Financial Review

(IN THOUSANDS, EXCEPT PER SHARE DATA)

The following table summarizes selected financial data for continuing operations as of and for the five years ended December 31:

	1997	1996[a]	1995	1994	1993
INCOME STATEMENT DATA:					
Net sales	**$ 936,855**	$ 695,251	$ 350,238	$ 313,795	$ 310,635
Cost of sales	**714,223**	553,942	283,148	265,367	263,090
Gross margin	**222,632**	141,309	67,090	48,428	47,545
Selling, general and administrative expenses	**102,449**	79,408	41,706	37,584	44,539
Research and technology expenses	**18,383**	16,742	7,618	8,201	7,971
Business acquisition and consolidation expenses	**25,343**	42,370	—	—	—
Restructuring expenses	—	—	—	—	46,600
Operating income (loss)	**76,457**	2,789	17,766	2,643	(51,565)
Interest expense	**25,705**	21,537	8,682	11,846	8,862
Other (income) expense, net	**—**	(2,994)	(791)	(4,861)	12,780
Bankruptcy reorganization expenses	**—**	—	3,361	20,152	641
Income (loss) from continuing operations before income taxes	**50,752**	(15,754)	6,514	(24,494)	(73,848)
(Benefit) provision for income taxes	**(22,878)**	3,436	3,313	3,586	6,024
Income (loss) from continuing operations	**$ 73,630**	$ (19,190)	$ 3,201	$ (28,080)	$ (79,872)
Income (loss) per share from continuing operations					
Basic	**$ 2.00**	$ (0.58)	$ 0.21	$ (3.84)	$ (10.89)
Diluted	**1.74**	(0.58)	0.20	(3.84)	(10.89)
BALANCE SHEET DATA:					
Current assets	**$ 387,050**	$ 316,931	$ 128,055	$ 148,352	$ 134,710
Non-current assets	**424,536**	384,805	102,547	95,105	128,532
Total assets	**$ 811,586**	$ 701,736	$ 230,602	$ 243,457	$ 263,242
Current liabilities	**$ 186,356**	$ 188,812	$ 66,485	$ 171,307	$ 72,965
Long-term liabilities	**375,329**	333,595	115,743	78,035	169,524
Stockholders' equity (deficit)	**249,901**	179,329	48,374	(5,885)	20,753
Total liabilities and stockholders' equity	**$ 811,586**	$ 701,736	$ 230,602	$ 243,457	$ 263,242
OTHER DATA:					
Cash dividends per share	**—**	—	—	—	—
Shares outstanding at year-end	**36,856**	36,561	18,091	7,301	7,310

[a] A discussion of the impact of business acquisitions on 1996 selected financial data is contained in Notes 1, 2 and 3 to the accompanying consolidated financial statements.

BUSINESS OVERVIEW

(In millions, except per share data)	Year Ended December 31, 1997	1996	1995
Sales	**$ 936.9**	$ 695.3	$ 350.2
Gross margin %	**23.8%**	20.3%	19.2%
Adjusted EBITDA[(a)]	**$ 137.6**	$ 71.9	$ 29.4
Adjusted operating income %[(b)]	**10.9%**	6.5%	5.1%
Income (loss) from continuing operations	**$ 73.6**	$ (19.2)	$ 3.2
Diluted earnings (loss) per share from continuing operations	**$ 1.74**	$ (0.58)	$ 0.20
Pro forma diluted earnings per share[(c)]	**$ 1.17**	$ 0.48	$ 0.38

(a) Earnings before business acquisition and consolidation expenses, other income, interest, bankruptcy reorganization expenses, taxes, depreciation and amortization.
(b) Excludes business acquisition and consolidation expenses.
(c) Excludes business acquisition and consolidation expenses and bankruptcy reorganization expenses, and assumes a U.S. effective tax provision of 36% on pro forma basis.

As Hexcel begins its 50th year in 1998, the Company completed 1997 with record sales, operating income and net income. In just two years since the bottom of the aerospace cycle, the Company has achieved a 168% increase in sales, increased its gross margin from 19.2% to 23.8%, and improved its Adjusted EBITDA from $29.4 million to $137.6 million, or a 368% increase. The Company expects sales to exceed $1 billion in 1998 for the first time in its history.

The dramatic turnaround was a result of three major factors. First, the Company led the consolidation of the advanced structural materials industry, through the acquisitions of the Ciba and Hercules (the "Acquired Businesses") composite materials businesses in 1996; second, a significant increase in commercial aerospace build rates—which is expected to lead to record deliveries for Boeing and Airbus in 1998; and third, the Company successfully embarked on a business consolidation program to eliminate excess capacity and to integrate the Acquired Businesses. In addition, Hexcel has positioned itself for the future by strengthening its balance sheet with the issuance of equity to Ciba as part of the consideration for the Ciba composite materials business, the issuance of $114.5 million of convertible debt in 1996, and most recently through entering into an amended and restated credit agreement.

BUSINESS ACQUISITIONS AND CONSOLIDATION

Business Acquisitions

Hexcel acquired most of Ciba-Geigy Limited's ("Ciba") composite materials, parts and structures businesses on February 29, 1996, Ciba's Austrian composites business on May 30, 1996, and various remaining assets of Ciba's worldwide composites division at various dates through February 28, 1997. The aggregate purchase price for the net assets acquired were approximately $208.7 million.

Hexcel acquired the assets of the composite products and carbon fibers businesses of Hercules Incorporated ("Hercules") on June 27, 1996 for $139.4 million in cash.

On September 30, 1997, Hexcel acquired from Fiberite, Inc. ("Fiberite") its satellite business consisting of intangible assets and inventory, and certain non-exclusive, worldwide rights to other prepreg technologies, for $37.0 million in cash. The acquisition was substantially downsized from an original agreement whereby the Company had, subject to certain terms and conditions, committed to purchase selected assets and businesses of Fiberite for approximately $300 million. As a result of the downsized transaction, the Company wrote-off $5.0 million of acquisition and financing costs to business acquisition and consolidation expenses. In addition, the Company expensed $8.0 million of acquired in process research and technology expenses purchased from Fiberite, which was also included in business acquisition and consolidation expenses.

Hexcel will pursue the continued expansion of its revenues and profitability through internally generated growth of existing product lines and by selective, strategic acquisitions or other business combinations. Recognizing the Company's significant market position in commercial aerospace, the growth potential of existing product lines in this market is primarily limited by commercial aircraft build rates and the penetration of advanced structural materials being limited to the development of new generations of aircraft. Hexcel therefore anticipates seeking growth through existing, developed and acquired product lines in space and defense, recreation, electrical, surface transportation, civil engineering/construction and other industrial markets. One of the Company's objectives is to increase sales to these markets from the 36% of total revenues reported in 1997 to more than 50% over time. Hexcel also expects to pursue financing opportunities that would, among other things, provide support for these objectives. There can be no assurance that growth can be accomplished in this manner, or that appropriate acquisitions or financing can be successfully consummated.

Further discussion of the business acquisitions is contained in Notes 1, 2 and 3 to the accompanying consolidated financial statements.

Business Consolidation

In May of 1996, Hexcel announced the commencement of a plan to consolidate the Company's operations over a period of three years. In December of 1996, the Company announced the commencement of further consolidation activities identified during the ongoing integration of the Acquired Businesses. The total expense of the business consolidation program through December 31, 1997 was $54.7 million, including $12.3 million and $42.4 million of expenses incurred in 1997 and 1996, respectively. Total expenses exclude $13.0 million of business acquisition and consolidation expenses relating to the Fiberite transaction, which was not included in the original program. The Company does not expect to incur any further significant additional expenses in relation to the business consolidation program. As of December 31, 1997, remaining cash expenditures to complete this program are estimated at $12 million, which approximates amounts accrued. Thus, when the program is complete, the Company expects that cash expenditures (for expenses and capital, net of estimated proceeds from asset sales) necessary to complete the program will approximate the initial estimate of $51 million.

The objective of the business consolidation program is to integrate acquired assets and operations into Hexcel, and to reorganize the Company's manufacturing and research activities around strategic centers dedicated to select product technologies. The business consolidation is also intended to eliminate excess manufacturing capacity and redundant administrative functions. Specific actions of the consolidation program included the closure of the Anaheim, California facility acquired in connection with the purchase of the Acquired Ciba Business, the reorganization of the Company's manufacturing operations in Europe, the consolidation of the Company's U.S. special process manufacturing activities, and the integration of sales, marketing and administrative resources.

As of December 31, 1997, the primary remaining activities of the business consolidation program relate to the European operations and the installation and customer qualifications of equipment transferred from the Anaheim facility to other U.S. locations. These qualification requirements increase the complexity, cost and time of moving equipment and rationalizing manufacturing activities. As a result, the Company continues to expect that the business consolidation program will take to the end of 1998 to complete.

After closing the Anaheim facility on schedule in the third quarter of 1997, the Company completed the sale of the facility on October 30, 1997. Net cash proceeds from the sale were approximately $8.5 million, which approximated book value.

The Company initially estimated that the business consolidation program would result in annual cost reductions of $32 million per year, beginning in 1999. By the nature of the program (i.e., consolidation of existing and Acquired Businesses, while at the same time the Company is experiencing an increase in its commercial aerospace market), the exact amount of annual savings is difficult to isolate. However, the Company continues to believe that cost savings have been achieved and, upon completion of the program, estimated cost savings will equal or exceed the target of $32 million per year. The program was a key contributor to the Company's improvement in operating margins in 1997.

Further discussion of the business consolidation program is contained in Note 3 to the accompanying consolidated financial statements.

RESULTS OF OPERATIONS

1997 Compared to 1996

Net Sales: Net sales for 1997 were $936.9 million, compared with net sales for 1996 of $695.3 million. On a pro forma basis, including full year results of the Acquired Businesses, 1996 sales were approximately $798.5 million. The 17.4% increase from pro forma 1996 sales was largely attributable to improved sales of composite materials to commercial aerospace customers and sales of engineered products to Boeing, but was partially offset by the translation effect of the strengthening U.S. dollar. On a constant currency basis, 1997 sales would have been approximately $38.0 million higher in 1997, reflecting a 22.2% increase over 1996 pro forma sales.

Approximately 46% of Hexcel's 1997 sales were to Boeing, Airbus, and related subcontractors, as compared to 32% in 1996. The increase is primarily due to the growth of the commercial aerospace market and to a much lesser extent Boeing's acquisition of McDonnell Douglas Corporation, which was completed on August 1, 1997. Reported commercial aircraft deliveries by Boeing (the 7-series) and Airbus improved significantly in 1997, from a combined 344 aircraft in 1996 to 503 aircraft in 1997, including 321 of the Boeing 7-series and 182 deliveries by Airbus. Depending on the product, orders placed with Hexcel are received anywhere between one and eighteen months prior to delivery of the aircraft to the customer. The Company sells material on every model of commercial aircraft sold by Boeing and Airbus, with sales per aircraft ranging from $0.2 million to over $1.0 million per aircraft on the Boeing 777.

The backlog of orders scheduled to be delivered in the next twelve months was $520 million as of December 31, 1997, a 29% increase over backlog as of December 31, 1996. In January 1998, Boeing reported that its current planned production rate for 7-series aircraft is 40 aircraft per month, with plans to increase this production rate to 43 aircraft per month in the second quarter of 1998. Airbus reported production output of 16.5 aircraft per month in 1997, and they expect to increase this rate to 24 per month by the end of 1998. Total estimated Airbus production for 1998 is expected to be 30% greater than that of 1997. Recent announcements regarding delays or cancellations of aircraft orders from certain Asian airlines have not had an observable impact on Hexcel's sales or backlog to date. The Company has, however, recently experienced a minor decline in sales of other materials to the Pacific Rim. Also, should aircraft orders be delayed or cancelled by the economic situation in Asia, and other buyers for these orders can not be found, then the Company's sales and earnings would be negatively impacted.

Hexcel believes that the availability of certain carbon fibers, an important raw material in manufacturing advanced structural materials, is currently insufficient to satisfy worldwide demand. The Company estimates it has production capacity and sufficient supplier commitments to purchase carbon fiber to meet its estimated 1998 and 1999 aerospace customer requirements. In early 1997, carbon fiber manufacturers, including the Company, announced plans to increase carbon fiber production capacity. During 1997, the Company substantially completed a carbon fiber capacity expansion program costing approximately $16 million, which has increased its capacity by 50%. However, should customer demand grow faster than expected or the mix or timing of customer requirements change, the Company may not be able to satisfy all of its customers' requirements.

Net sales to third-party customers by product group and market segment for 1997 and on a pro forma basis for 1996, which includes full year results of the Acquired Businesses, were as follows:

(In millions)	Fibers and Fabrics	Composite Materials	Engineered Products	Total	
1997 Net Sales					
Commercial aerospace	$ 23.7	$ 403.9	$ 169.8	$ 597.4	64%
Space and defense	13.9	64.2	10.2	88.3	9
Recreation	13.0	53.4	—	66.4	7
General industrial and other	119.5	63.9	1.4	184.8	20
Total	$ 170.1	$ 585.4	$ 181.4	$ 936.9	100%
1996 Pro Forma Net Sales					
Commercial aerospace	$ 17.4	$ 317.1	$ 102.5	$ 437.0	55%
Space and defense	20.2	60.8	10.4	91.4	11
Recreation	27.4	63.3	—	90.7	11
General industrial and other	116.8	60.8	1.8	179.4	23
Total	$ 181.8	$ 502.0	$ 114.7	$ 798.5	100%

The 36.7% growth in net sales to the commercial aerospace market from 1996 to 1997 was largely attributable to increased sales of composite materials and engineered products. The improvement in sales of composite materials reflects the commercial aircraft build rate increase noted above. The improvement for engineered products primarily reflects the production of structural and interior components outsourced to Hexcel by Boeing throughout 1997, as well as strong shipments of retrofit interiors to airline customers.

Space and defense net sales decreased 3.4% from 1996 to 1997, reflecting a decrease in sales of fibers and fabrics, which were partially offset by improved sales of composite materials to select military programs. The Company believes that military aircraft procurement, in both the U.S. and Europe, is likely to increase significantly from current levels over the next five years. The Company has composite material and carbon fiber qualifications on a number of significant military programs, including the European Fighter Aircraft, F-22, F-18, V-22, C-17 and the Titan and Delta space programs.

Recreation net sales also decreased from 1996 to 1997, reflecting the shift in emphasis of production to the commercial aerospace market as a result of the increased demand. The 3.0% increase in general industrial and other net sales was largely due to improved sales of fabrics for printed circuit boards and composite materials for various transportation applications. Hexcel anticipates sales to the recreation and general industrial and other markets to grow modestly throughout 1998.

