

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

## Results of Operations

### Business Overview

Despite high raw material costs due to the soaring price of oil, Japan's economy during the fiscal year ended May 31, 2007 on the whole remained on a recovery course, as evidenced by an active increase in capital investment backed by strong corporate performance, and by improvements in the hiring and personal income environments.

The chemical products industry, centering on digital home electronics and other IT-related fields, was generally headed toward expansion. But conditions remained difficult due to the effects of rising raw material costs caused by continuing high oil prices, and also due to falling product prices and inventory adjustments.

In the pharmaceuticals industry, in addition to the lowering of drug prices in April of last year, trends toward increased use of generic drugs and other steps aimed at controlling the cost of medicines became even stronger. At the same time, global competition in the research, development, and sale of new drugs intensified as a fight for survival among companies unfolded.

In the midst of such conditions, the Nippon Kayaku Group is aiming to raise its corporate value and become a company capable of sustained growth. For this purpose, we have invested business resources in key fields, worked to strengthen overseas operations and cut costs, and taken steps to improve profits.

As a result, and due to growth in our functional chemicals business and pharmaceutical business, the fiscal year ended May 31, 2007 produced more revenue than the previous fiscal year. Also, the profit was bigger than the previous fiscal year thanks to factors such as increased sales in the pharmaceuticals business.

### Net sales

In the fiscal year ended May 31, 2007, net sales reached 148.124 billion yen, an increase of 8.097 billion yen (5.8%) from the previous fiscal year. Net sales for the entire Group were 143% of the net sales for the parent company alone.

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

In the fiscal year ended May 31, 2007, the cost of sales was 93.537 billion yen, an increase of 6.462 billion yen (7.4%) from the previous fiscal year. It was up 0.9 percentage points from the previous fiscal year to 63.1% as a percentage with respect to net sales. Selling, general and administrative expenses in the fiscal year ended May 31, 2007 were 41.05 billion yen, an increase of 1.319 billion yen (3.3%) from the previous fiscal year.

### Operating Income

In the fiscal year ended May 31, 2007, operating income was 13.536 billion yen, an increase of 316 million yen from the previous fiscal year (2.4%). It was up 0.3 percentage points from the previous fiscal year to 9.1% as a percentage with respect to net sales.

### Operating Performance by Business Segment

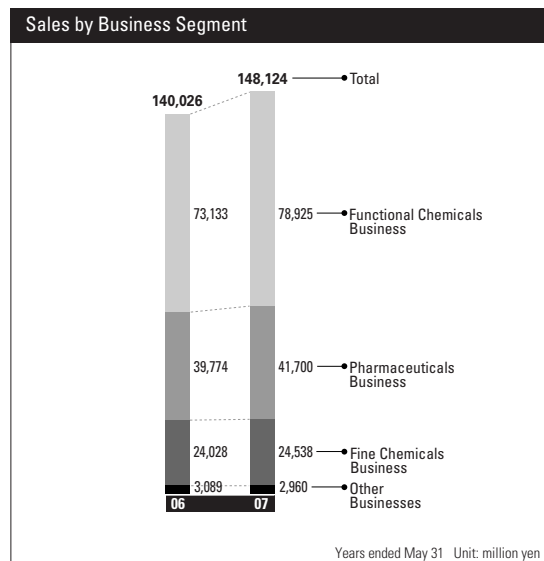
#### [Functional Chemicals Business]

In the fiscal year ended May 31, 2007, sales for the functional chemicals business reached 78.925 billion yen, an increase of 5.792 billion yen (7.9%) from the previous fiscal year.

In the functional materials business, sales of special epoxy resins for semiconductor encapsulation were higher than the previous fiscal year, however sales of UV-curing resins were lower. Due in part to the transfer of our polymer flocculent business, performance for the functional chemicals business as a whole was below the level of the previous fiscal year.

In the electronic materials business, sales of colors for inkjet printers were up from the previous fiscal year, while sales of resins for optical discs were down. In the area of optical films, sales of films for plasma displays were lower than the previous fiscal year, however Polatechno's polarizing film business was strong and exceeded the level of the previous fiscal year. Overall, sales in the electronic materials business were up from the previous fiscal year.

