

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

## Results of Operations

### Business Overview

During the first half of the fiscal year ended May 31, 2005, Japan's economy was in a state of recovery as a result of such factors as increased capital investment and expanding exports. During the second half, however, the future became unclear, because of skyrocketing crude oil and other raw material prices.

During the first half of the year, the chemicals industry showed robust performance, thanks to rising demand for digital home electronics and other IT-related products. In the second half, however, the business environment turned harsh as the IT field entered an adjustment period.

In the pharmaceuticals industry, drug prices were revised in April 2004 and the trend toward controlling the cost of drugs became even stronger. As well, global competition in the research, development, and sale of new medicines has become even more intense and has developed into a competition of survival between companies.

In the midst of such circumstances, the Nippon Kayaku Group has promoted (1) development and introduction of new products in growth fields, (2) qualitative strengthening and improved efficiency of business capabilities, (3) restructuring of the fine chemicals business and strengthening of the operating base, and (4) qualitative strengthening and improved efficiency of the Administration Group and the support organization.

As a result, the functional chemicals business began to show robust performance, covering the decline in the pharmaceuticals business caused by the effects of drug price revisions. Thus, the fiscal year ended May 31, 2005 produced more revenue and greater profit than the previous fiscal year.

### Net sales

In the fiscal year ended May 31, 2005, net sales reached 134.205 billion yen, an increase of 6.188 billion yen (4.8%) from the previous fiscal year. Net sales for the entire Group were 137% of the net sales for the parent company alone.

### Cost of Sales; Selling, General and Administrative Expenses

In the fiscal year ended May 31, 2005, the cost of sales was 86.062 billion yen, an increase of 4.441 billion yen (5.4%) from the previous fiscal year. It was also up 0.3% from the previous fiscal year to 64.1% as a percentage with respect to net sales. Selling, general and administrative expenses in the fiscal year ended May 31, 2005 were 37.963 billion yen, an increase of 1.676 billion yen (4.6%) from the previous fiscal year.

### Operating Income

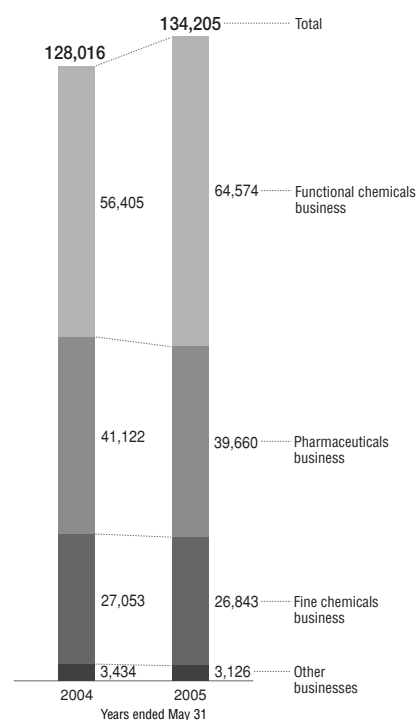
In the fiscal year ended May 31, 2005, operating income was 10.166 billion yen, an increase of 68 million yen from the previous fiscal year (0.7%). It was down 0.3% from the previous fiscal year to 7.6% as a percentage with respect to net sales.

### Operating Performance by Business Segment

As of the fiscal year ended May 31, 2005, the type-based business segments have changed. Therefore, when comparison is made with a previous fiscal year, the results from the previous year's segment are accordingly reclassified to correspond to the segment that applies after the change.

## Sales by Business Segment

(Unit: million yen)



### [Functional Chemicals Business]

In the fiscal year ended May 31, 2005, sales for the functional chemicals business reached 64.574 billion yen, an increase of 8.169 billion yen (14.5%) from the previous fiscal year.

In the functional materials business, sales of special epoxy resins for semiconductor encapsulation, UV-curing-type resins, and high-performance chemicals were up from the previous fiscal year, but sales of general-purpose chemical products were down from the previous fiscal year due to a stoppage in the production and sale of some products.