Gross Margin: Gross margin for 1997 was $222.6 million, or 23.8% of net sales, compared with $141.3 million, or 20.3% of net sales, for 1996. The improvement in 1997 gross margin relative to 1996 is the result of higher sales volume, expansion of the Company's fibers capacity and continued advances in manufacturing productivity resulting from the Company's consolidation and restructuring activities. Product price changes were not a significant factor in the 1997 gross margin improvement.

The integration of the Acquired Businesses into Hexcel, including the consolidation and rationalization of manufacturing facilities and processes, is a primary objective of the business consolidation program. While the Company has begun to realize the productivity improvements as a result of the program, these improvements will not be fully realized until 1999.

Selling, General and Administrative ("SG&A") Expenses: SG&A expenses were $102.4 million in 1997, or 10.9% of net sales. This compares to $79.4 million, or 11.4% of net sales for 1996. The aggregate dollar increase in SG&A is primarily attributable to the Acquired Businesses.

Research and Technology (R&T) Expenses: R&T expenses were $18.4 million in 1997, or 2.0% of net sales. This compares to $16.7 million, or 2.4% of net sales for 1996. The aggregate dollar increase in R&T is attributable to the additional activity from the Acquired Businesses. The Company expects to continue to increase R&T expenditures in 1998.

Operating Income: Operating income increased from $2.8 million, or 0.4% of net sales, in 1996 to $76.5 million, or 8.2% of net sales, in 1997. The aggregate increase in operating income reflects the higher sales volume, improved gross margins and a $17.0 million decrease in business acquisition and consolidation expenses. Excluding business acquisition and consolidation expenses, operating income as a percentage of sales increased from 6.5% in 1996 to 10.9% in 1997.

Interest Expense: Interest expense was $25.7 million, or 2.7% of net sales, for 1997 compared to $21.5 million, or 3.1% of net sales, for 1996. The increase in interest expense primarily represents the cost of financing the acquisitions of the Acquired Businesses. The 1996 amount also includes a $3.4 million write-off of capitalized debt issuance costs.

Provision for Income Taxes: In accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"), in 1996 and 1995 the Company had fully provided valuation allowance reserves against its net deferred tax assets primarily in the U.S. and Belgium where there were uncertainties in generating sufficient future taxable income. In 1997, the Company reversed $59.9 million of its valuation allowance reserve as follows: $17.0 million due to current year profitable U.S. operations, $39.0 million due to the Company's assessment that the realization of the remaining U.S. net deferred tax assets is more likely than not, and $3.9 million in Belgium due to a gain on sale of tangible and intangible assets to other Hexcel subsidiaries. The Company continues to reserve the balance of the net deferred tax assets of its Belgium operations. Going forward, the Company expects that its effective U.S. income tax rate will approximate the statutory rate.

Net Income (Loss): Net income for 1997 was $73.6 million or $1.74 per diluted share compared with a net loss of $19.2 million or $0.58 per diluted share for 1996. Excluding the $25.3 million in business acquisition and consolidation expenses and assuming a U.S. effective income tax rate of 36%, 1997 pro forma net income would have been $1.17 per share on a diluted basis. Pro forma net income for 1996 would have been $0.48 per diluted share on a comparable basis.

There were 36.7 million weighted average shares outstanding in 1997 compared to 33.4 million during 1996. The increase in the number of weighted average shares in 1997 is primarily attributable to the full year impact of the delivery of 18.0 million newly issued shares of Hexcel common stock to Ciba on February 29, 1996 in connection with the purchase of the Acquired Ciba Business. As of December 31, 1997, there were 36.9 million shares of Hexcel common stock issued and outstanding. See Note 15 to the accompanying consolidated financial statements for the calculation and the number of shares used for diluted earnings per share.

1996 Compared to 1995

Net Sales: Net sales for 1996 were $695.3 million, compared with net sales for 1995 of $350.2 million. The results for 1996 include the results of the Acquired Ciba Business and the Acquired Hercules Business for the periods from the respective acquisition dates through December 31, 1996. Excluding the results of the Acquired Businesses, 1996 sales were approximately $385 million, a 10% increase over 1995. This increase was largely attributable to improved sales of composite materials to commercial aerospace customers, and reflected the initial impact of increases in production rates for certain aircraft as well as the increased utilization of composite materials on new generation aircraft. In particular, the Company benefited from higher sales of carbon honeycomb core and carbon-based prepregs. The Company also benefited from improved sales of fabricated honeycomb parts to the commercial aerospace market, and from increased sales of fabrics for use in the manufacture of printed circuit boards. Changes in foreign currency exchange rates did not have a material impact on the level of 1996 sales relative to 1995 sales.

Approximately 32% of Hexcel's 1996 sales were to Boeing, Airbus, and related subcontractors. Reported commercial aircraft deliveries of Boeing 7-series and Airbus improved only modestly in 1996, from a combined 330 aircraft in 1995 to 344 aircraft in 1996. However, the 1996 sales benefited from the increase in scheduled deliveries for 1997 as orders placed with Hexcel are received anywhere between one and eighteen months prior to delivery of the aircraft to the customer.

Pro Forma Net Sales: Pro forma net sales for 1996, giving effect to the acquisitions of the Acquired Businesses as if those transactions had occurred at the beginning of the year, were $798.5 million. This compares with pro forma net sales for 1995 of $771.3 million. Pro forma net sales to third-party customers by product group and market segment for 1996 and 1995 were as follows:

(In millions)	Fibers and Fabrics	Composite Materials	Engineered Products	Total	
1996 Pro Forma Net Sales					
Commercial aerospace	$ 17.4	$ 317.1	$ 102.5	$ 437.0	55%
Space and defense	20.2	60.8	10.4	91.4	11
Recreation	27.4	63.3	—	90.7	11
General industrial and other	116.8	60.8	1.8	179.4	23
Total	$ 181.8	$ 502.0	$ 114.7	$ 798.5	100%
1995 Pro Forma Net Sales					
Commercial aerospace	$ 14.8	$ 294.7	$ 94.9	$ 404.4	52%
Space and defense	25.3	49.0	15.8	90.1	12
Recreation	31.3	74.3	—	105.6	14
General industrial and other	123.0	45.4	2.8	171.2	22
Total	$ 194.4	$ 463.4	$ 113.5	$ 771.3	100%

The growth in pro forma sales to the commercial aerospace market from 1995 to 1996 was largely attributable to increased sales of composite materials and commercial aerospace engineered products. The improvement in sales of composite materials reflects the commercial aircraft build rate and product utilization increases noted above. The improvement for engineered products primarily reflects the production of structural and interior components outsourced to Hexcel by Boeing during the second half of 1996, as well as strong shipments of retrofit interiors to airline customers.

Pro forma space and defense sales were essentially unchanged from 1995 to 1996, reflecting a decline in sales of fibers and fabrics and engineered structures, offset by improved sales of composite materials to select military programs.

The decrease in pro forma sales to the recreation market during 1996 is primarily attributable to reduced demand for composite materials by ski and snowboard manufacturers due to excess inventories. Pro forma sales of fabrics for certain marine applications were also slightly lower. The increase in pro forma general industrial sales reflects improved sales of fabrics for printed circuit boards and composite materials for various transportation applications, partially offset by reduced sales of carbon fibers to non-aerospace customers.

Gross Margin: Gross margin for 1996 was $141.3 million, or 20.3% of sales, compared with $67.1 million for 1995, or 19.2% of sales. Excluding the Acquired Businesses, 1996 gross margin was approximately 24% of sales. The improvement in 1996 gross margin relative to 1995, excluding the impact of the Acquired Businesses, is the result of both higher sales volumes and improved manufacturing productivity, especially for composite materials. Hexcel also benefited from the cost reductions associated with the completion, in mid-1995, of a previous restructuring of the Company's composite materials business. Product price changes were not a significant factor in the 1996 gross margin improvement.

The aggregate gross margin of the Acquired Businesses from the respective acquisition dates through December 31, 1996, was approximately 16% of sales. The integration of the Acquired Businesses into Hexcel, including the consolidation and rationalization of manufacturing facilities and processes, is a primary objective of the business consolidation program. Although the consolidation program commenced in 1996, the productivity improvements expected to result from this program will not be fully realized until 1999.

Selling, General and Administrative ("SG&A") Expenses: SG&A expenses were $79.4 million in 1996, or 11.4% of sales. This compares with 1995 SG&A expenses of $41.7 million, or 11.9% of sales. The aggregate dollar increase in SG&A expenses from 1995 to 1996 is attributable to the acquisitions of the Acquired Businesses. The slight decrease in SG&A expenses as a percentage of sales primarily reflects higher sales levels.

Research and Technology (R&T) Expenses: R&T expenses were $16.7 million in 1996, or 2.4% of net sales. This compares to $7.6 million, or 2.2% of net sales for 1995. The aggregate dollar increase in R&T is attributable to the acquisitions of the Acquired Businesses.

Operating Income: Operating income was $2.8 million in 1996, or 0.4% of sales, compared with $17.8 million in 1995, or 5.1% of sales. The $74.2 million increase in gross margin from 1995 to 1996 was more than offset by $37.7 million in additional SG&A expenses and $42.4 million in business acquisition and consolidation expenses.

Interest Expense: Interest expense totaled $21.5 million in 1996 and $8.7 million in 1995. The year-on-year increase primarily reflects the cost of financing the acquisitions of the Acquired Businesses. Hexcel financed approximately $200 million of aggregate purchase price with various debt and credit facilities, and wrote off $3.4 million of capitalized debt financing costs in connection with the acquisition-related refinancing of certain debt in 1996.

Provision for Income Taxes: Income tax provisions of $3.4 million in 1996 and $3.3 million in 1995 primarily reflect international taxes on certain European subsidiaries, state taxes, and the settlement of various tax audits. The 1996 income tax provision is net of a $2.5 million benefit from the favorable resolution of a U.S. federal tax audit. As of December 31, 1996, Hexcel had net operating loss ("NOL") carryforwards for U.S. federal income tax purposes of approximately $70 million and NOL carryforwards for Belgium income tax purposes of approximately $22 million. For the years ended December 31, 1996 and 1995, the Company has not recognized any tax benefits in 1996 or 1995 attributable to the potential future realization of these NOL carryforwards or any other deferred tax assets.

Net Income (Loss): The 1996 net loss was $19.2 million, or $0.58 per diluted share, compared with net income for 1995 of $2.7 million, or $0.17 per diluted share. The 1996 net loss includes business acquisition and consolidation expenses of $42.4 million, or $1.16 per share after income taxes. Net income for 1995 is after bankruptcy reorganization expenses of $3.4 million, or $0.21 per share.

There were 33.4 million weighted average shares outstanding during 1996, versus 15.6 million during 1995. The increase in the number of weighted average shares in 1996 is primarily attributable to the delivery of 18.0 million newly issued shares of Hexcel common stock to Ciba on February 29, 1996, in connection with the purchase of the Acquired Ciba Business. As of December 31, 1996, there were 36.6 million shares of Hexcel common stock issued and outstanding.

FINANCIAL CONDITION AND LIQUIDITY

Financial Resources

The Company had a Revolving Credit Facility, which provided up to $254.6 million of borrowing capacity. As of December 31, 1997, outstanding borrowings and letter of credit commitments under the Revolving Credit Facility totaled $158.3 million. The Revolving Credit Facility was scheduled to expire in February of 1999.

On March 5, 1998, the Company amended and restated the Revolving Credit Facility (the "Amended Facility"). The Amended Facility provides for borrowing capacity of up to $355 million and extends the expiration date by four years to March 2003. While the Company continues to be subject to various financial covenants and restrictions and is generally prohibited from paying dividends or redeeming capital stock, the Amended Facility provides $100 million in increased borrowing capacity and more flexibility as to the use of the borrowings than the Company's prior facility.

The Company expects that the financial resources of Hexcel, including the Amended Facility, will be sufficient to fund the Company's worldwide operations for the foreseeable future. Further discussion of the Company's financial resources is contained in Note 7 to the accompanying consolidated financial statements.

Adjusted EBITDA and Cash Flows

1997: Earnings before business acquisition and consolidation expenses, other income, interest, bankruptcy reorganization expenses, taxes, depreciation and amortization ("Adjusted EBITDA") was $137.6 million. Net cash provided from operations was $26.0 million including $33.6 million of business acquisition and consolidation payments and a $47.7 million increase in working capital as a result of the increase in sales volume.

Net cash used for investing activities was $82.9 million, including $57.4 for capital expenditures and $37.0 million for the Fiberite transaction, partially offset by $13.5 million of proceeds from the sale of the Anaheim facility and the Company's 50% interest in the Knytex joint venture to Owens Corning. These investing activities were funded by cash from operations and $57.2 million of borrowings primarily under the Revolving Credit Facility.

1996: Adjusted EBITDA was $71.9 million. Pro forma Adjusted EBITDA, giving effect to the acquisitions of the Acquired Businesses as if those transactions had occurred at the beginning of the year, was approximately $86 million.

Net cash provided by operating activities was $26.5 million. Net cash used for investing activities was $206.4 million, including $164.4 million used in connection with the acquisitions of the Acquired Businesses and $43.6 million for capital expenditures. Net cash provided by financing activities, including borrowings under the Revolving Credit Facility and proceeds from the issuance of $114.5 million in convertible subordinated notes, was $181.7 million. Non-cash financing of the purchase of the Acquired Ciba Business included the issuance of debt securities valued at $37.2 million and the issuance of 18.0 million shares of Hexcel common stock valued at $144.2 million.

1995: Adjusted EBITDA was $29.4 million, and pro forma Adjusted EBITDA was approximately $62 million. Net cash used by operating activities was $2.5 million. Net cash provided by investing activities was $15.7 million, primarily reflecting $31.9 million in cash proceeds from the sale of various assets and $12.1 million of capital expenditures. Net cash used by financing activities of $9.6 million includes proceeds from short-term debt and the issuance of Hexcel common stock, as well as the repayment of allowed claims in connection with Hexcel Corporation's emergence from bankruptcy reorganization proceedings.

Adjusted EBITDA and pro forma Adjusted EBITDA have been presented to provide a measure of Hexcel's operating performance that is commonly used by investors and financial analysts to analyze and compare companies. Adjusted EBITDA and pro forma Adjusted EBITDA do not represent alternative measures of the Company's cash flows or operating income, and should not be considered in isolation or as substitutes for measures of performance presented in accordance with generally accepted accounting principles.

Capital Expenditures

Capital expenditures were $57.4 million in 1997 compared with $43.6 million in 1996 and $12.1 million in 1995. The increase in 1997 expenditures over prior years reflects the impact of the Acquired Businesses on capital requirements, including the impact of certain business consolidation activities. The increase also reflects expenditures on manufacturing equipment necessary to improve manufacturing processes and to expand production capacity for select product lines that are in high demand, such as the Company's carbon fiber capacity expansion. A modest increase in capital spending is expected in 1998 as a result of ongoing opportunities for additional manufacturing improvements. Such expenditures will be financed with cash generated from operations and borrowings under the Amended Facility.

