



## MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND OPERATING RESULTS

The purpose of this analysis is to provide the reader with an overview of how the financial position of Héroux-Devtek Inc. ("Héroux-Devtek" or "the Company") changed between March 31, 2002 and March 31, 2003. It also compares the operating results and cash flows for the 12-month period ended March 31, 2003 to those for the same period the previous year. This analysis should be read in conjunction with the audited consolidated financial statements dated March 31, 2003.

### Forward-Looking Statements

In the interest of providing shareholders and potential investors with information regarding Héroux-Devtek, including management's assessment of future plans and operations, certain statements in this management discussion and analysis are forward-looking statements subject to risks, uncertainties and other important factors that could cause the Company's actual performance to differ materially from those expressed in or implied by such forward-looking statements.

Such factors include, but are not limited to: the impact of general economic conditions in Canada and the United States; industry conditions including changes in laws and regulations; increased competition; the lack of availability of qualified personnel or management; fluctuations in commodity prices; foreign exchange or interest rates; stock market volatility; and the impact of accounting policies issued by Canadian and U.S. standard setters. Some of these factors are further discussed under Risks and Uncertainties in this management discussion and analysis.

Although the Company believes that the expectations conveyed by the forward-looking statements are based on information available to it on the date such forward-looking statements were made, there can be no assurance that such expectations will prove to be correct. All subsequent forward-looking statements, whether written or orally attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by these cautionary statements.

### Overview

#### *General*

Héroux-Devtek designs, develops, manufactures and repairs systems and components for the aerospace and industrial sectors. Its primary products are landing gear, aircraft structural components and components for aircraft and industrial gas turbines.

The Company was founded in 1942 as Héroux Machine Parts Limited, and later changed its name to Héroux Inc. The Company became public in 1986. In 2000, it acquired Devtek Corporation and the two entities were merged to form Héroux-Devtek Inc., one of the largest second-tier manufacturers in the Canadian aerospace industry.

Héroux-Devtek serves two main market segments: aerospace & defence, and the industrial market. The Company provides the commercial aerospace market with landing gear, airframe structural components and aircraft engine components for business jets and regional jets (less than 100 passengers) and large commercial jets (more than 100 passengers). It also manufactures military aircraft landing gear and supplies parts and repair and overhaul services for military aircraft landing gear. Products for the defence side of the market consist of small arms and related equipment provided to the governments of Canada and other NATO countries.

Héroux-Devtek's main product for the industrial market is large components for gas turbines that generate electricity, with its largest customer being The General Electric Company. It also sells precision components for other industrial applications. The Company's sales by segment are as follows:

	<u>2003</u>	<u>2002</u>
Aerospace & Defence	88%	80%
Industrial	12%	20%
	<u>100%</u>	<u>100%</u>

Héroux-Devtek sells mainly to original equipment manufacturers (OEMs) such as GE, Bombardier and Boeing, and into the aftermarket, where its main customers are the U.S. Air Force and Navy. In fiscal 2003, sales to these main customers represented approximately 65% of the Company's total sales.

Héroux-Devtek is structured around four divisions: landing gear, aerostructure, gas turbine components, and logistics & defence. The Landing Gear Division designs, manufactures, repairs and overhauls landing gear and has built a strong and recognized design engineering team. The Aerostructure Division manufactures very large airframe components. While they continue to report as separate divisions, landing gear and aerostructure were grouped under a single management team in the fall of 2002 to take advantage of operating and administrative synergies. The Gas Turbine Components Division manufactures aircraft engine components and large components for the power generation and other industrial markets. Logistics & Defence manufactures small arms for the defence market. Each division is assigned responsibility for its own market development and operating results in order to foster entrepreneurship and employee involvement. The Company's corporate head office provides support to the divisions and retains responsibility for such areas as global strategic development, financing, legal counsel, human resources and public relations.

### *Business Strategy*

Héroux-Devtek's business strategy is to position itself as a key supplier for its customers in the three pillars of its business: landing gear, aerostructure and gas turbines. For the Company, being a key supplier means providing not only manufactured components but also other services such as design, assembly and program management in order to become a complete service provider and allow customers to focus on their core business. In order to achieve this, the Company aims to develop management and technical expertise so as to add value to products at competitive costs. It also seeks to grow to attain a critical mass in each of its market segments, while maintaining a solid financial position.

In practice, this translates into:

- A focused factory approach, with each plant specializing in a specific type of component.
- Standard, compatible information systems.
- Migration of technical and managerial know-how between divisions.
- A lean manufacturing approach in all its plants.
- Revenue stability through long-term agreements with its customers.

Héroux-Devtek pursues both external and internal growth. It seeks external growth through acquisitions that can be easily integrated into its existing operations or that bring complementary technology leading to greater added value. For internal growth, the Company looks to:

- Develop valued-added, proprietary products through design engineering.
- Establish or enhance its presence in certain product markets, such as the after-market repair and overhaul of commercial and military landing gear, design and manufacturing of small landing gear, and large structural assemblies for commercial and military aircraft OEMs.
- Diversify the customer base for its existing product lines, which generally means finding new OEM customers for its landing gear, airframe structural and aircraft engines components.

