

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Acquisition

On May 15, 2001, the Company acquired Generac Portable Products for net cash of \$267 million. See Note 3 to the Consolidated Financial Statements for additional information on the acquisition.

Results of Operations

FISCAL 2001 COMPARED TO FISCAL 2000

Sales

Net sales for fiscal 2001 totaled \$1,312 million, a decrease of \$280 million or 18% compared to the preceding year. The primary factors were a 10% decline in engine unit volume, 15% lower sales of service components due to the Company's distributors having adequate stocks of parts, and an unfavorable sales mix as the entire 10% engine unit decline was made up of larger horsepower engines. Inventories of riding equipment at the OEMs and retail were more than adequate to address soft demand for riding lawn and garden equipment.

The other major factor adversely affecting the fiscal year was the weak Euro which lowered revenues by \$24 million. These revenues decreased because the Company's pricing reflected the need to remain competitive in the European market.

The acquisition of Generac added \$30 million in sales.

Gross Profit

The gross profit rate decreased to 18% from 21% in fiscal 2000. The major reasons for the decrease were lower plant utilization having a \$32 million impact and the weak Euro of \$24 million. Offsetting these factors was the favorable pension income impact of \$12 million. Pension income included in gross profit totaled \$24 million in fiscal 2001.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses increased \$6 million or 4% compared to fiscal 2000. Expenses in this category increased almost \$20 million. The majority of the increase was due to the following factors: a \$16 million planned expansion of staff and expenditures for business development and introduction of new product, a \$3 million bad debt write-off, and \$3 million of Generac's operating costs incurred since the

acquisition. The increased costs were offset by \$14 million of lower employee benefit costs for profit sharing and increased pension income. Pension income in this category was \$4 million in fiscal 2001.

Interest Expense

Interest expense increased \$9 million or 44% in fiscal 2001 compared to fiscal 2000 because the level of borrowings was greater in fiscal 2001. The increased level of borrowings resulted from increased seasonal working capital needs and the funding of the Generac acquisition.

Other Income

Other income decreased \$13 million in fiscal 2001 compared to fiscal 2000. This decrease is attributed primarily to an \$8 million reduction in equity income from joint ventures and investments and \$5 million in translation losses.

Provision for Income Taxes

The effective tax rate decreased to 33.2% in fiscal 2001 from 37.0% in the previous year. The majority of the decrease was the result of the finalization and approval by the Congressional Joint Committee on Taxation of a refund on our Federal taxes related to Foreign Sales Corporation tax benefits.

FISCAL 2000 COMPARED TO FISCAL 1999

Sales

Net sales for fiscal 2000 totaled \$1,593 million, an increase of \$89 million or 6% compared to the preceding year. The primary factors were a \$104 million increase in sales dollars related to a 6% increase in engine unit shipments, a favorable mix of engines sold amounting to \$24 million and \$9 million from increased prices. Offsetting these factors was a \$48 million decrease of castings sales resulting from the disposition of the Company's ductile iron foundries in the first quarter of fiscal 2000.

Gross Profit

The gross profit rate increased to 21% in fiscal 2000 from 20% in fiscal 1999. Favorable factors to the gross profit were \$18 million attributed to the benefit of higher production during the year and \$9 million of price increases. Offsetting these improvements were \$6 million of higher costs for purchased items including increased costs for imported engines due to currency exchange rates.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses increased \$9 million or 7% compared to fiscal 1999. This increase was primarily from a \$6 million increase in research and development costs and a \$3 million increase in profit sharing expenses due to improved results. These increases were offset by a \$2 million decrease in costs related to the Company's POWERCOM software business that was sold in the first quarter of the preceding year.

Interest Expense

Interest expense increased \$4 million or 25% in fiscal 2000 compared to fiscal 1999. These increases were the result of the Company's higher level of short-term borrowings during the year to fund working capital needs.

