GROUP ACTIVITIES

GKN is a global engineering business serving the automotive and aerospace markets.

Automotive activities comprise GKN Driveline, Powder Metallurgy, AutoComponents, Emitec and OffHighway Systems.

Aerospace activities are concentrated on structural components, propulsion systems and special components for both military and civil aerospace markets.

For eleven months of the year the Group had a 50% shareholding in AgustaWestland, the European helicopter manufacturer. This was sold on 30 November 2004.

STRATEGY

GKN is committed to providing long-term shareholder value by supplying outstanding products and services to our global automotive and aerospace customers to produce growth in sales and sustained profitability. This will be achieved largely through a combination of organic development of our businesses and selective acquisitions which add to our technological capabilities, geographical presence or are in support of customer outsourcing programmes.

CHANGES IN THE COMPOSITION OF THE GROUP

With effect from 1 April 2004 the Group increased its shareholding in Tochigi Fuji Sangyo (TFS) from 33% to 84% with the result that is accounted for as a subsidiary, rather than an associated company, from that date. Because TFS is a publicly quoted company with a March year end its results as an associate were included six months in arrears. The 2004 accounts therefore include a 33% share of its results for the six months 1 October 2003 to 31 March 2004 and 100% of its results for the 9 months 1 April 2004 to 31 December 2004, with appropriate adjustment to earnings for the remaining 16% minority interest. The company is being integrated into the Driveline division and forms the nucleus of its Torque Systems Group.

For strategic reasons, the 50% shareholdings in AgustaWestland and Aerosystems International were sold on 30 November and 13 August, respectively. The results of these businesses have been incorporated in the consolidated results to the dates of disposal and are separately shown as "discontinued operations" in the profit and loss account. Comparative figures for 2003 for discontinued activities comprise these two companies together with the Group's share of Alvis plc which was sold in September 2003. On 1 September 2004 the Group sold Walterscheid Rohrverbindungstechnik GmbH, its German OffHighway hydraulic fittings operation.

CHANGES IN ACCOUNTING POLICY

There were no changes in accounting policy in the year. However, following a review by the directors and in order to bring the Group into line with comparable engineering companies, the method of charging depreciation on tangible fixed assets was changed with effect from 1 January 2004 from reducing balance to straight line and this increased the year's profit by £11 million compared with the previous basis.

REVIEW OF OPERATIONS

In this review and elsewhere in the annual report, in addition to the statutory measures of earnings, we have included references to profit before goodwill amortisation and exceptional items since we believe this shows most clearly the underlying trend in performance. Where appropriate, reference is made to results excluding the impact of both 2003 and 2004 acquisitions and divestments as well as the impact of currency translation. As in 2003, in the segmental analysis the cost of the UK pension deficit, which is material and cannot readily be attributed to the current Automotive or Aerospace businesses, is shown separately.

Group performance

Sales

Total sales, including our share of joint ventures and associates, were £4,447 million compared with £4,585 million in 2003, a decrease of £138 million (3.0%), which was more than accounted for by the reduction of £235 million in sales of discontinued businesses.

In continuing businesses, sales increased by 2.7% from £3,595 million in 2003 to £3,692 million in 2004. Excluding the impact of currency translation, acquisitions and divestments, the underlying increase in sales was similar at £131 million (3.8%).

Automotive sales of £3,123 million were £87 million (2.9%) above last year with an underlying increase of £118 million. 2004 was a year of relatively static market conditions in both Western Europe and North America which were compensated to some extent by continuing strong growth in emerging markets, albeit at somewhat lower rates than in 2003.

Aerospace Services sales of £569 million were £10 million (1.8%) higher than 2003. Excluding the impact of currency translation and acquisitions, the increase was 2.5%.

Sales in discontinued businesses were £755 million compared with £990 million in 2003. Most of this reduction reflected the absence of the Group's share of Alvis plc, which was sold in 2003 and the shorter period for which results were included for AgustaWestland and Aerosystems International. AgustaWestland, however, also experienced underlying sales reductions following completion of major UK military contracts in the first half of the year.

Operating profit (before goodwill amortisation and exceptional items)
Total Group operating profit before goodwill amortisation and exceptional items of £268 million was £34 million (11.3%) lower than 2003.

