pronounced as companies concentrate on better utilizing finite human and financial resources. This is a major opportunity for a specialized supplier such as Eaton, which provides highly engineered components that add value to customer products and magnify their competitive advantage.

The cumulative effect of the success of our global OEM customers in forcing market prices and best practices on their suppliers has been to raise the cost of competing. Those who have survived decades of Darwinian competition now have strong technological, manufacturing, marketing and service capabilities that would be difficult to duplicate under the pressure of today's fierce pricing.

The corollary is that almost every market in which Eaton participates is consolidating. This is sometimes evident in headline-grabbing acquisitions, but is seen even more clearly in businesses which, having achieved leadership, are now further reinforcing these competitive advantages through their ability to support higher levels of research and development and capital investments. Fewer companies are providing disproportionately greater numbers of products and services. This gives new importance to Eaton's very strong technology leadership. Looking ahead, it means that Eaton has to be proactive and rigorous in its strategic planning in order to maintain its leadership positions.

Eaton's priorities have been explicitly established in order to respond to—and take the fullest possible advantage of—the opportunities that we have identified. Our conclusion is that we must make the investments required to be a winner in the global market. From our owners' point of view, if these investments are successful, they will result in sustainable earnings growth at levels far beyond what we have achieved in the last several decades.

Eaton's growth strategy incorporates the following key elements:

I. Take our major products into the critical emerging markets of those countries undergoing rapid industrialization.

II. Use the technological strengths that we developed to protect our existing franchises from global competitors to build significant incremental new earnings sources.

III. Use the discretionary cash we generate to finance acquisitions which will further strengthen our leadership posture and enhance long-term earnings growth.

IV. Rethink every fundamental activity within Eaton in order to achieve best practices when benchmarked against the best global competitors.

V. Enrich our tradition of management strength by developing new talent and by encouraging a more venturesome corporate culture.

If we look at our 1996 operational performance within this frame of reference, we feel that our results present a mixed picture. We have been candid about the fact that we were somewhat disappointed with our reported earnings. We started the year with the hope that we could meet the challenging goal of at least equaling 1995's record results. The major market disappointment was the dramatic weakening in the semiconductor equipment market. We also had problems within our Truck Components Operations, compounded by unanticipated losses from our acquisition of the Brazilian transmission producer CAPCO. Finally, we were forced to conclude that in order to regain earnings momentum we had to incur some nonrecurring restructuring expenses within the year. Having acknowledged all of these challenges, it is also important to add that the great bulk of Eaton's operations performed extremely well when viewed in light of their prior year's results and competition.

In 1996, we consciously decided not to compromise our long-term growth strategy in order to try to enhance short-term earnings. We moved from planning to execution of our growth strategy. As had been expected, the investments in these growth initiatives diminished 1996's reported earnings. But we finished the year with even greater conviction about the opportunities that we have and about the inherent strengths of Eaton. We never take missing goals lightly, but transitional periods are always uncertain and we are convinced that we are on the right track.

The growth targets that we outlined last year—$10 billion in sales by the year 2000 and self-renewing earnings growth of at least 10 percent annually through the economic cycle—are intact. We are a fundamentally stronger company than we were last year, and we have every conviction that we can and will meet our growth objectives.

The new realities of the global marketplace have placed extraordinary demands on our workforce, and these men and women have shown exceptional talent, enthusiasm and dedication in helping Eaton achieve its reaching goals. These men and women are the reason for my confidence in our ability to succeed, and I extend my thanks to all of them. Our managers are under exceptional pressure. They not only must oversee their existing operations, but also must creatively leverage their strengths into new products, markets and countries. I appreciate their drive, commitment and support.

Even as we consciously work to develop a corporate culture that places greater emphasis on speed and agility in decision making and action, we reaffirm the underlying values that make our corporate culture a great strength. We are committed to integrity in every dimension of the company's behavior. Eaton has a stated philosophy which affirms our conviction that empowered individuals, drawing on their innate intelligence and motivation, are the basis for competitive advantage. In a year in which the principles of affirmative action have been distorted in the expedient rhetoric of political campaigns, we have committed ourselves to developing an inclusive organization which draws on the talent of all people. While we believe that our principal business mission is to create value for our owners, we feel strongly that these goals should be accomplished in a manner that makes us a responsible, caring corporate citizen.

Finally, I would like to thank the owners of the business, who supported our efforts to address the unanticipated problems of 1996. We know that we must regain earnings momentum. We feel this is achievable if our current economic outlook for the different country markets proves to be reasonably accurate. We know also that we must increase the pace of execution toward our long-term strategic goals. We are committed to justifying the continued confidence of our owners through our performance in 1997.

Sincerely,

Stephen R. Hardis
Chairman and Chief Executive Officer