

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

Results of Operations

FISCAL 1998 COMPARED TO FISCAL 1997

Sales

Net sales for fiscal 1998 totaled \$1,328 million, up 1% or \$11 million from the preceding year. This increase resulted primarily from a \$34 million increase in sales dollars due to a 3% increase in engine unit shipments and a \$6 million increase in service parts sales due to increased demand. These increases were partially offset by a \$19 million decrease in sales dollars due to a mix change to lower horsepower, lower priced engines and a \$10 million decrease in revenue from European customers with whom the Company shares currency risk.

Gross Profit

The gross profit margin for the 1998 fiscal year increased to 19% from 17% in the 1997 fiscal year. The primary reason for this favorable change was the lack of the \$37 million charge related to the early retirement window (described later). There was also a \$2 million increase due to improvements in manufacturing productivity. These were offset by the \$10 million in lost gross profit due to the reduced revenue from European customers described above.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses increased \$12 million or 11% between years. This increase was caused primarily by the costs associated with the new company-wide information system which totaled \$7 million (discussed later) and increased costs of new venture activities which totaled \$7 million, of which \$4 million related to the Company's POWERCOM software business. The Company signed a letter of intent for the sale of its POWERCOM software business shortly after the end of the fiscal year. This sale is not expected to result in any material gains or losses.

Interest Expense

Interest expense for the 1998 fiscal year was \$9 million higher than in 1997. This resulted from using increased domestic short-term borrowings to finance seasonal increases in accounts receivable and inventories during the year and an increase in long-term debt over the preceding year. Seasonal borrowings were paid off by the end of the fiscal year.

Provision for Income Taxes

The effective tax rate decreased to 37.6% in 1998 from 38.0% in the previous year. This was due primarily to reductions in the foreign tax provision and in other tax related items that were individually insignificant.

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%.

Liquidity and Capital Resources

FISCAL YEARS 1998, 1997 AND 1996

Cash flows from operating activities was \$136 million, \$143 million and \$94 million, in fiscal 1998, 1997 and 1996, 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 1998 cash flow from operating activities reflects a \$7 million increase in accounts receivable and an \$18 million decrease in inventories resulting from increased sales late in the last fiscal quarter.

The fiscal 1997 cash flow from operating activities reflects an increase in accounts receivable of \$11 million and lower inventories of \$11 million resulting from increased sales at the end of the fiscal year when compared to the previous year. Also, increased accounts payable of \$17 million caused by the timing of payments, increased accrued liabilities of \$5 million resulting primarily from increased profit sharing provisions, and increased federal and state income taxes payable of \$4 million caused by the timing of payments, all contributed to the cash flows of the Company.

The fiscal 1996 cash flow from operating activities reflects an increase in receivables of \$25 million resulting from higher sales at the end of the fiscal year and a decrease in accrued liabilities of \$26 million primarily due to decreased profit sharing provisions.

Net cash used in investing activities amounted to \$45 million, \$51 million and \$77 million in fiscal 1998, 1997 and 1996, respectively. Cash flows used in investing activities included additions to plant and equipment of \$46 million, \$71 million and \$78 million in fiscal 1998, 1997 and 1996, respectively. The fiscal 1998 capital expenditures principally related to investment in equipment. The fiscal 1997 capital expenditures related primarily to reinvestment in equipment and new products, while the fiscal 1996 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 million related to the sale

of the Menomonee Falls, Wisconsin facility. The sale of this facility is described under "Other Matters."

Net cash used in financing activities amounted to \$119 million, \$129 million and \$38 million in fiscal 1998, 1997 and 1996, respectively. These financing activities included the repurchase of the Company's common stock, totaling \$86 million in 1998 and \$179 million in 1997. In each of fiscal 1998 and 1997, \$15 million was paid on the 9.21% Senior Notes due 2001. Cash dividends totaled \$28 million, \$31 million and \$30 million in fiscal 1998, 1997 and 1996, respectively. The cash dividends in 1998 were less than those paid in the preceding two years because the common stock repurchase program resulted in less stock outstanding in that year. In fiscal 1997, the Company issued ten-year notes which resulted in \$98 million of net proceeds from the offering. The \$9 million in proceeds from the exercise of stock options in 1998 was substantially higher than in prior years due to increased option activity.

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. This credit facility expires in April 2002 and contains certain restrictive covenants. Because the Company has been using some available cash in its ongoing stock repurchase program, the Company will be placing more reliance on borrowings to fund working capital needs than it did prior to fiscal 1997. Accordingly, the Company experienced higher interest expense in fiscal 1998, and anticipates interest expense to remain at such higher levels in the future.

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 \$72 million in fiscal 1999, consisting of projects which include reinvestment in equipment and new products.

Management believes that available cash, the 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.

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 (described below) and a public debt offering in fiscal 1997. The Company also continued the repurchase of its outstanding common stock in the open market in the 1998 fiscal year. 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.

In fiscal 1997, the Company's Board of Directors authorized the purchase of up to \$300 million of shares of its common stock by means of a tender offer and open market or private transactions. As of June 28, 1998, purchases totaled \$264 million. Future purchases 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 any future purchases of its common stock through a combination of available cash, cash generated from operations and additional borrowings.

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

Other Matters

Year 2000 Issues

The Company is implementing a new company-wide information system. This new system is expected to address the great majority of information technology year 2000 computer issues. The new system will replace the Company's mainframe computer, which is being retired in early calendar 1999. The new system has been installed and implementation has been completed in approximately one-half of the Company's U.S. operations. Other internal year 2000 issues not directly related to the previously described project are being addressed and tested in parallel with

the main project. These are expected to be completed by the middle of the 1999 calendar year.

Project expenditures to date total \$26 million. The Company expects to incur an additional \$8 million of incremental costs, running through the 2002 fiscal year, because of related projects.