#### *Key Performance Indicators*

Héroux-Devtek measures its performance on a company-wide basis through key financial indicators that include sales, gross profit, EBITDA, operating income, working capital, long-term debt-to-equity ratio, and earnings per share. These items are discussed in the appropriate sections under Operating Results, below.

Management also tracks the performance within each division through certain indicators related to operations. These include Return On Net utilized Assets ("RONA"), backlog, value-added as a percentage of sales, percentage of on-time deliveries, non-quality costs, attainment of cost reduction targets, and production capacity utilization.

#### *Market Trends*

In the aerospace industry, there is a broad trend toward OEMs outsourcing manufacturing activities. OEMs are buying more components from increasingly fewer suppliers. They are tending to buy kits for assembly and large sub-assemblies, and to reduce their manufacturing activities in order to concentrate on design and marketing. OEMs are also tending to source their products in lower-cost countries. This is expected to be an ongoing trend.

Within these broader trends, the commercial aerospace market has been in a downturn since 2001. Large aircraft orders are still declining, with Boeing's production alone slashed by 50% in the past two years. Cash flow is still a major issue for airlines, which will continue to maintain pressure on aircraft manufacturers and engine producers, as airline earnings underlie orders for new aircraft. Furthermore, ongoing security concerns and their impact on air travel continue to cloud industry forecasts. Analysts are currently calling for the sector to recover in 2006 on the basis of a typical aerospace cycle of six to nine years.

On the positive side, the airlines are expected to emerge stronger from the industry's restructuring brought on by their financial situation. This was demonstrated on May 12, 2003, when US Airways announced that it had awarded Bombardier Aerospace a contract to build up to 275 regional jets. This also exemplifies what is expected to be a growing trend toward the use of regional jets by major airlines as pilots' unions reluctantly agree to relax the ceiling on the number of regional jets the airlines can use.

The downturn in the aerospace industry also means that competition is fiercer at the supplier level. While this puts pressure on margins, it also leads to supplier consolidation. Given its size and stable financial condition, Héroux-Devtek stands to benefit from consolidation, while smaller suppliers are at risk and may become acquisition opportunities.

The business jet market is currently depressed and is not expected to turn around until after the U.S. economy picks up, possibly in 2005. Nonetheless, sales remain higher than prior to 1999, and new product developments announced in September 2002 signal OEM confidence in the market.

In the interim, regional airlines remain strong, with a 31% increase in air traffic (measured in revenue passenger miles) from 2001 to 2002.

The military market also remains strong. The total U.S. Defence budget is expected to increase by 31% to US\$503 billion from 2003 to 2009. This represents a departure from the spending slowdown of the post cold war era. While budgets for military programs are subject to political climate, the need to modernize military fleets appears to be of high priority.

Several military programs for manned and unmanned vehicles are at various stages of development. Fighter programs such as the F-22, F18 E/F and JSF are moving forward, with a fiscal year 2004 budget of \$US13 billion for the three programs alone.

A strong interest is also clearly emerging in unmanned aircraft vehicle ("UAV") and more specifically in unmanned combat aircraft vehicle ("UCAV") whom objectives are to replace fighter aircraft. The U.S. military is also contemplating replacing its aging fleet of tanker aircrafts.

On the industrial side, the power generation market is also in a downturn. This was reflected in a significant drop in power system orders booked by Héroux-Devtek's main customers in fiscal 2003, and the resulting 53% decrease in its industrial deliveries for the year. This market is not expected to recover before 2006. However, wind energy is proving a fast growing power sector worldwide, surpassing the \$6 billion mark in 2001 and growing 15-20% annually, as countries try to bring down greenhouse gas emissions. In Germany, the largest wind power market ahead of the United States and Spain, the number of installed wind turbines rose 22% in 2002. This sector represents a market opportunity that Héroux-Devtek is currently assessing.

## RESULTS OF OPERATIONS

### Consolidated Sales

Consolidated sales for the year ended March 31, 2003 were \$260.6 million, down 17.6% from sales of \$316.3 million for fiscal 2002.

Sales rose slightly for the Aerostructure Division, but declined for the Company's other divisions, as shown in the following table:

Division	2003 (\$'000)	2002 (\$'000)	% Change
Landing Gear	161,252	174,534	-7.6
Aerostructure	23,986	23,503	+2.1
<b><i>Sub-total</i></b>	185,238	198,037	-6.5
Gas Turbine Components	52,486	89,370	-41.3
Logistics & Defence	22,907	28,873	-20.7
<b><i>Total</i></b>	260,631	316,280	-17.6

### *Landing Gear and Aerostructure Divisions*

During fiscal 2003, the Aerostructure Division was restructured so that it is now under the responsibility of the Landing Gear Division, which shares the same customer and supplier base. This will allow the Aerostructure Division to benefit from the established purchasing, quality, engineering and sales and marketing capabilities of the Landing Gear Division, and enhance the product offering to customers of both divisions.

