

Management's Discussion and Analysis

Consolidated Results of Operations

Business Overview

During the fiscal year ended May 31, 2008 the Japanese economy saw corporate profits compressed not only by high raw material prices caused by factors such as the soaring price of oil, but also by the slowdown in the U.S. economy at the beginning of 2008 that affected the exchange rates and resulted in a drastic devaluing of the dollar.

In the chemical products industry, despite generally strong growth in digital home electronics and other IT-related fields, the increasing price of raw materials caused by high oil prices, and compounded by the decline in product prices, resulted in continuing difficult conditions.

In the pharmaceuticals industry, drug price standards were revised downward in April 2008. In addition, the trend toward reducing drug costs by such means as promoting the use of generic pharmaceuticals continues to grow stronger, and global competition in the development and sales of new drugs has become more active than ever. As a result, the struggle among companies to survive is becoming increasingly fierce.

In the automobile industry, although sales in Japan were sluggish, the market continued to expand as a result of growth in emergent nations such as China. Under these conditions, automobile airbags for collision safety systems are being increasingly installed in the driver and passenger seats, and the use of side airbags is growing for protection against side collisions.

Under these conditions, in order to be a business that is able to delivery greater corporate value and continual growth, the Nippon Kayaku Group has worked to improve profits by cutting costs, further clarifying our portfolio,

investing management resources in key fields, and strengthening our overseas operations.

Net Sales

While sales increased in our safety systems business and pharmaceuticals business, the incorporation of the explosives business into the equity method subsidiary Kayaku Japan Co., Ltd. (formerly Hokuyou Kayaku Co., Ltd.) resulted in a decrease in income for the months of January through May, and sales were slow in the electronic materials business. As a result of these and other factors, consolidated sales for the fiscal year ended May 31, 2008 were 144.901 billion yen, a decrease of 3.222 billion yen (2.2%) from the previous fiscal year. Consolidated net sales for the fiscal year ended May 31, 2008 were 140% of the net sales of the parent company alone.

Gross Profit

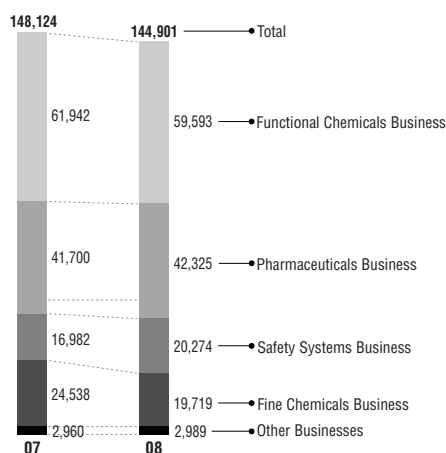
Gross profit for the fiscal year ended May 31, 2008 was 51.697 billion yen, a decrease of 2.889 billion yen (5.3%) from the previous fiscal year.

Selling, General and Administrative Expenses; Operating Income

In the fiscal year ended May 31, 2008, selling, general and administrative expenses were 39.245 billion yen, a decrease of 1.805 billion yen (4%) from the previous fiscal year due to the division of the explosives business and other factors.

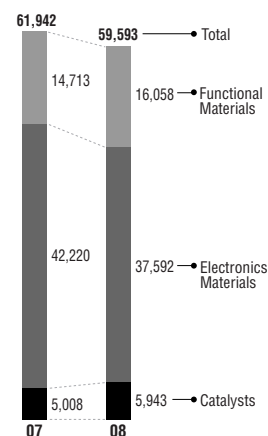
As a result, consolidated operating income for the fiscal year ended May 31, 2008 was 12.451 billion yen, a decrease of 1.084 billion (8%) yen from the previous fiscal year. Operating income ratio was down 0.5 percentage points from the previous fiscal year to 8.6%.

Sales by Business Segment



Years ended May 31 Unit: million yen

Sales of the Functional Chemicals Business



Years ended May 31 Unit: million yen

Other Income and Expenses

In the fiscal year ended May 31, 2008, other income and expenses totaled 237 million yen, an increase in income of 165 million yen (229%) from the previous fiscal year. The main factors of this increase were an increase in interest and dividend income and an increase in income from sales of property, plant and equipment.

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, 2008 was 12.688 billion yen, a decrease of 919 million yen (6.8%) from the previous fiscal year.

Income Taxes, Minority Interests, Net Income

In the fiscal year ended May 31, 2008, income taxes amounted to 5.361 billion yen, a decrease of 142 million yen (2.6%) from the previous fiscal year.

In the fiscal year ended May 31, 2008, minority interests was 697 million yen, a decrease of 797 million yen (53.3%) from the previous fiscal year.

As a result, net income for the fiscal year ended May 31, 2008 was 6.630 billion yen, an increase of 19 million yen (0.3%) from the previous fiscal year.

