

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

Results of Operations

Business Overview

While employment conditions were poor and personal spending was sluggish during the first half of the year, Japan's economy started on a slow path to recovery during the fiscal year ended May 31, 2004. Factors contributing to this recovery included an increase in exports accompanying the recovery of overseas economies, primarily in the U.S. and China, and the increased private capital investment that resulted from improved business performance. On the other hand, the Iraq situation generated global instability, while higher oil prices and other issues fueled concern, and the situation continued to defy an optimistic outlook.

In the pharmaceutical industry, reform of the health care system continued to force down drug prices, and a drug price revision was implemented in April 2004. In addition, because of the need for large-scale R&D, such as for genetic drug discoveries, there have been large mergers and widespread changes among companies that are now battling for survival.

In the chemicals industry, although demand for digital home electronics and other IT-related demand continued to increase and remained strong overall, increasing competition with neighboring countries resulted in falling prices and a harsh environment for the industry in some areas.

Under these conditions, at Nippon Kayaku we have been engaged in structural reforms which include the following:

- (1) Development and marketing of new products in growth markets
- (2) Qualitative strengthening and streamlining of the company's sales power
- (3) Restructuring of matured fields and strengthening of our business base
- (4) Strengthening of business support for management divisions, and the introduction of an ERP (Enterprise Resource Planning) system to streamline our indirect business.

As a result, sales and income increased in the fiscal year ended May 31, 2004. Solid demand in the fine chemicals business, including strong manufacturing and sales of polarizing film by Polatechno Co., Ltd., helped to make up for a decline in the pharmaceutical business caused by the April 2004 revision of drug prices and by overall increased competition.

Net Sales

Net sales in the fiscal year ended May 31, 2004 were ¥128.016 billion, up ¥4.585 billion (3.7%) over the previous fiscal year. Net sales for the entire Group were 133% of the sales for the parent company alone.

Cost of Sales; Selling, General and Administrative Expenses

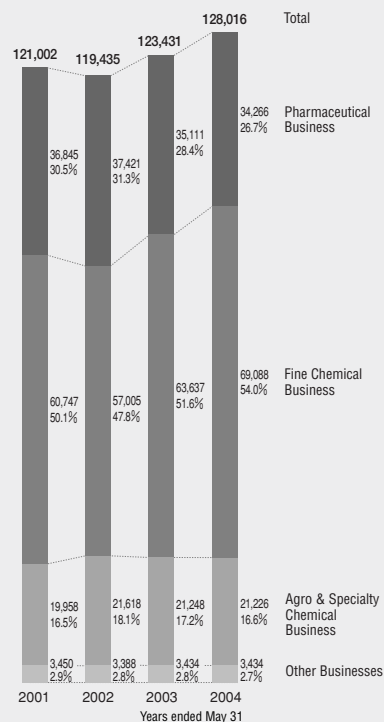
The cost of sales in the fiscal year ended May 31, 2004 was ¥81.621 billion, up ¥2.618 billion (3.3%) from the previous fiscal year, but declining 0.2 percentage points to 63.8% as a percentage with respect to net sales. Selling, general and administrative expenses in the fiscal year ended May 31, 2004 were ¥36.297 billion, an increase of ¥1.566 billion (4.5%) from the previous fiscal year.

Operating Income

Operating income in the fiscal year ended May 31, 2004 was ¥10.097 billion, up ¥399 million (4.1%) from the previous fiscal year and remaining constant at 7.9% as a percentage with respect to net sales.

Sales by Business Segment

(Unit: million yen)



* In June 2001 the Pharmaceuticals Group, Specialty Chemicals Division and the Fine Chemicals Group, Agro & Fine Chemicals Division were reorganized to become the Agro & Specialty Chemicals Group, Agrochemicals Division and Specialty Chemicals Division.

* Sales data for the fiscal year ended May 31, 2001 was calculated after reorganization of the business into three groups.