Gain on Disposition of Foundry Assets

At the end of August 1999, the Company contributed its two ductile iron foundries to Metal Technologies Holding Company, Inc. (MTHC) in exchange for \$24 million in cash and \$45 million aggregate par value convertible preferred stock. The provisions of the preferred stock include a 15% cumulative dividend and conversion rights into a minimum of 31% of MTHC common stock. Pursuant to Emerging Issues Task Force Abstract No. 86-29, the Company considered this contribution to be a monetary transaction, given the significant amount of cash received and recorded the consideration received at fair value. The preferred stock received was determined to have a fair value of \$22 million based on provisions of the stock and the prevailing market returns for similar investments, estimated to be 30%, as of the date of the transaction.

Other Income

Other income increased \$9 million in fiscal 2000 compared to fiscal 1999. This increase is primarily attributed to increased equity income from joint ventures.

Provision for Income Taxes

The effective tax rate used in fiscal 2000 was 37.0% compared with 37.5% in fiscal 1999.

Liquidity and Capital Resources

FISCAL YEARS 2001, 2000 AND 1999

Cash flow from operating activities was \$68 million, \$77 million and \$116 million, in fiscal 2001, 2000 and 1999, respectively.

The fiscal 2001 cash flow from operating activities decreased \$10 million, which reflects lower gains on the disposition of plant and equipment of \$16 million. The lower gains from disposition of plant and equipment were because fiscal 2000 contained the disposition of the foundry assets. The increase in inventories was \$114 million less in fiscal 2001 compared to the fiscal 2000 increase. This decrease was the result of planned inventory increases in fiscal 2000 to replenish abnormally low inventories to more normal levels. The change in accounts payable and accrued liabilities was \$48 million less in fiscal 2001 due to timing of payments and lack of accruals for profit sharing due to lower performance. The \$18 million increase in pension income is attributable to the Company's over funded pension plan.

The fiscal 2000 cash flow from operating activities decreased \$38 million. This reflects increased net income of \$30 million offset by the gain on disposition of foundry assets of \$17 million and an increased requirement for operating capital of \$41 million caused by increases in inventories at the end of fiscal 2000 offset by lower accounts receivable. The increase in inventories was planned as inventories at the end of fiscal 1999 were unusually low. Lower accounts receivable was caused by lower sales in June 2000 compared to June 1999.

The fiscal 1999 cash flow from operating activities declined \$20 million. This reflects improved net income of \$35 million, offset by an increased requirement for operating capital of \$49 million, caused primarily by strong fourth quarter business which increased year-end receivables and a restoration of inventories to higher year-end levels.

Net cash used in investing activities amounted to \$318 million, \$43 million and \$67 million in fiscal 2001, 2000 and 1999, respectively. These cash flows included additions to plant and equipment of \$61 million, \$71 million and \$66 million in fiscal 2001, 2000 and 1999, respectively. Fiscal 2001 and 1999 capital expenditures relate primarily to reinvestment in equipment and new products. The fiscal 2000 capital expenditures related primarily to reinvestment in equipment, capacity additions and new products. The fiscal 2001 cash used in investing activities includes \$267 million of cash paid for the Generac acquisition net of cash acquired. The fiscal 2000 cash used in investing activities is net of \$24 million of proceeds received on the disposition of plant and equipment.

Net cash provided by financing activities amounted to \$324 million in fiscal 2001. In fiscal 2000 and 1999 cash used by financing activities was \$77 million and \$73 million, respectively. Fiscal 2001 included \$399 million of proceeds received from issuing the 5.00% Convertible Senior Notes due 2006 and the 8.875% Senior Notes due 2011 to fund the acquisition of Generac and payment of short term-borrowings. During fiscal 2000, the Company repaid the remaining \$30 million on the 9.21% Senior Notes due 2001. There was no gain or loss associated with this repayment. In fiscal 1999 the Company paid \$15 million on these notes. Proceeds from the exercise of stock options amounted to \$45 million in fiscal 1999, substantially higher than in fiscal 2001 and 2000. Also, the Company repurchased fewer common shares in fiscal 2001 compared to fiscal 2000 and 1999.

Future Liquidity and Capital Resources

The Company has in place a \$250 million revolving credit facility to be used to fund seasonal working capital requirements and other financing needs. While this credit facility expires in April 2002, the Company is currently negotiating its replacement and expects to be completed during the second quarter of fiscal 2002. This facility and the Company's other indebtedness contain certain restrictive covenants, see Note 6 to the Consolidated Financial Statements.

