A World of Challenges.
A World of Opportunities.

Twin Disc, Incorporated
# Annual Report 2000

TWIN DISC, INCORPORATED is an international manufacturer and distributor of heavy-duty off-highway power transmission equipment. Company engineers work hand-in-hand with customers and engine manufacturers to design products with characteristics unique to their specific applications.

Twin Disc supplies the commercial, pleasure craft and military segments of the marine market with transmissions, surface and waterjet drives and electronic controls. Its off-highway transmission products are used in agricultural, all-terrain specialty vehicle and military applications. Twin Disc also sells industrial products such as power take-offs, mechanical, hydraulic, and modulating clutches and control systems to the agricultural, environmental and energy and natural resources markets.

The Corporation, which is a multinational organization headquartered in Racine, Wisconsin, currently has a diverse shareholder base with approximately one-third of the outstanding shares held by management, active and retired employees and other long-term investors.

Twin Disc, Incorporated

# Financial Highlights

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| Net Sales | $177,987 | $168,142 | $202,643 |
| Net Earnings (Loss) | 3,773 | (1,018) | 9,363 |
| Basic Earnings (Loss) Per Share | 1.34 | (0.36) | 3.30 |
| Diluted Earnings (Loss) Per Share | 1.34 | (0.36) | 3.24 |
| Dividends Per Share | 0.70 | 0.805 | 0.76 |
| Average Shares Outstanding For The Year | 2,820,534 | 2,834,909 | 2,833,663 |
| Fully Diluted Shares Outstanding For The Year | 2,820,730 | 2,843,877 | 2,886,209 |

## *Sales and Earnings by Quarter*

| 2000 | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | Year |
|---|---|---|---|---|---|
| Net Sales | $35,277 | $44,342 | $49,467 | $48,901 | $177,987 |
| Gross Profit | 6,856 | 9,952 | 11,590 | 12,960 | 41,358 |
| Net Earnings (Loss) | (897) | 693 | 1,726 | 2,251 | 3,773 |
| Basic Earnings (Loss) Per Share | (0.32) | 0.25 | 0.61 | 0.80 | 1.34 |
| Diluted Earnings (Loss) Per Share | (0.32) | 0.25 | 0.61 | 0.80 | 1.34 |
| Dividends Per Share | 0.175 | 0.175 | 0.175 | 0.175 | 0.700 |
| Stock Price Range (High-Low) | $20\frac{3}{8}$ - $16\frac{1}{2}$ | $16\frac{5}{8}$ - 11 | $18\frac{5}{16}$ - $11\frac{7}{8}$ | $17\frac{9}{16}$ - $15\frac{7}{16}$ | $20\frac{3}{8}$ - 11 |

| 1999 | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | Year |
|---|---|---|---|---|---|
| Net Sales | $40,625 | $40,108 | $41,139 | $46,270 | $168,142 |
| Gross Profit | 9,220 | 9,275 | 7,316 | 10,270 | 36,081 |
| Net Earnings (Loss) | 588 | (291) | (1,782) | 467 | (1,018) |
| Basic Earnings (Loss) Per Share | 0.21 | (0.10) | (0.63) | 0.16 | (0.36) |
| Diluted Earnings (Loss) Per Share | 0.21 | (0.10) | (0.63) | 0.16 | (0.36) |
| Dividends Per Share | 0.21 | 0.21 | 0.21 | 0.175 | 0.805 |
| Stock Price Range (High-Low) | $37\frac{3}{4}$ - $23\frac{3}{8}$ | $24\frac{1}{4}$ - $20\frac{1}{4}$ | $22\frac{3}{16}$ - 19 | $20\frac{3}{16}$ - $18\frac{9}{16}$ | $37\frac{3}{4}$ - $18\frac{9}{16}$ |

In thousands of dollars except per share and stock price range statistics.

# To Our Shareholders

2000

As predicted last year, fiscal 2000 recovered nicely with sales and, more importantly, earnings rebounding from the downturn experienced the previous year. Furthermore, the Technodrive and Rockford power take-off acquisitions have been successfully integrated and were accretive in their first year.

Net sales increased 6% to $178 million from $168 million a year ago while earnings improved to $3.8 million, or $1.34 per share, from a loss of $1 million, or $.36 per share, last year. Included in the results for fiscal 1999 were non-recurring charges of $2.5 million, or $.86 per share, reflecting the downsizing and closure of various operations.

Backlogs have strengthened during the past several months and point to another good year ahead.

Operations Review ] On balance, demand from our markets showed improvement during the year. While orders from the agricultural and logging sectors remained soft, activity in the pleasure craft marine and industrial markets continued strong. Commercial marine orders also registered recovery during the year.

With improving demand, our domestic manufacturing operations experienced increased volumes and heightened productivity. Our industrial power take-off business has benefited from the additional production of the Rockford product line acquired last year. Orders for commercial marine transmissions improved, and demand for aftermarket parts reverted to more normalized levels by year-end.

Overseas manufacturing operations benefited from strong demand as well as favorable currency exchange rates. The pleasure craft marine market provided strong shipping schedules for our Belgian facility. Our recently acquired Technodrive subsidiary also experienced volume gains during the year and produced better-than-expected results.

Results of marketing operations were mixed reflecting regional market conditions.

**Cash Flow and Financial Condition ]** Consistent with softer demand as we entered the year, actions were taken to keep spending in line with cash flow generated from operations. As a result, capital expenditures were held to $2.1 million compared with $ 6.4 million last year. Dividends of $2.3 million were paid during fiscal 2000 compared with $2.4 million a year ago. Debt was reduced by $1.0 million during the year.

Due primarily to the increase in asset value in our pension funds, we reversed last year's charge to retained earnings related to the adoption of a more conservative actuarial table for the Company's pension plan. The result was an $11.8-million non-cash credit to retained earnings in the year's final quarter.

**Strategic Initiatives ]** ***Growth*** Although the recession in our markets that extended from fiscal 1999 into 2000 interrupted our longer-term growth trend, we still have our sights set on achieving our Growth Challenge–$300 million in revenues by fiscal 2003. While this objective will not be accomplished easily, we are pursuing a combination of internal strategic growth initiatives and potential acquisitions that collectively have the potential to exceed our Challenge.

In addition to opportunities for further expansion into heavy-duty specialty truck transmission applications, prospects are good for growth in our marine and propulsion markets.

On the acquisition front, both of our recent additions have exceeded revenue and earnings projections and are expected to be solid contributors to our future success. We expect to conclude additional acquisitions going forward.

***People*** Our emphasis on developing our human resources over the past several years has begun to pay important dividends. Our pay-for-skills program has motivated our associates to become more flexible and responsive to moving where the work is required, resulting in improved sales per employee. And the introduction of new business systems with the concomitant training has made our entire staff more productive.

Individual development plans are being formulated for each employee to match skills and competencies to changing corporate requirements in an ever-shrinking and more competitive world.

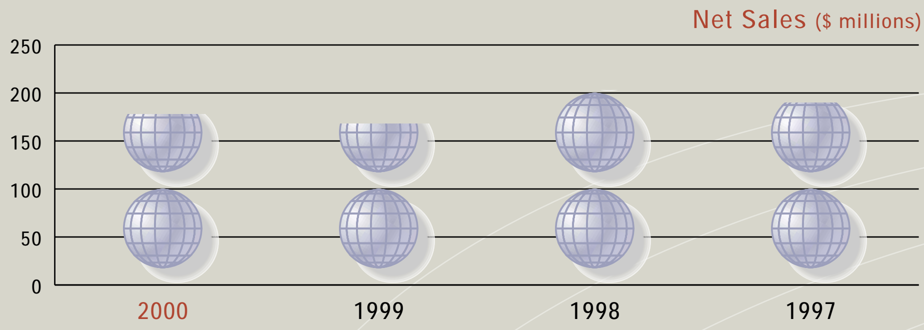
***Quality*** We view our commitment to quality in terms of total customer satisfaction, which is embodied in two simple directives. Our products must meet the highest standards of technical excellence, and our customers must receive exemplary service and support.

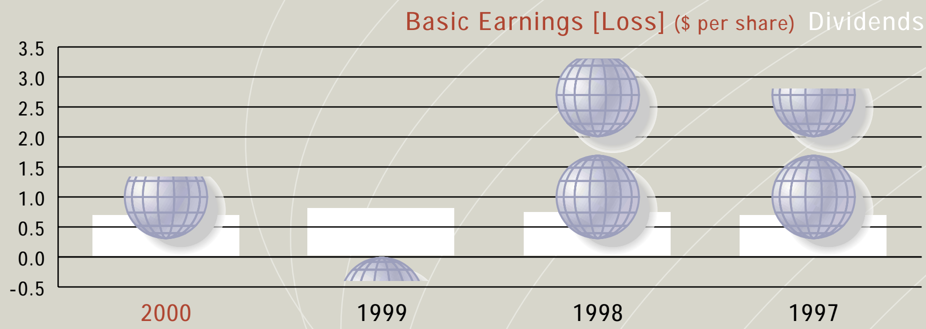
Twin Disc has an enviable reputation for its durable designs and quality manufacturing. Designed with the latest engineering techniques and technologies, our products must endure rigorous laboratory and field testing before they are introduced to our customers. Our products are manufactured in ISO 9001 certified facilities that incorporate cellular processes that ensure consistent quality.

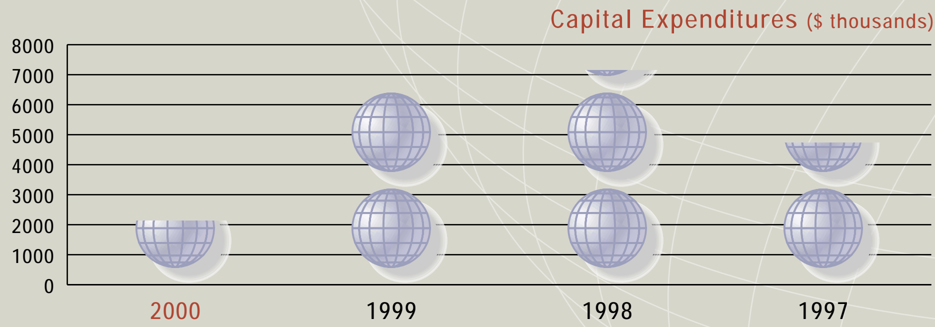
Our customers have seen significant improvements in on-time delivery as well as service support from our reorganized global service organization that is backed by a worldwide network of highly qualified distributors. Initiatives in progress to streamline our order entry process and address lead times will add further value to our customer service and support.

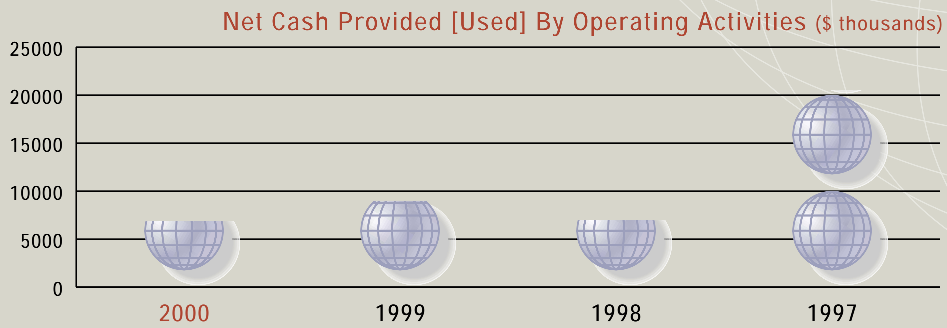
***Performance*** Our Corporate Challenge is to maintain at least a 10 percent average compound growth rate in earnings over a three-year period and to earn a return on net assets employed (RONAE) of at least 18 percent. While the loss in fiscal 1999 disrupted the positive trend line in place since 1992, results in fiscal 2000 have rebounded, and we remain committed to re-establishing our performance record going forward.

To accomplish this, we have implemented growth initiatives designed to improve volumes, as well as programs to enhance margins and improve asset utilization. In addition to the actions mentioned in Growth above, we have implemented an aggressive global procurement program that has begun to have a beneficial impact on product costs. Margins are also being enhanced as a result of the fixed cost actions taken during the recent recession.


