ILLINOIS TOOL WORKS INC. 2001 Annual Report


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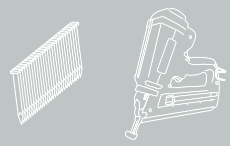
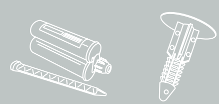
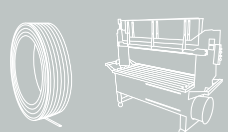
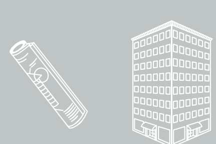
Illinois Tool Works Inc. (NYSE: ITW) designs and produces an array of highly engineered fasteners and components, equipment and consumable systems, and specialty products and equipment for customers around the world. A leading diversified manufacturing company with 90 years of history, ITW's 600 decentralized business units in 43 countries employ approximately 52,000 men and women who are focused on creating value-added products and innovative customer solutions.

## ITW AT A GLANCE

| | Product Categories | Major Businesses | Primary End Markets |
|---|---|---|---|
| **Engineered Products North America**  | Short lead-time plastic and metal components and fasteners, and specialty products such as polymers, fluid products and reseal-able packaging | Anchor, Buildex, Chemtronics, Deltar, Devcon, Duo-Fast, Fastex, Foamseal, Medalist, Minigrip/Zip-Pak, Paslode, Plexus, Ramset/Red Head, Shakeproof and Wilsonart | Construction, automotive, general industrial and consumer durables |
| **Engineered Products International**  | Short lead-time plastic and metal components and fasteners, and specialty products such as polymers, fluid products and electronic component packaging | Buildex, Deltar, Fastex, Henschel, Highland, Ispra, Jemco, Magnaflux, Meritex, Nexus, Plexus, Ramset/Red Head, Shakeproof and SPIT | Construction, automotive, general industrial, consumer durables and electronics |
| **Specialty Systems North America**  | Longer lead-time machinery and related consumables, and specialty equipment for applications such as food service and industrial finishing | Angleboard, BGK, Dynatec, Hi-Cone, Hobart, Loveshaw, Miller Electric, Norwood Marking, PRO/MARK, Ransburg, Signode, Traulsen, Trident and Vulcan | Food retail and service, general industrial, construction, and food and beverage |
| **Specialty Systems International**  | Longer lead-time machinery and related consumables, and specialty equipment for applications such as food service and industrial finishing | Auto-Sleeve, DeVilbiss, Dynatec, Gema, Gunther, Hi-Cone, Hobart, ITW Foils, Mima, Orgapack, Signode and Simco | General industrial, food retail and service, and food and beverage |
| **Leasing and Investments**  | This segment makes opportunistic investments in mortgage-related assets, leveraged and direct financing leases of aircraft and other equipment, properties and property developments, affordable housing and a venture capital fund | | |

## FINANCIAL HIGHLIGHTS

| Dollars in thousands except per share amounts | 2001 | 2000 | 1999 |
|---|---|---|---|
| **Year Ended December 31** | | | |
| **Operating Results** | | | |
| Operating revenues | $9,292,791 | $9,511,647 | $8,840,454 |
| Operating income | 1,306,103 | 1,577,453 | 1,390,038 |
| Operating income margin | 14.1% | 16.6% | 15.7% |
| Income from continuing operations | $ 802,449 | $ 969,451 | $ 835,895 |
| Return on operating revenues | 8.6% | 10.2% | 9.5% |
| Operating income margins by segment: | | | |
| Engineered Products—North America | 16.1% | 19.2% | 18.9% |
| Engineered Products—International | 10.9 | 10.3 | 10.0 |
| Specialty Systems—North America | 12.5 | 16.8 | 17.0 |
| Specialty Systems—International | 9.8 | 9.9 | 9.6 |
| Leasing and Investments | 53.0 | 54.4 | 54.0 |
| **Per Share of Common Stock** | | | |
| Income from continuing operations: | | | |
| Basic | $ 2.64 | $ 3.21 | $ 2.78 |
| Diluted | 2.62 | 3.18 | 2.74 |
| Cash dividends paid | 0.82 | 0.74 | 0.61 |
| **Returns** | | | |
| Return on average invested capital | 13.1% | 17.0% | 16.7% |
| Return on average stockholders' equity | 14.0 | 19.0 | 18.5 |
| **Liquidity and Capital Resources** | | | |
| Free operating cash flow | $1,245,251 | $ 909,882 | $ 913,902 |
| Total debt to capitalization | 20.7% | 26.8% | 28.4% |

Experienced managers who know what will sell and how to sell it. Innovative product development people who work closely with customers to create value-added products. Decentralized businesses that are smartly run and located where customers need them. Sales channels that are both direct and distributor based. A diversified portfolio of revenues that can soften economic fluctuations.

