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

Forward-Looking Statements

The Company has included in this Annual Report expectations for 1998, an outlook concerning the Asian situation, certain anticipated effects of strategic moves, market expectations, and expectations for capital spending. Actual results could differ materially from these forward-looking statements since they inherently are subject to risks and uncertainties. Important factors which could cause such a difference include: continuity of business relationships with and purchases by major customers, product mix, competitive pressure on sales and pricing, increases in material and other production costs which cannot be recouped in product pricing, costs associated with correcting the Year 2000 issue, difficulties in introducing new products as well as global economic and market conditions.

1996 Compared to 1995

Net Sales   Worldwide sales in 1996 reached nearly $7 billion for the first time in the Company's history, slightly above 1995. During 1996, the Company benefited from the diversity of its product lines as well as from its global markets as the highest sales growth occurred in international markets.

In 1996, sales for North America, which includes the United States and Canada, and Europe were flat compared to 1995. Despite the continued recession in Japan, sales in the Pacific Region rose 9% in 1996 over 1995, due in part to the acquisition of the Emwest electrical switchgear and controls business in May 1995. In Latin America, sales increased 38% in 1996 over 1995 despite economic weakness in Mexico, Brazil and Argentina. The increase in Latin America was attributable to the acquisition of CAPCO Automotive Products Corporation. On April 16, 1996, the Company purchased CAPCO, a Brazilian manufacturer of transmissions for light- and medium-duty trucks and transaxle components for passenger cars, for $135 million.

Electrical and Electronic Controls, the Company's largest segment, continued to experience growth in sales in 1996 as sales increased 7% in 1996 over 1995, which more than doubled from just three years ago. Activity in the markets served by this segment was more mixed in the second half of 1996 than earlier in the year.

Aided by continued strength in Cutler-Hammer's electrical power distribution equipment business, Industrial and Commercial Controls sales rose 6% in 1996 over 1995. New program launches in the North American automotive controls business and the acquisition of the IKU Group in May 1995 contributed to the Automotive and Appliance Controls' 8% sales increase in 1996 over 1995.

Specialty Controls sales increased 10% in 1996 over 1995 in spite of the sharp downturn in the worldwide market for semiconductor capital equipment in the second half of 1996. Sales of semiconductor equipment stabilized in the second half of 1996 at 23% below first half levels.

Vehicle Components segment sales decreased 4% in 1996 from 1995. The acquisition of CAPCO affected prior year results comparisons. Excluding the effects of CAPCO, 1996 sales for this segment were $2.88 billion, 7% below 1995.

Truck Components sales decreased 10% in 1996 from 1995. Excluding the effects of CAPCO, Truck Components sales declined 13% from the prior year's level. This reduction was primarily the result of the softening of the North American heavy-duty truck market from the record levels experienced in the prior two years.

Passenger Car and Light Duty Components experienced record sales in 1996, rising 10% over 1995, despite flat passenger car production in North America and Europe. This better-than-market performance was attributed to selected market share penetration and the continued trend towards multivalve engines. Continued demand for hydraulic components from the agricultural, construction and industrial markets enabled Off-Highway Vehicle Components to report record sales in 1996, rising 4% over 1995, despite generally flat market activity.

Operating Results   Income from operations declined 17% in 1996 from 1995. This reduction was primarily attributable to lower sales of Truck Components, offset by increased sales of Electrical and Electronic Controls, which historically have had a lower gross margin. The decrease also resulted from increased costs associated with various major growth programs designed to accelerate the Company's sustainable growth rate in the years ahead. During 1996, the Company spent $37 million more than in 1995 on these major growth programs.

Income from operations in 1996 was also markedly affected by $50 million of restructuring charges. These restructuring charges principally related to workforce reductions. Several business units took these charges in order to bring the Company's performance back to targeted levels.

Operating profit for the Electrical and Electronic Controls segment continued to be strong and improved 8% in 1996 over 1995. Restructuring charges of $16 million reduced operating profit. The improvement in operating profit was primarily attributable to improved sales volumes and added contributions from acquired businesses.

Operating profit for the Vehicle Components segment decreased 31% in 1996 from 1995. Excluding the effects of the April 1996 acquisition of CAPCO, 1996 operating profit was $302 million, a decrease of 27% from 1995. Operating results in this segment varied sharply by business unit and geographic region. Despite the disappointing results, most of the business units included in the segment demonstrated excellent performance throughout 1996. The reduction in operating profit was primarily attributable to lower sales volumes of Truck Components. The segment's operating results were below the Company's expectations given its earlier projection for a 22% downturn in the North American heavy-duty truck market in 1996 from 1995.

Vehicle Components operating profit for 1996 also was reduced by $34 million of restructuring charges, which included $15 million to continue the restructuring of the North American Axle and Brake business unit for the purpose of bringing these business units to acceptable levels of profitability. Of these restructuring charges, $19 million was recorded in the fourth quarter of 1996, principally related to the segment's Latin American and European operations.