In the catalysts business, sales of catalysts for acrylic



acid and methacrylic acid manufacturing went smoothly, surpassing sales from the previous fiscal year.

In the safety systems business, sales of airbag inflators and micro gas generators for seatbelt pretensioners were both strong, and were up from the previous fiscal year.

Due to factors such as falling product prices and rising costs, overall operating income for the functional chemicals business was 8.307 billion yen, a decrease of 1.869 billion yen (18.4%) from the previous fiscal year.

#### [Pharmaceuticals Business]

In the fiscal year ended May 31, 2007, sales for the pharmaceuticals business amounted to 41.7 billion yen, an increase of 1.925 billion yen (4.8%) from the previous fiscal year.

Among pharmaceutical products for the Japanese domestic market, our new product "PACLITAXEL Inj. NK" (anti-cancer drug) made a large contribution to sales. In addition, sales of "EPIRUBICIN Inj. Merck" (anti-cancer drug), "CARBOMERCK" (anti-cancer drug), "IA-CALL" (arterial injection anti-cancer drug), "IMMUCYST" (anti-cancer drug), as well as introduced-product "CALSED" (anti-cancer drug) all were strong, and exceeded the levels of the previous fiscal year. On the other hand, due to the effects of competitor products and other issues, sales of "FARESTON Tab." (anti-cancer drug), "RANDA Inj." (anti-cancer drug) and "MILLISROL Inj." (vasodilator) were down from the previous fiscal year. Overall, sales of pharmaceuticals for the Japanese domestic market were

up from the previous fiscal year.

In the area of exports, sales of BLEO (anti-cancer drug) and ETOPOSIDE (anti-cancer drug) were higher than the previous fiscal year, while sales of active pharmaceutical ingredients were lower. Overall, exports were down from the previous fiscal year.

Sales of active pharmaceutical ingredients to the Japanese domestic market were higher than the previous fiscal year, thanks to strong sales of active pharmaceutical ingredients for generic pharmaceuticals.

In the area of diagnostic agents, sales of "LANAZYME ST-439 Plates" (breast cancer diagnostic agent) and "LANA 1,5AG" (diabetes diagnostic agent) were down from the previous fiscal year.

Overall operating income for the pharmaceuticals business was 7.475 billion yen, an increase of 1.975 billion yen (35.9%) from the previous fiscal year.

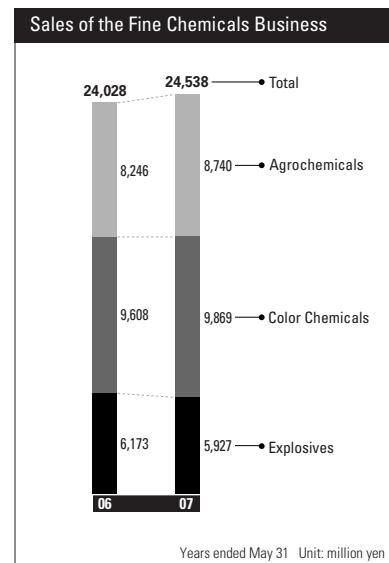
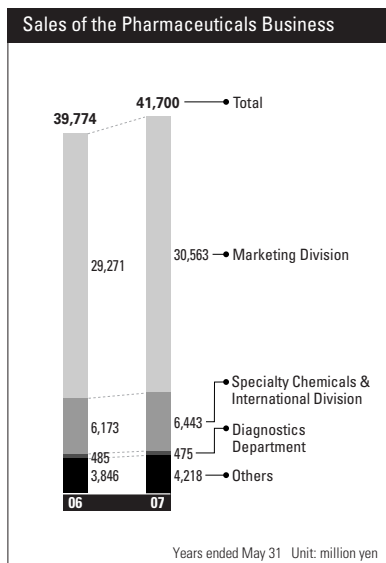
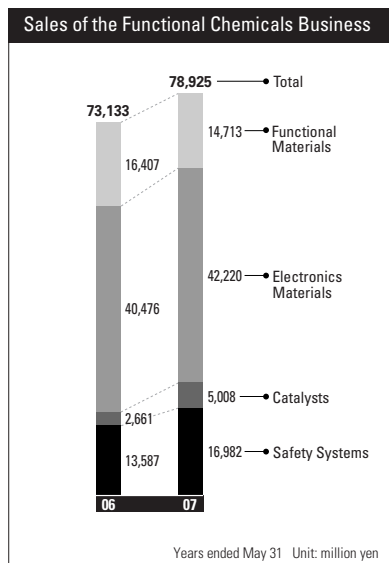
#### [Fine Chemicals Business]