Net Sales ($ millions)
250
200
150
100
50
0
2000
1999
1998
1997


Basic Earnings [Loss] ($ per share) Dividends
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
2000
1999
1998
1997


Capital Expenditures ($ thousands)
8000
7000
6000
5000
4000
3000
2000
1000
0
2000
1999
1998
1997


Net Cash Provided [Used] By Operating Activities ($ thousands)
25000
20000
15000
10000
5000
0
2000
1999
1998
1997

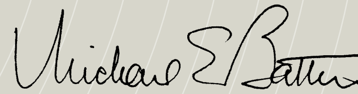
**Directors ]** At the 2000 annual meeting, Richard T. Savage will retire from the Board of Directors following seven years of service. Dick has been a consistent contributor and his wise counsel will be missed by his fellow directors and management.

In anticipation of the aforementioned retirement, at its June meeting, the Board elected as director David B. Rayburn, Executive Vice President–Operations of Modine Manufacturing Company. Modine is a manufacturer and marketer of heat exchangers and systems for the automotive industry. Dave brings an operational expertise and extensive background in manufacturing and industrial engineering that uniquely complement our strategic focus.

**Outlook ]** Fiscal 2000 was a recovery year for Twin Disc as we benefited both from improving market conditions as well as from deliberate efforts to enable our Company to become a more efficient organization. Twin Disc's consolidated backlog of new orders to be shipped in the next six months now stands at $53 million–down modestly from the $55 million reported at the end of the third fiscal quarter. The decline in backlog from the third to fourth quarter is attributable to the normal seasonal effect associated with customers' plant shutdowns and vacation schedules. On a year-to-year basis, our backlog improved 32 percent, beginning the year at $40 million and ending the year up $13 million.

Looking forward, we believe the momentum that built through fiscal 2000 will continue as we enter the new fiscal year. We are confident in our stronger and healthier company and expect to increase both sales and earnings in the year ahead.

Michael H. Joyce
President, Chief Operating Officer



Michael E. Batten
Chairman, Chief Executive Officer

Maneuvering successfully

through the world economies.

# This past two years vividly reflect the diverse economic challenges confronting our company.

There is no doubt that the world has become more interdependent. International trade, global communications and worldwide, 24-hour financial markets have brought once disparate national economies closer together. In fact, the internet revolution has accelerated the integration. As a result, the world has been moving increasingly towards a truly global economy.

Yet, as a supplier of power transmission products to international markets, Twin Disc has had to adapt simultaneously to different and often contradictory economic forces. The challenge has been to structure and manage our business to be able to serve global markets while at the same time deal successfully with the factors that can impinge on our market success.

Our market diversity helped offset the impact of the Asian economic crisis and the significant drop in oil prices during the past two years. While our commercial marine and vehicular transmission business declined, our pleasure craft marine and industrial power take-off businesses remained strong.

Further, having our manufacturing facilities in the United States and Europe with access to our affiliate plants in Japan, gives us not only manufacturing flexibility, but also a hedge against currency rates. In addition, it has allowed us to be competitive from the weaker currency production base while giving us access to lower cost components for the higher currency facilities.

Our recent reorganization into global marketing groups also allows us to manage our businesses on a worldwide basis with greater focus. We are able to get closer to our customers.

Our significant distribution network around the world extends our presence in the marketplace not only in new applications, but also in after market service and support.

Twin Disc has the diverse product mix, broad market experience, strategic international presence, and globally tuned corporate structure to successfully navigate within this new world economy.

## Twin Disc has evolved to a global supplier of broadly applied standard products as well as an array of more complex specialty products.

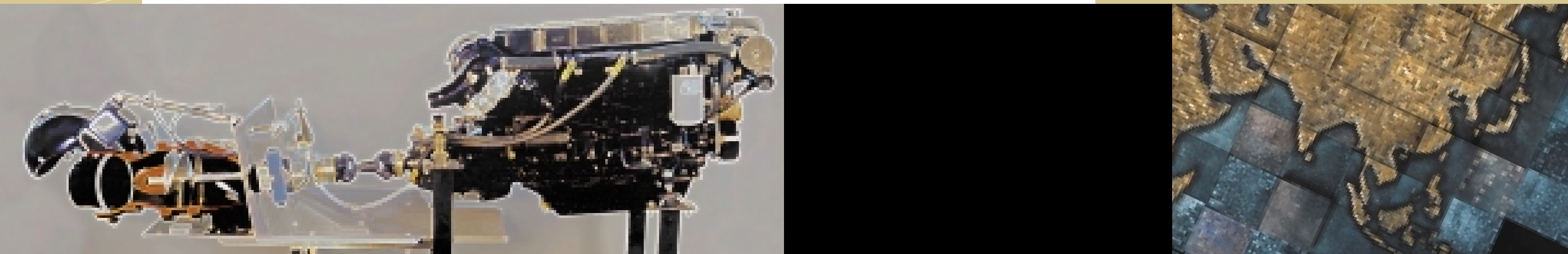
Our PTO products are basically clutches that actuate equipment by connecting it to a power source—engine or motor. Twin Disc's significant market share in PTOs is key to our success there. Economies of scale allow us to design and manufacture higher quality products that afford us a competitive advantage. In these standard products, Twin Disc is recognized as the standard of the industry.

On the other hand, our larger, more custom transmission systems and propulsion devices are inherently more design, manufacturing and marketing intensive. Yet, here too, Twin Disc products are the standard of the industry. The more difficult challenge is to provide the performance advantages of these products, with acceptable lead times, while establishing value-appropriate pricing.

Pursuing a value-added approach to our markets, we work with our customers in many ways, including offering technical support, to apply Twin Disc products to their equipment.

Each year we further streamline our processes. Using new techniques and technologies, Engineering develops innovative products that meet the expanding expectations and needs of our customers. Manufacturing continues to notch up quality and reduce costs.

Availability of product is critical to acquiring and maintaining customers in the world arena. Twin Disc's international sales and service network of more than 140 distributors, service dealers, subsidiaries and affiliates is



literally a global delivery pipeline. They are linked to each other and our manufacturing facilities around the world. Any distributor can tap the inventories of factories and other distributors to quickly acquire a product for a customer. The same applies to service parts. The vast Twin Disc supply network quickly responds to meet a customer's needs in the most expeditious manner.

Sustaining a world-class position

amidst global competition.

The Net influence

of the worldwide web.

## With information and technology being transferred across the world at the speed of light, future success will be scored in ones and zeros.

Even for a company with products as unique as Twin Disc, the Web raises the competitive stakes and the global opportunities. The Internet has made the world a local economy and every company a local supplier. To take advantage of this new cyber marketing environment, Twin Disc is engaging in a company-wide program of business-to-business e-commerce.

Initially we will link our distribution network to provide virtually all relevant information to help them better serve our customers—from order entry to inventory availability, to delivery scheduling and tracking. In effect, we are encouraging free commerce and knowledge transfer within our network.

This is a massive undertaking considering the technical database of hundreds of thousands of documents that support our products. The Company is rebuilding its technical and communications infrastructure to improve the speed and capacity of our TwinNet internet network. This is a global network of all Twin Disc locations, including manufacturing operations, subsidiaries, and company-owned distributors. We've partnered with several technology suppliers and participated in extensive outsourcing in order to accelerate the implementation.

The speed of communications today brings higher expectations for greater company responsiveness, faster availability of products and service parts, faster design and delivery of new products into the pipeline,

and faster meeting customer orders. Our TwinNet initiative will allow for better order coordination and greater manufacturing efficiencies between our domestic and European operations. It will contribute to prompt delivery and more responsive service support to get our products into the field sooner and keep them there longer.

From making chips on the manufacturing floor to employing computer chips in the worldwide Web, Twin Disc is adapting to the ever-accelerating pace of new world marketing.

Pacific Mariner introduced their new luxury line of 65′ pleasure craft powered by twin Caterpillar 3406E 800-horsepower engines driving through Twin Disc MG-5114A Marine Transmissions.

# Marine Market

Pleasure Craft Market ] Sales of marine transmissions to the U.S. pleasure craft market increased significantly during FY 2000. The market for mid-size and large boats in the pleasure craft market showed good growth, especially in the second half of the year. While taking advantage of the expanding market condition, Twin Disc also grew market share with the introduction of new transmission models. The Company's initiative last year to standardize a high percentage of our marine transmission components across many models has helped expedite delivery and shave manufacturing costs.

The Company started the North American sales activity for our newly acquired Technodrive marine transmission product line. This product line extends our range of marine transmission models and allows us to compete in the lower horsepower end of the pleasure craft market.

Sales of marine transmissions to European pleasure craft customers were up slightly compared to the previous year. Our Belgian subsidiary continued to improve sales to the European engine manufacturers and distribution customers.

Australian and Southeast Asian manufacture of pleasure boats continues at a strong pace with a large share of these boats being shipped to the U.S. market. Twin Disc market share in these boats is very good, with Twin Disc marine transmission products being sold by our subsidiary operations in Australia and Singapore. In addition, a good quantity of Twin Disc marine transmissions, attached to diesel engine packages, is sourced from the U.S. for the Southeast Asian boat builders.

The 94′ fishing vessel Theresa Marie, equipped with a 965-horsepower Detroit Diesel engine driving through a Twin Disc MG-5301DC Marine Transmission hauls up to 110 tons chum salmon caught by the seiner Pamela Rae.

This Azimut 58′ equipped with two MTU 8V183 engines and MG-5114RV Marine Transmissions cruises at 25 knots and tops out at 32.5 knots, putting style and comfort way out in front.

RT Magic, a Koren-designed Rotor® Tug owned by Kotug Tugboat Company maneuvers large container ships through Rotterdam Europort using three azimuth Z-Peller directional propulsion systems creating 6,300 horsepower working through three Twin Disc MCD 3000 Marine Control Drives.

Pamela Rae, a 58′ wooden-hulled seiner built in 1949, fishes for chum salmon south of Juneau, Alaska, powered by a 400-horsepower Cummins engine working through a Twin Disc MG-5114 Marine Transmission. Equipped with a 210-horsepower Caterpillar engine and Twin Disc MG-506 Marine Transmission, her 22′ companion skiff tends the nets.

The 247′ Coastal Venture, with a Caterpillar 3512 long-stroke engine producing 1675 horsepower through a Twin Disc MG-5600 Marine Transmission, plies the Inside Passage to deliver cargo between Seattle and Dutch Harbor, Alaska.

## Commercial Marine Markets ]

The U.S. commercial marine transmission market had a mixed year due to rapid decline and then recovery in the price of oil. The utilization rate for offshore oil exploration and production platforms fluctuated with the price of crude oil. We experienced solid sales in high horsepower marine transmissions for the latest generation of large crew supply boats. At the same time there was a year-long weakness in the intermediate size crew boat market. New tug boat and river pushboat construction continues to remain steady, but at a low level. However, additional sales came from the repower of older pushboats.

Sales to the North American fishing boat market were mixed. We experienced improved sales for new boats in the deep water trawler markets. During the same period the traditionally strong Northwest U.S. market for gill net and purse seine boats was weak for the second year in a row.

Australian market sales were generally weak with new fishing boat construction remaining at very low historical levels. Southeast Asian sales were up again as that area continues to recover from the financial crisis of recent years.

Four River Runner 150 low-wash ferries built by Damen Shipyards have begun a new form of mass transit in the Dordrecht region of the Netherlands. Each 100′ catamaran, equipped with twin Caterpillar 422-horsepower engines working through Twin Disc MG-5114A Marine Transmissions, can carry 130 passengers and 60 bicycles at 20 knots.

Marine Propulsion Products ] Twin Disc marine propulsion products consist of electronic controls, waterjets and Arneson Surface Drives. While sold into both commercial and pleasure craft markets, just as our transmissions, these products comprise performance characteristics requiring different application and installation knowledge than our transmission line. Therefore, we have elected to create a global marketing thrust specific to these performance products, which bring a distinct value-added benefit to the enjoyment and productivity of a boat. Select subsidiaries and marine distributors of our transmissions are trained in the specialized sales and service of these products. We consult with naval architects, boat builders, boat dealers and engine manufacturers around the world to encourage their utilizing these advance devices in their boat designs and propulsion systems.

