



CEO's speech at the 2006 AGM

Address by Leif Östling, President and CEO, to the Scania Annual General Meeting, 4 May 2006.

Ladies and gentlemen,

First of all, as President and CEO of the company, I would like to warmly welcome both new and old shareholders to the 2006 AGM. Let me extend a special welcome to the former shareholders of Ainax, now that you have switched from Ainax to Scania. I hope that as direct owners of Scania, you will be satisfied with the performance of our shares.

Scania is a strongly focused company, and our trucks are found in many important areas. You see them often on the roads here in Sweden. Perhaps you are not always so happy about this when you have to overtake them, but they fulfil an important task in our society. The fact is that all growth in cargo flow and transport work over the past 30 years has gone to road transport by truck. This is pleasing to us, but it also means we must assume a big responsibility for our products, as well as for the drivers who use them on the roads. It is important that both they and our products behave in ways that give our industry a good public image.

Scania also builds city buses and regional passenger coaches. Passenger transport services for slightly longer distances – 500 kilometres or so – are in fact being taken over increasingly by coaches. A lot of this transport task is shifting from railways. Again, the same thing applies: Those who drive our buses and coaches on the roads are a source of good publicity for our products.

Our product portfolio also includes industrial and marine engines, a business that Scania has engaged in for more than a century.

Scania performed well in 2005. We increased our volume, our revenue rose by 12 percent and net income was also positively affected, though it did not increase as fast as revenue. There were several reasons for this. The main reasons were currency rate developments in South America and the costs of the changeover to the P- and R-series trucks, plus substantially higher raw material costs in 2005 than in 2004. The doubling of steel prices had its full impact.

The first quarter of 2006 was a good quarter. Order bookings rose nicely and we maintained a high production level. This meant that our revenue was the best we have ever had at Scania in a first quarter. We achieved good net income, an increase of 25 percent, and an operating margin of 12.3 percent. Earnings per share are climbing.

If we look back and compare operating income quarter by quarter, we can see that 2006 started off very well, with the best earnings we have ever had in a first quarter. We are now in an upward cycle, and I believe that it will last for a number of years to come. There is very good underlying demand for transport equipment around the world today.

Order bookings were also at a record level. The first quarter came out very well, compared to what we have seen previously.

Order bookings early this year – as we will also see in our second quarter figures – include a speeding up of heavy truck investments. This is related to the fact that in October this year, new environmental regulations, or emission levels, for trucks and buses are being introduced in Europe. There are a number of customers who are buying up the slightly cheaper products available today, which are less technically advanced and not as environmentally friendly as the ones coming in October.

Thus, to some extent, the good order booking figures that we are seeing right now are an effect of pre-buying. We don't know how large this effect is. It will be very interesting to see how our order bookings develop after this year's summer holidays.

Turning to market developments and beginning with Europe, we are seeing how the new economies are beginning to take off. This includes extensive construction activity and exports of raw materials, minerals, oil and gas from Russia, for example. The European Union has been enlarged. This means that many activities have started up in these countries, and this requires transport equipment. Meanwhile a lot of jobs, especially in the manufacturing sector, are moving from the high-cost countries of western Europe to the new EU member countries, which also generates transport work.

In Europe as a whole, looking from here to the Ural mountains and across the west Siberian lowlands east of the Urals, where much of the gas and oil deposits are located, there is very good demand for both new and used vehicles. In Scania's case, we actually have a certain shortage of used vehicles. This is something I have not previously experienced, during all the years that I have been in this industry.

Turning to buses, in Europe we are seeing somewhat weaker demand early in the year, compared to strong demand in 2005. It is not really clear to us why this is the case, but we know that a number of major bus operators – Connex, to mention one example – have not been as active in the market in 2006 as they were last year. We will have to see how things change during the year.

We also have very good demand for industrial and marine engines – in fact a record level. We have never seen such high demand, not only in Europe but also elsewhere in the world, as we do right now.

Quite a lot of this is due to the strong economic growth in central and eastern Europe. Many generator sets and similar kinds of equipment are needed.

What about Latin America? There the market is always going up and down. During a ten-year period they have four or five good years, followed by two or three problem years. We are hoping that this type of behaviour in the region becomes part of history, but one can never be certain.

Right now, generally speaking, there is very good demand in South America. This is related to exports of various kinds of raw materials – minerals, iron ore – but also to strong demand for agricultural products around the world, and the continent is a major exporter of agricultural products. This means there is money in most of these countries.

We have seen very good market performance in all countries except Brazil, which had a weak second half of 2005. We believe things will be a little better during 2006, which is an election year.

The bus and coach market has been good outside of Brazil; the fact that it has not been

good in Brazil is also related to its being an election year. However, we are seeing a strong demand for our industrial and marine engines in the region.

