas, according to the industries in which the Group operates.

## 29. <u>Human Resources</u>

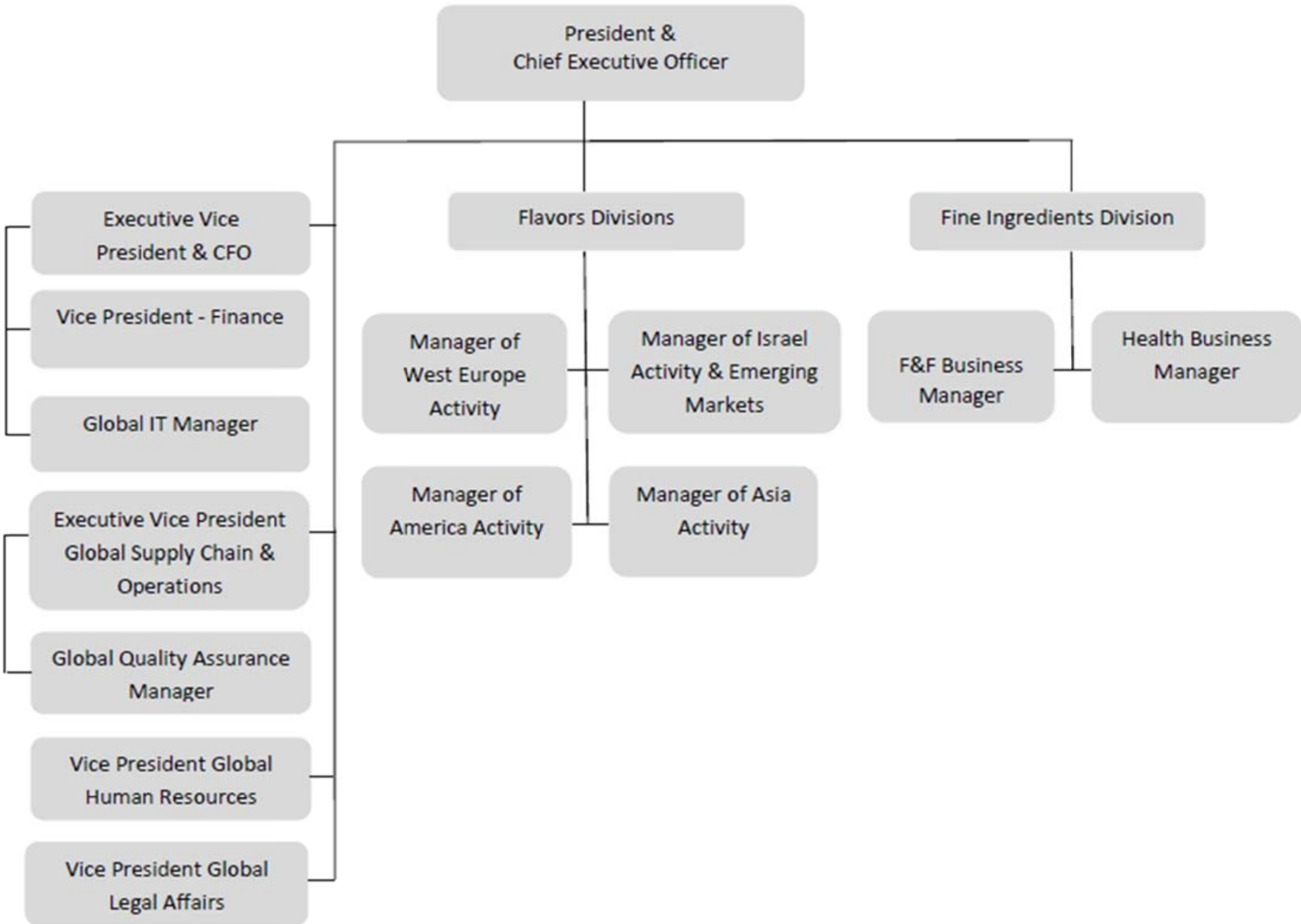
29.1 As at December 31, 2012 Frutarom employs 2,021 employees. The following table shows the number of employees employed by the Group by geographic region over the last three years:

| **Country** | **31.12.2012** | **31.12.2011** |
|---|---|---|
| Israel | 297 | 345 |
| Switzerland | 194 | 212 |
| Germany | 352 | 368 |
| UK | 293 | 281 |
| USA | 207 | 204 |
| Belgium | 32 | 31 |
| China and the Far East | 176 | 46 |
| Russia | 38 | 32 |
| Ukraine | 14 | 15 |
| Kazakhstan | 14 | 9 |
| France | 10 | 11 |
| Turkey | 16 | 17 |
| Mexico | 5 | 5 |
| Brazil | 73 | 4 |
| South Africa | 11 | 8 |
| Italy | 40 | 40 |
| Norway | 5 | 5 |
| Czech Reputlic | 2 | 2 |
| Slovenia | 212 | - |
| Serbia | 6 | - |
| Slovakia | 6 | - |
| Macedonia | 2 | - |
| Poland | 16 | 9 |
| **Total** | **2,021** | **1,644** |

29.2 The following table shows the breakdown of the Group's employees by fields of activity in the last two years:

| **Field** | **31.12.2012** | **31.12.2011** |
|---|---|---|
| Sales and marketing | 391 | 353 |
| Research and development | 280 | 253 |
| Operations | 1,016 | 775 |
| Management | 334 | 263 |
| **Total** | **2,021** | **1,644** |

29.3 Following is Frutarom's organizational chart:



29.4 The majority of Frutarom's employees at its sites located in Germany), the UK, Slovenia, US, and Israel (Haifa) are covered by collective bargaining agreements. These agreements vary from country to country and deal principally with conditions of employment, salaries, pension schemes, certain benefit programs, procedures for hiring and dismissing employees and procedures for settling labor disputes.

Employees that are not covered by collective bargaining agreements have personal employment agreements that vary from country to country based on the respective local regulation.

## Directors and Senior Management in the Company

29.5 As of December 31, 2012, the Company's senior management included six senior officeholders. In addition, the Group's global management includes five additional managers. The Company has personal employment contracts with the members of the management. These contracts include standard clauses regarding non-competition, confidentiality, and transfer of intellectual property rights to the Company, as is customary in the industry in which the Company operates.

29.6 A number of members of the Company's senior management are entitled to continue receiving their salaries and benefits from the Company and extended advance notice periods ranging between six and twelve months in the case of termination within a period of 12 months from the date on which ICC Handels AG's[16] holdings in the Company's share capital falls below 26%. Furthermore, upon the occurrence of such a change in control, all options and/or ordinary shares previously granted to these members of the senior management will become immediately exercisable, even if they have not yet matured.

29.7 Company director are insured under directors' and office holders' insurance policies. In addition, the Company also granted the officeholders an undertaking for advance indemnification for actions taken by virtue of their office in the Company. For further information see regulation 22 to Chapter 4 to the Company's 2012 Annual Report (Additional Details regarding the Corporation)

29.8 **Employee Equity Incentive Plans**

For details regarding the Company equity incentive plans, see Note 12b to the Company's financial reports.

[16] To the best of the Company's knowledge, ICC Handels AG is fully owned subsidiary of ICC Industries Inc., the Company's controlling party.

## 30. Raw Materials and Suppliers

**30.1** Frutarom purchases thousands of raw materials from a wide range of suppliers which it uses for the manufacture of its products, with more than one supplier for most products. The principal raw materials purchased by the Group include plants, leaves and roots from which the Company produces natural flavor extracts, functional food ingredients and pharmaceutical/nutraceutical extracts. In addition Frutarom purchases essential oils from which it manufactures specialty essential oils such as citrus oils and mint oils. Other raw materials purchased by the Group include natural and synthetic chemicals, alcohols, esters and acids and oleoresins. The Group's supply chain managers, both global and local, and the purchasing units regularly monitor the raw materials price trend and if necessary, the Group acts to adjust the selling prices of its products to the changes in the raw material prices. Frutarom has a global unit which coordinates purchase of raw materials defined as strategic from suppliers, serving both of the Group's primary activities.

**30.2** In recent years, none of Frutarom's suppliers have supplied more than 10% of the consumption of its raw materials. There is a small number of raw materials for which Frutarom has sole suppliers; however, since these raw materials are used in only a limited number of Frutarom's wide range of approximately 30,000 products, and since the raw materials having only one supplier are used in a limited number of Frutarom's products (none of which is substantial), the Company's management estimates that Frutarom's dependency on these exclusive suppliers is not material.

**30.3** Frutarom seeks to reduce costs of raw material used for the manufacture of its products, and to secure constant supply by purchasing raw materials directly from the source, with the aim of expanding its global procurement capacity in countries of origin, which serve as important sources of many raw materials, such as China, India and Brazil, expanding the pool of suppliers and strengthening relations with manufacturers, processors and growers of raw materials. The purchase of the raw materials used for the manufacture of the products of the Group's two activities is implemented through the support of the global headquarters of the supply chain in order to leverage the purchasing power of the raw materials in large quantities and achieve competitive prices. Frutarom is acting to strengthen and to establish a global procurement infrastructure, utilizing its increased purchasing power resulting mainly from its eight recent acquisitions.

**30.4** The Group carefully manages its global supply chain and acts to strengthen its relations with manufacturers, processors and growers of raw materials, mainly natural raw materials, in order to ensure availability of raw materials at its various production facilities. Frutarom maintains comparatively high stocks of certain raw materials, as most of the natural ingredients used by Frutarom in its production are crop- related goods. In addition, raw material delivery times are generally longer than the delivery times to customers committed by Frutarom, requiring Frutarom to maintain stocks of raw materials sufficient to enable it to supply its products to customers as ordered with short lead times. However, Frutarom generally maintains comparatively low stocks of finished goods. Furthermore, the availability and the prices of many of the raw materials used by Frutarom to manufacture its products, and in particular the natural ingredients, are subject to fluctuations as a result of international supply and demand. Over the past few years we have been witness to a continuing trend of a substantial rise in the price of most of the raw materials Frutarom uses to produce its products. Stability began to set in over 2012, and even reduction in prices for some of the raw materials Frutarom uses for the manufacture of its products. The Company has acted and will continue to act, so long as this trend continues, with diligence, in order to prevent future negative impact on its activity results, including by adapting the sale prices of the products impacted by the rise in raw material prices, expansion of the supplier pool, and optimization of the capacities of Frutarom's production sites throughout the world.

## 31. Working Capital

Frutarom's working capital is made up of cash and cash equivalents, debtors and debit balance and inventory, less short term credit and loans and current maturities of long term loans, creditors and credit balances. For further information see the Company's balance sheet in its financial reports.

## 32. Investments

**32.1** Frutarom's capital expenditure is in principle the result of the enhancement and expansion of existing facilities, as well as investment in developing new manufacturing facilities, investment in environmental protection, establishment of sales and marketing offices and research and development laboratories.

**32.2** Frutarom's planned investments for the next three years are expected to average approximately US$14 million to US$18 million per year. Most of the planned capital expenditures in the coming years are related to upgrades of existing production facilities and the improvement of their efficiency, continued implementation of a new company-wide IT system, improvements and capacity increases to Frutarom's production facilities, and investment in ecology, energy conservation and environment. Frutarom will examine the implementation of the various investments as necessary. The Company has begun working towards the establishment of a new plant in China for the production of sweet and savory flavors including sophisticated laboratories for development and applications. Construction is planned to begin in the second half of 2013, to be concluded in 2014. Over 2012 Frutarom was granted approval by the Ministry of Industry and Trade for the construction of a new plant in Israel, which will expand its research, development and production in Israel and the world, and will serve as a research and development center for natural products. The new plant will be located in Gilboa. An investment grant and tax benefits have been granted under the Israeli Encouragement of Investments Law. The investment grant will be at least 20% of the Company's investment in permanent assets. The plant will be built on 64 dunam. The investment in the new plant is expected to be approximately US$30 M.

**32.3** The balance of the depreciated cost of the fixed assets in the Company's balance sheet as at December 31, 2012 following deduction of investment grants is US$188.8 million. For further information on the Company's investment in fixed assets see Note 7 to the Financial Reports.

**32.4** The Company's management estimates that the cash flow from current operating activities will be sufficient to meet the Company's anticipated capital expenditure and working capital requirements to support the Company's internal growth in the next several years.

## 33. Financing

**33.1** Frutarom's activity is financed through equity and long-term loans from banks. During the period reported, the average and effective interests were set at 2%.

**33.2** During 2012 Frutarom used long term loans from banks for the purpose of financing acquisition made during the year. At December 31, 2012, the debt balance to banks totaled US$190 million.

For further information regarding the loan the Group took from banking corporations in 2012, see the Company's reports on the matter dated June 26, 2012 and December 15, 2012

**33.3** During the period from January 1, 2013 until the date on which this report was published, the Group took no credit from banking corporations in any significant amount.

**33.4** As part of a revision to the credit framework available to the Group, the following financial covenants were updated on February 16, 2012 as follows:

- The Company's equity will not at any time be less than US$300,000 thousand. As of December 2012, the Company's equity stood at US$453,560 thousand.

- The Company's equity will not at any time be less than an amount equal to 35% of the Company's balance sheet. As of December 2012, the Company's equity stood at approximately 58.7% of the Company's total balance sheet.

- The debt ratio after deduction of cash to EBITDA will not exceed 4.25. As of December 31, 2012 the ratio stood at 1.4.

As of the date of this report, the Company meets these financial covenants.

The Company has a negative pledge on its assets (in addition to the existing negative pledge on the assets of Frutarom Ltd.'s subsidiary). The Company has also committed to a restriction on distribution of dividends under which it is entitled to distribute:

1) Up to 50% of the surplus balance accumulated up to December 31, 2011, as this figure appears in the Company's balance relating to December 31, 2011.

2) Up to 50% of the Company's annual profits for each calendar year, as this figure appears in the Company's annual financial reports relating to same calendar year in which said profits accrued.

For further details on the liabilities with respect to the above financial covenants, the negative pledge and restrictions on distribution of dividends, and updates, see Note 14 to the Financial Reports and the Company's immediate report dated February 16, 2012.

**33.5** In view of Frutarom's solid capital structure, achieved by the support of the strong cash flow generated by Frutarom over the last few years, Frutarom is currently not engaged in contractual credit lines arrangements with banks, and there are no current liens on its assets. The Group has understandings with leading banks in the world allowing it to finance accelerated growth and strategic acquisitions as necessary.

**33.6** The Company's management believes that it will not be required to raise capital in the next year for its ongoing activities.

**33.7** For further details on the Company's loans see Note 9 to the Financial Reports.

## 34. Taxation

**34.1** For details of tax regulations applicable to the Company see Note 13 in the Financial Reports.

**34.2** The Company has final tax assessments in Israel until 2008, inclusive.

**34.3** The Company operates throughout the world, and as of the date of publication of the report, applicable tax rates vary from 13% to 42%. For details on the Company's related companies abroad see Note 13 to the Financial Reports.

**34.4** The effective tax rate (in the consolidated report) in 2012 was 20.8% compared with 20.5% in 2011. For details on the changes between the Company's statutory tax rate and the effective tax rates see Note 13 to the Financial Reports.

## 35. Environmental Risk Management

### Environmental Hazards

As of the date of publication of this report, Frutarom has 28 plants around the world which engage in the production of flavors and specialty fine ingredients, using and producing substances considered to be hazardous. These plants are therefore subject to different local legislation and regulations related to the environment and the prevention of environmental hazards.

**35.1** Environmental hazards which may materially affect the Group are:

**35.1.1** The emission of substances as a result of the activity of the Company's production facility in Haifa and Acco, which may harm humans and the environment if emissions are higher than the permitted volumes or concentrations. These hazards include hazardous odors outside the facility, which are substantial or unreasonable as defined by the Hazard Prevention Law, 1961. The Company takes the required steps to prevent uncontrolled emission of such substances according to the provisions of the law and the terms set in its business license by the Ministry of Environmental

Protection and the terms of the Environmental Arrangement Document (see clause 35.8 below).

**35.1.2** The Company's production, maintenance and use of materials in Israel which are defined as hazardous by the Hazardous Substances Law, 1993 (mainly flammable substances) may harm humans and the environment if they are not kept under the permitted levels. The Company possesses these substances under authority and terms of the toxicity permit it was granted by the Ministry of Environmental Protection, and takes the safety measures required when using these substances.

**Material Implications of Regulations**

**35.2** On October 30, 2007, the IPPC directive (96/61/EC) came into effect ("**Directive"**) in the European Union. This Directive sets stringent standards in all matters relating to preventing environmental hazards and is enforced on the Group's sites in Europe.

**35.3** On January 1, 2008 the Clean Air Law – 2008 ("**Clean Air Law"**) came into effect, adopting the principles of the Directive and applying these to plants defined as "sources of emissions requiring permits". In the event the Ministry of Environmental Protection finds that the Company's plant in Haifa is such "source of emissions requiring a permit", as defined in the Clean Air Law, the plant will be required to submit an application for an emissions permit will need to be submitted by March 1, 2014. In this case, it is possible that under the framework of the emission terms, the Haifa site will have to comply with stringent environmental demands compared to those currently applied under applicable law.

The Clean Air Law allows the imposition of emission fees on plants that are sources of emissions requiring a permit. Regulations have not yet been published regarding the method of fixing such fees, and it is not known when such fee will be imposed or what rate will be imposed on the Company.

As both the required technology and the levy rate are not yet defined by law and are not under the Company's control, the implications of the Clean Air Law on the Company is forward looking information and it is impossible to assess at the time of writing of this report.

## Material Litigation and Administrative Procedures Relating to the Environment

**35.4** According to understandings between the Company and the Ministry for Protection of the Environment, and addendum to the environmental agreement approved by the court on April 26, 2010 was signed on June 28, 2011, and was also approved by the court. Under this addendum, the Company will act for the gradual transfer of production with odor potential to the Company's plants outside of Israel. Such transfer will take place between 2012 and 2015. These processes constitute approximately 2% of Frutarom's overall production scope throughout the world.

For further information on the Agreement, see the Company's immediate report on the matter dated February 19, 2009 and April 28, 2010, and for details regarding the addendum to the Agreement, see the Company's immediate report dated June 28, 2011.

**35.5** A number of third-party claims were lodged against the Company citing bodily injury and economic damages and were filed against the Company at the Haifa District Court, due to contamination of the Kishon River, allegedly caused in part by the Company, as per the plaintiffs' claims. Based on the opinion of its legal advisors, Company management believes that the chances that these claims will be accepted by Court are slim and even if the court determines that the Company does bear some responsibility for the stated claims, it would not be material due to the large number of defendants, the minimal quantities of sewage infused by the Company in the relevant years (approximately 0.01% of the total sewage that was discharged by all defendants and the third parties), the compositions or duration of time in which the sewage was discharged by the Company compared to the duration of time in which sewage it was discharged by the other defendants. As of the year 2000, the Company ceased the discharge of any sewage to the Kishon River.

The following are the details of the lawsuits filed against the Company due to the contamination of the Kishon River:

(1) As part of a number of lawsuits (that were consolidated) for an undefined amount by 92 former Israel Defense Forces soldiers (or their heirs) against Haifa Chemicals Ltd (hereinafter: "HCL"), 20 of which were rejected during preliminary proceedings, and another 3 defendants for compensation for bodily injury allegedly caused to the plaintiffs due to contamination of the Kishon River during their military service, the defendants filed a third party

claim against the Company and other parties demanding that the third parties compensate the plaintiffs in case the court obliges them to pay the stated compensation since, in their opinion, the third parties are responsible for the plaintiffs' damages.

(2) As part of a lawsuit that was filed for an undefined amount by 17 former IDF soldiers (or their heirs), four of the ten defendants send third party notice to the Company and to other parties, demanding that the third parties compensate the plaintiffs and/or indemnify the defendants in case the court obliges them to pay the stated compensation.

(3) As part of a lawsuit that was filed for an undefined amount by 41 fishermen and their heirs against HCL and other defendants, for compensation for bodily injury allegedly caused as a result of the contamination of the Kishon River by the defendants, third party claims were filed against the Company and others by the plaintiffs in which the plaintiffs demanded that the third parties compensate the plaintiffs and/or indemnify the defendants in case the court obliges them to pay the stated compensation.

**35.6** During the reported period and until the date of publication of this report, there were no material legal or administrative procedures relating to environment protection pending against the Company or to which an officer in the Company is a party.

**<u>The Group's Policy on Environmental Risk Management</u>**

**35.7** Frutarom has acted and continues to act in an ongoing manner to prevent environmental hazards and to protect the environment. The Company is authorized within the framework of the Responsible Care program. The Company's management maintains a constant watch on the subject of environment protection and acts to reduce the environmental risks at all of the Group's sites.

As part of the implementation of the Frutarom's strategic program for environmental protection, environmental trustees have been appointed at the Group's key production sites in the world. The trustees have undergone routine validation and training in order to increase the involvement and awareness of the employees at all the Group's sites to the subject of protecting the environment.

All of the Group's sites hold the licenses relevant to the legislative system in their country and, in the Company's assessment, act in accordance with the law. The sites in Israel hold business licenses in accordance with the Law for

Licensing Businesses, 1968, and valid hazardous materials permits in accordance with the Law for Hazardous Materials, 1993.

**35.8** Following is a list of the Frutarom Group's key activities for reducing environmental hazards during 2012:

- In accordance with the Environmental Arrangement Document agreed upon between the Environmental Protection Ministry and the Company in February 2009, significant and extensive maintenance and upgrade works for handling the environmental issues including, among others, the installation of seven active carbon-based odor filtering systems, the installation of regenerative thermal oxidizer (RTO), the erection of a continuous monitoring system for the environmental systems and the implementation of the LDAR project for locating and repairing unfocused leakages in the site, and implementation of internal enforcement procedures relating to environmental matters. For further information on the Environmental Arrangement Document, see the Company's immediate report in the matter dated February 19, 2009.

- According to the addendum to the Environmental Arrangement Document agreed upon between the Environmental Protection Ministry and the Company in June 2011, production of a number of materials having stench potential were transferred from the Company's site in Haifa to a production site outside of Israel.

- At the Company's sites in Stuttgart, Germany and Reinach, Switzerland, all types of solid waste (organic waste, waste from the packing stage, plastic, carton and wood) are sent for recycling and reuse.

- At the Company's site in Wadenswil, Switzerland, an electric power station has been operating for a number of years. It operates on natural gases produced from the organic waste arising from the production process.

- At the Company's site in Reinach, Switzerland a heat recycling system has been operating for a number of years, leading to a significant reduction in energy consumption.

- At the Company's site in New Jersey, USA, a multi-year program for handling the site's sewage discharge is in place in cooperation and with the approval of the relevant authorities in the USA. As part of the program, the construction process of a closed sewage discharge system and the upgrade of sewage discharge facilities and additional activities related to the plant's infrastructure were completed at the end of 2010, preventing contact between rainwater and the plant's sewage. In addition, an alcohol recycling system from organic waste and from the extraction process was installed and has been in operation since 2010, leading to a reduction of approximately 30% in alcohol waste which requires organized disposal.

- At the Company's sites in Northern UK a great emphasis is put on the recycling of methanol and ethanol in production processes and thus a significant reduction of the volume of waste is achieved. In addition, organic materials are sent to the production of compost and thus they help the environment.

**Significant Environmental Amounts, Deductions and Costs**

**35.9** During the reported period and until the date of publication of this report, there were no significant amounts relating to the environments that were ruled against the Company.

**35.10** The total amount spent by the Company due to environmental costs in 2012 totaled US$2.8 million. This amount was spent for the prevention and reduction of environmental hazards and does not include investments made by the Company in its facilities as stated above. The Company does not foresee a significant change in the above costs during 2013.

## 36. Limitations and Supervision on the Company's Business

**36.1** The Company develops, produces and markets its products in a number of jurisdictions throughout the world and is subject to the legislation, regulations and supervision applicable to its activities in each of the various countries. These laws and regulations include, among others, the U.S. Food and Drug Administration's (FDA) regulations regarding activity in the United States; EU directives implemented into local law in the European countries in which the Company operates; and regulations determined by the Ministry of Health in Israel. These laws and regulations determine standards relating to food production, food marking and production facilities, equipment and the personnel required to produce products for human consumption.

**36.2** In addition, the Company is subject to various rules relating to health, work safety and environment at the local and international levels in the various countries where it operates.

The Company's production facilities in the United States, Israel, the United Kingdom, Switzerland, Germany, Slovenia, Italy, China, Turkey, Brazil and South Africa are subject to environmental standards in each of these countries relating to air emissions, sewage discharges, the use of hazardous materials, waste disposal practices and clean-up of existing environmental contamination. In recent years, there has been a significant increase in the stringency of environmental regulation and enforcement of environmental standards in each of these countries and in the world, and the costs of compliance have risen significantly.

**36.3** Frutarom estimates that it currently operates its facilities in compliance with relevant laws and regulations related to food manufacturing, work safety, health and the environment.

**36.4** For further information on regulation, health, safety and permits see to section 15.10 of this report.

## 37. Material Agreements and Cooperation Agreements

**37.1** For details regarding the Company's commitment to financing banking institutes to meet financial standards see section 33.4.

**37.2** For details regarding substantial loans the Group has taken from banking corporations, see the Company's immediate reports on the matter dated November 23, 2011, December 1, 2011, December 25, 2011, 26 June 2012 and 15 December 2012.

**37.3** The Company is not a party to strategic cooperation agreements.

## 38. Legal Proceedings

**38.1** For details regarding legal proceedings in which the Company is involved, see section 35.5 above, and Note 11b(2) of the Financial Reports.

**38.2** Except for the above, the Company is not involved in any significant legal proceedings in which the amount claimed (without interest and expenses) exceeds 10% of its current assets based on its consolidated financial reports.

## 39. Goals and Business Strategy

Frutarom's strategic objective is to achieve growth combining rapid profitable internal growth of its core business, at higher rates than average in the industry, together with strategic acquisitions in order to achieve its vision:

***"To be the Preferred Partner for Tasty and Health Success"***

The key elements of Frutarom's strategy are as follows:

**39.1 Focus on the core businesses, while leveraging synergies between them and providing comprehensive taste and health solutions to the food and beverage industry**

Frutarom will continue to focus on its two core businesses, Flavors and Specialty Fine Ingredients, while leveraging the synergies between them to create partnerships with and value to its customers by providing unique health and flavor solutions, tailor-made and customized according to its customers' demands. The trend towards consumption of products combining health and taste leads the growth in the global food and beverage industry in recent years. This trend has increased due to consumers' growing demand for food and beverage products with natural content and nutritional and healthy ingredients (low fat, salt, sugar etc.) and consumers' perception of these products as high-quality, healthier and environmentally friendlier along with the demand that products would not lose their high-quality taste despite their being "healthier". Since fine ingredients are the key components used in the production of flavors, Frutarom's expertise in natural fine ingredients and other ingredients enable it to develop and produce high quality, unique and customized flavor and health solutions as per its customers' demands. The Group's Fine Ingredients business benefits from the expertise of the Group in the Flavor business, allowing it to better understand the needs of its customers including third party flavor manufacturers. In addition, as some of the Company's fine ingredients are sold directly to food and beverage producers, the Group's strategy is to use a single sales person to sell both flavor and fine ingredients products to its customers, thereby improving its operational efficiency and allowing it to offer its customers an entire product portfolio.

As part of its strategy combining its core businesses, Frutarom focuses on its ability to offer its customers comprehensive, integrative solutions in the fields of taste and health. For example, Frutarom combines its Food Systems capabilities with its capabilities in the field of natural flavors, natural functional food ingredients, and other natural extracts for the production of new, innovative, integrative solutions suited to the needs of its customers, food and beverage producers. As part of its rapid and profitable growth strategy and its wish to offer its customers comprehensive solutions, Frutarom acted and will act to expand the scope of its activity and wide product portfolio in the savory field. Frutarom's acquisitions in recent years significantly strengthened its market share and the solutions it offers to manufacturers of meat and fish products, snacks and convenience food in a manner which will contribute to its continued growth.

**39.2 Continued focus on superior customer service and product development for both large multinational, midsized and local customers**

Frutarom continues to enhance its customer service and expand its product and solution portfolio for both large multinationals as well as mid- size and local customers. In the large multinational food and beverage customer segment, Frutarom focuses on specialized product offering and increase its offering of comprehensive natural solutions. In the mid-size, local and private label customer segment, Frutarom intends to continue to offer its customers the same level of service and customized product and solution development as normally reserved for large multinational companies. In addition, Frutarom offers mid-sized, local and private label customers, which are usually of limited resources compared to large, multinational customers, assistance in the development of their products while providing marketing support and flexibility in supply and quantities.

**39.3 Expand market position in developed markets**

Frutarom believes there are additional opportunities to expand in both Western Europe and North America supported by the unique solution portfolio it offers to its customers and by leveraging cross-selling opportunities resulting from its recent acquisitions and the future pipeline to perform additional acquisitions.

**39.4 Further penetration and foothold in emerging markets**

Frutarom believes that there are significant growth opportunities in certain fast growing emerging markets with growing demand for flavors and unique ingredients and with above average growth in the food and beverage markets. Over 2012 and in the beginning of 2013, Frutarom has continued to work towards strengthening its position in and further penetrate the emerging markets where it already operates, which include, among others, Asia, Central and Eastern Europe , Central and South America, Asia and Africa, and will continue to act thus, through organic growth and strategic acquisitions. The Company intends to expand into additional emerging markets, and to benefit from the high growth potential in these markets. Frutarom believes that increasing its local presence in these emerging markets will provide it with a competitive advantage and acts to accelerate its growth in these markets by focused strengthening of the development, production, marketing and sales in important targets countries while exploring options for future strategic acquisitions. Realization of the strategy for

Frutarom's accelerated expansion into target markets with high growth rates can be seen in the 60% growth, achieved by Frutarom in the emerging markets of China and South East Asia, Central and South America, Central and Eastern Europe and Africa between 2010 to 2012. Frutarom sales in BRIC countries grew by 31% in 2012. The sales segment in these strategic markets grew from 27% in 2010 to 36% this year.

### 39.5 Achieving leadership position in the growing market for natural and healthy products

Frutarom is well-positioned to take advantage of the growing trend of food and beverage manufacturers to utilize more natural and healthy ingredients in their products. The acquisitions of companies and activities it implemented in recent years in the fields of unique ingredients, and the various flavors fields, as well as strengthening its research and development and marketing infrastructure, strengthened Frutarom's position as a global market leader in the natural and healthy products field. Frutarom leverages the variety of its existing expertise in natural flavor extracts, functional food ingredients and natural pharmaceutical/nutraceutical extracts thus empowering its abilities to provide its customers with full solutions with the emphasis on taste and health. The Company intends to continue allocating resources to its research and development and sales and marketing activities to continue and expand the development and marketing of healthy and natural products. Frutarom cooperates with academic institutions, research institutes and start-ups worldwide in order to expand its pipeline of unique and innovative products that it intends to launch in coming years, while focusing on consumers' health and convenience.

### 39.6 Expanding investments in research and development

Frutarom believes that technology and innovation are key to its success. Therefore, the Company intends to continue to invest in research and development both in the Flavor and Fine Ingredients activities.

### 39.7 Improving profitability

Frutarom intends to act to expand its margins by: (a) continuing to focus on achieving organic profitable growth at a higher rate than the rate of the increase of fixed expenses (b) continuing to leverage and exploiting the synergies in and between Frutarom's activities (c) continued focus on operating efficiencies including maximization of facilities utilization and inventory management and strategic lowering of the cost of raw materials, while unifying global purchase and management, and allocating resources to focused purchase in important target countries, such as China and India; ;

(d) efficient assimilation and integration of acquisitions of recent years and new acquisition to be made while maximizing cross selling opportunities , and (e) realization of plans for integrating production sites and activities and transfer of other activities to countries where operational costs are lower, with the expectation of a US$10 million annual cost savings, and (f) continuing to improve its product mix and to develop and market unique new, higher margin, value-added products.

### 39.8 Continue rapid growth also through strategic acquisitions

Frutarom's acquisition strategy has also contributed to Frutarom's rapid growth, and Frutarom will continue to evaluate acquisition opportunities that meet its strict investment criteria and keep enhancing shareholder value as part of its ongoing growth strategy. Frutarom examines and will continue examining acquisition opportunities that will expand its portfolio of products, targeted geographic reach and customer base, and which provide Frutarom with further options to expand its integrative product portfolio and cross-selling opportunities. In addition, Frutarom is working diligently to integrate its recent acquisitions with its own operations in order to optimize cross-selling opportunities and additional synergies while realizing cost savings.

As stated, in 2012 Frutarom continued to execute strategic acquisitions and implement its rapid growth strategy. The three acquisitions made at the beginning of 2012, in the UK, Slovenia and in Brazil, strengthened its position as a global leading player in flavors and its geographic spread and allowed it to enter new markets. In addition, these acquisitions expended its product portfolio in the area of sweet and savory solutions, including natural products, combining fruit and vegetable ingredients and beverage bases, its customer base, both large, multi-nationals and medium sized and local, and provided the Company with a wide variety of cross selling options. The acquisitions also contributed to Frutarom's technology and know-how and managerial capacity.

For further information on the acquisition of Frutarom's strategic acquisitions over 2012, see sections 1.7.6 to 1.7.8 above.

## 40. Financial Data regarding Geographic Regions

The Group manufactures, markets, and sells its products throughout the world.

**40.1** The following table sets forth the Company's consolidated income from externals by sales to end users broken down by customers' geographic regions (in US$ millions):

| | 2010 | 2011 | 2012 | (%) of total 2012 Sales | (%) Increase 2012 Vs 2011 | (%) Increase 2012 Vs 2010 |
|---|---|---|---|---|---|---|
| **EMEA*** | 306.8 | 359.2 | 428.3 | 69.3% | 19.2% | 39.6% |
| **America**** | 56.0 | 60.3 | 91.1 | 14.7% | 51.4% | 62.7% |
| **Asia & the Far East** | 48.7 | 55.0 | 57.5 | 9.3% | 4.4% | 18.1% |
| **Israel***** | 39.6 | 43.9 | 41.1 | 6.6% | -6.4% | 3.7% |
| **Total** | 451.1 | 518.4 | 618.0 | 100.0% | 19.2% | 37.0% |

* **"EMEA"** in this report is defined as: Europe, Africa and the Middle East (excluding Israel).

Sales in Germany came to US$76.9 million, US$84.2 million and US$74.1 million in 2010, 2011 and 2012, respectively. Net of currency effects, sales in Germany in 2012 reached US$80.5 M compared with US$84.2M in 2011.

** In this report, America includes sales in the US in the sum of US$65.9 million, US$45.2 million and US$41.2 million in 2012, 2011 and 2010, respectively.

***Sales in Israel include the trade and marketing activity, which is not one of Frutarom's core activities. Net of currency effects and net of trade and marketing activity in Israel, not one of Frutarom’s core activities, sales in Israel grew in 2012 by 3.3%, compared with 2011.

## 40.2 Data according to geographic regions of main production sites:

40.2.1 Following is the sales breakdown by geographic locations of main production sites:

| | 2012 in US$ Thousands | | | | 2011 in US$ Thousands | | | | 2010 in US$ Thousands | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Flavors | Raw Materials | Cancel-lations | Total | Flavors | Raw Materials | Cancel-lations | Total | Flavors | Raw Materials | Cancel-lations | Total |
| **Europe** | 338,907 | 57,840 | (1,020) | 395,727 | 273,240 | 60,689 | (408) | 333,520 | 237,327 | 55,700 | (668) | 292,359 |
| **America** | 40,050 | 27,719 | - | 67,769 | 19,683 | 26,465 | - | 46,148 | 12,198 | 28,769 | - | 40,967 |
| **Israel** | 46,399 | 33,587 | (1,083) | 78,903 | 50,062 | 35,857 | (1,640) | 84,279 | 44,021 | 35,402 | (1,279) | 78,144 |

*Sales are presented according to Geographic location of the manufacturing site net of sales of products manufactured at other Frutarom sites at other geographic locations.

40.2.2 Following is the breakdown of operating margin by the geographic regions of main production sites and divisions:

| Flavor Activity | 2012 | 2011 | 2010 |
|---|---|---|---|
| **Activity operating margin%** | 13.0% | 12.7% | 15.1% |
| **Europe** | 14.0% | 13.1% | 16.1% |
| **America** | 18.0% | 15.0% | 16.0% |
| **Israel** | 19.8% | 20.6% | 20.8% |

| Specialty Fine Ingredients Activity | 2012 | 2011 | 2010 |
|---|---|---|---|
| **Activity operating margin%** | 8.8% | 8.1% | 11.9% |
| **Europe** | 8.4% | 7.9% | 12.7% |
| **America** | 3.4% | 5.1% | 4.6% |
| **Israel** | 13.4% | 16.5% | 19.3% |

Total assets (without intercompany balances) by geographic locations of main production sites in US$ thousands:

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| **Europe** | 459,503 | 370,719 | 342,374 |
| **America** | 113,240 | 114,260 | 57,239 |
| **Israel** | 67,435 | 74,944 | 80,303 |

For further information regarding geographic regions see Note (6) of the Financial Reports.

## 41. Risk Factors

Below are the main risk factors:

**Macroeconomic Risks**

- **The effects of the global economy on the Company's activities**

  Due to the nature of its global activity, Frutarom is exposed to fluctuations in the global economy. Economic crisis and recession in important target countries may cause dips in demand for the Company's products (mainly for premium products) and significantly slow down the development and launch of new products by Frutarom's customers. Global economic crisis may harm Frutarom's ability to raise funds for the execution of its strategic acquisitions. Over the last few years we have been witness to economic uncertainty in world markets, especially in European markets, including in EU member countries, where there has been a financial crisis which in some countries has turned into an economic slowdown or even a recession. For further information see description of risks regarding the Company's activities in Europe in section B to the chapter Exposure to Market Risks and Management in the Board of Directors Report.

- **Stability in emerging markets**

  Frutarom operates in a number of countries outside of Western Europe and the United States, such as Russia, Ukraine, Turkey, Slovenia, Kazakhstan, China, countries in South and Central America (Brazil and Mexico) and countries in North, South and West Africa, and therefore is generally exposed to the political, economic and legal systems and conditions in these countries which are generally less predictable than in developed countries. The Group's facilities in these countries could be subject to disruption as a result of economic and/or political instability or the expropriation and/or nationalization of its assets situated there. There is also a significant risk relating to operations in emerging market countries arising from the establishment or enforcement of foreign exchange restrictions, which could effectively prevent Frutarom from receiving profits from, or selling its interests in, companies located in these countries. While none of the countries in which Frutarom's subsidiaries are located currently have foreign exchange controls that affect it significantly, many of these countries have had such controls in the recent past and the Group cannot give any assurances that they will not reinstitute such controls in the future.

- **Currency fluctuations**

  For details regarding the risks from currency fluctuations, see currency risks in chapter B, Exposure to Market Risks and Risk Management in the Board of Directors' Report, and Note 3A to the financial reports.

- **Changes in interest rates**

  For details regarding the risks from changes in interest rates, see interest rate risks in chapter B, Exposure to Market Risks and Risk Management in the Board of Directors' Report.

**Industry Related Risks**

- **Competition in the markets in which the Group operates**

  Frutarom faces increased competition both from large multinational and mid-sized companies as well as smaller local companies in many of the markets in which it operates. Some of the Company's competitors have greater financial and technological resources, larger sales and marketing organizations and greater name recognition than the Company, and may therefore be better able to adapt to changes and trends in the industry.

  The global market for flavors is characterized by close, collaborative relationships between flavor manufacturers and their customers, particularly in the large multinational customer segment. Furthermore, large multinational customers, and increasingly, mid-sized customers, limit the number of their suppliers, placing those that remain on ''core lists''. To compete more successfully in this environment, Frutarom must make greater investments in customer relationships and tailored product research and development in order to anticipate customers' needs and to provide effective service. A failure by the Group to maintain positive relations with its existing customers, establish good relations with new customers, or secure inclusion on certain of the core lists, could have a material adverse effect on its business, results of operations or financial condition.

  In comparison to the flavor market, the fine ingredients market is more price sensitive and is characterized by comparatively lower margins. Some of the fine ingredients products manufactured by the Company are less specialized and more interchangeable with those of its competitors. In particular, overcapacity in the global production of certain types of fine ingredients may have a negative impact on Frutarom's sales and profitability. Although Frutarom is focusing as part of its strategy on those fine ingredients products exhibiting higher margins, there can be no guarantee that operating margins for its fine ingredients products will not decrease in the future, which could in turn have a material adverse effect on the Group's business, results of operations or financial condition.

- **The effect of changes in regulations on the Group**

Frutarom is subject to a variety of health, safety and environmental rules at national, state and local levels in the various countries in which it operates. Generally, there is a trend towards increased regulation in the industry in which the Group operates. This has been a result of increased public sensitivity toward the composition and use of flavor products and from the fact that as a result of their medicinal qualities and claimed health benefits, nutraceuticals and functional food products are being increasingly viewed by regulators as having similar characteristics to pharmaceutical products, which may lead their subject to the regulatory framework governing the market for pharmaceutical products. Frutarom has identified nutraceuticals and functional food ingredients as an important market for its future growth. The application of new governmental regulations on the nutraceuticals and functional foods could result in substantially greater ongoing compliance costs, which, in turn, could have a material adverse effect on the Company's business, results of operations or financial condition.

- **Compliance with environmental, health and safety regulations**

Companies in the flavor and fine ingredients industry such as Frutarom also use, manufacture, sell and distribute a number of environmentally hazardous materials, and therefore are subject to extensive regulation regarding the storage, handling, manufacture, transportation, use and disposal of their products, ingredients and byproducts. In particular, Frutarom's production and research and development activities in the UK, Switzerland, Germany, Italy, the US, Israel, Slovenia, China, Brazil and other countries are subject to environmental standards relating to air emissions, sewage discharges, the use and handling of hazardous materials, waste disposal practices and clean-up of existing environmental contamination. Any increase in the stringency of applicable environmental regulations could have a material adverse effect on the Group's business, results of operations or financial condition.

In addition to ongoing environmental compliance costs, the Company might, from time to time, be required to incur extraordinary expenditures to meet applicable environmental standards and may be liable for costs associated with any remedial actions that are required in locations in which the

Company's facilities are located. As the Company cannot predict environmental matters with certainty, the amounts the Company has budgeted or will budget in the future for environmental related projects and any reserves it may establish for environmental liabilities may not be adequate. Both the ongoing costs of environmental compliance and non-recurring expenditures may have a material adverse effect on the Company's business, results of operations or financial condition.

Frutarom is required to maintain and hold various environmental permits for operations at its facilities and is required to conduct its operations in accordance with conditions specified in these permits. Plant expansions are also subject to the securing of new or additional permits which may in some circumstances be difficult to obtain. All such permits may be revoked or modified by the relevant regulator acting unilaterally, and certain permits are time-limited and require periodic renewal. Any such revocation, modification or failure to renew a permit could have a material adverse effect on the Company's business, results of operations or financial condition.

- **Exposure to civil and criminal liabilities in connection with environmental, health and safety laws and regulations applicable to the Group**

  As a result of environmental, health and safety laws and regulations, Frutarom may be subject to significant civil and criminal liabilities for environmental pollution and contamination as well as for non-compliance with applicable laws, regulations and standards applicable to the potentially hazardous substances it uses and produces globally. Environmental and health and safety laws may provide for criminal sanctions (including substantial fines) for violations. Some environmental laws also provide for strict liability for releases of hazardous substances, which could result in the Company being liable for remedying environmental damage without regard to its negligence or fault. Other environmental laws impose joint and several liability for the clean-up of pollution and contamination and could therefore expose the Company to liability arising out of the conduct of others.

  A number of third party claims have been filed against Frutarom for bodily injury, property damages and for breach of environmental laws related to the pollution of the Kishon River located in Haifa, Israel. No assurance can be given as to the outcome of these claims (for details, see section 35.5 above). In February 2009, an environmental arrangement document was signed between the Company and the Ministry of Environmental Protection which relates to improvements and actions implemented by the Company in the Haifa site in the environmental field, and in June 2011 an addendum to the environmental arrangement document was signed between the parties (for details see section 35.8 above and the Company's immediate report dated February 19, 2009 and June 28, 2011). There is no certainty that the Company's activities in accordance with the Environmental Arrangement Document and the addendum thereto will be considered satisfactory by the Ministry for Environmental Protection, which may expose the Company to various sanctions.

In addition some environmental, health and safety laws may apply retroactively, imposing liability for past operations even though those operations may have been carried out in compliance with all applicable laws at the relevant time. Any civil or criminal liability under these laws may adversely affect the Company’s business, results of operations or financial condition.

Additionally, Frutarom may be subject to claims alleging personal injury or property damage as a result of alleged exposure to hazardous substances. The laws in the principal countries in which the Group operates allow for legal proceedings to be taken against it if its production facilities are alleged to have caused environmental contamination or personal injury. These proceedings may also be taken both by individuals and non-governmental organizations.

- **Fluctuations in prices of raw materials required for the production of the Group's products**

  For details regarding the risks from fluctuations in prices of raw materials required for production of Frutarom products, see the description of market risks in the Exposure to Market Risks and Risk Management in the Board of Directors’ Report.

- **Dependency on suppliers of unique raw materials and availability of natural ingredients**

  Frutarom is dependent on third parties for the supply of raw materials it requires to manufacture its products. Although the Group purchases raw materials from a very wide range of suppliers, with no single supplier representing more than 10% of its total raw material purchases there can be no guarantee that this will continue to be the case. Significant weather damages may cause a material shortage in natural ingredients which the Company uses. A shortage in these raw materials can damage Frutarom's sales for a certain period of time.

- **Payment of damages as a result of possible product liability claims due to product warranty**

  The Company's business exposes it to a risk of product liability, particularly as it is involved in the supply of flavors and fine ingredients to the food and beverage, flavor and fragrance, functional food, pharmaceutical/ nutraceutical and personal care industries. If a large product liability claim was successfully brought against the Company, its insurance coverage might not be adequate or sufficient to cover such a claim in terms of paying damages and/or defense costs. A lack of or inadequate insurance coverage could result in a material adverse effect on the Company's business, results of operations or financial condition. If product liability claims were brought against the Company, it might damage the Company's reputation as well as require the Company to divert significant time and effort of its management, which could adversely affect the Company's business regardless of the outcome of the claim.

**<u>Risks Unique to the Group</u>**

- **Frutarom's future ability to identify, acquire and integrate suitable businesses**

  A key element of Frutarom's strategy is growth and through acquisitions of flavor and specialty fine ingredients manufacturers. In line with this growth strategy, the Company made many strategic acquisitions of companies and activities in recent years. However, there can be no assurance that the Company will be able to continue to identify suitable acquisitions, acquire businesses on satisfactory terms or obtain the financing necessary to complete and support such acquisitions. Any failure to identify and execute future acquisitions successfully could adversely impact the Company's growth strategy.

  Merging acquired businesses involves a number of risks, including possible adverse effects on the Group's operating results, loss of customers, diversion of management's attention, failure to retain key personnel, risks associated with unanticipated events or liabilities or difficulties in the integration of the operations, technologies, systems, services and products of the acquired businesses. In addition, Frutarom may be unable to achieve the anticipated synergies (including cost savings) from such acquisitions. Any failure to successfully integrate past or future acquisitions could have a material adverse effect on the Company's business, results of operations or financial condition.

- **The rapid growth characterizing the Group's activity in recent years**

  The rapid growth, in both operations and geographical spread as was in recent years, requires effective management to ensure that the expected financial benefits through synergies and economies of scale are realized. A failure to adapt effectively to the rapid growth could result in losses or acquisition costs that are not recovered as quickly as anticipated, if at all. Such problems could have a material adverse effect on the Company's business, results of operations or financial condition.

- **Employing and retaining key employees**

  The Company's continued success depends on its ability to attract and retain trained flavorists, laboratory technicians and other skilled personnel. The Company operates in a highly specialized marketplace where the quality of product is crucial and skilled personnel are critical to ensuring the delivery of a high quality end product. If a number of such employees were to leave simultaneously the Company may have difficulty employing replacement personnel with the same experience and skill, in which case its research and development capabilities could be impacted. Further, Frutarom's continued success depends to a large extent on its senior management team. The loss of the services of certain members of its senior management or other key employees could have a negative impact on Frutarom's results and its ability to implement its strategy. A failure to attract or retain trained personnel or members of senior management could have a material adverse effect on the Company's business, results of operations or financial condition.

- **Protection of intellectual property**

  The Group's business depends on intellectual property, which consists mainly of formulas used to create its flavors. Frutarom's formulas are not registered as patents but constitute highly confidential proprietary business information, available to very few people even within the Group. Although Frutarom believes that it is not depends materially on any single proprietary formula, license or other intellectual property right, the loss of confidentiality with respect to proprietary formulas or loss of access to them and/or the future expiration of intellectual property rights could have an adverse impact on the Group's business, results of operations or financial condition.

  Frutarom relies, in part, on confidentiality and non-competition agreements with employees, manufacturers and third parties to protect its intellectual property. It is possible that these agreements will be breached and Frutarom may not have adequate remedies for any such breach. Disputes may arise concerning the ownership of intellectual property or the applicability of confidentiality agreements. Furthermore, the Company's trade secrets may become known or be independently developed by its competitors in which case the Company may not be able to enjoy exclusivity with respect to certain of its formulas or maintain the confidentiality of information relating to its products.