Arneson Surface Drives ] Twin Disc again posted record sales of Arneson Surface Drives. In Europe, growing relationships with upscale boat builders are paying off. Arneson Drives in the United States continue to break records in the racing circuits and to increase their popularity with boat builders. The main attributes of Arneson Drives are speed, fuel economy, their shallow draft capability and maneuverability. Boat owners can obtain more speed and precise handling from their Arneson propulsion system and save fuel over conventional propeller drive systems. This means they can obtain optimal weight-to-power ratio for a given hull. For instance, a major boat builder found he could improve a test boat's speed by 10 mph, run quieter with less vibration, and cut fuel costs by nearly 50%. Such performance will further Arneson's popularity among boat builders, engine manufacturers and the boating public.

RCMP Nadon, an all aluminum, 66′ catamaran powered by twin MAN diesel engines driving Twin Disc Arneson ASD-12 Surface Drives, has embarked on a 6-month, 22,000 nautical mile Voyage of Rediscovery. This remarkable circumnavigation of North America reenacts the historic voyage of the RCMP 104′ wooden hulled schooner St. Roch, in an attempt to raise funds to preserve the original vessel, now a Canadian National Historic Site in Vancouver.

The 115′ pearling vessel N.V. Nalena Bay, owned by Blue Seas Maritime Pty. Ltd., searches for and harvests the pearl beds of the South Pacific, powered by a 905-horsepower Caterpillar engine and Twin Disc MG-5301 Marine Transmission.

Electronic Controls ] Twin Disc electronic controls continued their positive acceptance among pleasure boat and commercial boat builders around the world. They lead the industry in quality, style and performance. In FY2000 the latest iteration was released. The EC-250 offers even more user-inspired features and is designed to interface with all popular electronic and mechanical engines and transmissions. With literally one finger on one lever, the operator can control a boat's direction and speed. Multiple drivetrains can easily be accommodated with multiple control heads. And multiple electronic control stations can be placed around the boat. There's even a portable handset that allows the operator to stand at the best vantage point for maneuvering in tight quarters.

Waterjets ] Although still a very specialized market, Twin Disc has established a highly regarded and diverse list of waterjet applications in Europe, South America and North America. The jet's speed, maneuverability, shallow draft and "no-propeller" safety advantage make it desirable for operations such as police and military patrol, water rescue, and wetlands survey craft. There also have been installations on fishing craft where speed to the fishing grounds must be balanced with the ability to deftly maneuver around nets. Twin Disc offers a complete line of 12 waterjet models ranging from 200 to more than 2000 horsepower.

This 41′ Lightning from Fountain Boats achieves 83 mph with twin Yanmar 420s to drive two Arneson ASD 8 Surface Drives through two Twin Disc MG-5061A Marine Transmissions. The prototype uses far less fuel than conventional propeller propulsion packages, picks up 10 mph on the top end, and runs much quieter and with less vibration.

This Twin Disc Technical Demonstrator Vehicle has proven more than up to the grueling challenges of the Saudi desert, thanks to its 400-horsepower Detroit Diesel Series 60 engine, Twin Disc TD61-1175 Automatic Transmission System, and Tatra 6x6 Fully Independent Suspension.

# All-Wheel Drive Vehicle Transmissions

## Industrial Vehicle Transmissions ]

We continued to see firm demand from four-wheel-drive tractor scraper applications that are being used in housing site development, land reclamation and landfill sites.

## All-Wheel Drive Vehicle Transmissions ]

In effect, this was a year of development of customer relationships and products that should have significant growth in the near future. The development period of actually getting a production order can often be years due to the vehicle testing required. The transmission system is so integral to the performance and to the construction of an Aircraft Rescue and Fire Fighting (ARFF) vehicle or large military tactical vehicle, there are many design and performance hurdles to overcome. Often many months, even years, of testing of the vehicle in actual use conditions are required. Consequently, we have a number of our automatic transmission systems currently in demonstration or test vehicles.

Long-time Twin Disc customer Sides, a French manufacturer of high performance fire trucks and ARFF vehicles, uses Twin Disc Fully Automatic Transmission Systems to provide fast on- and off-road travel to the emergency site and then "pump and roll capability" on scene—often all handled by a single operator.

The U.S. Marine Corps Logistics Vehicle Replacement Technical Demonstrator utilizes a Twin Disc TD61-1181 Transmission System and an Integrated Vehicle Hydraulic System and Single-Fluid-Forward™ System provided by Island City Engineering and marketed by Twin Disc.

Worldwide, the demand for such vehicles is good, and because of the size, importance and sophisticated equipment of these trucks, this is a lucrative market segment for Twin Disc. We firmly have established our transmission systems with major fire truck and military vehicle manufacturers around the world.

Twin Disc has become a significant player in a multinational supplier chain bringing such specialized vehicles to global customers. This year we participated in a 40-vehicle ARFF project for the new airports in China.

This Freightliner/Rosenbauer Panther FL 6x6 ARFF (Aircraft Rescue and Fire Fighting) vehicle powered by a Detroit Diesel 600-horsepower engine driving all wheels and pumps via a Twin Disc 1180 Series Automatic Transmission System. Forty of these vehicles have been shipped to airports in China.

# Industrial Products

This Millenium 2000 model yarder from Diamond Yarder uses a 430-horsepower Caterpillar 3406 connected to a Twin Disc TAC51-2012 Transmission with integral torque converter to haul timber out of the Washington forest. The Twin Disc transmission reduces work cycle time as well as wear and tear on the entire yarder system.

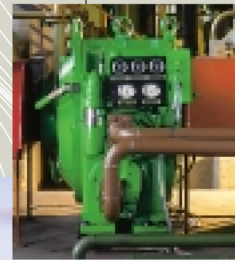
**Clutches & PTOs ]** Sales of PTO, clutch and general distribution products were up dramatically this year. The acquisition and integration of Rockford PTO last year proved very successful and kept our Racine PTO lines working around the clock. Most of the business came from manufacturers of rock crushers, hay grinders, wood shredders and irrigation pumps. Technodrive, our European acquisition, outperformed very positive projections in sales of pump drives throughout Europe.

**Universal Control Drives (UCDs) ]** Europe showed increased sales activity in Eastern Bloc countries. A UCD provides modulated power between an engine or motor to whatever is being driven—a pump or generator. It allows the engine or motor to operate at the most efficient rpm for specific requirements of the driven component. The greater operating efficiencies result in fuel and electric power savings. As formerly Communistic Eastern Bloc countries turn from state-subsidized to privatized municipal services and manufacturing plants, they must seek more cost-competitive means to operate. By incorporating UCDs in various applications, they can significantly reduce their energy costs.

J. H. Hart Urban Forestry uses a Bandit Industries Woodchipper with a TC-113 spring-loaded PTO to chew wood waste down to size.

Irrigation contractors such as Twin Disc customers Engines Inc. and Pivot Irrigation have consistently provided demand for PTOs for pumping installations in the western United States.

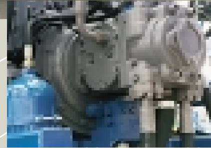
Twin Disc UCDs, long accepted in municipal pumping and power generation applications in Europe, are now finding new installation opportunities in Eastern Bloc countries where the transition to privatization demands more efficient use of power to reduce fuel and energy costs.



# Technodrive

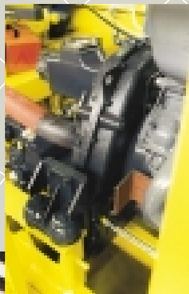
Technodrive Pump Drives allow the simultaneous running of two or more hydraulic pumps from a single prime mover—engine or motor. These hydraulic pumps then drive different devices on a given piece of equipment in order to accomplish various aspects of the overall task of the machine. The machine's productivity totally depends on the reliability and serviceability of the pump drive.

The following are only a small sampling of Technodrive installations. But they demonstrate the broad application versatility, diverse OEM popularity, and rugged-duty reputation of their pump drives.



Manure grinder/ fertilizer sprayer

Scraper tractor used to clear land sites.



Railway track renovation machine

Alfalfa mower/ harvester

Curb placing machine

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Results of Operations

### Net Sales, New Orders and Backlog

Revenues increased in fiscal 2000 as our distribution operations and domestic manufacturing rebounded from the previous year's downturn. Order rates were weak throughout fiscal 1999 and the backlog of orders scheduled for shipment during the next six months (six-month backlog) dropped 26 percent to $40 million by year-end. Improvement in demand began early in fiscal 2000 and resulted in the six-month backlog rising to $55 million in March 2000 before easing to end the year at $53 million - a 32 percent increase from the previous year.

Net sales of $168 million in fiscal 1999 were down 17 percent from fiscal 1998 but rose to $178 million, an increase of six percent, in fiscal 2000. The 1999 sales decline resulted from weak demand in many markets, customer inventory reductions adversely affecting replacement part sales, and the absence of the truck transmission contract completed in fiscal 1998. Most significantly, lower demand from the commercial marine market led to a 34 percent drop in domestic manufacturing sales. Other important factors in the sales decline were low oil prices; prices for commodities such as lumber and food, which were adversely affected by the Asian economic crisis; and reduced capital spending in the agricultural and construction equipment markets. Sales of lower-horsepower marine transmissions for pleasure craft also were down, causing a modest decline in sales from our Belgian plant. On the positive side, the acquisition of an Italian manufacturing company and purchase of a domestic product line, completed early in the second half of the fiscal year, provided a sales boost and slight incremental earnings in the last five months of fiscal 1999. Both acquisitions provided products that strengthen our global market position in industrial products. Technodrive S.p.A adds to the lower-horsepower end of our marine transmission line and provides several complementary industrial products. We also broadened our industrial product offerings with the mechanical power take-off product line acquired from Rockford Powertrain, Inc.

While order rates improved early in fiscal year 2000, year-to-year improvements in shipments began in the second fiscal quarter. The most significant components of the improvement were registered within our domestic manufacturing operation. Shipments of power take-offs, attributable to the product line purchased in the prior year; higher-horsepower marine transmissions used in commercial boats; power-shift transmissions for construction applications; and aftermarket parts sales all contributed to the increase. Shipments from our Belgian plant of lower-horsepower marine transmissions also increased slightly as demand for their use in pleasure craft applications remained steady, and shipments from the recently acquired Italian manufacturing subsidiary contributed for the full year.

Sales at our wholly owned distribution companies varied by global region, but generally rebounded in fiscal 2000 after the modest decline in 1999. Domestic declines in 1999 were related to low oil and commodity prices, which recovered and provided some improvement during the recently completed year. Although sales from our wholly owned European distributors were affected by changes we made in market representation, demand from the markets served trended upward in both years, and shipments were up materially in fiscal 2000. Sales in the Pacific Rim generally mirrored the economies in which they operate and were down in fiscal 1999 but began to improve in the year just completed.

The U.S. dollar strengthened against most currencies in each of the last two fiscal years, particularly Asian currencies in fiscal 1999 and the Euro in fiscal 2000. As a

result, pricing pressure increased, but the effects were partially offset by sales to U.S. customers from our Belgian operation. Although the general effect has been a reduction of reported dollar sales, the impact has not been significant. Price increases, implemented selectively in each year, generated revenues about equal to the rate of inflation.

At the end of fiscal 1999, the backlog of orders scheduled for shipment during the next six months was $40 million. As the new fiscal year began, order rates improved in both commercial marine and certain industrial markets. There were further improvements as the year progressed and the six-month backlog rose to $53 million at year-end, an increase of 32 percent for the year. Although somewhat higher at the end of the third fiscal quarter, backlog declined due to normal seasonal influences in the fourth quarter.

## Margins, Costs and Expenses

Manufacturing method and process improvements, cellular layout of machine tools, and cost control have all played critical roles in efforts to improve margins. But, as fixed costs are a large component of manufacturing expense, production volume is an important element in gross margin fluctuations.