In the fiscal year ended May 31, 2007, sales for the fine chemicals business amounted to 24.538 billion yen, an increase of 509 million yen (2.1%) from the previous fiscal year.

In the agrochemicals business, both domestic sales and exports were strong, and exceeded the levels of the previous fiscal year.

In the color chemicals business, sales from our overseas subsidiaries were strong, and were up from the previous fiscal year.

In the explosives business, sales were down from the



previous fiscal year, due to the effects of declining demand from civil engineering and stonecrushing applications.

Overall operating income for the fine chemicals business was 1.84 billion yen, a decrease of 44 million yen (2.3%) from the previous fiscal year.

#### [Other Businesses]

In the fiscal year ended May 31, 2007, sales from other businesses amounted to 2.96 billion yen, a decrease of 128 million yen (4.2%) from the previous fiscal year.

Operating income was 1.592 billion yen, an increase of 66 million yen (4.3%) from the previous fiscal year.

#### Other Income and Expenses

In the fiscal year ended May 31, 2007, interest and dividends received amounted to 361 million yen, while interest paid was 450 million yen. Other expenses (net) amounted to 161 million yen, an increase of 5.246 billion yen (97.0%) from the previous fiscal year.

#### Income before Income Taxes and Minority Interests

From the aforementioned results and due to absence of last year's profits from the sale of a former company housing site, income before income taxes and minority interests in the fiscal year ended May 31, 2007 was 13.608 billion yen, a decrease of 5.02 billion yen (26.9%) from the previous fiscal year.

#### Corporate Tax

In the fiscal year ended May 31, 2007, corporate tax was

5.503 billion yen, an increase of 1.866 billion yen (25.3%) from the previous fiscal year.

#### Minority Interests

In the fiscal year ended May 31, 2007, minority interests amounted to 1.494 billion yen, a decrease of 122 million yen (7.6%) from the previous fiscal year.

#### Net Income

In the fiscal year ended May 31, 2007, net income was 6.61 billion yen, a decrease of 3.03 billion yen (31.4%) from the previous fiscal year. It was down 2.4 percentage points from the previous fiscal year to 4.5% as a percentage with respect to sales. In the fiscal year ended May 31, 2007, net income for the entire Group was 152% of the net income for the parent company alone. Net income per share was 36.37 yen.

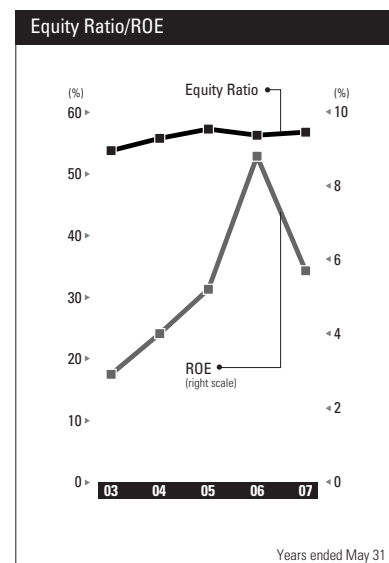
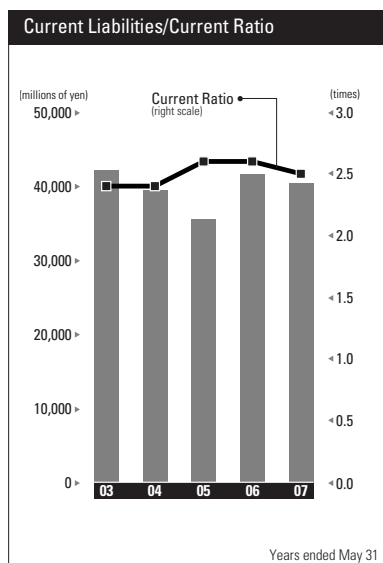
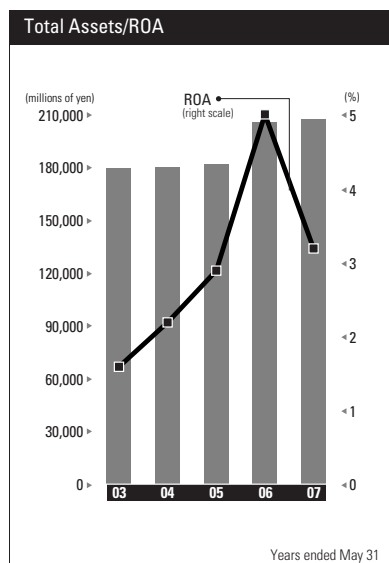
### Financial Condition