In the electronic materials business, sales of products such as colors for color inkjet printers, lens resins, LCD sealants, and resins for optical disks went smoothly and were up from the previous fiscal year. Also, optical films, Polatechno's polarizing plate business, and plasma display films did well, surpassing sales from the previous fiscal year.

In the catalysts business, sales of catalysts for acrylic acid manufacturing increased, surpassing sales from the previous fiscal year.

In the safety systems business, domestic and export sales of airbag inflators went well and were up from the previous fiscal year. Also, sales of micro gas generators for seatbelt pretensioners went smoothly at overseas subsidiaries (Europe and the United States), and saw a rise from the previous fiscal year.

In the fiscal year ended May 31, 2005, overall operating income for the functional chemicals business was 7.147 billion yen, an increase of 239 million yen (3.5%) from the previous fiscal year.

### [Pharmaceuticals Business]

Sales amounted to 39.66 billion yen, a decrease of 1.462 billion yen (3.6%) from the previous fiscal year.

Pharmaceutical products for the Japanese domestic market include new products "IA CALL" (anti-cancer drug) and "IMMUCYST" (anti-cancer drug), which contributed to sales; as well as "SALIGREN Cap." (drug for treatment of dry mouth syndrome) and "CARBOMERCK" (anti-cancer drug), the sales of which were strong, surpassing the previous fiscal year. On the other hand, sales of "AREDIA" (osteoclastic inhibitor) were down from the previous fiscal year due to changes in sales affiliations, while sales of "MILLISROL Inj." (vasodilator), "FARESTON Tab." (anti-cancer drug), "ODYNE tab." (anti-cancer drug), and "RANDA Inj." (anti-cancer drug) were down due to the effects of drug price revisions and other factors.

In the area of exports, ETOPOSIDE (anti-cancer drug) sales were up from the previous fiscal year, while BLEO (anti-cancer drug) sales remained at the same level.

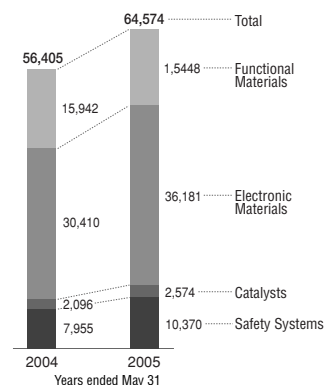
As for active pharmaceutical ingredients (API), sales of pharmaceutical bulk were up from the previous fiscal year, and sales of health food bulk by Nippon Kayaku Food Techno Co., Ltd., went well, surpassing sales from the previous fiscal year.

In the area of diagnostic agents, sales of "LANAZYME ST-439 plates" (breast cancer diagnostic agent) went smoothly, but remained at the same level as the previous fiscal year.

In the fiscal year ended May 31, 2005, overall operating income for the pharmaceuticals business was 4.86 billion yen, a decrease of 442 million yen (8.3%) from the previous fiscal year.

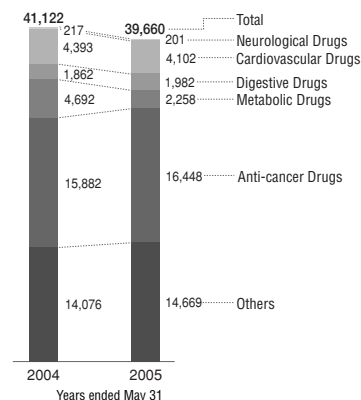
### Sales of the Functional Chemicals Business

(Unit: million yen)



### Sales of the Pharmaceuticals Business

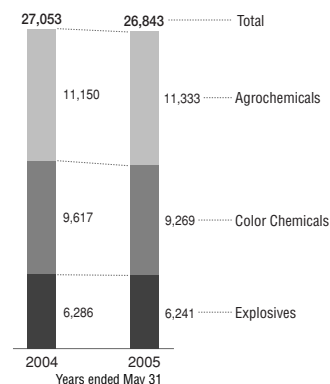
(Unit: million yen)



\* Sales by drug category are the results for domestic sales.