In fiscal 1999, the gross margin was more than three percentage points below that of fiscal 1998, primarily because of the reduced domestic sales volume, lower productivity, and unusual separation costs in the second and third quarters. During the 1999 second fiscal quarter, there was a domestic salaried staff reduction, and in the following period, a similar program was implemented overseas along with a voluntary separation program for domestic hourly associates. In Belgium, the workweek was shortened utilizing a government-supported layoff program. In addition to the one-time expenses, an adverse productivity impact, primarily in the third quarter, was associated with these actions.

The gross margin increased by almost two percentage points in fiscal 2000 with all manufacturing operations showing improvement. Domestically, higher production volume, a favorable product mix, and strict control of general manufacturing costs were the most significant factors, while productivity improvements, expansion of the workweek, and the favorable impact of sales denominated in the relatively strong dollar boosted margins overseas.

Marketing, engineering, and administrative (ME&A) expense declined four percent in fiscal 1999, but increased sharply as a percent of the reduced sales volume. Included in the expenses for the year were severance costs associated with the second- and third-quarter reductions in domestic and Belgian salaried staff. The total pre-tax impact of approximately $350,000 was recovered within one year.

In fiscal 2000, ME&A expense dropped a further four percent as a result of previous-year staff reductions, continued attention to cost control, and closure of our South African distribution operation.

In March 1999, we sold a portion of the investment in our Japanese affiliate, Niigata Converter Company (NICO), which resulted in a pre-tax gain of $1.4 million (discussed further in Footnote D to the consolidated financial statements), and reduced our ownership interest in NICO from 25.0 percent to 19.5 percent. Our share of NICO losses for fiscal 1999 versus modest earnings in fiscal 1998 was the cause of the year-to-year decline in the earnings of affiliates. Those earnings rebounded in fiscal 2000 with a strong performance from our U.S. distribution affiliate. At fiscal 1999 year-end, we announced the closure of our South African distribution subsidiary and recorded a provision to cover anticipated

losses from that action.

## Interest, Taxes and Net Earnings

Short-term borrowing increased in fiscal 1999 as significant additional debt was incurred to finance acquisitions, and interest expense increased by almost 40 percent. During the recently completed year, debt was reduced slightly, but a higher average outstanding balance and higher interest rates caused interest expense to increase.

The effective income tax rate in fiscal 1998 was above normal due to relatively higher foreign earnings, generally taxed at a higher rate. The substantial tax provision on almost-breakeven pre-tax earnings in fiscal 1999 was caused by: lower tax rates on losses domestically, offset by higher rates on income overseas; and by the lack of a recordable tax benefit on the provision for loss on the closure of our South African distribution subsidiary. In fiscal 2000, limitations on foreign tax credit utilization and a continued high proportion of foreign earnings resulted in a sharp increase in the effective tax rate. Statutory rates generally have remained unchanged.

## Liquidity and Capital Resources

The net cash provided by operating activities in fiscal 1999 was $9 million, up $2 million from the previous year. Despite operating losses for the year, reductions in both accounts receivable and inventory generated solid positive cash flows. In fiscal 2000, cash provided by operations dipped to $7 million. Positive cash flows from earnings, depreciation, and working capital reductions were partially offset by increased contributions to Company pension funds.

Expenditures for capital equipment exceeded depreciation by about $2 million in fiscal 1998 as experience helped identify the equipment needed to further improve cell performance. Due to the downturn and a desire to conserve cash, fiscal 1999 and 2000 capital expenditures were reduced from plan, and in the most recently completed year, were well below depreciation. As conditions improve, we expect the level of capital spending will rise to provide for more efficient machinery and to allow further refinement of individual manufacturing cells.

Working capital and the current ratio dropped significantly in fiscal 1999 due to the large increase in short-term debt incurred to finance acquisitions. Early in fiscal 2000, the short-term borrowings were replaced with a term revolver. The current ratio of 1.8 at June 30, 1999, rose to 2.2 at the end of fiscal 2000.

The book value of the Company, and thus its reported capital structure, changed significantly at both fiscal 1999 and 2000 year-ends. It was reduced by a non-cash charge to equity of $11.1 million at June 30, 1999. The charge was caused primarily by using a more conservative mortality table to estimate pension liabilities and generally reflects the amount by which those liabilities exceed plan assets. In fiscal 2000, principally as a result of good market return on plan assets, the charge was reversed, resulting in a similar increase in equity. In accordance with applicable accounting standards, the after-tax effects of the changes were charged directly to equity and shown in comprehensive income but did not affect reported primary earnings.

The Company believes the capital resources available in the form of existing cash, lines of credit (see Footnote F to the consolidated financial statements), and funds provided by operations will be adequate to meet anticipated capital expenditures and other foreseeable business requirements in the future.

# Other Matters

## Environmental Matters

The Company is involved in various stages of investigation relative to hazardous waste sites on the United States EPA National Priorities List. It is not possible at this time to determine the ultimate outcome of those matters; but, as discussed further in Footnote N to the consolidated financial statements, they are not expected to affect materially the Company's operations, financial position, or cash flows.

## Note on Forward-Looking Statements

Information in this report and in other Company communications that are not historical facts are forward-looking statements, which are based on management's current expectations. These statements involve risks and uncertainties that could cause actual results to differ materially from what appears here.

Forward-looking statements include the Company's description of plans and objectives for future operations and assumptions behind those plans. The words "anticipates," "believes," "intends," "estimates," and "expects," or similar anticipatory expressions, usually identify forward-looking statements. In addition, goals established by Twin Disc, Incorporated, should not be viewed as guarantees or promises of future performance. There can be no assurance the Company will be successful in achieving its goals.

In addition to the assumptions and information referred to specifically in the forward-looking statements, other factors could cause actual results to be materially different from what is presented here.

TWIN DISC, INCORPORATED AND SUBSIDIARIES

# CONSOLIDATED BALANCE SHEETS

JUNE 30, 2000 and 1999

| *(Dollars in thousands)* | 2000 | 1999 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 5,651 | $ 4,136 |
| Trade accounts receivable, net | 28,828 | 27,201 |
| Inventories, net | 50,190 | 54,500 |
| Deferred income taxes | — | 6,004 |
| Other | 5,333 | 5,906 |
| Total current assets | 90,002 | 97,747 |
| Property, plant and equipment, net | 34,303 | 38,935 |
| Investments in affiliates | 6,968 | 6,663 |
| Goodwill, net | 14,401 | 15,235 |
| Deferred income taxes | 4,416 | 4,349 |
| Intangible pension asset | — | 3,385 |
| Prepaid pension asset | 14,335 | — |
| Other assets | 9,765 | 10,586 |
| | $174,190 | $176,900 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Notes payable | $ 4,571 | $ 20,158 |
| Current maturities on long-term debt | 2,857 | 2,857 |
| Accounts payable | 11,571 | 10,724 |
| Deferred income taxes | 1,157 | — |
| Accrued liabilities | 20,752 | 21,022 |
| Total current liabilities | 40,908 | 54,761 |
| Long-term debt | 31,254 | 17,112 |
| Accrued retirement benefits | 23,795 | 37,567 |
| | 95,957 | 109,440 |
| Shareholders' equity: | | |
| Common shares authorized: 15,000,000; issued: 3,643,630; no par value | 11,653 | 11,653 |
| Retained earnings | 83,228 | 81,430 |
| Accumulated other comprehensive income (loss) | 799 | (8,516) |
| | 95,680 | 84,567 |
| Less treasury stock, at cost | 17,447 | 17,107 |
| Total shareholders' equity | 78,233 | 67,460 |
| | $174,190 | $176,900 |

The notes to consolidated financial statements are an integral part of these statements.

TWIN DISC, INCORPORATED AND SUBSIDIARIES

# CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED JUNE 30, 2000, 1999 AND 1998

| *(In thousands, except per share data)* | 2000 | 1999 | 1998 |
|---|---|---|---|
| Net sales | $177,987 | $168,142 | $202,643 |
| Cost of goods sold | 136,629 | 132,061 | 152,515 |
| Gross profit | 41,358 | 36,081 | 50,128 |
| Marketing, engineering and administrative expenses | 31,476 | 32,755 | 34,092 |
| Earnings from operations | 9,882 | 3,326 | 16,036 |
| Other income (expense): | | | |
| Interest income | 244 | 237 | 550 |
| Interest expense | (2,979) | (2,070) | (1,505) |
| Equity in net earnings (loss) of affiliates | 906 | (945) | 651 |
| Gain on partial sale of affiliate | — | 1,355 | — |
| Loss on closure of subsidiary | — | (1,140) | — |
| Other, net | 14 | (749) | 313 |
| | (1,815) | (3,312) | 9 |
| Earnings before income taxes | 8,067 | 14 | 16,045 |
| Income taxes | 4,294 | 1,032 | 6,682 |
| Net earnings (loss) | $ 3,773 | $ (1,018) | $ 9,363 |
| Earnings (loss) per share data: | | | |
| Basic earnings (loss) per share | $ 1.34 | $ (.36) | $ 3.30 |
| Diluted earnings (loss) per share | 1.34 | (.36) | 3.24 |
| Shares outstanding data: | | | |
| Average shares outstanding | 2,821 | 2,835 | 2,834 |
| Dilutive stock options | — | 9 | 52 |
| Diluted shares outstanding | 2,821 | 2,844 | 2,886 |

The notes to consolidated financial statements are an integral part of these statements.

# Consolidated Statements of Cash Flows

FOR THE YEARS ENDED JUNE 30, 2000, 1999 AND 1998

| *(In thousands)* | 2000 | 1999 | 1998 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net earnings (loss) | $ 3,773 | $ (1,018) | $ 9,363 |
| Adjustments to reconcile to net cash provided by operating activities: | | | |
| Depreciation and amortization | 6,980 | 6,454 | 5,607 |
| (Loss) gain on sale of plant assets | (3) | 38 | (402) |
| Gain on partial sale of affiliate | — | (1,355) | — |
| Loss on closure of subsidiary | — | 1,140 | — |
| Equity in net (earnings) loss of affiliates | (906) | 945 | (651) |
| Provision for deferred income taxes | (284) | — | 2,873 |
| Dividends received from affiliate | 600 | 625 | 495 |
| Changes in operating assets and liabilities: | | | |
| Trade accounts receivable, net | (2,922) | 3,898 | 3,361 |
| Inventories, net | 3,211 | 3,468 | (5,673) |
| Other assets | (770) | (1,757) | (7,842) |
| Accounts payable | 2,402 | (1,360) | (2,695) |
| Accrued liabilities | 168 | (759) | 2,777 |
| Accrued/prepaid retirement benefits | (5,364) | (1,361) | (244) |
| Net cash provided by operating activities | 6,885 | 8,958 | 6,969 |
| Cash flows from investing activities: | | | |
| Proceeds from sale of plant assets | 92 | 24 | 574 |
| Acquisitions of plant assets | (2,134) | (6,439) | (7,154) |
| Acquisitions of businesses | — | (16,785) | (1,021) |
| Payment for license agreement | — | — | (1,515) |
| Net cash used by investing activities | (2,042) | (23,200) | (9,116) |
| Cash flows from financing activities: | | | |
| Increases (decreases) in notes payable, net | (15,000) | 15,000 | 112 |
| Proceeds from long-term debt | 18,000 | — | — |
| Payments of long-term debt | (3,857) | — | — |
| Acquisition of treasury stock | (343) | — | (1,314) |
| Proceeds from exercise of stock options | 2 | 38 | 1,904 |
| Dividends paid | (1,974) | (2,282) | (2,160) |
| Net cash provided (used) by financing activities | (3,172) | 12,756 | (1,458) |
| Effect of exchange rate changes on cash | (156) | 535 | (291) |
| Net change in cash and cash equivalents | 1,515 | (951) | (3,896) |
| Cash and cash equivalents: | | | |
| Beginning of year | 4,136 | 5,087 | 8,983 |
| End of year | $ 5,651 | $ 4,136 | $ 5,087 |
| Supplemental cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest | $ 3,008 | $ 2,037 | $ 1,505 |
| Income taxes | 4,401 | 127 | 4,698 |

The notes to consolidated financial statements are an integral part of these statements.

# Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income

FOR THE YEARS ENDED JUNE 30, 2000, 1999 AND 1998

| *(In thousands)* | 2000 | 1999 | 1998 |
|---|---|---|---|
| Common stock | | | |
| Balance, June 30 | $11,653 | $11,653 | $11,653 |
| Retained earnings | | | |
| Balance, July 1 | 81,430 | 84,738 | 77,424 |
| Net earnings (loss) | 3,773 | (1,018) | 9,363 |
| Cash dividends | (1,974) | (2,282) | (2,160) |
| Stock options exercised | (1) | (8) | 111 |
| Balance, June 30 | 83,228 | 81,430 | 84,738 |
| Accumulated other comprehensive income (loss) | | | |
| Balance, July 1 | (8,516) | 2,757 | 2,352 |
| Foreign currency translation adjustment | | | |
| Balance, July 1 | 3,288 | 3,418 | 6,060 |
| Current adjustment | (2,489) | (130) | (2,642) |
| Balance, June 30 | 799 | 3,288 | 3,418 |
| Minimum pension liability adjustment, net | | | |
| Balance, July 1 | (11,804) | (661) | (3,708) |
| Current adjustment, net of related income taxes ($(7,547) in 2000, $7,125 in 1999 and $(1,948) in 1998) | 11,804 | (11,143) | 3,047 |
| Balance, June 30 | — | (11,804) | (661) |
| Accumulated other comprehensive income (loss) | | | |
| Balance, June 30 | 799 | (8,516) | 2,757 |
| Treasury stock, at cost | | | |
| Balance, July 1 | (17,107) | (17,153) | (17,632) |
| Shares acquired | (343) | — | (1,314) |
| Stock options exercised | 3 | 46 | 1,793 |
| Balance, June 30 | (17,447) | (17,107) | (17,153) |
| Shareholders' equity balance, June 30 | $78,233 | $67,460 | $81,995 |
| Comprehensive income (loss) | | | |
| Net earnings (loss) | $ 3,773 | $ (1,018) | $ 9,363 |
| Other comprehensive income (loss) | | | |
| Foreign currency translation adjustment | (2,489) | (130) | (2,642) |
| Minimum pension liability adjustment | 11,804 | (11,143) | 3,047 |
| Other comprehensive income (loss) | 9,315 | (11,273) | 405 |
| Comprehensive income (loss) | $13,088 | $(12,291) | $ 9,768 |

The notes to consolidated financial statements are an integral part of these statements.

## A. SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of the significant accounting policies followed in the preparation of these financial statements:

CONSOLIDATION PRINCIPLES – The consolidated financial statements include the accounts of Twin Disc, Incorporated and its subsidiaries, all of which are wholly owned. Certain foreign subsidiaries are included based on fiscal years ending May 31, to facilitate prompt reporting of consolidated accounts. All significant intercompany transactions have been eliminated.

TRANSLATION OF FOREIGN CURRENCIES – Substantially all foreign currency balance sheet accounts are translated into United States dollars at the rates of exchange prevailing at year-end. Revenues and expenses are translated at average rates of exchange in effect during the year. Foreign currency translation adjustments are recorded as a component of shareholders' equity. Gains and losses from foreign currency transactions are included in earnings. Included in other income (expense) of the consolidated statement of operations are foreign currency transaction losses of $144,000, $682,000 and $343,000 in 2000, 1999 and 1998, respectively.

CASH EQUIVALENTS – The Company considers all highly liquid marketable securities purchased with a maturity date of three months or less to be cash equivalents.

RECEIVABLES – Trade accounts receivable are stated net of an allowance for doubtful accounts of $704,000 and $534,000 at June 30, 2000 and 1999, respectively.

FAIR VALUE OF FINANCIAL INSTRUMENTS – The carrying amount reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable, notes payable and current maturities on long-term debt approximate fair value because of the immediate short-term maturity of these financial instruments. The carrying amounts reported for long-term debt approximates fair value because the underlying instruments bear interest at, or near, a current market rate.

DERIVATIVE FINANCIAL INSTRUMENTS – Derivative financial instruments (primarily forward foreign exchange contracts) may be utilized by the Company to hedge foreign exchange rate risk. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. The Company does not enter into financial instruments for trading or speculative purposes. For financial reporting purposes, forward foreign exchange contracts used to hedge the currency fluctuations on transactions denominated in foreign currencies are marked-to-market and the resulting gains and losses, together with the offsetting losses and gains on hedged transactions, are recorded in the "Other income (expense)" caption in the statement of operations. At June 30, 2000 and 1999, the Company had outstanding forward foreign exchange contracts to purchase $4,500,000 and $2,000,000, respectively, of Belgian francs with a weighted average maturity of 40 days and 33 days, respectively.

INVENTORIES – Inventories are valued at the lower of cost or market. Cost has been determined by the last-in, first-out (LIFO) method for parent company inventories, and by the first-in, first-out (FIFO) method for all other inventories.

PROPERTY, PLANT AND EQUIPMENT AND DEPRECIATION – Assets are stated at cost. Expenditures for maintenance, repairs and minor renewals are charged against earnings as incurred. Expenditures for major renewals and betterments are capitalized and amortized by depreciation charges. Depreciation is provided on the straight-line method over the estimated useful lives of the assets for financial reporting and on accelerated methods for income tax purposes. The lives assigned to buildings and related improvements range from 10 to 40 years, and the lives assigned to machinery and equipment range from 5 to 15 years. Upon disposal of property, plant and equipment, the cost of the asset and the related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in earnings. Fully depreciated assets are not removed from the accounts until physically disposed.

The Company reviews the carrying value of property, plant and equipment for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets.

INVESTMENTS IN AFFILIATES – The majority of the Company's investments in 20% to 50%-owned affiliates are accounted for using the equity method. Investments in less than 20%-owned affiliates are accounted for using the cost method.

REVENUE RECOGNITION – Revenues are recognized when products are shipped and title has transferred to the customer.

GOODWILL – Goodwill consists of costs in excess of net assets of businesses acquired. Goodwill is amortized using the straight-line method over its estimated beneficial lives, not to exceed 40 years. Subsequent to an acquisition, the Company continually evaluates whether later events and circumstances have occurred that indicate whether the goodwill should be evaluated for possible impairment. Goodwill at June 30, 2000 and 1999 of $14,401,000 and $15,235,000, respectively, are net of accumulated amortization of $1,542,000 and $839,000, respectively.

INCOME TAXES – The Company recognizes deferred tax liabilities and assets for the expected future income tax consequences of events that have been recognized in the Company's financial statements. Under this method, deferred tax liabilities and assets are determined based on the temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities using enacted tax rates in effect in the years in which the temporary differences are expected to reverse.

The Company does not provide for taxes which would be payable if undistributed earnings of its foreign subsidiaries or its foreign affiliate were remitted because the Company either considers these earnings to be invested for an indefinite period or anticipates that if such earnings were distributed, the U.S. income taxes payable would be substantially offset by foreign tax credits.

MANAGEMENT ESTIMATES – The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual amounts could differ from those estimates.

Recently Issued Accounting Standards-During 1998, the Financial Accounting Standards Board (FASB) issued FAS 133 "Accounting for Derivative Instruments and Hedging Activities" which establishes standards for accounting for derivatives and hedging activities. In July 1999, the FASB issued FAS 137, "Deferral of the Effective Date of FAS 133", which delays the effective date of FAS 133 one year. As a result, FAS 133 will be effective for the Company's 2001 fiscal year. The adoption of FAS 133 is not anticipated to have a significant impact on the Company's earnings or financial position.

RECLASSIFICATION – Certain reclassifications have been made to the financial statements of prior years to conform to the presentation for 2000.

## B. INVENTORIES

The major classes of inventories at June 30 were as follows (in thousands):

| | 2000 | 1999 |
|---|---|---|
| Finished parts | $40,313 | $42,405 |
| Work-in-process | 5,880 | 6,385 |
| Raw materials | 3,997 | 5,710 |
| | $50,190 | $54,500 |

Inventories stated on a LIFO basis represent approximately 35% of total inventories at June 30, 2000 and 1999. The approximate current cost of the LIFO inventories exceeded the LIFO cost by $20,549,000 and $17,936,000 at June 30, 2000 and 1999, respectively.

## C. Property, Plant and Equipment

Property, plant and equipment at June 30 were as follows (in thousands):

| | 2000 | 1999 |
|---|---|---|
| Land | $ 1,406 | $ 1,409 |
| Buildings | 22,582 | 22,698 |
| Machinery and equipment | 92,715 | 95,579 |
| | 116,703 | 119,686 |
| Less accumulated depreciation | 82,400 | 80,751 |
| | $34,303 | $38,935 |

## D. Investments in Affiliates

The Company's investments in affiliates consists of a 25% interest in a domestic distributor of Twin Disc products and an investment in Niigata Converter Company, LTD., Japan ("Niigata"), a manufacturer of power transmission equipment. In March of 1999, the Company sold a portion of its investment in Niigata in exchange for a $1.7 million note receivable due in various annual amounts commencing December 31, 2002, through December 31, 2008. The sale was a non-cash transaction for purposes of the consolidated statement of cash flows. As a result, a pre-tax gain of $1,355,000 was recognized in 1999.

Prior to the sale the Company accounted for its 25% interest in Niigata using the equity method. The Company recognized its share of Niigata's loss from April 1, 1998, through the date of sale of $1.5 million. After the sale, the Company accounted for its 19.5% interest using the cost method.

Combined condensed financial data for investments in affiliates accounted for under the equity method of accounting are summarized below (in thousands). The balance sheet information for 2000 and 1999 includes the domestic distributor balances only. The statement of operations information for 2000 includes the results of operation of the domestic distributor from June 1, 1999, through May 31, 2000. The statement of operations information for 1999 includes the domestic distributor results from June 1, 1998 through May 31, 1999, and Niigata results from April 1, 1998, through the date of sale; the 1998 information includes the domestic distributor results from June 1, 1997, through May 31, 1998 and Niigata results from April 1, 1997, through March 31, 1998.

| | 2000 | 1999 |
|---|---|---|
| Current assets | $ 10,145 | $ 8,734 |
| Other assets | 5,452 | 5,463 |
| | $ 15,597 | $ 14,197 |
| Current liabilities | $ 6,681 | $ 6,530 |
| Other liabilities | 235 | 210 |
| Shareholders' equity | 8,681 | 7,457 |
| | $ 15,597 | $ 14,197 |

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| Net sales | $ 23,866 | $116,115 | $152,558 |
| Gross profit | 9,813 | 13,008 | 20,897 |
| Net earnings (loss) | 3,624 | (3,780) | 2,606 |

## E. ACCRUED LIABILITIES

Accrued liabilities at June 30 were as follows (in thousands):

| | 2000 | 1999 |
|---|---|---|
| Salaries and wages | $ 3,989 | $ 4,522 |
| Retirement benefits | 4,024 | 3,362 |
| Other | 12,739 | 13,138 |
| | $ 20,752 | $ 21,022 |

## F. DEBT

Notes payable consists of amounts borrowed under unsecured line of credit agreements. Unused lines of credit total $19,488,000 at June 30, 2000. These lines of credit are available predominantly at the LIBOR interest rate plus 1.25% and may be withdrawn at the option of the banks. The weighted average interest rate of the lines outstanding at June 30, 2000 and 1999, was 5.26% and 5.88%, respectively.

Included in long-term debt is $17,142,000 and $20,000,000 on 7.37% ten-year unsecured notes, net of $51,000 and $60,000 unamortized debt issuance costs at June 30, 2000 and 1999, respectively. These notes contain certain covenants, including the maintenance of a current ratio of not less than 1.5. Principal payments of $2,857,000 are due in the years 2000 through 2005, with the remaining balance due on June 1, 2006. During 2000 the Company entered into a $20,000,000 revolving loan agreement. This agreement contains certain covenants, including restrictions on investments, acquisitions and indebtedness. The outstanding balance of $17,000,000 at June 30, 2000, is classified as a long-term liability as repayment is not expected within the next year. Notes under this agreement bear interest on a schedule determined by the Company's leverage ratio. The rate was 7.9% at June 30, 2000. Also included in long-term debt is $20,000 and $29,000 of debt related to a foreign subsidiary at June 30, 2000 and 1999, respectively.