YEAR 2000

The Company is continuing to monitor as well as implement its plan to resolve the Year 2000 issue in both existing software and other systems with embedded microprocessors. The Year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's programs that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a major system failure or miscalculations.

The Company presently believes that, with modifications to existing software and other systems with embedded microprocessors, and conversion to new software and other systems, the Year 2000 issue will not pose significant operational problems for the Company's computer and other systems as so modified and converted. However, if such modifications and conversions are not completed in a timely manner, or the Company's customers and suppliers do not successfully address their Year 2000 issues, the Year 2000 issue may have a material impact on the operations of the Company. The Company continues to evaluate appropriate courses of corrective action, including replacement of certain systems whose associated costs would be recorded as assets and amortized. The Company does not expect amounts required to be expensed for Year 2000 issues over the next two years to have a material effect on its financial position or results of operations. The amount expensed in 1997 was immaterial.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 1997, the Financial Accounting Standards Board issued Statement No. 130, "Reporting Comprehensive Income" ("SFAS 130"). Hexcel is required to adopt SFAS 130 in the first quarter of 1998. SFAS 130 establishes standards for reporting comprehensive income and its components in a full set of general purpose financial statements. Management does not anticipate that the adoption of SFAS 130 will have a significant impact on the consolidated financial statements.

In June 1997, the Financial Accounting Standards Board also issued Statement No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS 131"). Hexcel is required to adopt SFAS 131 in its annual consolidated financial statements covering the year ending December 31, 1998. SFAS 131 establishes standards for the way business enterprises report information about operating segments in annual financial statements. Beginning in 1999, the Company will also be required to report selected information about operating segments in its interim financial reports to stockholders. The Company has not yet determined the impact, if any, that the adoption of SFAS 131 will have on the consolidated financial statements.

FORWARD-LOOKING STATEMENTS AND RISK FACTORS

Certain statements contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations," elsewhere in this document, the Company's annual report or other communications (including press releases and analysts calls) that are not of historical fact, constitute "forward-looking statements" regarding events and trends which effect the Company's future operating results and financial position. Such forward-looking statements include, but are not limited to: (a) revenue and profitability growth objectives, including increasing sales to non-commercial aerospace markets as well as the execution of strategic acquisitions or other business combinations; (b) estimates of commercial aircraft orders and deliveries; (c) estimates of government defense procurement budgets and military and space build rates; (d) expectations regarding sales growth, sales mix, gross margins, manufacturing productivity, selling, general and administrative and R&T expenses, and capital expenditures; (e) the availability and utilization of NOL carryforwards for income tax purposes; (f) expectations regarding Hexcel's financial condition and liquidity, as well as future cash flows; (g) expectations regarding capital expenditures; (h) the estimated total cost of the Company's business consolidation program, the estimated amount of cash expenditure to complete the program and the estimated annual cost savings resulting from the consolidation program; and (i) the Year 2000 issue. The words "believes", "estimates", "anticipate", "expect", intend" and "project", as well as other words or expressions of similar meaning, are intended to identify forward-looking statements. Such statements are based on current expectations, are inherently uncertain, and are subject to changing assumptions.

Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of Hexcel, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, but are not limited to, the following: ability to identify and successfully consummate acquisitions and secure related financing; general economic and business conditions; changes in political, social and economic conditions and local regulations, particularly in Asia and Europe; foreign currency fluctuations; level of profitability by country; changes in, or failure to comply with, government regulations; demographic changes; changes in customer preferences; changes in build rates; the loss of any significant customers, particularly Boeing or Airbus; changes in sales mix; changes in government defense procurement budgets; changes in current pricing levels; technology; industry capacity; competition; changes in business strategy or development plans; availability of carbon fiber; disruptions of established supply channels; manufacturing capacity constraints; indebtedness of the Company; and the availability, terms and deployment of capital.

Because of the foregoing factors, in addition to other factors that affect the Company's operating results and financial position, past financial performance or the Company's expectations should not be considered to be a reliable indicator of future performance. Investors should not use historical trends to anticipate results or trends in future periods. Further, the Company's stock price is subject to volatility. Any of the factors discussed above could have an adverse impact on the Company's stock price. In addition, failure of sales or income in any quarter to meet the investment community's expectations, as well as broader market trends, can have an adverse impact on the Company's stock price.

The Company does not undertake an obligation to update its forward-looking statements or risk factors to reflect future events or circumstances.

Hexcel management has prepared and is responsible for the consolidated financial statements and the related financial data contained in this report. These financial statements, which include estimates, were prepared in accordance with generally accepted accounting principles. Management uses its best judgment to ensure that such statements reflect fairly the consolidated financial position, results of operations and cash flows of the Company.

Hexcel maintains accounting and other control systems, which management believes provide reasonable assurance that financial records are reliable for purposes of preparing financial statements and that assets are safeguarded and accounted for properly. Underlying this concept of reasonable assurance is the premise that the cost of control should not exceed benefits derived from control.

The Audit Committee of the Board of Directors reviews and monitors the financial reports and accounting practices of Hexcel. These reports and practices are reviewed regularly by management and by the Company's independent accountants, Price Waterhouse LLP, in connection with the audit of the Company's financial statements. The Audit Committee, composed solely of outside directors, meets periodically, separately and jointly, with management and the independent accountants.

JOHN J. LEE
Chief Executive Officer

STEPHEN C. FORSYTH
Chief Financial Officer

WAYNE C. PENSKY
Chief Accounting Officer

To the Board of Directors and Stockholders of Hexcel Corporation:

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations, of stockholders’ equity and of cash flows present fairly, in all material respects, the financial position of Hexcel Corporation and its subsidiaries at December 3l, 1997, and the results of their operations and their cash flows for the year in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company’s management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for the opinion expressed above. The financial statements of Hexcel Corporation for the years ended December 31, 1996 and 1995 were audited by other independent accountants whose report dated February 28, 1997 expressed an unqualified opinion on those statements.

Price Waterhouse LLP

PRICE WATERHOUSE LLP
San Jose, California
January 28, 1998, except as to
Aggregate Maturities of Notes
Payable in Note 7, which is
as of March 5, 1998

Consolidated Balance Sheets

(IN THOUSANDS)

	December 31, 1997	December 31, 1996
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,033	$ 7,975
Accounts receivable	181,192	151,263
Inventories	165,321	145,884
Prepaid expenses and other assets	6,665	11,809
Deferred tax asset	24,839	—
Total current assets	387,050	316,931
Property, plant and equipment	488,916	468,173
Less accumulated depreciation	(157,439)	(141,390)
Net property, plant and equipment	331,477	326,783
Intangibles and other assets	93,059	58,022
Total assets	$ 811,586	$ 701,736
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term liabilities	$ 13,858	$ 23,835
Accounts payable	70,011	73,117
Accrued compensation and benefits	37,306	30,969
Other accrued liabilities	65,181	60,891
Total current liabilities	186,356	188,812
Long-term notes payable and capital lease obligations	304,546	254,919
Indebtedness to related parties	34,967	32,262
Other non-current liabilities	35,816	46,414
Stockholders' equity:		
Preferred stock, no par value, 20,000 shares authorized, no shares issued or outstanding in 1997 and 1996	—	—
Common stock, $0.01 par value, 100,000 shares authorized, shares issued and outstanding of 36,856 in 1997 and 36,561 in 1996	369	366
Additional paid-in capital	266,177	259,592
Accumulated deficit	(15,541)	(89,171)
Cumulative currency translation adjustment	(1,104)	8,542
Total stockholders' equity	249,901	179,329
Total liabilities and stockholders' equity	$ 811,586	$ 701,736

The accompanying notes are an integral part of these consolidated financial statements.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	1997	1996	1995
Net sales	$ 936,855	$ 695,251	$ 350,238
Cost of sales	714,223	553,942	283,148
Gross margin	222,632	141,309	67,090
Selling, general and administrative expenses	102,449	79,408	41,706
Research and technology expenses	18,383	16,742	7,618
Business acquisition and consolidation expenses	25,343	42,370	—
Operating income	76,457	2,789	17,766
Interest expense	25,705	21,537	8,682
Other income, net	—	(2,994)	(791)
Bankruptcy reorganization expenses	—	—	3,361
Income (loss) from continuing operations before income taxes	50,752	(15,754)	6,514
(Benefit) provision for income taxes	(22,878)	3,436	3,313
Income (loss) from continuing operations	73,630	(19,190)	3,201
Discontinued operations:			
Losses during phase-out period	—	—	468
Net Income (loss)	$ 73,630	$ (19,190)	$ 2,733
Net income (loss) per share:			
Basic			
Continuing operations	$ 2.00	$ (0.58)	$ 0.21
Discontinued operations	—	—	(0.03)
Net income (loss)	$ 2.00	$ (0.58)	$ 0.18
Diluted			
Continuing operations	$ 1.74	$ (0.58)	$ 0.20
Discontinued operations	—	—	(0.03)
Net income (loss)	$ 1.74	$ (0.58)	$ 0.17
Weighted average shares:			
Basic	36,748	33,351	15,605
Diluted	45,997	33,351	15,742

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Stockholders' Equity

(IN THOUSANDS)

	Common Stock Outstanding Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Minimum Pension Obligation Adjustment	Cumulative Currency Translation Adjustment	Total Stockholders' Equity
Balance, January 1, 1995	7,301	$ 73	$ 62,626	$ (72,714)	$ (137)	$ 4,267	$ (5,885)
Net income				2,733			2,733
Sale of new common stock under standby purchase commitment and subscription rights offering	10,800	108	48,631				48,739
Activity under stock plans	(10)		2				2
Pension obligation adjustment					(398)		(398)
Currency translation adjustment						3,183	3,183
Balance, December 31, 1995	18,091	181	111,259	(69,981)	(535)	7,450	48,374
Net loss				(19,190)			(19,190)
Issuance of shares to Ciba, net of issuance costs of $2,993	18,022	180	141,001				141,181
Activity under stock plans	408	4	7,133				7,137
Other issuance of shares	40	1	199				200
Pension obligation adjustment					535		535
Currency translation adjustment						1,092	1,092
Balance, December 31, 1996	**36,561**	**366**	**259,592**	**(89,171)**	**—**	**8,542**	**179,329**
Net income				**73,630**			**73,630**
Activity under stock plans	**292**	**3**	**6,535**				**6,538**
Conversion of Subordinated Notes	**3**		**50**				**50**
Currency translation adjustment						**(9,646)**	**(9,646)**
Balance, December 31, 1997	**36,856**	**$ 369**	**$ 266,177**	**$ (15,541)**	**$ —**	**$ (1,104)**	**$ 249,901**

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

(IN THOUSANDS)

	1997	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES			
Income (loss) from continuing operations	$ 73,630	$ (19,190)	$ 3,201
Reconciliation to net cash provided (used) by continuing operations:			
Depreciation and amortization	35,797	26,730	11,623
Deferred income taxes	(33,203)	(520)	(329)
Write-off of purchased in-process technologies	8,000	—	—
Accrued business acquisition and consolidation expenses	25,343	42,370	—
Business acquisition and consolidation payments	(33,595)	(11,579)	—
Other income	—	(1,560)	(600)
Changes in assets and liabilities, net of effects of acquisitions:			
Increase in accounts receivable	(37,557)	(14,695)	(1,752)
Increase in inventories	(23,797)	(5,072)	(8,111)
Decrease (increase) in prepaid expenses and other assets	1,667	(1,430)	718
Increase (decrease) in accounts payable and accrued liabilities	23,567	15,549	(10,090)
Changes in other non-current assets and long-term liabilities	(13,878)	(4,096)	2,346
Net cash provided (used) by continuing operations	25,974	26,507	(2,994)
Net cash provided by discontinued operations	—	—	486
Net cash provided (used) by operating activities	25,974	26,507	(2,508)
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(57,369)	(43,569)	(12,144)
Cash paid for business acquisitions	(37,000)	(164,400)	(4,150)
Proceeds from sale of certain manufacturing facilities and an interest in a joint venture	13,500	1,560	27,294
Proceeds from sale of discontinued resins business	—	—	4,648
Other	(2,000)	—	17
Net cash (used) provided by investing activities	(82,869)	(206,409)	15,665
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issuance of long-term debt	3,199	286,974	4,317
Repayments of long-term debt	(9,679)	(124,288)	(5,402)
Proceeds from the revolving credit facility and short-term debt, net	57,186	15,319	20,923
Proceeds from issuance of common stock	6,538	3,702	48,741
Payments of allowed claims pursuant to the Reorganization Plan	—	—	(78,144)
Net cash provided (used) by financing activities	57,244	181,707	(9,565)
Effect of exchange rate changes on cash and cash equivalents	709	2,341	(694)
Net increase in cash and cash equivalents	1,058	4,146	2,898
Cash and cash equivalents at beginning of year	7,975	3,829	931
Cash and cash equivalents at end of year	$ 9,033	$ 7,975	$ 3,829

The accompanying notes are an integral part of these consolidated financial statements.

NOTE 1—SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Basis of Accounting

The accompanying consolidated financial statements include the accounts of Hexcel Corporation and subsidiaries ("Hexcel" or the "Company"), after elimination of intercompany transactions and accounts. Hexcel is a leading international developer and manufacturer of carbon fibers, reinforcement fabrics, and lightweight, high-performance composite materials, parts and structures for use in the commercial aerospace, space and defense, recreation, and general industrial markets. The Company serves international markets through manufacturing and marketing facilities located in the United States and Europe, as well as sales offices in Asia, Australia and South America. The Company is also a partner in a joint venture that manufactures and markets composite materials in Asia.

As discussed in Note 2, Hexcel acquired the worldwide composites division of Ciba-Geigy Limited ("CGL"), a Swiss corporation, and Ciba-Geigy Corporation, a New York corporation ("CGC" and together with CGL, "Ciba"), including most of Ciba's composite materials, parts and structures businesses, on February 29, 1996. The Company subsequently acquired Ciba's Austrian composites business on May 30, 1996, and various remaining assets of Ciba's worldwide composites division at various dates through February 28, 1997 (collectively, the "Acquired Ciba Business"). As also discussed in Note 2, Hexcel acquired the composite products division of Hercules Incorporated ("Hercules"), including Hercules' carbon fibers and prepreg businesses (the "Acquired Hercules Business"), on June 27, 1996, and the satellite business and rights to certain technologies from Fiberite, Inc. ("Fiberite") on September 30, 1997. Accordingly, the accompanying consolidated balance sheets, statements of operations, stockholders' equity and cash flows include the financial position, results of operations and cash flows, of the businesses acquired from Ciba, Hercules and Fiberite as of such dates and for such periods that these businesses were owned by the Company.

