

Financial Review

KEY FEATURES OF THE YEAR

We continued with the execution of our growth strategy in 1999. An important ingredient was the completion of eight acquisitions for a cash cost of £290 million which, including debt assumed on acquisition, totalled £490 million.

By far the largest of these, at a total cost of £348 million was The Interlake Corporation which contributed £318 million to sales for the 11 months under GKN ownership. Interlake comprises three operating divisions: Hoeganaes, Interlake Material Handling and Chem-tronics. Each one represents an important strategic development for GKN and reference is made to them elsewhere in this report.

Our powder metallurgy business continued to develop through six acquisitions in Sinter Metals including an increased shareholding in the South African operation. Other acquisitions all took place in the US with Fairview Sintered Metals in May, Michigan Sintered Metals in July, Elite Metal Products in August, Zenith Sintered Products in September and Borg-Warner's Gallipolis operation in October. The total cost of these acquisitions, including debt, was £131 million with annualised sales of £120 million. Sales of these businesses within GKN in 1999 were £36 million.

Automotive Driveline increased its stake in Asian Driveshaft in Malaysia from 42.1% to 57.9% in June and there were also small asset acquisitions during the year. The total cost of these was £11 million and the effect on sales and profits was not material.

We reported last year that the 48% shareholding in Normalair-Garrett (Holdings) Ltd was subject to reciprocal put/call options. These were exercised during December and the shares were sold for £38 million with an additional £35 million being received by way of special dividend.

ACCOUNTING STANDARDS

During the year Financial Reporting Standards (FRS) 12 and 13 have become effective. The impact of FRS 12 is shown on page 53. As noted, there has been no impact on profits for the year as a result of the change in Standard but there has been a small prior year adjustment in respect of environmental liabilities in our CLEANAWAY waste management joint venture. FRS 13 is a disclosure standard relating to financial instruments, including treasury matters, and its requirements are dealt with both in this review and in notes 20 and 21 on the Accounts.

SALES

Sales for the year, including the Group's share of joint ventures and associates rose by £937 million (25.3%) to £4,643 million. The net impact of currency was negligible while the effect of 1999 acquisitions and the full year impact of 1998 acquisitions was £449 million. Excluding these features the improvement was £486 million (13.1%) with most of the increase arising in Helicopters and the CHEP businesses worldwide.

Automotive sales rose from £2,230 million to £2,394 million, an increase of 7.4%, with £96 million attributable to the inclusion of Hoeganaes for the first time. Eliminating this and other acquisitions, sales were at much the same level as last year with improvements in Sinter Metals and Emitec offset by reductions in OffHighway Systems and AutoComponents where market conditions remained depressed.

Industrial Services sales grew by 42.4% to £810 million of which £152 million arose from the

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net impact of currency and acquisitions in 1998 and 1999. By far the most significant was Interlake Material Handling (which contributed £135 million). Organic growth generated increased sales of £90 million up by 15.8% largely resulting from ongoing fast progress of Industrial Services and CHEP in particular.

Aerospace sales of £1,439 million were £532 million (58.7%) above 1998. Acquisitions, including £87 million from Chem-tronics, accounted for £125 million of the increase with the balance largely arising in Helicopters as EH101 volume production commenced.

OPERATING PROFIT

Operating profit before goodwill amortisation rose from £463 million to £558 million, an increase of 20.5%. The adverse impact of currency was small at £3 million. Excluding this and the impact of 1998 and 1999 acquisitions the increase was £41 million (8.9%).

Automotive profits rose by £27 million (11.0%) largely as a result of acquisitions. The agricultural machinery markets again weakened during the year, particularly in North America, and profitability in this area fell as a result. Overall, however, Automotive margins improved from 11.0% to 11.4%.

Industrial Services profits of £147 million were £29 million (24.6%) higher than in 1998. Excluding currency and acquisitions the increase was £15 million (12.7%). Margins fell from 20.7% to 18.1% mainly due to the inclusion of Interlake Material Handling. Joint venture margins of 18.7% compared with 19.2% last year mainly due to start up costs both of new business initiatives, notably Wal*Mart, and further geographic expansion.

Aerospace profits improved from £99 million to £138 million, an increase of 39.4%. Whilst part of this reflected the result of acquisitions, the major factor was the increased production and delivery of helicopters during the year.

INTEREST

Interest payable by subsidiaries of £21 million compared with interest receivable of £20 million in 1998. The changed profile was largely a consequence of the acquisition programme where the most significant was Interlake. Interlake has been successfully integrated and its profits well exceeded the associated interest costs. Higher working capital levels in support of new business in Helicopters and a combination of new programmes and a civil market slowdown in Aerospace gave rise to the balance of the interest cost increase.

