

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Eaton Corporation (ETN)



**ALEXANDER M. CUTLER** is Chairman and Chief Executive Officer of Eaton Corporation, a \$15.4 billion diversified industrial manufacturer. Mr. Cutler was President and Chief Operating Officer from 1995 to August 2000. He began his career as a Financial Analyst in 1975 with Cutler-Hammer, which Eaton acquired. Mr. Cutler is a board member of DuPont, KeyCorp, the Greater Cleveland Partnership and United Way Services of Greater Cleveland. He's on the Business Roundtable's executive committee and chairs its Corporate Leadership Initiative. Mr. Cutler also belongs to The Business Council.

### SECTOR — INDUSTRIAL EQUIPMENT & COMPONENTS

**TWST: Would you give me a brief history of your company and what your focus is on now?**

**Mr. Cutler:** Eaton is a power management company. We produce products and services that help customers manage electrical, hydraulic and mechanical power. We're really focused in this broad arena that is in the spotlight today with higher energy costs and the prospect of carbon regulations around the world.

We were founded back in 1911 as a company that was focused in the vehicle markets. Today our largest businesses are our electrical, aerospace and hydraulics businesses.

**TWST: In what proportion do those businesses account for your total revenue?**

**Mr. Cutler:** The three I just named are just over 70% of our company revenues.

**TWST: Will you continue to concentrate on the same areas, given the new administration's focus on alternative energy?**

**Mr. Cutler:** Our focus really preceded the current administration's focus. We've been involved in power management for a great majority of the company's history, and so our largest business, which is our electrical business, utilizes a whole series of technologies that are used all the way from residential homes on up to utilities. So it's a broad array of applications where you find electrical energy use.

Clearly, one of the big initiatives today is conservation, and that's where over 20 of the different categories that contribute to LEED

points in buildings are actually activities we're involved in with our electrical products. Similarly, if you move over to our aerospace business, many of the technologies we have on both military and commercial aircraft allow planes to be significantly lighter, which then allows them to not have to use as much fuel. So for example, if you take the A380, we took a metric ton out of the weight of that airplane by using our high-pressure hydraulic systems. And then if you move over to our hydraulics business today, where we provide equipment both into factories for machine tools as well as on agriculture and construction equipment, the same energy efficiency and emissions pressures are present. In all of these areas, our focus has been, for quite some time, on how do you help people use energy more effectively, more safely and — what is very topical currently — reduce emissions and improve fuel economy.

**TWST: How is your business distributed between the domestic and international markets?**

**Mr. Cutler:** Just about 55% of our revenues come from outside the United States.

**TWST: Given the need for energy is growing rapidly in particular markets, how are you affected by a lack of power grids and the government's inability to sponsor state projects, like the building of new power grids? Do you plan on keeping your current market distribution, or do you expect to look increasingly more to the international market in the future?**

**Mr. Cutler:** If you think about the U.S. GDP, it's approximately 25% of world GDP. As a U.S.-headquartered company, we of course started our operations here in the U.S., so we had larger positions

here. Over the past few years, we have been quickly growing our businesses outside of the U.S. because we typically had smaller operations in those areas of the world. We would expect, moving forward, that you'll see our businesses outside the U.S. continue to grow more quickly than we have in the U.S. because, as a global company, our revenues really should look like the global GDP, where 75% of global GDP is outside of the U.S.

**TWST: What metrics are you particularly focused on for that expansion?**

**Mr. Cutler:** In the last 18 months, we've done two very large acquisitions in our electrical business. One was based in Germany, which was the Moeller Group. That acquisition brought us to a much larger scale all through Europe for our electrical business. We also acquired a business that was headquartered in Taiwan with a major footprint in China and Taiwan. This acquisition greatly expanded our Asia-Pacific activities. So if you take those two big moves, that's what moved us past the 50-50 balance between the U.S. and other markets. We've stated a goal by 2010 that we expect to be \$2.5 billion in revenue in the Asia-Pacific region, and we're well on our way to doing that. We tend to see that many of the emerging countries of the world are big consumers of the kind of products that we produce for their infrastructure. So we've been quite bullish in the China and India markets. We've felt that there has been very good growth in Eastern Europe and Russia, although the current liquidity

global liquidity crisis, it affects every economy unlike the traditional recessions that have come out from capacity and inflationary cycles. So virtually all regions of the world were hit very hard. As we look out today, we can see signs of business conditions improving in China and India, and we see some signs of improvement in Brazil. The U.S. is, we think, starting to show signs of deceleration in the rate of decline. I would not pronounce it yet a recovery as many are. And Europe is still struggling to find the bottom. So it's a very inconsistent pattern around the world this year. This year 2009 will be the first year that global GDP has declined since World War II. I think this conveys the magnitude of the severity of this recession.