### *Landing Gear*

The decline in landing gear sales overall reflects the slowdown in the large civil aerospace sector and reduced demand for spare parts for out-of-production aircraft.

As shown in the following table, the weighting of landing gear sales for 2003 shifted slightly from the commercial toward the military sector, and from manufacturing toward repair and overhaul products and services.

	<b>2003</b> <b>(\$'000)</b>	<b>2002</b> <b>(\$'000)</b>	<b>% Change</b>
Military	78,239	72,147	+8.4
Commercial	83,013	102,387	-18.9
<b>Total</b>	<b>161,252</b>	<b>174,534</b>	<b>-7.6</b>
Manufacturing	122,027	138,316	-11.8
Repair and overhaul	39,225	36,218	+8.3
<b>Total</b>	<b>161,252</b>	<b>174,534</b>	<b>-7.6</b>

It should be noted that the Landing Gear Division is continuing to build its engineering department, with new engineering sales of \$3.5 million in fiscal 2003. It also moved to consolidate its operations in 2002-2003 by transferring its DALs operations into its Kitchener operations, a process that is now complete. Furthermore, the Landing Gear Division successfully renewed a three-year labour agreement with unionized employees at its Longueuil facilities in April 2002.

Given the prevailing circumstances in the aerospace industry, it will be a challenge for the Company to maintain its landing gear business volume for the current year. The Company is presently in the bidding process for the repair and overhaul contract with the U.S. Air Force, valued at approximately \$12 million on an annual basis, for which a decision should be made by the customer in the summer of 2003.

### *Aerostructure*

As mentioned above, aerostructure sales rose slightly in fiscal 2003 compared to the previous year, reflecting an increase in market share in the regional jet business. This occurred despite certain manufacturing inefficiencies and rework that impacted deliveries in the last six months of the fiscal year. The situation has been rectified, and deliveries were back on schedule in the last quarter of fiscal 2003.

The Aerostructure Division is in the process of installing a second large piece of equipment at its Dorval plant. Without taking into account this installation, scheduled for completion by the end of June 2003, the current capacity utilization of the Dorval facility was approximately 50% at March 31, 2003. With the goal of increasing capacity utilization, improving efficiency and reducing manufacturing overhead costs, the division is transferring its Metro unit to its Dorval facility in the first half of the current year. This transfer is in line with the Company's strategy of creating centers of excellence.

Although the aerospace industry as a whole is depressed, the regional jet business remains solid. If this situation holds, the Company expects its aerostructure sales to grow in the current year.

### *Gas Turbine Components*

Sales for the Gas Turbine Components Division fell sharply in fiscal 2003. While this was due primarily to unprecedented cancellation of domestic power gas turbine orders, the division also saw sales in its other sectors slip, as shown below.

	<b>2003 (\$'000)</b>	<b>2002 (\$'000)</b>	<b>% Change</b>
Aerospace	21,051	25,948	-18.9
Industrial Gas Turbine	26,891	58,382	-53.9
Other Industrial	4,544	5,040	-9.8
<b>Total</b>	<b>52,486</b>	<b>89,370</b>	<b>-41.3</b>

Industrial gas turbine components alone accounted for \$31.5 million of the total \$36.9 million drop in year-over-year sales. The industrial gas turbine sector is not expected to turn around before 2006. In reaction to this, the Company initiated the process of consolidating its gas turbine component production by merging its Tampa operations into its Cincinnati business unit. Scheduled for completion by the end of the second quarter of the current year, this consolidation resulted in a \$9.2 million restructuring charge and goodwill impairment against earnings for fiscal 2003.

Sales of aircraft engines parts declined during the year due to order push-outs and weaker demand in the civil aerospace products in general. However, the Company expects its share of the aircraft engine parts market to rise in fiscal 2004.

### *Logistics & Defence*

Sales for the Logistics & Defence division fell 20.7% in fiscal 2003 to \$22.9 million from \$28.9 million a year earlier, due to the completion last year of a large accessories distribution contract. The reduction in sales from this contract was partially compensated by increased sales of manufactured products to Norway.

Based on current backlog, the Company expects to maintain its Logistics & Defence business volume in fiscal 2004 at last year's level.

