Financial review

Key features of the year

We continued with the execution of our growth strategy in 2000, although trading conditions were generally more difficult than in recent years.

Our Automotive businesses did well, notwithstanding a significant downturn in North American car and light vehicle production in December. These weak market conditions have continued into 2001.

The outsourcing agreements with Nissan in Japan and Opel in Germany were further important strategic developments in our Automotive Driveline business. These, together with the Dana facility in South Carolina, comprised the main acquisitions in 2000 and contributed £66 million of sales in the year.

Sinter Metals had a good year in Europe with sales and profits ahead of 1999. In North America, sales were ahead of 1999 but profits were lower reflecting the costs associated with a severe production decline in the last quarter which accelerated in December. A greater impact will be felt in the early months of 2001, as North American production remains very weak.

2000 has been a difficult year for GKN Aerospace Services. However the acquisition from Boeing of their military aircraft facility in St Louis, although not completed until after the year-end, formed a major element of the repositioning of the business as a first tier supplier to the major OEMs. As part of this process, the Aerospace business is being focused on seven centres of excellence. The total cost of the reorganisation is £70 million and has been included in exceptional items. It is expected to be completed in early 2002, following good progress in the last months of 2000.

The Helicopters business again had a record year as the production programme reached a peak. The negotiations with Finmeccanica to form AgustaWestland, the world's second largest helicopter manufacturer, were successfully concluded in 2001.

Sales and profits in Industrial Services were up 18.8% and 15.4% respectively. The joint ventures with Brambles Industries Limited of Australia were the main contributors to this growth. Sales in CHEP Americas were strongly ahead of last year, a principal driving factor being the Wal*Mart and The Home Depot agreements. In CHEP Europe, underlying sales growth was just under 9%. CLEANAWAY acquired Waste Management Deutschland in May 2000. Interlake Material Handling sales grew by 18%.

New accounting standards

Three new accounting pronouncements have been applied in the period:

UITF Abstract 24 'Accounting for Start-up Costs' – The only impact of the application of this Abstract is that unamortised start-up costs in CHEP USA, which totalled £10 million at 31 December 1999, have been written off as a prior year adjustment. There was no material impact on profits in either 2000 or 1999. Comparative balance sheet figures have been restated accordingly.

FRS 15 'Tangible Fixed Assets' – The Group has adopted the transitional arrangement of the Standard and has retained the book amounts of certain tangible assets which were previously revalued.

FRS 16 'Current Tax' – This Standard has had no impact on the Group results.

Sales

Sales for the year, including the Group's share of the sales of joint ventures and associates, rose by £453 million (9.8%) to £5,096 million. Excluding the impact of currency, 2000 acquisitions and divestments, and the full year impact of 1999 acquisitions, the improvement was £323 million (7.1%), with most of the increase arising in Automotive and the CHEP businesses worldwide.

Automotive sales rose from £2,394 million to £2,683 million, an increase of 12.1%. Eliminating acquisitions, divestments and currency, sales were 5.8% ahead of last year driven by improvements in Automotive Driveline and Sinter Metals in Continental Europe. Sinter in North

America and Hoeganaes were hit by a slow-down in the last quarter and the severe downturn in December. Automotive Driveline however had a strong year in North America and was less impacted by the market downturn because of a broad customer base. OffHighway Systems and AutoComponents sales were 6.2% ahead of last year on a like for like basis with market share gains offsetting the continuing depressed market conditions.

Industrial Services sales on a like for like basis grew by 16.2% to £962 million due principally to continued organic growth in the CHEP and CLEANAWAY joint ventures. In the US CHEP sales grew by 17.7% but this improves to 29.4% excluding Autocrates which was exited in 1999. CHEP Europe's growth rate is distorted in the second half, due to inclusion in 1999 of pre-2000 stock build up.

Aerospace sales of £1,451 million were £12 million (0.8%) above 1999, 4.1% higher if Normalair-Garrett, which was divested in 1999, is excluded. An increase in Helicopters was largely offset by a reduction in GKN Aerospace Services, where volume reductions in existing programmes are not yet fully offset by the growth on new programmes.

Operating profit

Operating profit before goodwill amortisation and exceptional items rose from £558 million to £593 million, an increase of 6.3%. The adverse impact of currency was £9 million though this was largely offset by gains from a reduction in foreign exchange cover. Excluding this and the impact of 1999 and 2000 acquisitions and disposals, the increase was £31 million (5.8%).

Automotive profits rose by £35 million (12.8%) largely as a result of increased shareholdings in Brazil (ATH) and Australia (Unidrive) combined with organic growth in North America. The agricultural machinery markets weakened again during the year, but cost reductions and market share gains maintained profitability close to the 1999 level. Overall, Automotive margins improved from 11.4% to 11.5%.

Industrial Services profits of £169 million were £22 million (15.0%) higher than in 1999. Excluding currency and acquisitions, the increase was £20 million (13.7%). Margins fell from 18.1% to 17.6%, mainly due to the growth of Interlake Material Handling, which is a lower margin business. Joint venture margins were 18.8% compared with 18.7% last year. Improved margins were achieved in CHEP Americas as new contracts, notably those resulting from Wal*Mart endorsements, started to generate revenue and the level of start-up costs incurred in 1999 was not repeated. In CHEP Europe profits were up on 1999 but were impacted by higher costs associated with the global IT rollout as well as the increased transport costs related to disruption in the second half.

Aerospace profits reduced from £138 million to £116 million, a decrease of 15.9%. Excluding Normalair-Garrett the reduction was 11.8%. The major factor was GKN Aerospace Services, which had a very difficult year with programme changes and accelerated start-ups causing difficulties, particularly on the introduction of the AS900 programme. These were offset by a 10.3% increase in profits at Helicopters.