Operating profit in continuing operations was £181 million, a reduction of £14 million (7.2%) from the previous year. Movements in currency exchange rates had a negative impact on both translation of results and transactions of £11 million and £14 million, respectively. The impact of higher raw material costs, mainly on steel and steel-based products, was significant and although some recovery was made from customers, the net impact on the operating profit for the year is estimated at around £40 million. Net acquisitions and divestments contributed £15 million. Total operating profit was also impacted by an increase of £15 million in the charge for the UK pension deficit.

Automotive operating profit decreased by £11 million (5.6%) to £184 million. Excluding translational currency effects, acquisitions, divestments and the benefit of the changed depreciation methodology the decrease was £18 million (9.7%).

Aerospace Services profits improved from £23 million to £35 million. Adjusting for translational currency impacts, acquisitions, divestments and the benefit of the changed depreciation methodology, underlying profit increased by £4 million (20.0%).

Profits in discontinued operations fell by £20 million to £87 million reflecting the lower sales noted above.

As noted previously, the charge to operating profit in respect of the UK pension scheme deficit rose to £38 million from £23 million in 2003 and this is shown separately in the segmental analysis. The increase was due to the higher annual charge commencing mid-way through 2003.

Operating exceptional items (including goodwill impairment)
There was a charge in the period of £250 million (2003 – £91 million) which comprised two elements:

- £99 million in respect of the restructuring measures announced in March 2004 to move some 20% of Driveline production capacity from high cost, low growth economies to the low cost emerging markets of Eastern Europe, South America and Asia Pacific, together with costs associated with the recovery programme in US Powder Metallurgy and overhead cost reductions elsewhere in the Group; and
- £151 million from a review of asset carrying values relating to the accelerated write down of goodwill and tangible assets in Powder Metallurgy where planned recovery in the US has been delayed by higher raw material prices and weak markets for the business's major customers. The 2003 total goodwill impairment of £91 million arose in Powder Metallurgy (£83 million) and Aerospace Services (£8 million).

The £99 million charged in respect of restructuring measures was somewhat lower than had been estimated earlier in the year as discussions about plant closures with customers and employees identified some potential alternative, cost-effective actions. It comprised £62 million in respect of asset write-downs in specific plants where definitive plans and intent existed or actions had been taken, and £37 million in respect of redundancy and other reorganisation costs where external announcements or commitments had been made by the end of the year, mainly in Driveline and Powder Metallurgy. Cash outflow in the year in respect of these totalled £16 million.

Looking forward, the original estimates of total charges of approximately £210 million, cash costs of £140 million and full year benefits of £60 million by 2007 remain valid.

Goodwill amortisation
Amortisation of goodwill was £29 million (2003 – £37 million). In continuing operations the charge was £24 million compared with £31 million in 2003.

Statutory operating loss/profit
There was an £11 million loss after goodwill amortisation and exceptional items (2003 – profit £174 million).

Exceptional items arising on sale of businesses
Exceptional profits arising on the sale of businesses totalled £687 million (2003 – £55 million). £652 million related to profit on the disposal of the Group's 50% shareholding in AgustaWestland, together with related property, for a cash consideration received in the year of £1,028.5 million and was after charging £100 million of goodwill previously charged directly to reserves on the original acquisition of Westland Group plc. No account has yet been taken of a further £35 million of consideration which remains in escrow pending the award by the UK Ministry of Defence of certain contracts relating to its fleet of Lynx helicopters. The balance of the exceptional profit of £35 million related mainly to the disposal of the Group's 50% shareholding in Aerosystems International and the wholly owned subsidiary Walterscheid Rohrverbindungstechnik GmbH.

Interest
Net interest payable by subsidiaries was £46 million (2003 – £56 million). The reduction was due mainly to a combination of lower average borrowings in the first 11 months of the year and interest for one month on the proceeds of sale of AgustaWestland and the effect of interest rate movements in our dollar and euro balance sheet hedges. The Group's share of net interest payable by joint ventures was £1 million (2003 – nil), all of which was in discontinued businesses.

Interest costs were covered 5.7 times (2003– 5.4 times) by operating profit before goodwill amortisation and exceptional items.

Looking ahead to 2005, in the light of the Group's strategic intent to pursue selective business acquisitions, it is currently intended to leave the Group's long-term fixed borrowings in place.