### Sales of the Fine Chemicals Business

(Unit: million yen)



**[Fine Chemicals Business]**

In the fiscal year ended May 31, 2005, sales for the fine chemicals business amounted to 26.843 billion yen, a decrease of 209 million yen (0.8%) from the previous fiscal year.

Domestic sales for the agrochemicals business declined, but thanks to an increase in exports, total sales were up from the previous fiscal year.

In the color chemicals business, domestic demand for textile dyes declined and was down from the previous fiscal year.

In the explosives business, sales were down from the previous fiscal year, due to a decline in domestic demand.

In the fiscal year ended May 31, 2005, overall operating income for the fine chemicals business was 1.887 billion yen, an increase of 115 million yen (6.5%) from the previous fiscal year. This was largely the result of cost reductions.

**[Other Businesses]**

In the fiscal year ended May 31, 2005, sales from other businesses were 3.126 billion yen, a decrease of 308 million yen (9.0%) from the previous fiscal year.

Overall operating income from other businesses was 1.482 billion yen, an increase of 74 million yen (5.3%) from the previous fiscal year.

**Other Income and Expenses**

In the fiscal year ended May 31, 2005, interest and dividends received amounted to 349 million yen, while interest paid was 416 million yen. Other expenses (net) amounted to 305 million yen, an increase of 1.371 billion yen (128.6%) from the previous fiscal year.

**Income before Income Taxes and Minority Interests**

From the aforementioned results, income before income taxes and minority interests in the fiscal year ended May 31, 2005 was 10.404 billion yen, an increase of 1.462 billion yen (16.4%) from the previous fiscal year.

**Corporate Tax**

In the fiscal year ended May 31, 2005, corporate tax was 4.067 billion yen, an increase of 103 million yen (2.6%) from the previous fiscal year.

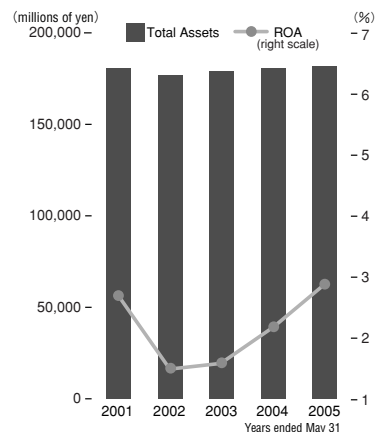
**Minority Interests**

In the fiscal year ended May 31, 2005, minority interests amounted to 1.02 billion yen, a decrease of 29 million yen (2.9%) from the previous fiscal year.

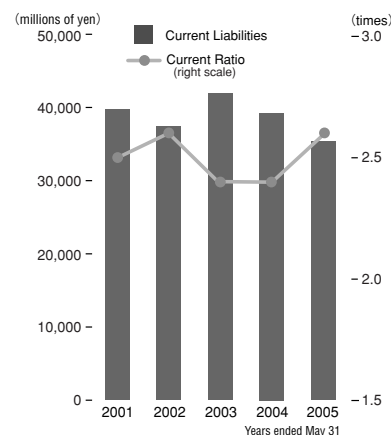
**Net Income**

In the fiscal year ended May 31, 2005, net income was 5.315 billion yen, an increase of 1.389 billion yen (35.4%) from the previous fiscal year. It improved 0.9% from the previous fiscal year to 4.0% as a percentage with respect to sales. In the fiscal year ended May 31, 2005, net income for the entire Group was 112% of the net income for the parent company alone. Net income per share was 28.87 yen.

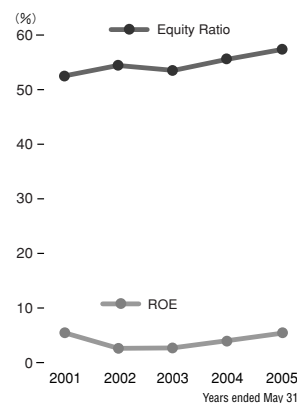
**Total Assets/ROA**



**Current Liabilities/Current Ratio**



**Equity Ratio/ROE**



## Financial Condition

### Total Assets

As of the end of May 2005, total assets were 181.364 billion yen, an increase of 1.541 billion yen (0.9%) from the end of the previous fiscal year.