Estimates and Assumptions

The accompanying consolidated financial statements and related notes reflect numerous estimates and assumptions made by the management of Hexcel. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosures with respect to contingent assets and liabilities, and the reported amounts of revenues and expenses. Although management believes that the estimates and assumptions used in preparing the accompanying consolidated financial statements and related notes are reasonable in light of known facts and circumstances, actual results could differ from the estimates used.

Cash and Cash Equivalents

Hexcel invests excess cash in investments with original maturities of less than three months. The investments consist primarily of Eurodollar time deposits and are stated at cost, which approximates fair value. The Company considers such investments to be cash equivalents for purposes of the statements of cash flows.

Accounts Receivable

Accounts receivable are net of reserves for doubtful accounts of $6,641 and $6,625 as of December 31, 1997 and 1996, respectively.

Inventories

Inventories are valued at the lower of cost or market, with cost determined using the first-in, first-out and average cost methods.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. Repairs and maintenance are charged to expense as incurred; replacements and betterments are capitalized.

The Company depreciates property, plant and equipment over estimated useful lives. Accelerated and straight-line methods are used for financial statement purposes. The estimated useful lives range from 10 to 40 years for buildings and improvements and from 3 to 20 years for machinery and equipment.

Intangibles and Other Assets

Goodwill and other purchased intangibles are included in "intangibles and other assets" at cost, less accumulated amortization (see Note 6). Amortization is provided on a straight-line basis over estimated economic lives which range from 10 to 20 years.

The Company periodically reviews the recoverability of long-term assets whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable.

Currency Translation

The assets and liabilities of European subsidiaries are translated into U.S. dollars at year-end exchange rates, and revenues and expenses are translated at average exchange rates during the year. Cumulative currency translation adjustments are included in stockholders' equity. Realized gains and losses from currency exchange transactions are recorded in "selling, general and administrative expenses" in the accompanying consolidated statements of operations and were not material to the Company's consolidated results of operations in 1997, 1996 or 1995.

Revenue Recognition

Product sales are recognized on the date of shipment.

Earnings per Share

The Financial Accounting Standards Board issued Statement No. 128, "Earnings Per Share" ("SFAS 128"), in March 1997 which is effective for reporting periods ending after December 15, 1997. The Company adopted SFAS 128 in the fourth quarter of 1997. SFAS 128 requires the presentation of "Basic" earnings per share which represents net earnings divided by the weighted average shares outstanding excluding all potential common shares. A dual presentation of "Diluted" earnings per share reflecting the dilutive effects of all potential common shares, is also required. The Diluted presentation is similar to fully diluted earnings per share under the prior accounting standard (see Note 15).

Stock-Based Compensation

In 1996, Hexcel adopted the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), which provide for the disclosure of pro forma net earnings and earnings per share as if the fair value method were used to account for stock-based employee compensation plans (see Note 14). Pursuant to SFAS 123, the Company has elected to continue to use the intrinsic value method to account for such plans in the accompanying consolidated financial statements, in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees".

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of trade accounts receivable. The Company's sales to two customers and their related subcontractors accounted for approximately 46% and 32% of the Company's 1997 and 1996 net sales, respectively (see Note 17). The Company performs on-going credit evaluations of its customers' financial condition but generally does not require collateral or other security to support customer receivables. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other financial information.

Recently Issued Accounting Standards

In June 1997, the Financial Accounting Standards Board issued Statement No. 130, "Reporting Comprehensive Income" ("SFAS 130"). Hexcel is required to adopt SFAS 130 in the first quarter of 1998. SFAS 130 establishes standards for reporting comprehensive income and its components in a full set of general purpose financial statements. Management does not anticipate that the adoption of SFAS 130 will have a significant impact on the consolidated financial statements.

In June 1997, the Financial Accounting Standards Board also issued Statement No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS 131"). Hexcel is required to adopt SFAS 131 in its annual consolidated financial statements covering the year ending December 31, 1998. SFAS 131 establishes standards for the way business enterprises report information about operating segments in annual financial statements. Beginning in 1999, the Company will also be required to report selected information about operating segments in its interim financial reports to stockholders. The Company has not yet determined the impact, if any, that the adoption of SFAS 131 will have on the consolidated financial statements.

Reclassifications

Certain prior year amounts in the accompanying consolidated financial statements and related notes have been reclassified to conform to the 1997 presentation.

NOTE 2—BUSINESS ACQUISITIONS

Acquired Ciba Business

Hexcel acquired most of Ciba's composite materials, parts and structures businesses on February 29, 1996, Ciba's Austrian composites business on May 30, 1996, and various remaining assets of Ciba's worldwide composites division at various dates through February 28, 1997. The Acquired Ciba Business is engaged in the manufacture and marketing of reinforcement fabrics and lightweight, high-performance composite materials, parts and structures for commercial aerospace, space and defense, recreation, and general industrial markets. Product lines include reinforcement fabrics, pre-impregnated fabrics ("prepregs"), structural adhesives, honeycomb core, sandwich panels and fabricated components, as well as composite structures and interiors primarily for the commercial and military aerospace markets.

The acquisition of the Acquired Ciba Business was consummated pursuant to a Strategic Alliance Agreement dated as of September 29, 1995, among Ciba and Hexcel, as amended (the "Strategic Alliance Agreement"). Under the Strategic Alliance Agreement, the Company acquired the assets (including the capital stock of certain non-U.S. subsidiaries) and assumed the liabilities of the Acquired Ciba Business, other than certain excluded assets and liabilities, in exchange for: (a) 18,022 newly issued shares of Hexcel common stock; (b) $25,000 in cash; (c) senior subordinated notes in an aggregate principal amount of $34,928, subject to certain adjustments (the "Senior Subordinated Notes"); and (d) senior demand notes in an aggregate principal amount equal to the cash on hand at certain of the non-U.S. subsidiaries included in the Acquired Ciba Business (the "Senior Demand Notes"). In exchange for assets acquired between

January 1, 1997 and February 28, 1997, from Ciba affiliates that continued to act as distributors for the Acquired Ciba Business (the "Ciba Distributors") throughout 1996, Hexcel undertook to deliver additional Senior Subordinated Notes to Ciba Specialty Chemicals Holding Inc., a Swiss Corporation ("CSCH") as successor to Ciba in an aggregate principal amount of approximately $2,300 which was accrued in 1997. The aggregate purchase price for the net assets acquired was approximately $208,700.

Acquired Hercules Business

Hexcel acquired the assets of the composite products division of Hercules (the "Acquired Hercules Business") on June 27, 1996. The Acquired Hercules Business, which manufactures carbon fibers and prepregs for commercial aerospace, space and defense, recreation, and general industrial markets, was purchased for $139,400 in cash.

In connection with the purchase of the Acquired Hercules Business, Hexcel obtained a new revolving credit facility (the "Revolving Credit Facility"). As discussed in Note 7, the Revolving Credit Facility was obtained to: (a) refinance outstanding indebtedness under a senior secured credit facility; (b) finance the purchase of the Acquired Hercules Business; and (c) provide for the ongoing working capital and other financing requirements of the Company, including business consolidation activities, on a worldwide basis (see Note 3).

Acquired Fiberite Assets

On September 30, 1997, the Company acquired from Fiberite, its satellite business consisting of intangible assets and inventory, and certain non-exclusive worldwide rights to other prepreg technologies, for $37,000 in cash. The acquisition was substantially downsized from the original agreement whereby the Company had, subject to certain terms and conditions, committed to purchase selected assets and businesses of Fiberite for approximately $300,000. As a result of the downsized transaction, the Company wrote-off $4,973 of acquisition and financing costs to business acquisition and consolidation expenses. In addition, the Company expensed $8,000 of acquired in-process research and technology purchased from Fiberite which is also included in business acquisition and consolidation expenses.

The acquisition of the satellite business and certain technologies from Fiberite on September 30, 1997 was accounted for using the purchase method, in accordance with Accounting Principles Board Opinion No. 16 "Business Combinations" ("APBO No. 16"). Under this method, substantially all of the $37,000 purchase price, less the $8,000 write-off of the acquired in-process research and technology expenses, was allocated to intangible assets. Transaction costs in relation to the downsized transaction were not material.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Assets Acquired and Liabilities Assumed or Incurred

The acquisitions of the Acquired Ciba Business and the Acquired Hercules Business (collectively, the "Acquired Businesses"), have been accounted for using the purchase method, in accordance with APBO No. 16. The assets acquired and the liabilities assumed or incurred in 1996 were:

	Acquired Ciba Business	Aquired Hercules Business	Total Acquired Businesses
Estimated fair values of assets acquired:			
Accounts receivable	$ 53,861	$ 16,819	$ 70,680
Inventories	63,048	22,289	85,337
Property, plant and equipment	119,446	110,611	230,057
Goodwill and other purchased intangibles	48,539	—	48,539
Other assets	3,069	642	3,711
Total assets acquired	287,963	150,361	438,324
Estimated fair values of liabilities assumed or incurred:			
Accounts payable and accrued liabilities	62,582	7,688	70,270
Notes payable and capital lease obligations	4,743	2,774	7,517
Deferred liabilities	14,233	499	14,732
Total liabilities assumed or incurred	81,558	10,961	92,519
Estimated fair values of net assets acquired	$ 206,405	$ 139,400	$ 345,805
Purchase price:			
Cash	$ 25,000	$ 139,400	$ 164,400
Senior Subordinated Notes issued to Ciba, at aggregate fair value	31,902	—	31,902
Senior Demand Notes issued to Ciba	5,329	—	5,329
Hexcel common stock issued to Ciba, valued at $8 per share	144,174	—	144,174
Aggregate purchase price	$ 206,405	$ 139,400	$ 345,805

The acquisitions of the Acquired Businesses were subject to certain post-closing adjustments, including the adjustment to the Senior Subordinated Notes discussed above and the pension adjustment discussed in Note 6.

Pro Forma Financial Information (Unaudited)

The pro forma net sales, net loss and net loss per share of Hexcel for the years ended December 31, 1996 and 1995, giving effect to the acquisitions of the Acquired Businesses and the related issuance of the Convertible Subordinated Notes (see Note 7) as if those transactions had occurred at the beginning of the periods presented, were:

	1996	1995
Pro forma net sales	$ 798,515	$ 771,325
Pro forma net loss	(21,191)	(10,189)
Pro forma basic and diluted net loss per share	(0.59)	(0.30)
Shares used in computing pro forma basic and diluted net loss per share	36,003	33,614

Pro forma adjustments giving effect to the Fiberite transaction as if it occurred at the beginning of 1997 and 1996 would not have had a material effect to the Company's consolidated financial statements.

NOTE 3—BUSINESS CONSOLIDATION

In May of 1996, Hexcel announced the commencement of a plan to consolidate the Company's operations over a period of three years. In December of 1996, the Company announced the commencement of further consolidation activities identified during the ongoing integration of the Acquired Businesses. The total expense of the business consolidation program was estimated to be approximately $58,000. Total expenses through December 31, 1997 were $54,700, excluding costs associated with the Fiberite transaction, which were not included in the original program. The Company does not expect to incur any further significant additional expenses in relation to this program. As of December 31, 1997, cash expenditures remaining to complete this program are estimated at $12,000, which approximates amounts accrued. Thus, when the program is complete, the Company expects that cash expenditures (for expenses and capital, net of estimated proceeds from asset sales) necessary to complete the program will approximate the initial estimate of $51,000.

The objective of the business consolidation program is to integrate acquired assets and operations into Hexcel, and to reorganize the Company's manufacturing and research activities around strategic centers dedicated to select product technologies. The business consolidation is also intended to eliminate excess manufacturing capacity and redundant administrative functions. Specific actions of the consolidation program included the closure of the Anaheim, California facility acquired in connection with the purchase of the Acquired Ciba Business, the reorganization of the Company's manufacturing operations in Europe, the consolidation of the Company's U.S. special process manufacturing activities, and the integration of sales, marketing and administrative resources.

As of December 31, 1997, the primary remaining activities of the business consolidation program relate to the European operations and the installation and customer qualifications of equipment transferred from the Anaheim facility to other U.S. locations. These qualification requirements increase the complexity, cost and time of moving equipment and rationalizing manufacturing activities. As a result, the Company continues to expect that the business consolidation program will take to the end of 1998 to complete.

After closing the Anaheim facility on schedule in the third quarter of 1997, the Company completed the sale of the facility on October 30, 1997. Net cash proceeds from the sale were approximately $8,500, which approximated book value.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Total accrued business acquisition and consolidation expenses at December 31, 1997 and 1996 were as follows:

	Employee Severance and Relocation	Facility Closure & Equipment Relocation	Other	Fiberite Transaction	Total
Balance as of January 1, 1996	—	—	—	—	—
Business acquisition and consolidation expenses	$ 17,285	$ 10,488	$ 14,597	$ —	$ 42,370
Liabilities assumed or incurred in business acquisitions	7,104	2,497	—	—	9,601
Cash expenditures	(5,306)	(1,109)	(5,164)	—	(11,579)
Non-cash usage, including asset write-downs	—	(6,678)	(8,357)	—	(15,035)
Balance as of December 31, 1996	19,083	5,198	1,076	—	25,357
Business acquisition and consolidation expenses	(25)	7,651	4,744	12,973	25,343
Cash expenditures	(6,644)	(8,771)	(5,207)	(12,973)	(33,595)
Non-cash usage, including asset write-downs, currency translation effects and reclassifications	(2,759)	(2,068)	(105)	—	(4,932)
Balance as of December 31, 1997	$ 9,655	$ 2,010	$ 508	$ —	$ 12,173

The consolidation program calls for the elimination of approximately 345 manufacturing, marketing and administrative positions at certain locations, partially offset by the addition of new positions at other locations. As of December 31, 1997, approximately 245 positions have been eliminated.

Accrued business consolidation costs of $12,173 as of December 31, 1997 were included in "other accrued liabilities", and $21,780 and $3,577 as of December 31, 1996, were included in "other accrued liabilities" and "other non-current liabilities," respectively, in the accompanying consolidated balance sheets. During 1997 and 1996, business consolidation activities were financed with operating cash flows and borrowings under the Revolving Credit Facility.

NOTE 4—INVENTORIES

Inventories as of December 31, 1997 and 1996, were:

	1997	1996
Raw materials	**$ 90,429**	$ 66,055
Work in progress	**47,953**	45,469
Finished goods	**26,939**	34,360
Inventories	**$ 165,321**	$ 145,884

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 5—PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment as of December 31, 1997 and 1996, were:

	1997	1996
Land	$ 13,729	$ 19,253
Buildings	206,900	127,863
Equipment	268,287	321,057
Property, plant and equipment	488,916	468,173
Less accumulated depreciation	(157,439)	(141,390)
Net property, plant and equipment	$ 331,477	$ 326,783

Depreciation expense for the years ended December 31, 1997, 1996 and 1995 was $33,214, $24,656 and $11,623, respectively.