Profit before tax
Total profit before tax, goodwill amortisation and exceptional items was £221 million compared with £246 million in 2003, a decrease of 10.2%.

Statutory profit before tax was £629 million compared with the 2003 figure of £173 million.

Taxation
The total tax charge decreased to £49 million from £70 million in 2003.

The tax rate, expressed as a percentage of profit before goodwill amortisation and exceptional items, for the year was 28.1% compared with a 2003 figure of 31.3%. The 3.2 percentage point decrease is largely attributable to an increase in credits arising from the settlement of prior year tax liabilities, this benefit being partially offset by an increased deferred tax charge resulting from the non-recognition of deferred tax assets in respect of current year tax losses and the revision of prior year capital allowance claims in the UK.

The tax rate for 2005 is expected to show a modest reduction following the disposal of the AgustaWestland business. In addition, there may be a favourable impact from the future resolution of outstanding tax issues.

The tax credit on exceptional items was £13 million (2003 – £7 million).

The total effective tax rate based on profits after goodwill amortisation and exceptional items was 7.8% (2003 – 40.5%).

Earnings

Earnings per share before goodwill amortisation and exceptional items were 21.3p compared with 22.8p in 2003, a reduction of 6.6%. After these items the figure was 78.8p (2003 - 13.8p). The effect of the 13.3 million shares bought into treasury in the final quarter of the year was negligible.

Dividend

A final dividend of 8.0p per share is proposed, payable on 10 May 2005 to shareholders on the register at 15 April 2005.

Shareholders may choose to reinvest this dividend under the Dividend Reinvestment Plan ('DRIP'). The closing date for DRIP mandates is 25 April 2005.

Together with the interim dividend of 3.9p, the total dividend for the year will be 11.9p, an increase of 2.6% over the equivalent figure for last year. The total dividend is covered 1.8 times by earnings before goodwill amortisation and exceptional items (2003 – 2.0 times).

Cash flow

Operating cash flow, which GKN defines as cash inflow from operating activities (£179 million) adjusted for capital expenditure (£184 million) and proceeds from the disposal of fixed assets (£8 million), was £3 million compared with £138 million in 2003 but was after a £100 million advance payment into the UK pension scheme and £21 million (2003 - £13 million) expenditure on exceptional items of both current and prior years.

Excluding the advance pension payment and the impact of exceptional provisions there was a £22 million outflow on working capital, largely reflecting higher stocks resulting from the increase in raw material prices and the increase in underlying sales.

Capital expenditure was £184 million (2003 – £162 million). This represented 115% of depreciation and is in line with our previous expectations that capital expenditure is likely to be in a range of 110% - 120% of depreciation in a normal year. Net interest paid was £46 million compared with £53 million in 2003.

Dividends from joint ventures and associates were £10 million (2003 – £68 million), most of the reduction reflecting the absence of a dividend from AgustaWestland.

Tax paid totalled £47 million compared with £63 million in 2003, the latter figure including the settlement of certain prior year tax issues. The figure for 2005 is expected to be broadly similar to 2004.

The net impact of acquisitions and divestments was an inflow of £1,045 million (2003 – £29 million) leaving a net cash inflow for the year, before dividend payments, of £963 million (2003 – £118 million). Proceeds from divestments in the year totalled £1,068 million in respect of the 50% stakes in AgustaWestland and Aerosystems International and the wholly-owned hydraulic fittings business, Walterscheid Rohrverbindungstechnik. Acquisitions mainly comprised an additional 51% of TFS for £34 million together with an additional 10% of Shanghai GKN Drive Shaft for £8 million. In addition, there were cash and bank balances on acquisition of £17 million.

Share buyback
In October 2004 the Company announced its intention to commence a share buyback programme up to a value of £100 million. By the end of November, the start of the 'close period', 13.3 million shares had been purchased into treasury at a cost of £30 million. It is intended to recommence the programme in 2005.

Net funds/borrowings
At the end of the year the Group had net funds of £65 million (2003 – net borrowings £793 million). These included the benefit of customer advances of £53 million in the Aerospace businesses (2003 – £48 million), which are shown in short-term creditors in the balance sheet. There were net borrowings in joint ventures of £2 million.