As for Asia and Oceania, we see how demand has improved in South Korea and Taiwan, where we have had a presence for more than 25 years. We are working to develop our sales and service network in China. In the market niches where our high-tech, high-performance products can operate – such as container transport services, hauling chemicals to processing plants, the steel industry, the pulp and petrochemical industries – there is now continuous growth, so we should see a rather favourable market trend for the type of products that we offer.

In Japan, we are slowly developing our partnership with Hino. Orders for a couple of hundred trucks are coming in each year.

I recently said that India is an attractive market. We have been studying India for a long time. We have a number of business acquaintances over there who, for a number of years, have been trying to persuade us to enter India, but we have not yet seen a market in India for the type of products we offer. We can see this from the number of vehicles that Volvo, our colleague and competitor, sells in the Indian market.

But now we think that things are beginning to happen in India that are of interest to us. This applies to the expansion of infrastructure such as motorway networks, and India is beginning to adopt logistics management rather similar to what we have in Europe. Today Indian companies are exporting many products to different markets around the world. This is why I have said that we will take another close look at India. At a later AGM, I will be back to report how this is going.

The Middle East and Africa are old markets for Scania. We have been in the Middle East since the 1950s, and we are seeing extremely good demand there. Turkey is forging ahead steadily, and demand is constantly increasing. Business is also very good in the Gulf states, and likewise in Saudi Arabia.

But we are also seeing good demand for trucks and buses in east Africa, in countries like Ethiopia, Kenya and Sudan. From Lake Victoria south, towards Tanzania and South Africa, we see how the market is continuously growing. Today we have a good structure and organisation there, and good market shares. This is true of both trucks and buses, and we see that investments are also being made in industrial and marine engines, especially in generator sets and water pumps of various kinds.

What is the growth picture like at Scania? We have grown by about 5-6 percent a year. The curve slumps about once every ten years. Right now we are in the midst of a growth period between two slumps. How the slumps will look in the future is closely connected with how stable economic growth will be in the new economies entering the global market.

Scania needs its growth, for two reasons. We need it so that we can continue developing our products. Looking back at our product development costs since the early 1970s, I can say that over these decades, we have continuously spent about 4 percent of our revenue in order to be competitive in our markets and also enter new markets and market segments. This means that in the future, in order to keep up, our revenue will have to grow at 5-6 percent a year.

Our sales growth creates a fleet of vehicles, which are a market for our service-related products. At the turn of the millennium we had about 400,000 active vehicles in our various markets. These vehicles need parts, maintenance and servicing. It is important to bring

these vehicles into our organisation so that we can earn money on this.

Our target is to build 100,000 new vehicles per year by around 2010. I don't think this will happen, but in any case we are aiming for 90,000 – 100,000 within the not too distant future. The fleet of Scania vehicles on the roads is growing in an interesting way. Of course this will provide us with fine business opportunities in our various markets – but only if we have a highly skilled, smart service organisation that can take care of this in a stringent, efficient way.

This means that in recent years, we have increased Scania's focus on providing services. Today the number of employees in our sales and service operations is about 40 percent of total employees, compared to about 10 percent in 1990. Of Scania's total non-current assets, excluding Customer Finance, about 50 percent are in this business today, compared to 20 percent 15 years ago. This implies that Scania has shifted its focus from being a pure vehicle manufacturer to being a combined vehicle and service supplier to its customers.

Personally, I believe that this on-going process of moving closer to the customer will not stop at the current percentage of our total employees, but instead we will see further growth in this area ahead. There are a number of factors pushing in that direction.

Providing service also involves a lot of parts sales, and that is a very profitable element of Scania's overall business.

What we are doing is investing in enlarging our service business and focusing more of our attention on it. This is why we have changed the structure of our sales organisation, both at corporate level and at country level, in order to make our organisations more efficient and smarter. Having previously taken care of servicing chassis, we are moving towards servicing whole transport fleets, what we call *fleet management*.

The new structure of our commercial operations implies that we are gathering all Scania-owned sales companies and service workshops around the world into one organisational unit, in order to benefit from economies of scale when it comes to corporate administration, certain common marketing activities aimed at major customers with large fleets and common IS/IT systems and structures. We are also co-ordinating these operations to benefit from common administration and from building and establishing service workshops in a standardised way, so we know that they are functioning smoothly and providing efficient handling and repairs of our products. We can also centralise a large proportion of the purchasing done today locally in each service company. In this way, we can win price concessions from suppliers, since we will be buying in larger volume.

Here I would like to touch on what we usually call Scania's leadership. An organisation like ours is of course always a matter of people. Despite all our investments in machinery and equipment, we depend on people. They are the ones who make everything work and ensure that we earn a good return on invested capital.

In the Scania Group, we have special leadership principles that we work with.

