

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

Results of Operations

FISCAL 1997 COMPARED TO FISCAL 1996

Sales

Net sales for fiscal 1997 increased 2% or \$29.4 million compared to the prior year. The primary reason for this was a 1% increase in engine unit shipments. The remaining 1% increase in net sales was a result of modest price increases and a mix improvement.

Gross Profit

Gross profit for fiscal 1997 decreased 15% or \$40.5 million compared to the same period in the prior year. The primary reason for this decrease was a charge of \$37.1 million related to an early retirement window accepted by certain Milwaukee hourly employees in accordance with the current union contract.

The gross profit rate was 17% in fiscal 1997 compared to 20% in fiscal 1996. In addition to the early retirement window, the gross profit rate was also negatively impacted by increases in warranty expenses totaling \$9.3 million due to claims experience, increases in the unit price of aluminum totaling \$3.7 million, and the absence in fiscal 1997 of the \$3.5 million credit for employees who had accepted early retirement in fiscal 1995 and canceled their acceptance in fiscal 1996. Savings from lower labor costs at the Company's new engine plants partially offset the preceding factors impacting the gross profit rate.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses for fiscal 1997 increased 8% or \$9.2 million compared to fiscal 1996. This increase was primarily due to increased employee compensation of \$4.0 million, planned increases in manpower and other costs of \$2.7 million relating to new venture activities, and increased professional services of \$1.5 million primarily resulting from the start of the implementation of a new enterprise-wide information system.

Provision for Income Taxes

The effective income tax rate used in both periods was 38.0%.

FISCAL 1996 COMPARED TO FISCAL 1995

Sales

Sales for fiscal 1996 totaled \$1,287 million, down 4% or \$52.6 million from the preceding year. The reason for this decrease was the absence of sales from the automotive lock business, which was spun off after eight months in the preceding fiscal year. These sales amounted to \$63.4 million in fiscal 1995.

Excluding the lock business sales, engine business sales increased \$10.8 million between years. This change was caused by an approximate 1.8% improvement in selling prices to the original equipment manufacturing customers, offset by a 1% decrease in engine unit sales that was almost entirely in the service sales area.

Gross Profit

The gross profit percentage remained consistent between years. This was the result of several factors: increased startup costs of \$6.4 million and inefficiencies related to the new plants, and less absorption of fixed costs due to fewer engines produced were offset by lower profit sharing provisions of \$18.0 million and the impact of a decrease in the unit price of aluminum totaling \$3.4 million. In addition, the 1995 gross profit included a \$19.1 million charge for the retirement window, of which \$3.5 million was reversed in 1996 due to a change of an accounting estimate for employees who had accepted an early retirement window in fiscal 1995 and subsequently canceled their acceptance in the second quarter of fiscal 1996.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses increased \$6.5 million or 6% between years. This was due to increases in salaries amounting to \$3.4 million, planned increases in manpower costs relating to new venture activities of \$6.4 million, increased professional services of \$2.1 million and higher advertising expenses of \$0.7 million. Offsetting these, in part, was a reduction

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in profit sharing accruals amounting to \$4.6 million and the lack of engineering and selling expenses of \$5.7 million from the spun off lock business.

Interest Expense

Interest expense for the 1996 fiscal year was 17% higher than in 1995. This was the result of using domestic short-term borrowing to finance increases in accounts receivable and inventories in mid-year. Seasonal borrowings were paid off by the end of the fiscal year. The preceding year had minimal seasonal short-term borrowings.

Other Income

Other income decreased \$3.5 million between years, primarily because of a reduction in interest income due to lower available investable funds. Funds were used for seasonal working capital and the construction of the new manufacturing plants. There also was an increase in the loss on disposition of plant and equipment between years.

Provision for Income Taxes

The effective income tax rate decreased to 38.0% in 1996 from 38.5% in the previous year due to lower state income taxes, increased Foreign Sales Corporation tax benefits, and reductions in other tax related items.

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 continued to implement its financial strategy by means of a "dutch auction" tender offer and a public debt offering in fiscal 1997 which it believes 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 believes that the substitution of lower (after-tax) cost debt for equity in its permanent capital structure will reduce its overall cost of capital. The Company believes 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.