The Company expects capital expenditures to be \$67 million for fiscal 2002. These anticipated expenditures are for continued investments in equipment and new products.

Management believes that available cash, the credit facility, cash generated from operations, existing lines of credit and access to debt markets will be adequate to fund the Company's capital requirements for the foreseeable future.

Financial Strategy

Management of the Company subscribes to the premise that the value of the Company is enhanced if the capital invested in the Company's operations yields a cash return that is greater than the Company's cost of capital. Given this belief, the Company implemented this financial strategy by means of a "dutch auction" tender offer and a public debt offering in fiscal 1997. The Company also continued the repurchase of its outstanding common stock in the open market in fiscal years 1998 through 2001. The Company believes this will provide a capital structure that makes greater use of financial leverage without imposing excessive risk on either the Company's shareholders or creditors. The Company

also believes that the substitution of lower (after-tax) cost debt for equity in its permanent capital structure will reduce its overall cost of capital and that its profitability and strong cash flows will accommodate the increased use of debt without impairing its ability to finance growth or increase cash dividends per share on its common stock.

The Company has remaining authorization to buy up to 1.8 million shares of company stock in open market or private transactions under the June 2000 Board of Directors' authorization to repurchase up to 2.0 million shares. The Company does not anticipate repurchasing shares in fiscal 2002.

Also as a part of its financial strategy, subject to the discretion of its Board of Directors and the requirements of applicable law and debt covenants, the Company currently intends to increase future cash dividends per share at a rate approximating the inflation rate.

Outlook

The Company projects sales to increase by almost 30% in fiscal 2002. A majority of the increase is because Generac's sales will be in the numbers for a full year at approximately \$310 million. Engine sales are anticipated to increase 7% due to engine volume, sales mix and some new products and services.

The gross profit percentage is projected to be approximately 17.5 % for the year. This is down from fiscal 2001, because of the weighting of Generac sales which are projected to have lower gross margins than the Company's engine business. The other negative impact on gross margins is the anticipated lower engine production between years and the new product and service introductions that are projected to have negative margins during startup.

Engineering, selling, general and administrative expenses are projected to increase from \$140 million to \$165 million. Generac's expenses in this category are \$24 million of the anticipated \$25 million increase.

Interest expense is anticipated to be \$45 million, depreciation \$60 million and capital expenditures \$67 million. The Company currently expects to have an effective tax rate of 35.0%.

The Company anticipates the first quarter operating results to be significantly lower than the prior years, due to slower sales and significantly lower production levels. The Company expects both sales and production levels to peak in a more historical pattern in fiscal 2002, which is basically late in the second fiscal quarter and then during the full third fiscal quarter.

Other Matters

General

On October 5, 2000, it was announced that one of the Company's largest customers, the Murray Group, was acquired by Summersong Investments, Inc. The Company does not expect this acquisition to adversely impact its annual supply arrangement with the Murray Group for the fiscal 2002 outdoor power equipment selling season, as there was no adverse impact in fiscal 2001.

In July 2001, the Company extended its collective bargaining agreement with one of its unions. This agreement expires in 2006, and contains provisions for future wage increases, medical cost sharing and increased pension benefits.

Emissions

The U.S. Environmental Protection Agency (EPA) has developed national emission standards under a two phase process for small air cooled engines. The Company currently has a complete product offering which complies with EPA's Phase I engine emission standards. The EPA finalized its Phase II emission standards in March of 1999. The Phase II program will impose more stringent standards over the useful life of the engine and will be phased in from 2001 to 2005 for Class II (225 or greater cubic centimeter displacement) engines and from 2003 to 2008 for Class I (under 225 cubic centimeter displacement) engines. The Company does not believe compliance with the new standards will have a material adverse effect on its financial position or results of operations.

The Company implemented a supplemental compliance plan for model years 2000 and 2001 with the California Air Resources Board (CARB), as required of companies which sell more than a threshold number of Class I engines into California. The objective of the plans is to achieve additional reductions in extreme non-attainment areas. While CARB's aggressive program resulted in a reduced product offering by the Company in California, the California program did not have a material effect on

the financial condition or results of operations of the Company.