Goodwill
At the year-end the balance sheet showed goodwill of £197 million (2003 – £340 million) in relation to subsidiaries and a further £7 million (2003 – £114 million) within the equity value of joint ventures and associates. The significant decrease in value of goodwill in subsidiaries reflects the £100 million impairment charge made in the year. The reduction in joint ventures and associates follows the divestment of AgustaWestland and the re-classification of TFS as a subsidiary.

Shareholders' equity
Shareholders' equity was £1,460 million at the end of the year compared with £926 million at the end of 2003. Retained profit for the year was £491 million after charging £100 million of goodwill previously written off to reserves. The shares purchased into treasury reduced shareholders' funds by £30 million while there was a small (£2 million) increase from shares issued. The currency impact arising on translation was £31 million negative and there were other positive movements of £2 million.

Divisional Developments and Performance
Automotive

Management
During the course of 2004 a small management team was created, led by Ian Griffiths, to take overall responsibility for the management of our Automotive businesses. The structure recognises the global nature of the automotive market and the requirements of our global customers. The objective is to create additional and accelerated value from the portfolio through a cohesive integrated strategy and to ensure the adoption of best in class practices and processes across the portfolio.

Markets
By comparison with 2003 car and light vehicle production was relatively stable in both North America, which was down 0.6%, and Western Europe, which was level with last year. There was, however, continued growth in the emerging markets of Asia Pacific where production in China and India rose by some 14% to 5.7 million units.

Notwithstanding these generally static markets, sales revenue of £3,123 million was £87 million higher than 2003. The impact of currency translation was £136 million negative while the full year impact of 2003 and 2004 acquisitions and changes in status added £114 million. The impact of divestments was small at £9 million so that on a like-for-like basis sales were £118 million (4.1%) higher than in 2003.

Operating profit was £184 million, £11 million (5.6%) below 2003. The impact of currency translation was £8 million adverse which was exactly offset by the benefit arising from the change in depreciation methodology. The net effect of acquisitions and divestments added £7 million and excluding all these factors profits fell by £18 million (9.7%). The major factor behind this reduction was significantly higher raw material costs, mainly steel and steel-based products. Some but not all of this cost was passed on to customers and the net effect is estimated to have reduced profits by some £40 million by comparison with 2003. The adverse transactional impact of currency was some £14 million, mainly on sales out of continental Europe.

GKN Driveline

Products and markets

GKN Driveline specialises in the manufacture of components for light vehicle drivelines (defined as the components that transfer torque between a vehicle's transmission and its driven wheels). These include geared components (transfer cases, power transfer units and final drive units), torque management devices and driveshafts (propshafts for longitudinal power transmission and sideshafts for lateral transmission). Since the acquisition of the majority shareholding in TFS, the division comprises GKN Driveline Driveshafts (GKN Driveshafts) and GKN Driveline Torque Systems Group.

GKN Driveshafts is the global leader in the production of constant velocity jointed (CVJ) products for use in light vehicle drivelines. The majority of CVJs are used in sideshafts for front wheel drive, rear wheel drive and four wheel drive vehicles; CVJ sideshafts are required for every driven axle with independent suspension. Some but not all longitudinal propshafts are also fitted with CVJs.

In 2004, based on internal estimates, GKN Driveshafts businesses, including its joint ventures, produced around 42% of CVJs for the global light vehicle market. The market share of the next largest producer is estimated at 16%. Nearly 25% of CVJs are produced by vehicle manufacturers (VMs) for their own use through 'in-house' operations. Orders won during the year confirm that there is unlikely to be any major change in the division's market share in the period up to 2006/7, the latest date for which reliable data is available.

GKN Driveshafts manufactures CVJs and related products in 21 countries across all major vehicle producing regions of the world and has enjoyed considerable success in developing markets, with strong market shares of some 84% in South America and 51% in the Asia Pacific region (excluding Japan and South Korea).

GKN Driveshafts is also one of the largest suppliers of premium propshafts, which we define as those propshafts with sophisticated joints, materials or other features. We estimate that in 2004 premium propshafts represented approximately 33% of global light vehicle propshaft demand, or some 10 million propshaft assemblies. GKN Driveshafts' share of this segment was in the region of 19%.