## G. LEASE COMMITMENTS

Approximate future minimum rental commitments under noncancellable operating leases are as follows (in thousands):

| Fiscal Year | |
|---|---|
| 2001 | $2,628 |
| 2002 | 2,103 |
| 2003 | 1,429 |
| 2004 | 651 |
| 2005 | 510 |
| Thereafter | 1,246 |
| | $8,567 |

Total rent expense for operating leases approximated $3,023,000, $2,941,000 and $2,571,000 in 2000, 1999 and 1998, respectively.

## H. SHAREHOLDERS' EQUITY

At June 30, 2000 and 1999, treasury stock consisted of 833,740 and 808,446 shares of common stock, respectively. The Company issued 150 and 2,200 shares of treasury stock in 2000 and 1999, respectively, to fulfill its obligations under the stock option plans. The difference between the cost of treasury shares issued and the option price is recorded in retained earnings. The Company acquired 25,444 shares of treasury stock in 2000.

Cash dividends per share were $.70 in 2000, $.805 in 1999 and $.76 in 1998.

In 1998, the Company's Board of Directors established a Shareholder Rights Plan and distributed to shareholders one preferred stock purchase right for each outstanding share of common stock. Under certain circumstances, a right may be exercised to purchase one one-hundredth of a share of Series A Junior Preferred Stock at an exercise price of $160, subject to certain anti-dilution adjustments. The rights become exercisable ten (10) days after a public announcement that a party or group has either acquired at least 15% (or at least 25% in the case of existing holders who currently own 15% or more of the common stock), or commenced a tender offer for at least 25% of the Company's common stock. Generally, after the rights become exercisable, if the Company is a party to certain merger or business combination transactions, or transfers 50% or more of its assets or earnings power, or certain other events occur, each right will entitle its holders, other than the acquiring person, to buy a number of shares of common stock of the Company, or of the other party to the transaction, having a value of twice the exercise price of the right. The rights expire June 30, 2008, and may be redeemed by the Company for $.05 per right at any time until ten (10) days following the stock acquisition date. The Company is authorized to issue 200,000 shares of preferred stock, none of which have been issued. The Company has designated 50,000 shares of the preferred stock for the purpose of the Shareholder Rights Plan.

## I. BUSINESS SEGMENTS AND FOREIGN OPERATIONS

The Company and its subsidiaries are engaged in the manufacture and sale of power transmission equipment. Principal products include industrial clutches, hydraulic torque converters, fluid couplings, power-shift transmissions, marine transmissions, universal joints, power take-offs and reduction gears. The Company sells to both domestic and foreign customers in a variety of market areas, principally construction, industrial, energy and natural resources, marine and agricultural.

The Company has two reportable segments: manufacturing and distribution. These segments are managed separately because each provides different services and requires different technology and marketing strategies. The accounting practices of the segments are the same as those described in the summary of significant accounting policies. Transfers among segments are at established inter-company selling prices.

Information about the Company's segments is summarized as follows (in thousands):

| | Manufacturing | Distribution | Total |
|---|---|---|---|
| **2000** | | | |
| Net sales | $166,067 | $46,726 | $212,793 |
| Intra-segment sales | 7,176 | 613 | 7,789 |
| Inter-segment sales | 26,327 | 690 | 27,017 |
| Interest income | 321 | 73 | 394 |
| Interest expense | 3,159 | 125 | 3,284 |
| Income taxes | 3,904 | 916 | 4,820 |
| Depreciation and amortization | 6,589 | 264 | 6,853 |
| Segment earnings | 3,464 | 1,587 | 5,051 |
| Segment assets | 154,971 | 24,518 | 179,489 |
| Expenditures for segment assets | 1,766 | 368 | 2,134 |

| | Manufacturing | Distribution | Total |
|---|---|---|---|
| **1999** | | | |
| Net sales | $156,661 | $41,426 | $198,087 |
| Intra-segment sales | 7,235 | 439 | 7,674 |
| Inter-segment sales | 21,545 | 726 | 22,271 |
| Interest income | 350 | 92 | 442 |
| Interest expense | 2,134 | 228 | 2,362 |
| Income taxes | 519 | 1,036 | 1,555 |
| Depreciation and amortization | 6,062 | 291 | 6,353 |
| Segment earnings | 1,147 | 170 | 1,317 |
| Segment assets | 152,251 | 25,448 | 177,699 |
| Expenditures for segment assets | 6,017 | 422 | 6,439 |
| **1998** | | | |
| Net sales | $206,812 | $46,981 | $253,793 |
| Intra-segment sales | 24,358 | 502 | 24,860 |
| Inter-segment sales | 25,959 | 331 | 26,290 |
| Interest income | 626 | 129 | 755 |
| Interest expense | 1,481 | 229 | 1,710 |
| Income taxes | 6,246 | 1,649 | 7,895 |
| Depreciation and amortization | 5,244 | 274 | 5,518 |
| Segment earnings | 9,196 | 2,051 | 11,247 |
| Segment assets | 134,870 | 27,705 | 162,575 |
| Expenditures for segment assets | 6,626 | 528 | 7,154 |

The following is a reconciliation of reportable segment net sales, earnings (loss) and assets, to the Company's consolidated totals (in thousands):

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| **Net sales** | | | |
| Total net sales from reportable segments | $212,793 | $198,087 | $253,793 |
| Elimination of inter-company sales | (34,806) | (29,945) | (51,150) |
| Total consolidated net sales | $177,987 | $168,142 | $202,643 |
| **Earnings (loss)** | | | |
| Total earnings (loss) from reportable segments | $ 5,051 | $ 1,317 | $ 11,247 |
| Other corporate expenses | (1,278) | (2,335) | (1,884) |
| Total consolidated net earnings (loss) | $ 3,773 | $ (1,018) | $ 9,363 |
| **Assets** | | | |
| Total assets for reportable segments | $179,489 | $177,699 | |
| Elimination of inter-company assets | (18,120) | (15,871) | |
| Corporate assets | 12,821 | 15,072 | |
| Total consolidated assets | $174,190 | $176,900 | |

Other significant items:

| | Segment Totals | Adjustments | Consolidated Totals |
|---|---|---|---|
| **2000** | | | |
| Interest income | $ 394 | $ (150) | $ 244 |
| Interest expense | 3,284 | (305) | 2,979 |
| Income taxes | 4,820 | (526) | 4,294 |
| Depreciation and amortization | 6,853 | 127 | 6,980 |
| Expenditures for segment assets | 2,134 | — | 2,134 |
| **1999** | | | |
| Interest income | $ 442 | $ (205) | $ 237 |
| Interest expense | 2,362 | (292) | 2,070 |
| Income taxes | 1,555 | (523) | 1,032 |
| Depreciation and amortization | 6,353 | 101 | 6,454 |
| Expenditures for segment assets | 6,439 | — | 6,439 |
| **1998** | | | |
| Interest income | $ 755 | $ (205) | $ 550 |
| Interest expense | 1,710 | (205) | 1,505 |
| Income taxes | 7,895 | (1,213) | 6,682 |
| Depreciation and amortization | 5,518 | 89 | 5,607 |
| Expenditures for segment assets | 7,154 | — | 7,154 |

All adjustments represent inter-company eliminations and corporate amounts.

Geographic information about the Company is summarized as follows (in thousands):

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| Net sales | | | |
| United States | $113,377 | $106,051 | $133,193 |
| Other countries | 64,610 | 62,091 | 69,450 |
| Total | $177,987 | $168,142 | $202,643 |
| Long-lived assets | | | |
| United States | $ 70,831 | $ 65,540 | |
| Belgium | 8,291 | 10,362 | |
| Other countries | 5,306 | 6,086 | |
| Elimination of inter-company assets | (4,656) | (7,184) | |
| Total | $ 79,772 | $ 74,804 | |

One customer accounted for approximately 10%, 8% and 11% of consolidated net sales in 2000, 1999 and 1998, respectively. Another customer accounted for approximately 6%, 8% and 11% during those years.

## J. STOCK OPTION PLANS

During fiscal 1999, the Company adopted the Twin Disc, Incorporated 1998 Stock Option Plan for Non-Employee Directors, a non-qualified plan, for non-employee directors to purchase up to 35,000 shares of common stock, and the Twin Disc, Incorporated 1998 Incentive Compensation Plan, a plan, where options are determined to be non-qualified or incentive at the date of grant, for officers and key employees to purchase up to 165,000 shares of common stock. The plans are administered by the Executive Selection and Compensation Committee of the Board of Directors which has the authority to determine which officers and key employees will be granted options. The grant of options to non-employee directors is fixed at options to purchase 1,000 shares of common stock per year or 600 at time of appointment. Except as described in the following sentence, all options allow for exercise prices not less than the grant date fair market value, immediately vest and expire ten years after the date of grant. For options under the Incentive Compensation Plan, if the optionee owns more than 10% of the total combined voting power of all classes of the Company's stock, the price will be not less than 110% of the grant date fair market value and the options expire five years after the grant date. In addition, the Company has 95,300 incentive stock option plan options and 63,450 non-qualified stock option plan options outstanding at June 30, 2000, under the Twin Disc, Incorporated 1988 Incentive Stock Option plan and the Twin Disc, Incorporated 1988 Non-Qualified Stock Option Plan for Officers, Key Employees and Directors, respectively. The plans terminated during 1999.

Shares available for future options as of June 30 were as follows:

| | 2000 | 1999 |
|---|---|---|
| 1998 Stock Option Plan for Non-Employee Directors | 23,000 | 29,000 |
| 1998 Incentive Compensation Plan | 132,750 | 159,500 |

Stock option transactions under the plans during 2000, 1999 and 1998 were as follows:

| | 2000 | Weighted Average Price | 1999 | Weighted Average Price | 1998 | Weighted Average Price |
|---|---|---|---|---|---|---|
| Non-qualified stock options: | | | | | | |
| Options outstanding at beginning of year | 84,600 | $22.55 | 80,500 | $22.50 | 94,150 | $21.71 |
| Granted | 12,000 | 19.94 | 19,000 | 24.69 | 13,100 | 28.75 |
| Cancelled | (13,000) | 23.31 | (14,700) | 25.08 | — | — |
| Exercised | — | — | (200) | 26.00 | (26,750) | 22.81 |
| Options outstanding at June 30 | 83,600 | $22.06 | 84,600 | $22.55 | 80,500 | $22.50 |

| | | |
|---|---|---|
| Options price range | | |
| ($14.00 - $20.00) | | |
| Number of shares | 40,800 | |
| Weighted average price | $ 19.36 | |
| Weighted average remaining life | 5.70 | years |
| Options price range | | |
| ($20.875 - $28.75) | | |
| Number of shares | 42,800 | |
| Weighted average price | $ 24.63 | |
| Weighted average remaining life | 7.39 | years |

| | 2000 | Weighted Average Price | 1999 | Weighted Average Price | 1998 | Weighted Average Price |
|---|---|---|---|---|---|---|
| Incentive stock options: | | | | | | |
| Options outstanding | | | | | | |
| at beginning of year | 132,250 | $23.70 | 124,300 | $23.57 | 161,550 | $21.60 |
| Granted | 22,800 | 20.20 | 33,900 | 25.80 | 29,900 | 29.18 |
| Cancelled | (35,500) | 23.25 | (23,950) | 26.58 | (7,050) | 20.15 |
| Exercised | (150) | 14.00 | (2,000) | 16.63 | (60,100) | 21.53 |
| Options outstanding at June 30 | 119,400 | $23.24 | 132,250 | $23.70 | 124,300 | $23.57 |

| | | |
|---|---|---|
| Options price range | | |
| ($14.00 - $20.00) | | |
| Number of shares | 46,050 | |
| Weighted average price | $ 19.26 | |
| Weighted average remaining life | 6.24 | years |
| Options price range | | |
| ($20.875 - $28.75) | | |
| Number of shares | 67,850 | |
| Weighted average price | $ 25.24 | |
| Weighted average remaining life | 7.44 | years |
| Options price range | | |
| ($31.625 - $32.25) | | |
| Number of shares | 5,500 | |
| Weighted average price | $ 31.74 | |
| Weighted average remaining life | 8.00 | years |