#### Total Assets

As of the end of May 2007, total assets were 207.081 billion yen, an increase of 1.772 billion yen (0.9%) from the end of the previous fiscal year.

#### Current Assets

As of the end of May 2007, the balance of cash and cash equivalents was 25.589 billion yen, an increase of 4.164 billion yen (19.4%) from the end of the previous fiscal year.



Time deposits were 109 million yen, an increase of 67 million yen (159.5%) from the end of the previous fiscal year. Trade receivables were 46.213 billion yen, an increase of 585 million yen (1.3%) from the end of the previous fiscal year. Inventories were 26.18 billion yen, a decrease of 469 million yen (1.8%) from the end of the previous fiscal year; and deferred tax assets were 2.422 billion yen, an increase of 254 million yen (11.7%) from the end of the previous fiscal year. Other current assets were 2.216 billion yen, a decrease of 5.087 billion yen (69.6%) from the end of the previous fiscal year. As a result, total current assets were 102.661 billion yen, a decrease of 5.983 billion yen (5.5%) from the end of the previous fiscal year.

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

As of the end of May 2007, the value of property, plant, and equipment was 69.783 billion yen, an increase of 7.028 billion yen (11.2%) from the end of the previous fiscal year. Accumulated depreciation was 118.857 billion yen. The total value of investments and other assets was 34.636 billion yen, an increase of 727 million yen (2.1%) from the end of the previous fiscal year.

### Liabilities

As of the end of May 2007, current liabilities were 40.316 billion yen, a decrease of 1.302 billion yen (3.1%) from the end of the previous fiscal year. Fixed liabilities were 36.531 billion yen, a decrease of 128 million yen (0.3%) from the previous fiscal year.

### Net Assets

As of the end of May 2007, net assets were 130.233 billion yen, an increase of 3.203 billion yen (2.5%) from the previous fiscal year.