Operating Performance by Business Segment

Because the business segments were changed beginning from the fiscal year ended May 31, 2008, the information from the previous fiscal year has been changed to the new segments for the purpose of comparison.

[Functional Chemicals Business]

In the fiscal year ended May 31, 2008, sales of the

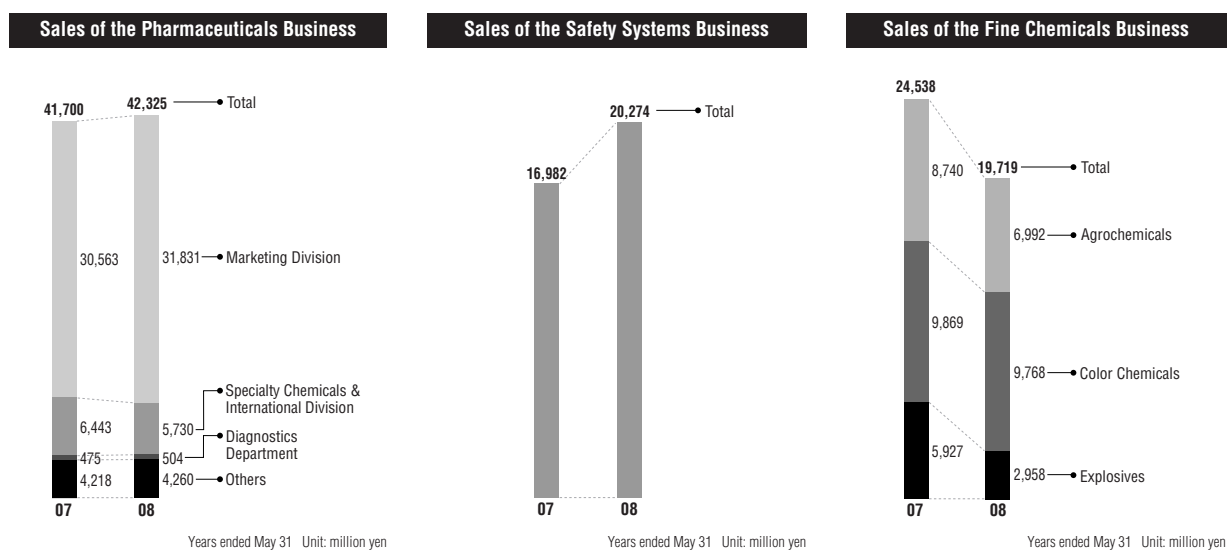
functional chemicals business were 59.593 billion yen, a decrease of 2.348 billion yen (3.8%) from the previous fiscal year.

In the functional materials business, sales of epoxy resins for semiconductor encapsulation exceeded the level of the previous fiscal year thanks to strong sales of our environmentally friendly epoxy resins. Sales of UV-curing resins were also up from the previous fiscal year. Performance for the functional materials business as a whole exceeded the level of the previous fiscal year.

In the electronic materials business, sales of colors for inkjet printers and sales of resins for optical disks were up from the previous fiscal year. However, sales of resins for lenses and sales of films for plasma displays among our optical functional films were down from the previous fiscal year. Polatechno polarizing films used in rear projection televisions were affected by a contraction of the market for these televisions, and sales of these products were down from the level of the previous fiscal year. Overall, sales in the electronic materials business were below the level of the previous fiscal year.

In the catalysts business, sales of catalysts for methacrylic acid manufacturing were strong, surpassing sales from the previous fiscal year.

Overall operating income for the functional chemicals business was 7.019 billion yen. While the functional materials business and catalyst business delivered strong performance, the large effects of soaring raw materials prices and the slow sales of Polatechno inorganic polarizing films resulted in operating income that was 1.404 billion yen (16.7%) below the level of the previous fiscal year.



[Pharmaceuticals Business]

In the fiscal year ended May 31, 2008, sales of the pharmaceuticals business amounted to 42.325 billion yen, an increase of 625 million yen (1.5%) over the previous fiscal year.

Among pharmaceutical products for the Japanese domestic market, the new products "GRANISETRON Intravenous Injection NK" (anti-emetic drug) and "LEVOFOLINATE intravenous injection drip NK" (effect-enhancing drug for anti-cancer drugs) made a large contribution to sales. Sales of "ODYNE Tab." (anti-cancer drug), "PACLITAXEL Inj. NK" (anti-cancer drug), "IA CALL" (arterial-injection anti-cancer drug), "CARBOMERCK" (anti-cancer drug), "EPIRUBICIN Inj. Merck" (anti-cancer drug), "CALSED" (anti-cancer drug), and "GELPART" (material for transcatheter arterial embolization) were also strong, and exceeded the levels of the previous fiscal year. On the other hand, due to the effects of competitor products and other factors, sales of "FARESTON Tab." (anti-cancer drug) and "MILLISROL Inj." (vasodilator) fell below the level of 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) were up from the previous fiscal year, but sales of ETOPOSIDE (anti-cancer drug) were down from the previous fiscal year. Overall, exports were down from the previous fiscal year.

