

Management's Discussion and Analysis

Consolidated Results of Operations

Business Overview

The Japanese economy during the fiscal year ended May 31, 2009 was affected by the global economic crisis which began with the U.S. financial crisis that surfaced beginning from the autumn of last year. Factors such as a dramatic fall in exports and the continuing high value of the yen worsened corporate earnings, while employment concerns and uncertainty over the future led to sluggish personal consumption. On the whole the economic conditions took a large step backwards. Conditions continue to be harsh, with large production adjustments in the electrical/electronic devices, semiconductor, automobile, and other industries, both in Japan and overseas.

Although the pharmaceutical industry is less susceptible than other industries to the effects of economic conditions, the move toward using generic pharmaceuticals and other trends toward restricting drug prices are growing in strength, and global competition for research, development, and sales of new drugs is becoming increasingly fierce. In many ways, the struggle for survival between companies is becoming increasingly intense.

Under these conditions, the Nippon Kayaku Group has aimed to reinforce the profit structure rather than expand sales, and in particular has worked to improve the profitability of the functional chemicals business and refine its sales product lineup. We have also strived for the optimal distribution of business resources to key business areas.

Net Sales

Consolidated net sales for the fiscal year ended May 31, 2009 were 134.353 billion yen, a decrease of 10.548 billion yen (7.3%) from the previous fiscal year. Despite strong

sales in the pharmaceuticals business, this result was due to sluggish demand and the large effects of the resulting inventory adjustments in the functional chemicals and safety systems businesses. Consolidated net sales for the fiscal year ended May 31, 2009 were 138% of the net sales of the parent company alone.

Gross Profit

Gross profit for the fiscal year ended May 31, 2009 was 47.218 billion yen, a decrease of 4.479 billion yen (8.7%) from the previous fiscal year.

Selling, General and Administrative Expenses; Operating Income

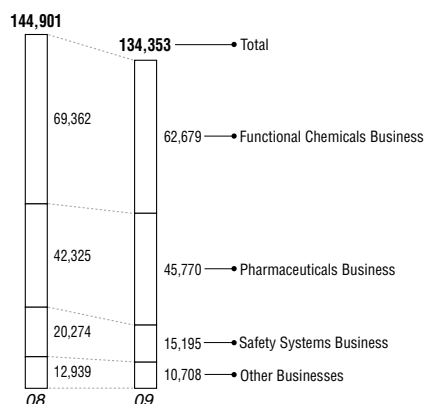
Selling, general, and administrative expenses for the fiscal year ended May 31, 2009 were 37.851 billion yen. This represents a decrease of 1.394 billion yen (3.6%) from the previous fiscal year – the result of efforts to reduce fixed costs.

Consolidated operating income for the fiscal year ended May 31, 2009 was largely affected by the decline in sales, and dropped to 9.367 billion yen, a decrease of 3.084 billion yen (24.8%) from the previous fiscal year. The operating income ratio dropped 1.6 points from the previous fiscal year to reach 7.0%.

Other Income and Expenses, Income before Income Taxes and Minority Interests

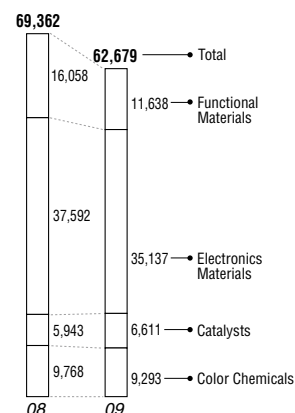
Due to a large increase in expenses over the previous fiscal year, the net amount of other income (expenses) for the fiscal year ended May 31, 2009 was an expense of 2.465 billion yen. The primary causes were a loss on valuation of investment securities in the Taiwanese company Skypola Optronics Corp. and a loss on foreign exchange due to the

Sales by Business Segment



Years ended May 31 Unit: million yen

Sales of the Functional Chemicals Business



Years ended May 31 Unit: million yen

high value of the yen.

