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

Results of Operations

FISCAL 1999 COMPARED TO FISCAL 1998

Sales

Net sales for fiscal 1999 totaled $1,502 million, an increase of $174 million or 13% when compared to the prior year. This increase was due to a $120 million increase in sales dollars resulting from an 8% increase in unit shipments, a favorable mix change in engines sold of $38 million and $16 million from increased prices.

Gross Profit

The gross profit margin increased to 20% in the 1999 fiscal year from 19% in the preceding year. This increase resulted primarily from the following factors: $16 million of price increases, $15 million attributed to the benefit of higher production during the year and $14 million in lower costs for purchased parts and engines and raw material. Lower aluminum costs, the major raw material used in engines, accounted for $8 million of the lower raw material costs. Offsetting these improvements were a mix shift to lower margin engines of $22 million and inefficiencies of $3 million caused by operating plants at full capacity.

Engineering, Selling, General and Administrative Expenses

Engineering, selling, general and administrative expenses for fiscal 1999 decreased 4% or $5 million compared to fiscal 1998. This decrease was primarily due to a $10 million decrease in costs related to the Company's POWERCOM software business that was sold in the first quarter of this fiscal year. Costs related to implementing the Company's new enterprise-wide information system decreased $2 million between the fiscal years. Offsetting these reductions in costs was a $4 million increase in profit sharing expenses due to improved results and a $1 million increase in research and development expenses.

Interest Expense

Interest expense decreased 12% or $2 million for the 1999 fiscal year compared to the 1998 fiscal year. This decrease was the result of $15 million repayment of long-term debt at the end of the 1998 fiscal year and lower average interest rates on working capital borrowings throughout the year.

Provision for Income Taxes

The effective tax rate decreased to 37.5% in 1999 from 37.6% in the previous year due to lower state income taxes and reductions in other related items.

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 an early retirement window. 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 enterprise-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.

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.

Liquidity and Capital Resources

FISCAL YEARS 1999, 1998 AND 1997

Cash flow from operating activities was $114 million, $136 million and $143 million, in fiscal 1999, 1998 and 1997, respectively. The primary source of funds was from net income excluding depreciation. The significant change between fiscal 1999 and fiscal 1998 amounts was due to changes in working capital as explained below.

The fiscal 1999 cash flow from operating activities reflects improved net income, excluding depreciation, of $37 million. Offsetting it is an increased requirement for operating capital of $60 million, caused primarily by strong fourth quarter business which increased year-end receivables and a restoration of inventories to higher year-end levels.

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.

Net cash used in investing activities amounted to $65 million, $45 million and $51 million in fiscal 1999, 1998 and 1997, respectively. Cash flows used in investing activities included additions to plant and equipment of $66 million, $46 million and $71 million in fiscal 1999, 1998 and 1997, respectively. The fiscal 1999 and 1997 capital expenditures related primarily to reinvestment in equipment and new products. The fiscal 1998 capital expenditures principally related to investment in equipment. 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 $73 million, $119 million and $129 million in fiscal 1999, 1998 and 1997, respectively. These financing activities included the repurchase of the Company's common stock, totaling $75 million in 1999, $86 million in 1998 and $180 million in 1997. In each of the fiscal years, $15 million was paid on the 9.21% Senior Notes due 2001. Cash dividends totaled $27 million, $28 million and $31 million in fiscal 1999, 1998 and 1997, respectively. The cash dividends paid decreased from the preceding year because the common stock repurchase program resulted in less stock outstanding. In fiscal 1997, the Company issued ten-year notes which resulted in $98 million of net proceeds from the offering. Proceeds from the exercise of stock options amounted to $45 million in 1999, 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 plans to use available cash to finance capacity expansions in fiscal 2000 and 2001, the Company will continue to utilize borrowings under the revolving credit facility to fund working capital needs. Accordingly, interest expense should stay approximately the same between years.