NOTE 6—INTANGIBLES AND OTHER ASSETS

Intangibles and other assets as of December 31, 1997 and 1996, were:

	1997	1996
Goodwill and other purchased intangibles, net of accumulated amortization of $4,657 and $2,074 as of December 31, 1997 and 1996, respectively	$ 67,237	$ 47,692
Debt financing costs, net of accumulated amortization of $2,487 and $877 as of December 31, 1997 and 1996, respectively	4,030	5,915
Prepaid pension asset	8,619	—
Deferred income taxes	9,901	—
Investments in joint ventures	—	1,450
Other assets	3,272	2,965
Intangibles and other assets	$ 93,059	$ 58,022

Goodwill and Other Purchased Intangibles

Goodwill and other purchased intangibles include certain intellectual property acquired in connection with the purchases of the Acquired Ciba Business, the Fiberite assets and the Hexcel-Fyfe joint venture (see below). Amortization expense for these assets for the years ended December 31, 1997 and 1996, was $2,583 and $2,074, respectively.

Debt Financing Costs

Debt financing costs are deferred and amortized over the life of the related debt. Unamortized debt financing costs relate to the Revolving Credit Facility obtained in June of 1996, and to the Convertible Subordinated Notes issued in July of 1996 (see Notes 2 and 7).

Investments in Joint Ventures

Investments in joint ventures are accounted for by the equity method. Equity in the earnings of joint ventures were not material to Hexcel's consolidated results of operations for 1997, 1996 or 1995.

As of December 31, 1997 and 1996, Hexcel owned a 45% and 43% equity interest in DIC-Hexcel Limited ("DHL"), respectively, a joint venture with Dainippon Ink and Chemicals, Inc. ("DIC"). On August 12, 1997, the Company sold its 40% equity interest in Hexcel-Fyfe, LLC, to its joint venture partner, Fyfe Associates Corporation, for net cash proceeds and the receipt of rights to certain intangible assets that approximated the Company's investment. On December 31, 1996, the Company sold its 50% equity interest in Knytex Company, LLC to the joint venture partner, Owens Corning Corporation, for net cash proceeds that approximated the Company's investment.

The DHL joint venture, which owns and operates a manufacturing facility in Komatsu, Japan, was formed in 1990 for the production and sale of Nomex honeycomb, prepregs and decorative laminates for the Japanese market. In December of 1996, Hexcel and DIC reached an agreement in principle to continue the DHL joint venture and expand its operations. The Company and DIC agreed to fund the joint venture's operations through 1998 by each contributing an additional $3,250 in cash, payable in installments through 1998. Of this amount, $2,000 was paid in 1997. As of December 31, 1997 and 1996, the Company's liability with respect to funding the venture's activities, has been accrued for in the accompanying consolidated balance sheets. In addition, the Company and DIC agreed to contribute certain additional technology and product manufacturing rights to DHL. Under the terms of the agreement in principle, the Company remains contingently liable to pay DIC up to $4,500 with respect to DHL's bank debt, but the possibility that such repayment will be required has diminished as a result of the improvement in the venture's business prospects.

Prepaid Pension Asset

As part of the Acquired Ciba Business, the Company acquired a net pension asset from a defined benefit plan covering employees of a United Kingdom subsidiary. Pursuant to the terms of the purchase agreement, these employees continued to participate in a defined benefit retirement plan sponsored by Ciba up to January 1, 1997, at which time, the net pension asset was valued at $8,688 and was transferred to a newly created plan sponsored by the Company. Accordingly, the Company recorded the $8,688 as a prepaid pension asset with a corresponding reduction in goodwill. As of December 31, 1997, the prepaid pension asset was $8,619, reflecting the net change for the year.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 7—NOTES PAYABLE

Notes payable, capital lease obligations and indebtedness to related parties as of December 31, 1997 and 1996, were:

	1997	1996
Revolving Credit Facility	$ 158,267	$ 98,656
European Credit and Overdraft Facilities	13,909	23,405
Convertible Subordinated Notes, due 2003	114,450	114,500
Convertible Subordinated Debentures, due 2011	25,625	25,625
Obligations Under IDRB Variable Rate Demand Notes	—	8,450
Various notes payable	680	1,212
Total notes payable	312,931	271,848
Capital lease obligations (see Note 8)	5,473	6,906
Senior Subordinated Notes Payable to CSC, net of unamortized discount of $2,233 and $2,666 as of December 31, 1997 and 1996, respectively	34,967	32,262
Total notes payable, capital lease obligations and indebtedness to related parties	$ 353,371	$ 311,016
Notes payable and current maturities of long-term liabilities	$ 13,858	$ 23,835
Long-term notes payable and capital lease obligations, Less current maturities	304,546	254,919
Indebtedness to related parties	34,967	32,262
Total notes payable, capital lease obligations and indebtedness to related parties	$ 353,371	$ 311,016

Revolving Credit Facility

In connection with the acquisition of the Acquired Hercules Business on June 27, 1996, Hexcel obtained the Revolving Credit Facility to: (a) refinance outstanding indebtedness under its current credit facility; (b) finance the purchase of the Acquired Hercules Business; and (c) provide for the ongoing working capital and other financing requirements of the Company, including business consolidation activities, on a worldwide basis. The Revolving Credit Facility provided for up to $254,600 of borrowing capacity and would have expired in February 1999. As discussed in Note 24, the Revolving Credit Facility was amended and restated in March 1998.

Interest on outstanding borrowings under the Revolving Credit Facility was computed at an annual rate of 0.4% in excess of the applicable London interbank rate or, at the option of Hexcel, at the base rate of the administrative agent for the lenders. In addition, the Revolving Credit Facility was subject to a commitment fee of approximately 0.2% per annum on the unused portion of the facility. As of December 31, 1997, letters of credit with an aggregate face amount of $3,700 were outstanding under the Revolving Credit Facility.

The Revolving Credit Facility was secured by a pledge of stock of certain of Hexcel's subsidiaries. In addition, the Company was subject to various financial covenants and restrictions under the Revolving Credit Facility, and was generally prohibited from paying dividends or redeeming capital stock.

As a result of obtaining the Revolving Credit Facility and the corresponding extinguishment of certain of the Company's credit facilities, Hexcel wrote off $3,400 of capitalized debt financing costs in 1996. This amount is included in "interest expense" in the accompanying consolidated statement of operations for 1996.

European Credit and Overdraft Facilities

In addition to the Revolving Credit Facility, certain of Hexcel's European subsidiaries have access to limited credit and overdraft facilities provided by various local lenders. These credit and overdraft facilities, which are only available to finance certain activities by specific subsidiaries, are primarily uncommitted facilities that are terminable at the discretion of the lenders. The credit and overdraft facilities in use by the Company's European subsidiaries as of December 31, 1997 and 1996, other than the Revolving Credit Facility, bear interest at rates between 2.5% and 7.7% per year.

Convertible Subordinated Notes, due 2003

In July of 1996, Hexcel completed an offering of $114,500 in convertible subordinated notes due 2003 (the "Convertible Subordinated Notes"). The Convertible Subordinated Notes carry an annual interest rate of 7% and are convertible into Hexcel common stock at a conversion price of $15.81 per share, subject to adjustment under certain conditions. Net proceeds of $111,351 from this offering were used to repay outstanding borrowings under the Revolving Credit Facility.

The Convertible Subordinated Notes are redeemable beginning in August of 1999, in whole or in part, at the option of Hexcel. The redemption prices range from 103.5% to 100.0% of the outstanding principal amount, depending on the period in which redemption occurs. As of December 31, 1997, $50 of the Convertible Subordinated Notes had been converted resulting in the issuance of 3 shares of common stock.

Convertible Subordinated Debentures, due 2011

The 7% convertible subordinated debentures, due 2011, are redeemable by Hexcel under certain provisions, although any such redemption is restricted by the terms of the Revolving Credit Facility. Mandatory redemption is scheduled to begin in 2002 through annual sinking fund requirements. The debentures are convertible prior to maturity into common stock of the Company at $30.72 per share, subject to adjustment under certain conditions.

Obligations Under IDRB Variable Rate Demand Notes

In 1997, Hexcel repaid in full various industrial development revenue bonds ("IDRBs") to obtain the benefit of reduced administration costs. The IDRBs had original maturity dates after 2001 and were guaranteed by bank letters of credit issued under the Revolving Credit Facility. The interest rates on the IDRBs were variable and averaged 4.0% in 1997, 4.2% in 1996 and 6.2% in 1995.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Senior Subordinated Notes Payable to CSC

In connection with the purchase of the Acquired Ciba Business, Hexcel delivered Senior Subordinated Notes to Ciba in an aggregate principal amount of $34,928. Hexcel has also consented to an assignment by Ciba of Ciba's rights and obligations under the Alliance Agreement to CSCH and Ciba Specialty Chemicals Corporation, a Delaware corporation (collectively "CSC"). In connection with the assignment of these rights and obligations, the Senior Subordinated Notes that were previously payable to Ciba are now payable to CSC. In accordance with the terms of the amended Strategic Alliance Agreement, Hexcel acquired certain assets of the Ciba Distributors between January 1, 1997 and February 28, 1997, in exchange for an undertaking to deliver additional Senior Subordinated Notes in an aggregate principle amount of approximately $2,300. Upon delivery of these additional Senior Subordinated Notes, the total aggregate principle amount of Senior Subordinated Notes payable to CSC will be approximately $37,200.

At the date of issue, the aggregate fair value of the Senior Subordinated Notes was $31,902, or $3,026 less than the aggregate principal amount. The original discount of $3,026 reflects the absence of certain call protection provisions from the terms of the Senior Subordinated Notes and the difference between the stated interest rate on the Senior Subordinated Notes and the estimated market rate for debt obligations of comparable quality and maturity. This discount, which is amortized over the life of the Senior Subordinated Notes, had an unamortized balance of $2,233 and $2,666 as of December 31, 1997 and 1996, respectively.

The Senior Subordinated Notes are general unsecured obligations of Hexcel that bear interest for three years at a rate of 7.5% per annum, payable semiannually from February 29, 1996. The interest rate will increase to 10.5% per annum on the third anniversary of the purchase of the Acquired Ciba Business (February 28, 1999), and by an additional 0.5% per year thereafter until the Senior Subordinated Notes mature in the year 2003.

As discussed in Note 9, Hexcel has various financial and other relationships with CSC. Accordingly, the Company's net indebtedness to CSC under the Senior Subordinated Notes has been classified as "indebtedness to related parties" in the accompanying consolidated balance sheets.

Aggregate Maturities of Notes Payable

Aggregate maturities of notes payable, excluding capital lease obligations (see Note 8), as of December 31, 1997, were:

Payable during years ending December 31:	
1998	$ 13,511
1999	672
2000	147
2001	154
2002	1,856
2003 and thereafter	331,558
Total notes payable	$347,898

(IN THOUSANDS, EXCEPT PER SHARE DATA)

At December 31, 1997, amounts owed under the Revolving Credit Facility totaled $158,267. As discussed in Note 24, the Revolving Credit Facility was amended and restated in March 1998. Under the amended terms, the facility was extended to 2003, and accordingly, the above table reflects the amended due date.

Estimated Fair Values of Notes Payable

The Revolving Credit Facility, and substantially all of the various European credit facilities and other notes payable outstanding as of December 31, 1997 and 1996, are variable-rate debt obligations. Accordingly, management believes that the estimated fair value of each of these debt obligations approximates the respective book value.

The aggregate fair values of the Convertible Subordinated Notes, due 2003, and the Convertible Subordinated Debentures, due 2011, are estimated on the basis of quoted market prices, although trading in these debt securities is limited and may not reflect fair value. The aggregate fair value of the Convertible Subordinated Notes, due 2003, was approximately $196,000 and $141,700 as of December 31, 1997 and 1996, respectively. The aggregate fair value of the Convertible Subordinated Debentures, due 2011, was approximately $25,500 and $24,000 as of December 31, 1997 and 1996, respectively.

NOTE 8—LEASING ARRANGEMENTS

Assets, accumulated depreciation and related liability balances under capital leasing arrangements as of December 31, 1997 and 1996, were:

	1997	1996
Property, plant and equipment	**$ 10,197**	$ 11,572
Less accumulated depreciation	**(3,593)**	(2,927)
Net property, plant and equipment	**$ 6,604**	$ 8,645
Capital lease obligations	**$ 5,473**	$ 6,906
Less current maturities	**(347)**	(768)
Long-term capital lease obligations, net	**$ 5,126**	$ 6,138

Certain sales and administrative offices, data processing equipment, and manufacturing facilities are leased under operating leases. Rental expense under operating leases was $4,559 in 1997, $4,623 in 1996 and $2,871 in 1995.

Future minimum lease payments as of December 31, 1997, were:

	Type of Lease	
Payable during years ending December 31:	Capital	Operating
1998	$ 858	$ 3,935
1999	858	3,304
2000	783	1,987
2001	512	714
2002	512	233
2003 and thereafter	5,948	1,402
Total minimum lease payments	$ 9,471	$ 11,575

Total minimum capital lease payments include $3,999 of imputed interest.

NOTE 9—RELATED PARTIES

In connection with the purchase of the Acquired Ciba Business, Hexcel delivered 18,022 newly issued shares of Hexcel common stock to Ciba, representing 49.9% of the Hexcel common stock issued and outstanding at that date. In addition, the Company and Ciba entered into the Alliance Agreement which currently provides for, among other things, the designation by Ciba of four of the Company's ten directors, and the approval of a majority of these four designated directors for the taking of certain significant actions by the Company. On February 21, 1997, the Company consented to an assignment by Ciba of Ciba's rights and obligations under the Alliance Agreement to CSC. In connection with the assignment of these rights and obligations, all of the Hexcel common stock previously held by Ciba is now held by CSC.

As discussed in Notes 2 and 7, Hexcel has delivered Senior Subordinated Notes in an aggregate principal amount of $34,928 to Ciba in connection with the purchase of the Acquired Ciba Business and has undertaken to deliver approximately $2,300 additional Senior Subordinated Notes in connection with the acquisition of certain assets of the Ciba Distributors. In connection with the assignment of Ciba's rights and obligations under the Alliance Agreement, the Senior Subordinated Notes that were previously payable to Ciba will be payable to CSC. During 1996, the Company also delivered Senior Demand Notes to Ciba in an aggregate principle amount of $5,329. The Senior Demand Notes were presented for payment and paid in full prior to December 31, 1996. Aggregate interest expense on the Senior Subordinated Notes in 1997 and 1996 was $2,762 and $2,715, respectively.