As a result of the above, net income before income taxes and minority interests for the fiscal year ended May 31, 2009 was 6.902 billion yen, a decrease of 5.786 billion yen (45.6%) from the previous fiscal year.

Income Taxes, Minority Interests, Net Income

In the fiscal year ended May 31, 2009, income taxes amounted to 3.55 billion yen, a decrease of 1.811 billion yen (33.8%) from the previous fiscal year. The effective tax rate reflected in the consolidated statements of income for the fiscal year ended May 31, 2009 increased to 51.44% from 42.25% for the previous fiscal year.

In the fiscal year ended May 31, 2009, minority interests were a loss of 366 million yen, a decrease of 1.063 billion yen from the previous fiscal year.

As a result, consolidated net income for the fiscal year ended May 31, 2009 was 3.718 billion yen, a decrease of 2.912 billion yen (43.9%) from the previous fiscal year.

Consolidated net income for the fiscal year ended May 31, 2009 was 61% of the net income of the parent company alone.

Operating Performance by Business Segment

Operating performance by business segment in the fiscal year ended May 31, 2009 is described below. Because the business segments were changed beginning from the fiscal year ended May 31, 2009, the information from the preceding fiscal year has been changed to match 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 62.679 billion yen, a

decrease of 6.682 billion yen (9.6%) from the previous fiscal year.

In the functional materials business, sales of special epoxy resins for semiconductor encapsulation dropped significantly from the previous fiscal year due to sluggish demand and the effects of inventory adjustments. Sales of UV-curing resins were also below the level of the previous fiscal year. Sales for the functional materials business as a whole also were down.

In the electronic materials business, although sales of colors for inkjet printers and Moxtek, Inc. (USA) components for X-ray analysis systems were higher than the previous fiscal year, sales of resins for optical discs, sealants for LCD displays, films for plasma displays, and Polatechno polarizing films all fell. Sales for the electronic materials business as a whole were also below the level of the previous fiscal year.

Sales in the catalyst business remained strong, and were higher than the previous fiscal year.

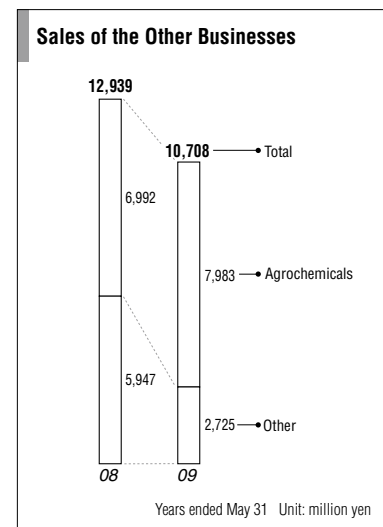
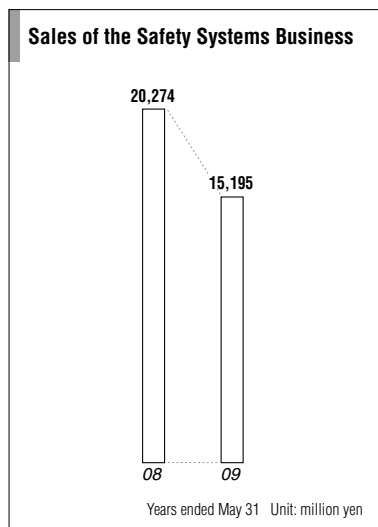
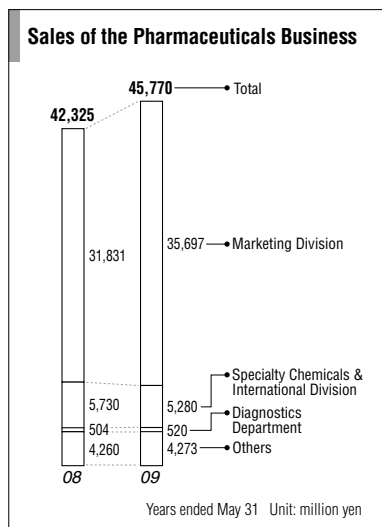
In the color chemicals business, sales were down from the previous fiscal year due to a drop in sales of textile dyes.