New Accounting Pronouncements

The Emerging Issues Task Force (EITF) issued EITF Abstract No. 00-10, "Accounting for Shipping and Handling Fees and Costs, and EITF Abstract No. 00-22, "Accountings for Points and Certain Time-Based and Volume-Based Sales Incentive Offers and Offers for Free Products or Services to be Delivered in the Future". These were adopted during fiscal 2001. The impact of adopting of EITF No. 00-10 was to reclassify approximately \$2 million of shipping revenue from cost of sales into revenue in each of fiscal 2001, 2000 and 1999. There was no impact of adopting EITF No. 00-22.

EITF Abstract No. 00-25, "Vendor Income Statements Characterization of Consideration Paid to a Re-Seller of a Vendor's Products", is to be adopted as of December 31, 2001. The Company will be required to reclassify co-op advertising expense from selling expense to sales as a reduction of gross sales. The reclassification will not have a material adverse effect on the Company's results of operations.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 provides for the elimination of the pooling-of-interests method of accounting for business combinations with an acquisition date of July 1, 2001 or later. SFAS No. 142 prohibits the amortization of goodwill and other intangible assets with indefinite lives and requires periodic reassessment of the underlying value of such assets for impairment. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001. An early adoption provision exists for companies with fiscal years beginning after March 15, 2001. On July 2, 2001, the Company adopted SFAS No. 142. Application of the nonamortization provision of SFAS No. 142 is expected to result in an increase in net income of approximately \$.7 million in fiscal 2002.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk from changes in foreign exchange and interest rates. To reduce the risk from changes in foreign exchange rates, the Company selectively uses financial instruments. The Company does not hold or issue financial instruments for trading purposes.

Foreign Currency

The Company's earnings are affected by fluctuations in the value of the U.S. dollar against the Japanese Yen and Euro. The Yen is used to purchase engines from the Company's joint venture, while the Company receives Euros for certain products sold to European customers. The Company's foreign subsidiaries' earnings are also influenced by fluctuations of the local currency against the U.S. dollar as these subsidiaries purchase inventory from the parent in U.S. dollars. Forward foreign exchange contracts are used to partially hedge against the earnings effects of such fluctuations. At July 1, 2001, the Company had the following forward foreign exchange contracts outstanding with the Fair Value Gains (Losses) shown (in thousands):

Currency	Notional Value	Currency Amount	Type	Fair Value \$
Japanese Yen	1,330,024	11,375	U.S.	(622)
Euro	36,000	33,569	U.S.	3,056
Japanese Yen	27,638	443	Australian	(4)
U.S. Dollars	5,242	9,733	Australian	275
U.S. Dollars	3,290	5,021	Canadian	(25)
British Pounds	682	1,921	Australian	(15)

All of the above contracts expire within twelve months.

Fluctuations in currency exchange rates may also impact the shareholders' investment in the Company. Amounts invested in the Company's non-U.S.

subsidiaries are translated into U.S. dollars at the exchange rates in effect at year end. The resulting translation adjustments are recorded in shareholders' investment as cumulative translation adjustments. The cumulative translation adjustments component of shareholders' investment decreased \$2.5 million during the year. Using the year-end exchange rates, the total amount invested in non-U.S. subsidiaries at July 1, 2001 was approximately \$21.7 million.

Interest Rates

The Company is exposed to interest rate fluctuations on its borrowings. The Company manages its interest rate exposure through a combination of fixed and variable rate debt. Depending on general economic conditions, the Company has typically used variable rate debt for short-term borrowings and fixed rate debt for longer-term borrowings.

At July 1, 2001, the Company had the following short-term loans outstanding (amounts in thousands):

Currency	Amount	Weighted Average Interest Rate
German Mark	33,062	5.85%
Dutch Guilder	1,277	6.32%
Canadian Dollars	2,120	5.10%
U.S. Dollars	3,300	5.18%
French Franc	208	4.54%

All of the above loans carry variable interest rates.

Long-term loans, net of unamortized discount, consisted of the following (amounts in thousands):

Description	Amount	Maturity
5.00% Convertible Notes	\$ 140,000	2006
7.25% Notes	\$ 98,718	2007
8.875% Notes	\$ 269,416	2011

The above loans carry fixed rates of interest.