Following is a table that summarizes the various risk factors and the Company's evaluation of their level of impact thereon:

| Risk Factor | Risk factor's level of impact on the Company | | |
|---|---|---|---|
| | High | Medium | Low |
| **Macroeconomic Risks** | | | |
| Effects of the global economy | | √ | |
| Stability in emerging markets | | √ | |
| Currency fluctuations | | √ | |
| Changes in interest rates | | √ | |
| **Industry Related Risks** | | | |
| Competition in the markets | | √ | |
| Changes in regulations | | √ | |
| Compliance with standards | | √ | |
| Exposures to liabilities | | √ | |
| Fluctuations in prices of raw materials | | √ | |
| Dependency on suppliers of unique raw materials and availability of | | √ | |
| Product liability claims | | √ | |
| **Risks Unique to the Company's Business** | | | |
| Identification of future acquisitions | | √ | |
| Adaptation to rapid growth | | √ | |
| Attraction and retention of key employees | | | √ |
| Protection of intellectual property | | | √ |

## 42. Details about valuations

42.1. The following are details about the valuation of the savory activity in Germany in accordance with Accounting Regulation IAS36 and the provisions of Regulation 8b to the Securities Regulations (Periodic and Immediate Reports), 1970:

| | |
|---|---|
| **Valuation subject** | Goodwill of the savory activity (Germany, Norway, Italy) |
| **Valuator** | BDO Ziv Haft Consultants and Management Ltd. |
| **Valuation requester** | Frutarom Industries Ltd., by Mr. Guy Gill, VP Finance |
| **Engagement date** | December 2012 |
| **Approval to attach to reports** | The valuator gave written approval to attach the evaluation to the Company's reports |
| **Valuation timing** | Goodwill value as of December 31, 2012.<br>Valuation was conducted during March 2013. |
| **Value of goodwill prior to valuation date** | €127,472 thousand |
| **Value of goodwill according to valuation** | €150,246 thousand |
| **Identification of evaluator and its characterization** | Ziv Haft Consulting and Management was established by partners in the BDO Ziv Haft Accounting firm. Ziv Haft Consulting and Management is part of the global BDO network and provides consulting and management services in a wide variety of areas for companies operating in different areas. The company has rich experience in the following areas: valuations, due diligence – financial and accounting) valuation of goodwill and intellectual assets, performance of financial analysis, current analysis of Israeli public hi-tech and communications companies, business plans, planning of presentations for potential investors, financial management and analysis of BOT and PFI projects, receivership, liquidation and appointment as special administrator, handling companies in crisis, formulating recovery plans, management of business and companies, supporting mergers and splits, transaction planning and more.<br>Evaluator: Pini Shmueli Nissan. |

| | |
|---|---|
| | Evaluator's education<br>• BA in Economics, Ben Gurion University of the Negev.<br>• M.Sc in economics, Eitan Bargelis School at the Tel-Aviv University.<br><br>Positions held:<br>• Director of research and consulting department at Forsyth;<br>• Director of consulting department at Ernst & Young<br><br>Areas of expertise:<br>• Performance of financial assessments and valuations, including valuations for accounting needs of reporting corporations and in similar scopes to those of the reported assessment or greater;<br>• Pricing and analysis of financial issues for government and private bodies;<br>• Support in IPOs and consultation in mergers.<br><br>The valuator is has no dependence on Frutarom and there are no indemnification agreements with the valuator. |
| **Valuation Model** | • DCF (discounted cash flow). |
| **Valuation Assumptions** | • Capitalization rate: 15.2% before taxes<br>• Growth rate: 2% long term<br>• Sensitivity to growth: 0% through 4%<br>• Sensitivity of capitalization rate: 13%-17%<br><br>Data used as a basis for comparison: the activity's results in recent years and its forecast. |
| **Prior Valuation** | • Valuation dated December 31, 2011 conducted by Ziv Haft Consultants and Management Ltd., signed on March 11, 2012. Value of activity according to the above valuation was €172,586 thousand. |

42.3. **Details about the valuation for the Savory Activity in Germany**

The following are details about the valuation of the flavors activity in the United States in accordance with Accounting Regulation IAS36 and the provisions of Regulation 8b to the Securities Regulations (Periodic and Immediate Reports), 1970:

| | |
|---|---|
| **Valuation subject** | Goodwill of the flavors activity in the United States |
| **Valuator** | BDO Ziv Haft Consultants and Management Ltd. |
| **Valuation requester** | Frutarom Industries Ltd., by Mr. Guy Gill, VP Finance |
| **Engagement date** | December 2012 |
| **Approval to attach to reports** | The valuator gave written approval to attach the evaluation to the Company's reports |
| **Valuation timing** | Goodwill value as of December 31, 2012.<br>Valuation was conducted during March 2013. |
| **Value of goodwill prior to valuation date** | US$66,345 thousand |
| **Value of goodwill according to valuation** | US$92,247 thousand |
| **Identification of evaluator and its characterization** | Ziv Haft Consulting and Management was established by partners in the BDO Ziv Haft Accounting firm. Ziv Haft Consulting and Management is part of the global BDO network and provides consulting and management services in a wide variety of areas for companies operating in different areas. The company has rich experience in the following areas: valuations, due diligence – financial and accounting) valuation of goodwill and intellectual assets, performance of financial analysis, current analysis of Israeli public hi-tech and communications companies, business plans, planning of presentations for potential investors, financial management and analysis of BOT and PFI projects, receivership, liquidation and appointment as special administrator, handling companies in crisis, formulating recovery plans, management of business and companies, supporting mergers and splits, transaction planning and more.<br><br>Evaluator: Pini Shmueli Nissan.<br><br>Evaluator's education |

| | |
|---|---|
| | • BA in Economics, Ben Gurion University of the Negev.<br>• M.Sc in economics, Eitan Bargelis School at the Tel-Aviv University.<br><br>Positions held:<br>• Director of research and consulting department at Forsyth;<br>• Director of consulting department at Ernst & Young<br><br>Areas of expertise:<br>• Performance of financial assessments and valuations, including valuations for accounting needs of reporting corporations and in similar scopes to those of the reported assessment or greater;<br>• Pricing and analysis of financial issues for government and private bodies;<br>• Support in IPOs and consultation in mergers.<br><br>The valuator is has no dependence on Frutarom and there are no indemnification agreements with the valuator. |
| **Valuation Model** | • DCF (discounted cash flow). |
| **Valuation Assumptions** | • Capitalization rate: 17.8% before taxes<br>• Growth rate: 2% long term<br>• Sensitivity to growth: 0% through 4%<br>• Sensitivity of capitalization rate: 16%-20%<br>Data used as a basis for comparison: the activity's results in recent years and its forecast. |

# Appendix A

# Frutarom Industries Ltd.

## Evaluation

## of the Savory Activity in Germany

## as at December 31, 2012

## March 2013

Strictly private and confidential

# Frutarom Industries Ltd.

## Impairment Study - Savory Unit
## As Of December, 2012

March 2013

BDO Ziv Haft
Amot Bituach House Building B, 48
Menachem Begin Road, Tel Aviv
66180
Israel

Dear Madams/Sirs,

We were requested by Frutarom Industries Ltd. (Hereinafter: **"Frutarom"** or the **"Company"**) to perform an Impairment Examination Study (Hereinafter: the **"Study"**) of the Savory sector (Hereinafter: the "**sector**" or the "**Unit"**) under the requirements of Statement of International Accounting standards 36 (**IAS 36**). To the best of our knowledge there is no prevention, legal or other, to perform the Study enclosed herein.

The Study was prepared for Frutarom and its management for the purpose of reporting its financial statements as of December 31, 2012, and may be provided to their external auditors. Unless required by applicable law (for instance, reference to a performance of an impairment test and its implications in the financial statements), it is not to be used or quoted in a prospectus and/or any other document without receiving our prior written consent.

Based on our study, we have concluded that the Unit's Goodwill is not deemed to be impaired, as of December 31, 2012.

The following table displays the Unit's revocable amount compared to the carrying amount (thousands €):

| Thousands € | |
|---|---|
| Recoverable Amount | 150,246 |
| Carrying Amount | 127,472 |
| **Impairment Amount** | - |

*Source: BDO analysis.*

In the course of our Annual Goodwill Impairment Test, we relied upon financial and other information, including prospective financial information obtained from Management and from various public, financial and industry sources. Our conclusion is dependent on such information being complete and accurate in all material respects.

The principal sources of information used in performing our Annual Goodwill Impairment Test include:

- The Unit's draft income statements and balance sheets breakdown for the fiscal year ended 2012;
- The Unit's budget for the year 2013;
- The Unit's perennial financial forecast for the years 2013-2016 (Hereinafter: the : Perennial Financial Forecast");
- Other information provided by Management, written or oral;
- Publicly available data;
- Discussions with Management;
- Publicly available information (articles, websites) regarding the industry; and
- Yahoo! Finance and other relevant financial websites.

In forming our opinion we have relied on sources, which appeared to us as reliable, and nothing came to our attention, which is likely to indicate the lack of reasonability of the data we used. We did not examine the data in an independent manner and, therefore, our work does not constitute verification of the correctness, completeness or accuracy of the data.

**Details regarding the valuation specialist**

BDO Consulting and Management Ltd. were founded by the partners of BDO Certified Public Accountants.

BDO Consulting and Management is part of the international BDO network, provides a full range of business services required for national and international businesses in any sector. Our company has vast experience in the following fields: business valuations, financial and tax due diligence, goodwill and intangible assets valuations, financial analyses, business plans, project finance PFI/PPP advisory, M&A, investment banking and more.

**Respectfully submitted,**
**BDO Ziv Haft**

**Consulting & Management Ltd.**

## Contents

# Section 1
# Unit Overview

# Unit Overview

## General

As aforesaid, Savoy forms part of the flavouring activity department of Frutarom. Savory deals with the development, manufacturing, and marketing of Savory Taste Solutions (the non-sweet taste spectrum). Its product line includes flavors, seasoning compounds, and functional ingredients for the food industry, with a specialization in the processed meat, fish, and convenience food sectors.

These non-sweet flavors are used primarily in the production of snacks, salty pastries, processed meat and fish and convenience foods. Additionally, Savory produces unique seasoning mixes and functional ingredients for meat, poultry and fish processors, as well as a variety of flavors of meat substitutes designed to help impart meat flavor in vegetarian preparations.

In recent years, Frutarom has accelerated its targeted growth by implementing a strategy combining profitable organic growth and execution of strategic acquisitions in order to expand its business opportunities in both emerging and developed markets. In the last decade, Frutarom has significantly increased, both in terms of its savory sector mergers and its acquisitions activity.

## Acquisitions Agreements

The following description shows the Unit's acquisitions executed by the Company:

- In January 2006, Frutarom acquired 70% of the issued and paid up share equity of GewurzMuhle Nesse GmbH and GewurzMuhle Nesse Gebr. Krause GmbH. The acquisition was performed through Frutarom Germany GmbH, a wholly owned

## Acquisitions Agreements

subsidiary of Frutarom. Frutarom paid Euro 18.41 million for the acquisition. During Q1 2008, an additional amount of Euro 18.89 million was paid for the exercise of an option for the acquisition of the remaining 30% of the issued and paid up share capital of Nesse and for the improvement in Nesse's operating profit during the years 2005-2007. As for today, the Company holds 100% of Nesse's share capital. The total purchase price amounted to 38 € million.

The acquisition of Nesse and the exercise of the option were another significant milestone in implementing Frutarom’s rapid growth strategy. The acquisition and the exercise of the option strengthened Frutarom’s technological capabilities and offering to customers in the savory field and contributed to strengthening and positioning Frutarom as a leading flavours supplier in Western and Eastern Europe. The Nesse acquisition expanded Frutarom’s geographic spread to additional countries in which Frutarom was less active, such as Poland, Czech Republic, and Latvia etc.

Nesse’s savory activity is synergetic to Frutarom’s activities in some of the countries in which it operates, especially in Europe. Frutarom is taking advantage of its large, dedicated global sales and marketing infrastructure to realize the substantial cross-selling opportunities created by the acquisition, by expanding both the customer base and the product portfolio.

- In October 2007, Frutarom acquired 100% of the share capital of Gewurzmuller Group for a cash consideration of 47.3 € million. The acquisition agreement

# Unit Overview

## Acquisitions Agreements

determined a future payment mechanism so that the final payment to be made will reflect the Gewurzmuller Group's value based on an average EBITDA multiple of 7.1, that the Gewurzmuller Group will achieve during the twelve months ending December 31, 2007.

During the third quarter of 2008, Frutarom paid the remaining said consideration for the acquisition of the Gewurzmuller Group for an amount of approximately 21.7 $ million (approximately Euro 13.9 million). During 2010, Frutarom acted to merge and consolidate the activities of Nesse, the Gewurzmuller Group and the Savory activities of CH for the purpose of achieving maximum efficiency and operational saving. The acquisition considerably boosted both Frutarom's technological capabilities and its product offering to its customers worldwide in the field of savory flavors and functional products, as well as Frutarom's extensive global customer base.

- In June 18, 2009, Frutarom signed, via its subsidiaries in Germany, an agreement to acquire CH's assets and Savory activities (Hereinafter: the "**CH activity**") in consideration of a cash payment of approximately 7.3 $ million (Euro 5.3 million). CH's Savory activity develops, manufactures and markets unique and innovative Savory flavor solutions which include flavors, seasoning mixes and functional raw materials to the food industry with a special emphasis on the processed meat field and convenience food. The activity is highly synergetic to those of the German Nesse and Gewurzmuller Group which were acquired by Frutarom in 2006 and 2007, respectively. During 2009, Frutarom acted to merge and consolidate the

## Acquisitions Agreements

activities of Nesse, the Gewurzmuller Group and CH activity for the purpose of achieving maximum efficiency and operational saving.

- On December 23, 2010, Frutarom signed an agreement, via a Norwegian subsidiary, for the acquisition of Rieber's Savory activity (the **"Rieber activity"**) in consideration of approximately 4.3 $ M (approximately NOK 25 M). The acquisition was completed on February 1, 2011.

The Rieber Activity acquired assets include the development, production and marketing of non-sweet flavor solutions including flavors, seasoning mixes and functional ingredients used by the food industry, and in particular by processed meat and fish and convenience food manufacturers. The Rieber Activity includes a research and development and marketing site in Norway as well as a broad customer base including a number of leading food manufacturers located mainly in Scandinavian countries. The Rieber Activity is highly synergetic with Frutarom's savory activity in Europe and in Israel.

During 2011, Frutarom began implementing a plan to transfer production from Norway to Germany. In light of the move, which was successfully completed on November 1, 2011, Germany will produce for Norway the products which Norway will market, utilizing existing knowledge and experience in Germany. This will lead to efficiency and operational savings resulting improvement in earnings and profitability by creating economies of scale for all the Savory activity ("the activity").

# Unit Overview

## Acquisitions Agreements

- On May 26, 2011, Frutarom signed an agreement, through a subsidiary, for acquisition of the activity and assets of the Christian Hansen Italia (Hereinafter: "**CH Italia activity**") for a consideration of approximately 24 € million (approximately 35.7 $ million). The transaction was financed through short-term bank credit, which was replaced by a loan for 42 months interest rate LIBOR + 2.4%. The acquisition was completed on July 29, 2011. CH Italia Activity's sales turnover during the fiscal year 2010 totalled approximately Euro 18.3 million (approximately $24.3 million).

  CH's Italia activity is synergetic with Frutarom's savory activity and will allow Frutarom to further position itself as a leading company within the European flavour market. Frutarom acts to merge the operation, development and sales activities of CH Italia with its existing activity.

## Production Facilities

The following are the main production facilities of the Unit:

- **Nesse-Loxstedt, Germany** (**Nesse**) - At this plant the Company's flavor activity produces savory flavor mixes.

  **Production Capacity and Shifts** - The plant operates five days a week in one shift. The plant has additional potential production capacity of about 30%-35%, assuming that it shifts to continuous production over three shifts.

- **Sittensen, Germany (Nesse)** - At this plant the Company's flavor activity produces savory flavor mixes and seasonings.

  **Production Capacity and Shifts** - The plant operates five days a week in two shifts (excluding Friday, when there is one shift). The plant has additional potential production capacity of about 30%-35% assuming that it shifts to continuous production over three shifts.

- **Stuttgart, Germany (Gewurzmuller)** - At this plant the Company's flavor activity produces savory flavor mixes and seasonings.

  **Production Capacity and Shifts** - The plant operates five days a week in one shift. The plant has additional potential production capacity of around 100% assuming that it produces continuously over three shifts.

# Unit Overview

## Production Facilities

- **Stuttgart, Germany (Blessing) -** At this plant under the Company's flavor activity, starter cultures are produced (for details regarding starter culture products, refer to section 1.23 of this report).

  **Production Capacity and Shifts** - The plant operates five days a week in continuous production. The number of shifts and their duration corresponds with the volume of the production activity. The plant has additional potential production capacity of around 20%.

- **Parma, Italy –** this plant was acquired in 2011.

## Selling and marketing

The Company markets and sells its products across a wide geographical area. Centers of activity are:

**Germany** - The German subsidiary has 20 local marketing points and sells units in 20 countries besides Germany, mainly in East and west Europe.

**Norway** - The River activity has a development and marketing facility in Norway, and a well range of customers, which includes leading food producers, mainly in the Scandinavia countries.

**Italy** - The CH activity has an extensive customer base in Russia, Ukraine, Poland, Czech Republic, in France and mainly among processed meat producers in Italy.

## Customers

The savory activity's' products sold to an extensive customer base comprised of thousands of large multinational, mid-sized, local and small customers. The customers are primarily food and they are located different countries worldwide.

The majority of sales are made to permanent customers. The savory activity is characterized by long-term relationships and customer loyalty. As is customary in the flavor market, there are no long-term supply contracts.

The German activity's main customers are leading food producers in both East and West Europe especially in Germany, Austria, Switzerland, Sweden, Denmark, Russia, Ukraine and Bulgaria. The CH activity's customers are all over Europe while the River's activity customers are mainly in the Scandinavia countries.

The activity of the Italian CH is market to customers located throughout Europe, while Rieber markets its products primarily in Scandinavia.

# Unit Overview

## Balance Sheet

The following table presents the unaudited balance sheet of the Unit as of December 31, 2011 and 2012 (Thousands €):

| Thousands € | 2011 | 2012 |
|---|---|---|
| Current Assets | | |
| Cash and Cash Equivalents | 3,370 | 7,255 |
| Trade Receivables ,net | 14,654 | 13,536 |
| Accounts Receivable | 1,007 | 1,245 |
| Inventory, Net of Advances | 18,430 | 15,891 |
| Deferred Tax | 784 | 1,272 |
| Total Current Assets | 38,245 | 39,199 |
| Fixed assets | 19,683 | 18,296 |
| Intangible Assets | 99,034 | 96,966 |
| Long Term IC,Net | 46,598 | 9,660 |
| **Total Assets** | **203,560** | **164,122** |
| Current Liabilities | | |
| Trade Payables | 15,257 | 11,114 |
| Other Short-Term Liabilities | 7,012 | 5,007 |
| Total Current Liabilities | 23,447 | 16,121 |
| Long Term Liabilities | 69,685 | 38,952 |
| Total liabilities | 93,131 | 55,072 |
| Equity | 110,429 | 109,050 |
| **Total Liabilities And Equity** | **203,560** | **164,122** |

*Source: Company's management.*

## Profit & Loss

The following table present the profit and loss pro forma statements, of the Savory activity, in a full year performance, as of December 31, 2011 and 2012 (Thousands €):

| Thousands € | 2011 | 2012 |
|---|---|---|
| Revenues | 104,058 | 111,120 |
| *% growth* | *6.4%* | *6.8%* |
| Cost of sales | 69,504 | 75,377 |
| *% of Revenues* | *66.8%* | *67.8%* |
| **Gross profit** | **34,554** | **35,743** |
| *% gross profit* | *33.2%* | *32.2%* |
| operating expenses | | |
| S&M | 12,912 | 14,180 |
| *% of Revenues* | *12.4%* | *12.8%* |
| R&D | 3,350 | 3,570 |
| *% of Revenues* | *3.2%* | *3.2%* |
| G&A | 4,976 | 6,855 |
| *% of Revenues* | *4.8%* | *6.2%* |
| **Operating income (EBIT)** | **13,316** | **11,138** |
| *% operating expenses* | *12.8%* | *10.0%* |

*Source: Company's management.*

# Section 2

# Market Overview

# Market Overview

## Flavor and fragrance industry worldwide

The global market for flavors, fragrances and raw materials in 2011, was estimated at approximately 23 $ billion. Frutarom is not active in the fragrances market, but is active in the market of natural functional food ingredients (excluding the above estimate), and therefore, it believes to sell in the markets where it operates, approximately 18.2 $ billion. According to Leffingwell & Associates, Frutarom is ranked as one of the ten largest companies in the field of taste and smell.

In 2011, the research company IAL Consultants, estimated that sales in industrialized countries (USA and Western Europe) in the flavors markets, in which the Company operates, will grow at an annual rate of 3% to 3.4%, from 2012 to 2015. Frutarom estimates that sales of raw materials, in those markets, will grow at an annual rate, similar to the years 2012 to 2015. According to these estimates, the growth rate in emerging markets where the Company operates, such as Asia, Central and South America, Eastern Europe and Africa, is expected to be significantly higher due to changes in consumer preferences in these markets and the transition to processed food, and can reach average annual rates of between 4% and 7.1% from 2012 to 2015.

The manufacturers of the flavor, fragrance and fine ingredient markets can be divided into three main groups: large multinational companies, mid-sized companies, and local and small companies.

**Large multinational manufacturers** generally operate globally and have revenues in excess of 1 $ billion. In the global flavor and fragrance markets there are five such manufacturers which, according to Leffingwell & Associates, represent approximately

## Flavor and fragrance industry worldwide

62% sales in the flavor, fragrance and fine ingredients markets (excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts). These multinational manufacturers focus primarily on customers who are large multinational food and beverage producers.

**Local and small companies** generally have revenues of less than 100 $ million (most of them are much smaller and sell only several million dollars). The Company estimates that in the global flavor and fragrance markets, there are approximately 700 such companies that, according to the estimation of Leffingwell & Associates, represent approximately 21% of the value of the flavor, fragrance and fine ingredients market (again excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts). These companies generally focus on smaller local customers and have limited capabilities in the areas of service, research and development and innovation.

**Mid-sized companies**, such as Frutarom, have revenues between 100 $ million and 1 $ billion. In the global flavor and fragrance markets there are only five such mid-sized companies. According to the estimation of Leffingwell & Associates these five companies represent approximately 17% of the value of the flavor, fragrance and fine ingredients market (excluding sales of natural functional food ingredients and pharmaceutical/nutraceutical extracts). Some of these mid-sized players focus heavily on specific geographic markets (such as the USA, France and Japan).

# Market Overview

## Food and beverage market - Barriers to Entry

The flavor and fine ingredient market in which the Company is active is characterized by high barriers to entry, such as:

- **Long-term relationships -** The market is characterized by long-term relationships between manufacturers and their customers, which include mostly the food and beverage, flavor and fragrance and pharmaceutical/nutraceutical industries. These industries impart great importance to reliability, quality of service and the manufacturers' knowledge and understanding of the customers' needs.

- **Research and development** - End user preferences are dynamic, making the customer's market (usually in food or beverage) competitive. The market is characterized by a large number of new and innovative products. Accordingly, manufacturers are required to invest heavily in research and development in order to offer a wide range of innovative products. Sometimes this investment is undertaken at the initiative of the flavor manufacturer, while other times at the customers' initiative (the food/beverage manufacturer) in cooperation with the flavor manufacturer.

- **Compliance with quality and regulatory standards** - The flavor and fine ingredient products are principally intended for the food and beverage and pharmaceutical/nutraceutical industries, which are subject to strict quality and regulatory standards. As a result, manufacturers are required to meet the same strict standards. In recent years the quality and regulatory standards have become increasingly stringent, possibly imposing a burden on the competitiveness of small flavor manufacturers and increasing barriers to entry for new players.

## Food and beverage market - Barriers to Entry

- **The importance of flavors in the final product** - Flavors play a major role in determining the taste of the end product and are often a vital element in determining its success. Flavors cannot be precisely replicated and, as they represent a relatively small percentage of the final product's overall cost, food and beverage manufacturers will usually avoid replacing the flavor and its manufacturer.

- **Investment in production capabilities** - In the fine ingredient field, considerable capital investment is required to build manufacturing facilities and/or increase existing production capabilities. These investments serve as a significant barrier to entry for new manufacturers in the industry.

In light of the barriers to entry described above, the penetration of new manufacturers into the market is done mainly through mergers and acquisitions. In general, the market is characterized by a trend of consolidation and a decrease in the number of players.

# Market Overview

## Flavors market

Flavors are the key building blocks that impart taste in processed food and beverage products and, as such, play a significant role in determining the consumer acceptance of the end products in which they are used.

The research company IAL Consultant, estimates that global 2011 sales of flavors for the industry amounted to approximately US $ 8 billion. Flavor products are sold primarily to producers of prepared food, beverage, dairy, bakery, meat and fish, confectionery and pharmaceutical products.

The following are examples of end user products using flavors:

- **Beverages** - carbonated, noncarbonated, sport and functional, alcoholic and juices.
- **Dairy** - yogurt, drinking yogurt, ice cream, cheese and chilled desserts.
- **Bakery** - cakes and cookies, crackers and cereals.
- **Confectionery** - candy, chocolate, jam and chewing gum.
- **Savory and convenience food** - ready meals, instant soup, ready sauces and instant noodles.
- **Snacks** - potato chips and other savory snacks.

## Flavors market

- **Meat** - sausages and frankfurters.
- **Processed Fish**.
- **Oral hygiene and pharmaceuticals** - toothpaste, mouthwash, vitamins and medicines.
- **Others** - animal feed and pet food and tobacco**.**

The global market for flavors has expanded rapidly over the last 60 years, primarily as a result of an increase in demand for, as well as an increase in the variety of, consumer end products containing flavors. The demand for consumer goods containing flavor products has increased as a result of rapid population growth and consumer preferences resulting from various factors such as increases in personal income, leisure time, health concerns and urbanization. These factors have led to an overall increase in food and beverage products containing flavors and to rapid growth in demand for convenience food and foods with healthier and more natural content.

# Market Overview

## Flavors market

The following table sets forth the sales of flavors by region in 2010 and the projected annual growth rate in these geographic regions:

| Country | Estimated world consumption in 2010 (US$ million) | Average growth expected in 2010-2015 |
|---|---|---|
| Western Europe | 1,619 | 3.0% |
| Eastern Europe | 551 | 4.0% |
| North America | 2,315 | 3.4% |
| South America | 493 | 7.1% |
| Asia - Pacific | 2,414 | 5.8% |
| Middle East and Africa | 5,741 | 4.4% |
| Total | 7,933 | 4.5% |

*Source: Estimates based on IAL Consultants 2010.*

## Flavors market

in 2010, Flavors in North America and Western Europe accounted for approximately 50% of global Flavor sales, although the population in these countries account for less than 10% of the world's population.

The demand for Flavor products in developed countries is expected to grow moderately, with more rapid growth expected in emerging markets such as Asia Central and South America, Eastern Europe and Africa. Sales in these emerging markets are expected to grow as a result of projected growth in GNP in these regions and from changes in consumer preferences.

Frutarom is enhancing its growth in these markets through a number of efforts including a focused strengthening of the research and development, production, marketing and sales infrastructure in the important target countries and exploring options for strategic acquisitions.

# Market Overview

## Flavors market - Characteristics

The following are the characteristics of the Flavor Market:

- **Reliable with high levels of service** - Food and beverage producers, the principal customers of flavor manufacturers, expect reliable, high-quality service to meet their needs in terms of support and lead time, while maintaining high quality, regulatory and safety standards. These requirements encourage the formation of long-term relationships between flavor producers and their customers. As a result large multinational customers, and increasingly also mid-sized customers, have pruned the flavor suppliers that they will work with, placing those that remain on "core lists" creating a barrier to entry for small flavor manufacturers.

- **Research and development** - The development of flavor products in general and of new flavor extracts in particular is a complex, creative and technological process that calls for depth of knowledge and skill on the part of a flavor manufacturer's research and development personnel. Effective research and development is critical in ensuring a continuous stream of innovative products and in maintaining the profitability and growth of a flavor manufacturer. The initiative for the development of new flavor products can be spurred by the flavor manufacturer or by the customer who is in need of a specific flavor for use in a newly developed end product. As such, in order to anticipate market demands, a flavor manufacturer's research and development personnel are required to be familiar with the taste requirements of various end product types and target markets. In addition, as most flavors are tailor made for a specific customer, a close collaborative relationship with the customer is essential. These flavor formulas are treated as commercial secrets and remain the proprietary asset of the flavor manufacturer.

## Flavors market - Characteristics

As most flavor products are tailor-made for a customer, customers are less likely to replace suppliers for such flavor products during the course of the end products' life cycle.

- **Low price sensitivity** - Since flavor products play a major role in determining the flavor of the end product to which they contribute, they are a vital element of its success. Flavor products cannot be precisely matched and their cost, compared to the total cost of the end products, is negligible. When selecting a flavor supplier, a customer will generally place a greater emphasis on the reputation, innovation, service, quality and consistency of the supplier than on the price of its flavors. The demand for flavors is therefore generally less sensitive to changes in price.

- **Production processes** - Flavor products in general and flavors in particular typically contain a variety of ingredients (typically over 30 per flavor), which are blended using unique formulas created by a manufacturer's flavor expert. The production processes involved in the manufacture of flavor products are less complex and capital intensive compared to those of fine ingredients. However, the production process for flavor products requires skill and knowhow to achieve the required consistency and quality.

- **High and relatively stable profitability** - As the flavors market tends to be characterized by long-term relationships and high customer loyalty, combined with relatively low price sensitivity and simple production processes, it generally benefits from high and stable margins. This is true also in comparison to the fine ingredient industry.

# Market Overview

## Food and Beverage Market - Characteristics

Flavors are sold primarily to food and beverage producers; therefore the flavor market is generally driven by trends characterizing the demands of food and beverage consumers.

According to Data Monitor, global sales in the food and beverage market amounted to 4,486 $ billion in 2011. Frutarom estimates that over 60% of such total global sales are generated by mid-sized, local and small food and beverage producers. Although there has been a general trend towards consolidation in the food and beverage industry, Frutarom estimates that mid-sized (annual revenues of between 100 $ million and 1 $ billion) and local and small (annual revenues of below 100 $ million) food and beverage producers will continue to play a significant role in the market, and that new mid-sized, local and small producers will continue to emerge.

The large multinational flavor manufacturers often focus on large multinational food and beverage producers, offering their customers a high level of service and tailor-made product development. Frutarom believes that these flavors producers focus to a lesser extent on mid- sized and local customers, offering limited service and offering less customizable product offering to these customers.

## Food and Beverage Market - Characteristics

However, the Company believes that mid-sized and local food and beverage producers require the same level of service and tailor-made products as their larger counterparts, and also require short lead times and manufacturing flexibility. Small, localized flavor producers generally do not have the product variety and service capabilities to support the needs of these customers. A specific example of this type of customer is the private label customer. This situation creates a business opportunity for mid-sized flavor producers to service this segment.

## Food and Beverage Market - Tendencies

The following are the main trends in the consumer market for food and beverages which in turn drive the flavor market:

- **Local and global tastes** - Taste preferences vary by geographic location and among different cultures. Flavor manufacturers must have thorough knowledge of local tastes in each of the countries in which they are active. It is also important for a global flavor manufacturer to have a physical presence in its key target markets in order to facilitate direct contact with customers, to better understand local tastes and to be able to respond quickly and efficiently to changes in consumer preferences. Additionally, the trend toward globalization now characterizes the flavor industry as multinational food and beverage customers are now launching global brands in many different markets simultaneously, often by changing the taste profile to meet the preferences of the respective populations worldwide.

# Market Overview

## Food and Beverage Market - Tendencies

- **Preference of natural products** - There has been a general increase in consumer demand for food and beverage products containing natural ingredients and having dietary values (reducing fat, salt, cholesterol, etc.). Natural products are generally perceived by consumers as being of higher quality, healthier and more environmentally friendly. Similarly, there is growing demand for organic products and 'clean label' products. As a result, natural food and beverage products are viewed as specialty, premium products that can command higher prices. This trend has created new opportunities for flavors manufacturers to develop new and innovative natural flavor products. Frutarom focuses on developing and producing natural products and currently its products consist of two thirds of natural products.

- **Private label** - private label goods manufacturers, which tend to be mid-sized, local or small food manufacturers, are a growing customer segment in the flavor industry. Over the last decade consumers of food products have become increasingly price conscious, increasing sales of private label products in comparison to the branded food and beverage industry. This trend was accelerated in 2009 as a result of the economic crisis. As a result, supermarket chains and other retailers have been increasing their private label product offerings. Supermarket chains and other retailers have also placed greater importance on developing their own brand image. The demand from supermarket chains and retailers for private label products that mimic existing branded products as well as unique premium products has provided the flavors industry with new

## Food and Beverage Market - Tendencies

opportunities for growth. Frutarom has increased and will continue to increase its market share in the private label market.

- **Continuously growing consumption of convenience food** - There is an increase in demand for processed foods with greater convenience (consumed both inside and outside of the home). This increase in demand for convenience foods has been spurred by new packaging and cooking technologies as well as changing social habits and consumer preferences. Examples of convenience foods include "ready to eat" meals, fresh pasta; ready-to-cook, fresh seasoned or marinated meat or poultry; salads; and sauces in liquid form. This has created new opportunities for flavor manufacturers in the savory flavors and functional fine ingredients fields which are responsible for the creation of food texture and its extended shelf life, to develop and market flavors and unique fine ingredients products for this segment.

- **Emerging markets** - In recent years, certain developing markets, such as Asia, Central and South America, Eastern Europe and Africa have experienced above-market-average growth in demand for flavors products. Further, these markets have been characterized by a trend towards increased consumption of processed foods, which in turn has driven the emergence of mid-sized, local and small food companies, creating new market opportunities for flavor manufacturers. The Company expects that the improvement in the global economy and in the consumption rate will lead to a continuous improvement in the growth rate of these markets.

# Market Overview

## Food and beverage market - Critical Success Factors

The critical success factors in the flavor segment are:

- **Long-term relationships** - Long-term relationships with customers and collaboration in the development of new products.
- **Global and local presence in target markets** - Knowledge of the various flavor preferences in the different markets and the ability to provide global and local support to customers.
- **Superior and reliable service** - The ability to provide a high level of service and the reliability of a flavors manufacturer in giving service are critical for mid-sized, local customers and multinational customers.
- **Presence in emerging markets** - Emerging markets grow at considerably higher rates in comparison to developed markets. Presence in these key areas, along with knowledge and understanding of their unique needs and the ability to provide support to local manufacturers is a critical success factor.
- **Innovation in research and development** - The ability to develop innovative products both at the initiative of the flavor manufacturer and in collaboration with customers is of extreme importance.
- **Compliance with strict quality, regulatory and safety standards** - Since the flavors are intended principally for the food and beverage and pharmaceutical markets, they must comply with strict quality, regulatory and safety standards.

## Flavors Market - Competition

In the flavor market, Frutarom's main competitors consist of large global manufacturers, mid-sized companies and smaller, local manufacturers. Competition is based to a large extent on innovation, product quality, the ability to provide the customer with added value, and establish and maintain long term customer relationships, value added service, reliability and development of products which are tailor made for the customers' needs and the future market directions. As the cost of flavors accounts for only a small percentage of the total cost of an end product, this market tends to display low price sensitivity. Flavor manufacturers must differentiate themselves by maintaining close collaborative relationships with customers, thorough knowledge and understanding of target markets, innovative abilities, effective research and development and an established reputation for consistent, reliable and effective service, product supply and quality, and the ability to supply product on short notice and with short lead time.

Large multinational flavor manufacturers are established, experienced companies with a global presence and established technical and commercial capabilities, focusing primarily on large multinationals customers. The large multinational flavors producers with whom Frutarom competes include Givaudan, Firmenich, IFF Inc., Symrise and Takasago.

The midsized flavors manufacturers with whom Frutarom competes, focus on both large multinational food and beverage producers as well as and mostly on mid-sized and smaller food and beverage producers who tend to operate in smaller geographical regions. Mid-sized flavor manufacturers with whom Frutarom competes include Sensient, Mane, Robertet, Kerry Ingredients, Wild and Dohler.

# Market Overview

## Competition

The Company estimates that there are approximately 700 small and local flavor manufacturers with more limited research and development capabilities who focus on narrow market segments and local customers. In recent years there has been a trend towards consolidation in the flavor manufacturing industry, resulting in increasing market concentration.

## Risks Factors

The risks of the global market of flavors, fragrances and fine Ingredients refers to macroeconomic risks and to risks related to the Industry.

## Risks Factors - Macroeconomic Risks

The following are the main macroeconomic risk factors:

- **The effect of the global economy on the Company's activities** - Due to the nature of its global activity, Frutarom is exposed to fluctuations in the global economy. Economic crisis and recession in important target countries may cause dips in demand for the Company's products (mainly for premium products) and significantly slow down the development and launch of new products by the customers.

## Risks Factors - Macroeconomic Risks

- **Stability in emerging markets** - the Company operates in a number of countries outside of Western Europe and the United States, such as Russia, Turkey, Kazakhstan, Ukraine, China, countries in North, South and West Africa and countries in Central and South America (such as Mexico and Brazil), and therefore is generally exposed to the political, economic and legal systems and conditions in these countries which are generally less predictable than in developed countries

- **Currency fluctuations** - The Company has sales, expenses, assets and liabilities denominated in currencies other than the U.S. due to that fact, fluctuations in the exchange rates of these foreign currencies could have an impact on a Company's results of operations.

- **Changes in interest rates** - The Company's sources of banking finance, as needed, for short and long term, are linked to different coins, according to the activity currency of the subsidiary, and bear Libor interest at variable rates in accordance with its policy. Therefore, if interest rates increase, the Company may not be able to refinance its credit agreements, or any other indebtedness, on attractive terms. Increases in interest rates will impact the Company's cash flow.

# Market Overview

## Risks Factors - Industry Risks

- **Extensive competition -** Companies in the global market of flavors, fragrances and fine Ingredients face increased competition both from large multinational and mid-sized companies as well as smaller local companies in many of the markets in which they operates. Some of the competitors have greater financial and technological resources, large sales and marketing organizations and great name recognition, and may therefore be better able to adapt to changes and trends in the industry. The global market for flavors is characterized by close, collaborative relationships between flavor manufacturers and their customers, particularly in the large multinational customer segment.

- **Changes in regulations -** Companies are subject to a variety of health, safety and environmental rules at national, state and local levels in the various countries in which it operates. Generally, there is a trend towards increased regulation in the industry in which the Group operates. This has been a result of increased public sensitivity toward the composition and use of flavor products and from the fact that as a result of their medicinal qualities and claimed health benefits, nutraceutical and functional food products are being increasingly viewed by regulators as having similar characteristics to pharmaceutical products, which may lead their subject to the regulatory framework governing the market for pharmaceutical products. The application of new governmental regulations on the nutraceutical and functional foods could result in substantially greater ongoing compliance costs, which, in turn, could have a material adverse effect on companies' business, results of operations or financial condition.

## Risks Factors - Industry Risks

- **Environmental, health and safety regulations** - Companies in the flavor and fine ingredients industry also use, manufacture, sell and distribute a number of environmentally hazardous materials, and therefore are subject to extensive regulation regarding the storage, handling, manufacture, transportation, use and disposal of their products, ingredients and byproducts. Any increase in the stringency of applicable environmental regulations could have a material adverse effect on companies business, results of operations or financial condition.

- **Payment of damages as a result of possible product liability claims due to product warranty -** A company's business exposes it to a risk of product liability, particularly as it is involved in the supply of flavors and fine ingredients to the food and beverage, flavor and fragrance, functional food, pharmaceutical and personal care industries. If a large product liability claim was successfully brought against the Company, its insurance coverage might not be adequate or sufficient to cover such a claim in terms of paying damages and/or defense costs. A lack of or inadequate insurance coverage could result in a material adverse effect on the Company’s business, results of operations or financial condition. If product liability claims were brought against the Company, it might damage the Company’s reputation as well as require the Company to divert significant time and effort of its management, which could affect the Company’s business regardless of the outcome of the claim.

# Market Overview

## Risks Factors - Industry Risks

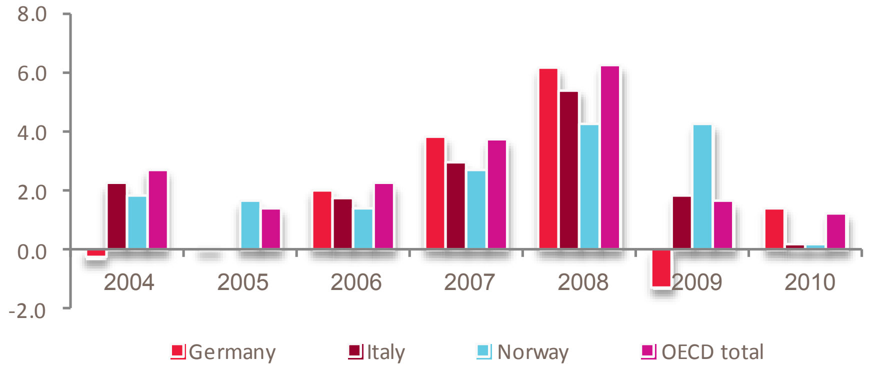
- **Fluctuations in prices of raw materials -** The last few years were characterized by relatively high fluctuations in the prices of raw materials used by companies in the flavor and fine ingredients industry, to manufacture its products. In certain periods, including the recent months, a global trend of increase in the prices of raw materials occurred, including an increase in some of the raw materials Frutarom uses in the manufacture of its products. The supply chain managers, both global and local, and the purchasing departments are closely monitoring the raw materials price trend globally.

  The global increase in demand for raw materials in general, and raw materials for the food industry, in particular, continues and strengthens in recent years. Source of the increase in demand is mainly in third world countries, which populations rapidly change their consumption habits. In addition, the raw materials market is affected by the food industry, which, in recent years, experiences a decrease in supply, which comes from damage to crops in different countries, arising from extreme and prolonged drought and floods.

  The phenomenon of decrease in supply is exacerbated by the increasing diversion of crops, such as wheat and soybeans, for corn and other crops which are sugar producers, which are now used to create ethanol and other materials which produce Bio Diesel.

## Risks Factors - Industry Risks

Increased demand with supply reduction is usually translated into an increase in commodity prices. The following graph shows the rates of increase in food prices, as presented by the OECD, between the years 2004-2010:



# Section 3
# Methodology

## IAS 36 - General

The International Accounting Standard 36 Impairment of Assets (hereinafter "IAS 36") objective is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognize an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

This Standard shall be applied in accounting for the impairment of all assets (other than exceptions as they appear in the standard content) or cash generating unit(s) including goodwill acquired from business combination. Goodwill acquired in business combination represents the value of the intangible assets which cannot be separately identified or separately recognized. Goodwill does not generate cash flow independently from other cash-generating unit(s), and often contributes to the cash flows of several cash-generating units. The Standard requires goodwill acquired in a business combination to be tested for impairment as part of impairment testing of the cash-generating unit(s) to which it relates, once a year or when there is a sign of impairment loss.

## Definitions

The following terms are used in this Standard with the meanings specified:

**Carrying amount** is the amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon.

**A cash-generating unit** is the smallest identifiable group of assets that generates cash inflows that are independent of the cash inflows from other assets or groups of assets.

**Corporate assets** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

**Depreciation (Amortization)** is the systematic allocation of the depreciable amount of an asset over its useful life. (In the case of an intangible asset, the term ‘amortization’ is generally used instead of ‘depreciation’. The two terms have the same meaning).

**Fair value less costs to sell** is the amount obtainable from the sale of an asset or cash-generating unit in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal.

**An impairment loss** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

**The recoverable amount of an asset or a cash-generating unit** is the higher of its fair value less costs to sell and its value in use.

# Methodology

## Definitions

a) The period of time over which an asset is expected to be used by the entity; or

b) The number of production or similar units expected to be obtained from the asset by the entity.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

## Determining an Impairment Loss

The Standard defines number of steps for the identification, recognition and measurement of value loss of an asset or cash generating unit. Moving on to the next step is subjected to the fulfillment of the previous step.

**Step A – Identifying an asset that may be impaired**

An entity shall assess at each reporting date whether there is any indication that an asset may be impaired. In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information:

- During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- Significant changes with an adverse effect on the entity have taken place

## Definitions

during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
- The carrying amount of the net assets of the entity is more than its market capitalization.

Internal sources of information:

- Evidence is available of obsolescence or physical damage of an asset.
- Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.
- Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

# Methodology

## Determining an Impairment Loss

If any indication of value loss exists, the entity shall estimate the recoverable amount of the asset. In case the value of the recoverable amount found is lower than the respective Carrying amount, the entity shall depreciate the value of the asset or the Cash-generating unit accordingly.

The standard requires an intangible asset with an indefinite useful life or not yet available for use and goodwill to be tested for impairment, once a year, regardless to the existence of indication of value loss.

**Step B - Deriving the Recoverable amount**

The Recoverable amount will be the higher of values between the Fair value less costs to sell and the Value in use.

**Step C** - **Recognizing and Measuring an Impairment Loss**

As mentioned in step B, the recoverable amount will be the higher of values between the Fair value less costs to sell and the Value in use. An entity shall depreciate the value of an Asset or a Cash-generating unit if, and only if, the Recoverable amount of the Asset or the Cash-generating unit is lower than its respective Carrying amount.

In order to determine the need for impairment, this study was prepared using Value in use approach.

## Applying IAS 36 - Goodwill

### IAS 36 - Long Lived Assets

The Long Lived Assets of the Company, according to the Company's assessments following the acquisition, include Savory Unit's Goodwill.

### IAS 36 - Goodwill

To perform the impairment examination we have evaluated the value in use of net assets of the Unit, as of December 31, 2012 by using the discounted cash flow (**DCF**) method under the income approach.

# Section 4
# DCF Approach

# DCF Approach

## General

The following table presents the Unit's profit & loss forecast and the actual results for the years 2011 and 2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| Revenues | 104,058 | 111,120 | 115,892 | 119,369 | 122,950 | 126,639 | 129,171 |
| *% Growth* | | *7%* | *4%* | *3%* | *3%* | *3%* | *2%* |
| Cost Of Sales | 69,504 | 75,377 | 75,522 | 76,844 | 79,150 | 81,524 | 83,155 |
| *% of Revenues* | *67%* | *68%* | *65%* | *64%* | *64%* | *64%* | *64%* |
| **Gross Profit** | **34,554** | **35,743** | **40,370** | **42,525** | **43,800** | **45,115** | **46,017** |
| ***% growth profit*** | *33%* | *32%* | *35%* | *36%* | *36%* | *36%* | *36%* |
| S&M | 12,912 | 14,180 | 12,797 | 13,181 | 13,576 | 13,984 | 14,263 |
| *% of Revenues* | *12%* | *13%* | *11%* | *11%* | *11%* | *11%* | *11%* |
| G&A | 4,976 | 6,855 | 6,668 | 6,835 | 6,937 | 7,041 | 7,182 |
| *% of Revenues* | *5%* | *6%* | *6%* | *6%* | *6%* | *6%* | *6%* |
| R&D | 3,350 | 3,570 | 4,000 | 4,140 | 4,227 | 4,316 | 4,402 |
| *% of Revenues* | *3%* | *3%* | *3%* | *3%* | *3%* | *3%* | *3%* |
| **Total Operating Expenses** | **21,238** | **24,605** | **23,465** | **24,156** | **24,740** | **25,341** | **25,847** |
| *% of Revenues* | *20%* | *22%* | *20%* | *20%* | *20%* | *20%* | *20%* |
| **Operating Profit (Loss)** | **13,316** | **11,138** | **16,905** | **18,369** | **19,060** | **19,774** | **20,169** |
| *% operating profit (loss)* | *13%* | *10%* | *15%* | *15%* | *16%* | *16%* | *16%* |
| **EBITADA** | | | **19,094** | **20,568** | **21,269** | **21,993** | **22,432** |
| *% of Revenues* | | | *16%* | *17%* | *17%* | *17%* | *17%* |

*Source: the Unit's financial results & BDO analysis.*

## Revenues

The following table presents the Unit's estimated revenues according to our prediction and the actual revenues results, for  the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| **Revenues** | 104,058 | 111,120 | 115,892 | 119,369 | 122,950 | 126,639 | 129,171 |
| *% Growth* | | *7%* | *4%* | *3%* | *3%* | *3%* | *2%* |

*Source: the Unit's financial results & BDO analysis.*

The Unit's revenues derived from two sub activities (Hereinafter all together: the **"Activity"**):

- The savory activity in Germany (Hereinafter: the "**activity in Germany**"), 88% of the total Unit.
- The savory activity of Italy (Hereinafter: the "**CH Activity**"), 12% of the total Unit.

The savory activity has an extensive customer base which is located in Israel and Europe, especially in Italy, Norway, Germany, Russia, Ukraine, Poland, Czech Republic, France, Austria and Switzerland.

The Savory activity has rapidly growth in the last few years. The growth in sales of the Savory activity derives mainly from focusing on both developed and emerging markets and by serving multinational, midsized and local customers with special focus on Private Label customers, and from the successful execution of strategic acquisitions in recent years.

# DCF Approach

## Revenues

On November 1, 2011, Frutarom executed the plan of removing the Rieber activity production process into the activity in Germany. As a result, the activity in Germany is the official producer of the Rieber activity, using the acquired knowledge and experience the activity in Germany has achieved operational efficiency and savings.

In 2011, the Unit's actual revenues summed to 104 € million. In 2012, the Unit's actual revenues summed to 111 € million. This reflects a growth rate of 6.8%.

For determining the rate of growth of the Company in 2013, we examined the growth rates of comparison companies' (Givaudan, IFF and Symrise) from 2010 to 2012. We found that these companies grew in 2012 by approximately 6%, similar to the savory activity of the Company. Therefore, it was assumed that in 2013 the Company's operations revenue will grow by about 4.3%, similar to the average growth of the comparison companies over the last three years.

The Company intends to continue focusing on its sales and marketing, in order to achieve the estimated growth. Projected growth rates are based on the natural growth of the activity, particularly in Germany, which is about 88% of total activity, continuing the growth trend in recent years, as discussed above.

In the rest of the forecast, it was assumed that the revenues will grow by about 4.3% in 2013, and will decrease to a rate of 2% in the terminal year, represents the rate of long-term growth of the Company.

## Cost of Sales and Gross profit

The following presents the Unit's estimated cost of sales according to our estimations, and the actual cost of sales results, for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| **Cost Of Sales** | 69,504 | 75,377 | 75,522 | 76,844 | 79,150 | 81,524 | 83,155 |
| *% of Revenues* | *67%* | *68%* | *65%* | *64%* | *64%* | *64%* | *64%* |

*Source: the Unit's financial results & BDO analysis.*

Cost of sales include: costs of raw materials, salaries, depreciation and amortization and other expenses.

In 2011, the cost of sales amounted to 70 million Euros, representing about 67% of the total revenues. In 2012, these expenses were a total of about 75 million Euros,, representing about 68% of total revenues.

During 2012, the raw material prices were increased, all over Europe, as well as in Germany. According to the Company's management, in 2012 the Company's products did not increase along with the increase of raw materials. During 2013, the Company intends to increase its product's prices and also act to increase efficiency in procurement, in order to increase the gross profitability.

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# DCF Approach

## Cost of Sales and Gross profit

As part of its activity, the Company purchases raw materials used in its operations in Germany, from European suppliers. In 2012, the Company began a process of replacing the raw material suppliers, and instead purchases raw materials directly from the manufacturers, located in China and India, rather than from the European supplier. The Company's goal is to create efficiency from a shorter chain operation.

Accordingly, on the Company's expense forecast, we predicted that the rate of cost of sales activity will declined in 2013, to a level of about 65% of activity, and will reach about 64% in the terminal year.

## Gross Profit

The following table presents the Unit's estimated gross profit in our prediction, and the actual gross profit results, for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Thousands € |
|---|---|---|---|---|---|---|---|
| **Gross profit** | 34,554 | 35,743 | 40,370 | 42,525 | 43,800 | 45,115 | 46,017 |
| *% gross profit* | *33%* | *32%* | *35%* | *36%* | *36%* | *36%* | *36%* |

*source: the Unit's financial results & BDO analysis.*

As a result of the assumptions described above, the gross margin in the forecast will amount to approximately 35% in 2013 and about 36% throughout the rest of the forecast.

## Operating Expenses and Operating Profit

### Selling and Marketing

The following table presents the Unit's estimated S&M expenses according to our forecast, and the actual S&M expenses results, for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| **S&M** | 12,912 | 14,180 | 12,797 | 13,181 | 13,576 | 13,984 | 14,263 |
| *% of Revenues* | *12%* | *13%* | *11%* | *11%* | *11%* | *11%* | *11%* |

*source: the Unit's financial results & BDO analysis.*

The Unit's S&M expenses consisting mainly of employee wages, advertising, commission's fee, overhead expenses and other expenses.

In 2011, the selling and marketing expenses of the Unit totaled around 13 million Euros, representing about 12% of total revenues. In 2012, these expenses were a total of 14 million Euros, representing 13% of total revenues.

In 2013, according to the Company's forecast, it was assumed that sales and marketing expenses will be about 12.8 million Euros and will be about 11% of the Unit's revenue. The reduction of these costs, from the total revenues, reflects the Company's intention to continue the optimizing process, as planned, which began in late 2012. In addition, according to the Company's management, the intentions to focus on reducing transportation costs, and thereby improve the effectiveness and profitability, in 2013.

Accordingly, the average S&M expenses ratio will stay on approximately 11% in the forecasted years. We have examined the forecasted S&M expenses of revenues ratio, and compared to the Unit's historic performances, and it was found to be reasonable.

# DCF Approach

## Operating Expenses and Operating Profit

### General and Administrative

The following table presents the Unit's estimated G&A expenses according to our forecast, and the actual G&A expenses results, for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| G&A | 4,976 | 6,855 | 6,668 | 6,835 | 6,937 | 7,041 | 7,182 |
| *% of Revenues* | *5%* | *6%* | *6%* | *6%* | *6%* | *6%* | *6%* |

*source: the Unit's financial results & BDO analysis.*

The Unit's G&A expenses consist mainly of relevant employee rent expenses, office expenses, vehicles expenses and other expenses.

In 2011, the G&A expenses were about 5 million Euros, which reflect a rate of 5% of revenues. In 2012, the G&A expenses were about 6.9 million Euros, which reflect a rate of 6% out of revenues.

In 2013, the Company expects to reduce the general and administrative costs due to the efficiency processes mentioned above. According to the Company's plan, it was assumed that the Company's General and administrative expenses in 2013 will be approximately 6.7 million Euros, which reflect a rate of about 6% of the income, the same as 2012.

We examine the forecasted G&A expenses out of revenues ratio compared to the Unit's historical performances and found it reasonable.