We must always co-ordinate our efforts – but at the same time we must work independently. This may sound like a paradox, but it is necessary. Independence means that you are in charge of certain matters and take responsibility for them, and that everyone in the organisation feels they not only *should* take responsibility but that they also *can and are allowed to* take responsibility.

In an organisation like this, success always depends on details. You could say that on the path to success, the devil is in the details. Without working with details in a disciplined way, you cannot succeed – but you also have to understand the big picture in order to handle the details in a way that is efficient and good for the overall process.

We tell our employees: Act now! If you see something that you feel must be dealt with, do it! Don't stand and wait for an order from a superior. Take initiatives. Do your job. But think long-term when you act.

Knowledge is extremely important. In an organisation like ours, the refinement of knowledge is what yields productivity improvements. This is achieved only by having high stability among employees and working with continuous learning. We can stimulate a sense of commitment by getting all the people in the organisation involved in the tasks at hand, regardless of where in the hierarchy these tasks are located.

We have watched the number of vehicles per employee in our production organisation gradually climb. Here we are counting all employees, including Per Hallberg, the man in charge of the whole thing. From producing about 2.5 vehicles per employee each year in 1990, we reached 5.6 in 2005, and we will be a bit above 6 vehicles this year. This is the way we count our increases in productivity. And if we can work with our leadership principles and with the systems, methods and models we have in our organisation, this trend will continue – we see no upper limit.

A “learning organisation” is entirely a matter of leadership. Motivational leadership is what we need to persuade people to continuously learn new things and continuously make improvements in their work with details, in their day-to-day job and in the organisation.

Being a learning organisation is responsible for most of the productivity improvement that I referred to earlier – from 2.5 to 6 units per employee. About two thirds of this is related to human factors: learning and the methods we work with in our organisation.

Then there are the other elements related to investments and restructuring efforts. We have absorbed quite a few restructuring expenses at Scania over the years.

By shrinking our number of production units during the 1990s, we moved component production from the Netherlands to Oskarshamn and Falun, Sweden. We considered starting component production in France too, but never did. We made a big change when we closed our bus factory in Katrineholm and moved all its operations to Södertälje. Now we are in the midst of another painful process: bringing together gearbox production and axle production in a single location, Södertälje, while outsourcing a number of components that we make today – but that are not critical to product quality – to external suppliers.

This is a painful process. It has also meant that employees have become disappointed, especially in Falun. This found its expression in a major downturn in the work pace for three or four weeks. We now have a delay in our delivery plans of about one week. Now we – employees and company management – have begun to reach a mutual understanding as to why these changes must be implemented. Since Easter, production has run very smoothly in Falun. We have begun to refill what we lost in our buffer stocks, and during May and June we will catch up with the existing delay.

This shows once again that, even in such a stressful situation, we have wonderful dedication and support in our organisation – even when we must tackle and implement difficult decisions. I am deeply impressed by the loyalty of all our employees, especially in Falun and Sibbhult during this very tough period, and by the fact that people have not lost

their sense of dedication.

As for product development, we have launched new buses and coaches and have added a lot of new features to our trucks. But the big news right now in connection with product development is engines that will meet the coming environmental standards. Of our research and development money, today about 60 percent is related to environmental issues.

We have gone through a fairly intensive period, and we have a fairly intensive period ahead of us over the next two years. That is the explanation, in case you think our development costs are relatively high. Still, they are no higher than they have historically been – usually around 4 percent of revenue.

We focus on the driver, who is absolutely the most important factor for us. Having properly used, well-trained drivers can mean transport costs 20 percent lower than with drivers who handle their vehicles carelessly. This applies to the costs of fuel, repairs and maintenance. The difference between a really good and a really bad driver is actually that much.

That is why we must do everything we can to help transport companies train the drivers who use our products. A Scania is good, but is actually no better than the driver makes it.

We will continue with the Young European Truck Driver competition, which we implemented in 2003 and 2005. In 2007 we will make it into a global competition. The purpose is to give drivers a little excitement and at the same time make them aware that they are important, that they have status and that we recognise that they mean a lot not only to a haulier's bottom line, but also serve as good ambassadors for the transport industry generally and for our products out on the roads.

We are a supplier that lives in a partnership with the customer. Such partnerships are often very old relationships. Customer loyalty towards us in all markets is between 75 and 80 percent. In 75-80 percent of our transactions, the customer comes back to us. Clearly when they do so, we have a well-established partnership with the customer.

Before I close, I would like to thank all our customers for the trust you show our organisation. We are grateful for the privilege of working together with you.

I would also like to take this opportunity to express my gratitude to all employees of the Scania organisation, who are the other side of the partnership, for their very fine contributions in sales, service, product development and production. Thank you for your superb contributions during 2005! We will certainly have to work hard during 2006 as well.