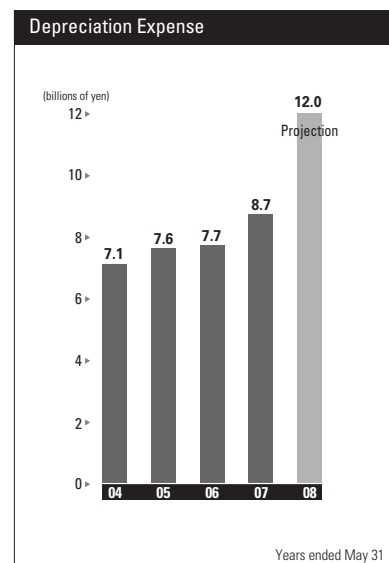
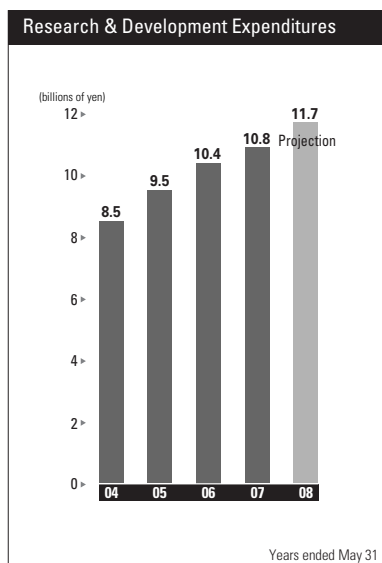
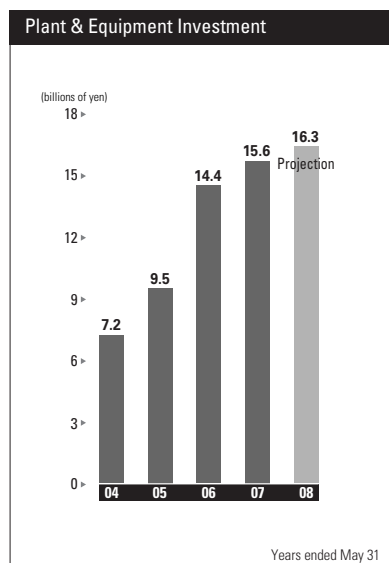
### Cash Flow

Cash flow from operating activities increased by 8.409 billion yen from the previous fiscal year to 20.201 billion yen. This increase was primarily due to a reduction in inventory assets.

Cash flow from investing activities showed an expenditure of 17.882 billion yen, an increase in expenditures of 10.78 billion yen from the previous fiscal year. This decrease in cash flow was primarily due to a decrease in revenue from the sale of tangible fixed assets and to an increase in expenditures for the acquisition of tangible fixed assets.

Cash flow from financing activities increased by 2.742 billion yen over the previous year, to record an income of 1.559 billion yen. This increase was primarily due to an increase in income from long-term loans.

As a result, the balance of cash and cash equivalents at the end of the year increased by 4.164 billion yen from the previous fiscal year, reaching 25.589 billion yen.



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<b>Business Risk</b>
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In order to ensure sustainable business operations, the Nippon Kayaku Group analyzes a broad range of risks associated with our business, and works to prevent and disperse them. The following are possible risks which could have a major effect on our group's operating results, financial position, or image in society.

*\* The following have been identified as risks to the Nippon Kayaku Group at the end of this consolidated fiscal year. These do not cover events that go beyond our predictions, and are not a comprehensive list of all risks facing our group.*

## 1. Changes in the Business Environment

### (1) Overall Business

The Nippon Kayaku Group is working to maximize its corporate value by creating a fusion of the technologies it possesses. For this purpose, we have established business strategies, development strategies, and other plans, and are managing our business in a way that is adapted to changes in the business environment. However while the functional chemicals business is a growth field that constitutes a large proportion of our sales and operating income, it is also a business that is susceptible to the effects of economic fluctuations. Domestic and international economic fluctuations, and changes in the business environment such as sluggish demand and intensifying competition, as well as the resulting changes to our business configuration, may have a major effect on the operating results and financial position of the Nippon Kayaku Group.

### (2) Functional Chemicals Business

The functional chemicals business is focused on information and communications products, which have a short cycle of technological innovation. It is critical that development of new products and creation of the production system be carried out rapidly. An inability to provide new products that satisfy market needs in a timely manner, or lagging behind the radical technological innovations of other companies, represent large risks.

### (3) Pharmaceuticals Business

Policies by the governments of Japan and other countries to reduce health care expenditures represent a risk to the pharmaceuticals business. In Japan, the health care insurance system has been overhauled, drug prices have been revised, and the use of generic drugs is being promoted. In Europe and America, there is downward pressure on prices under policies by vari-

ous national governments aimed at reducing pharmaceutical prices. In the active ingredients business, it is possible that business related to food products and food additives may be affected by recent problems involving the safety of food and other products.

### (4) Fine Chemicals Business

In the fine chemicals business, the agrochemicals business is affected greatly by crop growing conditions, which are subject to climate changes and other phenomena, as well as by the occurrence of harmful insects. It is also affected by tightening governmental regulations related to food safety and environmental effects.