## Operating Expenses and Operating Profit

### Research and Development

The following table presents the Unit's estimated R&D expenses according to our forecast, and the actual R&D expenses results for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| R&D | 3,350 | 3,570 | 4,000 | 4,140 | 4,227 | 4,316 | 4,402 |
| *% of Revenues* | *3%* | *3%* | *3%* | *3%* | *3%* | *3%* | *3%* |

*source: the Unit's financial results & BDO analysis.*

The Unit's R&D expenses consist mainly of relevant employee, material consumes and the others.

In 2011, the R&D expenses were 3.4 million Euros, which reflect a rate of 3% out of revenues. In 2012, the R&D expenses were 3.6 million Euros, which also reflect a rate of 3% out of revenues.

In order to project the future R&D expenses rate, we assumed that, depending on the Company's expectations, the Company's R&D expenses in 2013 will stand at about 4 million Euros, a rate which reflects about 3% of revenues.

In order to project the R&D expenses rate in the next forecasted years, starting from 2014, we analyzed the variable component and a fixed structure. In the long run it was assumed that the cost will increase depending on the long-term growth rate of the Unit. Accordingly, the average R&D expenses rate will stay at approximately 3% in the forecasted years.

# DCF Approach

## Operating Profit

The following table presents the Unit's estimated Operating Profit according to our forecast, and the actual Operating Profit, for the years 2011-2012 (thousands €):

| Thousands € | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|---|---|
| **Operating Profit** | 13,316 | 11,138 | 16,905 | 18,369 | 19,060 | 19,774 | 20,169 |
| *% Operating Profit* | *13%* | *10%* | *15%* | *15%* | *16%* | *16%* | *16%* |

*source: the Unit's financial results & BDO analysis.*

As a result of the operational expenses analysis, the Units' operating profit in the forecasted years will slightly increase from 15% in 2013, to 16% in the terminal year.

## Capital Expenditure and Depreciation

## Capital Expenditure

The following table presents our capital expenditure expenses forecast (thousands €)::

| Thousands € | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|
| Capital Expenditure | 890 | 1,220 | 1,553 | 1,889 | 2,263 |

*Source: BDO analysis.*

Forecast of capital expenditure expenses is based on management's policy regarding investment plans and in light of the investments required for the Company's operations. Examined the rate of investment of the revenue, in 2011 and 2012, and found that the rate stood at about 0.8% of total operating revenues. Accordingly, it was assumed that in 2013, the investment will be 0.8% of total revenues, to maintain the existing, and at years of the forecast, the investment will increase to a rate of about 1.9% of total operating revenues. It was assumed that, in the terminal year, the investment will be equal to the depreciation.

## Depreciation

The following table presents our depreciation expenses forecast (thousands €):

| Thousands € | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|
| Depreciation | 2,189 | 2,199 | 2,209 | 2,219 | 2,263 |

*Source: BDO analysis.*

In order to predict the forecast of depreciation expense for 2013, we relied on depreciation expense budget of the Company for 2013, which is a total of about 2.2 million Euros. These costs reflect a rate of about 1.9% from the activity.

Accordingly, it was assumed that the of depreciation expense for the terminal year, will be about 1.9% of the total revenues.

## Working Capital

In order to calculate the Unit's working capital forecast, we have used the Unit's historical data, as of the year 2012.

Working capital days were estimated to be:

- **Receivables days** - 52 days;
- **Inventory days -** 77 days;
- **Payables days -** 54 days.

# DCF Approach

## WACC

When applying the Income Approach, the cash flows expected to be generated by a business are discounted to their present value equivalent using a rate of return that reflects the relative risk of the investment, as well as the time value of money. This return, known as the weighted average cost of capital (“**WACC**”) is calculated by weighting the required returns on interest-bearing debt and common equity capital in proportion to their estimated percentages in an expected industry capital structure.

The general formula for calculating the WACC is:

**WACC = Kd (D%) + Ke (E%)**

Where:

| | |
|---|---|
| **WACC=** | Weighted average rate of return on invested capital; |
| **Kd=** | After-tax rate of return on debt capital; |
| **D%=** | Debt capital as a percentage of the sum of the debt, preferred and common equity capital (“Total Invested Capital”); |
| **Ke=** | Rate of return on common equity capital; and |
| **E%=** | Common equity capital as a percentage of the Total Invested Capital. |

## WACC

CAPM has been empirically tested and is widely accepted for the purpose of estimating a company’s required return on capital. In applying the CAPM, the rate of return on capital is estimated as the current risk-free rate of return on US Treasury bonds, plus a market risk premium expected over the risk-free rate of return, multiplied by the “**beta**” for the valued company. Beta is defined as a risk measure that reflects the sensitivity of a company’s stock (**or capital**) price to the movements of the stock market as a whole.

The CAPM rate of return on capital is calculated using the formula:

Ke **=** Rf + β(Rm * Rf)+ SCP+ Sp **Where**;

| | |
|---|---|
| **Ke=** | Rate of return on capital (in this case, Total Invested Capital); |
| **Rf=** | Risk free rate of return; (in this case, the interest taken is index-linked bond yield for the period of 10 years, weighted, Germany and Italy); |
| **B=** | Beta or systematic risk for this type of capital investment (in this case, the beta taken was for a period of five years, at a weekly section); |
| **Rm–Rf=** | Market risk premium; the expected return on a broad portfolio of stocks in the market (Rm) less the risk free rate (Rf); |
| **SCP** | Small cap premium - Ibbotson valuation edition 2012 yearbook; |
| **Srp** | Specific Premium. |

# DCF Approach

## WACC

We based on the Capital Asset Pricing Model (**CAPM**) in calculating the WACC. The following table is the parameters that served for the calculation of the Unit's WACC, for December 31, 2012:

| Name | Source | Symbol | Value |
|---|---|---|---|
| Unit's Debt | Based on the Comparison companies | D | 19% |
| Unit's Equity | Based on the Comparison companies | E | 81% |
| Cost Of Debt | The Company's Cost of Debt | Kd | 4.2% |
| Tax Rate | Effective tax rate of the unit | T | 30% |
| Risk Free Rate | Index-linked govermental bond yields for 10-year (Bloomberg) | Rf | 0.34% |
| Beta | Levered Beta- According to data of compairing Units: Givaudan , IFF and Symrise | ß | 0.74 |
| Market Premium | weighted Italy & Germany risk premium (Damodaran) | Rm-Rf | 6.1% |
| SCP | Ibbotson valuation edition 2012 yearbook | SCP | 6.1% |
| SRP | Specific Premium | SRP | 2.0% |
| Cost Of Capital | Rf +ß*(Rm-Rf)+SCP | Ke | 13.0% |
| Wacc | (D/V)*(1-T)*Kd + (E/V)*Ke | | 11% |

*Source: BDO analysis.*

The following data is the comparable companies included in the beta calculation: Givaudan, IFF and Symrise. Rate of the ß section taken weekly over five years.

According to IAS 36, while measuring the recoverable amount, no income tax receipts or payments should be included. Therefore, we should measure a Pre-tax discount rate. According to our estimation the pre-tax discount rate totals to approximately 15.2%.

The terminal growth rate of 2% was determined based upon the real economy expected growth rate in the long run.

## The Unit's Cash Flow

The following table shows the Unit's cash flow forecast, for December 31, 2012 and for the forecasted years (thousands €):

| Thousands € | 2013 | 2014 | 2015 | 2016 | Terminal |
|---|---|---|---|---|---|
| **Operating Profit (Loss)** | **16,905** | **18,369** | **19,060** | **19,774** | **20,169** |
| Change In Working Capital | 1,697 | 578 | 655 | 675 | 463 |
| Depreciation | 2,189 | 2,199 | 2,209 | 2,219 | 2,263 |
| Investment In Fixed Assets | 890 | 1,220 | 1,553 | 1,889 | 2,263 |
| **Annual Cash Flow** | **16,507** | **18,770** | **19,061** | **19,428** | **19,706** |
| **Residual Value** | | | | | **149,691** |
| **DCF** | **15,382** | **15,187** | **13,392** | **11,853** | **91,323** |
| **Total** | **147,137** | | | | |
| **Tax Shield ¤** | **3,109** | | | | |
| **Recoverable Amount** | **150,246** | | | | |

*Source: BDO analysis.*

The cash flow resulting from the above assumption was discounted at a rate of 15.2%. In addition, it was assumed that the cash flow will grow at a 2% growth rate in the long-run. Tax savings due to amortization of the gap between the purchase price which paid for the savory's activity in Italy and Norway and the tangible assets of those activity, were added to derive the Fair Value of the Unit. These tax savings reflect the future tax benefits associated with amortizing the asset for income tax purposes. Accordingly, The value of the Unit includes the discounted tax saving that a hypothetical (market participant) acquirer would benefit from, due to the amortization of this asset.

# Section 5

# Recoverable Amount versus Carrying Amount Comparison

# Recoverable Amount versus Carrying Amount Comparison

## Carrying Amount

The following table presents the carrying amount calculation (thousands €):

If and only if, it is found that the recoverable amount of the asset is less than the book value, then the entity will be required to estimate impairment of the asset being measured and reduce it accordingly.

For finding the book value of the activity, we examined the balance sheet of operations as of December 31, 2012, and the goodwill associated with the operation, which is registered in the books of Frutarom, December 31, 2012.

The following table presents the total book value of the company (thousands of Euros):

| Book Value | Thousands € |
|---|---|
| Trade Receivables ,net | 13,536 |
| Accounts Receivable | 1,245 |
| Inventory, Net of Advances | 15,891 |
| Property Plant and Equipment, Net | 18,296 |
| Software | 2,750 |
| Trade Payables | (11,114) |
| Other Short-Term Liabilities | (5,007) |
| Accrued Termination Liability (Severance / Pension) | (2,342) |
| Customers Relations | 9,175 |
| Know-How | 9,128 |
| Good-Will | 75,914 |
| **Total Carring Amount** | **127,472** |

*Source: company's management.*

## Recoverable Amount versus Carrying Amount

To observe potential impairment, the assets recoverable amount was compared to the carrying amount.

The following table summarizes the results of the impairment examination for the Unit, under ASC 350:

| Thousands € | |
|---|---|
| Recoverable Amount | 150,246 |
| Carrying Amount | 127,472 |
| **Impairment Amount** | - |

*Source: BDO analysis.*

The analysis of the table above shows that the recoverable amount of the Unit is greater than its carrying amount, as of the Valuation Date. Therefore, Frutarom's savory Division goodwill is not deemed to be impaired.



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# Section 6
# Appendix

# Appendix

## Appendix A

We examined the possible influence of changing the discount rate used in this report (**15.2%**) and the terminal growth rate (**2%**) on the value of the DCF-based Unit value.

The following table shows the predicted results with plus/minus 1% and 2% of discounts rates and terminal growth rates:

| Growth Rate | Discount Rate 17% | 16% | 15% | 14% | 13% |
|---|---|---|---|---|---|
| 0% | 119,983 | 127,070 | 135,093 | 144,250 | 154,801 |
| 1% | 124,062 | 131,828 | 140,690 | 150,897 | 162,783 |
| 2% | 128,680 | 137,258 | **147,137** | 158,637 | 172,195 |
| 3% | 133,950 | 143,513 | 154,644 | 167,764 | 183,459 |
| 4% | 140,020 | 150,797 | 163,497 | 178,686 | 197,181 |

*Source: BDO analysis.*

## Appendix B

We examined the possible influence of changing the gross profit rate in 2013 used in this report, on the value of the DCF-based Unit value:

| Rate of change | 4% | 3% | 2% | 1% | **0%** | (1%) | (2%) | (3%) | (4%) |
|---|---|---|---|---|---|---|---|---|---|
| Recoverable Amount | 189,534 | 179,712 | 169,890 | 160,068 | **150,246** | 140,424 | 130,602 | 120,780 | 110,957 |

*Source: BDO analysis.*

# SECTION B

## DIRECTORS' REPORT

**FRUTAROM INDUSTRIES LTD.**
**DIRECTORS' REPORT OF THE COMPANY'S STATE OF AFFAIRS**
**FOR THE PERIOD ENDING DECEMBER 31, 2012**

**BOARD OF DIRECTORS' DISCUSSIONS OF THE COMPANY'S STATE OF BUSINESS**

## A. REVIEW OF ACTIVITY

Frutarom Industries Ltd. (the **"Company"**) is a global company established in Israel in 1933. Frutarom became a public company in 1996 upon registration of its shares for trade on the Tel Aviv Stock Exchange. In February 2005, the Company's Global Depository Receipts were also listed on the London Stock Exchange Official List. The Company, itself and through its subsidiaries ("**Frutarom**" or the **"Group**") develops, produces and markets flavors and fine ingredients used in the manufacture of food, beverages, flavors, fragrances, pharmaceuticals/nutraceuticals and personal care products. Frutarom operates production facilities in Europe, North America, Latin America, Israel, Asia and Africa, marketing and selling over 30,000 products to more than 14,000 customers in more than 140 countries, and employing 2,020 people throughout the world.

Frutarom operates in two major segments: the Flavors segment and the Specialty Fine Ingredients segment.

- **The Flavors Segment -** Frutarom develops, produces, markets and sells sweet and savory flavor solutions, including flavors and products which in addition to flavors also contain fruit or vegetable ingredients and other natural ingredients ("food systems") which are used mainly in the manufacture of foods, beverages and other consumed products. Frutarom develops thousands of different flavors for its customers, most of which are tailor-made and customized for specific customers, and consistently develops new products to meet changing consumer preferences and future customer needs.

  In recent years, Frutarom's Flavors segment has undergone accelerated growth, and it currently constitutes 74% of Frutarom's total sales (compared to 33% in 2000). This accelerated growth is the result of the focus on the fast growing area of natural flavors, from development of innovation-based unique solutions combining taste and health for the large multi-national market segment, a focus on mid-size and local customers in emerging and developed markets (focusing in particular on private labels), emphasizing the provision of customized services, including technological and marketing support and assistance in the development of products; the offer of high level tailor-made services and products, as are normally provided for large multi-national companies and as the result of Frutarom's strategic acquisitions, which have and are being successfully incorporated with Frutarom's global activities.

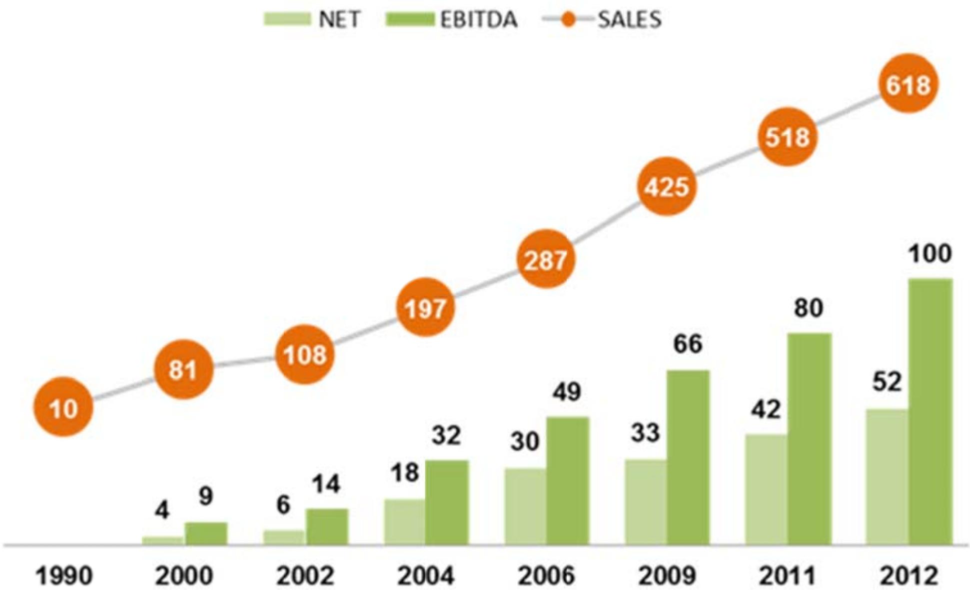
- **The Specialty Fine Ingredients Segment -** Frutarom develops, produces, markets and sells natural flavor extracts, natural functional food ingredients, natural pharmaceutical/nutraceutical extracts, aroma chemicals, essential oils, unique citrus products, natural gums and stabilizers. The Specialty Fine Ingredients products are sold primarily to the food, beverage, flavor, fragrance, pharmaceutical/nutraceutical and personal care industries.

  In its Specialty Fine Ingredients activities, Frutarom focuses on a value-added product portfolio, which gives Frutarom a competitive edge over its rivals. Most of the specialty fine ingredients are natural products which enjoy higher-than-average demand compared to non-natural products. Frutarom acts to expand the natural product portfolio it offers its customers, with particular emphasis on the area of natural, functional and healthy foods.

**RAPID GROWTH STRATEGY – PROFITABLE ORGANIC GROWTH AND STRATEGIC ACQUISITIONS**

Frutarom continues to act with determination to implement its rapid profitable growth strategy with focused strengthening of its development, manufacture, marketing and sales infrastructures together with continued examination of additional strategic acquisitions.

Since 2000, Frutarom has grown at an average yearly rate of 19%, through a combination of organic growth and 23 acquisitions. The Company's revenues over this period grew from revenues of US$81 million with an EBITDA of US$9 million and net profit of US$4 million in 2000 to record revenues of US$618 million, EBITDA of more than US$100 million and net profit of US$52 million in 2012, also achieving a record highs US$91 million in cash flow from operating activities.



- **Increasing Flavors' segment** - The successful implementation of Frutarom's rapid and profitable growth strategy allowed Frutarom to significantly increase its activities in the Flavors segment, its most profitable activity, to 74% of total Frutarom sales compared to 33% of total sales in 2000, while achieving organic growth at a rate higher than the growth rates in the markets in which it operates. The Company estimates that its rapid growth trend will continue even under today's challenging market conditions.

- **Emerging Markets** – Frutarom's accelerated expansion to target markets with higher growth rates is reflected in the 60% growth achieved in 2012 (compared with 2011), in the emerging markets of China and South East Asia, Central and South America, Central and Eastern Europe and Africa. The portion of Frutarom's sales out of total Company sales in these strategic markets increased from 27% in 2010 to 36% this year. In the BRIC countries, Frutarom's sales this year grew by 31%.

- **North America** - the results also reflect the continued rapid growth of the Flavors' activities in the United States, which is the largest market in the world for flavors, which increased this year by 43%.

  In light of Frutarom's rapid growth in markets outside of Western Europe, Frutarom's portion of sales in Western European markets (which also increased), standing at 51% in 2010, was 42% this year.

- Frutarom focuses and will continue to invest great resources on accelerating growth and increasing its market share in emerging markets where growth rates are higher, and in North America, in order to maximize the rapid growth potential and the many business opportunities therein, including, among other things, by focused strengthening of its R&D, production, marketing and sales infrastructures in important target countries and additional strategic acquisitions.

- **Combination of Taste and Health -** Frutarom is developing innovative tailor made taste and health solutions. The solutions provided by the Company are in line with the major trends in the global food market and with consumer demand, including combining taste with health, health supplements, anti-aging products and food targeting specific population and age groups. The added value which Frutarom offers its customers and Frutarom's abilities at the unique crossroads of taste and health combinations give the Company an important competitive advantage among customers in both developed and emerging markets.

- **Focus on providing quality service and product development for large multi-national customers and for medium size local customers –** Frutarom continues to expand the services it provides for its customers, and its product portfolio and solutions for both large multi-national customers and mid-size local customers, with a special emphasis on the rapidly growing private label market. Frutarom will continue to focus on unique products for the large multinational food and beverage manufacturing sector, and is constantly expanding its natural food solutions portfolio. For the mid-size and local customers segment, Frutarom offers the same high level of service and products and solutions adapted to specific customer requirements as generally provided to large multi-national customers. Frutarom also offers mid-size and local customers and private labels, usually with more limited resources than large and multi-national customers, assistance in the development of their products, while providing market support and flexibility regarding minimal quantities and dates of delivery.

- **Acquisitions and Mergers, and their contribution to the achievement of profitable growth** - Frutarom has extensive experience with successful implementation of acquisitions and mergers, and acts to integrate the acquired companies and activities into its existing activity, utilizing commercial and operational synergies in order to optimize the many cross-selling opportunities, cost savings and continued improvement of margins.

  After having conducted seven acquisitions in 2007 and three in 2009, all of which were successfully integrated with its global activities and contribute to both a growth in sales and improved margins, Frutarom has continued its acquisition strategy and completed five additional strategic acquisitions in 2011 and three more in the beginning of 2012.

**Increase in Margin and Profit**

**Contribution and integration of acquisitions –** Integration of the eight acquisitions is moving ahead successfully and according to plan. The acquisitions have already contributed not only to Frutarom's growth in sales but also to significantly improved profit. Frutarom continues to realize the many cross-selling opportunities and enhanced technological capacities resulting from these acquisitions, and to actualize the savings resulting from the integration of R&D, sales, marketing, operations and purchase infrastructures.

- **Streamlining -** Frutarom is moving forward with the integration of production sites and activities, and transferring other activities to countries where operating costs are lower, anticipating further significant yearly savings of US$10 million, which will come to fruition already in the second half of 2013 and mainly in 2014.

- **Creating and strengthening global purchase -** Frutarom continues to strengthen its global purchase infrastructure, utilizing the significant added purchasing power acquired through its recent acquisitions, and while expanding its pool of suppliers with an emphasis on increased purchase of raw materials used in the manufacture of its products from their countries of origin (especially natural raw materials).

  Realizing Frutarom's rapid growth strategy, the continued stabilization of raw material prices, furthering the streamlining processes and improvement of its costs structure, while taking optimal advantage of its productions sites throughout the world and successfully integrating of recent acquisitions, will bring about improved future margins. Frutarom's capital structure (total assets of US$772.5 million and equity of US$453.6 million as of December 31, 2012, constituting 58.7% of the total assets) and net debt level (total loans after deduction of cash), which stands at US$136.1 million as of December 31, 2012, supported by the cash flow it achieves and together with bank backing, will allow Frutarom to continue to realize the strategic growth as it has done over the past few years, including further strategic acquisitions, while strengthening its competitiveness and position as one of the leading global companies in the field of flavors and fine ingredients, and to realize its vision:

***"To be the Preferred Partner for Tasty and Healthy Success"***

## Acquisitions in 2012

- **Savoury Flavours -** On January 4 2012 Frutarom signed an agreement to acquire 100% of the share capital of the UK company Savoury Flavours (Holding) Ltd. ("Savoury Flavours") for approximately US$ 5.8 million (GBP 3.8 million), and additional consideration to be calculated according to performance, using a mechanism prescribed in the purchase agreement, which according to the Company's estimates will not exceed GBP 0.3 million. The Company also paid an additional GPB 0.1 million for adjustment of working capital as on the date of acquisition (US$0.2 million).

  Savoury Flavours, founded in 1999, develops, manufactures, and markets savory taste solutions including mainly flavors, seasoning compounds, marinades and sauces, specializing in snacks and convenience foods. Savoury Flavours has a development, manufacture and marketing site in the UK, and a wide customer base including food manufacturers and private labels in the UK and in emerging markets.

  Savoury Flavor's sales turnover in 2012 came to US$7.7 million (GBP 4.8 million). Savoury Flavours' production site is located next to the East Anglian Food Ingredients Ltd. (EAFI) production site, which manufacturers savory products as well.

  The geographic proximity between the two sites and the two companies' complimentary product range and technologies allow shared management of the two sites and the integration of their activities, creating synergies between them and with Frutarom's savory activities in the UK and throughout the world, which has grown significantly over the past few years.

For further information regarding the acquisition of Savoury Flavours, see the Company's immediate report dated January 5, 2012.

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- **Etol -** Over the first half of 2012, Frutarom purchased the full share capital of the Slovenian public company ETOL Tovarna arom in eteričnih olj d.d in return for an overall sum of €35.4 million.

  Etol, founded in 1924, deals in the development, manufacture and marketing of sweet and savory taste solutions, focusing on natural flavor products for the food and beverage industry. Etol also has great experience in the development and manufacture of fruit based flavors and products and food systems, specializing in local fruits of its geographic region, as well as extensive activities in the growing area of bases for beverages, in which Frutarom intends to significantly invest and expand activities. Etol products are sold to a wide customer base in Central and Eastern Europe and in emerging markets, with a focus on Slovenia, Russia, Poland, Ukraine, Turkey, Croatia, Serbia, Slovakia, Belarus, Macedonia, Czech Republic, Kazakhstan and other developed countries including Switzerland, Germany and England. Etol's customers include leading food and beverage manufacturers in the countries it operates in, including large multi-national food companies. Etol's activities are synergetic to Frutarom's activities.

  Etol and its subsidiaries employ some 240 employees, including a leading human capital in the areas of research and development and sales, and an experienced management team. Etol has a manufacturing and marketing site in Sofia Vas, Slovenia, in which it has invested extensively over the past few years, and has incorporated innovative technologies in the area of flavors. Etol also has additional real estate properties for future expansion. Frutarom is working towards the integration of Etol's activities with its global activities in the area of flavors, including by transfer of R&D and manufacturing activities to Etol, achieving a competitive advantage in light of Etol's R&D capabilities, its excellent geographic location and its attractive cost basis, harmonization of raw materials and utilization of the many cross-selling opportunities.

  The Etol Group's sales turnover in 2012 totaled €52.3 million (US$67.2 million).

  For further information regarding the acquisition of Etol, see the Company's immediate reports published on January 17, 18 and 26, 2012, February 12, 2012, March 17, 2012, May 8, 2012 and June 6 and 26, 2012.

- **Mylner** – On February 7, Frutarom signed an agreement to acquire 100% of the share capital of Mylner Indústria E Comércio Ltda, a Brazilian Flavors company, and its Brazilian parent company, Vila Osório Participações s/a in return for approximately US$15.7 million (BRL 27.1 million). Frutarom also paid Mylner a further BRL 4.4 million for Mylner’s cash balance. The acquisition was completed upon signing.

Mylner, founded in 1974, develops manufactures and markets flavor solutions, focusing mainly on sweet flavors for beverages and baked goods, natural plant extracts and natural flavor products. Mylner has a modern development, production and marketing site in Sao Paulo, Brazil, including land for future expansion. Mylner’s wide customer base includes leading food and beverage manufacturers in Brazil and in other developing countries in Latin America. Mylner’s sales turnover in 2012 came to US$9.2 million (BRL 18 million).

For further information regarding the acquisition of Mylner, see Note 5 to the Company’s financial statements of December 31, 2012, and the Company’s immediate reports published on February 7, 2012.

## B. FINANCIAL STATUS

The Group's total assets as of December 31, 2012 were US$772.5 million compared with US$650.0 million as of December 31, 2011.

The Group's current assets totaled US$301.0 million, compared with US$246.6 million, as of December 31, 2011.

The fixed assets after deduction of cumulative depreciation and other assets net as of December 31, 2012 totaled US$468.0 million, compared with US$401.2 million as of December 31, 2011.

The rise in the total assets is mainly due to acquisitions completed in 2012, and from translation differences of values of assets in subsidiaries having operational currency other than the dollar (in light of the strengthening of exchange rates of European currencies and the NIS against the US dollar, as of December 31, 2012 compared with December 31, 2011).

## C. RESULTS OF OPERATIONS IN 2012

2012 was another record year for Frutarom, in which it achieved record highs in sales, gross profits, operational profit, EBITDA, net profit, earnings per share and cash flow, despite challenging market conditions in the global economy in general and in Western Europe in particular, and despite the strengthening of the US dollar versus the main currencies in which Frutarom operates, which lowered sales and profits in dollar terms.

Sales

In 2012, Frutarom sales, net of currency effects, grew by 24.2% reaching a yearly record high of US$618.0 million, compared with US$518.4 million in 2011. Currency effect detracted 5.0% from growth and sales (US$26.1 million), in light of the strengthening of the US dollar versus European currencies and the Israeli shekel, so that in dollar terms, sales grew by 19.2%. The acquisitions made in 2011 and 2012 contributed US$115.5 million to sales over the period. Organic growth (net of the contribution of the acquisitions and currency effects) was 2.0% this year.

Flavor Activity sales, net of currency effects, increased by 29.5% compared last year, to a record high of US$457.3 million, constituting 74% of total Frutarom sales.

Accelerated growth in Flavors, the most profitable among Frutarom's activities, is the result of organic growth at a rate higher than the growth rates in the markets in which Frutarom operates, and from the acquisitions made in 2011 and 2012 in Flavors, which contributed US$97.9 million to sales in 2012. Organic growth in Flavors (net the contribution of these acquisitions and currency effects) reached 3.1% this year.

Frutarom's sales in Specialty Fine Ingredients increased, net of currency effects, by 0.1% compared with last year, reaching US$140.8 million. Dollar sales in Specialty Fine Ingredients taking into account currency effects fell by 2.9%. Specialty Fine Ingredients customers' reduction of inventory affected the fall in sales.

Frutarom's sales in Trade and marketing increased by US$16.0 million compared with 2011, reaching US$22.3 million. Sales included Etol's Trade and Marketing activity in Central Europe, which contributed US$17.6 million to sales in 2012.

Sales Breakdown by Fields of Activity 2002-2012 (US$ M)

| | | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Flavor Activity | Sales | 45.3 | 68.2 | 110.9 | 150.4 | 187.0 | 247.7 | 339.8 | 297.1 | 306.4 | 369.9 | 457.3 |
| | % | 42% | 49% | 56% | 62% | 65% | 67% | 72% | 70% | 68% | 71% | 74% |
| Fine Ingredient Activity | Sales | 57.7 | 67.0 | 81.7 | 89.8 | 98.4 | 115.0 | 124.3 | 123.8 | 141.5 | 145.0 | 140.8 |
| | % | 54% | 48% | 41% | 37% | 34% | 31% | 26% | 29% | 31% | 28% | 23% |
| Trade & Marketing | Sales | 6.2 | 6.5 | 6.8 | 6.3 | 6.7 | 10.5 | 13.2 | 7.1 | 5.4 | 6.4 | 22.3 |
| | % | 6% | 5% | 4% | 3% | 2% | 3% | 3% | 2% | 1% | 1% | 4% |
| Inter Segments | Sales | -1.7 | -2.3 | -2.6 | -2.7 | -4.9 | -4.9 | -4.0 | -2.8 | -2.2 | -2.9 | -2.4 |
| | % | -2% | -2% | -1% | -1% | -2% | -1% | -1% | -1% | 0% | 0% | 0% |
| Total Sales | | 107.5 | 139.3 | 196.8 | 243.8 | 287.2 | 368.3 | 473.3 | 425.2 | 451.1 | 518.4 | 618.0 |

As stated, the strengthening of the US$ between 2011 and 2012, versus European currencies and the NIS, detracted US$26.1 million from total Frutarom sales; US$21.7 million from the Flavors activity, and US$4.4 million from the Specialty Fine Ingredients activity.

The following is a summary of the profit and loss report for 2011 - 2012 (US$ M):

| | 2011 | 2012 | Change (%) 2011-2012 |
|---|---|---|---|
| **Sales** | 518.4 | 618.0 | 19.2% |
| **Gross profit** | 188.6 | 226.3 | 20.0% |
| **R&D, Sales, G&A and Other expenses** | 129.9 | 153.4 | 18.1% |
| **Operating profit** | 58.7 | 72.8 | 24.2% |
| **Operating profit net of onetime expenses** | 60.6 | 74.3 | 22.6% |
| **EBITDA** | 80.4 | 100.4 | 24.9% |
| **EBITDA net of onetime expenses** | 82.3 | 101.9 | 23.8% |
| **Financing Expenses** | 5.8 | 7.2 | 24.9% |
| **Profit before tax** | 52.9 | 65.6 | 24.1% |
| **Net profit** | 42.0 | 52.0 | 23.7% |

In 2012 Frutarom achieved record highs in sales, gross profits, operational profit, EBITDA, net profit, cash flow and earnings per share, despite the strengthening of the US$ versus the main currencies in which Frutarom operates (European currencies and the NIS), which reduced dollar terms sales and profits by 5.0%.

Gross Profit

Gross profit in 2012 increased by 20%, reaching a yearly record high of US$226.3 million compared with US$188.6 million in 2011. Gross margin, net of Trade and Marketing activity added following the acquisition of Etol (a non-core activity for Frutarom) and net of onetime reorganization expenses of US$0.4 million, reached 37.4%, compared with gross margin of 36.4% in 2011. Gross margin, including Trade and Marketing activity added following the acquisition of Etol, also increased, reaching 36.6%.

Contributing factors to improvement in gross profit and margins were organic growth in sales and stability in the prices of raw materials Frutarom uses in the manufacture of its products. The main effect of the actions which Frutarom takes to optimize its potential to reduce raw material costs and the utilization of the many operational synergies resulting from recent acquisitions is not yet seen in the results. Frutarom continues to strengthen its global purchase infrastructure, utilizing its added purchase power from its recent acquisitions and continuously expanding its pool of suppliers and with an emphasis on purchase of raw materials from their countries of origin (especially natural raw materials) used in the manufacture of its products.

Sales and Marketing, R&D, G&A and Other Expenses

In 2012, sales and marketing, R&D, G&A and other expenses totaled US$153.4 million (24.8% from sales), compared with US$129.9 million in 2011 (25.1% of sales).

Sales and marketing expenses, R&D, G&A and other expenses included onetime expenses of US$1.1 million. These onetime expenses included US$1.8 million for re-organization, acquisition expenses in the amount of US$1.0 million, and one-time income of US$1.7 million from gain on a bargain price for the acquisition of Etol.

Over the same period last year, sales and marketing, R&D, G&A and other expenses included onetime expenses for acquisitions, which came to US$1.9 million.

The increase in expenses derives from the increase in the scope of activity, and mainly from the acquisitions made in 2011 and 2012.

Frutarom has acted and continues to act to achieve optimal efficiency, to improve its cost structure and strengthen its future competitiveness, maximally utilizing its sites throughout the world and the successful integration of its latest acquisitions.

Operating Profit and EBITDA

In 2012, operating profit increased by 24.2%, reaching a yearly record high of US$72.8 million, (11.8% of sales) compared with US$58.7 million last year (11.3% of sales).

Operational profit net of onetime expenses (for reorganization and acquisitions) in 2012 increased by 22.6%, reaching US$74.3 million (12.0% of sales), compared with US$60.6 million (11.7% of sales) last year.

Frutarom's EBITDA for 2012 increased by 24.9%, reaching a yearly record high of US$100.4 million (16.2% of sales) compared with US$80.4 million during the same period last year (15.5% of sales).

EBITDA in 2012, net of onetime expenses (for reorganization and acquisitions) increased by 23.8%, reaching US$101.9 million (16.5% of sales), compared with US$82.3 million for the same period last year (15.9% of sales).

Financing Expenses / Income

In 2012, financing expenses totaled US$7.2 million (1.2% of sales), compared with US$5.8 million in 2011 (1.1% of sales).

Interest expenses in 2012 totaled US$7.2 million, compared with US$2.5 million over the same period last year. The interest expenses increase derived primarily from an increase in loans taken for the acquisitions.

In 2012 financing expenses from exchange differentials were negligible, compared with US$3.3 million in 2011.

Profit before Tax

In 2012, profit before tax went up by 24.1%, reaching a yearly record high of US$65.6 million (10.6% of sales, compared with US$52.9 million (10.2% of sales) in 2011.

Taxes on Income

In 2012, taxes on income totaled US$13.6 million (20.8% of profit before tax) compared with US$10.8 million (20.5% of profit before tax) in 2011. Tax expenses for 2011 and 2012 were affected by income from closing tax assessments for previous years and the distribution of profits among the various countries.

Net Profit

In 2012, net profit increased by 23.7%, reaching a yearly record high of US$52.0 million, compared with US$42.0 million in 2011. Net margin reached 8.4% in 2012, compared with 8.1% in 2011.

Earnings per Share

In 2012, earnings per share increased by 22.5%, reaching yearly record high of US$0.90, compared with US$0.73 in 2011.

## D. RESULTS OF OPERATIONS IN Q4 2012

### Sales

In Q4 2012, Frutarom sales, net of currency effects, grew by 13.5%, reaching a fourth quarter record high of US$144.9 million, compared with US$131.6 million during Q4 2011, despite challenging market conditions throughout the world and particularly in Western Europe. Currency effects detracted 3.4% from growth in sales (US$4.5 million), in light of the strengthening of the average exchange rate of the US dollar versus European currencies (except the GBP) and the NIS in Q4, compared to Q4 last year, so that in dollar terms, sales grew by 10.1%. The acquisitions made Q1 2012 contributed US$17.2 million to sales over the quarter. Organic growth (net of the contribution of the acquisitions and currency effects) was 0.5% this quarter.

Flavors Activity sales net of currency effects increased by 15.7% compared to Q4 last year, reaching a fourth quarter record high of US$111.7 million. The acquisitions made in the first quarter of 2012 in Flavors contributed US$13.8 million to sales during this quarter. Organic growth in Flavors (net of the contribution of the acquisitions and currency effect) reached 2.0% this quarter.

Specialty Fine Ingredients Activity sales reached US$29.5 million, compared with US$30.9 million in the same quarter last year, a 3.2% decrease in sales net of currency effects. A decrease in inventory among Frutarom's specialty fine ingredients' customers affected the fall in sales.

Frutarom sales in Trade and Marketing (not one of Frutarom's core activities) increased, achieving US$4.3 million. Sales included Etol's Trade and Marketing activity in Central Europe, which contributed US$3.4 million to sales this quarter.

**Sales Breakdown by Activity for Q4 2002-2012 (US$ M)**

| | | Q4 2002 | Q4 2003 | Q4 2004 | Q4 2005 | Q4 2006 | Q4 2007 | Q4 2008 | Q4 2009 | Q4 2010 | Q4 2011 | Q4 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Flavors Activity** | **Sales** | 10.4 | 18.5 | 40.1 | 30.8 | 45.5 | 78.5 | 71.3 | 76.6 | 78.1 | 100.1 | 111.7 |
| | **%** | 44% | 51% | 70% | 59% | 63% | 72% | 72% | 71% | 69% | 76% | 77% |
| **Fine Ingredient Activity** | **Sales** | 12.1 | 17.2 | 16.1 | 20.0 | 26.4 | 28.9 | 25.5 | 30.9 | 33.2 | 30.9 | 29.5 |
| | **%** | 51% | 47% | 28% | 38% | 36% | 27% | 26% | 29% | 30% | 23% | 20% |
| **Trade & Marketing** | **Sales** | 1.5 | 1.4 | 1.5 | 1.3 | 2.0 | 2.6 | 2.7 | 1.4 | 1.6 | 1.1 | 4.3 |
| | **%** | 6% | 4% | 3% | 2% | 3% | 2% | 3% | 1% | 1% | 1% | 3% |
| **Inter Segments** | **Sales** | -0.5 | -0.6 | -0.7 | 0.5 | -1.4 | -1.5 | -0.8 | -0.4 | -0.5 | -0.5 | -0.7 |
| | **%** | -2% | -2% | -1% | -1% | -2% | -1% | -1% | -1% | 0% | 0% | 0% |
| **Total sales** | | 23.5 | 36.5 | 57.0 | 52.6 | 72.5 | 108.5 | 98.7 | 108.5 | 112.4 | 131.6 | 144.9 |

As stated, the strengthening of the dollar between 2011 and 2012, versus European currencies (other than the GBP) and the NIS, detracted US$4.5 million from total Frutarom sales; US$4.1 million from Flavors sales, and US$0.4 million from Specialty Fine Ingredients sales.

**The following is a summary of the profit and loss report for Q4 in the years 2011 - 2012:**

In Q4 2012 Frutarom achieved record high fourth quarter highs in sales, gross profits, operational profit, EBITDA, net profit and earnings per share, despite the strengthening of the dollar versus the Euro, the Swiss franc and the NIS, which detracted 3.4% from sales and from dollar profits.

| | Q4 2011 | Q4 2012 | Change 2011-2012 (%) |
|---|---|---|---|
| **Sales** | 131.6 | 144.9 | 10.1% |
| **Gross profit** | 46.8 | 51.5 | 10.1% |
| **R&D, sales, G&A and Other expenses** | 34.6 | 37.8 | 9.2% |
| **Operating profit** | 12.2 | 13.7 | 12.9% |
| **Operating profit without one-time expenses for acquisitions** | 12.6 | 15.0 | 19.7% |
| **EBITDA** | 18.1 | 20.7 | 13.9% |
| **EBITDA without one-time expenses for acquisitions** | 18.5 | 21.9 | 18.5% |
| **Financing expenses** | 3.2 | 1.4 | -56.3% |
| **Profit before tax** | 8.9 | 12.3 | 38.0% |
| **Net profit** | 7.9 | 10.5 | 33.1% |

Gross Profit

Gross profit in Q4 2012 increased by 10.1% and reached a record Q4 high of US$51.5 million, compared with US$46.8 million in the same quarter in 2011. The gross margin, net of Etol's Trade and Marketing (a non-core activity of Frutarom) and net of onetime reorganization expenses of US$0.4 million, increased, reaching 36.4%, compared with gross profit of 35.5% in Q4 2011. Gross profit including Etol's Trade and Marketing activity came to 35.5%.

Sales and Marketing, R&D, G&A and Other Expenses

Sales and marketing, R&D, G&A and other expenses came to US$37.8 million in Q4 2012 (26.1% of sales) compared with US$34.6 million in Q4 2011 (26.3% of sales) in Q4 2011.

Sales and marketing expenses, R&D, G&A and other expenses in Q4 2012 included onetime reorganization expenses in the amount of US$0.9 million.

The increase in expenses derives from the increase in activities, and mainly from acquisitions made in 2012.

As mentioned, Frutarom continues to strive towards maximal efficiency, improving its cost structure and strengthening its future competitiveness, maximally utilizing its sites throughout the world and successfully integrating its most recent acquisitions.

Operating Profit and EBITDA

In Q4 2012, operating profit increased by 12.9% reaching a fourth quarter high of US$13.7 million (9.5% of sales) compared with US$12.2 million (9.2% of sales) for the same quarter last year.

Operating profit net of onetime reorganization expenses in Q4 2012 increase by 19.7%, reaching US$15.0 million (10.4% of sales), compared with US$12.6 million in Q4 2011 (9.5% of sales).

The EBITDA Frutarom achieved in Q4 2012 increased by 13.9%, reaching a fourth quarter high of US$20.7 million (14.3% of sales) compared with US$18.1 million in the same period last year (13.8% of sales).

The EBITDA net of onetime reorganization expenses in Q4 2012 increased by 18.5% reaching US$21.9 million (15.1% of sales) compared with US$18.5 million (14.1% of sales) in Q4 last year.

Financing Expenses / Income

In Q4 2012, financing expenses came to US$1.4 million (1.0% of sales) compared with financing expenses of US$3.2 million (2.5% of sales) in Q4 2011.

Interest expenses in Q4 2012 totaled US$1.6 million, compared with US$1.3 million in Q4 of last year.

Financing income from exchange differentials totaled US$0.2 million, compared with US$1.9 million during the same quarter last year. The increase in financing income for exchange differentials derives from the weakening of the exchange rate of the US$

mainly versus European currencies (except the GBP) and the NIS as of December 31, 2012, compared with the opposite trend during the same period in 2011.

Profit before Tax

In Q4 2012, profit before tax went up by 38.0%, reaching a fourth quarter record high of US$12.3 million (8.5% of sales), compared with US$8.9 million (6.8% of sales) in Q4 2011.

Taxes on Income

Taxes on income in Q4 2012 came to US$1.8 million (14.3% of profits before tax) compared to US$1.0 million during the same quarter last year (11.2% of profits before tax).

The rate of tax expenses for Q4 2011 and 2012 was affected by tax income from closing tax assessments for previous years, and distribution of profit among the different countries.

Net Profit

In Q4 2012, net profit went up by 33.1%, reaching a fourth quarter high of US$10.5 million, compared with US$7.9 million in Q4 2011. Net margin totaled 7.3%, compared with 6.0% in Q4 2011.

Earnings per Share

In Q4 2012, earnings per share increased by 30.9%, achieving a fourth quarter record high of US$0.18 per share, compared with US$0.14 per share in Q4 2011.

**Summary of the quarterly profit and loss reports for 2009 - 2012 (US$ M):**

| | Q1 2009 | Q2 2009 | Q3 2009 | Q4 2009 | Q1 2010 | Q2 2010 | Q3 2010 | Q4 2010 | Q1 2011 | Q2 2011 | Q3 2011 | Q4 2011 | Q1 2012 | Q2 2012 | Q3 2012 | Q4 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Income** | 98.4 | 106.7 | 111.6 | 108.5 | 113.5 | 114.3 | 111.0 | 112.4 | 121.0 | 130.6 | 135.3 | 131.6 | 151.2 | 164.8 | 157.1 | 144.9 |
| **Gross profit** | 35.2 | 39.4 | 41.2 | 39.6 | 43.5 | 46.9 | 43.2 | 41.3 | 45.7 | 48.5 | 47.7 | 46.8 | 54.9 | 61.8 | 58.1 | 51.5 |
| **Selling, Marketing, R&D, G&A and Other Expenses** | 25.0 | 26.7 | 27.9 | 28.6 | 26.9 | 27.5 | 28.2 | 29.2 | 29.0 | 31.5 | 34.8 | 34.6 | 37.1 | 40.0 | 38.5 | 37.8 |
| **Operating profit** | 10.2 | 12.8 | 13.3 | 11.0 | 16.6 | 19.4 | 15.0 | 12.1 | 16.6 | 17.0 | 12.9 | 12.2 | 17.8 | 21.8 | 19.5 | 13.7 |
| **EBITDA** | 14.5 | 17.4 | 18.3 | 16.0 | 21.3 | 24.0 | 19.8 | 16.9 | 21.5 | 22.2 | 18.6 | 18.1 | 25.0 | 28.5 | 26.3 | 20.7 |
| **Finance expenses** | 3.3 | 0.1 | 0.0 | 0.9 | 1.3 | 2.3 | -0.2 | -0.2 | -0.9 | 0.8 | 2.6 | 3.2 | 0.9 | 4.3 | 20.6 | 1.4 |
| **Profit before tax** | 6.9 | 12.7 | 13.2 | 10.1 | 15.3 | 17.1 | 15.2 | 12.2 | 17.5 | 16.2 | 10.3 | 8.9 | 16.9 | 17.5 | 18.9 | 12.3 |
| **Net profit** | 5.6 | 10.1 | 10.0 | 7.5 | 11.1 | 13.0 | 11.1 | 8.8 | 13.1 | 12.3 | 8.7 | 7.9 | 13.5 | 13.5 | 14.4 | 10.5 |

Frutarom's business is characterized by seasonal fluctuations, generally with higher sales in the first half of a given year, with lower sales and profitability during the second half; this occurs mainly in the fourth quarter. The seasonality is a result of the fact that a substantial portion of the Company's products is used by its customers in the manufacture of beverages, ice cream and yogurt, for which demand increases during the summer months. As a result, sales of certain flavor solutions and specialty fine ingredients produced by the Company rise in the first half of the year, as manufacturers of beverages, ice cream and yogurt restock their inventories and increase production in advance of rising demand during the summer months. Furthermore, most of the end of year holidays throughout the world, which have an effect on Frutarom's activity volume, fall in the fourth quarter. The effect of seasonality on Company's results and business has become more subtle in recent years as the Company has increased sales of savory flavor products, among others, following the acquisition of companies specializing in savory. The more moderate effect of seasonality is also due to an increase in the sales of natural functional food ingredients, and natural pharmaceutical/nutraceutical extracts, which are intended for the pharmaceutical/nutraceutical industries and are less affected by seasonality in demand.

## E. LIQUIDITY

The Company's cash flow from operating activities grew by 156% throughout 2012 reaching US$91.2 million, compared with US$35.6 million in 2011. A significant improvement in cash flow from operating activities was also achieved in Q4 2012, reaching US$28.6 million, compared with US$3.1 million in Q4 2011.

Frutarom continuously acts to maintain the appropriate optimal working capital level according to expected growth, while taking into account seasonality, availability of the various raw materials and their current and expected future prices.

## F. SOURCES OF FINANCING

### Sources of Equity

Frutarom's equity as of December 31, 2012 totaled US$453.6 million (58.7% of the balance sheet) compared with US$393.6 million as of December 31, 2011 (60.6% of the balance sheet). The change derives from the acquisitions completed in 2012, from an increase in net profit and from translation differences of values of assets in subsidiaries having operational currency other than the US$ (in light of the strengthening of exchange rates of European currencies and the NIS against the US$ as of December 31, 2012 compared with December 31, 2011).

**Long-Term Loans Including Current Maturities of Long Term Loans (Average)**

Average long-term credit from banks provided to the Company in Q4 2012 totaled US$178.2 million, compared with US$84.1 million in Q4 2011. The increase derives from the increase in loans taken for financing the Company's acquisitions.

**Short-Term Loans Excluding Current Maturities of Long Term Loans (Average)**

The average short-term credit from banks provided to the Company in Q4 2012 came to US$13.1 million, compared with US$62.8 million during the corresponding quarter in 2011. The decrease derives from the exchange of short term loans, which the Company took for interim financing of acquisitions with long term loans.

**Accounts Payable and Other Payable (Average)**

In Q4 2012, the Company had accounts payable and other payables in the amount of US$90.3 million, compared with US$75.6 million in the same quarter last year. During Q4 2012, the Company granted credit of US$113.6 million to its customers, compared with US$90.4 million during Q4 2011. The increase in accounts payable and other payable is mainly the result of Frutarom's recent acquisitions.

As detailed in this report with respect to the Company's financial status, its liquidity, the positive cash flow it generates from its operating activities and its sources of finance, and assuming no material adverse changes in its sales and/or profitability, the Company estimates that the cash flow it generates from current operations will enable the full repayment of its expected liabilities without the need for external financing sources.

## EXPOSURE TO AND MANAGEMENT OF MARKET RISKS

The Group's activity is characterized by significant decentralization. Through its two main activities (Flavors and Specialty Fine Ingredients) the Company produces thousands of products intended for thousands of customers throughout the world, using thousands of raw materials purchased from a wide range of suppliers worldwide. The Group is not significantly dependent on any one of its customers, products or suppliers.

### A. RESPONSIBILITY FOR MARKET RISK MANAGEMENT

Mr. Alon Granot, Executive Vice President and CFO, is responsible for managing market risk. The Company's Management and Board of Directors are updated on material changes in the Company's exposure to various risks, and conduct discussions as needed.

For details about Mr. Alon Granot, see Regulation 26a in Chapter D to this report (Additional Details on the Corporation).

## B. DESCRIPTION OF MARKET RISKS

Raw Material Price Risks

The Company is dependent on third parties for its supply of raw materials. The Company purchases raw materials from a very wide range of suppliers, with no single supplier representing more than 5% of total raw material purchases. Although there is more than one supplier for most of the raw materials purchased by Frutarom, and most of these materials are widely available, there can be no guarantee that this will continue to be the case. Furthermore, the price, quality and availability of the principal raw materials used by Frutarom, mainly in the area of natural products, are subject to fluctuations as a result of international supply and demand. Many of the raw materials used by the Group are crop-related; therefore their price, quality and availability could be adversely affected by unfavorable weather conditions. The Company does not normally make future transactions and is exposed to price fluctuations in the raw materials it uses in accordance with global price trends. The Company's Executive Vice President for Global Supply Chain and Operations follows raw material prices on an ongoing basis.

Over the past few years there has been a continuing trend of substantial price increases for most of the raw materials Frutarom uses for the manufacture of its products. There was some stabilization in price levels in 2012, and even a drop in some raw material prices.

Currency Risks

The Company's sales worldwide are conducted in a number of currencies (mainly in Euro, US Dollars, Swiss Francs, Pounds Sterling and New Israeli Shekels). Therefore, there is sensitivity to fluctuations in the exchange rates of these and other currencies. However, the fact that Frutarom's raw materials purchases are in fact conducted in various currencies reduces the exposure to currency fluctuation risks. Most of the non-US dollar monetary balances derive from the local activity of the Company's subsidiaries in Europe and in Israel. The functional currency of these companies is the local currency, and therefore the currency translation balances in the local currency of each of these companies does not influence the Group's finance expenses, and is directly attributed to a currency translation capital fund. Monetary balances in other currencies are attributed to financing expenses. Currency exposure is reviewed as necessary, and at least once every quarter. The Company does not generally take external hedging actions nor does it use other financial instruments for protection against currency fluctuations. For more details see Note 3A of the Company's financial statement of December 31, 2012, attached to this report.