### *Sales by Segment*

The Company's sales by segment and destination were as follows:

<b>Segment</b>	<b>2003 (\$'000)</b>	<b>2002 (\$'000)</b>	<b>% Change</b>
<b>Aerospace &amp; Defence</b>			
Civil	123,982	145,809	-15.0
Military	78,784	76,131	+3.5
Defence	26,430	30,918	-14.5
<i>Sub-total</i>	<b>229,196</b>	<b>252,858</b>	<b>-9.4</b>
<b>Industrial</b>			
Gas Turbine Components	26,891	58,382	-53.9
Other Industrial	4,544	5,040	-9.8
<i>Sub-total</i>	<b>31,435</b>	<b>63,422</b>	<b>-50.4</b>
<b>Total</b>	<b>260,631</b>	<b>316,280</b>	<b>-17.6</b>

Destination	2003	2002
Canada	27.3%	26.3%
US	64.7%	64.2%
International	8.0%	9.5%
	100%	100%

Civil Aerospace sales dropped by 15%, mainly due to sustained reduction in demand for large civil aerospace products and out-of-production aircraft parts. Military aerospace sales remained strong, however, with a 3.5% increase.

Industrial sales decreased by 50% due to significant reduction in industrial power generation market.

#### *New Major Sales Contracts*

During fiscal 2003, the Company announced several major sales contracts.

The Landing Gear Division was chosen by The Boeing Company to design and manufacture the landing gears for the X-45 Unmanned Combat Air Vehicle (UCAV) aircraft, being developed for the U.S. Defence Advanced Research Project Agency and Air Force. The first phase of the program is scheduled to take place over 18 months and will involve the design and manufacture of the first prototypes. Following this phase, the customer can exercise a first option for the production of landing gears for 30 additional aircrafts followed by a second option of up to 150 more units.

During the year, the Landing Gear Division also reported \$71.7 million in new military contracts. These new orders involve the manufacture of landing gear components for the C-5, KC-135, P-3, C130 and F-16 programs, and will be delivered mainly in the next two years.

The Gas Turbine Components Division was selected by G.E. Aircraft Engines to manufacture components for the J85, GE90 and F414 engines. The total value of the contracts is estimated at \$30.7 million and is based on deliveries that will take place through 2007.

#### **Gross Profit**

Consolidated gross profit decreased from 18.0% in fiscal 2002 to 12.4% in fiscal 2003.

#### *Landing Gear*

An increase in deliveries to \$45 million in the fourth quarter of fiscal 2003 had a favourable impact on gross profit for the year, improving the absorption of fixed manufacturing overhead costs. In addition, the Company wrote off \$1.5 million in development cost support program funding consisting of non-interest bearing debt, as the conditions under which repayment is required have not been met. This write-off was fully included under cost of sales as it was related to assets that had already been fully depreciated. Consequently, gross profit for fiscal 2003 remained steady at fiscal 2002 levels.

### *Aerostructure*

Expressed as a percentage of sales, gross profit for the Aerostructure Division decreased by 7.5% in fiscal 2003 compared to fiscal 2002, impacted by the aforementioned manufacturing inefficiencies and rework in the last six months of the year. These factors, combined with a low capacity utilization, reduced deliveries and gross profit below expected levels for 2002-2003. Given the normalization of the delivery schedule in the last quarter of the fiscal year and the potential to increase capacity utilization once the new equipment now being installed is up and running, throughput and margins should improve in the current fiscal year as the Company gains market share in the niches it serves.

### *Gas Turbine Components*

Gross profit for the Gas Turbine Components Division declined 25.4% in fiscal 2003, in part due to the significant reduction in business volume, particularly in industrial gas turbines. While operations in this division are being consolidated, the effect will not be seen until after the transition period. In the interim, the Company is incurring significant unabsorbed manufacturing overhead costs, and recorded a one-time restructuring charges and goodwill impairment of \$9.2 million. (see under Restructuring Charges and Goodwill Impairment below).

### *Logistics & Defence*

Gross profit for the Logistics & Defence Division increased by 1.3% due to a higher manufacturing sales content.

## **Restructuring Charges and Goodwill Impairment**

On the basis of the significant reduction in demand in the industrial gas turbine market, the economic environment in the United States and the Company's manufacturing capacity utilization, management took steps in fiscal 2003 to consolidate production and reduce its fixed manufacturing and general overhead costs. Héroux-Devtek is closing its gas turbine components manufacturing plants in Tampa and transferring production to its plants in Cincinnati. In an effort to minimize the impact on customer deliveries, the Company has provided for a six-month transition period.

In order to account for the closure of the Tampa plants, the Company recorded \$9.2 million in restructuring charges and goodwill impairment in fiscal 2003 to provide for the following:

- The write-down of capital assets to be disposed of;
- Provisions for unused leased equipment;
- Goodwill impairment related to the industrial gas turbine business;
- Other related direct expenses necessary to the realization of the restructuring plan.

Management decided to account for goodwill impairment related to the Company's Gas Turbine Components Division due to the significant reduction in industrial gas turbine business volume. The goodwill impairment represents an amount of \$2.1 million less \$0.9 million due to the write-off of related unused accrued liabilities recorded at the time this division was acquired.