The Group's share of joint venture interest payable rose to £24 million from £21 million in 1998 resulting from increased investment in support of the fast growth of CHEP.

PROFIT BEFORE TAX

Profit before tax, goodwill amortisation and exceptional items was £513 million compared with £462 million in 1998, an increase of 11.0%.

There was a small net exceptional gain of £11 million from the divestment of Normalair-Garrett and CLEANAWAY Netherlands together with costs relating to prior year divestments. However, this was after charging £31 million of goodwill previously written off to reserves so that the benefit to shareholders' funds of these transactions was £42 million.

After exceptional items and goodwill amortisation, profit before tax was £501 million. This compared with the 1998 figure of £707 million which included a £248 million credit in respect of the release of the Meineke litigation provision.

TAXATION

The rate of tax as a percentage of profit before goodwill amortisation and exceptional items fell to 26.7% from 29.0% last year as a number of initiatives, including the payment of 1998 dividends as Foreign Income Dividends, bore fruit.

EARNINGS, DIVIDEND AND RETURN OF CAPITAL PER SHARE

On a comparable basis, earnings per share rose by 13.9% to 52.4p. As noted on page 79, the Board is proposing a return of capital equivalent to 11.7p per share by way of the issue of redeemable 'B' shares. When combined with the interim dividend of 6.3p this brings the total cash payment per share to 18.0p, an increase of 10.4% over the 16.3p dividend paid in 1998. The return of capital in place of a final dividend will result in an ACT saving of up to £12 million.

CASH FLOW

Cash flow from operations was £391 million compared with £388 million in 1998. There were significant increases in stocks and debtors as Aerospace and Helicopter contracts developed.

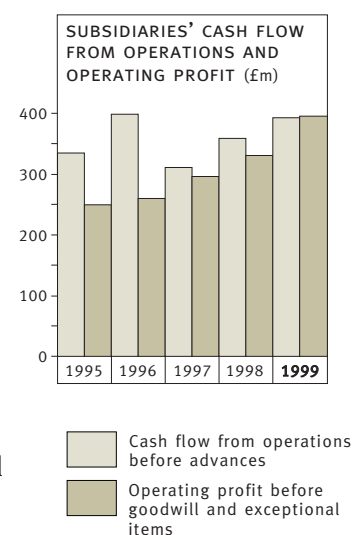
Capital expenditure was £236 million (1998 – £209 million), continuing to reflect very high levels of investment in the Helicopter and Driveline businesses together with the start of a significant programme in Hoeganaes. Taking accruals into account, expenditure of £247 million represented 187% of depreciation.

The net impact of acquisitions and divestments on the cash flow was £246 million (1998 – £166 million) and the net cash outflow for the year was £253 million (1998 – £131 million).

TREASURY MANAGEMENT

GKN co-ordinates all treasury activities through a central function whose purpose is to manage the financial risks of the Group as described below and to secure short and long-term funding at the minimum cost to the Group. The central treasury function operates within a framework of clearly defined Board approved policies and procedures, including permissible funding and hedging instruments, exposure limits and a system of authorities for the approval and execution of transactions. It operates on a cost centre basis and is not permitted to make use of financial instruments or other derivatives other than to hedge identified exposures of the Group. Speculative use of such instruments or derivatives is not permitted, and none has occurred during the year.

The central treasury function prepares a formal report biannually to the Board of GKN plc, and prepares formal monthly reports for the Finance Director and other senior executives of the Group. In addition, the gross and net indebtedness of the Group is reported on a weekly basis to the Chief Executive and the Finance Director, whilst liquidity, interest rate, currency and other financial risk exposures are monitored daily. The central treasury function is subject to a biannual internal and external controls review.



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FUNDING AND LIQUIDITY The Group funds its operations through a mixture of retained earnings and borrowing facilities, including bank and capital markets borrowings and leasing. The relative proportions of equity and borrowings are governed by specific Board approved parameters. These are designed to preserve prudent financial ratios, including interest, dividend and cashflow cover, whilst also minimising the overall weighted average cost of capital to the Group.

All the Group's borrowing facilities are arranged by the central treasury function and the funds raised are then lent to operating subsidiaries on commercial arms-length terms. In some cases operating subsidiaries have external borrowings, but these are supervised and controlled centrally. The Group's objective is to maintain a balance between continuity of funding and flexibility, through borrowing at a range of maturities from both capital markets and bank sources.