Hexcel purchases certain raw materials from various CSC subsidiaries, as successor to Ciba subsidiaries. In addition, the Company sells certain finished products to various CSC subsidiaries, including the Ciba Distributors. The Company's aggregate purchases from CSC subsidiaries and their predecessor Ciba subsidiaries for 1997 and for the period from March 1, 1996 through December 31, 1996, were $34,255 and $15,116, respectively. The Company's aggregate sales to CSC subsidiaries and their predecessor Ciba subsidiaries for the same periods were $5,620 and $32,408, respectively. These sales were primarily to the Ciba Distributors pursuant to a distribution agreement, which expired February 28, 1997. In addition, in 1997 and 1996 the Company incurred $1,234 and $214, respectively, of expenses related to the Acquired Ciba Business that are subject to reimbursement by CSC as successor to Ciba under the terms of the Strategic Alliance Agreement. As of December 31, 1997 and 1996, aggregate receivables from CSC or CSC subsidiaries and their Ciba predecessor included in "accounts receivable" in the accompanying consolidated balance sheets were $400 and $5,951, respectively. Aggregate payables to CSC or CSC subsidiaries and their Ciba predecessors included in "accounts payable" and "accrued liabilities" as of the same dates were $1,196 and $1,812, respectively.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 10—OTHER NON-CURRENT LIABILITIES

Other non-current liabilities as of December 31, 1997 and 1996, were:

	1997	1996
Postretirement benefit liability (see Note 12)	$ 14,066	$ 13,726
Liability for environmental remediation activities	5,080	7,070
Liability for business consolidation activities (see Note 3)	—	3,577
Liability for DIC-Hexcel Limited (see Note 6)	—	3,250
Pension and retirement liability (see Note 11)	2,702	2,206
Deferred tax liability (see Note 13)	2,970	1,433
Other	10,998	15,152
Other non-current liabilities	$ 35,816	$ 46,414

NOTE 11—RETIREMENT PLANS

Hexcel maintains a retirement savings and contribution plan and a defined benefit retirement plan covering most U.S. employees, except for certain employees with union affiliations. In addition, the Company maintains a separate retirement savings plan available to certain U.S. employees with union affiliations, and contributes to a union sponsored multi-employer pension plan covering these same employees. The Company also maintains various retirement plans covering certain European employees, as well as defined benefit supplemental retirement plans for eligible senior executives. The net expense to the Company of all of these retirement plans was $11,500 in 1997, $9,107 in 1996 and $2,768 in 1995.

Under the U.S. retirement savings and contribution plan, eligible employees may contribute up to 16% of their compensation to an individual retirement savings account. Hexcel makes matching contributions to individual retirement savings accounts equal to 50% of employee contributions, not to exceed 3% of employee compensation. Furthermore, the Company makes profit sharing contributions of up to an additional 4% of employee compensation when the Company meets or exceeds certain annual performance targets. Matching contributions to the U.S. retirement savings and contribution plan were $2,309 for 1997, $2,160 for 1996 and $1,290 for 1995. The profit sharing contributions were $3,648 for 1997 and $3,236 for 1996. There was no profit sharing contribution for 1995.

The U.S. defined benefit retirement plan is a career average pension plan covering both hourly and salaried employees. Benefits are based on years of service and the annual compensation of the employee. Hexcel's funding policy is to contribute the minimum amount required by applicable regulations.

Hexcel maintains a separate retirement savings plan available to certain U.S. employees with union affiliations of the composite structures business acquired from Ciba on February 29, 1996. Under this plan, employees may contribute up to 14% of their compensation to an individual retirement savings account. There are no matching or profit sharing contributions. In addition, the Company participates in a union sponsored multi-employer pension plan covering these same employees. The Company's contributions to this plan were $1,326 for 1997 and $731 for 1996.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

As part of the Acquired Ciba Business, the Company acquired a net pension asset from a defined benefit retirement plan covering employees of a United Kingdom subsidiary. Pursuant to the terms of the purchase agreement, these employees continued to participate in a defined benefit retirement plan sponsored by Ciba up to January 1, 1997, at which time, the accumulated benefit obligation and net pension asset was valued and transferred to a newly created plan sponsored by the Company.

The net periodic cost of Hexcel's defined benefit retirement plans for the years ended December 31, 1997, 1996 and 1995, were:

	U.S. Plans			European Plans	
	1997	1996	1995	**1997**	1996
Service cost – benefits earned during the year	**$ 2,310**	$ 2,365	$ 661	**$ 1,933**	$ 150
Interest cost on projected benefit obligation	**817**	646	660	**2,168**	132
Return on plan assets – actual	**(739)**	(477)	(1,103)	**(6,799)**	(109)
Net amortization and deferral	**265**	273	1,260	**4,002**	—
Net periodic pension cost	**$ 2,653**	$ 2,807	$ 1,478	**$ 1,304**	$ 173

The following table sets forth the funded status of the plans as of December 31, 1997 and 1996:

	U.S. Plans		European Plans	
	1997	1996	**1997**	1996
Actuarial present value of benefit obligations –				
Vested benefit obligation	**$ 12,424**	$ 9,082	**$ 22,813**	$ 2,760
Non-vested benefit obligation	**613**	473	**—**	—
Accumulated benefit obligation	**$ 13,037**	$ 9,555	**$ 22,813**	$ 2,760
Projected benefit obligation	**$ 14,910**	$ 11,070	**$ 32,627**	$ 3,494
Plan assets at fair value	**8,343**	5,974	**44,557**	2,405
Plan assets more (less) than projected benefit obligation	**(6,567)**	(5,096)	**11,930**	(1,089)
Unrecognized net (gain) loss	**1,436**	157	**(3,311)**	—
Unrecognized net transition obligation	**169**	212	**—**	—
Unrecognized prior service cost	**4**	32	**—**	1,183
Prepaid (accrued) pension liability	**(4,958)**	(4,695)	**8,619**	94
Less current portion	**2,256**	2,395	**—**	—
Long-term portion prepaid (accrued) pension liability	**$ (2,702)**	$ (2,300)	**$ 8,619**	$ 94

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Assumptions used to estimate the actuarial present value of benefit obligations as of December 31, 1997, 1996 and 1995, were:

	1997	1996	1995
U.S. defined benefit retirement plans:			
Discount rate	**7.5%**	7.5%	7.0%
Rate of increase in compensation	**4.5%**	4.5%	4.0%
Expected long-term rate of return on plan assets	**9.0%**	9.0%	9.5%

	1997	1996
European defined benefit retirement plans:		
Discount rates	**6.5%-7.0%**	6.5%-7.5%
Rates of increase in compensation	**2.0%-5.0%**	2.0%-4.5%
Expected long-term rates of return on plan assets	**6.5%-7.5%**	6.5%-9.0%

NOTE 12—POSTRETIREMENT HEALTH CARE AND LIFE INSURANCE BENEFITS

Hexcel provides certain postretirement health care and life insurance benefits to eligible retirees. Substantially all U.S. employees hired on or before December 31, 1995, are eligible for benefits, as well as certain U.S. employees hired on February 29, 1996, in connection with the purchase of the Acquired Ciba Business, and on June 27, 1996, in connection with the purchase of the Acquired Hercules Business. Effective January 1, 1996, the Company amended its postretirement benefit program to eliminate any benefits for employees hired after December 31, 1995, other than senior executives and certain employees hired in connection with business acquisitions.

Benefits are available to eligible employees who retire on or after age 58 after rendering at least 15 years of service to Hexcel, including years of service rendered to the Acquired Ciba Business or the Acquired Hercules Business prior to the dates of acquisition. Benefits consist of coverage of up to 50% of the annual cost of certain health insurance plans, as well as annual life insurance coverage equal to 65% of the final base pay of the retiree until the age of 70. Upon reaching 70 years of age, life insurance coverage is reduced. Effective January 1, 1996, Hexcel amended its postretirement benefit program to limit health care benefit coverage to selected health insurance plans for the majority of active employees.

Hexcel funds postretirement health care and life insurance benefit costs on a pay-as-you-go basis and, for 1997, 1996 and 1995, made benefit payments of approximately $750, $400 and $600, respectively. Net defined postretirement benefit costs for the years ended December 31, 1997, 1996 and 1995, were:

	1997	1996	1995
Service cost – benefits earned during the year	**$ 91**	$ 80	$ 279
Interest cost on accumulated postretirement benefit obligation	**752**	701	780
Net amortization and deferral	**(213)**	(222)	(201)
Net periodic postretirement benefit cost	**$ 630**	$ 559	$ 858

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Defined postretirement benefit liabilities as of December 31, 1997 and 1996, were:

	1997	1996
Accumulated postretirement benefit obligation:		
Retirees	**$ 7,483**	$ 7,302
Fully eligible active plan participants	**1,897**	1,658
Other active plan participants	**1,456**	1,031
	10,836	9,991
Unrecognized prior service credit	**556**	890
Unrecognized net gain	**3,210**	3,567
Defined postretirement benefit liability	**14,602**	14,448
Less current portion of postretirement benefit liability	**(536)**	(722)
Deferred postretirement benefit liability (see Note 10)	**$ 14,066**	$ 13,726

Two health care cost trend rates were used in measuring the accumulated postretirement benefit obligation. For indemnity health care costs, the assumed cost trend in 1997 was 10.0% for participants less than 65 years of age and 6.0% for participants 65 years of age and older, gradually declining to 5.0% for both age groups in the year 2002. For Health Maintenance Organization health care costs, the assumed cost trend in 1997 was 7.0% for participants less than 65 years of age and 4.0% for participants 65 years of age and older, gradually declining to 5.0% and 4.0%, respectively, in the year 1999.

The weighted average discount rate used in determining the accumulated postretirement benefit obligation was 7.0% in 1997 and 7.5% in 1996. The rate of increase in compensation used in determining the obligation was 4.5% in 1997 and 1996 and 4.0% in 1995.

If the health care cost trend rate assumptions were increased by 1.0%, the accumulated postretirement benefit obligation as of December 31, 1997 would be increased by 6.1%. The effect of this change on the sum of the service cost and interest cost would be an increase of 5.6%.

NOTE 13—INCOME TAXES

Provision for Income Taxes

Income (loss) before income taxes and the (benefit) provision for income taxes from continuing operations for the years ended December 31, 1997, 1996 and 1995, were:

	1997	1996	1995
Income (loss) before income taxes:			
U.S.	**$ 24,197**	$ (11,956)	$ (1,027)
International	**26,555**	(3,798)	7,541
Total income (loss) before income taxes	**$ 50,752**	$ (15,754)	$ 6,514
Provision (benefit) for income taxes:			
Current:			
U.S.	**$ 798**	$ (1,600)	$ 197
International	**9,527**	5,556	3,445
Current provision for income taxes	**10,325**	3,956	3,642
Deferred:			
U.S.	**(33,935)**	—	—
International	**732**	(520)	(329)
Deferred benefit for income taxes	**(33,203)**	(520)	(329)
Total (benefit) provision for income taxes	**$ (22,878)**	$ 3,436	$ 3,313

(IN THOUSANDS, EXCEPT PER SHARE DATA)

A reconciliation of the (benefit) provision to the U.S. federal statutory income tax rate of 35%, 34% and 34% for the years ended December 31, 1997, 1996 and 1995, is as follows:

	1997	1996	1995
Provision (benefit) at U.S. federal statutory rate	**$ 17,763**	$ (5,356)	$ 2,215
U.S. state taxes, less federal tax benefit	**519**	21	(254)
Impact of different international tax rates, adjustments to income tax accruals and other	**18,773**	(9,656)	492
Valuation allowance	**(59,933)**	18,427	860
Total (benefit) provision for income taxes	**$(22,878)**	$ 3,436	$ 3,313

In accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"), in 1996 and 1995 the Company had fully provided valuation allowance reserves against its net deferred tax assets primarily in the U.S. and Belgium where there were uncertainties in generating sufficient future taxable income. In 1997, the Company reversed $59.9 million of its valuation allowance reserve as follows: $17.0 million due to current year profitable U.S. operations, $39.0 million due to the Company's assessment that the realization of the remaining U.S. net deferred tax assets is more likely than not, and $3.9 million in Belgium due to a gain on sale of certain tangible and intangible assets to other Hexcel subsidiaries. The Company continues to reserve the balance of the net deferred tax asset related to its Belgium operations.

The Company has made no U.S. income tax provision for approximately $46,000 of undistributed earnings of international subsidiaries as of December 31, 1997. Such earnings are considered to be permanently reinvested. The additional U.S. income tax on these earnings, if repatriated, would be offset in part by foreign tax credits.

Deferred Income Taxes

Deferred income taxes result from temporary differences between the recognition of items for income tax purposes and financial reporting purposes. Principal temporary differences as of December 31, 1997 and 1996, were:

	1997	1996
Net operating loss carryforwards	**$ 21,000**	$ 33,922
Reserves and other, net	**31,580**	37,596
Accrued business acquisition and consolidation expenses	**4,380**	9,128
Accelerated depreciation and amortization	**(16,690)**	(13,646)
Valuation allowance	**(8,500)**	(68,433)
Net deferred tax asset (liability)	**$ 31,770**	$ (1,433)

Net Operating Loss Carryforwards

As of December 31, 1997, Hexcel had net operating loss ("NOL") carryforwards for U.S. federal and Belgium income tax purposes of approximately $53,000 and $5,000, respectively. The U.S. NOL carryforwards, which are available to offset future taxable income, expire at various dates through the year 2010. As a result of the ownership change, which occurred in connection with the purchase of the Acquired Ciba Business, the Company has a limitation on the utilization of U.S. NOL carryforwards of approximately $12,000 per year.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 14—STOCK-BASED INCENTIVE PLANS

The Hexcel Corporation Incentive Stock Plan as amended and restated ("Incentive Stock Plan"), authorizes the use of Hexcel common stock for providing a variety of stock-based incentive awards to eligible employees, officers, directors and consultants. The Incentive Stock Plan provides for grants of stock options, stock appreciation rights, restricted stock and restricted stock units, and other stock-based awards. In May 1997, Hexcel's stockholders increased the aggregate number of shares of Hexcel common stock available for use under the Incentive Stock Plan by 3,850 to 4,013. As of December 31, 1997, 1,193 of options were vested.

As of December 31, 1997 and 1996, the Company had outstanding a total of 352 and 286, respectively, of performance accelerated restricted stock units ("PARS"). Subject to certain conditions of employment, PARS vest in increments through 2004, subject to accelerated vesting under certain circumstances, and are convertible into an equal number of shares of Hexcel common stock. As of December 31, 1997, no PARS were vested.

In May 1997, Hexcel's stockholders approved the Management Stock Purchase Plan (the "MSPP"). The MSPP authorizes an aggregate of 150 shares of Hexcel common stock for use by the Company in providing stock-based incentive awards to senior executives and certain key management employees. Eligible executives and employees may purchase Restricted Stock Units ("Units") for up to 50% of their annual bonus pursuant to an irrevocable election made previously. Each Unit is purchased at 80% of the fair market value (as defined in the MSPP) of the Company's common stock at the date the bonus becomes available and is restricted for a period of three years. Subject to certain conditions of employment, the Units vest equally over a period of three years, and upon expiration of the restricted period are convertible on a one-to-one basis for shares of Hexcel common stock. No Units had been purchased as of December 31, 1997.