Operating Performance by Business Segment

[Pharmaceutical Business]

Sales in the pharmaceutical business for the fiscal year ended May 31, 2004 were ¥34.266 billion. While we worked primarily to expand sales of our existing products, we faced increasing competition for our main products, the effects of the drug price revision, and other factors. As a result, net sales declined by ¥844 million (2.4%) from the previous fiscal year.

Among pharmaceutical products for the Japanese domestic market, sales increased for SALIGREN capsules (drug for treatment of dry mouth syndrome), ASTRIC DRY SYRUP (anti-virus chemotherapy drug), and MS-TWICELON capsules (sustained release drug for cancer pain). However, sales of other products, including FARESTON tablets (anti-cancer drug) and RANDA injections (anti-cancer drug) declined, resulting in an overall decrease in net sales from the previous fiscal year.

Exports of the anti-cancer drug BLEO increased; however, those of another anti-cancer drug, ETOPOSIDE, fell below the previous fiscal year level.

For our diagnostic agents, sales increased for LANAZYME ST-439 PLATE, used in the diagnosis of breast cancer, while sales fell for LANA 1,5 AG AUTO LIQUID, a diabetes diagnostic agent.

Overall operating income in the pharmaceutical business for the fiscal year ended May 31, 2004 was ¥5.048 billion, down ¥1.004 billion (16.6%) from the previous fiscal year.

[Fine Chemical Business]

Due to growing demand for the materials that are used in IT-related products and digital home electronics, Sales in the fine chemical business for the fiscal year ended May 31, 2004 increased by ¥5.451 billion (8.6%) from the previous fiscal year to reach a total of ¥69.088 billion.

In the inflator business, sales of airbag inflators were up, due to strong sales of vehicles equipped with these products. Sales also grew for the micro gas generators that are used in seatbelt pretensioners, and business performance overall rose above the level of the previous fiscal year. Sales at both Indet Safety Systems a.s. (Czech Republic) and LifeSparc Inc. (U.S.) exceeded their previous fiscal year levels.

In the catalyst business, sales of catalysts used for acrylic acid production—our primary product—continued at the same level as the previous fiscal year.

Performance in the functional materials business increased both for domestic sales and exports. There was particular growth in sales of lens resins for projector televisions and resins for DVD optical discs. Sales of functional colors and thermal inks were also strong, and a recovery in demand for epoxy resins boosted sales of these products to above the level of the previous fiscal year. At Polatechno Co., Ltd., sales of projection materials and polarizing films were strong, and increased from their previous fiscal year levels.

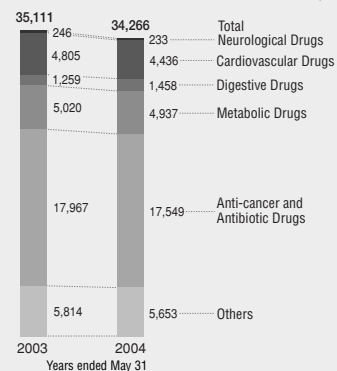
In the color chemicals business, sales of colors for color inkjet printers were strong and increased from the previous fiscal year. However, the sluggish state of the dyeing industry reduced demand for textile dyes, while falling prices and lower demand reduced sales of special non-textile dyes used for paper pulp. As a result, the overall performance of this business was lower than the previous fiscal year.

Sales in the explosives business also declined, due to lower demand from civil engineering projects.

Overall operating income from the fine chemicals business in the fiscal year

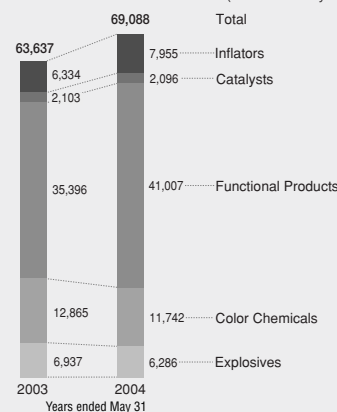
Sales of the Pharmaceutical Business

(Unit: million yen)