GKN Driveline Torque Systems Group comprises Torque Technology Group (TTG), Industrial and Distribution Services and Specialty Vehicles.

TTG produces a wide range of driveline components aimed at actively managing the flow of torque to the driven wheels based on road conditions, vehicle situation and driver intent. Torque management devices (TMDs) are mechanical or electro-mechanical devices that improve vehicle performance and handling by controlling the flow of torque throughout the driveline.

GKN offers the most complete range of TMD solutions as both stand-alone and integrated devices to VMs and to certain Tier One suppliers. In 2004, we estimate that on an annualised basis, GKN supplied approximately 18% of TMDs for light vehicle applications on a global basis. We expect to increase this share based on market acceptance of our electronically controlled coupling, ETM, during 2005.

Geared component sales by TTG are currently approximately £100 million per annum, realised through installation on many successful all wheel drive/four wheel drive vehicles. Increasingly, we are also involved in many active development projects on future vehicle programmes. We expect above market growth in power transfer units and final drive units as VMs continue to introduce new ‘crossover’ vehicles that combine four wheel drive with car-like dynamics and comfort, and our products are well positioned for success in these areas.

Industrial and Distribution Services operates an aftermarket business, primarily in Western Europe, that serves distributors and service outlets with a range of new and remanufactured driveline and other components, while Specialty Vehicles services non-automotive markets, such as marine and all-terrain, with driveline components.

The GKN Driveline business is managed globally to ensure effective use of resources and capital. Customers are served by global account teams that are structured to reflect customer organisations, and all manufacturing and sourcing decisions are reviewed from the perspective of global capacity and strategy.

<u>2004 highlights</u>
Sales in 2004 were £2,057 million (2003 – £1,938 million). The change in status of TFS from associate to subsidiary, the additional 10% stake in our joint venture Shanghai GKN Drive Shaft and the impact of prior year acquisitions accounted for £111 million of the increase. The effect of translational currency was £82 million adverse, leaving the underlying increase at £90 million (4.8%). This overall increase was encouraging as it was achieved in the face of static vehicle production and continued pricing pressure in major markets.

Productivity gains were made from continuous improvement which offset some of the annual selling price reductions. However, the adverse effect of higher raw material prices, which in most cases could not be fully recovered from customers, was significant and overall there was a slight reduction in operating margins from 2003. There were also some productivity improvements from the restructuring announced in March but, as expected, these did not provide significant benefits in the year.

As part of the division’s global strategy of increasing its manufacturing footprint in low cost regions, agreement was reached during the year for the acquisition of the remaining 51% of the shares not currently owned in Velcon, a Mexican manufacturer of CVJs. Completion took place on 1 February 2005 for a cash consideration of US$ 83 million (£44 million).

There continued to be a high degree of focus on research and development, and during the year the division invested some £74 million including expenditures for product and process improvement, cost reduction and innovation. All these costs were charged to operating profit during the year.

Powder Metallurgy
<u>Products and markets</u>
GKN’s Powder Metallurgy division produces metal powder and sintered products which are largely iron-based, although growth is currently seen in the use of aluminium and other alloys. GKN estimates that it has in the region of 16% global market share, with sales to major automotive and industrial original equipment manufacturers and first tier players.

At four times the size of the nearest competitor our advantage lies in technical development, manufacturing capability and global reach. Work continues to ensure that this advantage is fully leveraged.

GKN's sintered component production takes place in North America, Western Europe and the emerging markets (Asia Pacific and South America) with the percentages of sales in those regions being 52%, 42% and 6% respectively.

Hoeganaes is the largest producer of powder in North America with a greater than 50% market share and has also continued its development outside the US, particularly through growth in Europe due to increased usage by GKN's own sintering companies in this region. Hoeganaes' sales to external customers accounted for some 50% of its shipments and just over 10% of the Powder Metallurgy division's sales. Growth of the Romanian powder producer, which was acquired in 2003, continued as planned.

Powder technology was historically seen as essentially substitutional for cast or forged components but an increasing trend towards parts designed to take advantage of powder metal differentiation potential can be seen.

2004 highlights

2004 sales of £589 million were £19 million (3.1%) lower than 2003 due to the translational impact of currency. On a like-for-like basis there was an increase of £21 million (3.7%), with higher sales in Europe and strong growth in the emerging markets of India and Brazil offsetting the impact of reduced production by General Motors, Ford and Chrysler in North America.