In December 1997, the Board of Directors resolved to permit non-employee directors to elect to receive a portion or all of their annual retainer fees in the form of non-qualified stock options issued under the Incentive Stock Plan. These options may be used to purchase common stock of the Company at a price of 50% of the fair market value at the date of grant. Options vest proportionately over a period of one year from the date of grant. No such options had been granted as of December 31, 1997. Stock option data for the three years ended December 31, 1997, 1996 and 1995, were:

	Number of Shares	Weighted Average Exercise Price
Options outstanding at January 1, 1995	468	$ 12.37
Options granted	787	$ 5.63
Options exercised	(1)	$ 7.56
Options expired or canceled	(240)	$ 11.80
Options outstanding at December 31, 1995	1,014	$ 7.27
Options granted	1,577	$ 12.69
Options exercised	(447)	$ 9.40
Options expired or canceled	(85)	$ 11.45
Options outstanding at December 31, 1996	2,059	$ 10.36
Options granted	3,094	$ 18.24
Options exercised	(289)	$ 9.64
Options expired or canceled	(25)	$ 15.51
Options outstanding at December 31, 1997	4,839	$ 15.39

(IN THOUSANDS, EXCEPT PER SHARE DATA)

The following table summarizes information about stock options outstanding at December 31, 1997:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Options Outstanding	Weighted Average Remaining Life (in Years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
$ 4.75 – 5.00	160	7.3	$ 4.75	160	$ 4.75
$ 5.01 – 10.00	373	5.5	$ 5.99	335	$ 6.10
$ 10.01 – 15.00	1,211	8.0	$ 12.43	648	$ 12.42
$ 15.01 – 20.00	3,058	9.1	$ 18.13	49	$ 16.71
$ 20.01 – 25.00	15	9.2	$ 20.13	—	—
$ 25.01 – 30.00	20	9.6	$ 27.39	1	$ 29.38
$ 30.01 – 32.06	2	9.2	$ 30.49	—	$ 32.06
$ 4.75 – 32.06	4,839	8.5	$ 15.39	1,193	$ 9.80

Employee Stock Purchase Plan ("ESPP")

In July 1997, the Company established an ESPP to provide eligible employees an additional opportunity to share in the ownership of Hexcel. The maximum number of shares of common stock reserved for issuance under the ESPP is 200. Under the ESPP, eligible employees may contribute up to 10% of their base earnings toward the quarterly purchase of the Company's common stock at a purchase price equal to 85% of the fair market value of the common stock on the purchase date. During 1997, approximately 3 shares of common stock were issued under the ESPP.

Pro Forma Disclosures

In 1996, Hexcel adopted the disclosure requirements of SFAS 123, which provide for the disclosure of pro forma net earnings and net earnings per share as if the fair value method were used to account for stock-based employee incentive plans. Pursuant to SFAS 123, the Company has elected to continue to use the intrinsic value method to account for its stock option plans in the accompanying consolidated financial statements, in accordance with APBO No. 25.

If compensation expense had been determined for stock options granted in 1997, 1996 and 1995 using the fair value method at the date of grant, consistent with the provisions of SFAS 123, Hexcel's pro forma net income (loss) and diluted income (loss) per share would have been as follows:

	1997	1996	1995
Net income (loss), as reported	**$ 73,630**	$ (19,190)	$ 2,733
Pro forma compensation adjustment	**(6,275)**	(43)	(1,029)
Pro forma net income (loss)	**$ 67,355**	$ (19,233)	$ 1,704
Diluted net income (loss) per share, as reported	**$ 1.74**	$ (0.58)	$ 0.20
Pro forma compensation adjustment	**(0.14)**	0.02	(0.06)
Pro forma diluted net income (loss) per share	**$ 1.60**	$ (0.56)	$ 0.14

The weighted average fair value of options granted during 1997, 1996 and 1995 were $18.24, $12.75 and $5.63, respectively. The following ranges of assumptions were used in the Black-Scholes pricing models for options granted in 1997, 1996 and 1995: risk-free interest of 5.6% to 6.2%, estimated volatility of 40% to 49%, and an expected life of 3.6 years to 4.7.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

During 1996, the Company recognized $3,635 of compensation expense under the intrinsic value method resulting from stock options which vested in connection with the purchase of the Acquired Ciba Business. This compensation expense was based on the difference between the exercise price of the stock options granted and the market price of Hexcel common stock on the date that the Company's stockholders approved the Incentive Stock Plan under which these options were granted. The recognition of compensation expense in connection with these stock options resulted in a corresponding $3,635 increase in the additional paid-in capital of the Company.

NOTE 15—EARNINGS PER SHARE

In the fourth quarter of 1997, Hexcel adopted SFAS 128. SFAS 128 requires the presentation of "Basic" earnings per share which represents net earnings divided by the weighted average shares outstanding excluding all potential common shares. A dual presentation of "Diluted" earnings per share reflecting the dilutive effects of all potential common shares, is also required. The Diluted presentation is similar to fully diluted earnings per share under the prior accounting standard.

Computations of basic and diluted earnings (loss) per share for the years ended December 31, 1997, 1996 and 1995, are as follows:

	1997	1996	1995
Basic earnings (loss) per share:			
Net income (loss) from continuing operations	**$ 73,630**	$ (19,190)	$ 3,201
Weighted average common shares outstanding	**36,748**	33,351	15,605
Basic earnings (loss) per share	**$ 2.00**	$ (0.58)	$ 0.21
Diluted earnings (loss) per share:			
Net income (loss) from continuing operations	**$ 73,630**	$ (19,190)	$ 3,201
Effect of dilutive securities –			
Senior Subordinated Notes, due 2003	**5,087**	—	—
Senior Subordinated Debentures, due 2011	**1,111**	—	—
Adjusted net income (loss) from continuing operations	**$ 79,828**	$ (19,190)	$ 3,201
Weighted average common shares outstanding	**36,748**	33,351	15,605
Effect of dilutive securities –			
Stock options	**1,176**	—	137
Senior Subordinated Notes, due 2003	**7,239**	—	—
Senior Subordinated Debentures, due 2011	**834**	—	—
Adjusted weighted average common shares outstanding	**45,997**	33,351	15,742
Diluted earnings (loss) per share	**$ 1.74**	$ (0.58)	$ 0.20

The Convertible Subordinated Notes, due 2003, which were issued in 1996, and the Convertible Subordinated Debentures, due 2011, were excluded from the 1996 and 1995 computations of diluted earnings (loss) per share, as applicable, as they were antidilutive. Substantially all of the Company's stock options were included in the calculation of diluted earnings per share for the year ended December 31, 1997.

NOTE 16—CONTINGENCIES

Hexcel is involved in litigation, investigations and claims arising out of the conduct of its business, including those relating to government contracts, commercial transactions, and environmental, health and safety matters. The Company estimates its liabilities resulting from such matters based on a variety of factors, including outstanding legal claims and proposed settlements, assessments by internal and external counsel of pending or threatened litigation, and assessments by environmental engineers and consultants of potential environmental liabilities and remediation costs. Such estimates exclude counterclaims against other third parties. Such estimates are not discounted to reflect the time value of money due to the uncertainty in estimating the timing of the expenditures, which may extend over several years. Although it is impossible to determine the level of future expenditures for legal, environmental and related matters with any degree of certainty, it is the Company's opinion, based on available information, that it is unlikely that these matters, individually or in the aggregate, will have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

Legal and Environmental Claims and Proceedings

Hexcel has been named as a potentially responsible party with respect to several hazardous waste disposal sites that it does not own or possess which are included on the Superfund National Priority List of the U.S. Environmental Protection Agency or on equivalent lists of various state governments. The Company believes that its liability with respect to these sites is not material.

Pursuant to the New Jersey Environmental Responsibility and Clean-Up Act, Hexcel signed an administrative consent order to pay for the environmental remediation of a manufacturing facility it owns and formerly operated in Lodi, New Jersey. The Company's estimate of the remaining cost to satisfy this consent order is accrued in the accompanying consolidated balance sheets. The ultimate cost of remediating the Lodi site will depend on developing circumstances.

In connection with the purchase of the Acquired Ciba Business, Hexcel assumed various liabilities including a liability with respect to certain environmental remediation activities at an acquired facility in Kent, Washington. The Company is a party to a cost sharing agreement regarding the operation of certain environmental remediation systems necessary to satisfy a post-closure care permit issued to a previous owner of the Kent site by the U.S. Environmental Protection Agency. Under the terms of the cost sharing agreement, the Company is obligated to reimburse the previous owner for a portion of the cost of the required remediation activities. The Company's estimate of its share of the cost is accrued in the accompanying consolidated balance sheets as of December 31, 1997 and 1996.

Product Claims

In 1993, Hexcel became aware of an aluminum honeycomb sandwich panel delamination problem with panels produced by its wholly-owned Belgium subsidiary, Hexcel Composites S.A., and installed in rail cars in France and Spain. Certain customers have alleged that Hexcel Composites S.A. is responsible for the problem. The Company and its insurer continue to investigate these claims. The Company is also working with the customers to repair or replace panels when necessary, with certain costs to be allocated upon determination of responsibility for the delamination. Two customers in France requested that a court appoint experts to investigate the claims; to date, the experts have not reported any conclusions. The Company's primary insurer for this matter has agreed to fund legal representation and to provide coverage of the claim to the extent of the policy limit. The Company believes that, based on available information, it is unlikely that these claims will have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

U.S. Government Claims

Hexcel, as a defense subcontractor, is subject to U.S. government audits and reviews of negotiations, performance, cost classifications, accounting and general practices relating to government contracts. Under the direction of the Corporate Administrative Contracting Officer ("CACO"), the Defense Contract Audit Agency ("DCAA") reviews cost accounting and business practices of government contractors and subcontractors, including the Company. In 1996, the Company was engaged in discussions with the CACO and the DCAA regarding a number of cost accounting issues identified during the course of various audits performed by the DCAA. The Company reached an agreement with the CACO and the DCAA that resolved the primary issues identified during the course of these audits. Under the terms of the agreement, the Company paid the U.S. federal government $1,314 in exchange for the irrevocable discharge of any claims with respect to the issues that were resolved.

NOTE 17—RAW MATERIALS, SIGNIFICANT CUSTOMERS AND MARKETS

Hexcel purchases most of the raw materials used in production. Several key materials are available from relatively few sources, and in many cases the cost of product qualification makes it impractical to develop multiple sources of supply. The unavailability of these materials, which the Company does not anticipate, could have a material adverse effect on sales and earnings.

The Boeing Company ("Boeing") and Boeing subcontractors accounted for approximately 36% of 1997 sales, 22% of 1996 sales and 21% of 1995 sales. The Airbus Industrie ("Airbus") consortium and Airbus subcontractors accounted for approximately 10% of 1997 and 1996 sales, and less than 10% of 1995 sales. The loss of all or a significant portion of the business with Boeing or Airbus, which Hexcel does not anticipate, could have a material adverse effect on sales and earnings.

Net sales by market for the years ended December 31, 1997, 1996 and 1995, were:

	1997	1996	1995
Commercial aerospace	**64%**	56%	45%
Space and defense	**9**	11	11
Recreation	**7**	10	9
General industrial and other	**20**	23	35
Net sales	**100%**	100%	100%

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 18—BUSINESS SEGMENT DATA

Hexcel operates within a single business segment: Advanced Structural Materials. The following table summarizes certain financial data for continuing operations by geographic area as of December 31, 1997, 1996 and 1995, and for the years then ended:

	1997	1996	1995
Net sales to non-affiliates:			
U.S.	$ 598,555	$ 394,524	$ 197,665
International	338,300	300,727	152,573
Consolidated	$ 936,855	$ 695,251	$ 350,238
Income (loss) before income taxes:			
U.S.	$ 34,684	$ (2,934)	$ 2,912
International	16,068	(12,820)	3,602
Consolidated	$ 50,752	$ (15,754)	$ 6,514
Total assets:			
U.S.	$ 547,471	$ 429,025	$ 134,972
International	264,115	272,711	95,630
Consolidated	$ 811,586	$ 701,736	$ 230,602
Capital expenditures:			
U.S.	$ 40,667	$ 27,217	$ 7,729
International	16,702	16,352	4,415
Consolidated	$ 57,369	$ 43,569	$ 12,144
Depreciation and amortization:			
U.S.	$ 22,348	$ 15,239	$ 6,528
International	13,449	11,491	5,095
Consolidated	$ 35,797	$ 26,730	$ 11,623

The international segment is comprised primarily of operations in Western Europe conducted by various European subsidiaries. International net sales consist of the net sales of these European subsidiaries, sold primarily in Europe.

U.S. net sales include U.S. exports to non-affiliates of $70,875 in 1997, $53,333 in 1996 and $18,092 in 1995. Transfers from the Company's U.S. subsidiaries to its international subsidiaries for the years ended December 31, 1997, 1996 and 1995 were $44,650, $30,390 and $18,590, respectively. Transfers from the Company's international subsidiaries to its U.S. subsidiaries for the years ended December 31, 1997, 1996 and 1995 were $22,700, $11,480 and $4,380, respectively. Transfers between geographic areas are recorded on the basis of arm's length prices established by the Company.

To compute income (loss) before income taxes, Hexcel allocated administrative expenses to the international segment of $10,487 in 1997, $9,022 in 1996 and $3,939 in 1995.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 19—SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information, including non-cash financing and investing activities, for the years ended December 31, 1997, 1996 and 1995, consist of the following:

	1997	1996	1995
Cash paid for:			
Interest	**$ 22,300**	$ 14,061	$ 8,345
Taxes	**3,929**	8,911	3,864
Non-cash items:			
Debt issued in connection with Ciba acquisition	**—**	37,231	—
Common stock issued in connection with Ciba acquisition	**—**	144,174	—
Conversion of Senior Subordinated Notes	**50**	—	—
Compensation expense in connection with the issuance of common stock (see Note 14)	**—**	3,635	—

NOTE 20—OTHER INCOME, NET

Other income of $2,994 recognized in 1996 is largely attributable to the receipt of an additional $1,560 of cash in connection with the disposition of the Chandler, Arizona manufacturing facility and certain related assets in 1994, and to the receipt of $1,054 in partial settlement of a claim arising from the sale of certain assets in 1991.

Other income of $791 recognized in 1995 is largely attributable to the receipt of an additional $600 of cash in connection with the disposition of the Chandler, Arizona manufacturing facility and certain related assets in 1994.