Interest Risks

The Company's sources of banking finance, short- and long-term, are quoted in Euro, US Dollar, Pound Sterling, Swiss Franc, NIS and Chinese Yuan, (according to the functional currency of the borrowing company), and bear variable Libor interest. The

Company's policy is not to take protective steps against possible interest increases and there is therefore sensitivity to changes in interest rates. As of the balance sheet date, the Company does not hold any financial derivatives. As of December 31, 2012 the Company held long-term loans with the deduction of current maturities in an overall amount of US$137.8 million. The scope of its short-term debt, including current maturities of long-term loans, was US$52.2 million. The Company has cash flow reserves of US$53.9 million.

Risks Related to the Company's Activities in Europe

Over the past few years there has been economic uncertainty in world markets. A number of European countries, including those which are part of the EU, are suffering a financial crisis which has led to a recession in some of these countries. Frutarom estimates that the impact of the financial crisis and the slow-down in European Market growth on its activities is not expected to be significant, as its main sales are in the food industry, which is considered more protected and less influenced by recessions and slow-downs. Frutarom's activity in the PIGS countries (Portugal, Ireland, Greece and Spain) is marginal and negligible.

## C. THE COMPANY'S POLICY REGARDING MARKET RISK MANAGEMENT

1. The Group's management conducts an ongoing evaluation of market risks in the area of raw material prices. Unusual occurrences such as acute currency devaluations in a target country or price changes in important raw materials that could influence the Group's activity are discussed by the Board of Directors. Frutarom is working to strengthen its global purchasing, to strengthen relations with manufacturers of raw materials in the target countries in which these are produced, and to adjust the selling price of its products as necessary and in accordance with significant fluctuations in the pricing of raw materials. The Executive Vice President of Supply Chain and Operations is responsible for management of market risks in the area of raw materials prices.

2. The Group's management attempts to reduce currency exposure, whether economic or accounting, by balancing liabilities and assets in each of the various currencies in which the Group operates. The Executive Vice President and CFO is responsible for the management of currency exposure in the Group. The Group typically takes loans in local currency with variable Libor interest.

3. The risk level is not limited in advance by quantity; rather the level of exposure is evaluated by the Group's accounting department on a regular basis, and discussed among the Group's management, allowing immediate response to any unusual developments in the various markets. The exposure level is also reviewed by the Company's Board of Directors on an ad hoc basis.

4. During this report period, Frutarom did not use financial instruments or other instruments to protect itself from the market risks to which it is exposed.

In 2012, there were no changes to the Group's risk management policy.

## D. SUPERVISION OF RISK MANAGEMENT POLICY AND ITS IMPLEMENTATION

The exposure to raw material prices is evaluated by the Executive Vice President of Global Supply Chain and Operations, the purchasing department and operations management on a regular basis and reported to the management as necessary. Discussions are held by the Company's management once every quarter, addressing the implementation of risk management policy as it relates to raw materials prices, currency and interest. The Executive Vice President and CFO reports to the Board of Directors regarding exposure to these risks at least once a year and during times of extreme changes in the global economy, exchange rates, raw material prices, and interest rates.

In 2012, there were no deviations from the planned policy.

## E. LINKAGE BASES REPORT

## CURRENCY EXPOSURE ACCORDING TO PRIMARY LINKAGE BASES AS AT DECEMBER 31, 2012

| | US$ | NIS | GBP | Euro | CHF | Others | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | In US$ 000 | | | | | | |
| Cash and cash equivalents | 18,157 | 1,008 | 2,953 | 19,046 | 3,533 | 9,236 | 53,933 |
| Customers | 18,663 | 10,644 | 12,695 | 42,429 | 7,030 | 15,293 | 106,754 |
| Other debtors | 3,076 | 818 | 1,609 | 9,178 | 2,027 | 1,205 | 17,915 |
| Inventory | 40,460 | - | 18,066 | 35,489 | 19,836 | 8,582 | 122,433 |
| Other long term debtors | 162 | - | | 3,292 | | - | 3,454 |
| Fixed assets, net | 39,586 | - | 12,884 | 73,661 | 54,678 | 8,015 | 188,824 |
| Other assets, net | 66,114 | - | 53,707 | 138,145 | 3,903 | 17,329 | 279,198 |
| **Total assets** | **186,218** | **12,470** | **101,914** | **321,240** | **91,007** | **59,661** | **772,511** |
| **Liabilities** | | | | | | | |
| Bank loans | 53,552 | 5,893 | 22,694 | 60,256 | 46,177 | 1,460 | 190,032 |
| Suppliers | 14,183 | 2,841 | 3,350 | 20,639 | 4,829 | 2,395 | 48,237 |
| Other creditors | 4,138 | 7,449 | 7,211 | 10,697 | 6,633 | 3,141 | 39,269 |
| Employee retirement rights liabilities | - | - | - | 10,509 | 2,596 | 124 | 13,229 |
| Deferred taxes | 4,909 | | 6,493 | 8,407 | 6,602 | 881 | 27,292 |
| Other long term liabilities | - | - | - | - | - | 892 | 892 |
| Total liabilities | **76,782** | **16,183** | **39,748** | **110,508** | **66,837** | **8,893** | **318,951** |
| Equity capital | | | | | | | **453,560** |
| Net assets (liabilities) | **109,436** | **(3,713)** | **62,166** | **210,732** | **24,170** | **50,768** | - |

## F. SENSITIVITY TESTS

### Sensitivity to Changes in the US Dollar- Israeli Shekel Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | **+10%** | **+5%** | **-** | **-5%** | **-10%** |
| **Exchange rate** | **4.106** | **3.920** | **3.733** | **3.546** | **3.360** |
| | | | **US$ 000** | | |
| Cash and cash equivalents | (101) | (50) | 1,008 | 50 | 101 |
| Customers | (1,064) | (532) | 10,644 | 532 | 1,064 |
| Other debtors | (82) | (41) | 818 | 41 | 82 |
| | **(1,247)** | **(623)** | **12,470** | **623** | **1,247** |
| Credit from banking corporations | 589 | 295 | 5,893 | (295) | (589) |
| Suppliers and service providers | 284 | 142 | 2,841 | (142) | (284) |
| Other creditors | 745 | 372 | 7,449 | (372) | (745) |
| | **1,618** | **809** | **16,183** | **(809)** | **(1,618)** |
| **Total exposure, net** | **371** | **186** | **(3,713)** | **(186)** | **(371)** |

### Sensitivity to Changes in the US Dollar-Pound Sterling Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | +10% | +5% | - | -5% | -10% |
| **Exchange rate** | **0.680** | **0.649** | **0.618** | **0.587** | **0.557** |
| | | | **US$ 000** | | |
| Cash and cash equivalents | (295) | (148) | 2,953 | 148 | 295 |
| Customers | (1,270) | (635) | 12,695 | 635 | 1,270 |
| Other debtors | (95) | (47) | 948 | 47 | 95 |
| | **(1,660)** | **(830)** | **16,596** | **830** | **1,660** |
| Credit from banking corporations | 2,269 | 1,135 | 22,694 | (1,135) | (2,269) |
| Bank loans | 335 | 168 | 3,350 | (168) | (335) |
| Suppliers and service providers | 721 | 361 | 7,211 | (361) | (721) |
| Other creditors | - | - | - | - | - |
| | **3,325** | **1,664** | **33,255** | **(1,664)** | **(3,325)** |
| **Total exposure, net** | **1,665** | **834** | **(16,659)** | **(834)** | **(1,665)** |

## Sensitivity to Changes in the US Dollar-Euro Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | **+10%** | **+5%** | **-** | **-5%** | **-10%** |
| **Exchange rate** | **0.835** | **0.797** | **0.759** | **0.721** | **0.683** |
| | | | **US$ 000** | | |
| Cash and cash equivalents | (1,905) | (952) | 19,046 | 952 | 1,905 |
| Customers | (4,243) | (2,121) | 42,429 | 2,121 | 4,243 |
| Other debtors | (719) | (360) | 7,193 | 360 | 719 |
| | **(6,867)** | **(3,433)** | **68,668** | **3,433** | **6,867** |
| Credit from banking corporations | 6,026 | 3,013 | 60,256 | (3,013) | (6,026) |
| Suppliers and service providers | 2,064 | 1,032 | 20,639 | (1,032) | (2,064) |
| Other creditors | 1,070 | 535 | 10,697 | (535) | (1,070) |
| | **9,160** | **4,580** | **91,592** | **(4,580)** | **(9,160)** |
| **Total exposure, net** | **2,293** | **1,147** | **(22,924)** | **(1,147)** | **(2,293)** |

## Sensitivity to Changes in the US Dollar-Swiss Franc Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | **+10%** | **+5%** | **-** | **-5%** | **-10%** |
| **Exchange rate** | **1.007** | **0.962** | **0.916** | **0.870** | **0.824** |
| | | | **US$ 000** | | |
| Cash and cash equivalents | (353) | (177) | 3,533 | 177 | 353 |
| Customers | (703) | (352) | 7,030 | 352 | 703 |
| Other debtors | (82) | (41) | 815 | 41 | 82 |
| | **(1,138)** | **(570)** | **11,378** | **570** | **1,138** |
| Credit from banking corporations | 483 | 241 | 4,829 | (241) | (483) |
| Suppliers and service providers | 663 | 332 | 6,633 | (332) | (663) |
| Other creditors | **5,764** | **2,882** | **57,639** | **(2,882)** | **(5,764)** |
| | | | | | |
| Total exposure, net | **4,626** | **2,312** | **(46,261)** | **(2,312)** | **(4,626)** |

## Sensitivity to Changes in the US Dollar-Other Currencies Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | **+10%** | **+5%** | **-** | **-5%** | **-10%** |
| | | | **US$ 000** | | |
| Cash and cash equivalents | (924) | (462) | 9,236 | 462 | 924 |
| Customers | (1,529) | (765) | 15,293 | 765 | 1,529 |
| Other debtors | (55) | (28) | 552 | 28 | 55 |
| | **(2,508)** | **(1,255)** | **25,081** | **1,255** | **2,508** |
| Credit from banks | 146 | 73 | 1,460 | (73) | (146) |
| Suppliers and service providers | 240 | 120 | 2,395 | (120) | (240) |
| Other creditors | 314 | 157 | 3,141 | (157) | (314) |
| Other long term creditors | 89 | 45 | 892 | (45) | (89) |
| | **789** | **395** | **7,888** | **(395)** | **(789)** |
| **Total exposure, net** | **(1,719)** | **(860)** | **17,193** | **860** | **1,719** |

## Sensitivity to Changes in Interest Rate on Fixed Rate Loans – Fair Value Risk

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| **% of change** | +10% | +5% | - | -5% | -10% |
| | | | US$ 000 | | |
| **Long Term Loans (Euro)** | 14 | 8 | 1,450 | (7) | (14) |
| **Total exposure, net** | 14 | 8 | 1,450 | (7) | (14) |

## G. SUMMARY OF SENSITIVITY TESTS TABLES

The functional currency of the majority of the Group's companies is the local currency in each company's respective country of residence; therefore, the currency translations of balance sheet balances of these companies do not affect the Company's profit and loss report and are directly attributed to the Company's shareholders' equity (currency translation capital fund).

Sensitivity to Changes in the US Dollar- Israeli Shekel Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| Exchange rate | 4.106 | 3.920 | 3.733 | 3.546 | 3.360 |
| | US$ 000 | | | | |
| Total Exposure net | 371 | 186 | (3,713) | (186) | (371) |

Sensitivity to Changes in the US Dollar-Pound Sterling Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| Exchange rate | 0.680 | 0.649 | 0.618 | 0.587 | 0.557 |
| | US$ 000 | | | | |
| Total Exposure net | 1,665 | 834 | (16,659) | (834) | (1,665) |

Sensitivity to Changes in the US Dollar-Euro Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| Exchange rate | 0.835 | 0.797 | 0.759 | 0.721 | 0.683 |
| | US$ 000 | | | | |
| Total exposure, net | 2,293 | 1,147 | (22,924) | (1,147) | (2,293) |

Sensitivity to Changes in the US Dollar-Swiss Franc Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| Exchange rate | 1.007 | 0.962 | 0.916 | 0.870 | 0.824 |
| | US$ 000 | | | | |
| Total exposure, net | 4,626 | 2,312 | (46,261) | (2,312) | (4,626) |

Sensitivity to Changes in the US Dollar-Other Currencies Exchange Rate

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| | US$ 000 | | | | |
| Total exposure, net | (1,719) | (860) | 17,193 | 860 | 1,719 |

Sensitivity to Changes in Interest Rate on Fixed-Rate Loans – Fair Value Risk

| | Profit (Loss) from changes | | Fair value | Profit (Loss) from changes | |
|---|---|---|---|---|---|
| % of change | +10% | +5% | - | -5% | -10% |
| | US$ 000 | | | | |
| Total exposure, net | 14 | 8 | 1,450 | (7) | (14) |

## CORPORATE GOVERNANCE ASPECTS

### A. DIRECTORS WITH ACCOUNTING AND FINANCIAL EXPERTISE AND INDEPENDENT DIRECTORS

#### Directors with Accounting and Financial Expertise

The Company's Board of Directors has determined that the minimum number of directors with accounting and financial expertise will be set at two. This number takes into account the nature of the Company's activity, its size, the scope of its activity and the complexity of its activity. The Board believes that this minimum number will enable it to fulfill its responsibilities and requirements in accordance with the law and the Company's Articles of Association, especially with respect to its responsibility to evaluate the Company's financial status and to prepare and approve the financial reports.

As of the date of this report's publication, the Board of Directors of the Company includes five directors with accounting and financial expertise: Dr. John J. Farber, Mr. Hans Abderhalden, Mr. Yacov Elinav, Mr. Isaac Angel and Mr. Gil Leidner. For details regarding their skills, education, experience and knowhow, based on which the Company refers to them as directors with financial and accounting expertise, refer to regulation 26 in Chapter D of this report (Additional Details on the Corporation).

#### Independent Directors

As of the date of this report, the Company has not adopted the instruction with respect to the ratio of Independent Directors (as the term is defined in the Companies Law – 1999) into its Articles of Association.

### B. DETAILS ABOUT THE CORPORATION'S INTERNAL AUDITOR

#### The Company's Internal Auditor

Mr. Yoav Barak, CPA, was appointed internal auditor of the Company and began his work as internal auditor on January 17, 2005. The internal auditor complies with the provisions of section 146(b) of the Companies' Law 1999 and with the provisions of section 8 of the Internal Audit Law, 1992.

To the best of the Company's knowledge, the internal auditor does not hold securities of the Company.

To the best of the Company's knowledge, the internal auditor does not have material business relations or other material relations with the Group or with a related entity.

The internal auditor is not an employee of the Company, but provides the auditing services as an external contractor. The internal auditor does not fill other positions in the Company or provide additional external services.

**Appointment Method**

The appointment of the internal auditor was approved by the Company's Board of Directors on January 17, 2005, based on the Board of Directors' Audit Committee's recommendation. The appointment was approved by the Company's Board of Directors after reviewing the internal auditor's education (as a CPA and economist), his experience in the field of internal auditing and his experience in various managerial positions. The Company's Board of Directors found the internal auditor to be suitable to serve in this position in light of Frutarom's size, scope of activity and level of complexity.

**The Internal Auditor's Supervisor**

The internal auditor reports to the Company Board of Directors' Audit Committee and to the President of the Company.

**Audit Work Plan**

The audit work plan is an annual plan prepared by the internal auditor in coordination with the President of the Company and its management, and approved by the Board of Directors' Audit Committee. The preparation of the work plan is determined by the topics perceived as worthy of thorough analysis. The factors are determined according to their risk level with the goal of detecting faults, achieving efficiencies, ensuring the protection of the Group's assets and the compliance of the Group's procedures with the respective local laws. The annual audit work plan also includes a follow-up by the Company's management on the implementation of recommendations brought by the internal auditor and the Audit Committee. The internal auditor has independent discretion to deviate from the approved audit plan, subject to consultation with the Audit Committee. The internal audit is carried out in accordance with the approved annual audit plan and is updated as necessary in accordance with the findings of the audit. The internal audit is carried out through questionnaires and physical audits at the Company sites and held companies in Israel and throughout the world. Some of the audit topics are audited throughout the Group, while others are specific topics audited according to the annual work plan.

**Auditing Outside of Israel or of Held Companies**

The annual audit work plan refers to the activities of all the companies in the Group, both in Israel and abroad, including the Company's substantial held companies.

**Scope of the Internal Auditor's Position**

The scope of the internal auditor's position is adjusted to the Group's rate of expansion and growth. The internal auditor renders services to the Group at a scope of two and a half to three working days per week.

| | **Number of hours invested in internal auditing in the Company in 2012** |
|---|---|
| Activity in Israel | 610 |
| Activity outside of Israel | 519 |

The scope and level of complexity of the Group’s activity were taken into account in determining the scope of the internal auditor’s position.

In 2012, the Internal Auditor’s scope of services totaled 1,129 working-hours compared to 1,113 working-hours in 2011.

**Performing the Internal Audit**

As reported to the Company by the internal auditor, the work of internal audit is conducted according to professional standards accepted in Israel and the world, including the professional standards of the Israel Institute of Internal Auditors, which ensure a professional, reliable and independent audit. The audit reports are based on the findings of the audit and the documented facts. The Board of Directors is of the opinion that the internal auditor meets the requirements set forth in the above-mentioned professional standards, taking into account the professionalism, qualifications, experience, familiarity with the Group and the manner in which he prepares, submits and presents the findings of his audit.

**Free Access to the Internal Auditor**

The internal auditor has free and independent access to the Group's information systems, including those of held companies (whether ordinary or computerized), to all databases and to all programs for automatic data processing of the Company and its related companies, including financial data. The internal auditor may enter any and all assets of the Company, including its held companies, and conduct the audit.

**The Internal Auditor’s Report**

The internal auditor prepares the audit reports in writing and submits them to the Audit Committee and to the members of the Company’s management.

During 2012, three meetings of the Audit Committee were held which included discussions on the findings of the internal auditor. The meetings were held on the following dates: January 22, 2012, August 16, 2012 and November 22, 2012. The members of the Company's Audit Committee, the President of the Company, the Executive Vice President and CFO, the Executive Vice President for Global Supply Chain and Operations, the Global VP Legal and Corporate Secretary, the VP Finance and other relevant managers in the Group received the audit reports prior to the Audit Committee meetings in which discussions were held on the internal auditor's findings. Relevant managers were present at the Audit Committee's meetings when the audit reports relating to their activity were reviewed, as per the request of the Chairmen of the Audit Committee.

**Assessment by the Board of Directors of the Company of the Internal Auditor's Activity**

In the opinion of the Audit Committee, the scope, character and continuity of the internal auditor's activity and work plan are reasonable under the circumstances and fulfill the goals of the internal audit of the Company.

**Compensation**

The internal auditor's compensation in 2012 was NIS 296 thousand. No securities were granted to the internal auditor as part of his terms of engagement. The Company believes that this compensation will not affect the internal auditor's professional judgment. The internal auditor's remuneration is not in any way dependent on the results of his work.

## C. DETAILS ON THE CORPORATION'S EXTERNAL AUDITOR

The independent auditor of the Company is Kesselman & Kesselman, a member firm of PricewaterhouseCoopers. The assets of the consolidated companies which are audited by local accountants constitute 26% of the Company's total assets, and their revenue constitutes 26% of the total consolidated revenue of the Group.

The fees paid by the Company to its auditor are as detailed below:

1. Total fee for auditing services, for services related to the audit and for tax services in 2012 totaled US$1,200 thousand (compared to US$1,167 thousand in 2011) in Israel and in the subsidiaries abroad (14,251 hours in 2012 compared to 14,769 hours in 2011). The amount paid for tax services does not exceed 45% of the total fees detailed in this paragraph.

2. Other fees for additional services - the overall fees for services provided by the independent auditor which are not included in paragraph 1 above totaled US$78 thousand in 2012 (compared to US$56 thousand in 2011) in Israel and in subsidiaries abroad.

The Company's general meeting of shareholders approved the appointment of the independent auditor and authorized the Company's Board of Directors to determine its fees.

## D. DISCLOSURE REGARDING THE APPROVAL PROCESS OF THE FINANCIAL REPORTS

The Company's financial reports are submitted for approval to the Board of Directors, the Company's overall supervising body, a few days after the Board of Directors' committee for the review of the financial reports (the "**Balance Sheet Committee**") has discussed the financial reports and formed recommendations to the Board of Directors in accordance with the Companies Regulations (Instructions and Terms for the Approval Procedure of the Financial Reports), 2010 ("**Reports Approval Regulations**").

### Members of the Company's Board of Directors

The Board of Directors of the Company has seven members, five of whom are directors having accounting and financial expertise as detailed above. For more details regarding the Company's Board of Directors, see regulation 26 to Chapter D of this report (Further Details on the Corporation)

### Members of the Balance Sheet Committee

The members of the Balance Sheet Committee are the members of the Audit Committee – Mr. Yacov Elinav, External Director and the chairman of the committee, Mr. Isaac Angel, External Director, and Mr. Gil Leidner, Director. The Balance Sheet Committee members have financial and accounting expertise and ability to read financial reports and provided the Company with a written declaration in this regard. Mr. Yacov Elinav and Mr. Isaac Angel are independent directors by virtue of their status as External Directors. Mr. Gil Leidner is an independent director in accordance with the determination of the Company's Audit Committee from May 19, 2011 and the Board of Director's resolution dated August 17, 2011. For details regarding the skills, education, experience and knowhow of the members of the Balance Sheet Committee, based on which the Company refers to them as directors with financial and accounting expertise, refer to regulation 26 in Chapter D of this report (Additional Details on the Corporation).

### Balance Sheet Committee Process for Forming its Recommendation to the Board of Directors

The Company's financial reports were discussed at the meeting of the Balance Sheet Committee held on March 7, 2013. The members of the committee received the 2012 financial reports two business days prior to the meeting. All three members of the Balance Sheet Committee attended the meeting, as well as the Company's independent auditors, the Company's President and CEO, Mr. Ori Yehudai, the Executive Vice President and CFO, Mr. Alon Granot, the Vice President of Finance, Mr. Guy Gill, and

Karin Ben Ari, Legal Counsel. At the meeting, the Balance Sheet Committee discussed, inter alia, the estimates and evaluations in the financial reports, the effectiveness of the internal control on financial reporting, the completeness and fairness of the disclosure in the financial reports, the accounting policy adopted, the accounting handling of the Group's material issues, and the valuations, including the assumptions and estimations on which the information in the financial reports is based. In the framework of the discussion, the Balance Sheet Committee formed its recommendations to the Board of Directors in accordance with the Reports Approval Regulations.

The recommendations of the committee were delivered to the Company's Board of Directors three business days before the Board's meeting at which the financial reports were discussed. The Board of Directors considered the said time period reasonable in light of the scope and complexity of the recommendations.

**Board of Directors' Report Approval Procedure**

The members of the Board of Directors receive the draft financial reports several days before the date of the Board meeting at which the reports are brought for their approval. The Company's Independent auditors and members of the Company's senior management are also invited to attend the meeting, including Mr. Ori Yehudai, the President and CEO, Mr. Alon Granot, Executive Vice President and CFO, Mr. Amos Anatot, Executive Vice President and COO Global Supply Chain, Mr. Guy Gill, Vice President of Finance, and Ms. Tali Mirsky, Global Vice President of Legal Affairs and Corporate Secretary or another of the Company's legal counsel. Mr. Yoav Barak, the Company's internal auditor, is also invited to the meeting. During the meeting, the Board of Directors discusses the recommendations of the Balance Sheet Committee regarding the financial reports. The President and CEO and Executive Vice President and CFO also present the Group's business and financial results for the relevant period in comparison to previous periods to the Board of Directors at this meeting, with emphasis on special events that occurred during the period. During the presentation of the Group's results, members of the Company's management answer questions and relate to the Directors' comments. Following presentation of the Company's financial results, the Company's independent auditors answer the Directors' questions. Finally, the Board of Directors votes on approval of the financial reports. All of the members of the Board of Directors were present at the Board meeting held on March 12, 2013, and the financial reports for 2012 were unanimously approved.

## E. SENIOR OFFICE HOLDERS' REMUNERATION

(1) On March 12, 2013 the Company's Board of Directors, after approval by the Compensation Committee of the Board of Directors (the "**Compensation Committee**") from March 7, 2013, resolved on bonuses for senior office holders in the Company for 2012 (except the bonus for the President and CEO of the Company, as detailed in section 5 below). As the Company has not yet adopted a compensation policy under the 20$^{th}$ amendment to the Companies Law 1999 ("**20$^{th}$**

**Amendment”**), bonuses were approved according to the criteria which have served the Company in resolving on bonuses prior to the enactment of 20th Amendment, and according to other relevant criteria under the provisions of 20th Amendment, all as set forth in section 3 below. The bonuses were approved after a detailed discussion held by the compensation Committee and the Board of Directors with regard to each office holder separately.

In addition, the Board of Directors approved the purchase of Company shares for the purpose of granting such to office holders and others as part of the 2012 Plan. For further details regarding this resolution, see the Company’s immediate report published on March 13, 2013.

(2) Prior to the discussion on the remuneration of senior officeholders, the members of the Board of Directors were presented with all relevant data for each senior officeholder as required by regulations 21 and 22 of the Securities Regulations (Immediate and Periodic Reports), 1979 and by the provisions of sections B and C to the sixth addendum to these regulations, and other relevant data needed in order to resolve on the matter of the compensation, its components, fairness and reasonableness, including (A) financial data regarding the last year and previous years, data from previous years regarding the Company’s profitability and the amounts of bonuses paid in the Company, the overall compensation paid to each of the relevant senior office holders including all components thereof, terms of existing agreements for each senior office holder; (B) each office holder’s capabilities, achievements and contributions to the Company; (C) the recommendations of the Company’s President regarding compensation for each senior office holder serving under him (D) comparative data regarding compensation paid to senior office holders in comparable positions in other public companies in Israel with of a similar scope and nature to those of the Company; and (E) data regarding average and median wages of Company employees. The Compensation Committee and Board of Directors were provided with a survey regarding this data during the course of the meeting.

(3) In determining the amount of the bonuses (other than the bonus for the President and CEO of the Company, as detailed in section 5 below) the Compensation Committee and the Board of Directors took into account, inter alia, the following parameters: (a) the business and financial performance of the Group, its size, scope and nature of activity, the profit, profit margins and rate of growth achieved; (b) each senior office holders’ contribution to these achievements, the economic value of services rendered by each one to the Group, the scope of office, tasks, existing employment agreement, areas of responsibility and each senior office holder’s satisfaction of requirements of the position he holds; (c) the Company’s business goals; (d) professional experience and achievements of each senior office holder, education, skills and expected contributions to the Company; (e) customary terms of wages in the Company, the relation between the senior office holder’s terms of employment and the average and median wages of other Company employees, and the effect of any the gaps between these on work relations in the Company. The

Compensation Committee and the Board of Directors also took into account the Company's growth rate over the year, successful realization of the latest strategic acquisitions and the integration of such, and the fact of the Company's status as one of the leading companies in the world in its field, as well as considerations regarding promotion of the Company's goals, its work plans and policies and creating proper incentives for Company office holders, taking into account the long term and according to the office holders position. Bonuses were not determined on the basis of any ceiling amounts or pre-defined goals.

(4) The Board of Directors in its meeting of March 12, 2013 also discussed compensation for senior office holders under the provisions of regulation 10(b)(4) to the Securities Regulations (Periodic and Immediate Reports) 1970. The Board of Directors resolved, after a detailed discussion held with regard to each office holder separately, that the compensation granted to each one was fair and reasonable in light of the size and complexity of the Group, its business achievements over the last few years, tasks and scope of responsibility of each one of the senior office holders in the Group and each one's contribution to the achievements and economic value of the services provided to the Group by each one of the senior office holders.

(5) On December 6, 2012, the Board of Directors approved formalization of the annual bonus for the Company's President and CEO (the President), as part of his existing terms of employment, after approval of the Company's Audit Committee sitting as the Compensation Committee, on December 4, 2012. For further details regarding formalization of the President's bonus, the method of determination and reasoning, see the Company's report dated December 7, 2012.

## DISCLOSURE RELATING TO THE CORPORATE FINANCIAL REPORTING

### A. DIVIDEND DISTRIBUTION IN 2012

On March 14, 2012, the Company's Board of Directors resolved to approve a distribution of a cash dividend in the amount of NIS 0.2 per share. On May 6, 2012, a dividend in the total amount of US$3,029 thousand was paid out.

### B. OCCURRENCES FOLLOWING THE DATE OF THE REPORT ON THE FINANCIAL STATUS WHICH ARE MENTIONED IN THE FINANCIAL REPORT

On March 12, 2013, concurrently with the approval of the financial statements of December 31, 2012, the Company's Board of Directors resolved on the distribution of a dividend in the amount of NIS 0.24 per share, in a total amount of NIS 13,997 thousand (US$3,801 thousand).

### C. CRITICAL ACCOUNTING ESTIMATIONS

Preparation of the Company's financial reports in accordance with IFRS demands the use of critical accounting estimates, requiring Company management to use its judgment in the process of implementing the Company's general accounting policies in order to prepare estimates and make assumptions that influence the amounts presented in the financial reports.

Below are the critical accounting estimations used in preparing the Company's financial reports; during their implementation, management was required to make assumptions regarding circumstances and events involving significant uncertainty. In using its discretion to determine these estimates, Company management relied on past experience, various facts and on reasonable assumptions in accordance with the appropriate circumstances for each estimate. Actual results may differ from management's estimates. Regarding the material accounting estimates used in preparing the Company's financial reports, see also Note 4 to the Company's financial reports dated December 31, 2012, attached to this report.

#### Taxes on Income and Deferred Taxes

The Company is assessed for tax purposes in numerous jurisdictions; accordingly, the Company's management is required to exercise discretion in order to determine the overall provision in respect of taxes on income. The Company records provisions in its books based on its estimates of whether additional taxes will be due. Where the final tax outcome of these matters as determined by tax authorities is different from the amounts that were initially recorded, such differences will be carried to income and loss in the period in which the final tax assessment is determined by the tax authorities.

The Company also records deferred tax assets and liabilities based on the differences between the book value of its assets and liabilities and the amounts taken into account for tax purposes. The Company regularly reviews its deferred tax assets for recoverability based on historical taxable income, projected future taxable income, the expected timing of the reversals of existing temporary differences and the implementation of tax planning strategies. If the Company is unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time period within which the underlying temporary differences become taxable or deductible, the Company could be required to eliminate a portion of the deferred tax asset resulting in an increase in its effective tax rate and an adverse impact on operating results.

**Severance Pay**

The present value of the Company's liabilities in regards to severance pay is dependent on several factors that are determined on an actuarial basis, based on a number of assumptions. The assumptions used in the calculation of the net cost (income) in regards to severance pay include the long-term yield rate on the related severance pay funds and the rate of discount. Changes in those assumptions will impact the carrying amount of the assets and liabilities in respect of severance pay. The assumption regarding the expected yield on severance pay funds is determined uniformly in accordance with long-term historical yields.

The assumption regarding the required rate of discount is determined by external actuaries at the end of each year. This rate of discount is used in determining the estimated updated value of the future cash flows that would be required to cover the severance pay liabilities. The market of high quality corporate bonds is not sufficiently liquid to serve as a basis for determining the discount rate. Therefore, the determination of the required rate is based on the interest rates applicable to government bonds denominated in the currency in which the benefits will be paid having maturity periods approximating to the periods of the related liabilities.

Other key assumptions relating to pension liabilities, such as future payroll raises, are based on existing rates of payroll inflation.

**Provision for Contingent Liabilities**

Provisions for contingent legal liabilities are recorded in the books at the discretion of Company management regarding the likelihood that the cash flows will be used to meet such liabilities, and on the basis of the management's estimate regarding the present value of the expected cash flows that would be required to meet the existing liabilities.

**Provision for Impairment in Respect of Goodwill and Intangibles**

Once per year, the Company reviews the need to provide for impairment of goodwill and intangibles. The need to make such a provision is assessed in relation to the recoverable value of the Company's cash generating units. The recoverable amount of a cash generating unit is determined in accordance with the assumptions and calculations made by the Group's management.

## D. EXCLUSION OF THE COMPANY'S SEPARATE FINANCIAL REPORT UNDER REGULATION 9(C) OF THE REGULATIONS

The Company in its 2012 Annual Report, did not include a separate financial report as set forth in Regulation 9C of the Regulations (the **"Solo Report"**) due to the negligibility of the additional information of such report and the fact that the Solo Report would not add any material information for a reasonable investor, to that contained in the Company's consolidated reports.

The Company's decision that the information is negligible is based on the fact that the Company does not have any commercial activities of any kind and therefore the Company's results of operations have no effect on the Group's consolidated profit and loss reports. The Company does not employ workers and it does not have any sales or expenses to third parties.

All the Company's revenues (dividends and financing income on revaluation of capital notes with Frutarom Ltd.) derive from Frutarom Ltd.

As far as the balance sheet is concerned, apart from the settling of accounts with the Income Tax Authority, the Company does not have any balances vis-à-vis third parties. Its only balances are loans and balances vis-à-vis the (wholly owned) companies in the Group, and land property in the amount of US$139 thousand.

The Company's management determined that as long as income from externals or from companies not wholly owned by the Company are lower than 5% of the total revenues in the consolidated financial statements, and as long as the expenses to externals or from companies not wholly owned by the Company are lower than 5% of the total expenses in the consolidated financial statements, the Company's separate financial information as set forth in Regulation 9C of the Regulations is negligible and its absence will not affect the prospects of investors in the Company's shares to estimate the Company's liquidity prospects, and will not add any material information for a reasonable investor.

Company management has also examined the warning signs contained in Regulation 10(14) of the Regulations and found that they do not exist.

The Board of Directors of the Company held nine meetings during 2012.

The Board of Directors thanks Frutarom's employees and management for the Company's fine achievements.

| | |
|---|---|
| Dr. John J. Farber | Ori Yehudai |
| Chairman of the Board | President & CEO |

March 12, 2013

# SECTION C

## FINANCIAL REPORTS

C

**FRUTAROM INDUSTRIES LTD.**

2012 FINANCIAL STATEMENTS

**FRUTAROM INDUSTRIES LTD.**

2012 FINANCIAL STATEMENTS

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## REPORT OF THE AUDITORS

To the shareholders of

**FRUTAROM INDUSTRIES LTD.**

**Regarding the audit of the components of internal control over financial reporting in accordance with section 9B(c) to the Israeli Securities Regulations (Periodic and Immediate Reports), 1970**

We have audited components of internal control over financial reporting of Frutarom Industries Ltd. and its subsidiaries (hereinafter **-** the Company), as of December 31, 2012. These components of internal control were set as explained in the next paragraph. The Company's Board of Directors and Management are responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of components of internal control over financial reporting included in the accompanying periodic report for the above date. Our responsibility is to express an opinion on the components of internal control over financial reporting based on our audit**.**

Components of internal control over financial reporting were audited by us according to Audit Standard no. 104 of the Institute of Certified Public Accountants in Israel "Audit of the Internal Control Components over Financial Reporting" (hereafter **-** "Audit Standard 104"). These components are: (1) entity level controls, including controls on the preparation process and closing of the financial reporting and general controls of information systems, (2) controls over the process of purchasing process, consumption of materials and inventory (3) controls over the sales and receivables (all of these together are called the "audited control components").

We conducted our audits in accordance with Audit Standard 104. This standard requires that we plan and perform the audit to identify the audited control components and to obtain reasonable assurance whether these control components have been maintained effectively in all material respects. The audit includes obtaining an understanding of internal control over financial reporting, identifying the audited control components, assessing the risk that a material weakness exists in the audited control components, as well as review and assessment of effective planning and maintaining of these audited control components based on the estimated risk. Our audit, for those audited control components, also included performing such other procedures as we considered necessary under the circumstances. Our audit referred only to the audited control components, unlike internal control of all material processes over financial reporting, and therefore our opinion refers only to the audited control components. In addition, our audit did not take into account the mutual influences between the audited control components and those which are not audited, and therefore our opinion does not take into account such possible effects. We believe that our audit provides a reasonable basis for our opinion in the context described above.

Due to inherent limitations, internal control over financial reporting in general and components of internal controls in particular, may not prevent or detect a misstatement. Also, making projections on the basis of any evaluation of effectiveness is subject to the risk that controls may become inadequate because of changes in circumstances, or that the degree of compliance with the policies or procedures may be adversely affected.

In our opinion, the company effectively maintained, in all material respects, the audited control components as of December 31, 2012.

We also audited, the Company's financial statements as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012, in accordance with generally accepted auditing standards, and our report, of March 12, 2013 included an unqualified opinion on these financial statements.

| | |
|---|---|
| Haifa, Israel | Kesselman & Kesselman |
| 12, March, 2013 | Certified Public Accountants (lsr.) |
| | A member firm of International PricewaterhouseCoopers Limited |

*Kesselman & Kesselman, 1 Nathanson Street, Haifa 33034, Israel, P.O Box 33984, Haifa 31339*
*Telephone: +972 -4- 8605000, Fax:+972 -4- 8605001, www.pwc.co.il*

## REPORT OF THE AUDITORS

To the shareholders of

**FRUTAROM INDUSTRIES LTD.**

We have audited the consolidated statements of financial position of Frutarom Industries Ltd. (hereafter - the Company) as of December 31, 2012 and 2011 and the related consolidated statements of income, statements of comprehensive income, changes in equity and cash flows for each of the three years in the period ended on December 31, 2012. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of certain consolidated companies, whose assets included in consolidation constitute approximately 26% and 13% of total consolidated assets as of December 31, 2012 and 2011, and whose revenues included in consolidation constitute approximately 26%, 14%, and 13% of total consolidated revenues for each of the three years in the period ended December 31, 2012. The financial information of the above consolidated companies was audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to financial information included for these companies, is based on reports of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the accompanying financial statements referred to above present fairly, in all material respects, the consolidated financial position of the company and its subsidiaries as of December 31, 2012 and 2011 and the consolidated results of their operations, changes in equity and their cash flows for each of the three years in the period ended on December 31, 2012, in accordance with International Financial Reporting Standards (hereafter – IFRS) .

We have also audited in accordance with standard No. 104 of the Institute of Certified Public Accountants in Israel "Audit of the Internal Control Components over Financial Reporting", internal control components over financial reporting of the company as at December 31, 2012, and our report in March 12, 2013 included an unqualified opinion on the effectiveness of those components.

| | |
|---|---|
| Haifa, Israel | Kesselman & Kesselman |
| 12, March, 2013 | Certified Public Accountants (Isr.) |
| | A member firm of International PricewaterhouseCoopers Limited |

**FRUTAROM INDUSTRIES LTD.**

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

| | Note | As of 31 December 2012 | 2011 |
|---|---|---|---|
| | | U.S. dollars in thousands | |
| **Assets** | | | |
| **CURRENT ASSETS:** | | | |
| Cash and cash equivalents | 18 | 53,933 | 36,472 |
| Accounts receivable: | 15 | | |
| Trade | | 106,754 | 86,054 |
| Other | | 10,949 | 6,990 |
| Prepaid expenses and advances to suppliers | | 6,966 | 5,916 |
| Inventories | 16 | 122,433 | 111,214 |
| | | 301,035 | 246,646 |
| **NON-CURRENT ASSETS :** | | | |
| Property, plant and equipment – net | 7 | 188,824 | 145,455 |
| Intangible assets – net | 2f,8 | 279,198 | 255,710 |
| Deferred income tax assets | 13d | 3,075 | 2,073 |
| Other | 17 | 379 | 67 |
| | | 471,476 | 403,305 |
| **Total assets** | | 772,511 | 649,951 |

**Dr. John Farber**
**Chairman of the Board**

**Ori Yehudai**
**President and CEO**

**Alon Granot**
**Executive Vice President and CFO**

Date of approval of the financial statements by the Board of Directors: March 12, 2013.

| | Note | As of 31 December 2012 | 2011 |
|---|---|---|---|
| | | U.S. dollars in thousands | |
| **Liabilities and Shareholders' Equity** | | | |
| **CURRENT LIABILITIES:** | | | |
| Short-term bank credit and loans and current maturities of long-term loans | 9 | 52,196 | 52,699 |
| Accounts payable: | 19 | | |
| Trade | | 48,237 | 40,239 |
| Other | | 39,269 | 38,444 |
| | | 139,702 | 131,382 |
| **NON-CURRENT LIABILITIES:** | | | |
| Long-term loans net of current maturities | 9 | 137,836 | 88,947 |
| Retirement benefit obligations, net | 10 | 13,229 | 11,359 |
| Deferred income tax liabilities | 13d | 27,292 | 24,669 |
| Other | 5 | 892 | - |
| | | 179,249 | 124,975 |
| COMMITMENTS AND CONTINGENT LIABILITIES | 11 | | |
| **Total liabilities** | | 318,951 | 256,357 |
| **EQUITY:** | 12 | | |
| **EQUITY ATTRIBUTED TO OWNERS OF THE PARENT COMPANY:** | | | |
| Ordinary shares | | 16,713 | 16,597 |
| Other capital surplus | | 102,099 | 97,356 |
| Translation differences | 2c | 16,749 | 12,356 |
| Retained earnings | | 318,807 | 270,266 |
| Less - cost of Company shares held by the company and by subsidiary | | (3,043) | (2,981) |
| Non-controlling interest | | 2,235 | - |
| **Total equity** | | 453,560 | 393,594 |
| **Total equity and liabilities** | | 772,511 | 649,951 |

**The accompanying notes are an integral part of these financial statements.**

**FRUTAROM INDUSTRIES LTD.**

CONSOLIDATED INCOME STATEMENTS

| | Note | 2012 | 2011 | 2010 |
|---|---|---|---|---|
| | | **Year ended 31 December** | | |
| | | **U.S. dollars in thousands, (except for per share data)** | | |
| SALES | | 618,001 | 518,443 | 451,066 |
| COST OF SALES | 20a | 391,742 | 329,866 | 276,242 |
| **GROSS PROFIT** | | 226,259 | 188,577 | 174,824 |
| Selling, marketing, research and development expenses - net | 20b | 104,932 | 88,641 | 77,061 |
| General and administrative expenses | 20c | 49,197 | 39,231 | 35,099 |
| Other expenses (income) - net | 20d | (718) | 2,041 | (318) |
| **INCOME FROM OPERATIONS** | | 72,848 | 58,664 | 62,982 |
| FINANCIAL EXPENSES (INCOME) – net | 20e | 7,240 | 5,798 | 3,196 |
| **INCOME BEFORE TAXES ON INCOME** | | 65,608 | 52,866 | 59,786 |
| INCOME TAX | 13e | 13,628 | 10,835 | 15,675 |
| **NET INCOME FOR THE YEAR** | | 51,980 | 42,031 | 44,111 |
| **PROFIT ATTRIBUTED TO:** | | | | |
| Owners of the parent company | | 51,570 | 42,031 | 44,111 |
| Non-controlling interest | | 410 | - | - |
| | | 51,980 | 42,031 | 44,111 |
| | | **U.S dollars** | | |
| **EARNINGS PER SHARE:** | 2v | | | |
| Basic | | 0.9 | 0.73 | 0.77 |
| Fully diluted | | 0.9 | 0.73 | 0.77 |

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| | U.S. dollars in thousands | | |
|---|---|---|---|
| **Income for the year** | 51,980 | 42,031 | 44,111 |
| **Other comprehensive income -** | | | |
| Translation differences | 4,393 | (5,255) | (452) |
| **Total comprehensive income for the Year** | 56,373 | 36,776 | 43,659 |
| **Attributable to:** | | | |
| Owners of the parent company | 55,963 | 36,776 | 43,659 |
| Non-controlling interest | 410 | - | - |
| **Total** | 56,373 | 36,776 | 43,659 |

**The accompanying notes are an integral part of these financial statements.**

**FRUTAROM INDUSTRIES LTD.**

CONSODLIATED STATEMENTS OF CHANGES IN EQUITY

| | Note | Ordinary shares | Other capital surplus | Translation differences | Retained earnings | Cost of company shares held by subsidiary | Total |
|---|---|---|---|---|---|---|---|
| | | | | U.S. dollars in thousands | | | |
| **BALANCE AT 1 JANUARY 2010** | | 16,597 | 96,995 | 18,063 | 190,237 | (3,417) | 318,475 |
| **Comprehensive income:** | | | | | | | |
| Income for the year | | - | - | - | 44,111 | - | 44,111 |
| **Other comprehensive income -** | | | | | | | |
| Translation differences | 2c | - | - | (452) | - | - | (452) |
| **Total comprehensive income for the year** | | - | - | (452) | 44,111 | - | 43,659 |
| Plan for allotment of Company shares to employees of subsidiary: | 2r | | | | | | |
| Purchase of Company shares by subsidiary | | - | - | - | - | (1,261) | (1,261) |
| Receipts in respect of allotment of Company shares to employees | 12b | - | (1,344) | - | - | 2,017 | 673 |
| Allotment of shares and options to senior employees- | 12b | | | | | | |
| Recognition of compensation related to employee stock and option grants | | - | 979 | - | - | - | 979 |
| Dividend paid | 12c | - | - | - | (2,733) | - | (2,733) |
| | | - | (365) | - | (2,733) | 756 | (2,342) |
| **BALANCE AT 31 DECEMBER 2010** | | 16,597 | 96,630 | 17,611 | 231,615 | (2,661) | 359,792 |

**The accompanying notes are an integral part of these financial statements.**

**FRUTAROM INDUSTRIES LTD.**

CONSODLIATED STATEMENTS OF CHANGES IN EQUITY

| | Note | Ordinary shares | Other capital surplus | Translation differences | Retained earnings | Cost of company shares held by subsidiary | Total |
|---|---|---|---|---|---|---|---|
| | | U.S. dollars in thousands | | | | | |
| **BALANCE AT 1 JANUARY 2011** | | 16,597 | 96,630 | 17,611 | 231,615 | (2,661) | 359,792 |
| **Comprehensive income:** | | | | | | | |
| Income for the year | | - | - | - | 42,031 | - | 42,031 |
| **Other comprehensive income -** | | | | | | | |
| Translation differences | 2c | - | - | (5,255) | - | - | (5,255) |
| **Total comprehensive income for the year** | | - | - | (5,255) | 42,031 | - | 36,776 |
| Plan for allotment of Company shares to employees of subsidiary: | 2r | | | | | | |
| Purchase of Company shares by subsidiary | | - | - | - | - | (892) | (892) |
| Receipts in respect of allotment of Company shares to employees | 12b | - | (382) | - | - | 572 | 190 |
| Allotment of shares and options to senior employees- | 12b | | | | | | |
| Recognition of compensation related to employee stock and option grants | | - | 1,108 | - | - | - | 1,108 |
| Dividend paid | 12c | - | - | - | (3,380) | - | (3,380) |
| | | - | 726 | - | (3,380) | (320) | (2,974) |
| **BALANCE AT 31 DECEMBER 2011** | | 16,597 | 97,356 | 12,356 | 270,266 | (2,981) | 393,594 |

(Concluded) - 3

**FRUTAROM INDUSTRIES LTD.**

CONSODLIATED STATEMENTS OF CHANGES IN EQUITY

| | Note | Ordinary shares | Other capital surplus | Translation differences | Retained earnings | Cost of company shares held by the company | Total attributed to owners of parent company | Non-controlling interest | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | U.S. dollars in thousands | | | | | | | |
| **BALANCE AT 1 JANUARY 2012** | | 16,597 | 97,356 | 12,356 | 270,266 | (2,981) | 393,594 | - | 393,594 |
| **Comprehensive income:** Income for the year | | - | - | - | 51,570 | - | 51,570 | 410 | 51,980 |
| **Other comprehensive income -** Translation differences | 2c | - | - | 4,393 | - | - | 4,393 | - | 4,393 |
| **Total comprehensive income for the year** | | - | - | 4,393 | 51,570 | - | 55,963 | 410 | 56,373 |
| Plan for allotment of Company shares to employees of subsidiary: | | | | | | | | | |
| Purchase of Company shares by subsidiary | 2r | - | - | - | - | (1,330) | (1,330) | - | (1,330) |
| Receipts in respect of allotment of Company shares to employees | 12b | - | (846) | - | - | 1,268 | 422 | - | 422 |
| Allotment of shares and options to senior employees- Recognition of compensation related to employee stock and option grants | 12b | - | 1,553 | - | - | - | 1,553 | - | 1,553 |
| Proceeds from issuance of shares to senior employees | | 116 | 4,036 | - | - | - | 4,152 | - | 4,152 |
| Dividend paid | 12c | - | - | - | (3,029) | - | (3,029) | - | (3,029) |
| | | 16,713 | 102,099 | 16,749 | 318,807 | (3,043) | 451,325 | 410 | 451,735 |
| Non-controlling interest from business combination | | - | - | - | - | - | - | 1,825 | 1,825 |
| **BALANCE AT 31 DECEMBER 2012** | | 16,713 | 102,099 | 16,749 | 318,807 | (3,043) | 451,325 | 2,235 | 453,560 |

**The accompanying notes are an integral part of these financial statements.**

**FRUTAROM INDUSTRIES LTD.**

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Note | 2012 | 2011 | 2010 |
|---|---|---|---|---|
| | | **Year ended 31 December** | | |
| | | **U.S. dollars in thousands** | | |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | | | |
| Cash generated from operations (see Appendix) | | 104,774 | 47,363 | 69,692 |
| Income tax paid - net | | (13,563) | (11,788) | (7,626) |
| Net cash provided by operating activities | | 91,211 | 35,575 | 62,066 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | | | |
| Purchase of property, plant and equipment | | (12,558) | (7,835) | (8,465) |
| Purchase of intangibles | | (2,284) | (2,564) | (2,326) |
| Interest received | | 195 | 642 | 163 |
| Acquisition of subsidiaries - net of cash acquired | 5 | (75,280) | (57,963) | - |
| Acquisition of operations | 5 | - | (43,698) | - |
| Reimbursement in respect of acquisition of operation | 5 | - | 3,850 | - |
| Proceeds from sale of property | | 271 | 289 | 807 |
| Net cash used in investing activities | | (89,656) | (107,279) | (9,821) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | | | |
| Receipts from senior employees in respect of allotment of shares | | 4,152 | - | - |
| Interest paid | | (5,553) | (2,207) | (1,884) |
| Receipt of long-term bank loans | | 131,231 | 102,002 | - |
| Repayment of long-term bank loans | | (116,802) | (40,064) | (43,697) |
| Receipt (discharge of short-term bank loans and credit - net | | 7,319 | 8,201 | (2,147) |
| Purchase of Company shares by subsidiary – net of receipts in respect of the Shares | | (908) | (702) | (588) |
| Dividend paid | | (3,029) | (3,380) | (2,733) |
| Net cash provided by (used in) financing activities | | 16,410 | 63,850 | (51,049) |
| **INCREASE (DECREASE) IN CASH, CASH EQUIVALENTS AND BANK CREDIT** | | 17,965 | (7,854) | 1,196 |
| Balance of cash and cash equivalents and bank credit at beginning of year | | 36,472 | 44,389 | 42,940 |
| Profits (losses) from exchange differences on cash, cash equivalents and bank credit | | (504) | (63) | 253 |
| **BALANCE OF CASH, CASH EQUIVALENTS AND BANK CREIDT AT END OF YEAR** | | 53,933 | 36,472 | 44,389 |

**The accompanying notes are an integral part of these financial statements.**

**FRUTAROM INDUSTRIES LTD.**

CONSOLIDATED STATEMENTS OF CASH FLOWS

**APPENDIX TO CONDENSED CONSOLIDATED STATEMENT CASH FLOWS**

| | Year ended December 31 | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| | U.S. dollars in thousands | | |
| **Cash generated from operations:** | | | |
| Income before tax | 65,608 | 52,866 | 59,786 |
| **Adjustments required to reflect the cash flows from operating activities:** | | | |
| Depreciation and amortization | 26,012 | 20,612 | 18,081 |
| Recognition of compensation related to employee stock and option grants | 1,553 | 1,108 | 979 |
| Liability for employee rights upon retirement - net | (655) | 225 | 221 |
| Loss (gain) from sale and write-off of fixed assets and other assets | 92 | 17 | (508) |
| Erosion of loans | 1,003 | - | (142) |
| Interest paid - net | 5,358 | 1,565 | 1,721 |
| Loss from change in fair value of financial instruments | 289 | - | - |
| Income from bargain purchase | (1,729) | - | - |
| | 31,923 | 23,527 | 20,352 |
| **Operating changes in working capital:** | | | |
| Decrease (increase) in accounts receivable: | | | |
| Trade | (1,712) | (12,035) | (5,272) |
| Other | (206) | (3,046) | 2,723 |
| Decrease in other long-term receivables | 136 | - | - |
| Increase (decrease) in accounts payable: | | | |
| Trade | 1,506 | 8,342 | 2,388 |
| Other | 3,772 | (5,495) | (2,644) |
| (decrease) in other long-term payables | (379) | - | - |
| Decrease (increase) in inventories | 4,126 | (16,796) | (7,641) |
| | 7,243 | (29,030) | (10,446) |
| **Cash flows from operating activities** | 104,774 | 47,363 | 69,692 |

## NOTE 1 – GENERAL

**Information on the activities of Frutarom Industries Ltd. and its subsidiaries (hereafter - the "Group").**

Frutarom Industries Ltd. (hereafter – the Company) is a global company, founded in 1933. The Company operates through an Israeli subsidiary (hereafter - Frutarom Ltd.) and the companies under its control. The Group has two main operations: the Flavors activity and the Fine Ingredients activity. The Group develops, manufactures, markets and sells flavors and fine ingredients used by food and beverage producers, pharma-nutraceutical, flavors and fragrances, and personal care and cosmetics products as well as other products. The Group sells its products in more than 140 countries to more than 14,000 clients. The Group has production facilities in Europe, North America, Latin America, Israel, and Asia (see also a list of subsidiaries in Note 23); The group has 31 research and development laboratories and it sells and markets its products principally through its 50 sales and marketing offices. Segment information for the reporting years is presented as part of Note 6.

