

MANAGING THE DOWNTURN BUILDING FOR THE FUTURE

GKN was transformed in 2001 to become a focused, global engineering company. Strategic initiatives were undertaken, important new business was won and the Group delivered a solid trading performance with strong operating cash flow despite the economic downturn in a number of its major markets.



2001 financial highlights

Sales for the year of the automotive and aerospace businesses were £4.3 billion, an increase of 5% over the pro forma sales of those businesses in 2000. On the same basis, operating profit before goodwill amortisation and exceptional items was £306 million compared with £424 million last year, a reduction of 28%.

Within these figures, the favourable impact of currency translation was £59 million on sales and £7 million on operating profit.

Operating cash flow at £206 million was significantly ahead of 2000.

Net debt at the end of the year was £885 million compared with £601 million at the end of 2000 and £920 million at the half year. Interest cover was 5.0 times.

Divisional operating results are discussed in the Review of Operations on pages 12 to 19. The overall Group financial performance is summarised in the Financial Review on pages 28 to 31.

The advantage of leadership

No engineering business is immune from the cyclical nature of its markets and there have been difficulties in 2001. However, GKN's major businesses are world leaders in their sectors and this gives us competitive advantage in a downturn.

The challenge of managing the strategic development of the Group, while responding to the economic slowdown which hit some of our major markets during 2001, has required all the skill and experience of the GKN management team. This same strength will serve the Group and its shareholders well when the upturn comes.

Automotive Driveline Division (ADD) delivered a robust and remarkably resilient performance in 2001. Through its global

leadership, technological strengths and new programme wins it achieved an overall 10% increase in sales. Excluding the effect of currency and acquisitions ADD still achieved underlying sales growth of 3% over 2000 in a year when North American car and light vehicle output fell by 10%.

Our Automotive sales increased as recent acquisitions and an unusually high number of new programme wins offset the loss of established business arising from lower vehicle output in the US. Profits were lower however because new business does not initially achieve the same levels of contribution which arise over time on established programmes.

The overall performance of our automotive businesses was also reduced by Powder Metallurgy which was heavily impacted by the downturn in the US automotive market and by certain performance issues. This led to a disappointing performance for the year as a whole. Recovery actions have been implemented and we are confident that these will lead to an improved performance by Powder Metallurgy for 2002.

OffHighway and AutoComponents continued to deliver a creditable performance in the context of very depressed market conditions.

GKN Aerospace Services and AgustaWestland have the majority of their business in the defence markets for which the outlook is expected to remain positive.

AgustaWestland, our new joint venture, has come together extremely well and has justified our ambitions for the business by winning a succession of important export contracts throughout 2001.

While underlying performance improved at GKN Aerospace Services, the downturn in the civil aerospace market is already

affecting activity levels and the Group has taken significant steps to reduce costs.

In October, we announced with regret that employment within the Group would reduce by 1,250 people and that certain civil aerospace assets would be written down. This, together with charges relating to the demerger of the Industrial Services businesses and the restructuring of the Group's corporate centre, has led to total exceptional charges of £126 million for 2001.

The actions we have taken to respond to the changed economic circumstances have not impaired our ability to capitalise upon the upturn when it comes. We therefore feel able to take a positive and confident view of our prospects.

Improving our strategic position

GKN completed a number of important initiatives in 2001 to improve our strategic position. The most important of these were:

- › creating AgustaWestland, the world's No. 2 helicopter company. This 50:50 joint venture with Finmeccanica has enjoyed considerable success since its formation at the start of the year. The management team has come together well, synergies are being realised, the order book has been executed without disruption and major new programmes have been won;
- › completing the purchase of Boeing's US military aircraft fabrication operations in St. Louis, Missouri, USA. This transaction established a strategic relationship with the world's largest aerospace company and increased the Group's exposure to the US defence market. GKN is now an active supplier to US military aircraft programmes which represent future business worth an estimated \$4.2 billion to the Group;

› integrating new driveline operations in Japan and Germany within the global organisation of the Automotive Driveline Division. This follows outsourcing agreements in late 2000 with Nissan and with GM Opel. In doing so GKN established its first wholly owned manufacturing presence in Japan.