Consequently, the one-time restructuring charges and goodwill impairment taken in fiscal 2003 consist of the following:

	2003 (\$'000)
Restructuring charges recorded in the third quarter	7,376
Restructuring charges in the fourth quarter that could not be accounted for in the third quarter under Generally Accepted Accounting Principles	595
Goodwill Impairment – net	1,206
Total restructuring charges and goodwill impairment	9,177

The impact of these restructuring charges and goodwill impairment on net income represents \$6.5 million, net of income taxes.

### Selling and Administrative Expenses

For reporting purposes, selling and administrative expenses will henceforth include research and development expenses. The selling and administrative expense figure for fiscal 2002 has been restated to reflect this.

As a percentage of sales, fiscal 2003 selling and administrative expenses were comparable to last year's figures, as shown below:

	2003	2002
Selling and administrative expenses (\$'000)	21,339	25,788
% of sales	8.2	8.2

Selling and administrative expenses for fiscal 2003 include \$81,000 in expenses for the granting of stock options following the decision by the Company to expense the cost of stock options. No such expenses were recorded in fiscal 2002. The Company also granted 12,500 stock appreciation rights to its non-employee directors during fiscal 2003. Stock appreciation rights are expensed on an earned basis and their costs are determined based on the excess of the quoted market value of the Company's common shares over their granted value. No expense was recorded for stock appreciation rights in either fiscal 2003 or 2002.

### Operating Income

The table below shows operating income for the Company's two market segments. Operating income for fiscal 2003 does not include the one-time restructuring charge and goodwill impairment of \$9.2 million.

	2003			2002		
	Sales (\$'000)	Operating Income (\$'000)	Operating Income (% of sales)	Sales (\$'000)	Operating Income (\$'000)	Operating Income (% of sales)
Aerospace & Defence	229,196	17,625	7.6%	252,858	22,487	8.9%
Industrial	31,435	(6,589)	(21.0%)	63,422	8,607	13.6%
<b>Total</b>	260,631	11,036	4.2%	316,280	31,094	9.8%

Expressed as a percentage of sales, operating income for the Aerospace & Defence sector dropped 1.3% from 8.9% in fiscal 2002 to 7.6% in 2003. This reduction was mainly due to a 3.5% drop in civil aerospace operating income while military aerospace & defence operating income was similar to last year's level.

Operating income for the Industrial sector dropped 34.6%, essentially in relation to the decline in industrial gas turbine demand.

In total, operating income declined 5.6% to 4.2% in fiscal 2003 from 9.8% in 2002.

### Financial Expenses

Financial expenses amounted to \$2.0 million for fiscal 2003 compared to \$2.2 million last year.

Financial expenses for fiscal 2002 included \$690,000 in interest adjustments related to early repayment of long-term debt following the implementation of the new syndicated loans (see Note 11).

### Income Taxes

In fiscal 2003, the Company recorded an income tax recovery of \$281,000 compared to an income tax provision of \$10.1 million in fiscal 2002, equivalent to a rate of 35% on income before income taxes and goodwill amortization.

This year's tax recovery was mainly impacted by a favourable future income tax adjustment of \$600,000 and by the permanent non-deductibility for tax purposes of the \$1.2 million goodwill impairment included in the restructuring charges and goodwill impairment (see Note 15).

### Net Income

The following table shows net income before and after adjusting for the one-time restructuring charges and goodwill impairment taken in fiscal 2003. It also shows earnings per share on a fully diluted basis, before and after adjusting for the restructuring charges and goodwill impairment. Earnings per share, both basic and diluted, are based on a weighted average of 24,212,864 common shares outstanding in fiscal 2003. In fiscal 2002, they were based on weighted-average of 24,063,038 and 24,345,504 common shares outstanding respectively, for basic and diluted earnings per share.

	2003 (\$'000)	2003 Per share fully diluted	2002 (\$'000)	2002 Per share fully diluted
Net income before restructuring charges, net of income taxes	6,621	\$0.28	17,424	\$0.72
Restructuring charges and goodwill impairment, net of income taxes	(6,467)	(0.27)	-	-
Net income	154	\$0.01	17,424	\$0.72

### LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2003, the Company had cash and temporary investments of \$53 million, compared to \$56 million at March 31, 2002.

In March 2003, the Company extended its \$100 million Unsecured Syndicated Evergreen Revolving Credit Facilities, of which \$36.5 million was used at March 31, 2003 (see Note 13). These facilities can be used to support the Company's operations, future acquisitions and foreign exchange risk.

#### *Operating Activities*

The Company's operating activities provided cash flow as follows:

	2003 (\$'000)	2002 (\$'000)
Cash flow from operations	16,003	32,101
Net change in non-cash items related to operations	733	(4,103)
Cash flow provided by operating activities	16,736	27,998

In fiscal 2003, cash flow from operations was negatively impacted mainly by a \$17.3 million reduction in net income compared to last year, which includes \$4.0 million in cash items included in the restructuring charges (see Note 3). The net change of \$2.9 million in future income taxes also negatively impacted the Company's cash flow from operations, and was partially related to operating losses in the Gas Turbine Components Division.