Hexcel sold its Chandler, Arizona manufacturing facility and certain related assets, including technology, to Northrop Grumman Corporation ("Northrop") in 1994. Under the terms of the Chandler transaction, Hexcel retained a royalty-free, non-exclusive license to use the technology sold to Northrop in non-military applications. In addition, the Company will receive royalties from Northrop on certain applications of the technology by Northrop. The Company received net cash proceeds of $1,560 and $27,294 in relation to this sale in 1996 and 1995, respectively.

NOTE 21—BANKRUPTCY REORGANIZATION

On January 12, 1995, the U.S. Bankruptcy Court for the Northern District of California entered an order dated January 10, 1995, confirming the First Amended Plan of Reorganization (the "Reorganization Plan") proposed by Hexcel and the Official Committee of Equity Security Holders (the "Equity Committee"). On February 9, 1995, the Reorganization Plan became effective and Hexcel Corporation (a Delaware corporation) emerged from the bankruptcy reorganization proceedings which had begun on December 6, 1993, when Hexcel filed a voluntary petition for relief under the provisions of Chapter 11 of the federal bankruptcy laws.

The Reorganization Plan which became effective on February 9, 1995 provided for, among other things: (a) the completion of the first closing under a standby purchase commitment whereby Mutual Series Fund Inc. ("Mutual Series") purchased 1,946 shares of newly issued Hexcel common stock for $9,000 and loaned the Company $41,000 as an advance against the proceeds of a subscription rights offering for additional shares of Hexcel common stock; and (b) the reinstatement or payment in full, with interest, of all allowed claims, including prepetition accounts payable and notes payable. The subscription rights offering concluded on March 27, 1995, with the issuance of an additional 7,156 shares of Hexcel common stock. The resulting cash proceeds of $33,098 were used to reduce the outstanding balance of the loan from Mutual Series. The second closing under the standby purchase agreement was completed on April 6, 1995, with the issuance of an additional 1,590 shares of Hexcel common stock to Mutual Series, the issuance of an additional 108 shares of Hexcel common stock to John J. Lee, the Company's Chief Executive Officer, and the retirement of the remaining balance of the Mutual Series loan.

The Reorganization Plan provided for the reinstatement or payment in full, with interest, of all allowed claims, including prepetition accounts payable and notes payable. On February 9, 1995, Hexcel paid $78,144 in prepetition claims and interest, and reinstated another $60,575 in prepetition liabilities. The payment of claims and interest on February 9, 1995 was financed with: (a) cash proceeds of $26,694 received in the first quarter of 1995 from the sale of the Company's Chandler, Arizona manufacturing facility and certain related assets (see Note 20); (b) the $50,000 in cash received from Mutual Series in connection with the standby purchase agreement; and (c) borrowings under a $45,000 U.S. credit facility obtained on February 9, 1995. This $45,000 U.S. credit facility was subsequently replaced by a secured credit facility on February 29, 1996, which in turn was replaced by the Revolving Credit Facility on June 27, 1996 (see Notes 2 and 7).

Professional fees and other costs directly related to bankruptcy proceedings were expensed as incurred, and have been reflected in the accompanying consolidated statements of operations as "bankruptcy reorganization expenses." Bankruptcy reorganization expenses consisted primarily of professional fees paid to legal and financial advisors of Hexcel, the Equity Committee and the Official Committee of Unsecured Creditors. In addition, these expenses included incentives for employees to remain with the Company for the duration of bankruptcy proceedings and the write-off of previously capitalized costs related to the issuance of prepetition debt.

NOTE 22—DISCONTINUED OPERATIONS

In October of 1995, the Company sold its U.S. resins operations for net cash proceeds that approximated the net book value of the assets sold. This sale, which completed the divestiture of the Company's resins business, has been accounted for as a discontinued operation in the accompanying consolidated statements of operations and cash flows for 1995. The net sales of the discontinued resins business were $6,944 in 1995.

(IN THOUSANDS, EXCEPT PER SHARE DATA)

NOTE 23—QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly financial data for the years ended December 31, 1997 and 1996, were:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1997				
Net sales	$ 214,009	$ 241,629	$ 226,611	$ 254,606
Gross margin	46,889	57,818	54,967	62,958
Business acquisition and consolidation expenses	(2,899)	(2,818)	(15,433)	(4,193)
Operating income	16,384	24,516	9,331	26,226
Net income	8,226	15,135	37,948	12,321
Earnings per share				
Basic	$ 0.22	$ 0.41	$ 1.03	$ 0.33
Diluted	0.22	0.38	0.87	0.30
Dividends per share	—	—	—	—
Market price:				
High	$ 21.38	$ 20.00	$ 30.25	$ 31.75
Low	16.00	16.38	18.75	22.25
1996				
Net sales	$ 126,418	$ 166,770	$ 189,542	$ 212,521
Gross margin	26,783	35,188	35,813	43,525
Business acquisition and consolidation expenses	(5,211)	(29,209)	(1,382)	(6,568)
Operating income (loss)	4,090	(17,900)	8,789	7,810
Net income (loss)	1,848	(23,667)	346	2,283
Basic and diluted net income (loss) per share	$ 0.07	$ (0.65)	$ 0.01	$ 0.06
Dividends per share	—	—	—	—
Market price:				
High	$ 13.13	$ 16.00	$ 20.00	$ 19.88
Low	10.63	11.50	12.75	15.75

For the nine months ended September 30, 1997 and for the year ended December 31, 1996, except for the $39,000 reversal of the U.S. tax valuation allowance reserve on September 30, 1997, there was no net federal tax provision recorded on the Company's U.S. income (loss). Third quarter 1997 results include both the $39,000 reversal of the U.S. tax valuation allowance reserve and an additional charge of $13,000 to business acquisition and consolidation expenses in connection with the Company's acquisition of the Fiberite assets. In addition, first quarter 1996 results include other income of $2,697 (see Note 20).

NOTE 24—SUBSEQUENT EVENTS (UNAUDITED)

Revolving Credit Facility

On March 5, 1998, the Company amended and restated its Revolving Credit Facility (the “Amended Facility”). The Amended Facility provides for borrowing capacity of up to $355,000 and extends the expiration date to March 2003. Depending on certain predetermined ratios and other conditions, interest on outstanding borrowings under the Amended Facility is computed at an annual rate ranging from 0.313 to 1.125% in excess of the applicable London interbank rate or, at the option of Hexcel, at the base rate of the administrative agent for the lenders. In addition, the Amended Facility is subject to a commitment fee ranging from approximately 0.188 to 0.375% per annum of the total facility.

The Amended Facility is secured by a pledge of stock of certain of Hexcel’s subsidiaries. In addition, the Company continues to be subject to various financial covenants and restrictions, and is generally prohibited from paying dividends or redeeming capital stock.

Joint Ventures

In January 1998, the Company reached an agreement in principle with Boeing and Aviation Industries of China to form a joint venture, BHA Aero Composite Parts Co., Ltd., to manufacture composite parts for secondary structures and interior applications on commercial aircraft. This joint venture will be located in Tianjin, China. In February 1998, the Company signed an agreement with Boeing, Sime Darby Berhad and Malaysia Helicopter Services to form another joint venture, Asian Composite Manufacturing Sdn. Bhd., to manufacture composite parts for secondary structures for commercial aircraft. This joint venture will be located in Alor Setar, Malaysia. Products manufactured by both joint ventures will be shipped to the Company’s Kent, Washington facility for final assembly, inspection and shipment to Boeing as well as other customers worldwide. It is anticipated that the first parts will be delivered to customers in 2000. The Company’s total estimated financial commitment to both of these joint ventures will be approximately $31,000, which is expected to be made in increments through 2000. However, completion of these projects and related investments remain subject to certain significant conditions, including U.S. and foreign government approvals.

Stock-Based Incentive Plan

On February 5, 1998, the Company adopted the 1998 Broad Based Stock Incentive Plan (the “Broad Based Plan”), which authorizes the use of Hexcel common stock for providing a variety of stock-based incentive awards to eligible employees and consultants (but not to directors, officers and related consultants). The Broad Based Plan provides for grants of stock options, stock appreciation rights, restricted stock and restricted stock units, and other stock-based awards. The aggregate number of shares of Hexcel common stock available under the Broad Based Plan is 500.

H E X C E L   G L O B A L   F A C I L I T I E S   A N D   O F F I C E S

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Two Stamford Plaza
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Stamford, Connecticut USA
06901-3238

OPERATIONS CENTERS

North America

5794 West Las Positas Boulevard
Pleasanton, California USA
94588-8781

19819 84th Avenue
Kent, Washington USA
98032-1298

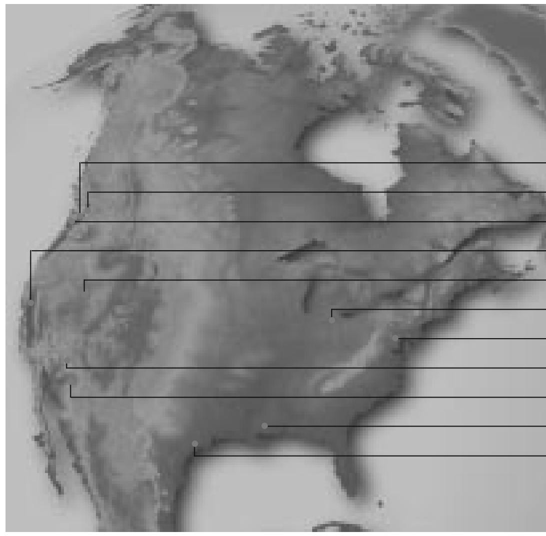
Europe

Duxford, Cambridge
CB2 4QD United Kingdom

3 Avenue Condorcet
69608 Villeurbanne Cedex
France

RESEARCH AND TECHNOLOGY CENTER

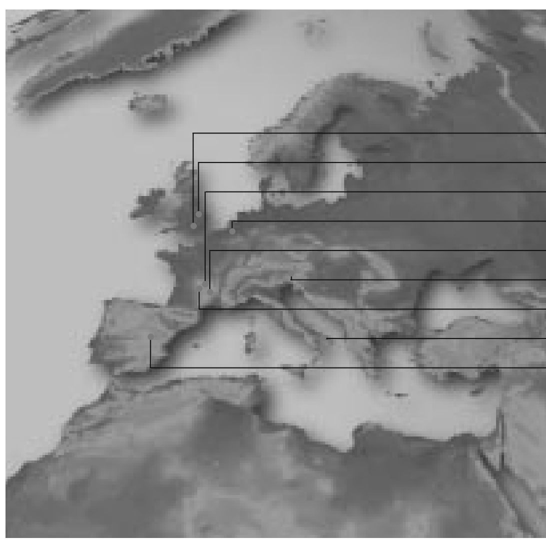
11711 Dublin Boulevard
Dublin, California USA
94568



WORLDWIDE MANUFACTURING FACILITIES

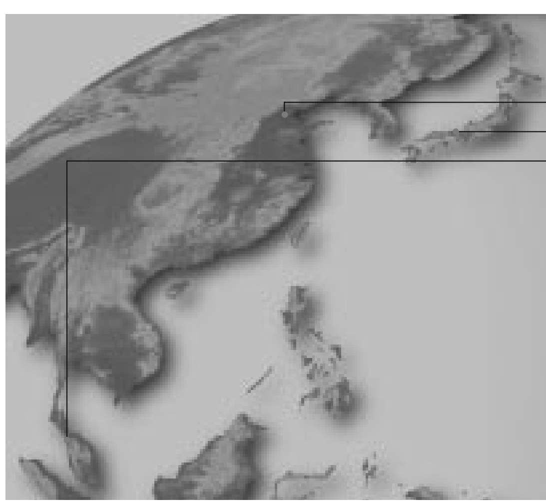
North America

Burlington, Washington USA
Bellingham, Washington USA
Kent, Washington USA
Livermore, California USA
Salt Lake City, Utah USA
Lancaster, Ohio USA
Pottsville, Pennsylvania USA
Tempe, Arizona USA
Casa Grande, Arizona USA
Decatur, Alabama USA
Seguin, Texas USA



Europe

Swindon, United Kingdom
Duxford, United Kingdom
Dagneux, France
Welkenraedt, Belgium
Les Avenières, France
Linz, Austria
Décines, France
Brindisi, Italy
Parla, Spain



Pacific Rim (Joint Venture)

Tianjin, China (announced)
Komatsu, Japan
Alor Setar, Malaysia (announced)

BOARD OF DIRECTORS

HEXCEL'S BOARD OF DIRECTORS
SEATED, LEFT TO RIGHT:
George Springer, John Lee, Franklin Wimer.
STANDING, LEFT TO RIGHT:
Joseph Sullivan, Stanley Sherman, Hermann Vodicka, Marshall Geller, Martin Solomon, John Cheesmond.

John J. Lee
Chairman, President and
Chief Executive Officer
Hexcel Corporation
Nominating Committee*
Finance Committee

John M.D. Cheesmond
Executive Vice President
Ciba Specialty Chemicals Inc.
(Switzerland)
Executive Compensation
Committee*
Finance Committee

Marshall S. Geller
Chairman of the Board and
Chief Executive Officer
Geller & Friend Capital
Partners, Inc.
Audit Committee
Executive Compensation
Committee
Nominating Committee

Stanley Sherman
President and
Chief Executive Officer
Ciba Specialty Chemicals
Corporation (North America)
Finance Committee
Executive Compensation
Committee

Martin L. Solomon
Chairman and Chief
Executive Officer
American Country
Holdings, Inc.
Finance Committee*
Audit Committee
Executive Compensation
Committee

George S. Springer
Paul Pigott Professor and
Chairman, Department of
Aeronautics and Astronautics;
Professor of Mechanical
Engineering and Professor
of Civil Engineering
Stanford University
Technology Committee*

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Joseph H. Colic
Professor of Chemical
Engineering
Virginia Polytechnic Institute
and State University
Nominating Committee
Technology Committee

Hermann Vodicka
Chief Executive Officer
and Member of the Board
Ciba Specialty Chemicals Inc.
(Switzerland)
Nominating Committee
Technology Committee

Franklin S. Wimer
President
UniRock Management
Corporation
Audit Committee*
Technology Committee

* Denotes Chairman

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Chairman, President and Chief Executive Officer; Director

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Senior Vice President Finance and Administration; Chief Financial Officer

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Senior Vice President; General Counsel; Secretary

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Corporate Controller; Chief Accounting Officer

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Vice President, Structures and Interiors Business Unit

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Gary L. Sandercock*
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David R. Tanonis
Vice President, Structures and Interiors Business Unit

Justin Taylor
President, Structures and Interiors Business Unit

* Member of Operating Committee

EXECUTIVE OFFICES

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INVESTOR RELATIONS

To receive Hexcel financial publications, please contact the Investor Relations Department at Hexcel Executive Offices.

TRANSFER AGENT REGISTRAR

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STOCK EXCHANGES

Hexcel common stock is listed on the New York Stock and Pacific Exchanges under the symbol “HXL”.

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