For ITW, these elements have added up to tremendous success over the years. But to find out what counts, we look beyond the numbers.

More than
$9,000,000,000
in revenues



**We achieve top-line growth by concentrating on the bottom line.** Throughout our long history, ITW's revenues have grown steadily. We are now a Fortune 200 company with $9.3 billion in revenues and thousands of customers and shareholders. As a decentralized company, our revenues are generated from hundreds of business units that operate independently under the ITW umbrella.



Key to our success is that as our resources broaden, our focus narrows. Growing the top line is necessary to fund operations, but our primary goal is adding value for our customers. While many companies seek growth by producing commodity products and raising prices, ITW concentrates on expanding the bottom line. We do this by developing specialized products and acquiring businesses that help to improve our market penetration.


**Successful decentralization requires employee know-how.** We place an unparalleled degree of trust in our business unit managers and the people who work for them. Our lean corporate structure and steady flow of acquisitions require our business units to initiate their own success. We motivate our managers by creating an entrepreneurial culture that grants them the authority—and accountability—of a business owner. We also empower these men and women to build on their success by providing capital for growth, facilitating product solutions through research and development contributions, and removing bureaucratic roadblocks.

who produce some

# 5,000

product lines

**Some of our best innovations come from simple observation.** Some corporations design products specifically to increase sales volume. ITW's main goal is not to create a bestseller, but to enhance customers' operations. To attain that goal, ITW develops highly engineered, proprietary products. Our unique approach begins at our customers' plants or worksites. By working closely with our customers, we determine how an ITW product or process could provide a better solution. Proof of our highly innovative nature is seen in our patent activities. In 2001, we had more than 17,000 unexpired patents and pending patent applications worldwide.

At

# 600

ITW companies



**80/20 is how we run our businesses.** Six hundred individual business units operate under the ITW umbrella, and 20 to 40 more are added each year due to acquisitions. Though they vary in terms of products and services, our businesses share certain essential elements. Each existing and newly acquired ITW business is run in accordance with our 80/20 business process. The basic concept of 80/20 is to structure each business around the key 20 percent of customers and products which account for 80 percent of sales. This sensible, highly effective process is applied companywide.

Our strict acquisition criteria also directly tie to our 80/20 process. For example, we typically acquire companies with well-respected brand names that are smaller, undervalued and well managed. These new businesses, with their complement of new products and processes, give us more capabilities to serve key 80/20 customers.


**Our global presence is driven by customer need.** When it comes to international expansion, we prefer to be a follower rather than a leader. Our goal is not to put more pins on a map, but rather to be in the countries where our customers need us. ITW's presence in 43 countries—and the 67/33 percent split between North American and international revenues in 2001—is largely due to having followed our customers as they expanded globally and requested our capabilities. Whether we are providing automotive products in Europe, construction products in Australia or industrial packaging in Latin America, customer need is paramount.




**We serve diversified end markets.** Serving diversified end markets gives us better portfolio balance and helps lessen the shocks from economic instabilities. Our 1999 acquisition of Premark added an entirely new end market—food retail and service—to our revenue mix. This successful acquisition resulted in the addition of $1.5 billion in revenue and helped to decrease our exposure to the automotive market. The Premark acquisition also increased our construction presence and helped give us much better revenue balance in construction versus 10 years ago. Today, the new housing, commercial and renovation/rehab sectors each account for roughly one-third of revenues within our construction portfolio.

We've found that what is most important can't be counted—

**Strengthening**

# 1

**to one relationships with customers**



**We are a global company with one simple philosophy.** ITW is a multibillion-dollar company that produces highly engineered products at hundreds of companies across the globe. Yet, we prefer to be known for one attribute: our customer focus. Proof of our customer commitment is found in every aspect of how we operate. Our decentralized focus, our innovative products, our 80/20 process and our empowered men and women ensure that our top customers receive our best resources. Put simply, our business units' credo is to stay close to our customers.