The Company is a limited liability company incorporated and domiciled in Israel. The address of its registered office is 25 Heshaish St., Haifa Bay. The Company's controlling shareholder is ICC Industries Inc.

The Company's shares have been listed on the Tel-Aviv Stock Exchange (the "TASE") since 1996. Since February 2005, Company shares are also listed through Global Depository Receipts on the official list of the London Stock Exchange (the "LSE").

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

### a. Basis of Preparation:

1) The Group's financial statements as of 31 December 2012 and 2011 and for each of the three years in the period ended 31 December 2012, are in compliance with International Financial Reporting Standards (hereafter – IFRS) and interpretations to IFRS issued by the International Financial Reporting Interpretations Committee (IFRIC) and include the additional disclosure required under the Securities Regulations (Annual Financial Statements), 2010.

   The significant accounting policies described below have been applied consistently in relation to all the years presented, unless otherwise stated.

   The financial statements have been prepared under the historical cost convention, subject to adjustments in respect of revaluation of amounts funded for severance pay, financial assets at fair value through profit or loss presented at fair value.

   The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Group's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in (Note 4). Actual results could differ significantly from those estimates and assumptions.

2) The period of the Group's operating cycle is 12 months.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

3) The Group analyses the expenses recognized in the income statements using the classification method based on the functional category to which the expense belongs.

**b. Principles of Consolidation**

Subsidiaries are all entities over which the Group has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are immediately exercisable or convertible are considered when assessing whether the Group controls another entity.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date the control ceases.

The group applies the acquisition method to account for business combinations. The consideration transferred for the acquisition of a subsidiary (hereafter – the acquired company) is the fair values of the assets transferred, the liabilities incurred and the equity interests issued by the Group.
The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition-related costs are expensed as incurred.
Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination (except for certain exceptional items specified in IFRS 3 – "Business Combinations") (as amended), hereafter – IFRS 3R) are measured initially at their fair values at the acquisition date.

Any contingent consideration accrued to the Group as part of a business combination is measured at fair value at the date of business acquisition. Subsequent changes to the fair value of the contingent consideration that is deemed to be an asset or liability is recognized in accordance with IAS 39 "Financial Instruments" either in profit or loss or as a change to other comprehensive income. Contingent consideration that is classified as equity is not re-measured, and its subsequent settlement is accounted for within equity.

The excess of the overall amount of the transferred consideration, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree over the fair value of the Group’s share of the identifiable net assets acquired and the liabilities assumed is recorded as goodwill –(see also f(1) below).
In cases were the net amount at acquisition date of the identifiable assets acquired and of the liabilities assumed exceeds the overall consideration that was transferred, the amount of non controlling interest in the acquiree and the fair value as of date of acquisition of any previous equity interest in the acquiree as above, the difference is recognized directly in income or loss at date of acquisition.

Inter-company transactions, balances, including income, expenses and dividends on transactions between group companies are eliminated. Profits and losses resulting from inter-company transactions that are recognized in assets (in respect of inventory and fixed assets) are also eliminated. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**c. Translation of Foreign Currency Balances and Transactions:**

1) Functional and Presentation Currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which that entity operates (the "Functional Currency"). The consolidated financial statements are presented in U.S. dollars, which is the Company's functional and presentation currency.

2) Transactions and balances.

Foreign currency transactions in currencies different from the functional currency (hereafter – foreign currency) are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are re-measured. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are attributed to income or loss.
Gains and losses arising from changes in exchange rates are presented in the statement of income among "financial expenses".

3) Translation of Financial Statement of Group Companies

The results and financial position of all the Company's entities (none of which has the currency of hyperinflationary economy) that have a Functional Currency different from the presentation currency are translated into the presentation currency as follows:

(a) Assets and liabilities for each statement of financial position presented are translated at the closing rate at the date of that statement of financial position;
(b) Income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates: in which case income and expenses are translated at the rate on the dates of the transactions);
(c) All resulting exchange differences are recognized among other comprehensive income.

On consolidation of the financial statements, exchange differences arising from the translation of the net investment in foreign operations and from loans and other currency instruments designated to serve as hedges to those investments are carried to other comprehensive income. When a foreign operation is partially disposed of or sold, exchange differences that were recorded in other comprehensive income are recognized in the statement of income as part of the gain or loss on realization or sale.

Goodwill and fair value adjustments arising on the acquisition of foreign operations are treated as assets and liabilities of the foreign operations and translated at the closing rate. Exchange differences arising from translation as above are recognized in other comprehensive income.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

4) Information regarding exchange rates, based on data published by the Bank of Israel:

| | NIS | Pound Sterling | Euro | Swiss Franc |
|---|---|---|---|---|
| Exchange rate as of December 31: | | | | |
| 2012 | 3.733 | 0.6184 | 0.7587 | 0.9158 |
| 2011 | 3.821 | 0.6485 | 0.7738 | 0.9407 |
| 2010 | 3.549 | 0.6461 | 0.7491 | 0.9369 |
| Increase (decrease) of the dollar: during the year | % | % | % | % |
| 2012 | (2.3) | (4.6) | (1.9) | (2.7) |
| 2011 | 7.7 | 0.4 | 3.3 | 0.4 |
| 2010 | (6.0) | 4.6 | 8.0 | (9.0) |

| | NIS | Pound Sterling | Euro | Swiss Franc |
|---|---|---|---|---|
| Average exchange rate during the year: | | | | |
| 2012 | 3.856 | 0.6310 | 0.7782 | 0.9379 |
| 2011 | 3.578 | 0.6238 | 0.7188 | 0.8853 |
| 2010 | 3.733 | 0.6468 | 0.7537 | 1.0409 |
| Increase (decrease) during of the dollar during the year: | % | % | % | % |
| 2012 | 7.8 | 1.2 | 8.3 | 5.9 |
| 2011 | (4.2) | (3.6) | (4.6) | (14.5) |
| 2010 | (5.1) | 1.0 | 4.8 | (4.1) |

**d. Segment Reporting (see also note 1)**

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker in the Group, who is responsible for allocating resources and assessing performance of the operating segments.

The Group is organized and managed on a worldwide basis in two major operating activities: Flavors and the Fine Ingredients. Another operation is Trade and Marketing. Each activity constitutes a segment.

**e. Property, Plant and Equipment:**

The cost of a property, plant and equipment item is recognized as an assets only if: (a) it is probable that the future economic benefits associated with the item will flow to the Group and (b) the cost of the item can be measured reliably.

Property, plant and equipment is stated at historical cost less accumulated depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items and only when the two criteria mentioned above for recognition as assets are met.

The carrying amount of a replaced part is derecognized. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

The cost of a property, plant and equipment item includes:

(a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

Depreciation and impairment of property, plant and equipment are recognized in the income statement.

Land owned by the Group is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost less their residual values over their estimated useful lives, as follows:

| | Percentage of Annual Depreciation |
|---|---|
| Buildings and land under financial lease | 2-4 |
| Machinery and equipment | 5-10 |
| Vehicles and lifting equipment | 15-20 |
| Computers | 20-33 |
| Office furniture and equipment | 6-20 |
| Leasehold improvements | 10 |

Leasehold improvements are amortized by the straight-line method over the terms of the lease, which are shorter than the estimated useful life of the improvements.

The asset's residual values, the depreciation method and useful lives are reviewed, and adjusted if appropriate, at least once a year.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 2g).

Gains or losses on disposals are determined by comparing proceeds with carrying amount. These are included in the statement of income among "other income - net".

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**f. Intangible Assets:**

1) The overall amount of goodwill arising on acquisition of a subsidiary, associated company or a proportionately consolidated company represents the excess of the consideration transferred in respect of acquisition of a subsidiary over the net amount as of acquisition date of the identifiable assets acquired and the liabilities assumed. Goodwill on acquisitions of subsidiaries is included in 'intangible assets'.
For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the cash generating units (CGUs), or groups of CGUs that is expected to benefit from the synergies of the combination. Each unit or group of units to which the goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal management purposes and which is not larger than an operating segment (before aggregation) (see also g. below).
Impairment reviews of CGUs (or groups of CGUs) are undertaken annually and whenever there is any indication of impairment of CGU or group of CGUs. The carrying value of the CGU (or group of CGUs) is compared to the recoverable amount, which is the higher of value in use and the fair value less costs to sell.
Any impairment loss is allocated to write-down the carrying amount of the CGU's assets (or CGUs) in the following order: first, the write down of any goodwill allocated to a cash generating unit (or a group of CGUs); and afterwards to the remaining assets of the CGU or (group of CGUs) on a proportionate basis using the carrying amounts of each asset of the CGU (or group of CGUs).
Any impairment is recognized immediately as an expense and is not subsequently reversed.

2) Product formulas acquired as part of a business combination transaction are initially recorded at fair value and amortized on a straight-line basis over their useful lives (10-20 years); (mainly 20 years).

3) Customer relationships acquired in a business combination are measured at fair value at the acquisition date. The customer relations have a finite useful life and are carried at the recognized amount less accumulated amortization. Amortization is calculated using the straight-line method over the expected life of the customer relationship (7-10 years).

4) Separately acquired trademarks and licenses are shown at historical cost. Trademarks and licenses acquired in a business combination are recognized at fair value at the acquisition date. Trademarks and licenses have a definite useful life and are presented at cost less accumulated amortization. Amortization is calculated using the straight-line method to allocate the cost of trademarks over their estimated useful lives (20 years).

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

5) Computer software

Acquired computer software licenses are capitalized on the basis of the costs incurred to acquire and bring to use the specific software licenses. These costs are amortized over their estimated useful lives (3-5 years) using the straight line method.
Costs associated with maintaining computer software programmes are recognized as an expense as incurred. Costs that are directly associated with the development of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognized as intangible assets. Costs include the employee costs incurred as a result of developing software and an appropriate portion of relevant overheads.
Computer software development costs recognized as assets are amortized over their estimated useful lives using the straight line method (3-5 years) commencing the point in time when the asset is available for use, i.e., it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

6) Research and Development

Research expenses are accounted for as expenses as incurred. Cost incurred in respect of development projects (attributable to the design and testing of new or improved products) are recognized as intangible assets when the following criteria are met:

- It is technically feasible to complete the intangible assets so that it will be available for use;
- Management intends to complete the intangible asset and use it or sell it;
- There is an ability to use or sell the intangible asset;
- It can be demonstrated how the software product will generate probable future economic benefits;
- Adequate technical, financial and other resources to complete the development and to use or sell the intangible asset are available; and
- The expenditure attributable to the intangible asset during its development can be reliably measured.

Other development costs that do not meet the above criteria are recognized as cost as incurred. Development costs previously recognized as an expense are not recognized as an asset on a subsequent period. Capitalized development costs are presented as intangible assets and amortized as from the time the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management through its useful life in accordance with the straight-line method.
The Group fully recognized the R&D expenses as incurred.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**g. Impairment of non-financial assets**

Assets that have an indefinite useful life, such as goodwill or intangibles that are not yet available for use are not subject to amortization and are tested annually for impairment or more often if events have occurred or changes in circumstances indicate that the carrying amount may not be recoverable.
Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.
An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets, other than goodwill, that were subject to impairment are reviewed for possible reversal of the impairment recognized in respect thereof at each statement of financial position date.

**h. Government Grants**

The group's research and development activities are supported in some of the countries in which it operates, and in Israel through the Israel Chief Scientist in the Ministry of Industry, Commerce and Labour (hereinafter - the OCS) by way of grants.

Grants from the government are recognized at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all attached conditions.

Government grants relating to costs are recognized in the income statement on a systematic basis over the periods in which the Group recognizes the relating costs (the costs that the grants are intended to compensate).

**i. Financial assets:**

**1) Classification**

The Group classifies its financial assets in the following category: Financial assets at fair value through profit or loss and loans and receivables. The classification depends on the purpose for which the financial assets were acquired. Group management determines the classification of its financial assets at initial recognition.

Financial assets at fair value through profit or loss

This category includes two sub-categories: financial assets held for trade and financial assets designated at fair value through profit or loss. A financial asset is classified into this category if it was acquired principally for the purpose of selling in the short term or if was designated to this category by management. Assets in this category are classified as current assets if expected to be settled within 12 months, otherwise they are classified as non-current.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

Receivable

Receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are included in current assets, except for maturities greater than 12 months after the statement of financial position date. These are classified as non-current assets. Receivables of the Group are classified as "accounts receivable" in the statement of financial position (Note 2k below).

**2) Recognition and measurement**

Regular purchases and sales of financial assets are recognized on the settlement date, which is the date on which the asset is delivered to the Group or delivered by the Group. Investments are initially recognized at fair value plus transaction costs for all financial assets not measured at fair value through profit or loss. Financial assets measured at fair value through profit or loss, are initially recognized at fair value, and transaction costs are expensed in the statement of income. Financial assets are derecognized when the rights to receive cash flows there from have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership. Financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables are measured in subsequent periods at amortized cost using the effective interest method.

Gains or losses that stem from changes in the fair value of financial assets at fair value through profit or loss are presented in statement of income under "financial expenses - net" in the period in which they incurred. Dividend income from financial assets at fair value through profit or loss are recognized in statement of income under "other income - net" when the group is eligible to these payments.

**3) Offsetting financial instruments**

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**4) Impairment of financial assets**

Financial assets are presented at amortized cost.

The Group assesses at the each statement of financial position date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

The criteria that the Group uses to determine that there is objective evidence of an impairment of a financial assets or group of financial assets include observable: information that came to the attention of the Group in connection with the following loss events:

- Significant financial difficulty of the issuer or obligor;
- breach of contract, such as a default or delinquency in interest or principal payments;
- The Group, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- It becomes probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for that financial asset because of financial difficulties;
- Observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio, including:
  (i) Adverse changes in the payment status of borrowers in the portfolio; or
  (ii) National or local economic conditions that correlate with defaults on the assets in the portfolio.

Where objective evidence for impairment exists, the amount of the loss is measured as the difference between the asset's carrying amount of the financial assets and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed for the asset upon initial recognition). The asset's carrying amount is reduced and the amount of the loss is recognized in the statement of income.

If the amount of impairment loss in a subsequent period decreases, and this decrease may be attributed to an objective event that took place after the impairment was recognized (like improved credit rating of the borrower), reversing the previously recognized impairment loss is recorded in income statements.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**j. Inventories**

Inventories are measured at the lower of cost or net realizable value. Raw material cost is determined using the "moving average" method.

The cost of finished goods and work in progress comprises raw materials, direct labour, other direct costs and related production overheads (based on normal operating capacity) but excludes capitalization of borrowing costs.

Net realizable value is the estimated selling price in the ordinary course of business, less the applicable and variable selling expenses.

**k. Trade Receivables**

Trade receivables are amounts due from customers for merchandise sold or services performed in the ordinary course of business. If collection is expected in one year or less they are classified as current assets. If not, they are classified as non-current assets.

Trade receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less provision for doubtful accounts (hereafter – "provision for impairment" or "provision for doubtful accounts"). As to the way the impairment provision is determined and accounting treatment applied thereto subsequently see i4) below.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**l. Cash and Cash Equivalents**

Cash and cash equivalents include cash in hand, short-term bank deposits and other highly liquid short-term investments, the maturity of which does not exceed three months, bank overdrafts (repayable upon demand).

**m. Share Capital**

Ordinary shares of the Company are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown as a deduction, net of tax, from the proceeds of issuance.

Where any Group company purchases the Company's equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs (net of income taxes) is deducted from equity attributable to the company's equity holders until the shares are cancelled or reissued. Where such shares are subsequently reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects are included in equity. Any difference between the cost of acquisition of the treasury shares and the consideration is carried to premium on shares.

**n. Trade Payables**

Trade payables are obligations of the Group to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less. If not, they are classified as non-current liabilities.
Trade payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

**o. Loans**

Loans are recognized initially at their fair value, net of transaction costs incurred. Loans are subsequently measured at amortized cost; any difference between the consideration (net of transaction costs) and the redemption value is recognized in the statement of income over the period of the loan using the effective interest method.
Loans are classified as current liabilities unless the Group has an unconditional right to defer settlement of the loans for at least 12 months after the end of the reporting period, in which case they are classified as non-current liabilities.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**p. Current and Deferred Income Taxes:**

The tax expenses for the reported years comprise of current and deferred tax. Tax is recognized in the statement of income.

The current income tax charge is calculated on basis of the tax laws enacted or substantially enacted at the statement of financial position date in the countries where the Company and the subsidiaries operate and generate taxable income. Management periodically evaluates tax issues related to its taxable income, based on relevant tax law, and makes provisions in accordance with the amounts payable to the Income Tax Authorities.

Deferred income tax is recognized using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Nevertheless, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affect neither accounting nor taxable income.

Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized. The amount of deferred income taxes is determined using tax rates (and laws) that have been enacted or substantially enacted by the statement of financial position date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax is not calculated on temporary differences arising on investments in subsidiaries, as long as the timing of reversal of the differences is controlled by the Group and it is expected that no such reversal will take place in the foreseeable future.

The group recognizes deferred income tax assets in respect of temporary differences deductible for tax purposes only if it is expected that the temporary difference is revered in the foreseeable future and to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred income tax assets and liabilities are offset only if:

- There is a legally enforceable right to offset current tax assets against current tax liabilities; and
- When the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

As stated in Note 13c, upon distribution of dividends from tax-exempt income of "approved enterprises" or "benefited enterprises", the amount distributed will be subject to tax at the rate that would have been applicable had the company not been exempted from payment thereof. The amount of the related tax is charged as an expense in the statement of comprehensive income, when such dividend is distributed.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**q. Employee Benefits:**

1) Pension Obligations

Group companies operate various pension schemes. The schemes are generally funded through payments to insurance companies or trustee-administered pension funds, determined by periodic actuarial calculations.

The Group has both defined benefit and defined contribution plans. A defined contribution plan is a pension plan under which the Group pays fixed contributions into a separate and independent entity. The Group has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods. A defined benefit plan is a pension plan that is not a defined contribution plan.

In accordance with the liability of Group companies to employees in respect of whom there is a defined benefit plan, the amounts that an employee will receive as severance pay on retirement depends on the number years of service and the employee's last salary. The severance pay liability recognized in the statement of financial position in respect of defined benefit plans is the present value of the defined benefit obligation at the statement of financial position date less the fair value of plan assets, with the addition of adjustments for unrecognized actuarial gains or losses and cost of unrecognized past services. The defined benefit obligation is calculated annually by actuary using the projected unit credit method.

The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows (after taking into account expected rates of pay raise).
The assumption as to the discount rate is determined by external actuaries at the end of each year. In certain countries, the Group uses high quality corporate bonds to determine the rate of discount. In countries where there is no deep market for high quality corporate bonds, the discount rate is determined based on interest rates on government bonds denominated in the currency in which the benefits will be paid and that have terms to maturity approximating the terms of the relevant liability.

The Group recognizes actuarial gains and losses arising from changes in actuarial assumptions and from the difference between assumptions made in the past and actual results, in excess of the greater of 10% of the value of plan assets or 10% of the defined benefit obligation. These gains or losses are charged or credited to the statement of income over the employees' expected average remaining working lives.

Past-service costs are recognized immediately in income, unless the changes to the plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past-service costs are amortized on a straight-line basis over the vesting period.

Amounts funded for severance pay are measured at fair value; these amounts constitute "plan's assets" as defined in IAS 19 are therefore offset from the balance of liability for employee rights upon retirement for the purpose of presentation in the statement of financial position.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

For defined contribution plans, the Group pays contributions to publicly or privately administered pension insurance plans on a mandatory basis. The Group has no further payment obligations once the contributions have been paid. The contributions are recognized as employee benefit expense commensurate with receipt from employees of the service in respect of which they are entitled for the contributions. Prepaid contributions are recognized as an asset to the extent that a refund of the excess amounts or a reduction in the future payments is available.

2) Vacation and Recreation Fees

Under the law in various countries, employee is entitled for vacation days and recreation fees (in Israel), both computed on an annual basis. The entitlement is based on the period of employment. The Group records a liability and an expense in respect of vacation and recreation fees, based on the benefit accumulated for each employee.

3) Bonus plans

Some of the Group's employees are entitled to receive an annual bonus in accordance with the bonuses plan determined by Group management for that year. The Group provides for payment of the bonus in accordance with meeting the targets of the plan and in accordance with Group's estimate as to the total amount of bonuses to be paid to employees.

**r. Share-Based Compensation**

The Group operates a number of equity-settled, share-based compensation plans, under which the Group receives services from employees as consideration for equity instruments (options) of Group companies. The fair value of the employee services received in exchange for the grant of the options is recognized as an expense in the statement of income. The total amount to be expensed is determined by reference to the fair value of the options granted:

- considering the impact of any non-market vesting conditions (for example, remaining an employee of the entity over a specified time period); and
- excluding the impact of any non-vesting conditions.

Non-market vesting conditions are included in assumptions about the number of options that are expected to vest. The total expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. At the date of each statement of financial position, the Group revises its estimates of the number of options that are expected to vest based on the non-marketing vesting conditions. It recognizes the impact of the revision to original estimates, if any, in the statement of income, with a corresponding adjustment to equity.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**s. Provisions**

Provisions are recognized when: the Group has a present legal or constructive obligation as a result of past events and it is probable that an outflow of resources will be required to settle the obligation and it is possible to prepare a reliable estimation of the amount of liability.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

Provisions are measured at the present value of the cash flow expected to be required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risk specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

**t. Revenue Recognition Policy**

Revenue is measured at the fair value of the consideration received or receivable for the sale of goods in the ordinary course of business. Revenue is shown net of value-added tax, returns, rebates and discounts and after eliminating sales within the Group.

Revenues from sale of goods are recognized by the Group when all of the following conditions are met:

(a) The significant risks and rewards of ownership of the goods have been transferred by the Group to the buyer;
(b) The group retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
(c) The amount of revenues can be reliably measured.
(d) It is probable that future economic benefit relating to the transaction will flow to the Group; and
(e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

The amount of revenue is not considered to be reliably measurable until all contingencies relating to the transaction have been resolved. The Group bases its estimates on historical results, taking into consideration the type of customer, the type of transaction and the specifics of each arrangement.

The products are occasionally sold with volume discounts; customers have a right to return faulty products. Sales are recorded based on the selling price, net of the estimated volume discounts and returns at the time of sale. Accumulated experience is used to estimate and provide for the discounts and returns. The volume discounts are assessed based on anticipated annual purchases. No element of financing is present as the sales are made with an average credit term, which is not higher than the market practice.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

**u. Leases**

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.
Long term lease contracts for lease of land from the Israel Land Administration and from other countries are presented among fixed assets.

**v. Earnings per Share**

Basic:

The computation of basic earnings per share is based, as a general rule, on the profit attributable to holders of ordinary Company shares divided by the weighted average number of ordinary shares in issue during the period, excluding Company shares held by a subsidiary (Notes 2m).

Fully Diluted:

When calculating the diluted earnings per share, the Group adds to the average number of shares outstanding that was used to calculate the basic earnings per share also the weighted average of the number of shares to be issued assuming the all shares that have a potentially dilutive effect would be converted into shares. The potential shares, as above are only taken into account in cases where their effect is dilutive (reducing the earnings per share or increasing the loss per share).

The weighted average number of shares used in calculating Basic and Diluted earnings per share is as follows:

| | **Basic** | **Diluted** |
|---|---|---|
| | **In thousands** | **In thousands** |
| **Year end 31 December:** | | |
| 2012 | 57,344 | 57,613 |
| 2011 | 57,265 | 57,475 |
| 2010 | 57,262 | 57,458 |

**w. Dividends**

Dividend distribution to the Company's owners is recognized as a liability in the Group's statement of financial position on the date on which the dividends are approved by the Group’s Board of Directors. Dividend paid includes an erosion component (from date of approval of dividend through date of payment thereof).

**x. New International Financial Reporting Standards, Amendments to Standards and New interpretations**

1) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the group:

a) IAS 19 – "Employee Benefits" (Amended 2011) (hereafter – the revised IAS 19)

The revised IAS 19 makes material changes to the recognition and measurement of defined benefit plans and termination benefit and to the disclosures for all employee benefits discussed in IAS 19. Set forth below is a summary of the key changes:

- The term "Actuarial gains and losses" was renamed "re-measurements" of the net defined liability (asset) (hereafter – "re-measurements"), which includes, in addition to actuarial gains and losses, certain components defined in the revised IAS 19. Re-measurements will be recognized immediately in other comprehensive income. Actuarial gains and losses will no longer be deferred using the “corridor” approach or recognized in profit or loss.
- Past-service costs will be recognized immediately in the period of a plan amendment; unvested benefits will no longer be spread over a future-service period.
- Annual expense for a funded benefit plan will include net interest expense or income, calculated by applying the discount rate to the net defined benefit asset or liability. This will replace the "finance charge" and "expected return on plan assets" currently applied under IAS 19.
- The distinction between short-term and long-term employee benefits for measurement purposes shall be based on when payment is expected, not when payment can be demanded.
- Any benefit that has a future-service obligation is not a termination benefit. A liability for a termination benefit is recognized when the entity can no longer withdraw the offer of the termination benefit or recognizes any related restructuring costs.
- There are additional disclosure requirements compared with IAS 19 in its present version.

The revised IAS 19 shall be applied for the first time by the company in the annual period beginning on 1 January 2013. The revised IAS 19 should be applied retrospectively, except for:

a) An entity needs not to adjust the carrying amount of assets outside the scope of the revised IAS 19 for changes in employee benefits costs that were included in the carrying amount before the date of initial application of the revised IAS 19.

b) Comparative information for some disclosures required in the revised IAS 19 about the sensitivity of the defined benefit obligation will not needed in financial statements for periods beginning before January 1, 2014.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (continued):

The current accounting policy of the Group is to recognize actuarial gains or losses arising from changes in actuarial assumptions and from the difference between past assumptions and actual results, by the amount these gains or losses exceed the higher of 10% of the present value of the defined benefit liability and 10% of the fair value of plan assets. These gains or losses are carried to income over the expected average term of employment. Subsequent to application of the revised IAS 19, the Company shall not defer the recognition of re-measurements. The "re-measurements", as to be recomputed in accordance with the new provisions, shall be fully carried to other comprehensive income in the period in which they have arisen.

The first time application of the IAS 19 is not expected to have material effect on the Group's consolidated financial statements.

b) Amendment to IAS 1**-** "Presentation of Financial Statements" (hereafter – Amendment to IAS 1). The amendment to IAS 1 changes the manner of disclosure of other comprehensive income items as part of the statement of comprehensive income.

Set forth below is a summary of the main amendments made to IAS 1:

- Items presented as part of the comprehensive income should be separated into two groups based on whether the items can be recycled in the future into profit or loss or not. Accordingly, items that cannot be reclassified into profit or loss in the future would be presented separately from items that can be recycled in the future into profit or loss.
- Entities electing to present comprehensive income items before the tax associated with these items will be required to present the tax effect separately for each of the two groups of the OCI items.
- The name of the statement of comprehensive income was changed to "statement of profit or loss and other comprehensive income". Nevertheless, IAS 1 allows entities to use other names.

The Group shall apply the amendment to IAS 1 for the first time to the annual reporting period commencing 1 January, 2013 with full retrospective application for all reported periods.

c) The International Accounting Standard Board (hereinafter – "IASB") has issued in the current period and prior periods, several new standards and amendments to existing standards regarding consolidated financial statements, separate financial statements, disclosures of interests in other entities, fair value measurement, and offsetting financial assets and financial liabilities. Application of the standards is partially for annual periods beginning on January 1, 2013 and partially for annual periods beginning on January 1, 2014.
Early adoption is permitted.
The Groups believes that the new standards and amendments have no material effects on the results of operations and financial position of the Group.

## NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT:

### a. Financial Risk Management

1) Financial Risk Factors

The Group's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk, cash flow interest rate risk and price risk), credit risk and liquidity risk. The Group's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Group's financial performance.

Risk management is carried out under policies approved by the board of directors and senior management. These policies cover specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of non-derivative financial instruments, and investment of excess liquidity. Group policies also cover areas such as cash management and raising short and long-term debt.

The Group's business is characterized by considerable dispersion. The Group produces tens of thousands of products intended for tens of thousands of customers throughout the world, using tens of thousands of raw materials purchased from a wide range of suppliers worldwide. As stated, the Group is not significantly dependent on any of its customers, products or suppliers.
Discussions on implementing the risk management policy as relates to currency exposure and interest are conducted by the Group's management once each quarter.

The Group does not use derivative financial instruments for its hedge or speculative purposes.

a) Market Risks:

1) Foreign Exchange Risk

The Group operates globally and is exposed to movements in foreign currencies affecting its net income and financial position, as expressed in U.S. dollars.

Transaction exposure arises because the equivalent amount in local currency paid or received in transactions denominated in foreign currencies may vary due to changes in exchange rates. Most Group entities produce their income primarily in the local currency. A significant amount of expenditures, especially for the purchase of goods for resale are in foreign currencies. Similarly, transaction exposure arises on net balances of financial assets held in foreign currencies. Since raw materials purchases for the Group's production are also conducted in various currencies, currency exposure is reduced.
The Group's subsidiaries manage this exposure locally. In addition, Group management monitors total global exposure of the Group.

Translation exposure arises from the consolidation of the Foreign Currency denominated financial statements of the Company's subsidiaries. The effect on the Group's consolidated comprehensive income is shown as a currency translation difference.

**NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT** (continued):

The following table presents currency exposure in respect of balance denominated in currencies that are different than the functional currency of the reporting company and also the effect on income after taxes. At 31 December 2012, 2011 and 2010, if the U.S. dollar had weakened/strengthened by 1% against the currencies referred to below with all other variables unchanged:

| | **31 December 2012** | | | |
|---|---|---|---|---|
| | **U.S. dollars in thousands** | | | |
| | **NIS** | **Pound sterling** | **Euro** | **Swiss Franc** |
| Financial asset(liabilities), net | (3,713) | 16 | (23,922) | (21) |
| **Gain (loss) from change:** | | | | |
| Impact of 1% strengthening | 29 | * | 189 | * |
| Impact 1% weakening | (29) | * | (189) | * |

| | **31 December 2011** | | | |
|---|---|---|---|---|
| | **U.S. dollars in thousands** | | | |
| | **NIS** | **Pound sterling** | **Euro** | **Swiss Franc** |
| Financial asset(liabilities), net | 9,643 | (12) | 7,494 | 62 |
| **Gain (loss) from change:** | | | | |
| Impact of 1% strengthening | (77) | * | (60) | * |
| Impact 1% weakening | 77 | * | 60 | * |

| | **31 December 2010** | | | |
|---|---|---|---|---|
| | **U.S. dollars in thousands** | | | |
| | **NIS** | **Pound sterling** | **Euro** | **Swiss Franc** |
| Financial asset/liabilities, net | 2,094 | (485) | 11,326 | 628 |
| **Gain (loss) from change:** | | | | |
| Impact of 1% strengthening | (15) | 4 | (84) | (5) |
| Impact 1% weakening | 15 | (4) | 84 | 5 |

* Represents amounts lower than $1 thousand.

**NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT** (continued):

2) Linkage of Monetary Balances

Monetary balances denominated in various currencies included in the Company's consolidated statement of financial position at 31 December 2012, are summarized below:

| | US dollar | NIS | Pound Sterling | Euro | Swiss Francs | Other currencies | Total |
|---|---|---|---|---|---|---|---|
| | U.S. dollars in thousands | | | | | | |
| Assets: | | | | | | | |
| Current assets: | | | | | | | |
| Cash and cash equivalents | 18,157 | 1,008 | 2,953 | 19,046 | 3,533 | 9,236 | 53,933 |
| Accounts receivable: | | | | | | | |
| Trade | 18,663 | 10,644 | 12,695 | 42,429 | 7,030 | 15,293 | 106,754 |
| Other | 623 | 818 | 948 | 7,193 | 815 | 552 | 10,949 |
| | 37,443 | 12,470 | 16,596 | 68,668 | 11,378 | 25,081 | 171,636 |
| Liabilities: | | | | | | | |
| Current liabilities: | | | | | | | |
| Short-term bank borrowings and loans | - | 5,893 | 55 | 4,946 | - | 1,450 | 12,344 |
| Accounts payable: | | | | | | | |
| Trade | 14,183 | 2,841 | 3,350 | 20,639 | 4,829 | 2,395 | 48,237 |
| Other | 4,138 | 7,449 | 7,211 | 10,697 | 6,633 | 3,141 | 39,269 |
| Non-current liabilities: | | | | | | | |
| Long-term loans | 53,552 | - | 22,639 | 55,310 | 46,177 | 10 | 177,688 |
| Other long-term payables | - | - | | | | 892 | 892 |
| | 71,873 | 16,183 | 33,255 | 91,592 | 57,639 | 7,888 | 278,430 |

Some of the balances are includes in the statements of financial position of the consolidated companies in the UK, EU, Switzerland and Brazil whose functional currencies are the Pound Sterling, the Euro, the Swiss Franc and the Brazilian Real, respectively, and therefore do not involve exposure to income and loss.

**NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT** (continued):

2) Linkage of Monetary Balances

Monetary balances denominated in various currencies included in the Company's consolidated statement of financial position at 31 December 2011, are summarized below:

| | US dollar | NIS | Pound Sterling | Euro | Swiss Francs | Other currencies | Total |
|---|---|---|---|---|---|---|---|
| | U.S. dollars in thousands | | | | | | |
| Assets: | | | | | | | |
| Current assets: | | | | | | | |
| Cash and cash equivalents | 12,804 | 783 | 4,896 | 10,649 | 772 | 6,568 | 36,472 |
| Accounts receivable: | | | | | | | |
| Trade | 17,284 | 10,939 | 10,312 | 31,098 | 5,767 | 10,654 | 86,054 |
| Other | 476 | 1,712 | 542 | 2,391 | 1,317 | 552 | 6,990 |
| | 30,564 | 13,434 | 15,750 | 44,138 | 7,856 | 17,774 | 129,516 |
| Liabilities: | | | | | | | |
| Current liabilities: | | | | | | | |
| Short-term bank borrowings and loans | - | - | - | 4,761 | - | - | 4,761 |
| Accounts payable: | | | | | | | |
| Trade | 9,936 | 3,791 | 4,764 | 16,562 | 3,744 | 1,442 | 40,239 |
| Other | 19,698 | - | 5,309 | 5,091 | 7,065 | 1,281 | 38,444 |
| Non-current liabilities: | | | | | | | |
| Long-term loans | 49,403 | - | 34,073 | 53,391 | - | 18 | 136,885 |
| | 79,037 | 3,791 | 44,146 | 79,805 | 10,809 | 2,741 | 220,329 |

Some of the balances are includes in the statements of financial position of the consolidated companies in the UK., EU and Switzerland whose functional currencies are the Pound Sterling, the Euro and the Swiss Franc, respectively, and therefore do not involve exposure to income and loss.

**NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT** (continued):

2) Cash Flow Risk Relating to Interest Rates

Since on a current basis the Group does not have significant assets bearing interest, its revenues and operating cash flow are not dependent on changes in interest rates.

The Group's interest rate risk arises from long-term and short-term borrowings. Borrowings received at variable rates expose the Group to cash flow interest rate risk.

The Group analyses its interest rate exposure. Various scenarios are simulated taking into consideration refinancing, renewal of existing positions and alternative financing. Based on these scenarios, the Group calculates the impact on profit and loss of a defined interest rate shift. For each simulation, the same interest rate shift is used for all currencies. The scenarios are run only for liabilities that represent the major interest-bearing positions.

Based on the simulations performed, the impact on post tax profit for the year 2012 of a 0.1% shift in interest rate on loans would have been a change of $ 124 thousand (2011 - $ 79 thousand; 2010 - $63 thousand).

b) Credit Risk

Credit risk arises from the possibility that the counter-party to a transaction may be unable or unwilling to meet their obligations causing a financial loss to the Group.

Trade receivables are subject to a policy of active risk management, which focuses on the assessment of country risk, credit limits, ongoing credit evaluation and accounting monitoring procedures.

There are no significant concentrations within trade receivables of counter-party credit risk due to the large number of customers that the Group deals with and their wide geographical spread. Country risk limits and exposures are continuously monitored. Collateral is generally not required.

The provision for impairment of trade receivables is determined on basis of a periodic test of all amounts due.

The exposure of other financial assets and liabilities to credit risk is controlled by setting a policy for limiting credit exposure to counter-parties, continuously reviewing credit ratings, and limiting individual aggregate credit exposure accordingly.

**NOTE 3 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT** (continued):

c) Liquidity Risk

Group entities must have sufficient availability of cash to meet their obligations. Each company is responsible for its own cash management, including the short-term investment of cash surpluses and the raising of loans to cover cash deficits, subject to Group policies and to monitoring of Group management.

The table presented below classifies the Group's financial liabilities into relevant maturity groupings based on the remaining period at 31 December 2012 to the contractual maturity date. Group entities do not have derivative financial liabilities. The amounts presented in the table represent the projected undiscounted cash flows.

| | **Less than 1 year** | **Between 1 and 3 years** | **Between 3 and 5 years** |
|---|---|---|---|
| | **U.S. dollars in thousands** | | |
| **As of 31 December 2012:** | | | |
| Borrowings | 55,306 | 105,666 | 35,342 |
| Accounts payable and accruals | 87,506 | 940 | - |
| | 142,812 | 106,606 | 35,342 |
| **As of 31 December 2011:** | | | |
| Borrowings | 55,678 | 84,144 | 6,616 |
| Accounts payable and accruals | 78,683 | - | - |
| | 134,361 | 84,144 | 6,616 |

**b. Capital management**

Group's objective is to maintain, as possible, stable capital structure. In the opinion of Group's management its current capital structure is stable.

Consistent with others in the industry, the Group monitors capital, including others also, on the basis of the gearing ratio. This ratio is calculated as net debt divided by total capital. Net debt is calculated as total borrowings (including 'current and non-current borrowings' as shown in the consolidated statement of financial position) less cash and cash equivalents. Total capital is calculated as 'equity' as shown in the consolidated statement of financial position plus net debt.

The gearing ratios at 31 December 2012 and 2011 were as follows:

| | **2012** | **2011** |
|---|---|---|
| | **U.S. dollars in thousands** | |
| Total borrowings (Note 9) | 190,032 | 141,646 |
| Less - cash and cash equivalents (Note 18) | (53,933) | (36,472) |
| Net debt | 136,099 | 105,174 |
| Total equity | 453,560 | 393,594 |
| Total capital | 589,659 | 498,768 |
| **Gearing ratio** | 23.1% | 21.1% |

## NOTE 4 – CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will by definition, not necessarily be equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

### a. Estimate of impairment of goodwill

The Group tests annually for impairment of goodwill, in accordance with the accounting policy states in note 2g. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates (Note 8).

### b. Taxes on income and deferred taxes

The Group is subject to income taxes in a large number of countries. Judgment is required in determining the worldwide provision for income taxes. The group is involved in transactions and computations whose final tax liabilities cannot be determined with certainty in the normal course of business. The Group recognizes liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due as a result of the tax audits. Where the final tax outcome of these matters, determined by tax authority is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax liabilities provisions in the period in which such determination is made.

The Group recognizes deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. The Group regularly reviews its deferred tax assets for recoverability, based on historical taxable income, projected future taxable income, the expected timing of the reversals of existing temporary differences and the implementation of tax planning strategies. If the Group is unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time period within which the underlying temporary differences become taxable or deductible, the Group could be required to eliminate a portion of the deferred tax asset resulting in an increase in its effective tax rate and an adverse impact on operating results.

### c. Severance pay

The present value of the liabilities in respect of severance pay is dependent on several factors that are determined on an actuarial basis in accordance with various assumptions. The assumptions used in the calculation of the net cost (income) in respect of severance pay include, inter alia, the long-term yield rate on the relating severance pay funds and the rate of discount. Changes in those assumptions shall influence the carrying amount of the assets and liabilities in respect of severance pay.

**NOTE 4 – CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS** (continued):

The assumption regarding the expected yield on severance pay funds is determined uniformly in accordance with long-term historical yields.

The assumption regarding the required rate of discount is determined by the external actuaries at the end of each year. This rate of discount shall be used in determining the estimated updated value of the future cash flows that would be required to cover the severance pay liabilities. The company uses the market of high-quality corporate bonds when this market available, when his not, government bonds is sufficient to serve as basis for determining the rate of discount. Therefore, in determining this rate the Group uses interest rate in the currency in which the benefits will be paid.

Other key assumptions relating to severance pay liabilities, such as future payroll raise and retirement rates are partially based on existing market conditions on that time and on past experience.

**d. Provisions**

Provision for legal liabilities are recorded in the books of accounts in accordance with Group management's judgment (based on the opinion of its legal advisors) regarding the reasonability that the cash flows shall indeed by used to meet the liabilities, and on the basis of the estimate determined by the management regarding the present value of the expected cash outflows that would be required to meet the existing liabilities.

**NOTE 5 – BUSINESS COMBINATIONS:**

**a. Acquisition of the operations of Rieber & Son ASA**

On February 1, 2011 the Group acquired through a Norwegian subsidiary the industrial savory business of Rieber & Son ASA (hereafter – Rieber).
The Rieber operations include developing, producing and marketing savory flavoring solutions, including flavoring extracts, spice blends and other functional raw materials for the food industry, especially for the processed meat and seafood industry and the convenience food market. The Rieber operations has a broad customer base, including some leading food producers, especially in Scandinavia.

The cost of acquisition presented in the finanical statements amounts to 24,540 thousands Norwegian Krones ($ 4,279 thousands); the acquisition was financed by self funds.

The cost of acquisition was fully allocated to intangible assets which were acquired based on their fair value at the time of the acquisition.

The product formulas and customer relations are amortized over economic life of 20 years and 10 years respectively. The goodwill is not amortized but rather tested at least once a year for impairment.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Towards the end of the fourth quarter of 2011, the Group completed the transfer of the production operations from Norway to Group's plants in Germany.

Set forth below are the assets and liabilities of Rieber at date of acquisition:

| | Fair value U.S. dollars In thousands |
|---|---|
| Non-current assets - | |
| Intangible assets: | |
| Goodwill | 3,540 |
| Product formulas | 373 |
| Customer relations | 366 |
| | 4,279 |

**b. Acquisition of the operations of East Anglian Food Ingredients Ltd.:**

On January 31, 2011, the Group acquired through a UK subsidiary the operations of the UK Company East Anglian Food Ingredients Ltd ("EAFI").

EAFI is engaged in development, production and marketing of savory flavoring solution, included flavoring extracts, spice blends and other functional raw materials for the food industry, focusing on convenience food, snacks and processed meat and fish. EAFI has a development, production and marketing site in the UK and a broad customer base.

The cost of acquisition presented in these financial statements amounts to $ 4,834 thousands (£ 3,000 thousands); the acquisition was funded from self funds.

The cost of acquisition was fully allocated to acquire tangible assets, intangible assets and liabilities which were acquired based on their fair value at the time of the acquisition.

The intangible assets that were recognized include: product formulas in the total amount of £ 146 thousands ($ 235 thousands), amortized over economic life of 20 years.
The acquired operations were merged to the existing operations of the subsidiary in U.K.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Assets and liabilities of EAFI at date of acquisition:

| | **Fair value** |
|---|---|
| | **U.S. dollars in thousands** |
| Current assets: | |
| Accounts receivable: | |
| Trade | 1,072 |
| Inventory | 1,909 |
| Non-current assets: | |
| Fixed assets | 2,438 |
| Intangible assets | |
| Product formulas | 235 |
| Current liabilities : | |
| Accounts payable and accruals-trade | (693) |
| Deferred income taxes | (127) |
| | 4,834 |

**c. Acquisition of the savory business of Christian Hansen Italia S.P.A:**

On 26 May 2011, the Group signed, through a UK subsidiary, an agreement to acquire assets and savory operations of Christian Hansen ITALIA S.p.a ("CH"). On 29 July 2011, the transaction was closed.

The Savory operation of CH (the "acquired operation" ) develops, produces and markets innovative savory solutions (the non-sweet taste spectrum) including flavors, seasoning compounds and functional ingredients for the food industry, with special emphasis on processed meat and convenience food applications. The acquired operation has an extensive customer base comprised mainly of leading Italian meat processors. The activity also enjoys export sales in Russia, Ukraine, Poland, the Czech Republic and France. Included among the assets purchased is a state-of-the-art, high-capacity plant located in Parma, Italy that will enable Frutarom to grow its activities and to take advantage of operational synergies with its existing savory activities in Europe. The Acquired Activity also has advanced R&D laboratories.

The Acquired operation is highly synergetic with the activity of the German companies Gewurzmuller and Nesse (acquired by Frutarom in 2007 and 2006 respectively), the German Savory Functional Systems activity of Chr. Hansen (acquired in 2009) along with the acquisitions of EAFI and Rieber completed in early 2011.

Net acquisition cost presented in these financial statements amounts to $ 34,585 thousands (Total of € 23,972 thousands and includes a payment of € 25,000 thousands net of a refund of € 1,028 thousands received from the sellers in accordance with the adjustments mechanisms set in the acquisition agreement). The acquisition was financed using long-term bank credit.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

The Group merged the marketing, finance, R&D and purchasing activities of the acquired operations with its existing operations.
The cost of acquisition was fully allocated to acquire tangible assets, intangible assets and liabilities based on their fair value on the date of acquisition.

The intangible assets that were recognized include: product formulas in the total amount of €3,118 thousands ($ 4,498 thousands), customer relations of € 4,034 thousands ($ 5,820 thousands) and goodwill of € 6,604 thousands ($ 9,527 thousands).

Assets and liabilities of CH at the date of acquisition:

| | **Fair value** |
|---|---|
| | **U.S. dollars in thousands** |
| Current assets: | |
| Accounts receivable: | |
| Inventory | 4,112 |
| Non-current assets: | |
| Deferred income taxes | 550 |
| Property, plant and equipment | 13,023 |
| Intangible assets | |
| Goodwill | 9,527 |
| Product formulas | 4,498 |
| Customer relations | 5,820 |
| Current liabilities : | |
| Accounts payable and accruals | |
| Others | (868) |
| Non-current liabilities : | |
| Long-term loans | (1,845) |
| Retirement benefit obligations, net | (232) |
| | 34,585 |

**d. Acquisition of Aromco Ltd.:**

On 19 August 2011, the Group acquired thorugh a UK subsidiary 100% of share capital of a UK company – Aromco Ltd. ("Aromco").

Aromco develops, manufactures, and markets flavors for the food and beverage industry. Aromco is active mainly in the UK and in developing markets with high growth potential in Eastern Europe, Africa and Asia. Aromco operates a factory in Hertfordshire, England.

The Acquired operation is highly synergetic with Groups flavors activity. Aromco has many potential synergies with the Group's operations. The Group works to merge Aromco's activity into its UK and global operations, realizing synergies.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

The cost of acquisition presented in these financial statements amounts to $24,614 thousand (£ 15,000 thousand). The acquisition was financed by a long-term bank loan.

The cost of acquisition was allocated to acquired tangible assets, intangible assets and liabilities at their fair value on the date of acquisition.

The intangible assets that were recognized include: product formulas at $3,354 thousand (£ 2,044 thousand), customer relations at $4,750 thousand (£ 2,895 thousand) and goodwill at $16,127 thousand (£ 9,828 thousand).

Assets and liabilities of Aromco at the date of acquisition:

| | **Fair value** |
|---|---|
| | **U.S. dollars in thousands** |
| Current assets: | |
| Cash and cash equivalents | 1,434 |
| Accounts receivable: | |
| Trade | 2,790 |
| Inventory | 1,058 |
| Others | 53 |
| Non-current assets: | |
| Property, plant and equipment | 530 |
| Intangible assets: | |
| Product formulas | 3,354 |
| Customer relations | 4,750 |
| Goodwill | 16,127 |
| Current liabilities : | |
| Accounts payable and accruals : | |
| Trade | (819) |
| Others | (2,456) |
| Deferred income taxes | (2,207) |
| | 24,614 |

**e. Acquisition of Flavor Systems International Inc.:**

On September 13, 2011, the Group signed through a US subsidiary an agreement to acquire 100% of the share capital of a US company – Flavor Systems International Inc. ("Flavor Systems"). The transaction was completed on October 3, 2011.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Flavor Systems in engaged in the development, production and marketing of sweet and savory flavors to the food and beverages markets. Flavor Systems owns a modern plant and R&D laboratories, located in Cincinnati, Ohio. The acquisition also includes a new and advanced production site. The site will enable expansion into market segments where the group is not active presently, such as the growing market for flavored coffee and shakes sold at convenience stores and large food chain stores in the US. In addition, through this acquisition, the group gains access for the first time to the US savory flavors market.

The operations of the acquired company are synergetic to the operations of Flavor Specialties in Corona, California, which was purchased by the group in 2009.

The final price of the transaction was determined in accordance with an agreed mechanism related to future considerations, based on a 6.5 multiplier of EBITDA exceeding $5 million gained by the operation of Flavor Systems during the 12 months starting on October 1, 2011 and ending on September 30, 2012 ("the target EBITDA"), up to a ceiling of $10 million. In addition, in the event that the target EBITDA during that period is less than $5 million, the sellers will repay up to $6 million to Frutarom. Therefore, the consideration for the acquisition may range from $28.8 million to $45.3 million, according to this mechanism. In addition, the Company paid $6.5 million for real-estate assets that are under the ownership of other companies owned by the shareholders of Flavor Systems. In accordance with the above-mentioned mechanism, the Group paid an additional amount of $ 10 million.

The cost of acquisition amounts to $ 35,262 thousands, with the addition of a contingent consideration of $ 10,000 thousands in accordance with the adjustment mechanism set in the acquisition agreement; the two amounts total $45,055 thousands. The acquisition was financed using long-term bank credit.

The cost of acquisition was allocated to acquired tangible assets, intangible assets and liabilities at their fair value on the date of acquisition.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Assets and liabilities of Flavor Systems at the date of acquisition:

| | Fair value U.S. dollars in thousands |
|---|---|
| Current assets: | |
| Cash and cash equivalents | 4 |
| Accounts receivable: | |
| Trade | 1,378 |
| Inventory | 2,120 |
| Others | 153 |
| Non-current assets: | |
| Property, plant and equipment | 10,871 |
| Intangible assets: | |
| Goodwill | 29,077 |
| Product formulas | 6,886 |
| Customer relations | 7,247 |
| Current liabilities : | |
| Accounts payable | (1,101) |
| Short term bank credit | (195) |
| Others creditors | (729) |
| Deferred income taxes | (288) |
| Long-term loans | (10,368) |
| | 44,055 |

**f. Acquisition of Savoury Flavours**

On January 4, 2012, Frutarom signed, through a UK subsidiary, an agreement for the purchase of 100% of the share capital of UK company Savoury Flavours (Holding) Limited and its subsidiaries (hereafter – "Savoury Flavours") in consideration for $ 5.8 million (£ 3.8 million) and an additional consideration that in the opinion of the Company shall not exceed £0.3 million. In addition, the Company paid £0.1 million due to working capital adjustment as of the day of the acquisition.