Bank borrowings are principally in the form of committed multi-currency bilateral revolving credit facilities with a group of relationship banks, and with a range of maturities from 364 days to 3 years. Borrowings under these facilities are unsecured and were denominated solely in US dollars at 31 December 1999.

Capital markets borrowings include the £300 million 6.75% unsecured bonds issued in October. These had a maturity on issue of 20 years.

At the year end the Group had committed facilities of £1,176 million, of which £385 million was drawn. The weighted average maturity profile of the Group's committed borrowings was 16 years. The Group also has access to substantial lines of uncommitted funds which are used principally to manage day-to-day liquidity. Wherever practicable, pooling, netting or concentration techniques are employed to minimise gross debt.

RISK MANAGEMENT The Group is exposed to a variety of market risks, including the effects of changes in foreign currency exchange rates and interest rates. In the normal course of business, the Group also faces risks that are either non-financial or non-quantifiable, including country and credit risk.

The Group uses interest rate swaps, forward rate agreements, netting techniques and forward exchange contracts to manage the primary market exposures associated with its underlying assets, liabilities and anticipated transactions.

COUNTERPARTY CREDIT RISK The Group is exposed to credit related losses in the event of non-performance by counterparties to financial instruments. Credit risk is mitigated by the Group's policy of only selecting counterparties with a strong investment graded credit rating, normally at least AA – or equivalent, and assigning financial limits to individual counterparties.

INTEREST RATE RISK The Group operates an interest rate policy designed to optimise interest cost and reduce volatility in reported earnings. This policy is achieved by maintaining a target range of fixed and floating rate debt for discrete annual periods, over a defined time horizon. This is achieved partly through the fixed rate character of the underlying debt instrument, and partly through the use of straightforward derivatives (forward rate agreements and interest rate swaps). The current minimum level of fixed rate debt is 70%, reducing to nil over a rolling 5 year period. It is, however, the Group's policy to keep these parameters under review from time to time to take account of movements in the interest rate environment and also changes in the disposition and nature of the Group's operating assets.

At 31 December 1999, 73% of the Group's gross financial liabilities were at fixed rates of interest. The weighted average period in respect of which interest has been fixed was 17.7 years.

CURRENCY RISK The Group has transactional currency exposures arising from sales or purchases by operating subsidiaries in currencies other than their functional currency. Under the Group's foreign exchange policy, such transaction exposures are hedged once they are known, mainly through the use of forward foreign exchange contracts.

The Group has significant investments in overseas operations, particularly in continental Europe and the Americas. As a result, the sterling value of the Group's balance sheet can be significantly affected by movements in exchange rates. The Group therefore seeks to mitigate the effect of these structural currency exposures by matching the net investment in overseas operations with borrowings denominated in their functional currencies. This is achieved by borrowing either directly (in either the local domestic or eurocurrency markets), or synthetically through the use of rolling annual forward foreign exchange contracts. The Group aims in this way to match as equally as possible the impact of currency movements on the Group's debt and on shareholders' funds, so that balance sheet gearing is relatively unaffected by such movements. The Group's current policy is to match a minimum of 80% of such movements with borrowings. Borrowings created synthetically through the use of forward foreign exchange contracts amounted to £1,057 million at 31 December 1999 and were denominated in US dollars (67%), euro (31%) and other currencies (2%).

NET BORROWINGS

At the end of the year the Group had net borrowings of £281 million compared with net funds of £139 million at the end of 1998. These included customer advances of £342 million and £343 million respectively which are shown in short-term creditors in the balance sheet.

SHAREHOLDERS' EQUITY

Shareholders' equity increased by £339 million to £1,354 million from £1,015 million at the end of 1998. On a proforma basis equity will reduce to £1,270 million on redemption of the redeemable 'B' shares.

THE EURO

Companies undertaking business in Europe have been able to conduct transactions in the euro since 1 January 1999. Plans continue to be developed for operations in the 11 member states that adopted the euro on 1 January 1999 to use it as their currency of accounting. Spanish subsidiaries began reporting in the euro on 1 January 2000 and others will do so progressively. Costs of conversion will not be material.

FINANCIAL RESOURCES AND GOING CONCERN

At 31 December 1999 the Group had available, but undrawn, committed borrowing facilities totalling £791 million.

In view of the strength of the year end balance sheet and in the light of future funding requirements the directors are of the opinion that it is appropriate for the accounts to be prepared on a going concern basis.