In April 1999, the Company's Board of Directors approved capital expenditures of $95 million for fiscal 2000. Of this, the Company expects to spend approximately $75 million in fiscal 2000, with the remainder spent in fiscal 2001. These anticipated expenditures include a significant amount for capacity increases, as well as, continuing investment in equipment and new products.

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 or cash required for operations.

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 fiscal 1999 and 1998. 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 share repurchase program authorized by the Board of Directors in fiscal 1997 for $300 million of its common stock was completed in the second quarter of fiscal 1999. In January 1999, the Board of Directors approved a repurchase of up to 1.3 million additional shares of the Company's common stock in open market or private transactions. Under this authorization, stock repurchases totaling .7 million shares were made in the second half of the year in open market transactions. The latest share repurchase authorization is intended to minimize dilution from shares issued for employee benefit plans and will be funded from available cash.

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 continuing implementation of an overall comprehensive Year 2000 Readiness 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. Progress is reported to the Company's Board of Directors regularly.

The Company completed implementation of its new enterprise-wide information system in January of 1999. All business transactions are being processed on the new system which addresses the great majority of information technology year 2000 computer issues. Other internal year 2000 issues not directly related to the previously described project are being addressed and tested. These are expected to be completed by October of 1999.

Project expenditures to date total $33 million. The Company expects any additional incremental costs to be immaterial.

The Company completed assessment of its non-information technology systems. An outside auditor was utilized to review these systems. The vast majority of remedial activities have been completed without material incremental costs. All remedial activities are expected to be completed by October 1999.

Random testing of both information and non-information systems has been conducted and will continue to be conducted until the end of the calendar year in order to ensure year 2000 readiness.

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 Company's vendors and financial institutions have also been surveyed for year 2000 readiness. Contingency plans have been developed to ensure that the Company will be able to continue operations for up to three days without deliveries. The Company will not be open for operations from December 31, 1999 to January 3, 2000. All major financial institutions have provided the Company with year 2000 preparedness statements.

The Company will utilize its December 31, 1999 to January 3, 2000 shutdown period to back up its systems, re-start those systems and resolve any open issues.

The last payroll for calendar year 1999 will be issued on December 29, 1999 and all arrangements for payment of the January 3, 2000 dividend payment will be made prior to December 31, 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) 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 submitted a supplemental compliance plan to 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 plan is to achieve additional reductions in extreme non-attainment areas. While CARB's aggressive program will result in a reduced product offering by the Company in California, the Company does not believe 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 issued Financial Accounting Standard (FAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities". This new standard as amended will be effective for the Company in fiscal 2001, 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.

Subsequent Event – Disposition of Foundry Assets

Effective August 23, 1999, the Company contributed certain assets related to its foundry operations to a third party. In exchange for this contribution, the Company received $23.6 million of cash and preferred stock with a face value of $45 million. The provisions of the preferred stock include a 15% cumulative dividend and is convertible into at least 31% of the common stock of the third party. The disposition will result in a gain.

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 27, 1999, the Company had the following forward foreign exchange contracts outstanding at the Fair Value Gains and (Losses) shown (in thousands):

Currency	Notional Value	U.S. Dollars	Fair Value Gains and (Losses)
Japanese Yen	2,426,000	20,400	($265)
Australian Dollars	10,000	6,400	(288)
Canadian Dollars	2,000	1,300	9

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/Euro 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 cumulative translation adjustments component of stockholders' equity decreased $0.2 million during the year. Using the year-end exchange rates, the total amount invested in subsidiaries at June 27, 1999 was approximately $19.1 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 27, 1999, the Company had the following short-term loans outstanding (amount in thousands):

Currency	Amount	Average Annual Interest Rate
German Mark	20,519	5.25%
Dutch Guilder	1,488	5.00%
Canadian Dollars	2,971	5.51%
Swedish Krona	1,000	8.05%
French Franc	200	5.19%
U.S. Dollars	4,335	5.31%

All of the above loans carry variable interest rates.

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

Description	Amount	Maturity
9.21% Senior Notes	$30,000	$15,000 in fiscal 2000 and 2001
7.25% Notes	98,307	2007

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