However, cash flow provided by operating activities was positively impacted in fiscal 2003 by a favourable net change in non-cash items related to operations of \$0.7 million compared to an unfavourable net change of \$4.1 million last year (see under Consolidated Balance Sheet below and Note 16).

#### *Investing Activities*

In fiscal 2003, investing activities used cash flow of \$17.5 million compared to \$32.4 million last year.

Purchase of capital assets totalled \$23.5 million in fiscal 2003 compared to \$30.3 million last year, with \$8.1 million and \$7.4 million of these amounts respectively financed through capital leases. Of the total capital expenditures, \$9.3 million was invested in the Aerostructure Division, consisting of \$7.1 million in new large equipment and \$2.2 million in other machinery and equipment. These expenditures were made to increase production capacity so as to gain market share in the regional jet market. An additional \$8.6 million was invested in the Landing Gear Division and \$5.5 million in the Gas Turbine Components Division.

In fiscal 2003, temporary investments declined by \$2.9 million, compared to a decrease of \$8.6 million last year.

In the current year, the Company will reduce its investments in capital assets to approximately \$15 million. This amount includes about \$5 million for the first phase of modernization of the plating department at the landing gear facility in Longueuil. This modernization will be implemented over the next three fiscal years.

#### *Financing Activities*

In fiscal 2003, financing activities used cash flow of \$3.9 million compared to a cash inflow of \$10.5 million last year.

Cash flow of \$4.6 million was generated in fiscal 2003 through an increase in long-term debt, compared to \$42.4 million last year. This year's amount consists mainly of \$3.2 million in new non-interest bearing loans and a \$1.1 million sale-and-leaseback arrangement relating to machinery and equipment for the Aerostructure Division. In fiscal 2002, following the restructuring of the Company's bank credit facilities, \$40.6 million in new long-term debt was used to repay \$13.3 million in bank loans and \$27.3 million in other long-term debt. The remaining increase in long-term debt last year essentially represented a new, \$1.7 million non-interest bearing loan.

In fiscal 2003, repayment of the long-term debt used cash flow of \$4.1 million compared to \$32.4 million last year. Last year, the Company also used \$10.2 million in cash flow to repay its bank loans.

In August 2002, the Company obtained TSX approval for the repurchase of up to 1,222,195 common shares during the 12-month period ending on August 20, 2003. In May 2003, the Company obtained TSX approval to increase the number of common shares to be repurchased during that period to 1,585,700 shares. At March 31, 2003, the Company had repurchased a total of 934,278 common shares for a cash consideration of \$4.5 million. The excess of the cost of the repurchased common shares over their average book value amounted to \$1.7 million and was accounted for in reduction of the Company's retained earnings.

The balance of the cash flow generated by financing activities in fiscal 2003 was from the issuance of 35,000 common shares related to the exercise of stock options for a cash consideration of \$189,000. In fiscal 2002, the exercise of stock options accounted for the issuance of 152,250 common shares for \$843,000. The Company also issued 1,000,000 common shares last year through a private placement for net proceeds of \$9.9 million.

### Capital Assets

Once the restructuring of the Company's U.S. operations and the transfer of its Metro Machining operations to its Dorval facilities is completed, certain capital assets will be disposed of. The value of these surplus capital assets at March 31, 2003 is shown in the table below, net of their write-down.

	<b>March 31, 2003</b>	
	<b>Cost (\$'000)</b>	<b>Net book value (\$'000)</b>
Land and buildings for resale	7,714	3,816
Machinery and equipment for resale	16,748	733
	<u>24,462</u>	<u>4,549</u>

### Consolidated Balance Sheets

The following table itemizes and explains the significant changes in the consolidated balance sheets between March 31, 2003 and March 31, 2002:

<u>Item</u>	<u>Change (\$ million)</u>	<u>Explanation</u>
Cash and temporary Investments	(3.0)	See statement of cash flows.
Accounts receivable	(11.0)	Related to reduced business volume and an enhanced accounts receivable collection effort in fiscal 2003.
Income tax receivable	3.8	Represents an income tax recovery related to losses incurred in the Gas Turbine Components Division.
Inventories	(2.5)	Related to reduced business volume in fiscal 2003 and improved inventory management in the Aerostructure and Logistics & Defence Divisions.