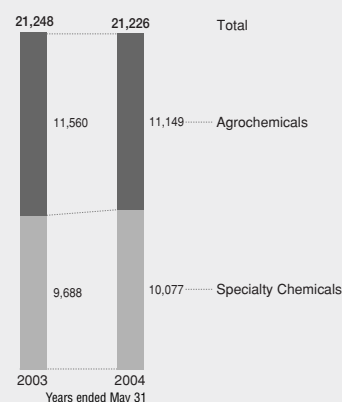
Sales of the Fine Chemical Business

(Unit: million yen)



Sales of the Agro & Specialty Chemical Business

(Unit: million yen)



ended May 31, 2004 was ¥8.170 billion, an increase of ¥2.269 billion (38.5%) over the previous fiscal year.

[Agro & Specialty Chemical Business]

Sales of the agro & specialty chemical business in the fiscal year ended May 31, 2004 were ¥21.226 billion, down ¥21 million (0.1%) from the previous fiscal year.

Performance in the agrochemicals business declined as a result of lower domestic sales.

Sales in the specialty chemicals business rose due to an increase in the level of already-consigned products and also to rising sales of preservatives and other products produced by Nippon Kayaku Food Techno Co., Ltd.

Overall operating income from the agro & specialty chemicals business in the fiscal year ended May 31, 2004 was ¥585 million, down ¥420 million (41.8%) from the previous fiscal year.

[Other Businesses]

Sales from other businesses in the fiscal year ended May 31, 2004 were ¥3.434 billion, on the same level as the previous fiscal year. Operating income was ¥1.408 billion, an increase of ¥170 million (13.8%) from the previous fiscal year.

Other Income and Expenses

Interest and dividend income in the fiscal year ended May 31, 2004 was ¥312 million, while interest expense was ¥402 million. Other net expenses decreased by ¥743 million to ¥1.066 billion (41.1%). This decrease was primarily due to the elimination of the write down on investment securities that was calculated in the previous fiscal year.

Income before Income Taxes and Minority Interests

As a result of the above, our income before income taxes and minority interests in the fiscal year ended May 31, 2004 was ¥8.941 billion, an increase of ¥1.297 billion (17.0%) from the previous fiscal year.

Income Taxes

Income taxes for the fiscal year ended May 31, 2004 were ¥3.964 billion, down ¥183 million (4.4%) from the previous fiscal year.

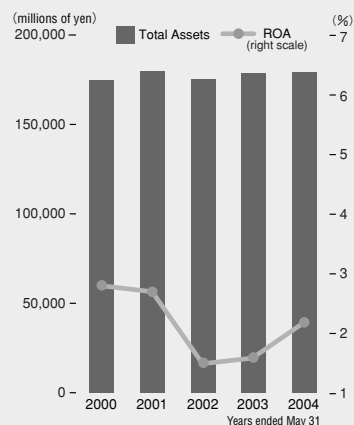
Minority Interests

Minority interests in the fiscal year ended May 31, 2004 were ¥1.050 billion, up ¥335 million (46.9%) from the previous fiscal year.

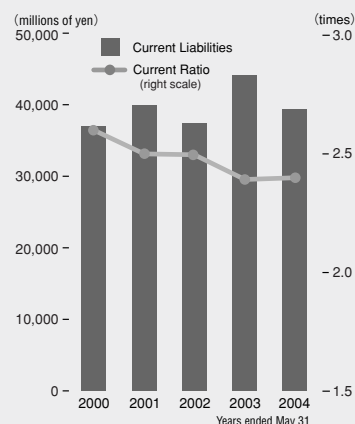
Net Income

Net income in the fiscal year ended May 31, 2004 was ¥3.926 billion, an increase of ¥1.145 billion (41.2%) from the previous fiscal year. The ratio of net income to net sales rose 0.8 percentage points this fiscal year to 3.1%. For the entire Group, net income in the fiscal year ended May 31, 2004 was 103% of that for the parent company alone. Net income per share was ¥21.22.