**Our company is structured so a direct link exists between the performance of our customers' businesses and that of our own. Therefore, adding value for our customers is not just an ambition. Our success depends on it.**

## To Our Shareholders



The year 2001 will go down in history as yielding the century's first economic recession, one that was further heightened by the horrific events of September 11. *Just as our country was challenged and responded swiftly and responsibly, so too did ITW and our people.* In 2001, our businesses grappled with a troubled economic environment and dramatic falloffs in a number of end markets. This resulted in an uncharacteristic decline in operating revenues and profitability for the year, the first our company has seen since the recession of the early 1990s.

In our 90-year history, we have endured several challenging economic situations. Each time, we've emerged a stronger, leaner, more focused organization. As the economy and our end markets rebound, which we anticipate as 2002 unfolds, we believe ITW will show improved operating performance.

ITW performed well in 2001, factoring in the significant weakness in the North American economy during the year, and the slowing economic conditions internationally in the latter half of the year. *We attribute our long-term sustainability—of both record earnings during recent years of economic expansion and relatively good performance during times of economic downturn—to our highly decentralized organization.* Maintaining a flat organizational structure and granting significant autonomy to our individual businesses allow them to respond quickly and directly to current customer and end market conditions.

A great deal of our business success is attributable to the active practice of our 80/20 business planning process. This process essentially allows our businesses to focus resources on key customers and end markets. *We believe the value of our 80/20 process has proven itself over the years, and it is now an operating philosophy that we apply to everything we do.* As we illustrate in this annual report, we know what counts. Our day-to-day challenge is to channel our broadest resources toward one overriding and critical goal: strengthening our "one-to-one" customer relationships.

### Financial Performance

As valued customers became affected adversely by the economic downturn, so were we. Contributing to our 2 percent decline in operating revenues for the year 2001 were a 7 percent decrease in base business and a

2 percent decline in currency translation, offset by a 7 percent contribution from acquisitions. With operating income and diluted net income per share each declining 17 percent for the full year, 2001 resulted in a dramatic but aberrational change from our record-breaking performance in 2000 and in prior years.

Whenever we face challenging economic environments, particularly those that lead to declines in our base business, we proactively rightsize our units to ensure they are in line with current customer needs. *We incurred $62 million of nonrecurring operating expense in 2001 in order to streamline our operations and improve our long-term profitability.* With an increased focus on enhancing business unit productivity, we intensified implementation of our 80/20 process, which should positively impact future earnings.

We believe that as the economy improves, operating revenues will increase and our current businesses will realize significant margin enhancement. This positive outlook is supported by the fact that over the last three years we have acquired businesses with revenues of approximately $5 billion. Operating margins declined in 2001 by 250 basis points due to weak top line performance and the lower margins associated with our acquisitions. Our job is to take advantage of the recovery in our end markets and raise the margins of newly acquired businesses to traditional levels. For established businesses, those we have owned for more than five years, operating margins average more than 20 percent. We believe this margin performance is among the highest in our industry peer group.



## Well Positioned as the Economy Recovers

*ITW is well positioned to benefit from an improving economy.* The company's basic tenets—customer focus, 80/20 business planning, value-added product development, decentralized operating structure, and an aggressive acquisition program—contribute directly to the continued growth and improvement of our businesses during normal economic environments. Other factors contributing to our optimistic view of the future include decreasing business unit costs, continuing to generate strong cash flows, and maintaining a solid ITW balance sheet.

As we enter 2002, several activities will be key to driving future company growth:

- We will continue to grow our base business. *Producing value-added products rather than "me-too" products helps strengthen our existing customer relationships and increases market share.* In addition, ITW businesses will derive benefits in 2002 from ongoing implementation of 80/20 activities, which will drive operating margin improvements.
- We will continue to acquire good companies and make them better. Our acquisition strategy, which resulted this past year in the addition of 29 businesses to the ITW portfolio representing $556 million in full-year revenues, is funded by our strong free operating cash flow.
- We will continue to divest assets prudently. In December 2001, we announced our intention to divest the Consumer Products segment after it became clear to us that these businesses originally associated with the Premark acquisition were contrary to our traditional focus on selling to commercial customers.
- We will continue to focus on the fundamentals that drive our stock price, such as returns on invested capital and generating free cash. For 2001, while our return on invested capital declined due to revenue falloff, we generated $1.2 billion in free cash.

