Overview

As anticipated, 1996 proved to be a challenging year. Sales in 1996 were slightly above 1995 while net income decreased 13% from 1995. During 1996, activity in the Company's markets around the world was much more mixed when compared to 1995. However, as the year ended, two of the Company's bellwether markets, worldwide semiconductor equipment and North American heavy-duty trucks, showed indications of stabilizing. Overall, performance in 1996 demonstrated the better balance in operating results that has been achieved between the Company's two major business segments: Electrical and Electronic Controls and Vehicle Components.

The Company was disappointed with its overall financial results, given the very good performance of the majority of operations during 1996 and the continued progress in turning around those operations that have been a drag on operating results in prior years. Persistent operating issues at a few operations have had a disproportionate effect on results during 1996. The Company has been clear about its determination to improve overall financial performance. Over the course of 1996, $50 million was invested to restructure those operations which have been lagging. The Company expects $50 million in annual mature year savings from these restructurings, with $25 million in net savings falling to the bottom line in 1997.

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 continued to benefit 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 1996 acquisition of CAPCO Automotive Products Corporation (CAPCO), which is more fully discussed under 'Acquisitions and Divestitures of Businesses' in the Financial Review.

Electrical and Electronic Controls, the Company's largest segment, continued its trend of growth in sales in 1996, rising 7% in 1996 over 1995, more than doubling from just three years ago. This segment now represents 56% of total sales. Activity in the markets served by this segment were 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. The Company continues to be encouraged by increases in the semiconductor industry's book-to-bill ratio, which are now beginning to be reflected in the equipment industry's order boards. Looking ahead, the Company currently anticipates year-to-year improvement in sales beginning in the second half of 1997.

As the leading worldwide producer of ion implanters, the Company is strategically positioned to capitalize on the technology and market trends of this very attractive but volatile industry. Despite the short-term pain, the Company has sustained a strong commitment to new product development in order to take full advantage of Eaton's leading position in this dynamic market.

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. In spite of this softening, North American heavy-duty truck backlog, which was at 70,000 units at year-end 1996, remains high by historical standards. In addition, the Company has seen a clear turn in new heavy-duty truck orders over the past four to five months. The increasing momentum provides a solid foundation for the Company's forecast that 1997 North American factory sales of heavy-duty trucks will be essentially equal to 1996's 191,000 units.

Passenger Car 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 can be attributed to selected market share penetration and the continued trend towards multivalve engines. Continuing 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. These programs are key components of a strategy to position the Company to take advantage of growth opportunities in the global marketplace. During 1996, the Company spent $37 million more