## 2. Rising Interest Rates

When determining the methods for procuring the funds necessary for operations, and the amounts required, the Nippon Kayaku Group considers its financial position as well as the monetary environment. Rising interest rates result in higher interest costs and may interfere with the procurement of funds.

## 3. Exchange Rate Changes

In order to minimize the risk to our overseas business and export-related transactions caused by sudden changes in the exchange rates, the Nippon Kayaku Group takes a number of steps, such as maintaining a balance of transactions denominated in foreign currencies. However it is still possible that there may be profits or losses on the foreign exchange.

Moreover, the operating results for overseas consolidated subsidiaries are converted to yen in order to create the consolidated financial statements, and are therefore affected by exchange rate changes.

## 4. Retirement Benefits

Based on mathematically calculated retirement benefit obligations and forecasts of pension plan assets, the Nippon Kayaku Group calculates its employee retirement benefit expenses and obligations. For this reason, the actual retirement benefits are affected by factors such as changes in the retirement bonus and pension system, changes to the discount rate used in the mathematical calculation, changes in the current value of the pension assets, and changes in the operating environment.

## 5. Valuation of Assets

Because the Nippon Kayaku Group owns securities and other items that have a current price, an event such as a large-scale drop in the stock market could result in loss for these financial instruments. In addition, fixed assets

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may also be affected when the measured recoverable value ends up less than the book value, as that difference is recognized as a fixed asset loss.

#### **6. Changes in Laws or Regulations**

The business activities of the Nippon Kayaku Group are conducted in accordance with the laws and regulations of Japan and all overseas countries where we operate. Future changes in laws, regulations, or policies may restrict our business activities or increase costs.

#### **7. Overseas Business**

The Nippon Kayaku Group is working to expand its overseas business activities, however this business may be affected by changes to laws, regulations, or policies in overseas countries, or by events such as terrorism, wars, or other social disruptions.

#### **8. Lawsuits**

As the Nippon Kayaku Group conducts business in a wide variety of areas, there is the possibility that it could become the target of lawsuits, legal contests, or other legal actions.

#### **9. Violation of Intellectual Property Rights**

While the Nippon Kayaku Group carefully controls its patents and other intellectual property, it may not be possible to fully prevent violation by third parties. On the other hand, there is also the possibility that some of the Group's products or technologies may in the future be viewed as violating the intellectual property rights of another company.

#### **10. Research and Development**

The Nippon Kayaku Group considers research and development to be the engine that drives our business growth, and is actively engaged in R&D activities. In particular for pharmaceuticals, agrochemicals, and other products requiring R&D over extended periods of time, there may be cases of significant delays in product development, and also instances in which an R&D theme is abandoned without being commercialized. In addition, in the functional chemicals business, there is the possibility of a radical technological innovation by another company that will render us unable to develop and provide products that satisfy customer needs in a timely manner.

#### **11. Procurement of Raw Materials**

In order to obtain stable procurement of raw materials, the Nippon Kayaku Group disperses risk by securing multiple suppliers and other means. However events such as

sudden price changes or an interruption in supply of raw materials are possible.

#### **12. Product Quality**

The Nippon Kayaku Group has established control standards that are based on ISO9001 and other international standards, and manufactures products in accordance with them. Moreover, through measures such as the purchase of product liability insurance, we have created a risk prevention system for use in the unlikely event that a liability problem occurs. However, there is no guarantee that this system will be able to fully cover any settlement costs. In addition, there is the possibility for pharmaceuticals and agrochemicals that unpredictable side effects or other problems will be discovered after the product is marketed.

#### **13. Accidents and Disasters**

In order to prevent accidents involving manufacturing equipment, distribution, or other areas of our operations, and to prevent damage from natural disasters, the Nippon Kayaku Group has implemented safety measures that are in conformance with Group standards; however these cannot guarantee that accidents and natural disasters will not occur. There is the possibility of high expenditures and damage to the Group reputation in the event that an accident or other occurrence results in physical damage or injury at a plant or in the surrounding area, or in the event that our actions interfere with a customer's production and the customer demands compensation.