## Management Strength

The ability to manage a company successfully depends solely on people. *At ITW, our management strength continues to be a key and consistent attribute.* As an example, our Executive Vice Presidents, each one charged with the responsibility of managing the performance of approximately 75 businesses, collectively account for nearly 200 years of combined company service or nearly 22 years of average tenure. We are also proud of the quality of our Board of Directors. During 2001, we were pleased to add our newest board member. James Cantalupo comes from McDonald's Corporation, where he serves as President and Vice Chairman, Emeritus. While we welcomed Jim Cantalupo, we said goodbye to board member H. Richard Crowther, who served in that role for seven years. We will miss the valuable counsel Dick provided to the board and the company over the years. We wish him the very best.

## Strong Future Outlook

The past year has provided a worthy test of a company's mettle. Throughout our history, ITW has passed many similar tests. *Each time, we have demonstrated our long-term strength by consistently recovering from difficult economic periods and producing significant levels of growth and shareholder value.* In fact, over the past 25 years, ITW has delivered a compounded annual total return of 18 percent to our shareholders while our diluted earnings per share has grown at a 14 percent rate. As we look back on our past achievements and focus on our prospects for 2002 and the years ahead, we believe ITW remains a superior company and a solid, long-term investment. Many thanks to our people, customers and shareholders for their contributions to our success.

*—February 28, 2002*

Frank S. Ptak
Vice Chairman

W. James Farrell
Chairman and
Chief Executive Officer

James M. Ringler
Vice Chairman

# Management Team



David B. Speer
Executive Vice President

David T. Flood
Executive Vice President

W. James Farrell
Chairman and Chief Executive Officer

Philip M. Gresh, Jr.
Executive Vice President

Frank S. Ptak
Vice Chairman

Thomas J. Hansen
Executive Vice President

Russell M. Flaum
Executive Vice President

Jon C. Kinney
Chief Financial Officer

James M. Ringler
Vice Chairman

Allan C. Sutherland
Senior Vice President

Hugh J. Zentmyer
Executive Vice President

# Business Review

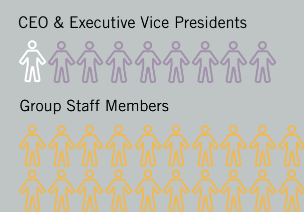


## Organizational Structure

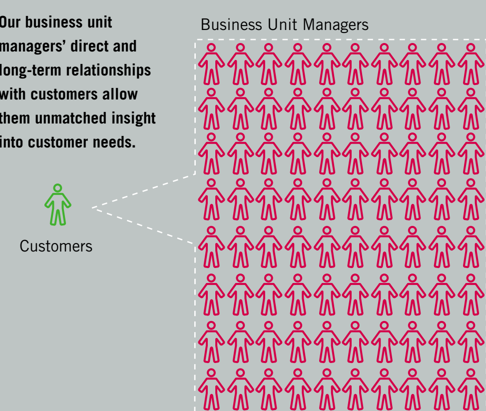
ITW is a decentralized company that concentrates significant resources on its 600 business units and maintains a flat, lean corporate structure. Our senior management team is comprised of a Chief Executive Officer with oversight of eight Executive Vice Presidents (EVP). Each EVP supervises two to three group staff members at the corporate level, and approximately 75 general managers at the business unit level, and has responsibility for close to $1.1 billion in revenue. This allocation of responsibility creates a high level of accountability and facilitates close oversight of the business. Although the model has expanded, today's EVPs operate within the same personnel-to-revenue ratio as those of 20 years ago. This time-tested formula continues to prove its merit.

ITW business unit managers, whose proximity to customers enables them to determine unfulfilled product and process needs, generate a majority of the company's new product ideas. As a result, they are given the authority to make decisions quickly. This increases speed to market for new and enhanced products, and ensures that our businesses remain ahead of the competition.

**We maintain a flat, lean corporate structure that concentrates our personnel and resources at the business unit level, close to our customers.**




**Our business unit managers' direct and long-term relationships with customers allow them unmatched insight into customer needs.**



## Acquisition Program

Acquisitions are critical to ITW's ongoing growth and profitability. Since 1994, we have completed 20 to 45 acquisitions per year. In the past three years, more than $5 billion of ITW revenue—which is being groomed for growth—was generated by acquisitions. Acquired companies are expected to double their operating margins, which initially average 9 percent margins, over a five-year period. Our three-year average operating margin of 15.5 percent is near the top of our peer group.