The Company has developed an overall comprehensive Year 2000 Program to address year 2000 issues. This program is based on the Automotive Industry Action Group's model system consisting of five steps: Awareness; Inventory and Assessment; Remediation; Testing; and Readiness Certification. Oversight of the program is the responsibility of a group of senior executives with progress reported to the Company's Board of Directors.

A risk assessment and exposure analysis has been made, and each area has been ranked as high, medium or low. The Company's high risk areas have been identified as information technology systems and infrastructures, customers, suppliers, and financial institutions. The software for a new company-wide information system, which is broad based, has already been installed and is effectively in use for over 50% of company operations. And since remaining operations are substantially similar, management does not anticipate the need to develop an extensive contingency plan for information technology systems.

The non-information technology systems are midway through the assessment phase and remediation is scheduled for completion by mid-calendar year 1999 without material incremental costs anticipated. Based on the assessment of its non-information technology systems to date, the Company currently does not anticipate the need to develop an extensive contingency plan for non-information systems, so it is not expecting to incur material incremental costs to do this.

The Company's largest customers have certified that they will be year 2000 compliant before the end of calendar year 1999, as to their relationships with the Company. The identification of critical vendors has been completed and a survey is scheduled for completion by the first quarter of calendar year 1999. Alternative suppliers will be identified for those not expected to be compliant by the end of 1999, as to their relationships with the Company. The Company's financial institutions are currently being surveyed and it is anticipated that they are year 2000 compliant, or will be before the end of calendar year 1999.

Selected areas, both internal and external, will be tested to assure the integrity of the Company's remediation programs. The testing will be completed by mid-calendar year 1999.

It is anticipated that any requisite changes necessary to become year 2000 compliant will be completed prior to mid-calendar year 1999 and contingency plans will be developed, as necessary, to address unforeseen circumstances prior to the end of calendar year 1999.

The Company believes its Year 2000 Program is adequate to detect in advance year 2000 compliance issues, and that it has the necessary resources to remedy them. However, the year 2000 problem has many aspects and potential consequences, some of which are not reasonably foreseeable, and there can be no assurance that unforeseen consequences will not arise.

Emissions

The U.S. Environmental Protection Agency (EPA) is developing 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 issued a Notice of Proposed Rulemaking for Phase II emission standards in January of 1998 incorporating the agreement in principle reached between EPA and several engine manufacturers, including the Company. This proposed Phase II program will impose more stringent standards over the useful life of the engine and will be phased in from 2001 to 2005. EPA expects to finalize the Phase II regulation by the end of 1998. 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) staff completed a review of the existing Tier II standards and proposed that alternative standards and implementation dates be adopted by CARB. Alternative Tier II standards were adopted by CARB at its March 26, 1998 meeting and are not harmonized with EPA's proposed Phase II, but rather require the accelerated introduction of overhead valve engine technology into California. In addition, individual companies which sell more than a threshold number

of Class I engines into California must submit a supplemental compliance plan to CARB to achieve additional reductions in extreme non-attainment areas. While CARB's aggressive program may result in a reduced product offering by the Company in California, it is not anticipated that the California program will have a material effect on the financial condition or results of operations of the Company.

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.

New Accounting Pronouncements

In June 1998 the Financial Accounting Standards Board adopted Financial Accounting Standard No. 133 "Accounting for Derivative Instruments and Hedging Activities". This new standard will be effective for the Company in fiscal 2000, and requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. Any fair value changes will be recorded in net income or comprehensive income. The Company does not expect that the adoption of this standard will have a material effect on the results of operations.

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 foreign currencies primarily as a result of purchasing engines from its Japanese joint venture. 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 June 28, 1998, the Company had the following forward foreign exchange contracts outstanding at the Fair Value Gains and (Losses) shown (in thousands):

<u>Currency</u>	<u>Notional Value</u>	<u>U.S. Dollars</u>	<u>Fair Value Gains and (Losses)</u>
Japanese Yen	3,600,000	28,000	(\$2,200)
Australian Dollars	400	300	60

All of the above contracts expire in less than one year.

Although the Company sells its domestically produced engines to foreign customers in U.S. dollars, the Company has shared some of the currency risk with customers for certain sales transactions. Accordingly, the Company is exposed to fluctuations in foreign exchange rates, primarily related to the U.S. dollar/European Currency Unit rate. Historically, the Company has managed these risks through limitations on the amount of sharing provided to customers. These programs are generally for one year.

Fluctuations in currency exchange rates may also impact the stockholders' equity of 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 stockholders' equity as cumulative translation adjustments. The dollar was stronger relative to many of the foreign currencies at June 28, 1998 compared to June 29, 1997. Consequently, the cumulative translation adjustments component of stockholders' equity decreased \$1.1 million during the year. Using the year-end exchange rates, the total amount invested in subsidiaries at June 28, 1998 was approximately \$9.9 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 June 28, 1998, the Company had the following short-term loans outstanding (amount in thousands):

<u>Currency</u>	<u>Amount</u>	<u>Average Annual Interest Rate</u>
German Mark	19,561	4.52%
British Pounds	140	8.10%
Dutch Guilder	1,715	5.10%
Irish Punt	227	6.90%
Canadian Dollars	2,797	6.50%
Swedish Krona	1,000	8.05%
French Franc	665	5.19%
U.S. Dollars	4,700	5.94%

All of the above loans carry variable interest rates.

Long-term loans consisted of the following (amounts in thousands):

<u>Description</u>	<u>Amount</u>	<u>Maturity</u>
9.21% Senior Notes	\$45,000	\$15,000 in fiscal 1999, 2000 and 2001
7.25% Notes	98,102	2007

Each of the above loans carries a fixed rate of interest.