Exceptional items

Exceptional costs of £45 million have been charged within operating profit. This represents the costs of restructuring GKN Aerospace Services to create a global first tier supplier operating from centres of excellence.

Exceptional profits on sale or closure of businesses totalled £27 million compared with £11 million in 1999. The 2000 figure includes the gains arising on the exchange of businesses with Dana, £57 million, and on the sale of the London Heliport, £7 million, offset by GKN Aerospace Services closure costs of £32 million.

The Group's share of associate's exceptional items of £6 million relates to the sale by Alvis plc of its shares in Avimo Group Ltd.

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Interest

Interest payable by subsidiaries was £31 million compared with £21 million in 1999. The increase was largely a consequence of the acquisition programme, combined with higher working capital levels in support of new business and increased levels of production, notably in GKN Aerospace Services and Helicopters.

The Group's share of joint venture interest payable rose to £34 million from £24 million in 1999. This was due to the acquisition by CLEANAWAY of Waste Management Deutschland, and further capital expenditure in support of the continued growth of CHEP, notably in the US.

Profit before tax

Profit before tax, goodwill amortisation and exceptional items was £528 million compared with £513 million in 1999, an increase of 2.9%.

After exceptional items and goodwill amortisation, profit before tax was £481 million. This compared with the 1999 figure of £501 million.

Taxation

The rate of tax as a percentage of profit before goodwill amortisation and exceptional items fell to 25.2% from 26.7% last year, principally due to the further recovery of surplus ACT through the issue of redeemable 'B' Shares.

Earnings

Earnings per share before goodwill amortisation and exceptional items rose by 4.0% to 54.5p.

Dividend

A final dividend of 12.9p per share is proposed giving a total dividend for the year of 19.8p, an increase of 10.0% over the amount distributed to shareholders in 1999 via the interim dividend and the return of capital. The dividend is covered 2.5 times by pre-exceptional earnings.

Cash flow

Cash flow from operations was £365 million compared with £391 million in 1999.

There were significant increases in working capital, principally in GKN Aerospace Services in support of new programmes and the restructuring process. In addition, there was additional working capital in the US Automotive businesses as a result of the market conditions.

Capital expenditure was £261 million (1999 – £236 million), continuing to reflect very high levels of investment in the Helicopter, Automotive Driveline and Sinter Metals businesses, together with the completion of a significant expansion programme in Hoeganaes. Taking accruals into account, expenditure of £258 million represented 158% of depreciation.

The net impact of acquisitions and divestments on cash flow was £113 million (1999 – £246 million) and the net cash outflow for the year was £147 million (1999 – £253 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 an annual internal and annual external review of controls.

Funding and liquidity

GKN 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 cash flow 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 three years. Borrowings under these facilities are unsecured and were denominated solely in sterling at 31 December 2000.

Capital markets borrowings include the £300 million 6.75% unsecured bonds issued in October 1999. These bonds had a maturity on issue of 20 years.

At the year-end, the Group had committed borrowing facilities of £1,245 million, of which £627 million were drawn. The weighted average maturity profile of the Group's committed borrowings was 10.6 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, swaptions, 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 long-term 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, interest rate swaps and swaptions). As reported previously, it is the Group's policy to keep the parameters governing interest rate fixing under review to take account of movements in the interest rate environment and also changes in the disposition and nature of the Group's operating assets. As a result of the latest such review carried out during the year ended 31 December 2000, the Group's previous policy requiring a minimum of 70% fixed rate interest (reducing to nil over a rolling five year period) was amended to provide for greater

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flexibility in managing the Group's overall cost of capital. The revised parameters now adopted require interest rates to be fixed in the range 30%-70% of the level of underlying borrowings forecast to arise over a 12 month horizon, reducing on a tapering basis to a minimum of 0% fixing for debt maturities extending beyond three years on a rolling basis.

At 31 December 2000, 44.8% 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 17.6 years.

Currency risk

The Group has transactional currency exposures arising from sales or purchases by operating subsidiaries in currencies other than the subsidiaries' 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 level of hedges may be varied from time to time, as the volume of underlying trading also varies. Differences arising on such variations are taken to the profit and loss account either as a credit or as a charge. In 2000, the adjustment led to a small credit.

The Group has a significant investment in overseas operations, particularly in Continental Europe and the Americas. As a result, the sterling value of the Group's balance sheet can be affected by movements in exchange rates. The Group therefore seeks to mitigate the effect of these translational currency exposures by matching the net investment in overseas operations with borrowings denominated in their functional currencies, except where significant adverse interest differentials or other factors would render the cost of such hedging activity uneconomic. 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. Borrowings created synthetically through the use of such contracts amounted to £414 million at 31 December 2000 and were denominated in euro (83%), yen (14%) and other currencies (3%).

Net borrowings

At the end of the year, the Group had net borrowings of £601 million (1999 – £281 million). This was after taking account of the cash received from customer advances of £315 million (1999 – £342 million) which are shown in short-term creditors in the balance sheet.

Shareholders' equity

There was an increase in shareholders' equity in the year of £113 million to £1,457 million largely reflecting the retained profit of £176 million less the £84 million paid to redeem the 'B' Shares.

The euro

Companies undertaking business in Europe have been able to conduct transactions in the euro since 1 January 1999. The majority of the Group's subsidiaries within the 11 member states in the euro zone adopted the euro as their currency of accounting with effect from 1 January 2001 or earlier. Plans are in place to ensure that the remaining subsidiaries and the Group's joint venture operations will convert by 1 January 2002. The costs of conversion have not been, and are not anticipated to be, material.

Financial resources and going concern

At 31 December 2000 the Group had available, but undrawn, committed borrowing facilities totalling £618 million.

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.