Operating income for the functional chemicals business as a whole was 4.409 billion yen, a decrease of 3.353 billion yen (43.2%) from the previous fiscal year. This was due to contracting profits in the functional materials business and at Polatechno Co., Ltd.

[Pharmaceuticals Business]

In the fiscal year ended May 31, 2009, sales of the pharmaceuticals business amounted to 45.770 billion yen, an increase of 3.444 billion yen (8.1%) from the previous fiscal year.

Among pharmaceutical products for the Japanese



domestic market, there were strong sales of "PACLITAXEL Inj. NK" (anti-cancer drug), "CARBOPLATIN Intravenous Infusion NK" (anti-cancer drug), "EPIRUBICIN Inj. NK" (anti-cancer drug), "IA CALL" (arterial-injection anti-cancer drug), "GRANISETRON Intravenous Inj. NK" (anti-emetic drug), "LEVOFOLINATE Intravenous Infusion NK" (anti-cancer drug effect potentiator), and "GELPART" (material for transcatheter arterial embolization), with sales of these products exceeding the levels of the previous fiscal year. Sales of "ODYNE Tab." (anti-cancer drug) were on approximately the same level as the previous fiscal year. On the other hand, the effects of factors such as drug price revisions and competitor products resulted in lower sales of "RANDA Inj." (anti-cancer drug), "FARESTON Tab." (anti-cancer drug), and "MILLISROL Inj." (vasodilator). Overall sales of pharmaceutical products for the Japanese domestic market were up from the previous fiscal year.

In the area of exports, sales of "BLEO" (anti-cancer drug) fell below the level of the previous fiscal year, and sales of exports as a whole were lower.

In the area of active pharmaceutical ingredients for the Japanese domestic market, sales of active pharmaceutical ingredients for generic pharmaceuticals were strong, and sales of active pharmaceutical ingredients to the Japanese domestic market as a whole were higher than the previous fiscal year.

In the area of diagnostic agents, sales of "LANAZYME ST-439 Plates" (breast cancer diagnostic agent) and "LANA 1,5AG" (diabetes diagnostic agent) were strong, and sales for diagnostic agents as a whole were higher than the previous fiscal year.

Operating income for the pharmaceuticals business as a whole was 9.355 billion yen, an increase of 1.517 billion

yen (19.4%) from the previous fiscal year.

[Safety Systems Business]

In the fiscal year ended May 31, 2009, sales of the safety systems business were 15.195 billion yen, a decrease of 5.079 billion yen (25.1%) from the previous fiscal year. This was due to the significant drop in worldwide automobile sales and inventory adjustments which became pronounced in the autumn of 2008. The effects of the high value of the yen were also large.

Sales of the airbag inflators that are produced and sold in Japan were on the same level as the previous fiscal year, thanks to growing numbers of vehicle models where these products are installed. Sales of the micro gas generators for seatbelt pretensioners which are produced and sold in Japan, the U.S., and the Czech Republic were affected by the drop in automobile sales and the high value of the yen, and were significantly below the level of the previous fiscal year.