<u>Item</u>	<u>Change</u> (\$ million)	<u>Explanation</u>
Other assets	(0.8)	Mainly due to early collection of preferred shares representing a balance of sale for a subsidiary disposed of in 1999.
Goodwill	(2.1)	Goodwill impairment related to the Gas Turbine Components Division.
Accounts payable and accrued liabilities	(1.8)	Reduction related to reduced business volume and the related inventory, and the write-off of \$0.9 million in accrued liabilities related to goodwill referred to above. See also Note 3.
Customers' advance	(2.2)	See Note 10.
Long-term debt (including current portion)	2.4	<ul style="list-style-type: none"> <li>• Increase of \$4.6 million in new long-term debt.</li> <li>• \$8.1 million in new capital leases for equipment.</li> <li>• Write-off of \$1.5 million in non-interest bearing debt not requiring repayment under current market conditions.</li> <li>• Capital repayments of \$4.1 million.</li> <li>• Repayment of \$2.5 million in immigrant loans using related investments.</li> <li>• Favourable exchange rate variation of \$2.2 million.</li> </ul>
Capital stock	(2.6)	Represents mainly the repurchase of 934,278 common shares at average book value during fiscal 2003.
Contributed surplus	0.1	Counterpart of the expense related to the granting of stock options in fiscal 2003.
Cumulative translation adjustment	(1.8)	See Note 14.
Retained earnings	(1.6)	See statement of retained earnings.

The Company continues to enjoy a strong balance sheet, which puts it in an excellent position to benefit from the current economic challenges.

The Company's long-term debt-to-equity ratio was 0.51:1 on March 31, 2003 compared to 0.46:1 on March 31, 2002. At year-end 2003, the balance sheet included cash and temporary investments of \$53.0 million, of which \$45.2 million was invested in temporary investments. At March 31, 2002, cash and temporary investments stood at \$56.0 million, including \$42.3 million in temporary investments.

#### **Off-Balance Sheet Items and Commitments**

The Company has entered into operating leases for machinery and equipment amounting to \$19.2 million as of March 31, 2003. These amounts are mainly repayable over the next five years (see Note 18).

In August 2002, the Company entered into a five-year interest rate swap agreement for an amount of US\$10.0 million related to its long-term debt, which fixes the LIBOR interest rate at 4.1% (see Note 4).

At March 31, 2003, the Company also had forward foreign exchange contracts totalling US\$60.5 million at an average exchange rate of 1.5063. These contracts related to its export sales and mature at various dates between April 2003 and September 2007 (see Note 4). This compares to US\$69.0 million in forward foreign exchange contracts held at March 31, 2002 at an average exchange rate of 1.4889.

## **CHANGES IN ACCOUNTING POLICIES AND NEW GUIDELINES**

### *Goodwill Amortization*

Effective April 1, 2002, the Company adopted new Canadian Institute of Chartered Accountants (CICA) recommendations on a prospective basis, and therefore ceased amortizing goodwill and adopted the goodwill impairment model introduced by the new rules. The adoption of these new standards had no significant impact on its financial position as at April 1, 2002. Under the previous accounting rules, the goodwill amortization expense for fiscal 2003 would have amounted to \$1.3 million.

### *Stock-Based Compensation*

Effective April 1, 2002, the Company also adopted the new CICA recommendations with respect to the granting of stock options and stock appreciation rights on a prospective basis. The Company will henceforth expense the granting of all stock options and stock appreciation rights. This expense is included in selling and administrative expenses, and its counterpart, as to the granting of stock options, is included in the contributed surplus shown in the Company's shareholders' equity and, as to the stock appreciation rights, in the Company's accounts payable and accrued liabilities.

### *Disclosure of Guarantees*

In February 2002, the CICA issued accounting guidelines addressing the disclosures to be made regarding the Company's obligation under certain guarantees issued by it. See Note 18 for details on these disclosures.

## **FUTURE CHANGES IN ACCOUNTING POLICIES**

Effective April 1, 2003, the Company prospectively adopted new CICA recommendations relating to impairment, and disposal of long-lived assets and asset retirement obligations. (see Note 2).

## **RISKS AND UNCERTAINTIES**

Héroux-Devtek operates in industry segments that have a variety of risk factors and uncertainties. The Company's business, financial condition and results of operations could be materially adversely affected by any of the risks and uncertainties described below. The risks and uncertainties described below are not the only ones facing the Company. Additional risks and uncertainties not presently known to the Company or that the Company currently believes to be immaterial may also adversely affect its business.

### *Reliance on Large Customers*

The Company has exposure due to its reliance on certain large contracts and customers. The Company's three largest customers account for more than half its sales. Any loss or delay in certain orders from any of these customers could have a negative impact on the Company's results.

### *Operational Risk*

The activities conducted by the Company are subject to operational risks including competition from other businesses, performance of key suppliers, product performance warranty, regulatory risks, successful integration of new acquisitions, dependence on key personnel and reliance on information systems, all of which could affect the ability of the Company to meet its obligations.

### *General Economic Conditions*

Unfavourable economic conditions may adversely affect the business of the Company. For example, the large civil aerospace industry, which represents approximately 15% of the Company's sales, is experiencing considerable turmoil, especially the market for planes with more than 100 seats. Furthermore, the industrial power generation market, which collapsed in 2002, is not expected to recover before 2006. This could adversely affect the Company's financial condition and results of operations. Although long-term growth will likely eventually resume, the timing of that resumption is uncertain, and these sectors will remain cyclical. In addition, curtailment of production activities due to unfavourable economic conditions could result in the Company incurring significant costs associated with temporary layoffs or termination of employees.