**TWST: You mentioned decoupling, and I think there's been some evidence that decoupling is happening in some of the BRIC economies, particularly China, India and Brazil, as well — though not so much — Russia.**

**Mr. Cutler:** I would argue that even China was hit very hard. If you look at the third and fourth quarter of last year, and first quarter of this year, China's growth dropped from its recent trend growth rate. So I would say that all regions in the world were heavily affected. What's a little different for China is that they launched a stimulus program earlier than many other countries and actually got the dollars onto the street much more quickly. I think that's the reason we've seen that particular economy come back. Obviously, you have the very bullish election, the Congress party in India, that

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crisis has really flattened a lot of the prospects in Eastern Europe and Russia at this time. But over time we feel it will come back. We've also grown quite quickly in Brazil. And we have growing operations in the Middle East. You may have seen we just formed a small joint venture in the Middle East about a month ago.

**TWST: Would you talk a bit about that?**

**Mr. Cutler:** It's in Abu Dhabi, United Arab Emirates. Initially only about \$10 million in revenue, but what it allows us to do is to have a local assembly capability to support our fast-growing customers in the Middle East.

**TWST: Aside from your prospects for expansion, how has your company been affected by the recession?**

**Mr. Cutler:** We, like many industrial companies, have been heavily affected by the recession. If you looked at our quarterly results, you'll see we've had sales down on the order of 30%, depending upon which of the last several quarters you are looking at. So many of the industrial markets have been hit hard. The liquidity crisis really has reached all segments of the world. I think a year and a half ago, many people were debating whether you would see the so-called decoupling theory prove out — that many of the underdeveloped nations would continue to grow right through this period of weakness. I think what everyone has come to understand is when you have a fundamental

caused many people to feel that, as I think the prime minister said, India is open for business. So there has been a surge of activity there. Then Brazil has been very active in stimulus activity, particularly around the automotive segment, where we've seen some very strong results in Brazil this year. So again, I think where you've seen strength around the world it has been where governments have gotten involved quickly and actively to try to provide some immediate stimulus to help deal with the enormous contraction that took place as liquidity contracted.

**TWST: Given the context of what we're talking about now, about the recession and the prospects that it has for liquidity within the domestic and global economy, how are you planning to maintain your strategy and direction? You state that your company is committed to attaining 10% sales and 15% earnings growth, while growing returns on investments increasingly beyond the cost of capital.**

**Mr. Cutler:** The first two objectives, when faced with an economy like we've seen starting at the end of third quarter of last year and right through now, are to position your company in such a way that it can compete effectively right through the downturn. And unfortunately, that means that a lot of resources have to be reduced. So we, like many other companies, have gone through a

very painful resizing of the company. That's largely behind us at this point. We've been sharing all the information on most programs on a quarterly basis on our conference calls. The second key thing one has to do is to be very, very aware of liquidity. We've been quite successful in producing \$1.1 billion of operating cash flow over the last three quarters. I think during a period of downturn, one of the key elements is the strength of any company's balance sheet. And our balance sheet remains quite strong. Having said that, we have been able to maintain our important R&D and forward-looking marketing programs. We've seen recessions before. We know they have a beginning and an end. And while we are not at the end of this one, we're really trying to manage with an eye toward improved conditions because our customers are going to need the same kind of services we provided historically that really help them get at lowering their energy costs and using energy more effectively and more cleanly.

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**TWST: What is your business model?**

**Mr. Cutler:** Well, that is sort of a broad question. We run our company as an integrated operating company; and when I say that, it is in contrast to a holding company. While we have a number of different business segments that we report on, we do a lot of things in a very common way in the company to really leverage our costs and allow us to invest in our growth. So we have a system that we call the Eaton Business System, which is the holistic system that we utilize to manage the company both inside and outside.

**TWST: What are your priorities for the next four to eight quarters?**

**Mr. Cutler:** In this environment, I think the big priority is to maintain laser-like focus and avoid the temptation to look out too far in terms of the economic environment, because I think everyone has found it has been hazardous when you get these very abrupt changes to try to look out multiple years in terms of forecasting a market. We obviously do that in terms of our R&D because it has a long lead time to it, but we try to stay very focused upon being agile on what has been a rapidly declining worldwide market here. We're continuing to run our daily operations with a pretty tight, short-term look to ensure that we're really putting the right kind of resources in place. So I see the big priorities right now are to make sure the company is sized appropriately and that we have strong liquidity that will allow us to continue to run the company towards opportunities as they emerge. It is still a little murky looking out in terms of markets, unlike three and four years ago, when one could look out nine months and see what markets would look like with a bit more clarity. I would describe this as a time where organizations have to be highly agile. They have to be in a position to quickly change direction, and they've got to have the liquidity to allow them to do so. Those have really been our focus points.