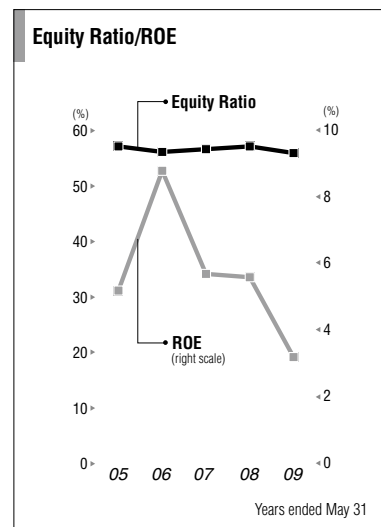
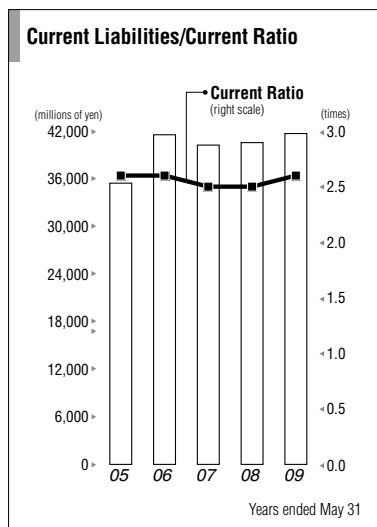
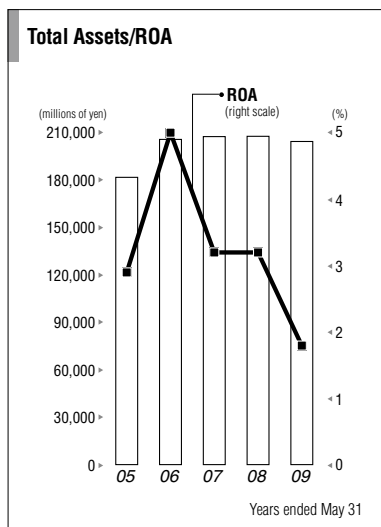
The safety systems business as a whole recorded an operating loss of 1.664 billion yen, a decrease of 1.844 billion yen from the previous fiscal year.

[Other Businesses]

In the fiscal year ended May 31, 2009, sales of the other businesses were 10.708 billion yen, a decrease of 2.231 billion yen (17.2%) from the previous fiscal year. This was due to the integration in FY 2008 of our explosives business with Kayaku Japan Co., Ltd, a company accounted for by the equity method.

In the agrochemicals business, both domestic sales and exports were higher than the previous fiscal year.

Results from the real estate and other business were below the levels of the previous fiscal year.



Despite the effects from the integration of our explosives business, operating income was 2.145 billion yen, an increase of 298 million yen (16.2%) from the previous fiscal year. This was due to increasing sales in the agrochemicals business and to improvements in the profit structure.

Information by geographical segment

Following is information by geographical segment in the fiscal year ended May 31, 2009.

[Japan]

Sales amounted to 116.882 billion yen, a decrease of 8.287 billion yen (6.6%) from the previous fiscal year.

Operating income was 13.825 billion yen, a decrease of 2.705 billion yen (16.4%) from the previous fiscal year.

[Other regions]

Sales amounted to 17.471 billion yen, a decrease of 2.260 billion yen (11.5%) from the previous fiscal year. Sales at Indet Safety Systems a.s. in the Czech Republic decreased. In the U.S., although sales at Moxtek Inc. grew, sales at Lifesparc Inc. dropped.

Operating income was 260 million yen, a decrease of 1.182 billion yen (82.0%) from the previous fiscal year. Operating income at Indet Safety Systems a.s. in the Czech Republic decreased. In the U.S., although operating income at Moxtek Inc. rose, operating income at Lifesparc Inc. fell.

Consolidated Financial Position

Total Assets, Liabilities, and Net Assets

As of the end of the fiscal year ended May 31, 2009, total assets decreased by 3.270 billion yen from the previous

fiscal year to reach 203.998 billion yen. The primary increase was due to an increase in the purchase of marketable securities, while the primary decrease was due to a reduction in trade receivables and investment securities.

As of the end of the fiscal year ended May 31, 2009, liabilities increased by 1.991 billion yen from the previous fiscal year to reach 78.186 billion yen. The primary decrease was due to a reduction in trade payables, while the primary increase was due to an increase in long-term debt.

As of the end of the fiscal year ended May 31, 2009, net assets decreased by 5.262 billion yen from the previous fiscal year to reach 125.812 billion yen. The primary decrease was due to the payment of dividends and a decrease on valuation and translation adjustments.

