This 3DAdvisors Report Covers:	
✓	**Insider Trading**: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
	Governance: Corporate Governance Issues

Insider Selling Tied to Deteriorating Financials
ITT Industries, Inc. (NYSE: ITT)

July 14, 2003

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ITT Industries, Inc. is a global multi-industry company engaged, directly and through its subsidiaries, in the design and manufacture of a wide range of engineered products and the provision of related services. The Company has four principal business segments. Fluid Technology is engaged in the design, development, production, sale and after-sale support of products, systems and services used to move, measure and manage fluids. Defense Electronics and Services develops, manufactures and supports high-technology electronic systems and components, and provides communications systems and engineering and applied research. Motion and Flow Control comprises a group of units operating in the motion control and flow control market segments. Electronic Components develops and manufactures connectors, interconnects, cable assemblies, switches, key pads, multi-function grips, panel switch assemblies, dome arrays, input/output card kits and LAN (local area network) components.

Summary of 3DAdvisors Findings for ITT

- **Insider Trading:** Convergence of insiders is the first clue
- **Accounting:** Pension issues are causing a longer than expected hang over
- **Accounting:** Strained cash flow may limit financing options

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Discussion of 3DAdvisors Findings

Insider Trading: Convergence of insiders is the first clue

A surge of insider distribution at ITT Industries caused us to lift a few rocks to see what may be lying underneath. We found it fascinating how this convergence of selling occurred just prior to the departures of both CFO David Anderson, who had defected to Honeywell in June, and Gerard Genron, who resigned his position as president of the electronic-components group at about the same time.

To us, it seemed odd that a Company CFO would leave, just prior to mid-year forecast activities. The correlated selling activity by a group of remaining insiders (read: who were not leaving the company) provided more clues that begged for follow-up.

The first thing we noticed, with regards to ITT's insider picture, was the sales by director **Rand Araskog**. Now we usually don't focus on director activity but Araskog has proven to be a savvy insider whose actions, with regards to stock trading, have generally proved quite prescient over the years. Prior to this, he had not sold an ITT share since February of 1999. At that time, it was a 200,000-share sale, and it occurred in the $38 to $39 range. By the following February, ITT shares were trading in the low $20's. This is only one example of his timing. There are many more.

This time, he's dropped 100,000 ITT shares in the $65 range. This represents almost 48% of his position. There were a host of other insider sellers as well, all selling between mid May and early July at prices ranging from $62 to $65.75 each. This convergence is very interesting to us, as these individuals, as a group, have not moved collectively in such a short time period before:

Louis Giuliano (56) - Chairman and CEO. Giuliano exercised options that had been exercisable since 1995 and sold the underlying 198,028 shares. These options were not set to expire until October 2004. The sale was large for Giuliano's profile. In fact, not only was it his largest we've seen, it was his first since back in March of 1999. This trimmed his actionable holdings (exercisable options and common stock) by 20%.

Vincent Maffeo (52) - General Counsel. Maffeo cleared out of two options series held, selling the underlying 49,000 shares in the process. The options involved had been vested since January of 1999 and would not have expired until March 2007 at the earliest. This was Maffeo's largest sale on record and it trimmed his actionable position by 27%.

Edward Williams (64) – CFO. Williams' appointment to the vacated CFO position was announced on June 16th. Williams, a 16-year ITT veteran, was controller prior to his promotion. His exercise, and sale, of long-vested options (not set to expire until October of 2004) totaling 24,084 shares occurred in late May, about a month prior to his promotion. It would seem that the timing of his sale might have coincided with the exit of former CFO Anderson. This was Williams' first, and largest sale since October of 2001.

Brenda Reichelderfer (44) - President of ITT's Electronic-Components Group. Newly appointed as president of the group, Reichelderfer's sale takes on similar traits as the others, as she too exercised long-vested options not set to expire until at least January of 2008. Her exercise of 17,000 options, and their subsequent sale, was her first we've seen on record.

Martin Kamber (54) - Senior V.P., Corporate Development. Kamber exercised options for 16,000 shares (options exercisable since April of 2001 and not expiring until January of 2010) and sold them.

It is very rare to see recently promoted insiders selling. It is more common to see a "gung-ho!" type attitude in such individuals. We certainly do not normally see selling by them. In the cases of Edwards and Reichelderfer, we have two doing so. Their actions give us the impression that internal problems may have forced the exit of their former comrades, resulting in "Battlefield Promotions" being thrust upon on them. Could it be that they are less-than-enthused by the problems facing them in their new positions?