2004 was also marked by a Letter of Intent with Shanghai Automotive Industry Corporation to review the feasibility of forming a joint venture in China to position GKN Powder Metallurgy in this rapidly developing market.

The division was particularly badly affected by the substantial increase in the cost of scrap steel, its primary raw material, which rose from an average of $158 per ton in 2003 to $302 per ton in 2004 and resulted in a significant reversal of profitability, leading to a small loss in the year and delaying the planned return to acceptable margins. As noted in the financial section of this review, as a result of this and further reductions in the market share of major customers it was considered appropriate to make an impairment charge of £151 million in respect of capitalised goodwill and fixed assets of the division.

Operational improvements continued as the manufacturing footprint was progressively restructured and rationalised. This ongoing achievement is underpinned by the launch of the GKN Group Lean Enterprise programme providing the tools to drive operational excellence in a robust, disciplined fashion.

During the year new business intake continued positively, with an annualised peak sales value of approximately £100 million won in all three operating regions including strong growth in new customers and applications. These programme wins, which comprise both new and replacement business, will largely phase into production in 2006/7. Further impetus for future growth is expected to be provided by developments at the new European Technical Centre which was officially opened in the summer. Customer relationships continued to strengthen, marked notably by a supplier of the year award from General Motors amongst others.

AutoComponents, Emitec and OffHighway Systems

Products and markets

AutoComponents, which is predominantly UK-based, manufactures structural components and engine cylinder liners for passenger car, light vehicle and heavy commercial vehicle markets in Western Europe and the US. Early in 2005 the division entered into an agreement to establish a 59% owned subsidiary in China with a view to establishing a new low cost production base to serve existing and emerging markets. Emitec, our 50:50 joint venture with Siemens, produces metal substrates for catalytic converters used in cars and light vehicles.

OffHighway Systems (OHS) designs and manufactures steel wheels and drive-line systems for the global agricultural and construction industries. Approximately 80% of its sales are to the agricultural market.

The European agricultural machinery market declined by 3% compared with 2003, but this was less than expected. By contrast, US agricultural machinery sales increased by 23% as a result of record net farming income in 2003. Overall, US production increased by 28% as field inventories were also rebuilt from historically low levels.

Led by China and the recovering US economy, globally the construction market enjoyed a record year. Production and sales were up by 24% in both of these markets. Europe also returned to growth after the stagnation of the previous two years with production up 13% over 2003.

2004 also saw production of both agricultural and construction machinery increase in other regions and China, India, Japan and Brazil now account for approximately 33% of global production. OHS sales in these areas will increase in 2005 as new local facilities come on stream.

2004 highlights

AutoComponents sales were £143 million compared with £157 million in 2003. Despite this reduction, driven largely by customer platform changes, operating profit was broadly flat inclusive of new programme start up costs and the net impact of the significant contract and platform changes on the major programmes. Underlying operating conditions remain difficult within this business.

Emitec suffered from the cessation of US contracts at the end of 2003. The Group's share of sales fell from £55 million in 2003 to £42 million, reflecting an underlying decrease of 20.8%. Profit on the same basis fell by more than 50%.

OffHighway Systems sales rose from £278 million to £292 million. Excluding the impact of currency and divestments the increase was £31 million (11.9%) reflecting both the strength of demand, noted above, and the full recovery of steel price increases. Profits also improved significantly from a combination of volume increases and productivity gains.

Aerospace Services

Products and markets

GKN Aerospace Services operates in two main product sectors, Aerostructures and Propulsion Systems & Special Products. We also have an Engineering Design Services business.

As a leader in the design and manufacture of advanced composites, transparencies and complex metal structures at the component and assembly level we serve all the major airframe and engine OEMs. Products and services are provided to both fixed wing and rotary wing manufacturers, with 60% of sales in the US. Current annual sales are approximately 65% to military and 35% to civil customers.

