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To Our Shareholders:

It is tempting in a year of record sales, earnings and earnings per share to focus primarily on those achievements. Instead, I would like to put the year's major accomplishments into a strategic context. In terms of reshaping the business for improved competitiveness, 1997 was the most significant year in Eaton's history. I believe that shareholders can better understand our performance when they understand the logic that directs our actions.

The emergence of truly global markets is the most important fact of business life with which all of us must deal. This has been made possible by today's extraordinary communications capabilities and transportation costs so low as to be a minor factor for most products. In practical terms, it means that we must contend with the best-of-the-best competitors who do business anywhere in the world. By definition, this puts tremendous pressure on prices. The resulting competition is Darwinian in nature. We strongly believe that unless we are clear leaders in a market—or have a realistic probability of attaining leadership—we will not be able to generate the financial returns necessary to permit us to renew our technologies and capital facilities. If a company is not advancing, it is in some form of retreat. We therefore have to be brutally objective about our competitive prospects.

The consequences of this reasoning can be seen in our decision to divest several of our important businesses. A divestiture decision is always difficult. This was particularly true in the case of the sale of our truck axle operation to Dana Corporation, since the axle division was Eaton's first business, dating to the company's founding in 1911. Our axle business has been an important contributor to Eaton's growth and prosperity. The strategic assessment we made in 1997, however, was that it was critical for us to add a leadership position in the truck clutch business to complement the leadership position we enjoy in our truck transmission franchise. The truck clutch business is especially important in helping us maintain global leadership in automated transmissions, and the acquisition of the Spicer Clutch business from Dana Corporation enabled us to achieve this key objective. Further, while the performance of our truck axle business improved dramatically in 1997—and we are confident that it will continue to achieve its turn-around targets in 1998—it has its greatest economic value as part of Dana, which already has a large and successful axle business. Moreover, a significant aspect of the agreement we reached with Dana is that Eaton will exclusively market the two companies' combined heavy-duty drivetrain product line through our truck marketing and services group.

The decision to sell our Appliance Controls Division to Siebe plc was also difficult. We were proud of the leadership position in the worldwide appliance controls market that we had built over the last several decades. But the unavoidable strategic conclusion was that because of the intense price competition among the principal appliance producers, further consolidation in the supplier industry was inevitable. We felt that our long-term objectives would be best served by selling our business to Siebe, a company that is well-positioned to achieve clear leadership in the appliance controls field, and reinvesting the proceeds into Eaton operations that we believe offer greater potential for long-term growth.

The sale of our defense electronics subsidiary, AIL Systems Inc., to its management and employees concluded a divestiture effort announced 10 years ago. AIL was an important contributor to Eaton during the 1980s. By 1987, however, we recognized that the defense industry would need to consolidate in the face of contracting governmental procurement. None of us foresaw the extraordinary pace of this consolidation. AIL, whose strength has always been in the quality and talent of its people, managed well in this difficult environment. As new owners of the business, the AIL team is well positioned to capitalize on future business opportunities.