Accounting: Pension issues are causing longer than expected hang over

ITT bit the Pension bullet, hard, in F/Y 2002. The Company was forced to lower its assumptions on Expected Return on Plan Assets from 9.61% to 8.86%. Of more significance may have been the effect of lowering the Discount Rate assumption from 7.14% to 6.44%. This latter number worked havoc on the under-funded status of Pension's huge Benefit obligation, causing the Company to register the largest Minimum Pension Liability adjustment, $1.07 billion, we've seen for a company of this size. To give you an example of the significance of the lowered Discount Rate assumption, the 70 basis point decrease dropped the Pension's funded status from under-funded by $383.5 million to under-funded by $1.3 billion.

The corresponding charge to Equity, for the period, of $785 million pared Shareholders' Equity by 40%. This was far higher than the $470 million charge some on Wall Street had expected, and this was after the Company had contributed $50 million to the Pension in Q4 of 2002.

ITT followed up the Q4 Pension contribution with another $200 million in Q1 of 2003. The Company states further that it may face an additional contribution burden of between $200 and $400 million three to four years out. Certainly, this drain on cash resources would seem to limit future opportunities (read: acquisitions) as the Company focus must shift towards maintaining its current financial profile in the face of the significant constraints represented by its Pension burden.

Certainly, the ITT Pension situation is hardly new news. Wall Street seems to be betting that the worst is behind the Company, though. From their $60 level, on January 1st, ITT shares dropped 17% to $50 by late March when the 10K, revealing the Pension details, came out. We all know that they have rallied back in the current market environment. Interestingly enough, even in the face of a continuing strong stock market rally, the momentum in ITT share price seems to have stalled, and at the same time that those key executive resignations and the corresponding insider selling have surfaced.

Accounting: Strained cash flow may limit financing options

First Quarter, 2003 earnings got a big boost from a large $61 million tax refund. The payment allowed the Company to recognize interest income of $22.1 million in the quarter. This resulted in a net interest income (ITT nets interest income against interest expense) of $15.1 million for the quarter. The interest income, from the refund, represented about $0.17 of the reported $0.94 basic EPS for the Q1 period or about 18% of EPS.

It should be stated here that the Company did not try to hide the above fact. The Company's rather tepid forecast for 2003 stated that "Higher taxes, including the absence of a $61.2 million tax refund, are the primary reason that the Company anticipates lower EPS, in 2003, of $3.70 to $3.90.

There may have been other reasons behind the less-than-enthusiastic outlook. Another situation we're monitoring is the fact that ITT's Free Cash Flow moved into negative territory in Q1, and this is the case even *after* you back out the $200 million Pension Prepayment. It clearly appears that Q1 Free Cash Flow was negative to the tune of about $40 million. We went back a few years, looking for cyclicality, and did not spot a period where Cash from Operations weakened to this extent on a regular basis. One of the culprits here is a jump in Accounts Receivables, which increased $100 million during the period. The Company blamed this on "increased sales volume weighted toward the end of the quarter." Whatever the reason, the fact stands that DSO's jumped eight days, during the period, to 70 days. Checking back to 1996, this is the highest level we've seen.

ITT has a big reliance on its Commercial Paper program and related revolving credit facilities in order to supplement its Cash From Operations. If cash flow continues to tighten as it has in Q1, the reliance on these programs becomes more critical and these credit facilities tightened up in Q1. The Company financed its Q1 $200 million Pension Contribution by utilizing its Commercial Paper and revolving credit agreements. These facilities (both Commercial Paper and Revolver) are capped at total of $1 billion. After the Q1 Pension contribution, borrowings under these facilities approximated $540 million, up from $282 million at Y/E 2002 but not enough to threaten the cap. However, it did show that financing options, under current facilities, are reduced in the absence of a revised strategy.

In the current environment of cautious banking behavior, a strategy geared to rely on Commercial Paper seems inappropriate. Or does such a strategy exist out of necessity? It would seem that ITT's financing options are limited in the face of the pension issues and their balance sheet impact, other than perhaps further divestitures to raise cash. This is probably why the more expensive short term Commercial Paper route was taken (for the Pension contribution) as opposed to lower cost, longer-term solutions. We take this as a signal not of impending doom, but rather, a question as to whether the debt and capital structures are well positioned for the long haul. To this we would add that it does not seem to be the greatest time to be seeing the CFO defecting. Ditto for the insider selling during a time when it would appear (in the eyes of Wall Street at least) that the worst is over for this one.