The Company accounts for its stock option plans under the guidelines of Accounting Principles Board Opinion No. 25. Accordingly, no compensation cost has been recognized in the statement of operations. Had the Company recognized compensation expense determined based on the fair value at the grant date for awards under the plans, consistent with the method prescribed by FAS 123, the net earnings and earnings per share would have been as follows (in thousands, except per share amounts):

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| Net earnings (loss) | | | |
| As reported | $ 3,773 | $(1,018) | $9,363 |
| Pro forma | 3,648 | (1,277) | 9,125 |
| Basic earnings (loss) per share | | | |
| As reported | $ 1.34 | $ (.36) | $ 3.30 |
| Pro forma | 1.29 | (.45) | 3.22 |
| Diluted earnings (loss) per share | | | |
| As reported | $ 1.34 | $ (.36) | $ 3.24 |
| Pro forma | 1.29 | (.45) | 3.16 |

The above pro forma net earnings and earnings per share were computed using the fair value of options at the date of grant (for options granted after June 1995) as calculated by the Black-Scholes option-pricing method and the following assumptions: 21% volatility, 3.8% annual dividend yield, interest rates based on expected terms and grant dates, a 5-year term and an exercise price equal to the fair market value on the date of grant except for incentive options granted to greater than 10% shareholders which are calculated using a 3-year term and an exercise price equal to 110% of the fair market value on the date of grant. For those options granted during 2000, 1999 and 1998 with exercise prices equal to the grant date fair market value, the exercise prices and weighted average fair values of the options were $19.94 and $3.70 in 2000, $25.26 and $5.02 in 1999 and $28.75 and $5.81 in 1998, respectively. For those options granted with exercise prices greater than the grant date fair market value, the exercise prices and weighted average fair values of the options were $21.93 and $2.43 in 2000, $28.08 and $2.71 in 1999, $31.63 and $3.26 in 1998, respectively.

## K. ENGINEERING AND DEVELOPMENT COSTS

Engineering and development costs include research and development expenses for new products, development and major improvements to existing products, and other charges for ongoing efforts to refine existing products. Research and development costs charged to operations totaled $1,852,000, $2,505,000 and $3,104,000 in 2000, 1999 and 1998, respectively. Total engineering and development costs were $6,322,000, $7,829,000 and $8,833,000 in 2000, 1999 and 1998, respectively.

## L. RETIREMENT PLANS

The Company has noncontributory, qualified defined benefit pension plans covering substantially all domestic employees and certain foreign employees. Domestic plan benefits are based on years of service, and, for salaried employees, on average compensation for benefits earned prior to January 1, 1997, and on a cash balance plan for benefits earned after January 1, 1997. The Company's funding policy for the plans covering domestic employees is to contribute an actuarially determined amount which falls between the minimum and maximum amount that can be contributed for federal income tax purposes. Domestic plan assets consist principally of listed equity and fixed income securities.

In addition, the Company has unfunded, non-qualified retirement plans for certain management employees and directors. Benefits are based on final average compensation and vest upon retirement from the Company.

In addition to providing pension benefits, the Company provides health care and life insurance benefits for certain domestic retirees. All employees retiring after December 31, 1992, and electing to continue coverage through the Company's group plan, are required to pay 100% of the premium cost.

The following table sets forth the Company's defined benefit pension plans' and other postretirement benefit plans' funded status and the amounts recognized in the Company's balance sheets and income statements as of June 30 (dollars in thousands):

| | Pension Benefits | | Other Postretirement Benefits | |
|---|---|---|---|---|
| | 2000 | 1999 | 2000 | 1999 |
| Change in benefit obligation: | | | | |
| Benefit obligation, beginning of year | $115,865 | $104,156 | $ 32,749 | $ 28,619 |
| Service cost | 1,518 | 1,517 | 19 | 23 |
| Interest cost | 8,028 | 7,254 | 2,265 | 1,978 |
| Actuarial (gain) loss | (6,806) | 11,384 | (1,481) | 4,548 |
| Benefits paid | (9,518) | (8,446) | (3,325) | (2,419) |
| Benefit obligation, end of year | $109,087 | $115,865 | $ 30,227 | $ 32,749 |
| Change in plan assets: | | | | |
| Fair value of assets, beginning of year | $ 98,283 | $100,265 | $ — | $ — |
| Actual return on plan assets | 16,876 | 4,279 | — | — |
| Employer contribution | 7,048 | 2,185 | 3,325 | 2,419 |
| Benefits paid | (9,518) | (8,446) | (3,325) | (2,419) |
| Fair value of assets, end of year | $112,689 | $ 98,283 | $ — | $ — |
| Funded status | $ 3,602 | $ (17,582) | $(30,227) | $ (32,749) |
| Unrecognized net transition obligation | 606 | 836 | — | — |
| Unrecognized actuarial loss | 4,398 | 19,972 | 6,817 | 8,755 |
| Unrecognized prior service cost | 2,495 | 3,167 | — | — |
| Net amount recognized | $ 11,101 | $ 6,393 | $ (23,410) | $ (23,994) |
| Amounts recognized in the balance sheet consist of: | | | | |
| Prepaid benefit cost | $ 14,335 | $ — | $ — | $ — |
| Accrued benefit liability | (3,234) | (16,343) | (23,410) | (23,994) |
| Intangible asset | — | 3,385 | — | — |
| Deferred tax asset | — | 7,547 | — | — |
| Minimum pension liability adjustment | — | 11,804 | — | — |
| Net amount recognized | $ 11,101 | $ 6,393 | $ (23,410) | $ (23,994) |
| Weighted average assumptions as of June 30: | | | | |
| Discount rate | 8.00% | 7.25% | 8.00% | 7.25% |
| Expected return on plan assets | 9.00% | 9.00% | | |
| Rate of compensation increase | 5.00% | 5.00% | | |

| | Pension Benefits | | |
|---|---|---|---|
| | 2000 | 1999 | 1998 |
| Service cost | $ 1,518 | $ 1,517 | $ 1,328 |
| Interest cost | 8,028 | 7,254 | 7,235 |
| Expected return on plan assets | (8,532) | (8,617) | (6,750) |
| Amortization of prior service cost | 672 | 672 | 672 |
| Amortization of transition obligation | 179 | 183 | 185 |
| Recognized net actuarial loss (gain) | 699 | 102 | 92 |
| Net periodic benefit cost | $ 2,564 | $ 1,111 | $ 2,762 |

| | Postretirement Benefits | | |
|---|---|---|---|
| | 2000 | 1999 | 1998 |
| Service cost | $ 19 | $ 23 | $ 21 |
| Interest cost | 2,265 | 1,978 | 2,153 |
| Recognized net actuarial loss | 457 | 399 | 205 |
| Net periodic benefit cost | $ 2,741 | $ 2,400 | $ 2,379 |

Effective January 1, 1998, the Company changed certain of its actuarial assumptions including the mortality table used and the assumed retirement age for the defined benefit plans and the postretirement plan. The changes resulted in an increase to the benefit obligation and unrecognized actuarial loss of approximately $10 million.

The pension plans held 62,402 shares of Company stock with a fair market value of $1,065,000 and $1,252,000 at June 30, 2000 and 1999, respectively.

The assumed weighted average health care cost trend rate was 6% in fiscal year 2000 and 1999. A 1% increase in the assumed health care cost trend would increase the accumulated postretirement benefit obligation by approximately $2.0 million and the interest cost by approximately $140,000. A 1% decrease in the assumed health care cost trend would decrease the accumulated postretirement benefit obligation by approximately $1.9 million and the interest cost by approximately $130,000.

The Company sponsors defined contribution plans covering substantially all domestic employees and certain foreign employees. These plans provide for employer contributions based primarily on employee participation. The total expense under the plans was $1,699,000, $1,572,000 and $1,582,000 in 2000, 1999 and 1998, respectively.

## M. Income Taxes

United States and foreign earnings (loss) before income taxes were as follows (in thousands):

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| United States | $ 367 | $(3,555) | $ 7,944 |
| Foreign | 7,700 | 3,569 | 8,101 |
| | $ 8,067 | $ 14 | $16,045 |

The provision (credit) for income taxes is comprised of the following (in thousands):

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| Currently payable: | | | |
| Federal | $ 664 | $(1,376) | $ 154 |
| State | 6 | 49 | 114 |
| Foreign | 3,908 | 2,359 | 3,541 |
| | 4,578 | 1,032 | 3,809 |
| Deferred: | | | |
| Federal | (137) | 402 | 2,582 |
| State | 220 | (292) | 183 |
| Foreign | (367) | (110) | 108 |
| | (284) | — | 2,873 |
| | $ 4,294 | $ 1,032 | $ 6,682 |

The components of the net deferred tax asset as of June 30, were as follows (in thousands):

| | 2000 | 1999 |
|---|---|---|
| Deferred tax assets: | | |
| Retirement plans and employee benefits | $ 4,852 | $12,826 |
| Alternative minimum tax credit carryforwards | 301 | 599 |
| Foreign tax credit carryforwards | 1,933 | 1,968 |
| State net operating loss and other state credit carryforwards | 771 | 1,075 |
| Research credit carryforwards | — | 135 |
| Other | 3,950 | 2,581 |
| | 11,807 | 19,184 |
| Deferred tax liabilities: | | |
| Property, plant and equipment | 5,744 | 6,182 |
| Other | 2,804 | 2,649 |
| | 8,548 | 8,831 |
| Total net deferred tax assets | $ 3,259 | $10,353 |

Following is a reconciliation of the applicable U.S. federal income taxes to the actual income taxes reflected in the statements of operations:

| | 2000 | 1999 | 1998 |
|---|---|---|---|
| U.S. federal income tax at 34% | $2,743 | $ 5 | $5,455 |
| Increases (reductions) | | | |
| in tax resulting from: | | | |
| Foreign tax items | 1,387 | 463 | 173 |
| Accrual for prior years | 150 | 74 | 705 |
| Other, net | 14 | 490 | 349 |
| | $4,294 | $1,032 | $6,682 |

## N. CONTINGENCIES

The Company is involved in various stages of investigation relative to hazardous waste sites, two of which are on the United States EPA National Priorities List (Superfund sites). The Company's assigned responsibility at each of the Superfund sites is less than 2%. The Company has also been requested to provide administrative information related to two other potential Superfund sites but has not yet been identified as a potentially responsible party. Additionally, the Company is subject to certain product liability matters in the normal course of business.

At June 30, 2000, the Company has accrued approximately $1,050,000, which represents management's best estimate available for possible losses related to these contingencies. This amount has been provided over the past several years. Based on the information available, the Company does not expect that any unrecorded liability related to these matters would materially affect the consolidated financial position, results of operations or cash flows.

## O. ACQUISITIONS

In January 1999, the Company purchased the mechanical power take-off product business from Rockford Powertrain, Inc. for approximately $13.5 million. This transaction was accounted for using the purchase method of accounting and resulted in goodwill of approximately $11 million which is being amortized over 30 years. In February 1999, the Company purchased Technodrive S.p.A of Decima, Italy for approximately $3.9 million, net of cash acquired of $700,000. This transaction was accounted for using the purchase method of accounting and resulted in goodwill of approximately $2.9 million which is being amortized over 25 years. Technodrive manufactures industrial power take-offs, clutches, hydraulic pump mount drives and marine transmissions. The pro forma effects of the acquisitions are not significant to the net sales, net (loss) earnings, and earnings per share amounts reported in the financial statements.