Founded in 1999, Savoury Flavours develops, manufactures, and markets savory taste solutions, including mainly flavors, seasoning compounds, marinades, and sauces, specializing in snacks and convenience foods. Savoury Flavours has a development, manufacturing, and marketing site in the United Kingdom, and a wide customer base including food manufacturers and private label manufacturers in the U.K. and in emerging markets.

In the 12 months ended December 31, 2011, Savoury Flavours' sales turnover total amounted $7.1 million.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Savoury Flavours' production site is located close to EAFI's production site (savory operation that was acquired in 2011). Frutarom merged and combined the two operations as well as with integrated those operations into Frutarom's savory operations in the UK and all over the world and will continue so in the coming months. The geographic proximity, along with the two companies' complementary product portfolios and technologies, will allow business synergies between Savory Flavours' and Frutarom's fast growing activities in savory foods categories in the UK and worldwide.

The transaction was financed using bank credit and was completed on the day the said agreement was signed.

The cost of acquisition was allocated to tangible assets, intangible assets and liabilities which were acquired based on their fair value at the time of the acquisition. The intangible assets recognized include product formulas in the total amount of £ 837 thousands ($ 1,291 thousands), customer relations in the total amount of £ 336 thousands ($ 518 thousands) and goodwill in the total amount of £ 2,492 thousands ($ 3,843 thousands).

Assets and liabilities of Savoury Flavours at the date of acquisition:

| | Fair value |
|---|---|
| | U.S. dollars in thousands |
| Current assets: | |
| Accounts receivable: | |
| Trade | 1,078 |
| Inventory | 990 |
| Others | 123 |
| Non-current assets: | |
| Property, plant and equipment | 170 |
| Intangible assets: | |
| Product formula | 1,291 |
| Customer relations | 518 |
| Goodwill | 3,843 |
| Current liabilities : | |
| Accounts payable: | |
| Trade | (526) |
| Other | (865) |
| Non-current liabilities: | |
| Deferred income taxes | (447) |
| Other | (363) |
| | 5,812 |

The acquired operations generated revenue of $ 7,694 thousands and net income of $733 thousands (after acquisition and finance costs), for the period from the acquisition date through December 31, 2012.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

**f. Acquisition of Etol**

In the first quarter of 2012, Frutarom purchased, through a Swiss subsidiary, app. 98% of the share capital of the public Slovenian company Etol in consideration for € 34.6 million. On May 8, 2012, Etol was delisted from the Slovenian Stock Exchange. On June 5, 2012 Frutarom has completed the acquisition of the remaining shares of Etol, So that the total cost of acquisition of all of Etol's shares amounted to approximately € 35.4 million ($ 45.7 million).

Together with its subsidiaries, Etol, founded in 1924, develops, manufactures and markets sweet and savory flavors, focusing on natural flavor products for the food and beverage industry. Etol also has great experience in development of fruit based flavors and products and Food Systems, specializing on local fruits of the region as well as extensive activating in the growing area of bases for beverages that plans to further invest in order to substantially expand its global activity.

Etol also has trade and marketing activities for products it does not manufacture, targeted for European countries, which will be integrated into the trade and marketing sector, together with the trade and marketing sector in Israel. Trade and marketing activities are not counted among Frutarom's core activities.

In the twelve months ended December 31, 2011, Etol group's consolidated sales turnover amounted to € 51.3 million ($ 71.4 million).

Etol has a sophisticated and innovative plant located on some 70 dunam of land east of Ljubljana in Slovenia. Etol’s products are sold to a wide customer base in Central and Eastern Europe and in emerging markets, including Russia, Poland, the Ukraine, Croatia, Serbia, Belarus, Hungary, Slovakia, Macedonia, the Czech Republic, Kazakhstan, Turkey and other emerging markets as well as developed countries such as the UK, Switzerland and Germany. Among Etol’s customers, leading food and beverage manufacturers in the countries it operates, including large multi-national food companies. The activitiese of Etol are synergetic with Frutarom’s activities.

Frutarom is acting to integrate Etol's research and development, marketing and sales, logistics, procurement and manufacture with its own global operations, creating operational synergies and cross-selling.

The consideration paid in cash amounted to $ 45,734 thousands (€ 35,387 thousands) and was fully funded by long-term bank credit.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

The cost of acquisition was allocated to tangible assets, intangible assets and liabilities which were acquired based on their fair value at the time of the acquisition. The intangible assets recognized include product formulas in the total amount of € 2,472 thousands ($ 3,195 thousands), customer relations in the total amount of € 1,267 thousands ($ 1,637 thousands) and gain on a bargain purchase in the total amount of € 1,338 thousands ($ 1,729 thousands). The product formulas and customer relations are amortized over an economic useful life of 20 years and 10 years, respectively. The gain on a bargain purchase was recorded as a one-off income in the statement of income.

Assets and liabilities of Etol at the date of acquisition:

| | **Fair value** |
|---|---|
| | **U.S. dollars in thousands** |
| Current assets: | |
| Cash and cash equivalents | 1,068 |
| Accounts receivable: | |
| Trade | 16,092 |
| Inventory | 10,435 |
| Others | 4,925 |
| Non-current assets: | |
| Property, plant and equipment | 38,647 |
| Software | 1,752 |
| Other | 629 |
| Intangible assets: | |
| Product formula | 3,195 |
| Customer relations | 1,637 |
| Gain on a bargain purchase | (1,729) |
| Current liabilities : | |
| Accounts payable - | |
| Trade | (4,049) |
| Other | (2,988) |
| Deferred income taxes | (534) |
| Non-current liabilities | |
| Employee benefits | (2,144) |
| Long-term loans | (21,202) |
| | 45,734 |

The acquired operations generated revenue of $ 67,193 thousands and net income of $6,126 thousands (net of acquisition expenses and finance expenses relating to the acquisition) for the period from the acquisition date through December 31, 2012.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

**g. Acquisition of Mylner Industria E Comercio Ltda**

On February 6, 2012 Frutarom signed, through a subsidiary, an agreement for the acquisition of 100% of the share capital of the Brazilian company Mylner Industria E Comercio (hereafter – “Mylner”) and its parent company Vila Osorio Participacoes in consideration for $ 15.7 million (27.1 Brazlian real). Frutarom also paid a total of 4.4 million Brazilian reals for the cash balance of Mylner out of which a total of 3.1 Brazilian real (capitalized value – 3 million Brazilian real) has not yet been paid and used as security for the seller's indemnification liability in accordance with the purchase agreement, to be realized in installments over 3 years.

Mylnar, founded in 1974, develops, produces and markets sweet flavors for beverages and baked goods, and natural flavor products. Mylner has a modern development, production, and marketing site in the area of Sao Paulo, Brazil, including land for future expansion, and employs some 70 workers. Mylner’s wide customer base includes leading food manufacturers mainly in Brazil, and in other developing countries in Latin America.

In 2011, Mylner sales turnover amounted to $ 11.4 million (app. 19 million Brazilian real). The transaction was financed by a long term bank credit and was completed on the date of signing the agreement.

The cost of acquisition was allocated to tangible assets, intangible assets and liabilities which were acquired based on their fair value at the time of the acquisition. The intangible assets recognized include product formulas in the total amount of 2,948 thousands Brazilian real ($ 1,685 thousands), customer relations in the total amount of 2,707 thousands Brazilian real ($ 1,547 thousands) and goodwill in the total amount of 19,976 thousands Brazilian real ($ 11,415 thousands). The product formulas and customer relations are amortized over an economic useful life of 20 years and 10 years, respectively.

**NOTE 5 – BUSINESS COMBINATIONS** (continued):

Assets and liabilities of Mylner at date of acquisition:

| | **Fair value** |
|---|---|
| | **U.S. dollars in thousands** |
| Current assets: | |
| Cash and cash equivalents | 2,542 |
| Accounts receivable: | |
| Trade | 680 |
| Inventory | 977 |
| Non-current assets: | |
| Fixed assets | 1,359 |
| Intangible assets: | |
| Product formula | 1,685 |
| Customer relations | 1,547 |
| Goodwill | 11,415 |
| Current liabilities : | |
| Trade | (578) |
| Other | (1,078) |
| Short-term credit | (5) |
| Deferred income tax | (1,063) |
| Non-current liabilities | |
| Other | (1,025) |
| | 16,456 |

The acquired operations generated revenue of $8,546 thousands and net income of $ 177 thousands (net of acquisition expenses in the amount of $370 thousands and finance expenses relating to the acquisition) for the period from the acquisition date through December 31, 2012.

## NOTE 6 – SEGMENT REPORTING

### a. Operating Segments

For management purposes, the Group is organized on a worldwide basis into two major operating activities: Flavour and Fine Ingredients. Another operating activity is Trade and Marketing (each operation is considered to be a reportable segment (Note 2d). Results of operating segments are measured based on operating income.

Frutarom's Flavors Activity develops, produces, markets and sells high-quality, value added sweet and savory flavors used mainly by manufacturers of food and beverages and other consumer products including flavors and Food Systems products (products combining fruits, vegetables and/or other natural ingredients, including sweet and non-sweet flavors. These products are used in a wide variety of food products such as dairy, ice cream, sweets, salty baked products, convenience food and other prepared meals). As part of Frutarom's Specialty Fine Ingredients Activity develops, produces, markets and sells natural flavor extracts, natural functional food ingredients, natural pharma/nutraceutical extracts, specialty essential oils, citrus products, aroma chemicals, and natural gums.

The Fine Ingredients are sold principally to the food and beverage, flavor and fragrance, pharmaceutical and personal care industries. The Trade and Marketing activity focuses in trade and marketing of raw materials produced by third parties. These operations are the basis on which the Group reports its primary segment information.

Segment data provided to the chief operating decision-maker in respect of the reported segments for the year ended:

**31 December, 2012 is as follows:**

| | Flavors operations | Fine ingredients operations | Trade and marketing operations | Eliminations | Total Consolidated |
|---|---|---|---|---|---|
| Income statement data: | U.S. dollars in thousands | | | | |
| Sales – net: | | | | | |
| Unaffiliated customers | 457,341 | 138,318 | 22,342 | - | 618,001 |
| Intersegment | - | 2,445 | - | (2,445) | - |
| Total sales and other operating income | 457,341 | 140,763 | 22,342 | (2,445) | 618,001 |
| Segment results | 59,477 | 12,378 | 1,000 | (7) | 72,848 |
| Financial expenses – net | | | | | 7,240 |
| Taxes on income | | | | | 13,628 |
| Net income | | | | | 51,980 |

**31 December, 2011 is as follows:**

| | Flavors operations | Fine ingredients operations | Trade and marketing operations | Eliminations | Total Consolidated |
|---|---|---|---|---|---|
| Income statement data: | U.S. dollars in thousands | | | | |
| Sales – net: | | | | | |
| Unaffiliated customers | 369,894 | 142,176 | 6,373 | - | 518,443 |
| Intersegment | - | 2,832 | - | (2,832) | - |
| Total sales and other operating income | 369,894 | 145,008 | 6,373 | (2,832) | 518,443 |
| Segment results | 46,811 | 11,745 | 353 | (245) | 58,664 |
| Financial expenses – net | | | | | 5,798 |
| Taxes on income | | | | | 10,835 |
| Net income | | | | | 42,031 |

**NOTE 6 – SEGMENT REPORTING** (continued):

**31 December 2010 is as follows:**

| | Flavors operations | Fine ingredients operations | Trade and marketing operations | Eliminations | Total Consolidated |
|---|---|---|---|---|---|
| Income statement data: | U.S. dollars in thousands | | | | |
| Sales – net: | | | | | |
| Unaffiliated customers | 306,374 | 139,267 | 5,425 | - | 451,066 |
| Intersegment | - | 2,273 | - | (2,273) | - |
| Total sales and other operating income | 306,374 | 141,540 | 5,425 | (2,273) | 451,066 |
| Segment results | 46,268 | 16,813 | 124 | (223) | 62,982 |
| Financial expenses - net | | | | | 3,196 |
| Taxes on income | | | | | 15,675 |
| Net income | | | | | 44,111 |

**b. Additional information:**

1) Geographical Segment information

The Group has operating production facilities in Europe, North America, Israel and Asia. In addition, the Group has 31 research and development laboratories and sells and markets its products principally through its 50 sales and marketing offices.

2) Sales by Destination Based on End Customer Location
Following are data regarding the distribution of the Company's sales by:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| | U.S. dollars in thousands | | |
| EMEA* | 428,326 | 359,238 | 306,790 |
| America** | 91,065 | 60,257 | 55,970 |
| Asia and the Far East | 57,539 | 55,053 | 48,710 |
| Israel*** | 41,071 | 43,895 | 39,596 |
| | 618,001 | 518,443 | 451,066 |
| ***Including trade and marketing operations | 4,720 | 6,373 | 5,425 |

* Europe, Africa and the middle east (excluding Israel).

Sales in Germany amounted to $ 74,085 thousands, $ 84,219 thousands and $ 76,946 thousands in 2012, 2011 and 2010, respectively.

** In this report America includes sales in the USA amounting to $ 65,867 thousands, $ 45,191 thousands and $ 41,183 thousands in the years 2012, 2011 and 2010, respectively.

## NOTE 7 – PROPERTY, PLANT AND EQUIPMENT

**a. Composition of assets, grouped by major classifications and changes therein in 2012 is as follows:**

| | Cost | | | | | Accumulated depreciation | | | | | Depreciated balance |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Balance at beginning of year | Additions during the year | Retirements during the year | Other* | Balance at end of year | Balance at beginning of year | Additions during the year | Retirements during the year | Other* | Balance at end of year | 31 December 2012 |
| | U.S. dollars in thousands | | | | | U.S. dollars in thousands | | | | | |
| Land and buildings | 84,991 | 2,951 | (3) | 64,804 | 152,743 | 14,277 | 3,607 | - | 25,999 | 43,883 | 108,860 |
| Machinery and equipment | 132,938 | 7,330 | (538) | 37,357 | 177,087 | 84,964 | 8,727 | (315) | 30,770 | 124,146 | 52,941 |
| Vehicles and lifting Equipment | 4,969 | 973 | (545) | 1,208 | 6,605 | 3,156 | 822 | (450) | 688 | 4,216 | 2,389 |
| Furniture and office equipment (including computers) | 35,626 | 979 | (776) | 4,867 | 40,696 | 16,900 | 1,571 | (764) | 3,834 | 21,541 | 19,155 |
| Leasehold improvements | 12,795 | 325 | (12) | 281 | 13,389 | 6,567 | 903 | (8) | 448 | 7,910 | 5,479 |
| | 271,319 | 12,558 | (1,874) | 108,517 | 390,520 | 125,864 | 15,630 | (1,537) | 61,739 | 201,696 | 188,824 |

* Arising from acquisition of consolidated companies and operations and from translation of foreign currency financial statements of consolidated subsidiaries.

**NOTE 7 – PROPERTY, PLANT AND EQUIPMENT** (continued):

**Composition of assets, grouped by major classifications and changes therein in 2011 is as follows:**

| | Cost | | | | | Accumulated depreciation | | | | | Depreciated balance |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Balance at beginning of year | Additions during the year | Retirements during the year | Other* | Balance at end of year | Balance at beginning of year | Additions during the year | Retirements during the year | Other* | Balance at end of year | 31 December 2011 |
| | U.S. dollars in thousands | | | | | U.S. dollars in thousands | | | | | |
| Land and buildings | 62,427 | 1,309 | (14) | 21,269 | 84,991 | 10,698 | 2,172 | - | 1,407 | 14,277 | 70,714 |
| Machinery and equipment | 123,141 | 4,246 | (423) | 5,974 | 132,938 | 75,202 | 8,088 | (301) | 1,975 | 84,964 | 47,974 |
| Vehicles and lifting Equipment | 4,413 | 596 | (451) | 411 | 4,969 | 2,593 | 687 | (291) | 167 | 3,156 | 1,813 |
| Furniture and office equipment (including computers) | 33,822 | 1,242 | (343) | 905 | 35,626 | 15,467 | 1,206 | (333) | 560 | 16,900 | 18,726 |
| Leasehold improvements | 12,166 | 442 | - | 187 | 12,795 | 5,887 | 634 | - | 46 | 6,567 | 6,228 |
| | 235,969 | 7,835 | (1,231) | 28,746 | 271,319 | 109,847 | 12,787 | (925) | 4,155 | 125,864 | 145,455 |

* Arising from acquisition of consolidated companies and operations and from translation of foreign currency financial statements of consolidated subsidiaries.

**b. Lease of land**

1) Frutarom Ltd. has a leasehold right in land located in the Akko Industrial Zone and the Haifa Bay. The net capitalised lease fees as at December 31, 2012, in respect of the said lands, amount to$ 1,141 thousands (2011- $ 1,173 thousand). The leasing period is 49 years ending in the years 2032 through 2042. Frutarom Ltd. has a right to extend the leasing for an additional 49-year period.

2) A subsidiary in China has “Land Use Rights” on land in China. The rights are for a period of 50 years ending in 2046. Net capitalised lease fees as at December 31, 2012, in respect of the said land, amount to $ 175 thousand (2011 - $ 183 thousand).

3) In 2012 and 2011, a subsidiary in China acquired “Land Use Rights” on land in China for the purpose of erecting a plant in China. The rights are for a period of 50 years. The cost presented in these financial statements is $ 1,211 thousands.

## NOTE 8 – INTANGIBLE ASSETS:

| | Original amount | | Amortized balance | |
|---|---|---|---|---|
| | 31 December | | 31 December | |
| | 2012 | 2011 | 2012 | 2011 |
| Know-how and product formulas | 56,271 | 48,596 | 41,782 | 37,611 |
| Goodwill | 198,752 | 180,656 | 197,493 | 179,428 |
| Customer relations | 46,210 | 41,765 | 29,807 | 29,982 |
| Trademarks | 230 | 219 | 99 | 105 |
| Computer software | 25,264 | 17,877 | 10,017 | 8,584 |
| | 326,727 | 289,113 | 279,198 | 255,710 |

**NOTE 8 – INTANGIBLE ASSETS** (continued):

**Composition of Intangible Assets, Grouped by Major Classifications and Changes Therein is as Follows**:

| | **Computer software** | **Know-how and Product formulas** | **Goodwill*** | **Customer relations** | **Trademarks** | **Total** |
|---|---|---|---|---|---|---|
| | | | **U.S. dollars in thousands** | | | |
| **Balance as of 1 January 2011 – net** | 8,668 | 25,427 | 126,879 | 16,046 | 116 | 177,136 |
| Acquisitions | 2,564 | - | - | - | - | 2,564 |
| Adjustment arising from acquisition of consolidated companies and operations | - | 15,346 | 57,796 | 18,183 | - | 91,325 |
| Exchange differences | (180) | (958) | (5,247) | (1,105) | - | (7,490) |
| Annual amortization charge (Note 2f) | (2,468) | (2,204) | - | (3,142) | (11) | (7,825) |
| **Closing net book amount** | 8,584 | 37,611 | 179,428 | 29,982 | 105 | 255,710 |
| Changes in the year ended 31 December 2012: | | | | | | |
| Acquisitions | 2,284 | - | - | - | - | 2,284 |
| Retirements during the year | (26) | - | - | - | - | (26) |
| Adjustment arising from acquisition of consolidated companies | 1,752 | 6,921 | 15,733 | 3,702 | - | 28,108 |
| Exchange differences | 247 | 510 | 2,332 | 410 | 5 | 3,504 |
| Annual amortization charge (Note 2f) | (2,824) | (3,260) | - | (4,287) | (11) | (10,382) |
| **Closing net book amount** | 10,017 | 41,782 | 197,493 | 29,807 | 99 | 279,198 |

* Goodwill as of 31 December 2012 is allocated to the Flavor segment in the U.K., Germany, Israel, Norway, Italy, the USA and Brazil and to the Fine Ingredients segment in Belgium, USA and the UK.

**NOTE 8 – INTANGIBLE ASSETS** (continued):

**Impairment test for goodwill**

The goodwill recorded in the Group's books of accounts arises from acquisitions of consolidated companies and operations carried out by the Group over the years, the goodwill is allocated to the cash-generating units of the Group in accordance with the unit and the business segment from which it arises.

Set forth below is a summary of goodwill allocation between the various cash-generating units:

| | 31 December | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| Cash-generating unit 1 | 100,062 | 97,915 |
| Cash-generating unit 2 | 36,120 | 35,645 |
| Cash-generating unit 3 | 15,893 | 15,154 |
| Cash-generating unit 4 | 11,053 | 10,540 |
| Cash-generating unit 5 | 9,748 | - |
| Cash-generating unit 6 | 6,705 | 6,574 |
| Cash-generating unit 7 | 6,066 | 5,784 |
| Cash-generating unit 8 | 4,030 | - |
| Cash-generating unit 9 | 2,699 | 2,699 |
| Cash-generating unit 10 | 2,619 | 2,619 |
| Cash-generating unit 11 | 2,498 | 2,498 |
| **Total** | 197,493 | 179,428 |

The changes in goodwill between the years are due to acquisitions of new companies/operations, changes in the exchange rate of the currency of the foreign operation compared with the dollar as explained in Note 5.

The recoverable amount of a cash-generating unit is determined based on value-in-use calculations. These calculations use pre-tax cash flow projections based on past results of the unit, its budget for the following year and the projection for future years, cash flows beyond the five-year period are extrapolated using a grow rate of 2%, which does not exceed the long-term growth rate for the food business, in which the Group operates.

The average discount rate taken into account in the calculation is 15.8% before taxes.

Group management determined profit rates based on past performance and its expectations for developments in respect of each of the cash-generating units.

The recoverable amount of cash-generating unit 1 and 2 was calculated and examined by an external assessor, whereas the recoverable amount of the remaining cash-generating units was calculated and examined by Group management.

The results of the above analysis show that the value of goodwill of each of the said cash-generating units has not been impaired, both in the basic calculations and in calculations performed for the purpose of sensitivity test.

## NOTE 9 – BORROWINGS

| | December 31 | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| **Non current borrowings** | 137,836 | 88,947 |
| **Current borrowings:** | | |
| Current maturities of long-term loans | 39,852 | 47,938 |
| Bank borrowings | 12,344 | 4,761 |
| | 52,196 | 52,699 |
| **Total borrowings** | 190,032 | 141,646 |

Bank borrowings as of December 31, 2012 mature until 2016 and bears average interest of 2% according to the loan terms and Libor rates as of 31 December, 2012
The exposure of the Group's cash flows to interest rate changes is dependent at the rate of Libor-Euro, Libor-Dollar, Libor-Swiss franc and Libor-Pound Sterling and it is updated on a quarterly semi-annual basis.

Due to the above, the fair value of current and non-current borrowings equals their carrying amount, as the impact of discounting is not significant. The fair values are based on cash flows discounted the borrowings' discount rate.

The carrying amounts of the Group's borrowings are denominated in the following currencies:

| | Weighted average interest rates* | 31 December | |
|---|---|---|---|
| | | **2012** | **2011** |
| | | **U.S. dollars in thousands** | |
| Pound sterling | 2.86% | 22,694 | 34,073 |
| Dollars | 2.09% | 53,552 | 49,403 |
| Euro | 2.05% | 60,256 | 58,152 |
| Swiss Franc | 1.21% | 46,177 | - |
| NIS | 3.1% | 5,893 | - |
| Other currencies | 8.09% | 1,460 | 18 |
| | | 190,032 | 141,646 |

* Interest rates as of 31 December, 2012

The long term liabilities (net of current maturities) mature in the following years after the balance
sheet dates:

| | **2012** | **2011** |
|---|---|---|
| | **U.S. dollars in thousands** | |
| Second year | 33,736 | 65,462 |
| Third year | 68,987 | 16,941 |
| Fourth year | 35,113 | 6,544 |
| | 137,836 | 88,947 |

The Group has several loans, in respect of which it has undertaken to meet certain financial covenants (see note 14). As of 31 December 2012, the Group meets all the required financial covenants.

## NOTE 10 – LIABILITY FOR EMPLOYEE RIGHTS UPON RETIREMENT:

**a.** Labour laws and agreements in Israel and abroad require the Company and its consolidated companies to pay severance pay and/or pensions to employees dismissed or retiring from their employ in certain other circumstances. Group companies' liability is covered mainly by regular contributions in defined contribution plans. The amounts funded as above are not reflected in the balance sheets since they are not under the control and management of the companies.

**b.** Under the agreement with its employees, the U.S. subsidiary financed a defined benefit plan. As part of the collective agreement signed between the Company's subsidiary and the industrial labour union on 13 October, 2000, the U.S. subsidiary suspended the said plan and joined, as from that date, a comprehensive pension plan of the labour union, which is a defined contribution plan.
The U.S. subsidiary will continue financing its existing liabilities under the suspended pension plan. The amount of liability for employee rights upon retirement and amounts funded, as presented in the consolidated accounts, reflect, inter alia, the U.S. subsidiary's liability in respect of the suspended plan.

**c.** The Swiss and German subsidiaries have a liability for payment of pension to employees in Switzerland and Germany under a defined benefit plan. The said liabilities have been transferred to these subsidiaries as part of the acquisition of subsidiaries in 2003 and 2007, respectively. The consolidated companies make deposits with pension plans in respect of these liabilities. The amount of the liability for pension (net) included in the balance sheet reflects the difference between the liability for pension payments and the assets of the pension fund, as detailed in d. below.

Amounts charged to income statement in respect of defined benefit plan are as follows:

| | Year ended December 31 | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| | **U.S. dollars in thousands** | | |
| Current service cost | 1,484 | 1,528 | 1,310 |
| Interest cost | 1,388 | 1,496 | 1,522 |
| Actual return on plan assets – U.S. subsidiary | (158) | (171) | (160) |
| Expected return on plan assets – Swiss and German consolidated companies | (789) | (852) | (832) |
| Net actuarial losses (gains) recognized during the year | (819) | 143 | 40 |
| Total included in expenses | 1,106 | 2,144 | 1,880 |

**NOTE 10 – LIABILITY FOR EMPLOYEE RIGHTS UPON RETIREMENT** (continued):

Changes in net liability for employee rights upon retirement recorded in the statement of financial position in respect of post employment defined benefit plans, were as follows:

| | Year ended December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| **At 1 January** | 11,359 | 11,242 |
| Total expenses included in employees' remuneration | 1,106 | 2,144 |
| Adjustments due to acquisition of consolidated companies | 2,144 | - |
| Benefits paid | (1,421) | (1,899) |
| Currency translation effects and others | (61) | (128) |
| **At 31 December*** | 13,127 | 11,359 |

The following amounts were recognized in the statement of financial position for post-employment defined benefit plans:

| | December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| Present value of obligations arising from fully or partially funded plans | 57,644 | 48,623 |
| Fair value of plan assets | (33,315) | (32,480) |
| Excess of the present value of funded liability over plan assets | 24,329 | 16,143 |
| Unrecognised actuarial losses | (11,202) | (4,784) |
| Balance of liability recognized in the statement of financial position* | 13,127 | 11,359 |

Amounts recognized in the statement of financial position for post-employment defined benefit plans are predominantly non-current and are reported as non-current liabilities.

*As of 31 December 2012, the balance includes a debit balance of $ 102 thousands presented among Non-current assets as other.

**NOTE 10 – LIABILITY FOR EMPLOYEE RIGHTS UPON RETIREMENT** (continued):

The Group operates defined benefit schemes in several countries for which the actuarial assumptions vary based on local economic and social conditions. The assumptions used in the actuarial valuations of the defined benefit plans, were as follows:

| | U.S.A. | | | Germany | | | Switzerland | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2012** | **2011** | **2010** | **2012** | **2011** | **2010** | **2012** | **2011** | **2010** |
| Discount rates | 4.15% | 5.15% | 5.7% | 3.03% | 4.77% | 4.85% | 1.8% | 2.3% | 2.75% |
| Projected rates of payroll raise | | | | 1.16% | 1.16% | 1.16% | 2.0% | 2.0% | 2.5% |
| Expected rates of return on plan assets | 7.0% | 7.25% | 7.25% | 4.81% | 5.03% | 5.64% | 2.0% | 2.5% | 2.75% |

**NOTE 11 – COMMITMENTS AND CONTINGENT LIABILITIES**

a. **Commitments**:

1) Lease Commitments:

Some of the Group's premises, warehouses, sites and vehicles in the U.K., Germany, Belgium and Israel occupied by the Group are rented under various operating lease agreements. The lease agreements for the premises will expire on various dates between 2013 and 2018.

Minimum lease commitments of the Group under the above leases, at rates in effect on 31 December 2012, are as follows:

| | **$ in thousands** |
|---|---|
| Year ending 31 December: | |
| 2013 | 5,105 |
| 2014 | 2,409 |
| 2015 | 1,631 |
| 2016 | 1,540 |
| 2017 | 1,363 |
| 2018 | 551 |
| | 12,599 |

Rental expenses totaled $ 5,818 thousand, $ 4,673 thousand and $ 4,528 thousand, in the years ended 31 December 2012, 2011 and 2010, respectively.

**NOTE 11 – COMMITMENTS AND CONTINGENT LIABILITIES** (continued):

2) Royalty Commitments:

Frutarom Ltd. is committed to pay royalties to the Government of Israel on proceeds from sales of products in the research and development of which the Government participates by way of grants. Under the terms of Company's funding from the Israeli Government, royalties of 3%-5% are payable on sales of products developed from a project so funded, up to 100% of the amount of the grant received by the Frutarom Ltd. (dollar linked); as from 1 January, 1999 – with the addition of an annual interest rate based on Libor.
The maximum royalty amount payable by Frutarom Ltd. at 31 December 2012 is $1,202 thousand.
In 2012, Frutarom Ltd. was of the opinion that it is more likely than not that it would not be required to refund Chief Scientist grants in the total amount $52 thousand (2011 - $158 thousand); therefore it carried this amount to income.

**b. Contingent Liabilities:**

Legal Procedures against the Company and consolidated companies:

(a) A number of third party notices have been filed against the Group. The claims are for bodily injury and economic damages, which the plaintiffs allege resulted from the pollution of the Kishon River, for which – according to the plaintiffs – the Group was among those responsible. Group's management believes, based on the opinion of its legal counsel, that the chances that the plaintiffs will prevail in the claims are remote. Group also believes that even if it will be found liable due to the circumstances of the said claim, the potential damage that might arise to the Group is immaterial, due to the large number of defendants, the very small quantity of effluents discharged by the Group during the relevant years (about 0.01% of total effluents discharged by all the defendants and the third parties); due to the period during which effluents were discharged by the Group compared with the other defendants.

**NOTE 11 – COMMITMENTS AND CONTINGENT LIABILITIES** (continued):

Commencing in 2000, the Group discontinued discharge of all effluents to the Kishon River.

Set forth below are the claims filed against the Group concerning the pollution of the Kishon River:

(1) As part of several claims (that were joined), the amount of which was not specified, and which were filed by 92 former soldiers (or their inheritors) against Haifa Chemicals Ltd. ("HCL") (twenty of which were rejected in preliminary stages) and against three other defendants for alleged bodily injury caused to the plaintiffs while the defendants polluted the Kishon River in the course of their military service, the defendants sent the Group and other parties third party notices; in these notices, the defendants demand that if the Court will find them liable for the damages caused to the plaintiffs, the third parties will bear the compensation to be paid to the plaintiffs, since according to the claimants, those third parties were responsible for the damages.

(2) As part of a claim, the amount of which was not specified, and which was filed by 17 former IDF soldiers (or their heirs), four of the ten defendants sent third party notices to the Company and to other parties. In these notices, the defendants demand that the third parties shall compensate the claimants, should the Court rule the payment of such compensation.

(3) As part of a claim, the amount of which was not specified, and which was filed by 41 fishermen and by their relatives against HCL and other parties, for alleged bodily injury, allegedly caused as a result of the pollution of the Kishon River by the defendants, the defendants sent the Company and other parties third party notices; in these notices, the defendants demand that if the Court will find them liable for the damages caused to the plaintiffs, the third parties will bear part of the compensation to be paid to the fishermen and/or indemnify the defendants for payment of the said compensation.

(b) A claim was lodged against the Company in the Haifa District Court in August 2007, for a smell hazard that was allegedly caused to the claimant by the company's Haifa plant (hereafter- the claim). At the same time an application was submitted for approval of the claim as a class action (hereafter – application for approval). The claimants claim that the smell hazards caused by the plant have damaged the individual's autonomy and his/her right to breathe clean air, to the extent that their quality of life was damaged. The amount of damages claimed as specified in the application as above was NIS 225 million ($ 59 million).

On 19 February, 2009, the company signed a compromise agreement as part of the application for approval as above and the claim (hereafter- the agreement).
On April 26, 2010, the Court approved the agreement as a Court Ruling.
According to the court decision, the company paid to the applicants, who submitted the application for approval to their representatives and to a society working for preservation of the environment a total of NIS 775 thousands ($ 203 thousands).

**NOTE 11 – COMMITMENTS AND CONTINGENT LIABILITIES** (continued):

In accordance with further understandings that were agreed upon between the Company and the Ministry of Environmental Protection, the parties signed on 28 June, 2011 addendum to the environmental agreement, where under in the years 2012-2015 the Company will work to gradually transfer production processes with potential smell hazards to its plants outside Israel. These processes constitute app. 2% of the overall global production capacity of Frutarom.

(c) In addition to the aforementioned, consolidated companies of the Group are a party to legal procedures in the ordinary course of business; in the opinion of Group's management the said legal procedures do not materially affect the Group's financial position. Some of the claims are covered by insurance policies and in respect of the other claims, the Group has sufficiently provided in its accounts.

The Company believes that the above claim would not have a material effect on its business and operations.

**NOTE 12 – EQUITY:**

**a. Share Capital:**

1) Composed of ordinary shares of NIS 1 par value, as follows:

| | Number of shares in thousands and the amount thereof, denominated in NIS | |
|---|---|---|
| | December 31 | |
| | 2012 | 2011 |
| Authorized | 100,000 | 100,000 |
| Issued and paid | 58,266 | 57,826 |

Company listed shares are quoted on the TASE at NIS 46.55 ($12.47) per share as of 31 December, 2012. The GDRs representing the Company's shares are quoted on the official list of the LSE.

3) Ordinary Company shares of NIS 1 par value, are held by the company and included in the issued and paid share capital constitute 0.8% (477,711 shares) and 1% (576,283 shares) of the balance of ordinary issued and paid shares of this type as of 31 December 2012 and 2011, respectively.
The purchase cost of those shares was deducted from equity as part of "Cost of Company's shares held by the company and a subsidiary" balance. The shares are held as "Treasury Shares".

**b. Employee Shares and Option Plans for Senior Employees of Subsidiaries:**

1) Commencing 2003 and on a semi-annual basis, the Board of Directors resolves to allot options to senior managers and other senior employees based on the recommendations of the remuneration committee. In accordance with the Board of Directors' resolution and taking into consideration the number of shares available to the Company for the purpose of allotment of the options, the Company acquires Company shares in the Stock Exchange and grants the options against those shares.

Through 1 February, 2012, the shares were acquired by Frutarom Trust Ltd. – a fully owned subsidiary; the shares were held in trust until the exercise of the options in respect of which the shares were acquired. Commencing 1 February, 2012, the Company itself acquires and holds the shares designed for grant of options. Options granted in accordance with the 2003 stock option plan ("the 2003 plan") and in accordance with the 2012 stock option plan ("the 2012 plan") are exercisable in three equal batches at the end of every year for a period of 3 years from date of grant. The Board of Directors has the exclusive right to declare the exercise of the options at an earlier date. The exercise price of the option granted in accordance with the said plans, as set determined by the Board of Directors equals a third of the average purchase price paid by the Company in respect of those shares. Options granted under this plan expire at the end of 6 years from date of grant. All tax liabilities arising from grant of options and/or from exercise thereof apply to the employee. The number of exercised shares in respect of each option, as well as the exercise price are adjusted in accordance with the changes in the Company's share capital, such changes originating in split of shares, consolidation of shares, dividend distributed in shares and/or creation of new types of shares, excluding a number of exceptions where the employer-employee relationship between the Company and an employee are terminated; in such a case the employee shall be entitled to exercise all the options exercisable at the date of termination of employer-employee relationship within 90 days from the said date. The remaining options granted to the employee and which were not exercised by the employee shall expire.

Options that are not exercisable at the time of termination of the employer-employee relationship shall expire immediately upon termination of the relationship as above.

The theoretical economic value of the options in respect of grants from 2007 through 2012, is based on the following assumptions: expected dividend yield of 0% for each one of the years 2007-2011, beginning from 2012 dividend yield expected of 0.44%, expected volatility of 25.68%-45.28%; risk-free interest rate of 1.74%-7% (based on the expected term of the option until exercise); and expected term until exercise of: two years in respect of the first batch, three years in respect of the second batch and four years in respect of the third batch.

The 2012 plan is managed in compliance with the provisions in section 102 to the Israel Income Tax Ordinance.
In accordance with the track chosen by the company and pursuant to the terms thereof, the company is allowed to claim, as an expense for tax purposes, the work income component credited to employees, and is not entitled to claim as an expense for tax purposes the amounts credited to employees as equity benefits.

2) Set forth below are data regarding the options under the 2012 Plan, which have not yet been exercised by Company employees, as of December 31, 2012:

| **Year of grant** | **Number of options in respect of which the vesting period ended** | **Number of options in respect of which the vesting period has not yet ended** | **Exercise price $** |
|---|---|---|---|
| 2007 | 27,757 | - | 2.88-3.06 |
| 2008 | 33,709 | - | 2.82 – 3.07 |
| 2009 | 47,822 | - | 2.65 – 2.77 |
| 2010 | 27,285 | 49,041 | 3.15 – 3.22 |
| 2011 | 15,909 | 42,328 | 3.24 |
| 2012 | 16,153 | 202,032 | 2.96 – 3.2 |
| | 168,635 | 293,401 | |

As of 31 December, 2012, the remaining amount of compensation, computed as the excess or the fair value of the said options granted to employees over the exercise price at the date of grant not yet recorded as expenses in the income statements is approximately $530 thousand. The said remaining compensation will be charged to income using the accelerated method over the remaining vesting period.

**NOTE 12 – EQUITY** (continued):

As to shares granted to the president of the Company - Note 21.a.2.

The changes in the number of options outstanding and their related weighted average exercise prices are as follows:

| | 2012 | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|
| | Average exercise price in U.S. $ Per share | Options | Average exercise price in U.S. $ per share | Options | Average exercise price in U.S. $ per share | Options |
| **Outstanding at 1 January** | 2.97 | 417,342 | 3.10 | 424,098 | 2.80 | 445,332 |
| Granted | 3.15 | 228,914 | 3.59 | 73,348 | 3.18 | 161,277 |
| Forfeited | 3.08 | (32,111) | 3.07 | (17,481) | 2.86 | (46,440) |
| Exercised | 2.78 | (152,109) | 2.88 | (62,623) | 2.77 | (136,071) |
| **Balance at 31 December** | 3.10 | 462,036 | 2.97 | 417,342 | 3.10 | 424,098 |

The following table summarizes information about exercise price and the contractual terms of options outstanding at 31 December, 2012:

| Share rights outstanding | | | Share rights exercisable | | |
|---|---|---|---|---|---|
| Exercise Prices | Number outstanding at December 31, 2012 | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable at December 31, 2012 | Weighted average remaining contractual life |
| $ | | Years | $ | | Years |
| 3.06 | 16,454 | 0.25 | 3.06 | 16,453 | 0.25 |
| 2.88 | 14,303 | 0.75 | 2.88 | 11,304 | 0.75 |
| 3.07 | 14,908 | 1.25 | 3.07 | 14,908 | 1.25 |
| 2.82 | 18,801 | 1.75 | 2.82 | 18,801 | 1.75 |
| 2.65 | 17,804 | 2.25 | 2.65 | 17,804 | 2.25 |
| 2.77 | 30,019 | 2.75 | 2.77 | 30,018 | 2.75 |
| 3.22 | 35,290 | 3.25 | 3.22 | 12,913 | 3.25 |
| 3.15 | 41,036 | 3.75 | 3.15 | 14,372 | 3.75 |
| 3.24 | 58,237 | 4.25 | 3.24 | 15,909 | 4.25 |
| 2.96 | 58,222 | 4.75 | 2.96 | 16,153 | 4.75 |
| 3.25 | 70,240 | 5.25 | 3.25 | - | 5.25 |
| 3.21 | 89,722 | 5.75 | 3.21 | - | 5.75 |
| | 462,036 | | | 168,635 | |

3) In January 2006, the Company allotted 725,000 options, which are exercisable into 725,000 Company shares to four senior employees as part of a private offering; 350,000 of the said options were granted to the president of the Company and 125,000 were granted to a senior office holder. The options that were granted were exercisable in three equal batches which vested on 1.1.2008, 1.1.2009 and 1.1.2010. The exercise price is NIS 31.068 per share. On 31 January 2006, the Tel-Aviv Stock Exchange approved the registration of 600,000 Company shares of NIS 1 par value, which will arise from exercise of the said options. 125,000 stocks out of the said amount are existing stocks held by Frutarom Ltd.

   The original expiry date of the options was 2 February, 2012. On 30 January 2012, the Company's Board of Directors resolved to extend the period till expiry by 1 further year till 31 January, 2013 ("extension period"). This resolution was made after the Company's Audit Committee approved the extension of the exercise period. All options were exercised in the course of the extension period.

   The theoretical economic value of the allotted shares – computed using the Black & Scholes shares valuation model, amounted at date of grant to U.S. $1,620 thousand. This value is based on the following assumptions: expected dividend at a rate set to 0% in all years; standard deviation of expected share price returns of 29%-31%, annual risk-free interest at a rate of 4.35%-4.45% and an expected average option life until exercise of one year, two years, three years and four years.

   The volatility measured at the standard deviation of expected share price returns is based on statistical analysis of weekly share price over the last twelve months, twenty four months and thirty six and forty eight months (in accordance with the vesting periods of the batches).

4) On 15 July 2010 the Company's Board of Directors approved a plan to grant options to senior managers ("the 2010 plan") based on the recommendations of the remuneration committee; as part of the plan, the Board of Director approved the grant of up to 1,000,000 options (not registered for trade) to the company president and 10 further employees and office holders in the Group; the Board also approved the grant of additional 255,000 options to employees and office holders in the Group ("options for future allocation"). The grant of options to the company president was also approved by the Company's Audit Committee. The options were granted without consideration.

   Each option is exercisable into one share for an exercise price of NIS 30.26 which is the closing price of Company's share on the last trading day prior to Board's resolution on such allocation. Each option for future allocation that will be granted to future offerees as part of the plan will be exercisable into one share for an exercise price that will equal an average of closing prices in the ten consecutive trading days prior a Board's resolution on such future allocation, so long as the exercise price of each future allocation option is no less than the par value of Company shares.

**NOTE 12 – EQUITY** (continued):

The fair value of the options at date of grant - computed based on the binomial model – is NIS 3.4 million ($ 0.9 million); this value is based on the following assumptions: adjusted standard deviation of 38% per year, risk-free interest rate of 3.5% and termination rate (prior to end of the vesting period) of 17%; this rate is based on a sample of the changes in manpower of offerees rank for the last several years.

In 2011, the Company granted 40,000 further options to a senior office holder in the Company out of the number of options designed for future allotment; (this grant was also approved by the Company's audit committee). The exercise price in respect of this grant was set to NIS 36.93 ($10.41); the exercise price is unlinked and is equal to the average closing rates of the Company's share in the 10 trading days that preceded the resolution of the Company's board as to allotment of the options. The theoretical economic value of the options at date of grant - computed using the binomial model – is NIS 0.2 million ($0.06 million).

On August 20, 2012, the Company's Board of Directors approved the grant of up to 945,000 options (not registered for trade) as part of the 2010 plan to the president and 10 other employees and office holders in the Group; the Board also approved the future grant of up to 200,000 further options to employees and office holders in the Group ("the future options"); the resolution was made based on the recommendations of the remuneration committee. The grant of options to the senior manager was also approved by the Company's Audit Committee. The options were granted without consideration.

Each option is exercisable into one share for an exercise price of NIS 34.85 which is the closing price of Company's share on the last trading day prior to Board's resolution on such allocation. Each future option that will be allotted to future offerees as part of the plan will be exercisable into one share for an exercise price that will equal an average of closing prices in the ten consecutive trading days prior a Board's resolution on such future allocation, so long as the exercise price of each future allocation option is no less than the par value of Company shares. On 1 October, 2012, the Company's Board of Directors approved the allotment of 120,000 options to another senior office holder in the Company as part of the 2010 plan.

The fair value of the options at date of grant - computed based on the binomial model – is NIS 4.7 million ($ 1.2 million); this value is based on the following assumptions: adjusted standard deviation of 29% per year, risk-free interest rate of 2.7% and termination rate (prior to end of the vesting period) of 11.5%; this rate is based on a sample of the changes in manpower of offerees rank for the last several years.

As to the fair value of the options granted to the president – see note 21.a.2.

The 2010 plan is managed in compliance with the provisions in section 102 to the Israel Income Tax Ordinance.

The Group creates deferred taxes for grants that fall into the scope of IFRS 2 – "Share Based Payment" – in accordance with the proportionate part of the estimated amount deductible for tax purposes by the Group at date of exercise of benefit by the employee and in respect of which work services were provided by the employee.

**NOTE 12 – EQUITY** (continued):

through the date of the statement of financial position (i.e., the estimated overall amount deductible for tax purposes divided by the overall vesting period and multiplied by the vesting period that has elapsed through the date of the statement of financial position). The said deferred taxes are recognized in the statement of income.

**c. Dividend and Retained Earnings**

1) The amounts of the dividend paid presented in the statement of changes in shareholders' equity are net the share of a subsidiary holding Company shares (Note 2m). The subsidiary's share in the dividend is $ 27 thousand, $ 30 thousands and $26 thousand in 2012, 2011, 2010, respectively.
   In determining the amount of retained earnings available for distribution as a dividend, the Companies Law stipulates that the cost of the Company's shares acquired by a subsidiary (that are presented as a separate item on the statement of changes in shareholders' equity) is to be deducted from the amount of retained earnings presented among Company's shareholders' equity.

2) In its meeting on March 12, 2013, the Company's Board of Directors resolved to distribute a final cash dividend out of retained earnings as of December 31, 2012; the amount of this dividend is $3,801 thousand (NIS 13,997 thousand). Frutarom Ltd. does not intend to distribute dividend out of tax exempt income arising from "approved enterprise", as explained in Note 13c.

3) The dividend paid in 2012 and 2011 amounted to $ 3,029 thousand (NIS 0.2 per share) and $ 3,380 thousands (NIS 0.2 per share). As mentioned in 2) above, the dividend in respect of the year ended 31 December 2012 at NIS 0.24 per share and totaling $3,801 thousand was discussed in the Company's Board of Directors.

**NOTE 13 - TAXES ON INCOME**:

**a. Corporate taxation in Israel**

1) Commencing 2008, the results for tax purposes of the Company and its Israeli subsidiaries are measured in nominal values. The Israeli companies are companies of foreign investors and have elected to keep their books and records in dollars for tax purposes, as permitted under the Income Tax Regulations (Principles for the Bookkeeping of Foreign Invested Companies and of Certain Partnerships and the Determination of Their Taxable Income), 1986.

**2) Tax rates**

The income of the Company and its Israeli subsidiaries (other than income from “approved" or "beneficiary enterprises”) is taxed at the regular rate; under the provisions of the Law for Amendment of the Income Tax Ordinance, 2005, of August 2005 and the provisions of the Economic Rationalization Law (Legislation Amendments for the Implementation of the Economic Plan for the years 2009 and 2010), of July 2009, the corporate tax rates is to be gradually reduced as from 2010 and thereafter, as follows: 2010 – 25%, 2011 – 24%, 2012 – 23%, 2013 – 22%, 2014 – 21%, 2015 – 20%, 2016 and thereafter – 18%.

On December 6, 2011, the "Tax Burden Distribution Law" Legislation Amendments (2011) was published in the official gazette. Under this law, the previously approved gradual decrease in corporate tax is discontinued. Corporate tax rate will increase to 25% as from 2012.

Capital gains of the Company are subject to tax at the regular corporate tax rate applicable during the tax year. However capital gains derived prior to January 1, 2003 are taxed at a rate of 26% in 2009, 25% in 2010 and 24% in 2011. Commencing 2012, the tax rate applicable to all capital gains of the Company shall be 25%.

**b. Subsidiaries outside Israel**

Subsidiaries that are incorporated outside of Israel are assessed for tax under the tax laws in their countries of residence. The principal tax rates applicable to subsidiaries outside Israel are as follows:

Companies incorporated in the USA – tax rate of 41% - 42%
Companies incorporated in Germany– tax rate of 30%
Company incorporated in Belgium – tax rate of 34%
Company incorporated in Italy – tax rate of 31.4%
Company incorporated in Norway – tax rate of 28%.
Companies incorporated in the UK – tax rate of 24% (January –March 2012 – tax rate of 26%, April 2012 through March 2013 tax rate of 24%; commencing April 2013 – tax rate of 23%).
Company incorporated in the Switzerland – tax rate of 22%.
Company incorporated in Slovenia – tax rate of 18%
Companies incorporated in China – tax rate of 25%
Companies incorporated in Brazil – tax rate of 34%

**NOTE 13 –TAXES ON INCOME** (continued):

**c. Encouragement Laws in Israel**

**1) Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the Law)**

Under the law, including Amendment No. 60 to the law that was published in April 2005, by virtue of the “approved enterprise” or “benefited enterprise” status granted to certain enterprises of the Company, and by virtue of the “Foreign Investors’ Company“ status it was granted, Frutarom Ltd. is entitled to various tax benefits.

The main tax benefits that was available to Frutarom Ltd till 2010 are:

(a) Reduced tax rates

During the 10-year period of benefits, commencing in the first year in which Frutarom Ltd. earns taxable income from the approved or benefited enterprises (provided the maximum period to which it is restricted by law has not elapsed), the following reduced tax rates apply:

(1) Corporate tax at the rate of 20% on income from certain approved or benefited enterprises owned by foreign investors' companies (this tax rate is determined based on the percentage of foreign shareholding as defined by the law).

(2) Tax exemption on income from certain approved enterprises which had previously opted for by Frutarom Ltd. the "alternative benefits" track (involving waiver of investment grants) and tax exemption on income from a benefited enterprise; the length of the exemption period is two, four or six years, after which the income from these enterprises is taxable at a decreased rate (see 1a above) for an additional eight, six or four years, respectively.

That part of income eligible for tax benefits as above is based on the ratio between the turnover allocated to the "approved enterprise" or "benefited enterprise" and the overall turnover of the enterprise.

In accordance with the Encouragement of Capital Investments Regulations (Erosion of Base Turnover), 2007, Frutarom Ltd. is eligible for base turnover erosion subject to complying with the provisions of the said regulations.

In the event of distribution of cash dividends out of income, which was tax exempt as above (including liquidation dividend for benefited enterprises), Frutarom Ltd. would have to pay the decreased tax rate (see 1a above) in respect of the amount distributed, (Note 2p).

(b) Accelerated depreciation

Frutarom Ltd. is entitled to claim accelerated depreciation for five tax years commencing in the first year of operation of each asset, in respect of buildings, machinery and equipment used by the approved enterprise.

**NOTE 13 –TAXES ON INCOME** (continued):

(c) Conditions for entitlement to the benefits

The entitlement to the above benefits is conditional upon fulfilling the conditions stipulated by the law, regulations published thereunder and the instruments of approval for the specific investments in approved enterprises. In the event of failure to comply with these conditions, the benefits may be cancelled and Frutarom Ltd. may be required to refund the amount of the benefits, in whole or in part, with the addition of interest. As mentioned above, as of 31 December 2012, the Group meets the requirements.