To strengthen our position in current markets or to create opportunities in new ones, ITW focuses on two types of acquisitions. Bottom-up acquisitions, the most common variety, are identified by business unit managers in response to a customer need or market opportunity. Top-down acquisitions, much larger in scope, are generated occasionally by senior managers to add or diversify end markets. In 2001, we completed 29 acquisitions representing $556 million of acquired revenues and all acquisitions were generated by our business units.

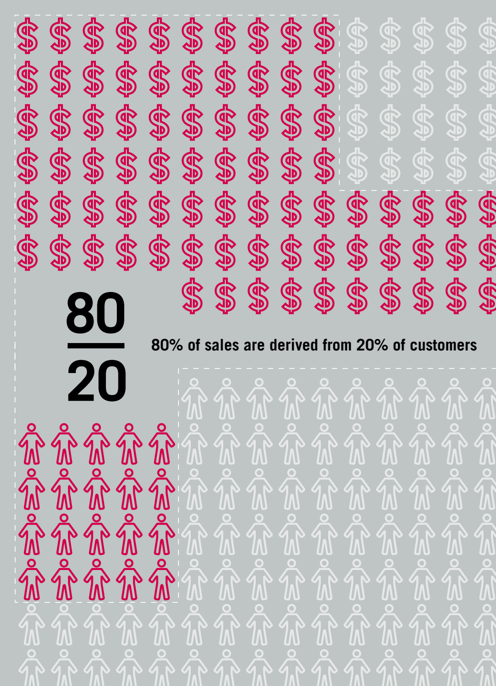
Our highly successful track record of new company integration is the result of strict acquisition guidelines and a thorough evaluation process. The main criterion is that the acquisition add value, leading to improved products and service for our customers. A prototypical ITW acquisition candidate is an undervalued, privately held company with demonstrated technology and recognizable brand names. Strong brand names also are important company-wide, as 70 percent of our more than $9 billion in revenue originates from products where we have leading market positions.

In 1999, ITW acquired Premark International, a manufacturer with two distinct businesses: commercial food equipment for restaurants and supermarkets, and laminate products for construction applications. To help improve these businesses, we began concentrating on a core group of units that represented 86 percent of total Premark revenues. In 2000, the first year of the acquisition, we moved operating margins from 9 percent to 11 percent. In 2001, even with a weak top line caused by adverse end market conditions, operating margins improved to 12 percent. In addition, if 2001 revenues had remained flat to prior year levels, Premark margins would have approached 14 percent last year. Premark remains on track to reach its targeted operating margin of 18 percent at year-end 2004.

## 80/20 Operating Strategy

Our 80/20 process originated in the early 1980s, during a period of economic transformation from inflation-related growth to growth through market penetration. As our businesses reexamined their operations in order to remain competitive, the idea of structuring a business to concentrate on its most profitable pieces emerged.

The 80/20 process focuses a business' resources on the 20 percent of its customers who represent 80 percent of the revenues. This process is really about simplifying and focusing on key parts of the business. We believe simplicity focuses action, while complexity often blurs what is important. At the end of the day, applying the 80/20 process increases customer satisfaction through improvements in product development and delivery. It also reduces inventory, increases market penetration and strengthens ITW's industry reputation. We continuously apply this highly effective process to all aspects of our operations, and consider it to be a core company discipline.



## Balanced Portfolio

Over the past 10 years, ITW has improved diversification in key end markets. In the construction market, which represents 24 percent of our revenues, we have become balanced—both in terms of end markets and geographies. For example, the new housing, commercial and remodeling/rehab segments today each account for roughly one-third of construction revenues. That is a dramatic shift from 10 years ago when remodeling/rehab accounted for only 1 percent of construction revenues. The geographic mix also has improved in construction revenues. Ten years ago, international construction revenues were heavily weighted toward Europe. Today, nearly half of our international construction revenues come from Australia and Latin America.

In the automotive market, the company's geographic presence continues to show better balance. Currently, of the company's total 16 percent of automotive revenues, 10 percent originates from North America and 6 percent from Europe. In 1990, Europe accounted for a much smaller percentage contribution.

Maintaining a well-balanced revenue mix helps ITW soften cyclical market swings. Thanks to our acquisition activities, we continue to take steps to diversify our customers and end markets.



**Diversified End Markets**