In connection with its financial strategy, the Company repurchased 3,506,190 shares of its

common stock at a price of \$51.00 per share or approximately \$179 million in the aggregate, entered into a new credit facility allowing borrowings of up to \$250 million and completed a \$100 million ten-year note offering. The Company funded the tender offer with \$169 million of available cash and \$10 million of short-term borrowings under the new credit facility. A portion of the net proceeds of the ten-year debt offering was used to repay short-term borrowings. The new credit facility also provides a source of financing for the seasonal working capital needs of the Company.

The Company's Board of Directors authorized the purchase of up to \$300 million of shares of common stock by means of the tender offer and open market or private transactions. The Company has from time to time purchased additional shares of common stock pursuant to an open market repurchase program. As of August 22, 1997, the Company has repurchased 457,900 shares at a total cost of \$22.7 million pursuant to its open market repurchase program. Any future purchases by the Company will depend on many factors, including the market price of the shares, the Company's business and financial position and general economic and market conditions. The Company intends to fund future repurchases of its common stock through a combination of available cash and additional borrowings.

Also as a part of its financial strategy, subject to the discretion of the Company's Board of Directors and the requirements of applicable law, the Company currently intends to increase future cash dividends per share at a rate no more than the inflation rate.

Liquidity and Capital Resources

FISCAL YEARS 1997, 1996 AND 1995

Cash flow from operating activities was \$142.9 million, \$94.5 million and \$95.8 million, in fiscal 1997, 1996 and 1995, respectively. The primary source of funds was from net income excluding depreciation. The significant change between fiscal 1997 and fiscal 1996 amounts was due to changes in working capital as explained below.

The fiscal 1997 cash flow from operating activities reflects an increase in accounts receivable of \$10.5 million and lower inventories of \$11.4 million resulting from increased sales at the end of the fiscal year. Also, increased accounts payable of

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\$16.6 million caused by the timing of payments, increased accrued liabilities of \$4.6 million resulting primarily from increased profit sharing provisions, and increased federal and state income taxes payable of \$4.2 million caused by the timing of payments contributed to the cash flows of the Company.

The fiscal 1996 cash flow from operating activities reflects an increase in receivables of \$25.2 million resulting from increased sales at the end of the fiscal year and also reflects a decrease in accrued liabilities of \$25.9 million primarily due to decreased profit sharing provisions.

The fiscal 1995 cash flow from operating activities reflects a decrease in accounts receivable of \$11.1 million due to lower sales late in the fourth quarter of fiscal 1995 and an increase in inventories of \$62.8 million. This increase in inventories was primarily due to two factors. The Company maintained a stable rate of production while experiencing a reduction in orders from equipment manufacturers due to less favorable spring weather. In addition, the Company planned an increase in inventories to provide a cushion for the transfer of engine assembly to the three new plants under construction.

Cash used in investing activities amounted to \$51.2 million, \$76.7 million and \$129.2 million in fiscal 1997, 1996 and 1995, respectively. The 1997 cash flows from investing activities included additions to plant and equipment of \$71.3 million, \$77.7 million and \$131.0 million in fiscal 1997, 1996 and 1995, respectively. The fiscal 1997 capital expenditures related primarily to reinvestment in equipment and new products, while the fiscal 1996 and fiscal 1995 expenditures principally related to the construction of three new engine manufacturing plants and a foundry and plant expansions at existing facilities. The 1997 cash flows from investing activities also included \$16.0 million related to the sale of the Menomonee Falls, Wisconsin facility. The sale of this facility is described under "Other Matters."

Cash flows used in financing activities amounted to \$129.0 million, \$37.6 million and \$16.8 million in fiscal 1997, fiscal 1996 and fiscal 1995, respectively. The fiscal 1997 cash used in financing activities includes the repurchase of the Company's common stock totaling \$179 million pursuant to the dutch auction tender offer and open market repurchase program previously discussed. Also in fiscal 1997,

the Company issued ten-year notes which resulted in \$97.9 million of net proceeds from the offering. The Company also paid \$15 million as its first installment on its 9.21% Senior Notes in fiscal 1997. Cash dividends totaled \$30.5 million, \$30.4 million and \$28.3 million, in fiscal 1997, 1996 and 1995, respectively. Fiscal 1997 and 1996 cash used in financing activities also reflects the repayment of foreign loans of \$1.6 million and \$6.5 million, respectively. Fiscal 1995 reflects increased borrowings by the Company's foreign subsidiaries of \$12.1 million to fund working capital requirements.