**2) Amendment to the Israel Capital Investment Encouragement Law, 1959**

The Israel Law of Economic Policy for the Years 2011 and 2012 (Legislation Amendments), which was passed by the Knesset (the Israeli parliament) on December 29, 2010, includes an amendment to the Israel Capital Investment Encouragement Law, 1959 (hereinafter - the amendment). The amendment became effective on January 1, 2011.

The amendment sets out benefit tracks to replace those provided by the Law for Encouragement of Capital Investments, 1959 (hereafter – the law) before it was amended. Key changes in programs include a grants program for entities in development area A, and two new tax benefit programs ('preferred enterprise' and 'special preferred enterprise'). In essence, these provide a uniform tax rate on the entire preferred income of an entity, as the term preferred income is defined in the amendment.

Corporate tax rate under the law are:

| Years | Development area A | All other parts of Israel |
|---|---|---|
| 'Preferred enterprise' | | |
| 2011-2012 | 10% | 15% |
| 2013-2014 | 7% | 12.5% |
| 2015 and thereafter | 6% | 12% |
| 'Special preferred enterprise' | | |
| 2011 and thereafter | 5% | 8% |

Benefits will be provided to a preferred enterprise indefinitely, as opposed to a special preferred enterprise, which will receive benefit for a period of 10 years. Benefits are to be given to qualifying companies under the amendment, based on criteria similar to those prescribed by the law prior to the amendment. Transition provisions in the amendment state that a company will be able to continue benefit from tax breaks under the previous version of the law until it is amended and until the end of the benefits period, as defined by the law. A company will be permitted to set a 'year of election' that will be not later than the 2012 tax year, as long as the minimum qualifying investment started through the end of 2010. In each year during the period of benefits, the company will be entitled to decide to irreversibly enter the scope of the amendment and to benefit from preferable tax rates.

The Company entered the scope of the amendment beginning in the 2011 tax year.

**NOTE 13 –TAXES ON INCOME** (continued):

**3) The Law for the Encouragement of Industry (Taxation), 1969:**

a. Frutarom Ltd. is an “industrial company” as defined by this law. As such, Frutarom Ltd. is entitled to claim amortization over 8 years of acquired product formulas, as well as depreciation at increased rates for equipment used in industrial activity as stipulated by regulations published under the inflationary adjustments law, and have done so.

b. The Company and Frutarom Ltd. file a consolidated tax return in accordance with the Law for the Encouragement of Industry. Accordingly, each company is entitled to set-off its tax losses (created commencing the year in which consolidated reporting for tax purposes began) against the taxable income of the other company, subject to certain restrictions.

**NOTE 13 –TAXES ON INCOME** (continued):

**d. Deferred Income Taxes**

1) Composition of deferred taxes as of dates of statements of financial position and changes therein in those years are as follows:

| | | **Provisions for employee rights** | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | **Depreciable fixed assets** | **Severance Pay** | **Vacation and recreation pay** | **Inventories** | **Other** | **Depreciable intangibles** | **In respect of Carry forward tax losses** | **Total** |
| | **U.S. dollars in thousands** | | | | | | | |
| **Balance at 1 January, 2011** | 12,926 | (1,407) | (165) | (1,535) | (335) | 11,021 | - | 20,505 |
| Changes in 2011: | | | | | | | | |
| Additional taxes as a result of acquisition of subsidiaries | (327) | - | | 255 | 37 | 2,107 | - | 2,072 |
| Differences from translation of foreign currency financial statements of subsidiaries | (75) | 12 | | (18) | 7 | (296) | 32 | (338) |
| Amounts carried to c income | 437 | 340 | (10) | 369 | 165 | (485) | (459) | 357 |
| **Balance at 31 December 2011** | 12,961 | (1,055) | (175) | (929) | (126) | 12,347 | (427) | 22,596 |
| Changes in 2012: | | | | | | | | |
| Additional taxes as a result of acquisition of Subsidiaries | 3,095 | - | - | (27) | (17) | 2,266 | (3,329) | 1,988 |
| Differences from translation of foreign currency financial statements of subsidiaries | 313 | (27) | | 33 | 22 | 393 | (112) | 622 |
| Amounts carried to c income | 226 | (77) | (15) | (290) | (484) | 1,461 | (1,811) | (990) |
| **Balance at 31 December 2012** | 16,595 | (1,159) | (190) | (1,213) | (605) | 16,467 | (5,679) | 24,216 |

**NOTE 13 –TAXES ON INCOME** (continued):

2) Deferred taxes are presented in the statements of financial position as follows:

| | December 31 | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| Among non-current assets | 3,075 | 2,073 |
| Among non-current liabilities | (27,292) | (24,669) |
| | (24,217) | (22,596) |

3) The deferred taxes in respect of Group activities in Israel are computed at the tax rate of 13% (2011 – 13%). This rate is an average taking into account the tax rates applicable to income from Frutarom Ltd.'s preferred enterprises (in accordance with the amendment to the law, see also note 13c2).

Deferred taxes of foreign subsidiaries in Switzerland, U.S.A, U.K. and Germany are computed at the tax rates applicable to these companies (see b above).

**e. Taxes on Income Included in The Income Statements for the presented periods:**

1) As follows:

| | **2012** | **2011** | **2010** |
|---|---|---|---|
| | **U.S. dollars in thousands** | | |
| Current taxes: | | | |
| For the reported year's income | 15,335 | 11,592 | 15,178 |
| Adjustments in respect of previous years | (717) | (1,114) | 577 |
| | 14,618 | 10,478 | 15,755 |
| Deferred taxes: | | | |
| Creation and reversal of deferred taxes | (990) | 357 | (80) |
| T o t a l | 13,628 | 10,835 | 15,675 |

Current taxes are computed in accordance with the statutory tax rates of Group entities around the world (see above) and in accordance with relevant tax benefits for each country.

**NOTE 13 –TAXES ON INCOME** (continued):

2) Following is a reconciliation of the theoretical tax expense, assuming all income is taxed at the regular tax rates applicable to companies in Israel (Note 13c above) and the actual tax expense:

| | **2012** | **2011** | **2010** |
|---|---|---|---|
| | **U.S. dollars in thousands** | | |
| Income before taxes on income, as reported in the income statements | 65,608 | 52,866 | 59,786 |
| Theoretical tax expense in respect of this income – at 25% (2011 – 24%; 2010 – 25%) | 16,402 | 12,688 | 14,947 |
| Less – tax benefit arising from approved enterprise /benefited enterprise status | (1,158) | (1,788) | (806) |
| Increase in taxes resulting from different tax rates applicable to foreign subsidiaries | 52 | 1,167 | 2,922 |
| Decrease in taxes arising from computation of deferred taxes at a rate which is different from the theoretical rate | (159) | 331 | (764) |
| Increase (decrease) in deferred taxes as a result of future changes in the tax rates | - | (170) | (533) |
| Increase (decrease) in taxes arising from permanent differences – disallowable expenses (income) | (412) | (76) | (5) |
| Decrease in taxes resulting from utilization, in the reported year, of carry forward tax losses and other expenses for which deferred taxes were not created (net of increase in taxes in respect of tax losses incurred in the reported year for which deferred taxes were not created) | (372) | (151) | (502) |
| Difference between the basis of measurement of income reported for tax purposes and the basis of measurement of income for financial reporting purposes – net | - | - | 15 |
| Income taxes in different tax rates | | | - |
| Other | (8) | (52) | (176) |
| Taxes on income for the reported year | 14,345 | 11,949 | 15,098 |

**f. Tax Assessments**

The Company and its Israeli subsidiaries have received final tax assessments through the year 2008.

**NOTE 13 –TAXES ON INCOME** (continued):

**g. Effect of adoption of IFRS in Israel on tax liability**

As mentioned in note 2a, the Group prepares its financial statements in accordance with IFRS.

As also indicated in the said note, IFRS vary from Accounting Principles Generally Accepted in Israel and accordingly, preparation of financial statements in accordance with IFRS may reflect a financial position, results of operations and cash flows that are materially different from the ones presented in financial statements presented in accordance with accounting principles generally accepted in Israel.

In accordance with the law for the amendment of the Income Tax Ordinance (No. 174 – Temporary Order as to Tax Years 2007, 2008 and 2009), 2010 that was passed in the Knesset on January 25, 2010 and published in the official gazette on February, 4, 2010 (hereafter – the amendment to the ordinance), Accounting Standard No. 29 issued by the Israel Accounting Standard Board would not apply upon determining the taxable income for tax purposes in respect of tax years 2007, 2008 and 2009; this would be the case even if the said accounting standard was applied for the said tax years in the financial statements.
The meaning of the amendment to the ordinance is that IFRS would actually not be applied upon computation of the income reported for tax purposes for the said tax years.

On 31 October, 2011 the Government of Israel published a law memorandum in connection with the amendment to the Income Tax Ordinance (hereafter – the law memorandum) resulting from application of IFRS in the financial statements. Generally, the law memorandum adopts IFRS. Nevertheless, the law memorandum suggests making several amendments to the Income Tax Ordinance, which will serve to clarify and determine the manner of computation of taxable income for tax purposes in cases where the manner of computation is not clear and IFRS do not comply with the principles of the tax method applied in Israel. At the same time, the law memorandum generally adopts IFRS. The legislation procedures relating to the law memorandum have not yet been completed and it is doubtful whether they shall be completed in the near future.

Since the legislation procedures relating to the law memorandum have not yet been completed the Company estimates that the term of the temporary order which applies to the years 2007 to 2011 shall be extended so that it will also apply to 2012. In view of the fact that the temporary order applies to tax years 2007 to 2011 as above and in view of the potential extension of the term of the temporary order to 2012, the Group's management expects that at this stage the new legislation shall not apply to tax years preceding 2013.

Taking into consideration the temporary order which applies to tax years 2007 to 2011 and the Company's estimate regarding the potential extension of the term of the temporary order to 2012 as above, the Company computed its taxable income for tax years 2007 to 2012 based on Israeli accounting standards applicable prior to adoption of IFRS in Israel, subject to certain adjustments

The amendment to the ordinance did not have a material effect on the tax expenses reported in these financial statements.

## NOTE 14 – LIABILITIES SECURED BY PLEDGES AND RESTRICTIONS PLACED IN RESPECT OF LIABILITIES:

a. To secure borrowings and long-term loans received by a US subsidiary, this subsidiary recorded a charge on current inventory and trade receivables.

b. To secure long-term loans and other services received by subsidiaries in Israel and the UK, the subsidiary in Israel and subsidiary in the UK recorded a negative pledge on their assets.

c. To secure the long-term loan extended by Bank Leumi Ltd. Bank Leumi Ltd. in the USA, the First International Bank of Israel Ltd. and by two Swiss banks the Group has undertaken upon itself to meet the following financial criteria:
   1) The amount representing the Group's equity would not be lower than $300 million at any given time. As of 31.12.2012 the Group's equity amounts to $ 453,560 thousands.
   2) The amount representing the Group's equity would not be lower than 35% of total assets. As of 31 December, 2012, the Company's equity equals 58.7% of total Company balance sheet.
   3) The ratio between the total financial liabilities of the Group and its operating profit before tax expenses with the addition of depreciation and amortization would not exceed 4.25. As of 31 December, 2012 the said ratio is 1.4.

d. To secure borrowings and banking services received from Bank Leumi Ltd. and the First International Bank of Israel Ltd., the Company has undertaken to meet the following restrictions regarding dividend distribution. The Company shall be allowed to distribute as dividend:

   1) Up to 50% of the retained earnings accumulated through 31 December 2011; based on the retained earnings balance recorded in the Company's balance sheet as of 31 December 2011.

   2) Up to 50% of the Company's net income for each calendar year based on the net income data recorded in the Company's statement of income for the calendar year during which the said income was accumulated.

e. To secure a long-term loan received by a Swiss subsidiary, the Swiss subsidiary and its subsidiaries recorded a negative pledge on their assets.

f. To secure a long-term loan extended by two Swiss banks, the Swiss subsidiary has undertaken to meet the following financial covenants to be computed on the basis of the consolidated financial statements of the subsidiary and all the companies it owns (hereafter – the Swiss group):

   1) The ratio between debt net of cash and EBITDA shall not exceed 3. As of 31 December 2012, the ratio was 1.07.
   2) The amount of equity shall not be lower than 35% of total balance sheet of the Swiss group. As of 31 December 2012 the ratio was 48.2%.

As mentioned above, as of 31 December 2012, the Group meets its obligations.

**NOTE 15 – ACCOUNTS RECEIVABLE:**

| | December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| **a.** Trade – composed as follows: | | |
| Open accounts | 104,396 | 84,217 |
| Interested parties | 342 | 139 |
| | 104,738 | 84,356 |
| Cheques collectible | 2,016 | 1,698 |
| | 106,754 | 86,054 |
| The item includes – provision for doubtful accounts | 3,640 | 2,808 |

As of 31 December, 2012 certain trade receivable balances– amounting to $ 22,636 thousands (2011 **-** $ 17,514 thousands) are in arrears of up to 120 days after date in which payment was due. A provision for doubtful account in the total amount of $961 thousand (2011 **-** $ 1,167 thousands) was made in respect of it of those balances.
Those balances include the accounts of a large number of customers, in respect of which the Company has not encountered lately any collection problems. The carrying amount of accounts receivable is a reasonable approximation of their fair value since the effect of discounting is immaterial.

The aging analysis of these trade-receivable balances is as follows:

| | December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| Through 90 days | 21,694 | 16,884 |
| 90 to 120 days | 942 | 630 |
| | 22,636 | 17,514 |
| Provision for doubtful accounts | (961) | (1,167) |
| | 21,675 | 16,347 |

As of 31 December, 2012, the Company made a provision for doubtful accounts in respect of balances in the total amount of $2,957 thousand (2011 – $2,582 thousand) in arrears of more than 120 days. The amount of the provision as of 31 December, 2012 was $2,379 thousand (2011 – $1,641 thousand).

The aging of the said balances is presented below:

| | December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| 120 days to 1 year | 1,483 | 1,639 |
| Over 1 year | 1,474 | 943 |
| | 2,957 | 2,582 |
| Provision for impairment of receivables | (2,379) | (1,641) |
| | 578 | 941 |

**NOTE 15 – ACCOUNTS RECEIVABLE** (continued):

Amounts charged to provision for doubtful accounts or released therefrom were included among "selling, marketing, research and development expenses" in the statement of income (see note 20b).

| | December 31 | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| **b.** Other: | | |
| Employees and institutions | 398 | 272 |
| Government institutions | 9,173 | 5,872 |
| Sundry | 1,378 | 846 |
| | 10,949 | 6,990 |

**NOTE 16 – INVENTORIES**

| | December 31 | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| Raw materials and supplies | 61,180 | 52,537 |
| Products in process | 10,697 | 6,976 |
| Finished products | 48,299 | 50,144 |
| | 120,176 | 109,657 |
| Inventories for commercial operations – purchased products | 2,257 | 1,557 |
| | 122,433 | 111,214 |

**NOTE 17 – OTHER**

| | December 31 | |
|---|---|---|
| | **2012** | **2011** |
| | **U.S. dollars in thousands** | |
| Prepaid expenses in respect of operating lease | 60 | 67 |
| Asset in respect of employee benefits | 102 | - |
| Sundry | 217 | - |
| | 379 | 67 |

**NOTE 18 – CASH AND CASH EQUIVALENTS:**

Classified by currency, linkage terms and interest rates, the cash and cash equivalents are as follows:

| | **Weighted Interest rates as of 31 December 2012** | December 31 | |
|---|---|---|---|
| | | **2012** | **2011** |
| | | **U.S. dollars in thousands** | |
| In Dollars | 0.2% | 18,157 | 12,804 |
| In Pounds sterling | - | 2,953 | 4,896 |
| In Euro | 0.1% | 19,046 | 10,649 |
| In Swiss Francs | 0.1% | 3,533 | 772 |
| Yuan | 0.1% | 2,878 | 4,949 |
| NIS | - | 1,008 | 783 |
| Brazilian real | 7.3% | 3,257 | - |
| Other | | 3,101 | 1,619 |
| | | 53,933 | 36,472 |

## NOTE 19 – ACCOUNTS PAYABLE:

| | December 31 | |
|---|---|---|
| | 2012 | 2011 |
| | U.S. dollars in thousands | |
| **a.** Trade: | | |
| Open accounts | 48,237 | 40,239 |
| **b.** Other: | | |
| Payroll and related expenses | 11,439 | 10,759 |
| Government institutions | 14,682 | 7,418 |
| Provision for commissions and discounts | 2,527 | 2,282 |
| Accrued expenses | 8,674 | 7,341 |
| Provisions | 320 | 236 |
| Conditional consideration in respect of acquisition of subsidiaries | 657 | 9,793 |
| Sundry | 970 | 615 |
| | 39,269 | 38,444 |

The carrying amount of accounts payables is a reasonable approximation of their fair value since the effect of discounting is immaterial.

## NOTE 20 – INCOME STATEMENT ANALYSIS:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| | U.S. dollars in thousands | | |
| **a. Cost of Sales:** | | | |
| Industrial operations: | | | |
| Materials consumed | 279,694 | 256,031 | 200,141 |
| Payroll and related expenses | 48,763 | 44,408 | 38,400 |
| Depreciation and amortization | 13,134 | 11,209 | 9,926 |
| Other production expenses | 32,734 | 29,206 | 25,758 |
| | 374,325 | 340,854 | 274,225 |
| Decrease (increase) in work in process and finished products inventories | (1,876) | (16,034) | (2,372) |
| | 372,449 | 324,820 | 271,853 |
| Commercial operations – cost of products sold | 19,293 | 5,046 | 4,389 |
| | 391,742 | 329,866 | 276,242 |
| **b. Selling, Marketing, Research and Development Expenses –** net: | | | |
| Payroll and related expenses | 54,369 | 48,136 | 41,386 |
| Transportation and shipping | 16,196 | 14,335 | 12,164 |
| Provisions for payment of commissions | 5,841 | 3,742 | 3,109 |
| Provision for doubtful accounts | (441) | (347) | 214 |
| Depreciation and amortization | 8,510 | 5,984 | 5,253 |
| Travel and entertainment | 4,015 | 3,416 | 2,733 |
| Office rent and maintenance | 4,818 | 3,902 | 3,841 |
| Other | 11,624 | 9,473 | 8,361 |
| | 104,932 | 88,641 | 77,061 |
| The item includes expenses for product development and research activities, net* | 28,031 | 24,333 | 21,563 |
| * net of participation from government departments and others | 384 | 655 | 992 |

**NOTE 20 – INCOME STATEMENT ANALYSIS** (continued):

| | Year ended 31 December | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| | U.S. dollars in thousands | | |
| **c. General and Administrative Expenses:** | | | |
| Payroll and related expenses | 28,852 | 23,864 | 20,720 |
| Depreciation and amortization | 4,368 | 3,419 | 2,902 |
| Professional fees | 3,094 | 2,110 | 2,067 |
| Communication, office supplies and Maintenance | 5,266 | 4,416 | 5,031 |
| Travel and entertainment | 1,595 | 1,686 | 1,396 |
| Other | 6,022 | 3,736 | 2,983 |
| | 49,197 | 39,231 | 35,099 |
| **d. Other Expenses (income)** – net: | | | |
| Capital loss on sale of fixed assets | 92 | 17 | (508) |
| Rental | (11) | (36) | (69) |
| Expenses relating to acquisition of subsidiaries | 954 | 1,876 | 85 |
| Expenses for institutional audit | - | 150 | 223 |
| Other | (24) | 34 | (49) |
| Income from bargain purchase | (1,729) | - | - |
| | (718) | 2,041 | (318) |
| **e. Financial Expenses** – net: | | | |
| In respect of long-term loans and credit | 5,154 | 1,489 | 1,749 |
| In respect of exchange differences of trade receivables and trade payable balances – net | 48 | 3,254 | 1,107 |
| In respect of cash and cash equivalents, short-term deposits and loans, short-term credit and other – net | 2,038 | 1,055 | 340 |
| | 7,240 | 5,798 | 3,196 |

## NOTE 21 - RELATED PARTIES - TRANSACTIONS AND BALANCES:

### a. Transactions with Related Parties:

"Interested parties" - As this term is defined in Israel Securities Regulations (Annual Financial Statements), 2010.
"A related party" - As this term is being defined in IAS 24 - "Related Party Disclosure" (hereafter – IAS 24R).

Key management personnel, who are included together with other officer holders, in the definition of "related party" as per IAS 24R) include the members of the board of directors and the president and CEO of the Company

The main shareholder of the company is ICC Industries Inc. which is holding 36.66% of company shares. The remaining shares are widely held. The controlling shareholder in ICC Industries Inc. is Dr. John Farber – the Chairman of the Board of Directors, who also holds 0.08% of Company's shares.

**NOTE 21 – RELATED PARTIES – TRANSACTIONS AND BALANCES** (continued):

1) Transactions with the controlling shareholder and its affiliates:

During the ordinary course of business, the Company and its affiliates conduct negligible transactions with the companies affiliated to the controlling shareholder. As part of these transactions, the Company's subsidiary sells to Fallek Chemical Japan, an affiliate of the controlling shareholder, products at market prices for marketing to a specific customer in Japan. In addition, as part of these transactions, the Company purchases from Azur S.A., an affiliate of the controlling shareholder, raw materials at cost prices and production services at market price. These transactions were approved by the Company's Board of Directors and they are considered to be negligible as this term is defined by regulation 41(a)(6)(a) of the Securities Regulations (Annual Financial Reports), 2010.

| | **2012** | **2011** | **2010** |
|---|---|---|---|
| Income (expenses): | **U.S. dollars in thousands** | | |
| Sales – affiliates (companies controlled by the controlling shareholder): | | | |
| Fallek Chemical Japan | 574 | 405 | 593 |
| Other | 4 | 9 | 9 |
| | 578 | 414 | 602 |
| Purchases: | | | |
| Affiliates (companies controlled by the controlling shareholder): | | | |
| Azur S.A | (1,743) | (1,819) | (1,689) |
| Dividend | (1,132) | (1,257) | (1,019) |
| Other expenses: | | | |
| Affiliates - | | | |
| Azur S.A. | (42) | (35) | - |
| Benefits to related parties: | | | |
| Wages and salaries | (2,603) | (2,119) | (2,040) |
| Director fees (in the Company) | (186) | (192) | (150) |

2) Shares granted to the President of the Company

As part of the Board resolution, the President of the Company was granted, on 2 January 2006, 350 thousand options; the fair value of options that the Company allotted to the President, computed using the Black & Scholes shares valuation model (based on the assumptions described in Note 12c), was estimated at the date of grant to $783 thousand (Note 12c).
On January 30, 2012, the Company's board of directors resolved to extend by one year the exercise period of the options until 31 of January 2013. The total benefit granted to the President due to the extension is $202 thousand.
On July 15, 2010, the Company's board of directors approved the grant of 275,000 options to the President of the Company; the value of the benefit is computed in accordance with the binomic model and was estimated at $ 322 thousands at date of grant.

**NOTE 21 – RELATED PARTIES – TRANSACTIONS AND BALANCES** (continued):

On August 20, 2012, the Company's board of directors approved the grant of 275,000 options to the President of the Company; the value of the benefit is computed in accordance with the binomic model and was estimated at $ 434 thousands at date of grant.

The total benefit component granted to the President under the 2012 and 2010 plans (see note 12) in the years 2012, 2011 and 2010 as computed at date of grant is $806 thousand, $156 thousand and $516 thousand, respectively.
Benefit costs that have been charged to the income statements, in respect of the said shares granted in the years 2012, 2011 and 2010 are $513 thousand $ 216 thousands and $223 thousand, respectively.

3) Terms of the employment update for the President of the Company

On December 6, 2012, the Company's Board of Directors approved formalization of the President’s annual bonus as part of his existing terms of employment.

The annual bonus to which the President shall be entitled will be comprised of two components – a cash component and an equity based component, to be determined according to formulas prescribed in the agreement, as follows:

Cash component:

| Annual EBITDA excluding one-time items US$M | Bonus % | Comments |
|---|---|---|
| 0-50 | 0 | |
| 50-70 | 1.1 | On the entire amount |
| 70-100 | 1.2 | On the incremental part only |
| Above 100 | 1.3 | On the incremental part only |

According to the formula prescribed as appears in the table above, EBITDA higher than the threshold amount prescribed (“Threshold Amount”) entitles the President to an annual bonus according to levels set, and above the first level, the percentage of the increased bonus relates to the delta between the levels only (i.e., the increment).
The bonus will be paid to the President at the time of payment of the first monthly wage following the date of the Board of Directors’ approval of the Company’s annual financial statements.

Equity based component:

| Annual EBITDA excluding one-time items US$M | Bonus % | Comments |
|---|---|---|
| 0-50 | | |
| 50-70 | 0.25 | On the entire amount |
| 70-100 | 0.275 | On the incremental part only |
| Above 100 | 0.290 | On the incremental part only |

**NOTE 21 – RELATED PARTIES – TRANSACTIONS AND BALANCES** (continued):

According to the formula prescribed as appears in the table above, EBITDA higher than the Threshold Amount entitles the President to options for the purchase of Company shares under 2012 option plan to whose overall market value at the time of their purchase is equal to 1.5 times the amount of the said bonus component, so that the bonus amount constitutes 2/3 the value of the options granted to the President, and the exercise price of the options to be paid by the President will constitute 1/3 the value of the Company shares at the time of their purchase.

The formula for calculating this component was determined according to the levels in the table above, and above the first level, the percentage of the increased bonus relates to the delta between the levels only (i.e., the increment).

The annual bonus, including both components thereof, is limited to a cap of US$ 2.5 million.

4) The articles of incorporation of the company allow insurance coverage to officials in the company as outlined by Israeli legislation. The company applied a policy of indemnifying officers and other officials in subsidiaries. The company decided to buy insurance to officers in relation to their job, subject to the law and other restrictions.

**b. Balances with Related Parties:**

| | 31 December | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| | **U.S. dollars in thousands** | | |
| 1) Current receivables – presented among “other receivables-other” and “trade receivables" | | | |
| Affiliated companies: | | | |
| Fallek | 342 | 137 | 275 |
| ICC | - | 2 | - |
| | 342 | 139 | 275 |
| Highest balance during the year | 342 | 221 | 293 |
| 2) Current payables shareholder and related parties: | | | |
| Azur S.A. | 18 | 57 | 29 |
| | 18 | 57 | 29 |

**NOTE 22 – SUBSEQUENT EVENTS:**

**Distribution of dividend**

On March 12, 2013 the Company’s Board of Directors declared the distribution of a dividend of NIS 0.24 per share. Total amount of the dividend is $3,801 thousand (based on exchange rate as of date of confirmation of these financial statements).

## NOTE 23 – LIST OF CONSOLIDATED SUBSIDIARIES AND INVESMENT IN SUBSIDIARIES

### a) LIST OF CONSOLIDATED SUBSIDIARIES

| Name of company | Country | Percentage of shareholding and control 31 December 2012 | |
|---|---|---|---|
| | | 2012 | 2011 |
| | | % | % |
| Subsidiaries: | | | |
| Frutarom Ltd.(1) | Israel | 100 | 100 |
| Frutarom Trust Ltd.(2) | Israel | - | 100 |
| (1)Frutarom Ltd. holds the following companies: | | | |
| Frutarom Trade and Marketing (1990) Ltd. | Israel | 100 | 100 |
| Galilee Essences Ltd.(3) | Israel | - | 100 |
| Frutarom (UK) Holdings. (4) | U.K. | 100 | 100 |
| International Frutarom Corporation (5) | U.S.A | 100 | 100 |
| Frutarom Russia Ltd. | Russia | 100 | 100 |
| Frutarom Ukraine Ltd. | Ukraine | 100 | 100 |
| Frutarom Kazakhstan LLp. | Kazakhstan | 100 | 100 |
| Frutarom Flavors (Kunshan) Company | China | 100 | 100 |
| Frutarom Gida Urunleri San. ve Tic.Ltd. Sti. | Turkey | 100 | 100 |
| Frutarom Mexico S.A | Mexico | 100 | 100 |
| Frutarom do Brazil Ltd.(6) | Brazil | 100 | 100 |
| Frutarom F&F (Shanghai) Trading .co.Ltd. | China | 100 | 100 |
| Frutarom South Africa (Proprietary) Ltd. | South Africa | 75 | 75 |
| Turkish Holdings Ltd. (3) | Turkey | 100 | 100 |
| Notra Liz Ltd. | Israel | 55 | 55 |
| Frutarom (Asia Pacific) Ltd.(7) | Hong Kong | 100 | 100 |
| Frutarom Singapore Pte Ltd. | Singapore | 100 | - |
| (2)The company has been closed in 2012. | | | |
| (3)Inactive company | | | |
| (4) Frutarom (UK) Holdings Ltd. holds full ownership in the following companies: | | | |
| Frutarom Switzerland Ltd.(8) | | 100 | 100 |
| Frutarom (UK) Ltd.(9) | | 100 | 100 |
| Frutarom Italy S.R.L. (10) | | 100 | 100 |
| Frutarom Norway A.S. | | 100 | 100 |
| (5) International Frutarom Corporation holds the following companies: | | | |
| Frutarom U.S.A. Inc.(11) | | 100 | 100 |
| Frutarom Flavor & Fragrance Costa Rica SRL. | | 100 | - |
| (6) Frutarom do Brazil Ltd holds full ownership in: | | | |
| Vila Osorio Participacoes S/A(12) | | 100 | - |
| (7) Frutarom (Asia Pacific) Ltd. holds in the following companies: | | | |
| Frutarom Flavors & Ingredients (Shanghai) (**) | | 99 | 99 |
| (8) Frutarom Switzerland Ltd. has full ownership in the following companies: | | | |
| Frutarom Germany GmbH(13) | | 100 | 100 |
| Frutarom Nordic A/S | | 100 | 100 |
| Frutarom France S.A.R.L | | 100 | 100 |
| Frutrarom (Marketing) S.R.L(3) | | 100 | 100 |
| Frutarom Netherlands B.V.(14) | | 100 | 100 |
| Frutarom Etol Tovarna arom in etericnih d.o.o(15). | | 100 | - |

**FRUTAROM INDUSTRIES LTD.**

NOTES TO THE CONSOLIDAETD FINANCIAL STATEMENTS (continued)

**NOTE 23 – LIST OF CONSOLIDATED SUBSIDIARIES** (continued):

| Name of company | Country | Percentage of shareholding and control | |
|---|---|---|---|
| | | 31 December | |
| | | 2012 | 2011 |
| | | % | % |
| (9) Frutarom (UK) Ltd. has full ownership in the following companies: | | | |
| Aromco Ltd. | | 100 | 100 |
| Savoury Flavors (Holdings) Ltd (17) | | 100 | - |
| (10) Frutarom Italy S.R.L. has holdings in the following companies: | | | |
| Frutarom Czech Republic S.r.o. (***) | | 90 | 90 |
| (11) Frutarom U.S.A. Inc. has full ownership in the following companies: | | | |
| Frutarom USA Holdings Inc. | | 100 | 100 |
| Flavors system International Inc.(18) | | 100 | 100 |
| (12) Vila Osorio Participacoes S/A has holdings in the following companies: | | | |
| Mylner Industria E Comercio Ltda | | 100 | - |
| (13)Frutarom Germany GmbH has holdings in the following companies: | | | |
| Frutarom Savory Solutions GmbH (19) | | 100 | 100 |
| (14)Frutarom Netherlands B.V. holds full ownership in the following companies: | | | |
| Frutarom Belgium N.V. | | 100 | 100 |
| (15) Frutarom Etol Tovarna arom in etericnih olj d.o.o has holdings in the following companies: | | | |
| Etol Polska SP z.o.o. | | 100 | - |
| Etol JVE d.o.o. | | 100 | - |
| Etol Skopje (20) | | 100 | - |
| Etol Kazahstan t.o.o. | | 100 | - |
| Etol SK s.r.o. CZ | | 100 | - |
| Etol Russia Ltd. | | 100 | - |
| (16) Aromco Ltd. has holdings in the following companies:: | | | |
| Aromco South Africa (PTY) Ltd | | 100 | 100 |
| MIS Aromco Flavors India (p) Ltd | | 100 | 100 |
| (17) Savoury Flavors (Holdongs) Ltd has holdings in the following companies:: | | | |
| Savoury Flavors Ltd. | | 100 | - |
| Imarco Food Ingredients Ltd | | 100 | - |

**NOTE 23 – LIST OF CONSOLIDATED SUBSIDIARIES** (continued):

| | | |
|---|---|---|
| (18) Flavors system International Inc. holdings in the following companies:: | | |
| FSI Beverage System, LLC | 100 | 100 |
| FSI Fragrance, LLC | 100 | 100 |
| (19) Frutarom Savory Solutions GmbH holdings in the following companies:: | | |
| GewürzMüller AG(3) | 100 | 100 |
| NESSEpol Sp. z.o.o | 100 | 100 |
| (20) Etol Skopje holdings in the following companies:: | | |
| Ingrediants dooel Skopje | 100 | - |

**(*)** the remaining percentage is held by Frutarom Industries .Ltd.
**(**)** the remaining percentage is held by Frutarom F&F (Shanghai) Trading .co.Ltd.
**(***)** the remaining percentages are held by Frutarom (UK) Holdings.

**b) INVESMENT IN SUBSIDIARY HELD DIRECTLY BY THE COMPANY**

| Name of the subsidiary | State of Incorporation | Percentage of shareholding | The value of the investment | Capital notes |
|---|---|---|---|---|
| | | | 31 December 2012 | |
| | | | U.S. dollars in thousands | |
| Frutarom Ltd. | Israel | 100% | 344,574 | 105,073 |

# SECTION D

## ADDITIONAL INFORMATION

D

**Chapter D – Additional Details**

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| | |
|---|---|
| **Company name**: | **Frutarom Industries Ltd.** |
| **Company number:** | **52-004280-5** |
| **Address:** | **25 HaShaish St., Haifa Bay**<br>**P.O.B. 10067, 26110** |
| **Email:** | **info@frutarom.com** |
| **Telephone:** | **+972-4-846 2449** |
| **Fax:** | **+972-4-872 2517** |
| **Balance Sheet date:** | **December 31, 2012** |
| **Date of report:** | **March 12, 2013** |
| **Period of report:** | **January 1, 2012 - December 31, 2012** |

## Regulation 10A - Summary of Quarterly Profit and Loss Reports

The following is the summary of the total profit of the corporation for each of the calendar quarters in the reported year:

| IN US$ 000 | Q1 - 2012 | | Q2 -2012 | | Q3 - 2012 | | Q4 - 2012 | | 2012 Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| **SALES** | **151,217** | **100.0%** | **164,796** | **100.0%** | **157,108** | **100.0%** | **144,880** | **100.0%** | **618,001** | **100.0%** |
| **Cost of sales** | | | | | | | | | | |
| Material consumed | 73,267 | 48.5% | 78,536 | 47.7% | 77,545 | 49.4% | 70,111 | 48.4% | 299,459 | 48.5% |
| Other manufacturing | 23,018 | 15.2% | 24,490 | 14.9% | 21,506 | 13.7% | 23,269 | 16.1% | 92,283 | 14.9% |
| | | - | | - | | - | | - | | - |
| Total | **96,285** | **63.7%** | **103,026** | **62.5%** | **99,051** | **63.0%** | **93,380** | **64.5%** | **391,742** | **63.4%** |
| **GROSS PROFIT** | **54,932** | **36.3%** | **61,770** | **37.5%** | **58,057** | **37.0%** | **51,500** | **35.5%** | **226,259** | **36.6%** |
| **R&D, Selling and G&A** | | | | | | | | | | |
| R&D | 7,129 | 4.7% | 7,090 | 4.3% | 6,966 | 4.4% | 6,846 | 4.7% | 28,031 | 4.5% |
| Selling expenses | 18,131 | 12.0% | 20,387 | 12.4% | 19,255 | 12.3% | 19,128 | 13.2% | 76,901 | 12.4% |
| General & Administration | 13,016 | 8.6% | 12,114 | 7.4% | 12,257 | 7.8% | 11,810 | 8.2% | 49,197 | 8.0% |
| Other expenses | (1,181) | (0.8)% | 394 | 0.2% | 70 | 0.0% | (1) | (0.0)% | (718) | (0.1)% |
| **Total** | **37,095** | **24.5%** | **39,985** | **24.3%** | **38,548** | **24.5%** | **37,783** | **26.1%** | **153,411** | **24.8%** |
| **OPERATING PROFIT** | **17,837** | **11.8%** | **21,785** | **13.2%** | **19,509** | **12.4%** | **13,717** | **9.5%** | **72,848** | **11.8%** |
| Financing expenses | 1,895 | 1.3% | 1,925 | 1.2% | 1,736 | 1.1% | 1,636 | 1.1% | 7,192 | 1.2% |
| Translation (gain) losses | (972) | (0.6)% | 2,388 | 1.4% | (1,144) | (0.7)% | (224) | (0.2)% | 48 | 0.0% |
| Total | 923 | 0.6% | 4,313 | 2.6% | 592 | 0.4% | 1,412 | 1.0% | 7,240 | 1.2% |
| **PROFIT BEFORE TAX** | **16,914** | **11.2%** | **17,472** | **10.6%** | **18,917** | **12.0%** | **12,305** | **8.5%** | **65,608** | **10.6%** |
| TAX | 3,413 | 2.3% | 3,924 | 2.4% | 4,526 | 2.9% | 1,765 | 1.2% | 13,628 | 2.2% |
| Tax rate | 20.2% | | 22.5% | | 23.9% | | 14.3% | | 20.8% | |
| **NET PROFIT** | **13,501** | **8.9%** | **13,548** | **8.2%** | **14,391** | **9.2%** | **10,540** | **7.3%** | **51,980** | **8.4%** |

**Regulation 10C - Use of Proceeds on Securities**

Not relevant.

**Regulation 11 – List of Investments in Subsidiaries and Related Companies**

| Name of company | Type of Share | Par Value | Number of Shares | Total Par Value | Holding % | | |
|---|---|---|---|---|---|---|---|
| | | | | | Equity | Voting | Right to appoint director |
| Frutarom Ltd.* 51-013293-9 | Ordinary | NIS 1 | 23,972,645 | 23,972,645 | 100 | 100 | 100 |

All other companies in the Frutarom Group are held through Frutarom Ltd., directly or indirectly. For further details regarding the consolidated companies in the Frutarom Group and rates of holding, see Note 23 to the Company's financial statements of December 31, 2012.

**Regulation 12 - Changes in Investments in Subsidiaries and Related Companies**

A. Frutarom Switzerland Limited

In January through June 2012, Frutarom, through Frutarom Switzerland Limited, acquired the full share capital of the public company Etol. The acquisition was performed through transactions on and outside of the Stock Exchange and by purchase offer in Slovenia, in consideration for an overall sum of €35.4million.

For more details regarding the acquisition of Etol, see the Company's immediate reports dated January 17, 18 and 26, 2012, February 12, 2012, March 17, 2012, May 8, 2012 and June 6 and 26, 2012.

B. Frutarom do Brazil Ltda

On February 7, 2012, Frutarom, through Frutarom do Brazil Ltd., signed an agreement for the acquisition of 100% of the share capital of the Brazilian Mylner Indústria E Comércio Ltda and its Brazilian parent company, Vila osório participações s/a in consideration for approximately US$15.7million (BRL 27.1 million). Frutarom paid a further sum of BRL4.4 M for Milner's cash balance. The acquisition was completed upon signing.

For further details regarding the acquisition of Mylner, see the Company's immediate report dated February 7, 2012.

## Regulation 13 - Income of and from Subsidiaries and Related Companies

| Company name | Profit ((loss) for the report period (US$ 000) | Other profit (loss) (US$ 000) | Total profit (loss) for the report period | Dividend (US$ 000) | | Management fee (US$ 000) | | Interest | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | before the report period | After the report period | before the report period | After the report period | before the report period | After the report period |
| Frutarom Ltd. | 49,309 | 4,393 | 53,702 | 3,029 | - | - | - | - | - |

## Regulation 14 – Loans

Granting loans is not one of the Group's main business activities.

## Regulation 20 - Trade on the Stock Exchange

During the report period the Company issued 439,480 additional ordinary shares of NIS 1 par value each.

During the report period trade in the Company's shares was not halted.

## Regulation 21 –Payments to Interested Parties and Senior Officeholders

Section (a)(1)

Following are details regarding the remuneration recorded in the Company's Financial Report for the period ended December 31, 2012 made to each of the five most highly remunerated senior officeholders in the Company or corporation under its control that was paid in connection with their position in the Company or a corporation under its control:

| Details of Officeholder | | | | Remuneration for Services [1] | | | | | | | Other Payments | | | Total (1) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Name | Position | % Position | % of Holdings [2] | Salary [3] | Bonus | Shares' Based Payment | Manag-ement Fees | Consu-lting Fees | Comm-ission | Other | Interest | Rent | Other | |
| Ori Yehudai | President & CEO [6] | 100% | 2.00% [7] | 936 | 1,155 (4) | 513 (8) | - | - | - | - | - | - | - | 2,603 |
| Alon Granot | EVP & CFO [9] | 100% | 0.25% [10] | 263 | 123 (4) | 152 (11) | - | - | - | - | - | - | - | 538 |
| Amos Anatot | EVP – Supply Chain [12] | 100% | 0.27% [13] | 283 | 131 (4) | 92 (14) | - | - | - | - | - | - | - | 506 |
| Tali Mirsky Lachman | VP – Legal & Company Secretary [15] | 100% | 0.13% [16] | 200 | 35 (4) | 55 (17) | - | - | - | - | - | - | - | 289 |
| Dana Maor | VP – Global HR [18] | 100% | 0.14% [19] | 206 | 16 (4) | 59 (20) | - | - | - | - | - | - | - | 281 |

Notes to the above table:

[1] Remuneration reflects cost to the Company. Amounts are in US$ thousands.

[2] On a fully diluted basis as at the date of this report.

[3] Including fringe benefits (car, telephone, social benefits, provisions for termination of employment and any other payment made to the senior officeholders).

[4] For details regarding the determination of bonuses by the Board of Directors and Compensation Committee, see section E in the section Corporate Governance in the Company's Board of Directors' Report for December 31, 2012.

[5] Since 2003, the Board of Directors has every six months resolved with regards to granting options to senior officeholders and other senior employees, based on the recommendations of the Compensation Committee Based on the Board's resolution and taking into account the number of outstanding shares available to the Company for grant of options, the Company then buys its shares on the Tel Aviv Stock Exchange and as against these shares, options are granted.

Up until February 1, 2012, shares were purchased by Frutarom Trust Ltd., a wholly owned subsidiary of the Company, and held by it until the options are exercised. Starting from February 2012, shares are purchased and held by the Company itself. Options granted under the 2003 Option Plan (**"2003 Plan"**) and under the 2012 Option Plan ("**2012** Plan") are vested over a three year period from the date on which they were granted, one third every year. The Board of Directors of the Company has the exclusive authority to declare options granted under these plans exercisable as of any earlier date. The Board of Directors has set the exercise price for the options at one third of the average share price paid by the Company for the shares. Options granted under these plans expire on the sixth anniversary of the grant date. Any tax consequences or liabilities arising from the grant or exercise of any options under the plan are the responsibility of the employee. The number of shares per option granted under these plans and the exercise price, are adjusted according to changes in the Company's outstanding share capital resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of shares. Except for a few exceptions, when employment is terminated for an employee holding options granted under these plans, such employee has the right to exercise all vested options within 90 days from the date of termination. Any remaining options granted but not exercised as above are deemed forfeited. Options not exercisable on the date of the termination of employment are immediately forfeited on that date .

In January 2006, the Company granted 725,000 options exercisable into 725,000 ordinary shares of the Company to four senior employees, 350,000 of which were granted to Mr. Ori Yehudai and 125,000 of which were granted Mr. Alon Granot. The options granted to Messrs. Yehudai and Granot were exercisable in three equal portions which vested on January 1, 2008, January 1, 2009 and January 1, 2010. The exercise price was NIS 31.068 per share. The original expiry date of the options was on February 1, 2012, and on January 30, 2012 the Board of Directors, after receiving approval of the Audit Committee, resolved to extend the expiry date by one year, until January 31, 2013 (the **" Extension Period"**). Over the Extension Period, the above options were realized in full.

On July 15, 2010 the Company's Board of Directors approved an option plan for senior employees (“**2010** Plan”), and as part of this the Company’s Board of Directors, following the recommendation of the Compensation Committee, approved the grant of up to 1,000,000 options to Mr. Yehudai and ten more employees and officeholders in the Group, as well as additional quantity of up to 255,000 options to be granted in the future to employees and officeholders in the Group (the **"Options for Future Allocation**"). Allocation of these options to Mr. Yehudai was also approved by the Company's Audit Committee. The options were granted free of consideration.

Each option is exercisable into one share for an exercise price of NIS 30.26, which is the closing price of the Company's share on the last business day prior to the Board of Directors' resolution on the grant of the options. Every Option for Future Allocation granted to the Company's future grantees under the plan will be exercisable into one share for an exercise price equal to the average of the Company shares’ closing price over the last ten (10) trading days prior to the Board of Directors' resolution on the future grant, provided the exercise price for each Option for Future Allocation will not be less than the par value of the exercisable share. On February 7, 2011 the Board of Directors approved grant of 40,000 options to a senior officeholder in the Company, as part of the 2010 Plan.

On August 20, 2012 the Company’s Board of Directors, following the recommendation of the Compensation Committee, granted up to 945,000 options unlisted for trade, as part of the 2010 Plan, to Mr. Yehudai and to another ten employees and office holders in the Group, and an additional 200,000 Options to be allocated in future to employees and office holders in the Group (“**Future Options**”). Allocation of the Options to Mr. Yehudai was also approved by the Company’s Audit Committee. The Options were granted free of consideration.

Each Option may be exercised into one share, in return for an exercise price equal to NIS34.85, the closing price of the Company’s share on the last date of trade before the Company Board of Directors’ resolution regarding allocation of Options. Each Future Option allocated to future offerees as part of the Plan will be exercisable into one share in return for an exercise price equal to the average closing prices of the Company’s shares over the last ten (10) trading days before the Board of Directors’ resolution regarding Future Allocation, provided the exercise price of each option for Future Allocation is not less than the par value of the exercisable shares. On October 1, 2012, the Company’s Board of Directors approved the allocation of 120,000 Options to an additional senior office holder under the 2010 Plan.

The amounts in the table reflect the benefit component recorded for the options granted under the 2003 Plan, the 2012 Plan and the 2010 Plan (for grants made in 2007 through 2012), as recognized in the Company's 2012 Financial Reports.

For further details regarding the Company's Option plans, see Note 12 to the Company's financial statements of December 31, 2012.

[6] Mr. Yehudai has been employed by the Company since 1986, and in 1996 became President and CEO. Mr. Yehudai's terms of employment include monthly salary (index linked), social benefits as is customary in the industry (including managers' insurance, education fund, insurance for loss of work capacity, recuperation pay, sick leave and vacation days), a 13th month salary, ancillaries (including mobile phone, landline at home and newspapers), and a manager's vehicle. In addition, Mr. Yehudai is entitled to an annual bonus as detailed in section (5) in section E in the section Corporate Governance in the Company's Board of Directors' Report for December 31, 2012, and to grant of options according to the Company's option plan, as explained in sections (7) and (8) below. Mr. Yehudai's employment may be terminated [within?] 6 months of the date on which the Company notifies of its wish to terminate employment by advance written notice, and 3 months from the date on which Mr. Yehudai notifies the Company of his wish to terminate employment in the Company. In the event a notice of termination is delivered to Mr. Yehudai by the Company within 12 months following the date upon which ICC Handels AG's holdings (directly or indirectly) fall below 26% of the issued and paid up capital of the Company or the voting rights in the Company, the Company shall continue to pay his salary for a period of 12 months beginning on the date of the end of the notice period, save payment for vacations, sick leave, bonuses and options. In this event all options previously granted to Mr. Yehudai will also become immediately exercisable, even if their vesting period has not been completed. Upon termination of his employment with the Company, Mr. Yehudai is entitled to receive severance pay equal to two times the severance pay to which he is entitled to under law.

[7] As of December 31, 2012, Mr. Yehudai held 769,049 options exercisable into 769,049 ordinary shares of the Company.

[8] As at the date of this report the balance of options granted to Mr. Yehudai under the 2003 Plan is 131,628, the balance of options granted to Mr. Yehudai under the 2010 Plan is 550,000, and the balance of options granted to Mr. Yehudai under the 2012 plan is 46,910.

[9] Mr. Granot has been employed by the Company since 2001. Mr. Granot's terms of employment include monthly salary, social benefits as is customary in the industry (including managers' insurance, education fund, insurance for loss of work capacity, recuperation pay, sick leave and vacation days), a 13th month salary, a yearly bonus at the Company's discretion, ancillaries (including mobile phone, landline at home and newspaper), and a vehicle. In addition, Mr. Granot is entitled to options granted to him

according to the Company's option plan, as explained in sections (10) and (11) below. Mr. Granot's employment may be terminated with 3 months advance written notice given by either party. In addition to the advance notice period as stated above, in the event notice of termination is delivered to Mr. Granot by the Company within 12 months following the date upon which ICC Handels AG's holdings (directly or indirectly) fall below 26% of the issued and paid up capital of the Company or the voting rights in the Company, the Company shall continue to pay his salary and for a period of 6 months beginning on the date of the end of the notice period, save payment for vacations, sick leave, bonuses and options. In this event all options previously granted to Mr. Granot will also become immediately exercisable, even if their vesting period has not been completed.

[10] As of December 31, 2012, Mr. Granot held 149,162 options exercisable into 149,162 ordinary Company shares.

[11] As at the date of this report the balance of options granted to Mr. Granot under the 2003 Plan is 9,619, the balance of the options granted to Mr. Granot under the 2010 Plan is 125,000 and the balance of options granted to Mr. Granot under the 2012 plan is 14,543.

[12] Mr. Anatot has been employed by the Company since 2010. Mr. Anatot's terms of employment include monthly salary, social benefits as is customary in the industry (including managers' insurance, education fund, insurance for loss of work capacity, recuperation pay, sick leave and vacation days), a yearly bonus at the Company's discretion, a mobile phone and a vehicle. In addition, Mr. Anatot is entitled to options granted to him according to the Company's option plan, as explained in sections (13) and (14) below. In the event notice of termination is delivered to Mr. Anatot within 12 months following the date upon which ICC Handels AG's holdings (directly or indirectly) fall below 26% of the issued and paid up capital of the Company or the voting rights in the Company, the Company shall continue to pay his salary and for a period of 6 months beginning on the date of the end of the notice period, save payment for vacations, sick leave, bonuses and options. In this event all options previously granted to Mr. Anatot will also become immediately exercisable, even if their vesting period has not been completed.

[13] As of December 31, 2012 Mr. Anatot held 161,853 options exercisable into 161,853ordinary shares of the Company.

[14] As of the date of this report, the balance of options granted to Mr. Anatot under the 2003 Plan is 7,737, the balance of options granted to Mr. Anatot under the 2010 Plan is 138,340 and the balance of options granted to Mr. Anatot under the 2012 Plan is 15,776.

[15] Ms. Mirsky has been employed by the Company since 2010. Ms. Mirsky's terms of employment include monthly salary, social benefits as is customary in the industry

(including managers' insurance, education fund, insurance for loss of work capacity, recuperation pay, sick days and vacation days), a yearly bonus at the Company's discretion, a mobile phone and a vehicle. In addition, Ms. Mirsky is entitled to options granted to her according to the Company's option plan, as explained in sections (16) and (17) below. Ms. Mirsky's employment may be terminated with 3 months advance written notice given by either party. In the event a notice of termination is delivered to Ms. Mirsky by the Company within 12 months following the date upon which ICC Handels AG's holding (directly or indirectly) fall below 26% of the issued and paid up capital of the Company or the voting rights in the Company, all options previously granted to Ms. Mirsky will become immediately exercisable, even if they vesting period has not been completed.

[16] As of December 31, 2012, Ms. Mirsky held 91,718 options exercisable into 91,718 ordinary shares of the Company.

[17] As of the date of this report, the balance of options granted to Ms. Mirsky under the 2003 Plan is 2,628, the balance of options granted to Ms. Mirsky under the 2010 Plan is 66,667 and the balance of options granted to Ms. Mirsky under the 2012 Plan is 9,090.