### *Military Spending*

Although significant increases in military budgets, particularly in the United States, were announced in the recent years for a period of up to 2009, these expenses are approved by government on a yearly basis and are subject to political climate and changes.

### *Foreign Currency Fluctuations*

The Company is exposed to risks resulting from foreign currency fluctuations arising either from carrying on businesses in Canada in foreign currencies or through operations in the United States. As to its operations in Canada, the Company makes use of derivative financial instruments in order to mitigate these risks.

### *Liquidity and Access to Capital Resources*

The Company requires continued access to capital markets to support its activities. To satisfy its financing needs, the Company relies on long-term and short-term debt and cash flow generated from operations. Any impediments to the Company's ability to access capital markets, including significant changes in market interest rates, general economic conditions or the perception in the capital markets of the Company's financial condition or prospects, could have a material adverse effect on the Company's financial condition and results of operations.

### *Restrictive Debt Covenants*

The contracts governing certain of the Company's indebtedness and syndicated credit facilities contain covenants that, among other things, restrict the Company's ability to:

- sell all or substantially all its assets;
- incur secured indebtedness;
- engage in mergers or consolidations; and
- engage in transactions with affiliates.

These restrictions could impair the Company's ability to finance its future operations or its capital needs, or to engage in other business activities that may be in its interest.

### *Changing Interest Rates*

The Company's profitability may be directly affected by the level of and fluctuations in interest rates. The Company uses derivatives as an integral part of its asset/liability management program to reduce its overall financial risk.

#### *External Business Environment*

The Company faces a number of external risk factors, more specifically, general economic conditions, government policies and changing priorities or possible spending cuts by governments.

#### *Warranty Casualty Claim Losses*

The products manufactured by the Company are complex and sophisticated and may contain defects that are difficult to detect and correct. Errors may be found in the Company's products after they are delivered to the customer. If so, the Company may not be able to correct such errors. The occurrence of errors and failures in the Company's products could result in warranty claims or the loss of customers. Any claims, errors or failures could have an adverse effect on the Company's operating results and business. In addition, due to the nature of the Company's business, the Company may be subject to liability claims involving the Company's products or products for which the Company provided services. The Company cannot be certain that its insurance coverage will be sufficient to cover one or more substantial claims. Furthermore, there can be no assurance that the Company will be able to obtain insurance coverage at acceptable levels and cost in the future.

#### *Environmental Matters*

The Company's activities are subject to environmental laws and regulations associated with risks to human health and the environment. Changes to these laws and regulations could have a significant adverse effect on the Company's operations and financial situation. The Company monitors these risks through environmental management systems and policies.

#### *Collective Bargaining Agreements*

The Company is party to some collective bargaining agreements, which are subject to expiration at various times in the future. If the Company is unable to renew these agreements or others as they become subject to renegotiation from time to time, it could result in work stoppages and other labour disturbances, which could have a material adverse effect on the Company's business.

## **OUTLOOK**

Overall, the Company foresees continued challenges ahead in fiscal 2004. The financial difficulties of the major airlines will maintain pressure on the aerospace industry, and the power generation sector is not expected to turn around in the near term.

In light of this, the Company is pursuing its business strategy in preparation for the eventual upturn in its market segments. It is working to transform its business cost structure by merging operations within its Gas Turbine Components, Landing Gear and Aerostructure Divisions, a process that will also help move Héroux-Devtek toward its goal of creating centres of excellence in the three pillars of its business.

The Company is presently in the bidding process for the repair and overhaul contract with the U.S. Air Force, valued at approximately \$12 million on an annual basis, for which a decision should be made by the customer in the summer of 2003.



## Selected Quarterly Financial Information

	Total (Audited)	First Quarter (Unaudited)	Second Quarter (Unaudited)	Third Quarter (Unaudited)	Fourth Quarter (Unaudited)
<i>For the fiscal year ended March 31, 2003:</i>					
Sales (\$'000)	260,631	69,160	62,299	59,394	69,778
Net income (loss) before restructuring charges and goodwill impairment (\$'000)	6,621	3,017	2,890	(1,946)	2,660
Earnings (loss) per share, before restructuring charges and goodwill impairment (\$)	0.28	0.12	0.12	(0.08)	0.11
Net income (loss) (\$'000)	154	3,017	2,890	(6,814)	1,061
Earnings (loss) per share (\$): Basic	0.01	0.12	0.12	(0.28)	0.04
Diluted	0.01	0.12	0.12	(0.28)	0.04
<i>For the fiscal year ended March 31, 2002:</i>					
Sales (\$'000)	316,280	78,019	76,225	78,911	83,125
Net income (\$'000)	17,424	4,074	4,201	4,620	4,529
Earnings per share (\$): Basic	0.72	0.17	0.17	0.19	0.19
Diluted	0.72	0.17	0.17	0.19	0.18