Growth through innovation

Innovation has always been at the heart of how GKN creates new products, wins new markets or finds new, improved ways for its people to work together. Four years ago GKN launched a central initiative to increase the emphasis we place on the power of innovation to grow and even transform our business. At the same time we saw an opportunity to align innovation with the development of learning across the Group.

The level of activity focused on innovation and learning was intense. A global network of committed individuals quickly came together supported by a small central team and a proprietary, web-based communications system. A particularly striking aspect of the process was the rapid and spontaneous way in which hundreds of people across GKN began to make a contribution.

Belief in the power of innovation and learning is more embedded within our corporate culture than ever before. We therefore decided in 2001 that if we are to drive long-term results from this achievement then the innovation and learning process should be championed by the leadership teams within each of our businesses. Management of the process is therefore now closer to our products, our markets and our customers.

Innovation at work

Examples of innovation at work within GKN can be found across our automotive and aerospace businesses. We have new, advanced driveline components and torque management systems under development for our customers. A radical approach to secondary drivetrains for agricultural vehicles is meeting with success in the market. We are extending our expertise in aluminium into new automotive product areas. In aerospace we continue to enhance our world-leading capabilities in the production of advanced composite and metallic structures.

Management's commitment

GKN faces the future from a position of strength. The management team is committed to growing shareholder value by delivering outstanding operational performance and above average growth through the business cycle. We will do this through a very clear core strategy which is focused on:

› organic growth

There are opportunities available to our existing businesses through growth in emerging markets, in the four-wheel drive and all-wheel drive vehicles sector, in powder metal components, in helicopters and in the increasing use of composite structures in aircraft.

› customer outsourcing

This continues to be a major opportunity for our Automotive Driveline Division. Our acquisition of Boeing's military aircraft structures business and specialist thermal joining centre has demonstrated how outsourcing can also grow our aerospace business.

**USING OUR OPERATIONAL AND FINANCIAL
STRENGTH TO BUILD FOR THE FUTURE**

› **consolidation**

GKN has driven the consolidation of the powder metallurgy industry. Consolidation is also likely to become a trend within aerospace as prime contractors search for improved efficiencies from their supply chain.

Meanwhile, we remain alert to high quality, bolt-on acquisition opportunities which make strategic sense and are aligned to our existing growth platforms. Focusing on our strengths and building leadership positions in our sectors is at the heart of our strategic vision.

The contribution of GKN's people

As part of the continued evolution of the Group we established a change programme four years ago in which we involved 550 managers in a series of workshops. Working closely with the Columbia Business School our objective was to improve our business processes and enhance the performance of business teams.

Today we are continuing to work actively on team development but we are also focusing more intently on individual empowerment and creativity. A series of leadership programmes is being established with Columbia to help promising young executives to fully develop their potential and to allow more senior executives to build on their experience.

Increasingly within GKN there is a strong sense of empowerment. This is something we encourage, for the outcome of sensible empowerment is improved operational performance.

2001 has been a demanding year for the GKN team. The effort and dedication of people at all levels, throughout our global organisation, has served the interests of the business and its shareholders well. GKN has a long tradition of outstanding performance and successful corporate renewal. This is due, in no small measure, to the steadfast and unstinting loyalty of many thousands of individual employees even in times of major change. We thank them for their contribution.

Outlook

The outlook for automotive markets is uncertain. For the year as a whole we expect world vehicle production to be lower than in 2001. We foresee some improvement in defence-related aerospace but civil aerospace markets are likely to remain depressed. The restructuring actions announced in October are underway and, together with recovery initiatives in Sinter Metals, should go some way to mitigating further declines in our markets.

Lower demand in most of our markets, together with the cost of the consolidation of UK helicopter operations announced in January this year, will adversely affect results in the first half. We expect results to improve as the year progresses. For the longer term the underlying operational and financial strength of our business enables us to continue to build for the future so that we may capitalise fully on the upturn when it comes.



Marcus Beresford 6 March 2002