[18] Ms. Maor has been employed by the Company since 2009. Ms. Maor's terms of employment include monthly salary, social benefits as is customary in the industry (including managers' insurance, education fund, insurance for loss of work capacity, recuperation pay, sick leave and vacation days), a yearly bonus at the Company's discretion, a mobile phone and a vehicle. In addition, Ms. Maor is entitled to options granted to her according to the Company's option plan, as explained in sections (19) and (20) below. Ms. Maor's employment may be terminated with 3 months advance written notice given by either party.

[19] As of December 31, 2012, Ms. Maor held 81,768 options exercisable into 81,768 ordinary shares of the Company.

[20] As of the date of this report, the balance of options granted to Ms. Maor under the 2003 Plan is 6,011, the balance of options granted to Ms. Maor under the 2010 Plan is 66,667 and the balance of options granted to Ms. Maor under the 2012 Plan is 9,090.

Section (a)(2)
There are no senior officeholders in the corporation who received higher remuneration not included in the above table.

Section (a)(3)
There are no interested parties in the corporation who received remuneration not mentioned in the above table, except for directors. The remuneration paid to all of the directors in 2012, which does not deviate from the customary directors' remuneration, came to a total of US$186 thousand.

Section (b)
No remuneration has been given to senior officeholders after the reporting period and prior to the submission of this report in connection with their service or employment in the reporting period which were not recognized in the Financial Statements for the reporting period.

**Regulation 21A – Control of the Corporation**

The controlling shareholder in the Corporation is ICC Industries Inc. The controlling shareholder of ICC Industries Inc. is Dr. John J. Farber.

**Regulation 22- Transactions with Controlling Parties**

Following are details, to the best of the Company's knowledge, of any transaction with the controlling shareholder or in which the controlling shareholder has personal interest in its approval, in which the Group engaged in 2012 or later, through the date of publication of this report or which is still valid at the time of the publication of the report:

Transactions included in Section 270(4) of the Companies Law, 1999 (the "**Companies Law**")

**(a)** The Company's annual general meeting of shareholders held on June 10, 2012 resolved as follows:

- **Amendment of the Company Articles**

  Amendment of the Company's Articles of Association in a manner adapting them to the updated wording of the Companies Law and of the Efficiency of Enforcement Proceeding of the Securities Authority (Legislation Amendments) Law, 2011 ("**Administrative Enforcement Law**"), allowing, inter alia, insurance and indemnification of officeholders and directors in connection with expenses of administrative enforcement processes and payment to injured parties, as prescribed under sections 56H and 52[52](A)(1)(a) to the Securities Law, 1968 (hereinafter: "**Administrative Enforcement Payments**" and the "**Securities Law**", accordingly).

- **Granting undertakings for indemnification of directors who are controlling parties or relatives thereof, for a period of three years.**

  To approve granting undertakings for indemnification of directors who are controlling parties or relatives thereof, for a period of three years.

- **Purchase of insurance policies for directors who are controlling members of relatives thereof**

  Approval of the Company's engagement under the directors' insurance policy for directors who are controlling members or their relatives under conditions identical to those given to directors who are not controlling members or their relatives, as have been from time to time, for a period of three years.

  For further details regarding the above transactions see the Company's report on the General Meeting of May 13, 2012 and June 11, 2012.

**(b)** In accordance with the Board of Directors' decision dated February 9, 2011, passed after being approved by the Audit Committee, as of February 10, 2011, every director in the Company will be paid annual and participation remuneration (including External Directors and directors who are controlling shareholders or related to controlling shareholders) in the amount equal to the amount set out in the Companies Regulations (Rules for Remuneration and Expenses of External Directors) – 2001 ("Remuneration Regulations"), according to the Company's ranking as may be from time to time.

Transactions not included in Section 270(4) of the Companies Law

During its ordinary course of business, the Group executes negligible transactions with companies under the controlling shareholder's control. As part of these transactions, the Company's subsidiary sells products to a company controlled by the controlling shareholder for marketing to a specific customer in Japan. In the framework of these transactions, the Company also purchases raw materials from a company controlled by the controlling shareholder at cost, as well as production services at market price. For more information regarding the above transactions, see Note 22 of the Financial Reports.

Transactions are classified as negligible in accordance with the approval of the Board of Directors dated January 17, 2011, setting guidelines and rules for the classification of a transaction of the Company or of its consolidated or related company with an interested party as negligible ("**Negligibility Procedure**"). According to the above resolution, the Company follows these guidelines in order to examine the extent of the Company's disclosure in the periodic reports and the prospectus, including shelf proposal reports, with regards to transactions with interested parties as set out in regulation 41(A)(6)(a) of the Securities Regulations (Annual Financial Reports), 2010 ("**Financial Reports Regulations**") and with regards to transactions with controlling shareholders or such that a shareholder has a personal interest in their approval, as stated in regulation 22 of the Securities Regulations (Immediate and Periodic Reports), 1970 ("**Periodic Reports Regulations**") and in regulation 54 of the Securities Regulations (Prospectus' details, draft, shape and form), 1969, and to examine the need to issue an immediate report on the stated transactions, as set out in regulation 37a(6) of the Periodic Reports

Regulations. For details on the Negligibility Procedure, see the Company's Immediate Report dated January 18, 2011.

**Regulation 24 - Holdings of Interested Parties**

For details regarding holdings of interested parties in the Company see the immediate report on the status of holdings of interested parties and senior office holders published on March 12, 2012. To the best of the Company's knowledge, there have been no material changes in interested parties' holdings since the date referred to in the status.

**Regulation 24A – Registered and Issued Share Capital and Convertible Securities**

Registered Share: Capital: NIS 100,000,000 divided into 100,000,000 shares of NIS 1 par value each.

Issued Share Capital: NIS 58,319,681 divided into 58,319,681shares of NIS 1 par value each.

Issued Share capital after deduction of dormant shares: NIS57,857,634 divided into 57,857,634 shares of NIS 1 par value each

As of the date of this report the Company holds 462,047 of its ordinary shares for the benefit of the Company's employees and office holders, in accordance with the Company's 2003 Plan and 2012 Plan. These shares are dormant shares under section 308(A) to the Companies Law, and therefore do not confer any rights.

As at December 31, 2011 the balance of options existing under the option plan which the Board of Directors adopted in 2003, 2006, and 2010 is 576,283, 440,000 and 785,000, respectively. For further details regarding the above option plans, see regulation 21 above and Note 12 to the Company's financial reports and the Company's financial reports.

**Regulation 24B - Registry of the Company's Shareholders**

For the updated registry of the Company's shareholders, see the Company's immediate reports dated February 28, 2013.

**Regulation 25A – Registered Office**

| | |
|---|---|
| Registered office: | 25 HaShaish St., P.O.B. 10067, Haifa Bay 26110, Israel |
| Email: | info@frutarom.com |
| Telephone: | +972 4 846 2402 |
| Fax: | +972 4 872 2517 |

## Regulation 26 – Members of the Board of Directors

| **Name of Director** | **Dr. John J. Farber, Chairman** | **Maya Farber** | **Sandra Farber** | **Hans Abderhalden** |
|---|---|---|---|---|
| **ID \Passport no.** | 111-201-362 (USA) | 152-434-380 (USA) | 453588940 (USA) | x4983003 (Swiss) |
| **DOB** | 1925 | 1936 | 1957 | 1939 |
| **Address for service of court processes** | 435 E. 52 St., New York, N.Y. 10022, U.S.A. | 435 E. 52 St., New York, N.Y. 10022, U.S.A. | 340 Riverside Drive, New York NY 10025 US | Lerchenbergstrasse 114, 8703 Erlenbach 8703, Switzerland |
| **Nationality** | U.S.A. | U.S.A. | U.S.A. | Swiss |
| **Member of BOD committees** | No | No | Was a member of the Compensation Committee until 26.11.12 | No |
| **Independent \ external director** | No | No | No | No |
| **Director with financial and accounting expertise or professional capacity** | Financial and Accounting Expertise and Professional Capacity | Professional Capacity | Professional Capacity | Financial and Accounting Expertise and Professional Capacity |
| **Company , subsidiary or associated company employee or interested party** | Chairman of ICC Industries Inc., the Company's controlling shareholder | No | Vice-Chair of ICC Industries Inc. | Director in Frutarom Switzerland Ltd. and consultant |
| **Year began serving as director** | 1996 | 1996 | 2011 | 2004 |
| **Education** | Ph.D. in Chemistry from Polytechnic Institute of Brooklyn, New York | Hunter College, New York and Art Students' League | Juris Doctor, New York University School of Law, 1985 | IMD Program for Executive Development from IMD, Switzerland |
| **Occupation over past five years** | Chairman of the Board of the Company and of ICC Industries Inc. | Artist | Vice-Chair of ICC Industries Inc. | Director in Frutarom Switzerland Ltd. and advisor |

| | | | | |
|---|---|---|---|---|
| **Names of corporations where serves as director** | Chairman of the Board of ICC Industries Inc. And serves as Director in ICC Industries Inc. subsidiaries | ICC Industries Inc. | Vice-Chair of ICC Industries Inc. and director in ICC subsidiaries | Frutarom Switzerland Ltd. |
| **Relative of other Interested party in the corporation** | Married to Ms. Maya Farber and father of Ms. Sandra Farber, both directors in the Company | Married to Dr. John J. Farber, Chairman of the Board and the mother of Ms. Sandra Farber, director in the Company | Daughter of Dr. John J. Farber, the Chairman of the Board and Ms. Maya Farber, director in the Company | No |
| **Accounting and financial expertise for purposes of minimal no. of directors under section 92(A)(12) to the Companies Ordinance** | Yes | No | No | Yes |

| Name of Director | Isaac Angel | Yacov Elinav | Gil Leidner |
|---|---|---|---|
| **ID \Passport no.** | 012735478 (Israeli) | 006287338 (Israeli) | 50776889 (Israeli) |
| **DOB** | 1956 | 1944 | 1951 |
| **Address for service of court processes** | 2A Zahal St., Tel Aviv | 10 Hadudaim St., Herzlia | 3 Ha'aliya St., Beit Yitzhak, 42920 |
| **Nationality** | Israeli | Israeli | Israeli |
| **Member of BOD committees** | Member of the Board's Audit Committee, Balance Sheet Committee and Compensation Committee | Member of the Board's Audit Committee, Balance Sheet Committee and Compensation Committee | Member of the Board's Audit Committee and Balance Sheet Committee and from 26.11.12 serves on the Board's Compensation Committee |
| **Independent \ external director** | External director | External director | Independent director |
| **Director with financial and accounting expertise or professional capacity** | Financial and Accounting Expertise and Professional Capacity | Financial and Accounting Expertise and Professional Capacity | Financial and Accounting Expertise and Professional Capacity |
| **Company , subsidiary or associated company employee or interested party** | No | No | No |
| **Year began serving as director** | 2008 | 2008 | 2010 |
| **Education** | High school | BA in economics and business management, the Hebrew University, Jerusalem | L.L.B, Tel Aviv University |
| **Employment over past five years** | Business advisor | Chairman of the board of Dash Provident Fund Management Ltd., Chairman of Yellow Pages Ltd., Chairman of the Bank for Industrial Development Israel Ltd. | Managing partner at Galram Consultants from 2004 to date |

| | | | |
|---|---|---|---|
| **Names of corporations where serves as director** | Served as a director at Briltex Ltd. until Feb. 2013 | Yellow Pages Ltd., Kamur Ltd., Delek Real Estate Ltd., Yuvalim Pension Fund Management Ltd., Elinav Consulting and Services Ltd.; S. Shlomo Holdings Ltd.; Dash Securities and Investments Ltd.; Dash Provident Funds Ltd.; Dash Institutional Ltd.; Sapiens Ltd.; B.G.I Ltd.; Polar Communication Ltd.; Ipex Provident Funds Ltd.; Ofer Investments Ltd; Global Box Ltd. | Member of the Management Committee of the Research Fund of Tel Aviv Sourasky Medical Center |
| **Relative of other Interested party in the corporation** | No | No | No |
| **Accounting and financial expertise for purposes of minimal no. of directors under section 92(A)(12) to the Companies Ordinance** | Yes | Yes | Yes |

## Regulation 26A - Senior Officeholders

| Name of office holder | Ori Yehudai | Alon Granot | Amos Anatot |
| --- | --- | --- | --- |
| **Position in corporation, subsidiary, associated company or interested party** | President and CEO<br>Serves as director in Frutarom subsidiaries | Executive Vice President and CFO.<br>Serves as director in Frutarom subsidiaries | Executive Vice President Global Supply Chain and Operations<br>Serves as director in Frutarom subsidiaries |
| **ID no.** | 052731569 | 057210247 | 51923548 |
| **DOB** | 1954 | 1961 | 1953 |
| **Year in which began serving in the company** | President and CEO as of 1996 (first began working for the Company in 1986) | 2001 | 2010 |
| **Independent authorized signatory** | No | No | No |
| **Interested party in the corporation or relative of senior office holder or of interested party** | Interested Party by his service as the Company's President and CEO | No | No |
| **Education** | BA in Economics (Tel Aviv University)<br>MA in Business Administration (Tel Aviv University) | BA in Economics and Business Administration (Haifa University)<br>MA in Economics (Technion) | B.Sc. Industrial Management (Technion) |
| **Business experience over past five years** | : President and CEO of the Company | Executive Vice President and CFO of the Company | VP Teva Europe, Teva Pharmaceuticals |

| Name of office holder | Dana Maor | Tali Mirsky-Lachman | Guy Gil | Yoav Barak |
|---|---|---|---|---|
| Position in corporation, subsidiary, associated company or interested party | Vice President, Global HR | Vice President Global Legal Affairs and Corporate Secretary | Vice President Finance | Internal Auditor |
| ID no. | 22973440 | 029423837 | 24223380 | 53670352 |
| DOB | 1967 | 1972 | 1969 | 1955 |
| Year in which began serving in the company | 2009 | 2010 | 2006 | 2004 |
| Independent authorized signatory | No | No | No | No |
| Interested party in the corporation or relative of senior office holder or of interested party | No | No | No | No |
| Education | BA, Psychology and Criminology ( Bar-Ilan University) MA Industrial Psychology (Bar-Ilan University) | L.L.B in Law and Business Administration (IDC, Herzeliya) | BA in Economics and Accounting ( Haifa University) | BA in Economics and Accounting (Haifa University) |
| Business experience over past five years | Vice President HR, Radvision | VP General Counsel and Corporate Secretary at Alvarion Ltd | VP Finance of the Company | Internal auditor for companies, CEO, Zika Electrodes Ltd., Chairman of Regba Furniture, Agricultural Cooperative, Internal Auditor for Shemen Industries Ltd., Chairman of Lavi Furniture Industries, Agricultural Cooperative, Director at Fridenzon Logistic Services Ltd. |

**Regulation 26B – Independent Signatories**

The Company does not have independent signatories as the term is defined under clause 37(d) of the Securities Regulations, 1968.

**Regulation 27 –Company Auditors**

The Group's auditors are Kesselman & Kesselman, 1 Nathanson St., Haifa 33034, Israel.

To the best of the Group's knowledge the auditors are not interested parties and/or related to any senior officeholder or interested party in the Group.

**Regulation 28 – Changes to Memorandum or Articles of Association**

On June 10, 2012 an amendment to the Company's Articles was approved by the General Meeting. For details regarding the changes approved see the reports on the General Meeting dated May 13, 2012 and June 11, 2012. The Company published the updated version on June 11, 2012.

**Regulation 29 – Recommendations and Resolutions of the Directors and of the Special General Meeting of Shareholders**

Recommendations of the Board of Directors to the General Meeting of Shareholders and its decisions that do not require the approval of the General Meeting of Shareholders:

a) On December 6, 2012 the Company's Board of Directors, after being granted the approval of the Audit Committee also sitting as the Compensation Committee, resolved on formalizing the President's annual bonus as part of his conditions of office and employment. For more details regarding formalization of the President's bonus, including the formulas for calculating the bonus, manner of determining such and the approving Committee's reasoning, see the Company's report on the matter dated December 7, 2012.

b) On March 12, 2013 the Company's Board of Directors resolved on the distribution of dividend of NIS 0.24 per share, totaling NIS 13,996,723.

c) On March 14, 2012 the Company's Board of Directors resolved on the distribution of a dividend of NIS 0.2 per share, totaling NIS 11,565,271.

d) On January 30, 2012 the Company's Board of Directors, following the approval of the Audit Committee on January 23, 2012, resolved to extend the period for exercising 403,365 options (security number: 1095884) by 12 months, so that the final exercise date of these options will be on January 31, 2013. For more details regarding this resolution of the Board of Directors, see the Company's immediate report on the matter dated January 31, 2012.

Resolutions of the Extraordinary General Meeting:

e) On June 10, 2012, the Company's general meeting of shareholders resolved:

- To approve the General Meeting's amendment of the Company Articles in a manner in a manner adapting them to the updated wording of the Companies Law and of the Efficiency of Enforcement Proceeding of the Securities Authority (Legislation Amendments) Law, 2011 ("**Administrative Enforcement Law**") allowing, inter alia, insurance and indemnification of directors and officeholders in the Company in connection with administrative enforcement proceedings and payment to parties harmed by violations, as prescribed under sections 56H and 52[54](A)(1)(a) to the Securities Law 1968 ("**Administrative Enforcement Payments" and** "**Securities Law**").

- To approve updating undertakings for indemnification of officeholders and directors who are not controlling shareholders or relatives of such.

- To approve providing indemnification agreement for directors who are controlling shareholders or relatives of such.

- To approve extending insurance for directors and officeholders who are not controlling shareholder or relatives of such in a manner which will include events which may be insured under the Administrative Enforcement Law, and increasing the limit of liability of the insurance per event and per period from US$15 million (in the event the Company shares are listed for trade on the Tel Aviv Stock Exchange only) and US$30 million (in the event the Company shares are listed for trade on any foreign stock exchange outside of Israel) (as approved by the General Meeting of the Company's shareholders on December 28, 2004) to US$40 million.

- To approve engagement with an insurance company under a policy for insuring directors who are controlling shareholder or relatives of such under terms identical to those for directors who are not controlling shareholder or relatives of such, as may be from time to time, for a period of three years.

- Not to approve exculpation in advance each of the directors who are controlling shareholder, or relative of such, from all or part of liability towards the Company, in accordance with the Company's articles of association and the Companies Law, as may be from time to time, for a period of three years

For more details, including the full wording of the General Meeting's resolutions, see the reports on the General Meeting dated May 13, 2012 and June 11, 2012.

**Regulation 29A – Company Resolutions**

In this matter, see regulation 22 above (transactions with controlling members), the resolution of the Board of Directors under Regulations 29 d) above, resolution of the general meeting as detailed in regulation 29 e) above and the Company's reports of May 13, 2012 and June 11, 2012 on the general meeting.

The immediate report published by the Company on December 7, 2012 regarding formalization of the annual bonus for the President and CEO of the Company, as part of his existing terms of employment

Date: March 12, 2013

Frutarom Industries Ltd.

| | | |
|---|---|---|
| By: | ______________________ | ______________________ |
| Name: | Dr. John Farber | Ori Yehudai |
| Office: | Chairman of the Board | President and Chief Executive Officer |

**CORPORATE GOVERNANCE QUESTIONNAIRE**

Please note the following:

(1) The questionnaire is set up in such manner that the answer "correct" to all questions is a positive indication of the existence of good corporate governance, and vice versa. The answer "correct" must be marked in the relevant box using a ✓and incorrect must be marked using a ×; to clarify, the questionnaire <u>does not</u> exhaust all aspects of corporate governance relevant to the corporation, but rather only deals with a number of aspects; to obtain further information (and depending on the issue) the corporation's routine reports should be referred to.

(2) "Report year" means from 1.1.2012 until 31.12.2012.

(3) The normative framework appears next to each question. If the question refers to mandatory provisions, this will be explicitly stated.

(4) If a corporation wishes to add information which could be important for reasonable investors with regards to answers to the questionnaire, it must do so as part of the <u>final remarks</u> to the questionnaire, making reference to the relevant question.

| **INDEPENDENCE OF BOARD OF DIRECTORS** | | | | | |
|---|---|---|---|---|---|
| | | | **correct** | **incorrect** | **Normative framework** |
| 1. | | Two external directors or more served in the corporation during each report year.<br><br>*In this question you may answer "correct" if the period of time during which two external directors did not serve does not exceed 90 days, as stated in section 363A.(10) to the Companies Ordinance. However, for either answer (correct/incorrect) the period of time in the report year (in days)during which two or more external directors did not serve must be noted (including also time periods retroactively approved, separating between different external directors):*<br>Director A: Isaac Angel – served as an external director during the entire report year.<br>Director B:Yaacov Elinav served as an external director during the entire report year.<br>Number of external directors serving in the corporation as of the date of publication of this questionnaire: 2 | √ | | **Mandatory provision**<br><br>Section 239 to the Companies Law |
| 2. | A. | The number of independent directors serving in the corporation: 3 | ____ | ____ | Section 1 to the First Addendum (Recommended Provisions for |
| | B. | As of the date of publication of this questionnaire -<br>- In a corporation with a controlling member or a controlling cluster (in this section: **controlling member**) – one-third of the members of the board of directors, at least, independent | √ | | |

| | | | | | |
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| | | - In a corporation with no controlling member – a majority independent members of the board of directors. | | | Corporate Governance) of the Companies Law + Regulation 10(B)(9a) and 48(C)(9a) to the Reports Regulations |

| | | | | | |
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| | C. | The corporation has prescribed in its articles that a rate[1]/minimal number of independent directors must serve.<br>If the answer is "correct" –<br>State the rate/number of independent directors prescribed in the articles: _____.<br>The corporation fulfilled the provisions of the articles during the report year (in the matter of independent directors):<br>☐ Yes<br>☐No<br>*(Please mark the appropriate box).* | | × | |
| 3. | | During the report year, an inquiry was held regarding the external (and the independent) directors and it was found that during the report year they satisfied the provisions of section 240(b) and (f) of the Companies Law with regards to absence of connection to the corporation of the external (and independent) directors serving in the corporation, and all conditions required for service as an external (or independent) director were satisfied.<br><br>If the answer is "correct" – note the organization that performed the inquiry: the Company's legal department | √ | | Sections 240(b), 241, 245A and 246 of the Companies Law |
| 4. | | All the directors who served in the corporation over the report year <u>are not</u> directly or indirectly subordinate[2] to the CEO (except directors who are representatives of employees, if an employee representative director exists in the corporation). | √ | | Section 3 to the First Addendum (Recommended Provisions for Corporate Governance) of the Companies |

[1] In this questionnaire – "rate" - a certain number out of all the directors. For example, in a corporation where there is a rate of one-third independent directors, 1/3 will be noted.
[2] The fact that a director serves in a held corporation is not considered "reporting to" for the matter of this question.

| | | | | | |
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| | | If the answer is "incorrect" (i.e., the director is subordinate to the CEO) – note the number of directors who <u>do not</u> have the stated restriction: ____ | | | Law |
| 5. | | Before every meeting of the board of directors, the corporation requested all directors participating in such discussion and/or vote to declare any personal interest and/or conflict of interest with regards to approval of a transaction, as the case may be.[3]<br>In addition, note whether directors who declared personal interest and/or conflict of interest participated in such discussion and/or vote (other than the discussion and/or vote where a majority of the board of directors had a personal interest, as stated in section 278(B) to the Companies Ordinance):<br><br>☐ Yes. The rate of such directors participating in discussion and/or voting: ___<br>(please add more lines according to the number of discussions/votes during the report year)<br><br>☐No | | | Sections 255, 269 and 278 of the Companies Law |
| 6. | | During the report year, the board of directors did <u>not refuse</u> to provide professional consulting services on the corporation's account, if requested by a director under section 266(A) to the Companies Law.<br><br>If the answer is "incorrect" (i.e., the board of director did refuse) – note the reasons for the director's request, and the grounds on which the board of directors refused the request, or, alternatively, refer to the immediate report in which such disclosure was made: ________<br><br>☒ Not relevant *(The board of directors was not so requested)* | | | Section 266(A) to the Companies Law |
| 7. | | The controlling member (including such member's relatives and/or designees) <u>who is not</u> a director or other senior officeholder in the corporation <u>was not present</u> at the meetings of the board of directors held during the report year.<br><br>If the answer is "incorrect" (i.e., the controlling member and/or relative and/or designee was present at such meetings of the board of directors) – note the following | √ | | Section 106 to the Companies Law |

[3] During the first application year, corporations are exempt from answering this question.

| | | | | correct | incorrect | Normative framework |
|---|---|---|---|---|---|---|
| | | | details regarding the identity of the additional person at such aforesaid meetings of the board of directors:<br>Identity: ________<br>Position: ________<br>Details of controlling member (if person present is not the controlling member himself): ______<br>Was such person there to present a particular issue:<br>☐ yes ☐no<br>*(Please mark the appropriate box)*<br><br>Frequency of presence at meetings of the board of directors during the report year: ________<br><br>☐ Not relevant (there is no controlling member in the company) | | | |
| **DIRECTORS' CAPACITY AND SKILLS** | | | | | | |
| | | | | **correct** | **incorrect** | **Normative framework** |
| 8. | | | Company articles contain <u>no</u> provision restricting the option of immediately terminating the office of all directors in the corporation who are not external directors (*in this matter – resolution by ordinary majority* ***is not*** *considered restricting).*<br><br>If the answer is "incorrect" (i.e., such restriction does exist) – note: _____. | √ | | Section 222 and 85 to the Companies Law, section 46B to the Securities Law |
| | | A | The time period prescribed in the articles for directors to serve in office: _____ | | | |
| | | B | The majority required in the articles to terminate the directors' office: ______ | | | |
| | | C | Quorum prescribed in the articles for a general meeting for termination of directors' service : ___ | | | |
| | | D | Majority required for amendment of these articles: ___ | | | |
| 9. | | | At the general meeting where appointment was on the agenda, all the directors who served over the report year declared prior to the date of convening of the meeting that they had the required skills (including details of such) and capacity to dedicate the appropriate time to the fulfillment of office, and that no restrictions as stated in sections 226 and 227 to the Companies Law, and in the case of independent directors, the conditions appearing in sections (1) and (2) to the definition of "independent director" in section 1 to the Companies Law do exist.<br><br>If the answer is "incorrect" , provide the names of the | √ | | **Mandatory Provision**<br>Sections 224A + 224B to the Companies Law |

| | | | | | |
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| | | directors who <u>did not</u> satisfy the above: _____ | | | |
| 10. | | The corporation has a training plan for new directors in the area of the corporation's business and in the area of the law applicable to the corporation and directors, and plan for a continued training of serving directors, adapted, inter alia, to the position in which directors serve in the corporation.<br><br>If the answer is "correct" – note whether the plan operated during the report year:<br>☐ yes<br>☐no<br>*(Please mark the appropriate box)* | | x | Section 4(A) to the First Addendum (Recommended Corporate Governance Provisions) of the Companies Law |
| 11. | | The chairman of the board of directors (or a person appointed by the board of directors) is responsible for assimilation of the corporate governance rules applicable to the corporation, and ensures that the directors were updated on issues relating to corporate governance over the report year.<br><br>If the board of directors appointed another person to serve as the responsible party, please state the name and position of such person: Adv. Tali Mirsky, Global VP Legal Affairs & Corporate Secretary | √ | | Section 4(B) to the First Addendum (Recommended Provisions for Corporate Governance) of the Companies Law |
| 12 | A | The corporation has prescribed a minimal number of members of the board of directors who must have accounting and financial expertise.<br><br>If the answer is "correct" – note the minimal number prescribed: 2 | √ | | **Mandatory provision**<br><br>Section 92(A)(12) to the Companies Law |
| | B. | During the entire report year, additional directors with accounting and financial expertise served in the corporation, in addition to the external director having accounting and financial expertise, in such number as prescribed by the board of directors.<br><br>*In this question, you may answer "correct" if the period of time during which no additional directors which accounting and financial expertise served does not exceed 60 days. However, for any answer (correct/incorrect) the period of time in the reporting period (in days) during which no such directors served must be noted: 0* | √ | | **Mandatory provision**<br><br>Section 219(D) to the Companies Law |
| | C. | The number of directors who served in the corporation | ____ | ____ | Sections 92(A)(12), 219(D), 240(A1) to |

| | | | | | |
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| | | over the report year:<br>Having accounting and financial expertise: 5<br>Having professional capacity: 7<br><br>*In the event of any changes in the above number of directors during the report year, the lowest number of directors of any kind who served during the report year must be stated (save during a 60 day period from the time of the occurrence of such change).* | | | the Companies Law, regulation 10(B)(9)(a) to the Reporting Regulations. |
| 13 | A. | Upon appointment of any external director during the report year, the provisions of section 239(D) to the Companies Law in the matter of diversity of gender composition of the board of directors was satisfied.<br><br>☒ Not relevant *(no external directors were appointed during the report year)* | | | **Mandatory provision**<br><br>Section239(d) to the Companies Law |
| | B. | During the entire report year, the composition of the board of directors included members from both genders.<br><br>If the answer is “incorrect” – note the period of time (in days) during which the above was not correct: _______.<br><br>*In this question, you may answer “correct” if the period of time during which there were not directors of both genders does not exceed 60 days. However, for any answer (correct/incorrect) the period of time in the reporting period (in days) during which there were not directors of both genders must be noted: 0.* | √ | | Section 2 to the First Addendum (Recommended Provisions for Corporate Governance) of the Companies Law |
| | C. | Number of directors of each gender serving on the board of directors of the corporation as of the date of publication of this questionnaire:<br><br>Men: 5 Women: 2 | ----- | ----- | |
| | | | | | מאיפה זה בא? לא ראיתי שאלה דומה בעברית |
| **MEETINGS OF THE BOARD OF DIRECTORS** | | | | | |
| | | | **correct** | **incorrect** | **Normative framework** |
| 14 | A. | Number of meetings of the board of directors held during each quarter of the report year:<br><br>First quarter (2012): 2 | ______ | ______ | Sections 97, 98 and 224 to the Companies Law |

| | | | | | | |
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| | | | Second quarter: 1<br>Third quarter: 1<br>Fourth quarter: 2 | | | |
| | | B. | Next to the name of each director who served in the corporation over the report year please note the rate of participation in meetings of the board of directors (including meetings of board of directors' committees in which such director serves as a member, and as noted below) held over the course of the report year (relating to such directors' term of service:<br><br>(*Please add more lines according to number of directors)* | ----- | ----- | |

| Name of director | Rate of participation in meetings of the board of directors | Rate of participation in meetings of the audit committee (regarding directors who are members of this committee) | Rate of participation in meetings of the balance sheet committee (regarding directors who are members of this committee) | Rate of participation in meetings of other board of directors' committees (state the name of the committee) |
|---|---|---|---|---|
| Dr. John Farber | 100% | | | |
| Mrs. Maya Farber | 100% | | | |
| Ms. Sandra Farber | 100% | | | 100% compensation committee – was a member until 26.11.12 |
| Mr. Yaacov Elinav | 100% | 100% | 100% | 100% Compensation Committee |
| Mr. Isaac Angel | 100% | 100% | 100% | 100% Compensation Committee |
| Mr. Hans Abderhalden | 100% | | | |
| Mr. Gil Leidner | 100% | 100% | 100% | 100% Compensation Committee (member from 26.11.12) |

| | | | | | |
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| 15. | | Over the report year, the board of directors held one discussion at least regarding the CEO and other officeholders subordinate to the CEO's regarding the management of the corporation's business, in their absence, after having given them an opportunity to state their positions. | √ | | Section 5 to the First Addendum (Recommended Provisions for Corporate Governance) of the Companies law |
| 16. | | Over the report year, one general meeting was held (by | √ | | **Mandatory** |

| | | | | | |
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| | | no later than the end of fifteen months after the last general meeting) | | | **provision**<br><br>Section 60 to the Companies Law |
| SEPARATION BETWEEN TASKS OF CEO AND CHAIRMAN OF THE BOARD OF DIRECTORS | | | | | |
| | | | **correct** | **incorrect** | **Normative framework** |
| 17. | | A chairman of the board of directors served throughout the entire report year.<br><br>*In this question, you may answer "correct" if the period of time during which no chairman of the board of directors served does not exceed 60 days as stated in section 363A.(2) to the Companies Law. However, for any answer (correct/incorrect) the period of time (in days) during which no chairman served in the corporation must be stated: 0* | √ | | **Mandatory provision**<br><br>Section 94(A) to the Companies Law |
| 18. | | A CEO served throughout the entire report year.<br><br>*In this question, you may answer "correct" if the period of time during which no CEO served does not exceed 90 days as stated in section 363A.(6) to the Companies Law. However, for either answer (correct/incorrect) the period of time (in days) during which no chairman served in the corporation must be stated: 0* | √ | | **Mandatory provision**<br><br>Section 119 to the Companies Law |
| 19. | | In corporations where the chairman of the board of directors also serves as the CEO of the corporation and/or exercises his authority, the double office has been approved in accordance with the provisions of section 121(c) to the Companies Law.<br><br>If the answer is "correct" – please make reference to the immediate report regarding the general meeting which approved double office and/or exercising of such authorities: ___.<br><br>☒ Not relevant (if no double office is held in this corporation) | | | **Mandatory provision**<br><br>Sections 95, 121 to the Companies Law |
| 20. | | The CEO <u>is not</u> a relative of the chairman of the board of directors.<br><br>If the answer is "incorrect" (i.e., the CEO is a relative of the chairman of the board of directors) – | √ | | **Mandatory provision**<br><br>Sections 95, 121 to the Companies Law |
| | | A. State the familial relations between the parties: ______. | ______ | ______ | |

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| | | B. | Service was approved under section 121 (c) to the Companies Law.<br><br>☐ yes<br>☐no<br>*(Please mark the appropriate box)* | ______ | ______ | |
| 21. | | The controlling member or his relative <u>do not serve</u> as CEO or senior officeholders in the corporation except as a director.<br><br>☐ Not relevant (there is no controlling member in the company) | | √ | | Section 106, to the Companies Law |
| AUDIT COMMITTEE | | | | | | |
| | | | | **correct** | **incorrect** | **Normative framework** |
| 22. | | All external directors were members of the audit committee over the course of the report year. | | √ | | **Mandatory provision**<br>Section 115 to the Companies Law |
| 23. | | Chairman of the audit committee is an external director. | | √ | | **Mandatory provision**<br>Section 115 to the Companies Law |
| 24. | | The following <u>did not</u> serve on the audit committee over the report year – | | ______ | ______ | **Mandatory provision**<br>Section 115 to the Companies Law |
| | | A | The controlling member or his relative.<br>☐ Not relevant (there is no controlling member in the company) | √ | | |
| | | B | Chairman of the board of directors | √ | | |
| | | C | A director employed by the corporation or by the controlling member of the corporation or by a corporation under his control. | √ | | |
| | | D | A director who provides permanent services to the corporation or to the controlling member of the corporation or to a corporation controlled by the controlling member. | √ | | |
| | | E | A director whose main livelihood is on the controlling member.<br>☐ Not relevant (there is no controlling member in the company) | √ | | |

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| 25. | | Any persons unauthorized to attend meetings of the audit committee, including the controlling member or his relative were not present at these during the report year, except in accordance with the provisions of section 115(E) to the Companies Law. | √ | | **Mandatory provision** Section 115(E) to the Companies Law |
| 26. | | Quorum for discussion and resolutions for all meetings of the audit committee held during the report year was a majority of the members of the committee, and most of those present were independent directors, at least one of whom was an external director.<br><br>If the answer is "incorrect" – name the rate of meeting where this requirement was not satisfied: ______. | √ | | **Mandatory provision** Section 116A to the Companies Law |
| 27. | | The audit committee held at least one meeting over the report year in the presence of the internal auditor and the auditor, as the case may be, and in the absence of officeholders in the corporation who are not members of the committee, in the matter of deficiencies in management of the corporation. | √ | | **Mandatory provision** Section 117(1) to the Companies Law- section 6 to the First Addendum (Recommended Provisions for Corporate Governance) |
| 28. | | In all meetings of the audit committee in which persons not authorized to serve on the committee were present, they attended with the approval of the chairman of the committee and/or at the request of the committee (with regard to the legal counsel and corporate secretary, who is not a controlling member of relative). | √ | | **Mandatory provision** Section 115(e) to the Companies Law |
| 29. | | Arrangements prescribed by the audit committee were in place during the report year regarding the manner of handling corporate employee's complaints regarding faulty management of the business and regarding protection given to such complainant employees. | √ | | **Mandatory provision** Section 117(6) to the Companies Law |
| ROLES OF THE BALANCE SHEET COMMITTEE (hereinafter - the Committee) IN ITS PRELIMINARY WORK FOR APPROVAL OF THE FINANCIAL STATEMENTS | | | | | |
| | | | **correct** | **incorrect** | **Normative framework** |
| 30. | A. | The recommendations of the balance sheet committee regarding the financial statements submitted during the report year were brought before the board of directors a reasonable time prior to the board of directors' discussion on the draft financial statements and all deficiency or problem discovered was reported. | √ | | Regulation 2(3) to the Balance Committee Regulations and Disclosure Guidelines in the |

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| | | | | | matter of approval of financial statement process |
| | B. | State the time period (in days) which the board of directors determined to be reasonable time for submission of the recommendations of the balance sheet committee in advance of the meeting of the board of directors in which the periodic or quarterly statements were approved: 2 business days | _____ | ____ | |
| | C. | The number of days passed between the date on which the recommendations were passed on to the board of directors to the date of the board of directors' approval:<br><br>First quarter (2012): 2 business days<br>Second quarter: 2 business days<br>Third quarter: 2 business days<br>Annual report: 3 business days | _____ | _____ | |
| 31. | The corporation's auditor was invited to all the meetings of the board of directors and of the balance sheet committee in which the corporation's financial statements relating to the report year were discussed. | | √ | | **Mandatory provision** Section 168 to the Companies Law, regulation 2(2) to the Approval of Financial Statements Regulations |
| 32. | Throughout the report year, all the following conditions existed with regard to the balance sheet committee : | | _____ | ______ | |
| | A. | Number of members of the committee was not less than three (during the time of the discussion in the balance sheet committee and upon approval of said statements). | √ | | **Mandatory provision**<br><br>Regulation 3 to the Approval of Financial Statements Regulations |
| | B. | All the conditions prescribed in in section 115(B) and (C) to the Companies Law existed (in the matter of service of members of the audit committee). | √ | | |
| | C. | Chairman of the committee was an external director. | √ | | |
| | D. | All members are directors, and most members are independent directors. | √ | | |
| | E. | All members have the capacity to read and understand financial statements and at least one of the independent directors has accounting and financial expertise. | √ | | |
| | F. | Members of the committee submitted declarations before being appointed. | √ | | |

| | | | correct | incorrect | Normative framework |
|---|---|---|---|---|---|
| | G. | Quorum for discussion and resolution in the committee was a majority of members, provided a majority of members present were independent directors, including at least one external director. | √ | | |
| | If the answer is “incorrect” regarding one or more of the sub-sections of this question, please state what conditions did not exist: _______. | | ____ | ____ | |
| AUDITOR | | | | | |
| | | | **correct** | **incorrect** | **Normative framework** |
| 33. | The audit committee (and/or the balance sheet committee) was satisfied that the scope of the auditor’s work for auditing services over the report year and his fees, proportional to the scope of audit hours over the report year, are appropriate for performance of proper auditing work. | | √ | | Section 117(5) to the Companies Law |
| 34. | Before the auditor was appointed, the audit committee (and/or the balance sheet committee) submitted its recommendations to the relevant organ in regarding the auditor’s scope of work and fees.<br><br>☐ Not relevant (no auditor was appointed during the report year)<br><br>If the answer is “correct” – note whether the relevant organ in the corporation acted in accordance with the recommendations of the audit committee(and/or the balance sheet committee):<br><br>☒ Yes<br>☐ No (if the answer is “no”, please explain in the comments at the end of this questionnaire how the relevant organ (naming such) was satisfied regarding the scope of work and wages of the auditor).<br><br>*(Please mark the appropriate box)* | | √ | | Section 117(5) to the Companies Law |
| 35. | The audit committee (and/or balance sheet committee) ensured that there was no restriction on the auditor’s work in the report year. | | √ | | Securities Law and Regulations (in the matter of “Duly Audited Statements”) |
| 36. | The audit committee (and/or balance sheet committee) discussed the findings of the report and its implications with the auditor in the report year. | | √ | | Regulation 2 to the Balance Committee Regulations + section 6 to the |

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| | | | | Section 1 to the First Addendum (Recommended Provisions for Corporate Governance) of the Companies Law |
| 37. | The audit committee (and/or balance sheet committee) was satisfied regarding the auditor's capacity to perform the corporation's audit, prior to his appointment, in light of the nature of the corporation's activity and its complexity. | √ | | Securities Law and Regulations (in the matter of "Duly Audited Statements") |
| 38. | Please state the number of years over which the partner at the auditor's accounting firm handling the audit has served in office (as the corporation's auditor): 1 | ____ | ____ | Securities Law and Regulations (in the matter of "Duly Audited Statements") |
| 39. | The auditor participated over the report year in all meetings of the balance sheet committee examining the financial statements to which he was invited. | √ | | Section 168(B) to the Companies Law, Regulation2 to the Balance Sheet Committee Regulations |
| | TRANSACTIONS WITH INTERESTED PARTIES | | | |
| | | **correct** | **incorrect** | **Normative framework** |
| 40. | The corporation adopted a procedure, approved by the audit committee, in the matter of transactions with interested parties, in order to ensure that such transactions are duly approved. | | x | **Mandatory provision** Section 117, 253, 255, 270-278 of the Companies Law |
| 41. | The controlling member or its relative (including companies controlled by such) <u>are not</u> employed by the corporation or providing management services for it.<br>If the answer is "incorrect" (the controlling member or his relative are employed by the corporation or providing management services for it) note:<br>- The number employed by the corporation from among the controlling member and/or relatives (including companies controlled by such): __<br>- Were the employment agreements and/or management services agreements approved by the organs named by law:<br>☐ yes<br>☐no<br>*(Please mark the appropriate box)*<br><br>☐ Not relevant (no controlling member in the corporation) | √ | | Section 270(4) of the Companies Law |

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| 42. | To the best of the corporation's knowledge, the controlling member has <u>no</u> additional business in the corporation's areas of activity (one or more).<br>If the answer is "incorrect" – state whether an arrangement for restricting actions between the corporation and the controlling member has been prescribed:<br><br>☐ yes<br>☐no<br>*(Please mark the appropriate box)*<br><br>☐ Not relevant (no controlling member in the corporation) | √ | | Section 254 of the Companies Law, section 36 of the Securities Law (important details for reasonable investor) |

Remarks:

Section 27 – the discussion on the report year took place on February 7, 2013 after a deferment of the meeting of the audit committee.

Dr. John J. Farber
Chairman of the Board of Directors

Yacov Elinav
Chairman of the Audit Committee
Chairman of the Balance Sheet Committee

Date signed: March 12, 2013

# SECTION E

Report on the Effectiveness of the Internal Controls on the Financial Reporting and Disclosure

E

**Annual Report Regarding Effectiveness of Internal Audit on Financial Reporting and on Disclosure**

The management of Frutarom Industries Ltd (the "**Corporation)**, supervised by the Corporation's Board of Directors is responsible for prescribing and conducting a proper internal control on the Corporation's financial reporting and disclosure.

For this matter, the members of the management are:

1. Ori Yehudai, President and CEO
2. Alon Granot, Executive Vice President and CFO
3. Amos Anatot, Executive Vice President Global Supply Chain and Operations.
4. Dana Maor, Global Vice President, Human Resources
5. Guy Gill, Vice President Finance
6. Tali Mirsky-Lachman, Global Vice President, Legal Affairs and Corporate Secretary
7. Lilit Levi, Global Chief Information Officer

Internal control on financial reporting and disclosure includes controls and procedures which are conducted in the Corporation, which are planned by the President and CEO and the CFO and under their supervision, or by whoever fills these positions in practice, under the supervision of the Corporation's Board of Directors. These controls and procedures are meant to provide a reasonable level of certainty regarding the reliability of the financial reporting and the preparation of the financial reports in accordance with the provision of the law, ensuring that the information the Corporation is required to disclose in the reports it publishes under the provisions of the law is gathered, processed, summarized and reported on the date and the manner prescribed by law.

Internal control includes, among other things, controls and procedures designed to ensure that the information the Corporation, as stated, is required to disclose is gathered and delivered to the Corporation management including to the President and CEO, and to the highest ranking financial officer to whoever fills these positions in practice, in order to allow timely decision making with regards to the disclosure requirement.

Due to its structural limitations, internal control on financial reporting and disclosure is not designed to provide absolute certainty that misrepresentation or omission of information in the reports will be avoided or revealed.

Management, supervised by the Board of Directors, tested and assessed the internal auditing of the financial reports and the Corporation's disclosure and its effectiveness. The assessment of the effectiveness of the internal control on financial reporting and on disclosure performed by management, supervised by the Board of Directors, included:

Mapping out and identification of the business processes which management deems very material to the financial reports and disclosure. Testing key controls and testing the effectiveness of the controls. Components of the internal control included control of closing processes for accounting periods, preparation and editing of financial reports and disclosures, controls on the level of the organization, general controls on information systems and controls on business processes: (1) sales and customers (2) material consumption, inventory and procurement.

Based on the assessment of effectiveness performed by management, supervised by the Board of Directors as explained above, and subject to the statements below regarding the acquired company (as defined below), the Board of Directors and Corporation management have concluded that the internal audit on the Corporation's financial reporting and disclosure as at December 31, 2012 is effective.

Acquisition of the Etol Company ("Etol") over the reporting year and reference to FAQ (SOX)

Regarding the description of Etol and the acquisition transaction, see Note 5G to the Company's Periodic Report.

Assessment of effectiveness of internal audit on the financial statement and the disclosure performed by the Company's management under the supervision of the Board of Directors did not include assessment of effectiveness of internal audit on the financial statement and disclosure of Etol.

In accordance with the guidelines of the Securities Authority from July 2010, FAQ (SOX)1, an acquired corporation may be excluded from the assessment of effectiveness of internal audit report until the period report of the year following the year in which control was gained in the acquired corporation.

The reasons for not including the acquired company in the report of assessment of effectiveness of internal audit for this periodic report and the reasons the Company was not able to assess the effectiveness of the acquired company's internal audit as of the date of the report are, in brief, the following:

(A) The date on which the transaction was concluded and the internal audit processes required for implementation – insufficient time had passed for assessment and mapping out internal audit processes existing at Etol from the date on which the transaction was completed until the date of the report, or for full implementation of the Company's internal audit processes at Etol.

(B) Accompanying processes for completion of the transaction – a number of processes were in play for the purpose of the Company's gaining control of the corporation, some complex, relating to handling and organizing work interfaces with the acquired company, including in the matter of the financial statements and the preparation of such, creating adaptations and adjustments between the Company's information systems and those of the acquired company, which, in addition to the aforesaid, extended the period required for implementation of the internal auditing process.

In order to assess the effectiveness of Etol's internal audit, the Company, starting from the date on which the acquisition was completed, began examination of the acquired company's existing processes and audits in the matter of financial reporting and disclosure, mapping out risks and identifying material processes.

The Company's management would like to emphasize that based on its work experience with Etol from the date of acquisition, Etol’s internal auditor, on the opinion of the acquired company's auditing accountants and based on the fact that Etol prior to it’s acquisition was not a traded company which reported under the rules of the IFRS, the exclusion of the acquired company from the Report Regarding Effectiveness of Internal Audit has low probability of affecting the Company's internal audit or the information presented in the financial statements.

**<u>Directors' Declarations</u>**

**<u>Declaration of the President and CFO</u>**

The undersigned, Mr. Ori Yehudai, hereby declares as follows:

1. I have reviewed the Periodic Report of Frutarom Industries Ltd. (the "**Corporation**") for the third quarter of 2012 (the "**Reports**");

2. To my knowledge, the Reports do not include any false representations of any material fact and do not omit representation of any material fact required in order to ensure that the representations contained in these, in light of the circumstances under which they were included, are not misleading in relation to the period of the Reports;

3. To my knowledge, the financial reports and other financial information contained in the reports duly reflect the Corporation's financial situation, its results of operations and cash flow for the dates and periods to which the Reports relate in all material aspects;

4. I have disclosed to the Corporation's auditors, the Board of Directors and the Audit Committee of the Corporation's Board of Directors, based on my most updated assessment of the internal control on financial reporting and disclosure:

   a. All the material deficiencies and weaknesses in prescribing and implementing the internal control on the financial reporting and on the disclosure, if any, which may reasonably adversely affect the ability of the Corporation to gather, process or report on financial information in a manner which could raise concerns regarding the reliability of the financial reporting and the preparation of the financial reports in accordance to the provisions of the law; and –

   b. Any fraud, material or not material, which involves the CEO or anyone directly reporting to him or other employees who hold significant positions in the internal control on the financial reporting and on disclosure;

5. I, alone, or together with others in the Company:

   a. Set controls and procedures, or ensured the existence and set up of controls and procedures under my supervision, designated to ensure that material information relating to the Corporation, including its consolidated companies as defined in the Securities Regulations (Compiling Annual Financial Reports), 5770-2010, is brought to my attention by others in the Corporationand the consolidated companies, particularly during the preparation of the Reports; and

b. I set controls and procedures, or ensured the enactment and performance of controls and procedures under my supervision, designed reasonably ensure the reliability of the financial reporting and the preparation of the financial reports in accordance with the provisions of law, including in accordance with accepted accounting principles:

c. I have assessed the effectiveness of the internal control on the Corporation's financial report and on the disclosure, and presented the conclusions of the Board of Directors and of the management regarding said effectiveness of the internal control in this report as of the date of the reports.

The above does not derogate from my lawful responsibility, or from the lawful responsibility of any other person.

Date: March 12, 2013

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Ori Yehudai

President and CEO

# Directors' Declarations

## Declaration of the Executive Vice President and CFO

The undersigned, Alon Granot, hereby declares as follows:

1. I have reviewed the financial reports and other financial information contained in the reports of Frutarom Industries Ltd. (the "**Corporation**") for 2012 (the "**Reports**");
2. To my knowledge, the financial reports and other financial information contained in the Reports do not include any false representations of any material fact and do not omit representation of any material fact required in order to ensure that the representations contained in these, in light of the circumstances under which such representations were included, are not misleading in relation to the period of the Reports;
3. To my knowledge, the financial reports and other financial information contained in the reports duly reflect the Corporation's financial situation, its results of operations and cash flow for the dates and periods to which the Reports relate in all material aspects;
4. I have disclosed to the Corporation's auditors, the Board of Directors and the Audit Committee of the Company's Board of Directors, based on my most updated assessment of the internal control on financial reporting and disclosure:
   a. All the material deficiencies and weaknesses in prescribing and implementing the internal control on the financial reporting and on the disclosure, if any, which may reasonably adversely affect the ability of the Corporation to gather, process or report on financial information in a manner which could raise concerns regarding the reliability of the financial reporting and the preparation of the financial reports in accordance to the provisions of the law; and –
   b. Any fraud, material or not material, which involves the president and CEO or anyone directly reporting to him or other employees who hold significant positions in the internal control on the financial reporting and on disclosure;

5. I, alone, or together with others in the Corporation:

   a. Set controls and procedures, or ensured the existence and set up of controls and procedures under my supervision, designated to ensure that material information relating to the Corporation, including its consolidated companies as defined in the Securities Regulations (Compiling Annual Financial Reports), 5770-2010, as may be relevant to the financial reports and other financial information contained in the Reports, is brought to my attention by others in the Corporationand the consolidated companies, particularly during the preparation of the Reports; and

   b. Set controls and procedures, or ensured the enactment and performance of controls and procedures under my supervision, designed reasonably ensure the reliability of the financial reporting and the preparation of the financial reports in accordance with the provisions of law, including in accordance with accepted accounting principles;

   c. I have assessed the effectiveness of the internal control on the Corporation's financial report and on the disclosure, insofar as such relate to the financial reports and to any other financial information contained in the reports as of the date of the reports; my conclusions regarding my aforesaid assessment has been brought before the Board of Directors and the management and is contained in this report. .

The above does not derogate from my lawful responsibility, or from the lawful responsibility of any other person.

Date: March 12, 2013

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Alon Granot
Executive Vice President and CFO