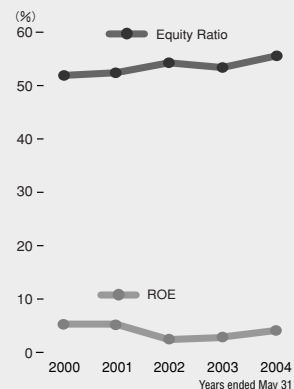
Total Assets/ROA



Current Liabilities/Current Ratio



Equity Ratio/ROE



Financial Conditions

Total Assets

Total assets on May 31, 2004 were ¥179.823 billion, an increase of ¥706 million (0.3%) from the end of the previous fiscal year.

Current Assets

Cash and cash equivalents on May 31, 2004 totaled ¥17.402 billion, a decrease of ¥8.229 billion (32.1%) from the end of the previous fiscal year. Time deposits were ¥10 million, a decrease of ¥1.181 billion (99.2%). Marketable securities were ¥988 million, a decrease of ¥12 million (1.2%). Trade receivables amounted to ¥47.966 billion, an increase of ¥3.3 billion (7.4%). Inventories were ¥23.11 billion, an increase of ¥323 million (1.4%), and deferred income taxes were ¥2.013 billion, an increase of ¥408 million (25.4%). Other current assets decreased by ¥210 million (8.7%) to ¥2.210 billion. As a result, total current assets were ¥93.651 billion, a decrease of ¥5.571 million (5.6%) from the end of the previous fiscal year.

Property, Plants, and Equipment; Investments and Other Assets

The value of property, plants, and equipment on May 31, 2004 totaled ¥57.069 billion, down ¥939 million (1.6%) from the end of the previous fiscal year. Accumulated depreciation was ¥115.496 billion. The total value of investments and other assets was ¥29.102 billion, an increase of ¥7.218 million (33.0%) from the end of the previous fiscal year.

Liabilities

Current liabilities on May 31, 2004 were ¥39.389 billion, a decrease of ¥2.676 billion (6.4%) from the end of the previous fiscal year. Non-current liabilities were ¥34.157 billion, a decrease of ¥1.012 billion (2.9%).

Shareholders' Equity

Shareholders' equity was ¥100.207 billion on May 31, 2004, and the equity ratio rose 2 percentage points to 55.7% compared to the previous fiscal year.

Cash Flows

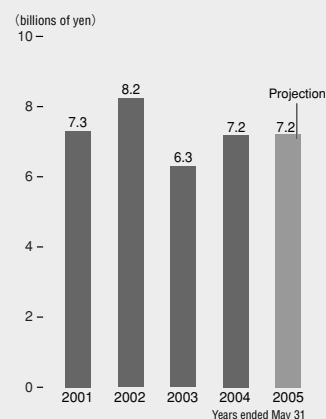
Cash flows from operating activities decreased by ¥7.579 billion from the previous fiscal year to ¥4.644 billion. This decrease was primarily due to the change from a rising trend to a falling trend in notes and accounts payable, and to the increase in the amount of income taxes paid.

The net cash expended in investment activities increased by ¥4.664 billion to ¥11.360 billion. The primary causes of this increase were the purchase of Moxtek, Inc. by Polatechno Co., Ltd. and the acquisition of 100% overseas subsidiaries involved in the inflator business.

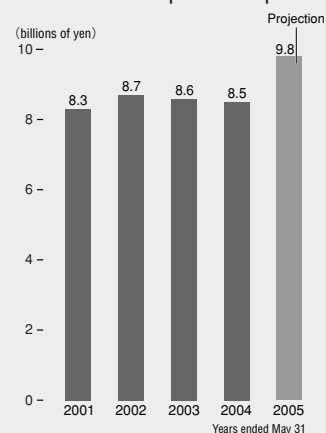
Due primarily to the proceeds from long-term debt, cash flows from financing activities increased by ¥4.361 billion from the previous fiscal year, to a net expenditure of ¥1.445 billion.

As a result of the above, cash and cash equivalents on May 31, 2004 decreased from the end of the previous fiscal year by ¥8.228 billion to ¥17.402 billion.

Plant & Equipment Investment



Research & Development Expenditures



Depreciation Expense

