Management's Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions

AAG also ended the year with a decline in sales. Most of the decline was in North America, which represents more than three-fourths of its global market, where volumes were down $187 or 8%. While there was a reported improvement in domestic aftermarket retail sales in 2001, this did not significantly improve our sales, as retailers generally met the higher demand with existing inventory. Divestitures also contributed $44 to the decline. Sales in Europe declined $25 due to $8 in adverse currency effects and a $17 decline in organic sales. Sales in South America were down $2 as a $23 currency decrease was partially offset by local growth of $15 and $6 of acquisition impact. Divestitures accounted for $13 of the $16 sales decline recorded in Asia Pacific.

EFMG experienced a sales decrease of $263 or 11% for 2001 versus last year. Sales for the final quarter of 2001 held even with the third quarter, which had shown a 14% decline from the second quarter of the year. The Fluid Systems business in this group benefited from having content on models that avoided the severe OE production cuts that have affected most of the other SBUs. Sales in North America were down $231 or 14% as the automotive, commercial vehicle and aftermarket sectors all trailed prior year volumes. Sales in Europe were down $31 or 5% with adverse currency effects of $25 playing a significant role. Sales were generally flat in South America as adverse currency effects of $22 were nearly offset by organic growth of $15 and a net acquisition impact of $5.

CVS experienced a year-on-year decline in sales in 2001 of $480 or 30% for the reasons cited relative to the heavy truck market in the discussion of ASG above. The decline in CVS sales included $60 of divestiture impact, $56 of which was in North America. Excluding this effect, sales in North America for the period were 26% below those of 2000. Aggregate sales for the other three regions declined $33 or 36% in a year-on-year comparison with $7 due to divestitures and adverse currency effects.

OHSG finished the year down $165 or 21% in sales versus 2000, with $9 resulting from divestitures, all in North America. Currency impact accounted for $19 of the decline, and organic sales fell $92 in North America, where overall markets were weak, and $49 in Europe, where the construction market softened and the agricultural market remained weak.

Sales in Other decreased $104 or 43% compared to 2000, reflecting the sale of most of the Warner Electric businesses at the end of February 2000.

Revenue from lease financing decreased $28 or 20% in 2001 as DCC realized a decline of $24 on reduced leasing activity, including a $10 decline in income realized on the sale of leased assets, and a $4 decline in its interest income.

In 2001, other income included a $50 gain on the divestitures of our Chelsea power take-off business and of our Glacier industrial bearings businesses. Also included in 2001 was a $35 loss on the sales of our Mr. Gasket subsidiary, our Marion, Ohio forging facility and the assets of our Dallas, Texas and Washington, Missouri Engine and Fluid Management Group operations. Included in the total for 2000 was $179 of gains on the divestitures of the Gresen hydraulics business, certain portions of our constant velocity joint business, most of the global Warner Electric businesses and the Commercial Vehicle Cab Systems Group. In addition, a $10 net charge related to final settlement of the Midland Grau divestiture was recorded in the third quarter of 2000, bringing to $169 the amount of net non-recurring income included in other income.

Gross margin for 2001 was 9.8% versus 13.9% in 2000. Margins in all our SBUs were severely affected as the decline in volume reduced our ability to absorb fixed operating expenses. Cost of sales included charges of $86 in 2001 and $17 in 2000 in connection with our restructuring activities.

Selling, general and administrative (SG&A) expenses decreased $147 during 2001 compared to last year. The net effect of divestitures accounted for $21 of this change, and currency exchange caused another $20 of the decline. The largest changes occurred in Europe, where currency fluctuations caused $7 of the $33 non-divestiture related decrease. Most of the remaining decrease was from the North American region, where our operating units scaled their capacity in reaction to severely reduced customer production schedules in the light truck and commercial vehicle markets.

Operating margin (our gross margin reduced by SG&A expenses) was 0.2% in 2001 compared to 4.8% in 2000 for the above reasons.

Interest expense was $14 lower as a result of lower debt and reduced rates.

Both the effective tax rates and the comparison of the effective tax rates for 2001 and 2000 are impacted by the substantial pre-tax loss reported in 2001. Because of the pre-tax loss in 2001, certain permanent differences between financial accounting rules and tax regulations that increase the tax rate when we report pre-tax income serve to reduce the effective rate.

Equity in earnings of affiliates in 2001 was $22 lower than in 2000. The $39 reduction in equity earnings in Mexico and the $11 decrease in earnings from DCC's equity investments adversely affected this line item. Partially offsetting these items were the earnings related to our investment in GETRAG and the loss reduction that occurred when we acquired the remaining interest in Danaven and began consolidating its results.

We reported a $298 net loss in 2001 versus net income of $334 reported in 2000. Comparisons are made difficult by the unusual charges and one-time gains recorded in both years. In 2001, we recorded after-tax charges of $313 in connection with our restructuring efforts and $10 of gains on divestitures. In 2000, we recorded $43 of restructuring and other unusual charges net of the gains recorded on several divestitures. Excluding these items, earnings would have been $5 in 2001 and $377 in 2000.

Unusual items in 2001 included net after-tax charges of $41 in ASG, $85 in AAG, $108 in EFMG, $12 in CVS and $43 in OHSG; a net charge of $14 was reflected in the Other category. In 2000, unusual charges were $47 in ASG, $39 in AAG and $32 in EFMG, while one-time gains were $27 in CVS, $16 in OHSG and $32 in Other.

Results of Operations (2000 versus 1999)

Our worldwide sales were $12,317 in 2000, a 6% or $842 decline from the $13,159 recorded in 1999. The divestitures completed in the first quarter of 2000 were a significant factor in the decline. Net of the effect of acquisitions, these divestitures accounted for a $410 reduction in sales for the year. Currency fluctuations accounted for an additional $279 decline in sales.

U.S. sales were $8,552, a 9% or $861 decline from the 1999 level, with divestitures net of acquisitions accounting for $408 of the decrease. Exports from the U.S. declined from $939 in 1999 to $832 in 2000.

Sales by region for 1999 and 2000 are presented in the following table.