**TWST: How are you ensuring strong liquidity?**

**Mr. Cutler:** It really starts with having a conservative view of your balance sheet capital structure, and we have that at Eaton. We've also been very successful at working down our working capital over the past few months, and I had mentioned that \$1.1 billion of operating cash flow in the past nine months. And then we've been very prudent about watching major commitments for capital expenditures during this time period. Until we can really see markets stabilize, we've been trying to avoid major commitments. That of course is part of what causes the stall in global business conditions. Until businesses can start to see some evidence that markets are really turning up, you're not likely to see broad-based capital expenditures, and without broad-based capital expenditures, you don't tend to get a strong economic environment. That's why it's so important from a government policy point of view that there be real clarity about government policy in each of these regions of the world, particularly in a time when

economies are weak. Spenders tend to be hesitant, and when policies are not clear that puts more risk into the environment, and then people tend to be even more hesitant. I think the areas of the world where you're seeing active investment today are where governments have been quite clear about what the policies and priorities are, and business is starting to move there.

**TWST: Are you withdrawing from markets where you don't see active investment occurring, even if you are already invested?**

**Mr. Cutler:** No, we are not withdrawing. We are obviously involved in running businesses every day. The understandable concern about the short-term business environment is causing the big investments that really start an economy rolling to be delayed. I would describe us in the United States as being in a period of uncertainty. As a result, major new investments aren't being made and people are obviously concerned about unemployment; they are concerned about all the legislation that's potentially ahead of us here over the next year in trying to ascertain what does all of that prospective change mean for the long-term economic growth.

**TWST: What is your competitive advantage?**

**Mr. Cutler:** I think if you talk to our customers, you can get the very best view of our competitive advantage. Eaton has always been a company with very advanced technologies and a tremendous reputation for having been able to apply that technology to commercial advantage for our customers. If you think about the environment that we sit in today, I think virtually everyone would agree that looking forward both as a result of availability and regulation, we're going to see higher and higher costs of energy. That higher cost of energy means that our customers need to find a way to offset that cost with improved efficiency, and we provide many of those technologies that allow them to do that.

**TWST: What are the two or three reasons why investors should look more closely at your company right now?**

**Mr. Cutler:** I think the biggest reason is the prospective of continued, more expensive energy. Eaton is really an enormous play on the increasing cost of energy. We're a diversified industrial company with energy solutions in a variety of fields. So when you think of the balance of our company — we're about 55% outside of the U.S., about 45% in the U.S — about one-third of our businesses hit the peak of their economic activity in the early portion of the economic cycle. About another third hit the middle portion, and another third hit in the late portion. So Eaton is unusually well positioned to compete right through the economic cycle advantageously and regardless of which region of the world is up. In terms of the economic cycle, we're positioned well to take advantage of that as well.

**TWST: What is your background and those of a couple of your key senior executives?**

**Mr. Cutler:** I came up through the operating side of the company. I'm a career Eaton employee.

**TWST: And your executives?**

**Mr. Cutler:** If you took our three Vice Chairmen, the individual who is running our electrical business, Tom Gross, was with Allen-Bradley early in his career and then with Danaher. He has been with Eaton since 2003. Craig Arnold, who runs our industrial sector, spent the early part of his career with General Electric, and he's been with us since 2000. And then Rick Fearon, who is our Chief Financial and Planning Officer, has been with a couple of companies; most recently before Eaton, he was with Transamerica, and he has been with us since 2002.

**TWST: Would you like to add anything else?**

**Mr. Cutler:** I think the issue in and around Eaton that is interesting both to investors and to customers right now is the

enormous transformation that Eaton has been through since the late 1990s. We've become a global company. We were a vehicle components company. Those are the original points of business heritage for the company. Today, we're primarily an electrical, aerospace and hydraulics company. As you've watched us come through what has been the deepest recession since World War II, our diversity has very clearly served us very well. And if you look at the businesses I mentioned, our electrical, hydraulics and aerospace business, they are providing 100% of our profits today because the vehicle markets are obviously in a very challenged time period. Finally, I would say that if investors are convinced that energy costs are going to be higher over any future time period, Eaton is really extremely well positioned to take advantage of that secular trend through both our balance and our technologies.

**TWST: Thank you. (MRR)**

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