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

verview

For Eaton Corporation, 1997 proved to be a watershed year. The Company reported all-time record sales, earnings and earnings per share. Favorable market conditions, the benefits of restructuring actions taken in prior years, and the extraordinary efforts of the Company's employees worldwide all contributed to these outstanding results. During 1997, the Company's businesses performed well virtually across the board and notable progress was made to build an enterprise capable of higher sustainable earnings growth in the years ahead. This performance was achieved while spending at an accelerated pace on new product development and international expansion.

To help achieve growth in future years, the Company completed a number of strategic repositioning moves. In the second half of the year, the Company completed acquisitions of Fusion Systems Corporation and Dana Corporation's worldwide Spicer Clutch business, which will build upon and extend the considerable strengths of the Semiconductor Equipment and Truck Components businesses, respectively. Also in the second half of the year, the Company sold AIL Systems Inc., which represented the Company's Defense Systems business segment, and the Appliance Controls business. On January 2, 1998, the Company completed the sale of the worldwide Axle and Brake business to Dana Corporation. Looking forward, the combination of these strategic moves is believed by management to have increased the Company's inherent earnings growth rate by about 10 percent.

In the latter part of 1997, the economic climate in Asia worsened considerably. Poor regulation and currency management skills by certain ernments in the region contributed to local currency devaluations a d bank failures. This crisis was the primary cause of the decrease in operating profit for the Company's Pacific Region. However, as of December 31, 1997, these effects were not material to operations or financial results for the Company as a whole.

1997 compared to 1996

Net Sales Worldwide sales in 1997 exceeded $7 billion for the first time in the Company's history, 9% above 1996. Sales for North America showed improvement; however, sales in Europe were flat. In Latin America, sales increased 45% in 1997 over 1996 despite economic weakness in Mexico, Brazil and Argentina. The Company is now achieving the full strategic benefits of the April 1996 acquisition of CAPCO Automotive Products Corporation, which contributed to the sales increase in Latin America. Despite the continued recession in Japan and the crisis in Asia, sales in the Pacific Region rose 7% in 1997 over 1996.

Electrical and Electronic Controls, the Company's largest business segment, continued on a growth trend by achieving record sales in 1997, increasing 4% in 1997 over 1996. This segment represents 53% of total sales. Activity in most markets remained firm, and the semiconductor equipment market began to rebound in the second half of 1997 after a difficult 1996.

Aided by continued strength in Cutler-Hammer's market position, strong construction markets, and a booming commercial aircraft market, Industrial and Commercial Controls also achieved record sales in 1997, increasing 7% over 1996 results. Cutler-Hammer is now enjoying ll benefit of the synergies anticipated from the 1994 acquisition of Westinghouse's Distribution and Control Business Unit.

Sales of the Company's Automotive and Appliance Controls businesses were off 2% from one year ago. Sales volumes were up while the strength of the U.S. dollar versus major European currencies reduced sales by 5%. Sales were lowered an additional 3% compared to 1996 as a result of the sale of the Company's Appliance Controls business on December 1, 1997 to Siebe plc. The net increase in volume compares favorably with about a 3% year-to-year increase in automotive production in North America and Europe.

Specialty Controls, which includes the Company's Semiconductor Equipment Operations, reported record sales, increasing 3% in 1997 over 1996. During the third quarter of 1997, the Company acquired Fusion Systems Corporation, a leading supplier of front-end process equipment to the semiconductor industry. Excluding Fusion, Specialty Controls sales trailed 1996 results by 2%. While second half 1997 industry orders were somewhat stronger than anticipated, it is too early to determine the impact of the Asian economic crisis on our customers' demand for front-end processing equipment.

Vehicle Components segment sales reached a record level, increasing 16% in 1997 over 1996. Truck Components, Passenger Car and Light Duty Components, and Off-Highway Vehicle Components all experienced record sales in 1997. After a difficult 1996, the 1997 success of this segment demonstrates that the Company's managers met the full challenge to achieve performance excellence.

Truck Components achieved record sales, increasing 19% in 1997 over 1996. CAPCO, the Brazilian medium-duty transmission manufacturer acquired in 1996, accounted for $54 million of the $338 million increase in sales in 1997. With CAPCO's increase in sales and the favorable impact of new business awards from automotive manufacturers, the Company is now achieving the full strategic benefits of this important acquisition. The Company's Spicer Clutch unit, which was acquired from Dana Corporation in the third quarter of 1997, also contributed $68 million in sales in 1997. Excluding Spicer Clutch, sales were also at record levels, increasing 15% above one year ago. North American factory sales of Class 8 trucks rose about 13% in 1997 to 216,000 and, based on current backlogs and the pace of orders, 1998 production is expected to rise another 5% to 10%. The European market was also up last year, though a more modest 6%, and the Company expects the pace of improvement to continue in 1998. The effects of the current austerity plan in Brazil make that market more problematic after a 30% market rise in 1997.

Passenger Car and Light Duty Components experienced record sales in 1997, rising 10% over 1996. CAPCO contributed approximately $26 million of the $74 million increase in sales in 1997. The increase in volume was ahead of the increase in automotive production in North America, Europe, and Latin America. This trend can be attributed to continued penetration of selected automotive products, and greater participation in Latin American markets.

Continuing demand from the North American hydraulics market enabled Off-Highway Vehicle Components also to report record sales in 1997, rising 15% over 1996. CAPCO contributed $20 million of the $73 million increase in sales. Higher levels of new product introductions for the Company's worldwide agricultural and construction equipment customers also contributed to the increase in sales. The Company's sales gains in 1997 were double the pace of the hydraulics industry, a result