### Current Assets

As of the end of May 2005, the balance of cash and cash equivalents was 17.191 billion yen, a decrease of 211 million yen (1.2%) from the end of the previous fiscal year. Time deposits were 26 million yen, an increase of 16 million yen (160%) from the end of the previous fiscal year. Trade receivables were 46.523 billion yen, a decrease of 1.443 billion yen (3%) from the end of the previous fiscal year. Inventories were 24.144 billion yen, an increase of 1.034 billion yen (4.5%) from the end of the previous fiscal year; and deferred tax assets were 2.01 billion yen, a decrease of 2 million yen from the end of the previous fiscal year. Other current assets were 2.866 billion yen, a decrease of 332 million yen (10.4%) from the end of the previous fiscal year. As a result, total current assets were 92.716 billion yen, a decrease of 935 million yen (1.0%) from the end of the previous fiscal year.

### Property, Plant and Equipment; Investments and Other Assets

As of the end of May 2005, the value of property, plant and equipment was 57.533 billion yen, a decrease of 463 million yen (0.8%) from the end of the previous fiscal year. Accumulated depreciation was 116.935 billion yen. The total value of investments and other assets was 31.115 billion yen, an increase of 2.013 million yen (6.9%) from the end of the previous fiscal year.

### Liabilities

As of the end of May 2005, current liabilities were 35.509 billion yen, a decrease of 3.879 billion yen (9.8%) from the end of the previous fiscal year. Fixed liabilities were 35.237 billion yen, an increase of 1.08 billion yen (3.2%) from the previous fiscal year.

### Shareholders' Equity

As of the end of May 2005, shareholders' equity was 103.81 billion yen and the equity ratio was 57.2%, an increase of 1.5% from the previous fiscal year.

## Cash Flows

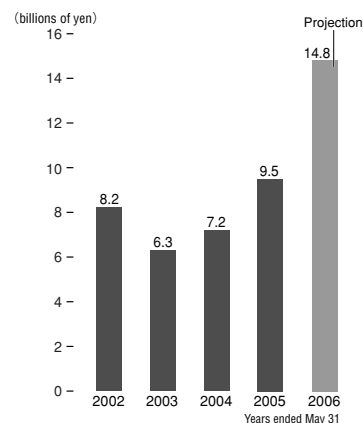
Cash flows from operating activities increased by 7.515 billion yen from the previous fiscal year to 12.16 billion yen. This increase was primarily due to the change from a rising trend to a falling trend in notes and accounts receivable, and to the decrease in the amount of corporate taxes paid.

Cash flows from investment activities showed a decrease in expenditures of 3.595 billion yen from the previous fiscal year to 7.765 billion yen. This decrease was primarily due to a decrease in expenditures from subsidiary stock acquisitions.

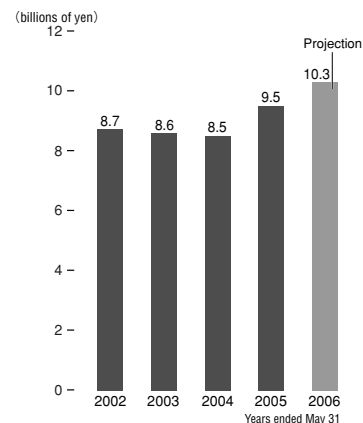
Cash flows from financing activities showed an increase in expenditures of 3.027 billion yen from the previous fiscal year to 4.473 billion yen. This increase was primarily due to expenditures from the redemption of corporate bonds.

As a result of the aforementioned activities, the balance of cash and cash equivalents as of the end of May 2005 decreased by 211 million yen from the end of the previous fiscal year to 17.191 billion yen.

## Plant & Equipment Investment



## Research & Development Expenditures



## Depreciation Expense