As for active pharmaceutical ingredients for the Japanese domestic market, because sales of generic drug materials were down from the previous fiscal year, overall sales of active pharmaceutical ingredients for the domestic market were also down.

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

Overall operating income for the pharmaceuticals business was 7.837 billion yen, an increase of 362 million yen (4.8%) over the previous fiscal year.

[Safety Systems Business]

In the fiscal year ended May 31, 2008, sales of the safety systems business amounted to 20.274 billion yen, an increase of 3.291 billion yen (19.4%) over the previous fiscal year.

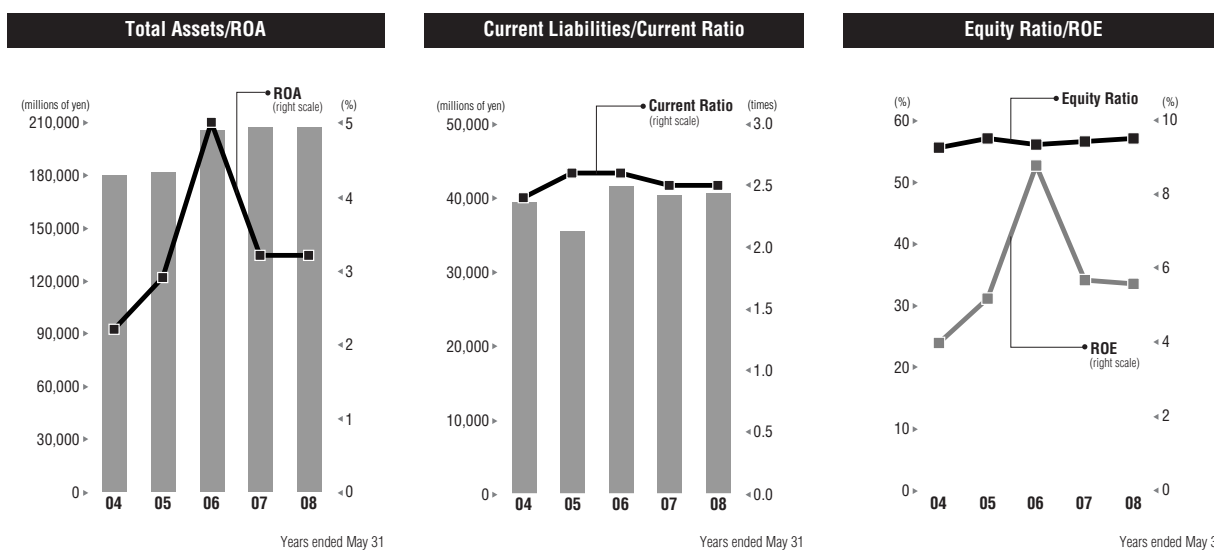
Sales of airbag inflators and micro gas generators for seatbelt pretensioners went smoothly, exceeding sales from the previous fiscal year.

Overall operating income for the safety systems business was 180 million yen, an increase of 296 million yen over the previous fiscal year.

[Fine Chemicals Business]

On January 2, 2008, the Nippon Kayaku explosives business was integrated to form Kayaku Japan Co., Ltd., a new company created by joint investment between Nippon Kayaku and the Asahi Kasei Chemicals Corporation. Because Kayaku Japan is accounted for by the equity method, the results from the Nippon Kayaku explosives business are consolidated only for the period from June through December of 2007.

In the fiscal year ended May 31, 2008, sales of the fine chemicals business were 19.719 billion yen, a decrease of 4.819 billion yen (19.6%) from the previous fiscal year.



In the agrochemicals business, results were significantly below the level of the previous fiscal year due to slumping domestic sales.

In the color chemicals business, results were down from the previous fiscal year due to slow sales of textile dyes.

In the explosives business, results were significantly below the level of the previous fiscal year as a result of the business integration that formed Kayaku Japan Co. Ltd.

Overall operating income for the fine chemicals business was 1.123 billion yen, a decrease of 717 million yen (39.0%) from the previous fiscal year. This was due to the effects of integrating our explosives business, as well as to the large effects that elimination of China's value-added tax refund and the rising price of raw materials had on the color chemicals business.

[Other Businesses]

In the fiscal year ended May 31, 2008, sales of other business amounted to 2.989 billion yen, up 28 million yen (1.0%) over the previous fiscal year.

Operating income was 1.592 billion yen, approximately the same as the previous fiscal year.