## P. CLOSURE OF SUBSIDIARY

In June 1999, the Company approved a plan to terminate operations at its South African subsidiary, Twin Disc (South Africa) Pty. Ltd, early in fiscal 2000. The Company recorded a loss of $1,140,000 in 1999 related to the termination of operations, which consists primarily of the recognition of cumulative translation losses of $829,000 with the remaining amounts related to disposals of inventories and fixed assets, and severance benefits. The results of the subsidiary's operations through June 30, 1999, are included in the consolidated financial statements.

# Report of Independent Accountants

To the Shareholders
Twin Disc, Incorporated
Racine, Wisconsin

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, changes in shareholders' equity and comprehensive income and cash flows present fairly, in all material respects, the financial position of Twin Disc, Incorporated and Subsidiaries at June 30, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2000, in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP
Milwaukee, Wisconsin
July 21, 2000

# Ten Year Financial Summary

| *(In thousands of dollars, except where noted)* | 2000 | 1999 | 1998 |
|---|---|---|---|
| **STATEMENT OF OPERATIONS** | | | |
| Net sales | $177,987 | $168,142 | $202,643 |
| Costs and expenses, including marketing, engineering and administrative | 168,105 | 164,816 | 186,607 |
| Earnings (loss) from operations | 9,882 | 3,326 | 16,036 |
| Other income (expense) | (1,815) | (3,312) | 9 |
| Earnings (loss) before income taxes | 8,067 | 14 | 16,045 |
| Income taxes (credits) | 4,294 | 1,032 | 6,682 |
| Net earnings (loss) | 3,773 | (1,018) | 9,363 |
| **BALANCE SHEET** | | | |
| ***Assets*** | | | |
| Cash and cash equivalents | 5,651 | 4,136 | 5,087 |
| Receivables, net | 28,828 | 27,201 | 28,320 |
| Inventories, net | 50,190 | 54,500 | 53,280 |
| Other current assets | 5,333 | 11,910 | 6,893 |
| Total current assets | 90,002 | 97,747 | 93,580 |
| Investments and other assets | 49,885 | 40,218 | 31,646 |
| Fixed assets less accumulated depreciation | 34,303 | 38,935 | 35,728 |
| Total assets | 174,190 | 176,900 | 160,954 |
| ***Liabilities and Shareholders' Equity*** | | | |
| Current liabilities | 40,908 | 54,761 | 29,553 |
| Long-term debt | 31,254 | 17,112 | 19,949 |
| Deferred liabilities | 23,795 | 37,567 | 29,457 |
| Shareholders' equity | 78,233 | 67,460 | 81,995 |
| Total liabilities and shareholders' equity | 174,190 | 176,900 | 160,954 |
| ***Comparative Financial Information*** | | | |
| Per share statistics: | | | |
| Basic earnings (loss) | 1.34 | (.36) | 3.30 |
| Diluted earnings (loss) | 1.34 | (.36) | 3.24 |
| Dividends | .70 | .805 | .76 |
| Shareholders' equity | 27.84 | 23.79 | 28.94 |
| Return on equity | 4.8% | (1.5)% | 11.4% |
| Return on assets | 2.2% | ( .6)% | 5.8% |
| Return on sales | 2.1% | ( .6)% | 4.6% |
| Average shares outstanding | 2,820,534 | 2,834,909 | 2,833,663 |
| Diluted shares outstanding | 2,820,730 | 2,843,877 | 2,886,209 |
| Number of shareholder accounts | 1,480 | 1,138 | 774 |
| Number of employees | 999 | 1,029 | 1,078 |
| Additions to plant and equipment | 2,134 | 6,439 | 7,154 |
| Depreciation | 5,766 | 5,648 | 5,205 |
| Net working capital | 49,094 | 42,986 | 64,027 |

1993 Net Earnings data and Return percentages reflect operating earnings before the effect of adopting Financial Accounting Standards 106 and 109.
The cumulative effect of their adoption was a net loss of $14.44 million or $5.16 per share.

| 1997 | 1996 | 1995 | 1994 | 1993 | 1992 | 1991 |
|---|---|---|---|---|---|---|
| $189,942 | $176,657 | $164,232 | $141,193 | $139,403 | $136,255 | $152,990 |
| 177,342 | 164,486 | 154,347 | 136,244 | 135,284 | 134,242 | 155,395 |
| 12,600 | 12,171 | 9,885 | 4,949 | 4,119 | 2,013 | (2,405) |
| 80 | (1,264) | (1,301) | 18 | (95) | (162) | (721) |
| 12,680 | 10,907 | 8,584 | 4,967 | 4,024 | 1,851 | (3,126) |
| 4,951 | 4,348 | 2,912 | 578 | 1,362 | 810 | (711) |
| 7,729 | 6,559 | 5,672 | 4,389 | 2,662 | 1,041 | (2,415) |
| 8,983 | 2,043 | 3,741 | 4,166 | 2,903 | 2,987 | 2,288 |
| 32,428 | 34,917 | 29,247 | 25,682 | 25,106 | 26,026 | 24,567 |
| 47,844 | 51,083 | 47,157 | 41,569 | 42,562 | 36,686 | 40,913 |
| 8,707 | 8,597 | 10,345 | 8,993 | 6,961 | 4,521 | 5,886 |
| 97,962 | 96,640 | 90,490 | 80,410 | 77,532 | 70,220 | 73,654 |
| 26,544 | 30,344 | 30,463 | 26,830 | 21,813 | 10,554 | 9,648 |
| 34,249 | 35,715 | 37,348 | 36,676 | 37,560 | 38,724 | 42,877 |
| 158,755 | 162,699 | 158,301 | 143,916 | 136,905 | 119,498 | 126,179 |
| 29,621 | 34,002 | 36,852 | 32,710 | 31,252 | 35,694 | 38,785 |
| 19,944 | 19,938 | 14,000 | 11,500 | 13,000 | — | 4,309 |
| 35,393 | 33,578 | 32,827 | 34,309 | 31,244 | 7,365 | 8,463 |
| 73,797 | 75,181 | 74,622 | 65,397 | 61,409 | 76,439 | 74,622 |
| 158,755 | 162,699 | 158,301 | 143,916 | 136,905 | 119,498 | 126,179 |
| 2.78 | 2.36 | 2.03 | 1.57 | .95 | .37 | (.85) |
| 2.75 | 2.34 | 2.02 | 1.56 | .95 | .37 | (.85) |
| .70 | .70 | .70 | .70 | .70 | .70 | .85 |
| 26.48 | 27.07 | 26.75 | 23.36 | 21.93 | 27.10 | 26.42 |
| 10.5 % | 8.7 % | 7.6 % | 6.7 % | 4.3 % | 1.4 % | (3.2)% |
| 4.9 % | 4.0 % | 3.6 % | 3.0 % | 1.9 % | .9 % | (1.9)% |
| 4.1 % | 3.7 % | 3.5 % | 3.1 % | 1.9 % | .8 % | (1.6)% |
| 2,781,174 | 2,776,805 | 2,790,111 | 2,799,390 | 2,799,603 | 2,820,513 | 2,824,815 |
| 2,808,226 | 2,805,123 | 2,812,703 | 2,809,390 | 2,806,603 | 2,823,885 | 2,826,123 |
| 845 | 913 | 996 | 1,058 | 1,139 | 1,214 | 1,271 |
| 1,081 | 1,080 | 1,097 | 1,099 | 1,114 | 1,221 | 1,483 |
| 4,734 | 4,140 | 4,290 | 4,216 | 4,684 | 4,390 | 8,218 |
| 5,141 | 5,071 | 4,792 | 4,670 | 4,958 | 5,452 | 5,568 |
| 68,341 | 62,638 | 53,638 | 47,700 | 46,280 | 34,526 | 34,869 |

# Directors

## Michael E. Batten
Chairman, Chief Executive Officer

## Michael H. Joyce
President, Chief Operating Officer

## James O. Parrish
Vice President-Finance & Treasurer

## John A. Mellowes
Chairman and Chief Executive Officer
Charter Manufacturing Co.
(A privately held producer of bar, rod wire
and wire parts)
Mequon, Wisconsin

## Paul J. Powers
Retired Chairman, President-Chief Executive Officer
Commercial Intertech Corp.
(Manufacturer of Hydraulic Components,
Fluid Purification Products, Pre-Engineered
Buildings and Stamped Metal Products)
Youngstown, Ohio

## Richard T. Savage
Retired Chairman, President-Chief Executive Officer
Modine Manufacturing Company
(Manufacturer of Heat Exchange Equipment)
Racine, Wisconsin

## David L. Swift
Retired Chairman, President-Chief
Executive Officer
Acme-Cleveland Corporation
(Manufacturer of Diversified Industrial Products)
Pepper Pike, Ohio

## George E. Wardeberg
Vice Chairman
Wisconsin Energy Corp.
(A holding company with subsidiaries in electric,
natural gas, energy services and manufacturing)
Milwaukee, Wisconsin

## David R. Zimmer
Former Executive Vice President
United Dominion Industries
(Manufacturer of Proprietary Engineered Products)
Charlotte, North Carolina

## David B. Rayburn
Executive Vice President of Operations
Modine Manufacturing Company
(Manufacturer of Heat Exchange Equipment)
Racine, Wisconsin

# Officers

**Michael E. Batten**
Chairman, Chief Executive Officer

**Michael H. Joyce**
President, Chief Operating Officer

**James O. Parrish**
Vice President—Finance & Treasurer

**Henri-Claude Fabry**
Vice President—Marine and Distribution

**Lance J. Melik**
Vice President—Corporate Development
Vice President—Transmission and Industrial Marketing

**Fred H. Timm**
Corporate Controller & Secretary

**Paul A. Pelligrino**
Vice President—Engineering

**Arthur A. Zintek**
Vice President—Human Resources

# Corporate Data

## Annual Meeting
Twin Disc Corporate Offices
Racine, Wisconsin
2:00 P.M.
October 20, 2000

## Shares Traded
New York Stock Exchange: Symbol TDI

## Annual Report on Securities and Exchange Commission Form 10-K
Single copies of the Company's 2000 Annual Report on Securities and Exchange Commission Form 10-K will be provided without charge to shareholders after September 30, 2000, upon written request directed to the Secretary, Twin Disc, Incorporated, 1328 Racine Street, Racine, Wisconsin 53403.

## Transfer Agent & Registrar
Firstar Trust Company
Milwaukee, Wisconsin

## Independent Accountants
PricewaterhouseCoopers LLP
Milwaukee, Wisconsin

## General Counsel
von Briesen, Purtell, & Roper, s.c.
Milwaukee, Wisconsin

## Corporate Offices
Twin Disc, Incorporated
Racine, Wisconsin 53403
Telephone: (262) 638-4000

## Wholly-Owned Subsidiaries
Twin Disc International S.A.
Nivelles, Belgium
Twin Disc Srl
Viareggio, Italy
Twin Disc Technodrive Srl
Decima, Italy
Technodrive SARL
Chambery, France
Twin Disc (Pacific) Pty. Ltd.
Brisbane, Queensland, Australia
Twin Disc (Far East) Ltd.
Singapore
Mill-Log Equipment Co., Inc.
Coburg, Oregon
Southern Diesel Systems Inc.
Miami, Florida
TD Electronics, Inc.
Loves Park, Illinois

## Partially Owned Affiliate Companies
Palmer Johnson Distributors, LLC
Sturgeon Bay, Wisconsin

## Manufacturing Facilities
Racine, Wisconsin
Nivelles, Belgium
Kamo and Omiya, Japan
Decima, Italy
Loves Park, Illinois

## Sales Offices
*Domestic*
Racine, Wisconsin
Coburg, Oregon
Portland, Oregon
Kent, Washington
Miami, Florida
Jacksonville, Florida
Loves Park, Illinois
*Foreign*
Nivelles, Belgium
Brisbane and Perth, Australia
Singapore
Viareggio, Italy
Decima, Italy
Chambery, France
Edmonton, Canada
Vancouver, Canada
*Affiliate Company*
Sturgeon Bay, Wisconsin

## Manufacturing Licenses
Niigata Converter Company, Ltd.
Tokyo, Japan

Twin Disc, Incorporated

1328 RACINE STREET
RACINE, WISCONSIN 53403 USA

WWW.TWINDISC.COM