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

Dollars in millions

We began the year 2001 experiencing the fluctuations in production runs that resulted from our original equipment (OE) customers trying to balance existing inventories and production schedules with the demands of an uncertain marketplace. Our efforts were focused on trying to scale our businesses to levels that would get us below conservative estimates for production and avoid the underabsorption of overhead that adversely affected our operating results in 2000. The second quarter provided the first signs that production schedules, while well below prior year levels, might be returning to more predictable patterns and that the efforts to downsize our operations were having a positive effect. Sales in our Automotive Systems Group rose 5% over the first quarter after falling 25% during the four previous quarters. Our automotive aftermarket business also reported measurable sales growth for the first time since the middle of 1999, and consolidated profit after tax increased substantially from the first quarter on a modest overall sales gain.

The optimism generated during the second quarter faded as we moved through the third quarter. Dealer inventory of light vehicles, especially models that are key to Dana, was increasing again despite increased incentives, and additional days were carved out of OE production schedules already reduced by seasonal closings. Hopes for a general recovery in the economy, which would have benefited the vehicular markets, were swept away in the days following September 11. The terrorist attacks resulted in immediate changes in how people and products were transported, especially movement across international borders. For a period of time, production schedules based on just-in-time deliveries were severely impacted by the delays resulting from increased security. The United States acknowledged that its economy was in a recession and consumer confidence declined amid uncertainty as to how long the weakness would last.

We faced the extraordinary challenges posed by the situation by making a number of difficult decisions that were necessary to properly align our resources with customer demand, ensure an adequate return on committed capital and preserve cash. In October, we initiated a review of more than 30 facilities for consolidation or closure, committed to reducing our work force by more than 15%, announced plans to sell the businesses of Dana Credit Corporation (DCC) and reduced our fourth quarter dividend to one cent per share. By the end of the quarter, we had announced the closure of 21 facilities and had reduced our work force by 7%. Additional closures are planned for 2002. Executing these restructuring plans continues to be our primary focus in 2002.

Liquidity and Capital Resources

Cash Flows – Operating activities in 2001 generated positive cash flow of $639, declining $345 from the prior year. The primary component of the change was earnings, as the $298 net loss in 2001 represents a $632 decrease from the net income of $334 reported in 2000. Included in the $476 of expenses related to our 2001 restructuring activities were charges of $206 related to the impairment of inventory and long-lived assets which did not require the use of cash. Our continuing focus on reducing working capital helped generate $350 during the year, including $303 from reductions in accounts receivable and inventory. This result was achieved despite the repayment of approximately $100 financed by a sale of accounts receivable at the end of 2000 and payment of $104 representing the final installment on our investment in GETRAG Cie. The latter item affected working capital through its inclusion in other accrued liabilities at the end of 2000.

Efforts to control capital spending impacted cash flows from investing activities in 2001. After reducing capital spending by 18% in 2000, we carved $237 or 36% from last year's total to finish at $425. Divestitures generated proceeds of $236 in 2001, while the acquisition of the remaining 51% interest in Danaven, a Venezuelan affiliate in which we previously held a minority position, required a $21 outlay. Net loan activity of our DCC businesses in 2001 resulted in proceeds of $112, while loan activity in 2000 required $82.

Our 2001 cash flows related to financing activities included an $888 reduction of net short-term borrowings, reflecting the application of a large portion of the proceeds from our August note placement and also cash available from the working capital reduction. Due to the reduced level of investments in new leases, DCC was able to use lease payments and proceeds from asset sales to fund $205 of the reduction in short-term debt. The new notes drove the net cash inflow of $346 related to long-term debt; however, a portion of the proceeds from those issues was used to retire medium-term notes. These debt reductions were partially offset on our balance sheet by the consolidation of approximately $90 of debt in the second quarter of 2001 in connection with our purchase of the interest in Danaven. The $140 of dividends paid in 2001 reflects a $47 reduction over 2000 as a result of reducing our quarterly dividend to one cent per share in the final quarter of 2001. Financing cash flows in 2000 included $381 expended for stock repurchases, which were discontinued in September 2000.

Managing our cash remains a high priority in 2002, especially in light of the $300 of cash outlays expected in connection with our restructuring activities. Based on the levels of production we have assumed for 2002, we are currently projecting a $100 decrease in working capital, exclusive of our restructuring activities. Within our investing activities, we have budgeted capital spending of approximately $275 in 2002 and expect to realize $300 or more in proceeds from divestitures. Annualizing the present quarterly dividend would result in related outflows of $6 versus the $140 paid in 2001. Hitting these targets should enable us to significantly reduce our outstanding debt during 2002.

Financing Activities – Until the end of 2000, we had generally relied on the issuance of commercial paper to satisfy a significant portion of our short-term financing requirements. However, the debt rating services lowered our credit ratings in the first quarter of 2001, primarily due to the significant downturn in our markets since the fourth quarter of 2000 and the impact of the downturn on our operations. Following the rating actions, the commercial paper markets ceased to be available to us and we began borrowing against our committed bank lines.

In March 2001, we established a $400 accounts receivable securitization program. The initial proceeds were used to reduce debt, including amounts outstanding under our revolving credit facilities. The amounts outstanding under the program are reflected as short-term borrowings in our consolidated financial statements. The amounts available under the program are subject to reduction based on significant adverse changes in the credit ratings of our customers, customer concentration levels or certain characteristics of the underlying accounts receivable. This program is subject to termination by the lenders in the event our credit ratings are lowered beyond a level specified in the agreement.