Following is a summary of the results by geographical segment for the fiscal year ended May 31, 2008.

[Japan]

Sales amounted to 125.169 billion yen, a decrease of 3.280 billion yen (2.6%) from the previous fiscal year.

Operating income was 16.531 billion yen, a decrease of 911 million yen (5.2%) from the previous fiscal year.

[Other regions]

Sales amounted to 19.732 billion yen, an increase of 57 million yen (0.3%) over the previous fiscal year. Sales of Indet Safety Systems a.s. in the Czech Republic increased, while sales of Moxtek Inc. in the U.S. fell. In China, sales of Polatechno (Hong Kong) Co., Ltd. decreased.

Operating income was 1.442 billion yen, a decrease of 261 million yen (15.4%) from the previous fiscal year.

Consolidated Financial Condition

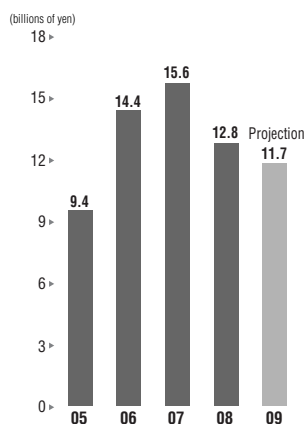
Total Assets, Liabilities and Net Assets

As of the end of May 2008, total assets were 207.269 billion yen, an increase of 188 million yen from the end of the previous fiscal year. The main increasing factor was loans to affiliated companies, and the main decreasing factors were marketable securities and inventories.

As of the end of May 2008, liabilities were 76.194 billion yen, a decrease of 652 million yen from the end of the previous fiscal year. The main decreasing factor was accrued income taxes.

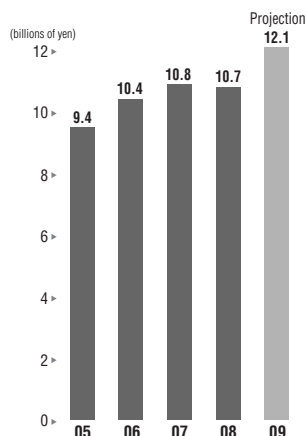
As of the end of May 2008, net assets were 131.074 billion yen, an increase of 840 million yen from the end of the previous fiscal year. The main increasing factor was net income, and the main decreasing factor was cash dividends paid.

Plant & Equipment Investment



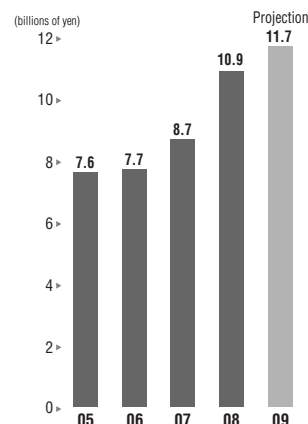
Years ended May 31

Research & Development Expenditures



Years ended May 31

Depreciation Expense



Years ended May 31

Consolidated Cash Flows

In the fiscal year ended May 31, 2008, net cash provided by operating activities decreased by 4.226 billion yen from the previous fiscal year to reach 15.975 billion yen. This decrease was primarily due to an increase in income taxes.

In the fiscal year ended May 31, 2008, net cash used in investing activities totaled 17.929 billion yen, an increase in payments of 46 million yen from the previous fiscal year.

In the fiscal year ended May 31, 2008, net cash used in financing activities totaled 1.880 billion yen, a decrease in proceeds of 3.440 billion yen from the previous fiscal year. This decrease was primarily due to a decrease in proceeds from long-term debt.

As a result of the above, the balance of cash and cash equivalents at the end of the current fiscal year decreased by 3.926 billion yen from the end of the previous fiscal year to reach 21.662 billion yen.

Business Risk

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 various 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) Safety systems business

The safety systems business is involved with sales of automobile safety systems. Changes in the demand for automobiles in the countries and regions where the Nippon Kayaku Group sells its products, caused by economic fluctuations or other factors, may have a significant effect on the operating results and financial position of the Group.

(5) 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. For inventory assets, if an evaluation of profitability determines that the net selling price is below book value, the difference is recognized as a loss on revaluation. In addition, fixed assets 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 recognizes that research and development is a driving force behind business growth, and is actively engaged in R&D activities. For pharmaceuticals and agrochemicals, a long R&D period is required to verify the effectiveness and safety of a product, and vast expense is required in order to develop a single product. For these reasons, it may not be possible to recover large R&D costs in the event that research is abandoned during a later phase of development.

In addition, in the functional chemicals business and safety systems business, both the pace of technological innovation and changes in customer needs are extremely fast. There is the possibility that we may be unable to develop and supply new products in a timely manner.

In the event that R&D activities do not produce results, there is the possibility of significant effects on the operating results and financial position of the Nippon Kayaku Group.

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.