Future Liquidity and Capital Resources

In connection with the debt offering and tender offer, the Company entered into a new credit facility allowing borrowings of up to \$250 million to primarily fund seasonal working capital requirements and other financing needs of the Company. The term of the new credit facility is five years and such facility contains certain restrictive covenants. Because the Company used \$169 million of available cash to fund a portion of the tender offer, the Company anticipates placing more reliance on borrowings to fund working capital requirements than it has in recent years. The Company will incur additional interest expense in the future as a result of the issuance of ten-year notes and increased reliance on the new revolving credit facility.

In May 1997, the Company filed a shelf registration for \$175 million of debt securities to be issued periodically. Of this, \$75 million has not yet been issued on the registration statement. The Company may decide to offer all or part of the remaining securities depending on many factors, including general economic conditions, cash required for operations and the timing of the remaining open market repurchases of its common stock.

Management expects capital expenditures to total \$56 million in fiscal 1998 for reinvestment in equipment and new products. As previously mentioned, the Company is also implementing a new enterprise-wide information system, the expenditures for which are expected to total \$25 million over the next five years.

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

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Other Matters

Sale of the Menomonee Falls, Wisconsin Facility

The sale of the Company's Menomonee Falls, Wisconsin facility for approximately \$16.0 million was completed during fiscal 1997. The provisions of the contract state that the Company will continue to own and occupy the warehouse portion of the facility for a period of up to ten years (the "Reservation Period"). The contract also contains a buyout clause, at the buyer's option and under certain circumstances, of the remaining Reservation Period. Under the provisions of Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate," the Company is required to account for this as a financing transaction as the Company continues to have substantial involvement with the facility during the Reservation Period or until the buyout option is exercised. Under this method, the cash received is reflected as a deferred revenue, and the assets and the accumulated depreciation remain on the Company's books. Depreciation expense continues to be recorded each period, and imputed interest expense is also recorded and added to deferred revenue. Offsetting this is the fair value lease income on the non-Company occupied portion of the building. A pretax gain, which will be recognized at the earlier of the exercise of the buyout option or the expiration of the Reservation Period, is estimated to be \$10 million to \$12 million. The annual cost of operating the warehouse portion of the facility is not material.

Emissions

The U.S. Environment Protection Agency (EPA) is developing national emission standards under a two phase process for equipment powered by small air cooled engines. In 1995, the EPA promulgated its Phase I emission standards, which will be reflected in the Company's 1998 model year engines. The EPA and several engine manufacturers, including the Company, recently announced an agreement in principle to further cut pollution emitted by gasoline engines. These reductions are expected to be incorporated into the EPA's Phase II emission standards to be issued in 1998 and to be phased in from 2001 to 2005. While it is impossible to precisely quantify the cost of compliance until the standards are issued, the Company believes compliance with the new standards will not have a material adverse effect on its financial position or results of operations.

The California Air Resources Board (CARB) has also adopted emission standards to be effective in two tiers. Tier I was effective as of August 1995.

Tier II of the CARB engine emission standards will not be effective until 1999 or later. CARB has directed its staff to review its Tier II standards in light of technological and economic issues raised by the industry. The Company expects this review to be completed in late 1997 or early 1998. In the event the Company is unable to comply with the Tier II standards and they remain unchanged, the Company believes that any resulting downturn in sales will not have a material adverse effect on the Company's financial position or results of operations.

New Accounting Pronouncements

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share." This statement establishes a new standard for computing and presenting earnings per share in financial statements. The Company will adopt the new standard in its 1998 second quarter financial statements. The impact of adoption of this standard will not be material to the Company's results of operations.

Cautionary Statement on Forward-Looking Statements

Certain statements in Management's Discussion and Analysis, in the Letter to Shareholders on pages 2 through 5 and in About Briggs & Stratton on pages 6 through 11 may contain forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. The words "anticipate", "believe", "estimate", "expect", "objective", and "think" or similar expressions are intended to identify forward-looking statements. The forward-looking statements are based on the Company's current views and assumptions and involve risks and uncertainties that include, among other things, the effects of weather on the purchasing patterns of the Company's customers and end use purchasers of the Company's engines; the seasonal nature of the Company's business; actions of competitors; changes in laws and regulations, including accounting standards; employee relations; customer demand; prices of purchased raw materials and parts; domestic economic conditions, including housing starts and changes in consumer disposable income; and foreign economic conditions, including currency rate fluctuations. Some or all of the factors are beyond the Company's control.