The overall aerospace market improved in 2004, with initial signs of recovery in the civil sector expected to continue into 2005. Airbus and Boeing are anticipating an increase in the number of aircraft deliveries from 605 in 2004 (up from 586 in 2003) to around 670 in 2005 and industry forecasts of the compound annual growth rate (CAGR) for the civil sector are around 6% for the rest of the decade. In the military market a CAGR of 4% from 2004 to 2010 is forecast, with the US being the dominant force. Although we are cautiously optimistic about the recovery in the aerospace sector it does remain fragile with some major airlines in the US in difficulty and the defence sector having to balance conflicting priorities.

Beyond these market trends we also see significant growth opportunities for GKN driven by increased use of composite materials on new platforms and engines, focused acquisitions which arise from outsourcing opportunities or provide access to complementary technologies or products, and further industry consolidation.

2004 highlights
Sales of £569 million compared with £559 million in 2003. The effect of currency on translation of sales revenue was £37 million negative, while 2003 acquisitions and disposals added a net £34 million. Eliminating these factors, underlying sales were £13 million (2.5%) higher than 2003.

Profits for the year of £35 million compared with £23 million in 2003. £3 million of the improvement came from the change in depreciation methodology but this was entirely offset by £3 million from currency translation as the US dollar showed further weakness in the year. The full year impact of the aerospace business acquired from Pilkington in October 2003 was £8 million so that the underlying increase in the year was £4 million (20%). This reflected a marked improvement in the second half of the year, following a first half which had been impacted by tooling and other asset write-downs and US programme delays which have now been rectified.

The military side of the business continued to perform steadily and there was also some improvement in civil in the second half as a consequence of uplift in demand which is expected to continue into 2005.

Discontinued Operations

AgustaWestland

The Group completed the sale of its 50% shareholding in AgustaWestland on 30 November 2004. Figures for 2004 therefore reflect our share for the eleven months ended on that date and are based on accounts which reflect the contract margin and provision reviews which normally take place as part of the year end procedures.

GKN's share of sales revenue in 2004 of £740 million was £136 million below the 2003 figure, reflecting the loss of one month's revenue, together with lower underlying sales largely as a consequence of the completion of the EH101 contract for the UK Ministry of Defence during the early part of 2003 and delivery of the final six Apaches for the British Army in 2004.

As a consequence, GKN's share of operating profit of £86 million was £16 million below last year.

As noted earlier, the Group also booked an exceptional profit of £652 million on disposal of the business.

Other discontinued operations

During the year the Group also sold its 50% shareholding in Aerosystems International to its joint venture partner BAE Systems plc. This business contributed £15 million (2003 - £26 million) to Group sales and £1 million (2003 - £1 million) to operating profit in the year.

OTHER FINANCIAL MATTERS

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 twice yearly report to the Board, 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 annual internal and external reviews of controls.

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 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 arm's-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 three year committed multi-currency bilateral revolving credit facilities with a group of relationship banks. There were no borrowings against these facilities as at 31 December 2004.

Capital markets borrowing of £705 million includes unsecured issues of £350 million 6.75% bonds maturing in 2019 and £325 million 7% bonds maturing in 2012, together with £30m debenture stock of Westland Group plc, which is secured on assets of that company and certain of its subsidiaries.

At the year-end the Group had committed borrowing facilities of £1,319 million, of which £737 million was drawn. The weighted average maturity profile of the Group's committed borrowings was 10.8 years. This leaves the Group well placed to fund its strategic growth plans and to withstand any sudden changes in liquidity in the financial markets.

The Group also has access to significant 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.

At the year-end the Group had £752 million pounds on deposit as a result of the receipt of the AgustaWestland sales proceeds at end November. The deposits were mainly held in money market funds or with banks at maturities of 3 months or less.

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). The Group's normal policy is to require interest rates to be fixed for 30% to 70% of the level of underlying borrowings forecast to arise over a 12 month horizon. However, this policy was suspended in December as it was deemed inappropriate given the absence of floating rate bank debt following the receipt of the sale proceeds of GKN's share in AgustaWestland. Consequently, as at 31st December 2004, 89% of the Group's gross financial liabilities were at fixed rates of interest, whilst the weighted average period in respect of which interest has been fixed was 10.9 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 a charge.

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 euro-currency markets), or indirectly through the use of rolling annual forward foreign exchange contracts. Borrowings created through the use of such contracts amounted to £775 million at 31 December 2004 and were denominated in US dollars (44%), euro (46%) and Japanese yen (10%).