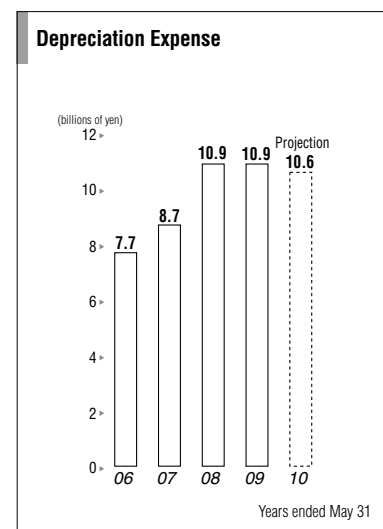
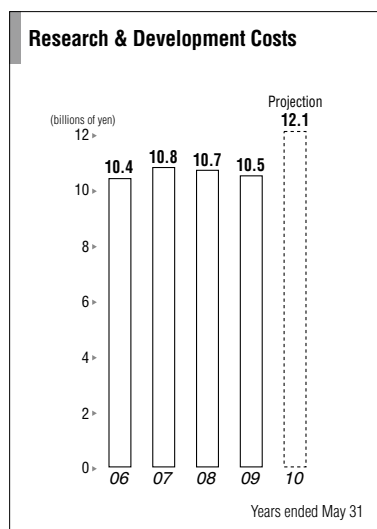
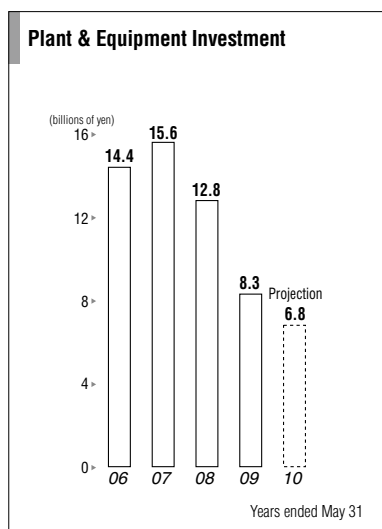
Consolidated Cash Flows

In the fiscal year ended May 31, 2009, net cash provided by operating activities was 18.037 billion yen, an increase of 2.062 billion yen from the previous fiscal year. This increase was primarily due to a decrease in trade receivables and to a decrease in the amount of income taxes paid.

In the fiscal year ended May 31, 2009, net cash used in investing activities was 9.448 billion yen, a decrease in payments of 8.480 billion yen from the previous fiscal year. This decrease was primarily due to a decrease in payments for the acquisition of property, plant and equipment.

In the fiscal year ended May 31, 2009, net cash provided by financing activities was 4.558 billion yen, an increase in proceeds of 6.438 billion yen from the previous fiscal year. This increase was primarily due to proceeds from long-term debt.

As a result of the above, the balance of cash and cash equivalents at the end of the year increased by 13.399



billion yen from the end of the previous fiscal year to reach 35.061 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 the fiscal year ended May 31, 2009. 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 the functional chemicals business, which accounts for a large percentage of our sales and operating income, is a business area that is highly 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

In the pharmaceuticals business, there is the risk of measures being taken by the Japanese or foreign governments to restrict health care expenses. In Japan, the health insurance system has been revised, including revisions to drug prices and measures to

promote the use of generic drugs. In Europe and North America, there is pressure to lower prices as a result of measures by the governments of various countries to restrict pharmaceutical costs. 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 related 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) Other Businesses

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 unexpected 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.

14. Swine Flu

The Nippon Kayaku Group has formulated plans for preventing infection and continuing our business in preparation for a possible outbreak of swine flu (H1N1). However mutations of the virus are entirely unpredictable and it is possible that depending on its infectious strength and virulence, swine flu may affect our business activities, including the temporary closure of business locations and a curtailing of operations.