Pensions and post-retirement benefits

Pension costs in these accounts have been accounted for on an SSAP 24 basis. The total charge to Group operating profit before goodwill and exceptional items was £90 million (2003 – £74 million).

The increase, which was predicted in last year's annual report, arose largely as a consequence of the triennial valuation of the UK scheme which took place during the course of the 2003 and which is discussed in more detail below. Because the valuation applied for only part of that year there was a consequent additional increase in 2004 of £15 million.

Pending the move to International Financial Reporting Standards in 2005, the Group has not adopted FRS 17 in the 2004 accounts, but is disclosing fully the effects had it done so. These are shown in the appendix to this press release and cover both the balance sheet and profit and loss account impacts.

UK pensions

Much of the external focus is on the Group's UK pension scheme which has approximately 58,000 members of whom only 10% are currently in service with the remainder either deferred or current pensioners. As a UK defined benefit scheme, this is run on a funded basis with funds set aside in trust to cover future liabilities to members. An actuarial valuation of the scheme was carried out in 2003 which showed that the aggregate funding on an ongoing basis was 69%. As a consequence, the Group raised its regular annual cash payment to the fund to £54 million in both 2003 and 2004. This figure is expected to apply at least until the next valuation. Employees have also increased their contributions to reflect the higher cost of providing future benefits. In addition, £100 million advance payment to the scheme was made by the Company in December 2004.

Under SSAP 24 the charge to profit for the UK scheme was £48 million (2003 – £33 million), analysed as £9 million in respect of current service, £38 million in respect of the deficit and £1 million in respect of other costs. Because of the materiality of the deficit and since it relates in large part to employees of companies which are no longer part of the Group, as in 2003 it is shown separately in the segmental analysis to enable underlying performance to be understood better.

Overseas pensions

The charge for overseas post-retirement benefits under SSAP 24 was £42 million (2003 - £39 million), including an additional £1 million in companies acquired.

FRS 17 also values post-retirement benefits outside the UK, including those countries where schemes are unfunded and it is already the practice to provide for the liability in the balance sheet. The principal regions involved are the Americas, continental Europe and the Rest of the World. The detailed assumptions underlying the FRS 17 additional net liabilities in those territories of £36 million, £35 million and an asset of £17 million respectively, are explained further in note 6 in the appendix to this press release.

Summary
In total, at 31 December 2004 on the FRS 17 basis, there was a net additional liability on all pension/post-retirement obligations of £580 million (2003 – £563 million) in addition to the net £68 million (2003 – £138 million) already included in long-term liabilities/prepayments on the balance sheet. This net liability arises after a deferred tax credit of £181 million (2003 – £203 million) which, it should be noted, is restricted by the forecast availability of UK taxable profits.

Joint ventures
Following the divestments made in 2004 there would be no significant impact on the equity of joint ventures from the application of FRS 17.

International Financial Reporting Standards
The European Union requires all listed companies to report under International Financial Reporting Standards (IFRS) for accounting periods commencing on or after 1 January 2005 with prior year comparatives on the same basis.

We gave details in our 2003 Annual Report of the programme of work the Group had established to enable it to report under IFRS for the first time when it announces its 2005 interim results. That work continued during the year and, in December 2004, we advised that in addition to generally introducing more volatility, the key areas of impact on the profit and loss account and balance sheet will be in accounting for financial instruments, post-retirement benefits, development expenditure and share-based payments. There will also be other changes of less significance.

It is our intention to re-state the 2004 results on an IFRS basis at the end of April, prior to the publication of the interim results, to allow the impact to be interpreted and understood.

Financial resources and going concern
At 31 December 2004 the Group had net funds of £65 million. In addition it had available, but undrawn, committed borrowing facilities totalling £582 million.

Having assessed the future funding requirements of the Group, the Directors are of the opinion that it is appropriate for the accounts to be prepared on a going concern basis.

Cautionary statement
This press announcement contains forward looking statements that are subject to risk factors associated with, amongst other things, the economic and business circumstances occurring from time to time in the countries and sectors in which the Group operates. It is believed that the expectations reflected in these statements are reasonable but they may be affected by a wide range of variables which could cause actual results to differ materially from those currently anticipated.