

# Analysis of Results of Operations and Financial Condition

## 1. Results of Consolidated Operations

### 1. Overview

Fiscal 2004 started with the world economy showing signs of stagnation from the effects of the new SARS virus and the Iraq war, but later entering a recovery centered on Asia and the United States. The U.S. economy was especially vigorous, as personal spending was spurred by a large-scale tax cut and strong housing investment amidst a low-interest policy. The Japanese economy also recovered quickly in the second half of the fiscal year, pulled up by the resurgence of the U.S. economy and exports to Asia. Accompanied by a rise in capital investment, the recovery of the domestic economy became broad-based by fiscal year-end.

In this economic environment, the Nitto Denko Group (the "Group") continued to supply the fast-growing Flat-Panel Display (FPD) industry with materials for Liquid-Crystal Displays (LCD) and surface protection. The Group also shipped electronic circuit and bonding and jointing materials to makers of cellular phones and personal computers. Both product sectors grew strongly, resulting in a 19.5% year-on-year increase in net sales, to a record ¥452,726 million. We also achieved record-high results in earnings, as operating income increased by 64.9% to ¥55,912 million and net income increased by 73.6% to ¥33,386 million.

### 2. Analysis of Income Statement

#### Sales

Net sales were ¥452,726 million, an increase of 19.5% over the previous fiscal year. Excluding the impact of foreign exchange conversion due to the appreciation of the yen, the real growth rate in sales was 21.8%. Domestic sales rose by 8.3% to ¥243,200 million, thanks to brisk sales of LCD-related materials, bonding and jointing materials for cellular phones and home electronics, and sealing materials. With increased exports of LCD-related materials to Asia and Oceania, and due to a rise in U.S. sales following merger-acquisition activities, overseas sales increased by 35.9% to ¥209,526 million. The ratio of overseas sales to total consolidated sales went up from 40.7% to 46.3%.

Sales in the Industrial Products segment increased by 10.4% over the previous year to ¥191,694 million. The Group posted strong sales of bonding and jointing materials and sealing materials for use in cellular phone-related products, personal computer peripheral devices exported to East Asia, and home electronics. In addition, shipments of surface protection materials and cleaning materials for the FPD industry contributed significantly to growth in this segment. Although sales of automotive sealing materials also grew, electronic insulating materials for the electric-

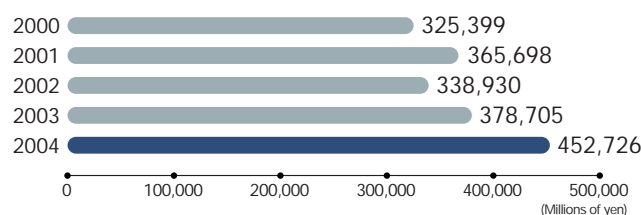
power industry were sluggish, as were sales of packaging materials and consumer products. Starting with fiscal 2004, Permacel Automotive (PCA), a manufacturer of automotive materials in the U.S., became a consolidated subsidiary and contributed ¥6,948 million to sales.

Sales in the Electronic Products segment increased by 32.8% to ¥219,805 million. LCD-related materials contributed the most to the increase as advanced compensation films for high-definition LCDs soared amid solid growth in the LCD television market. Sales of wide-angle polarizing films and polarization conversion films for cellular phones, laptop PCs, and LCD TVs also expanded greatly. Another factor in the sales increase was a moderating decline in unit prices compared to fiscal 2003 due to a tight supply-demand balance. In circuit materials, a vigorous cellular phone market spurred favorable sales growth as we concentrated on the color LCD and compact camera markets. Sales of circuit materials for hard disk drives were brisk. The start of regular production at our new Suzhou Plant in China, near Shanghai, also contributed to revenue growth. In electronic processing materials, sales of protection sheets and laminating devices for semiconductor manufacturing were favorable thanks to a recovery in the semiconductor and electronic components industries. Although shipments of semiconductor-related materials for optical semiconductors were firm, sales were flat overall.

Sales in the Functional Products segment increased by 3.5% to ¥41,829 million. The market for medical-related materials was stagnant as a whole due to the effects of government policies to control healthcare costs. Although sales of surgical tape and medical sanitary materials were flat, transdermal therapeutic patches for asthma sold well. In high-polymer separation membranes, sales of membranes used for rinsing in the semiconductor industry and LCD panel industries were firm, but due to a decline in sales of large-scale desalination membranes, sales were weak overall. Engineering plastics sold well overall, as shipments of inner pressure-regulating membranes for office automation equipment and automotive electronics were firm, and sales of process materials and related items for the electronics industry also increased.

*Note) The figures in sales by segment are presented in total (no eliminations considered).*

#### Net Sales



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

Along with the rise in net sales, cost of sales (COS) increased by 17.0% to ¥314,786 million. Despite the decrease in product prices, the ratio of COS to sales declined by 1.5 percentage points to 69.5%. Contributing to this improvement were operating merits of scale from the expansion of sales volume, as well as efforts to rationalize operations and lower material unit costs.

Selling, general and administrative expenses (SG&A) increased by 8.3% over the previous year to ¥82,028 million. The primary factors were rises in personnel costs, freight, advertising, and selling fees. The ratio of SG&A to net sales decreased 1.9 percentage points to 18.1%.

### Operating Income

In addition to the rise in sales, the declines in ratios of COS and SG&A led to a major increase in operating income, which rose by 64.9% to ¥55,912 million.

As a segment, Electronic Products contributed the most to this increase in income, with a net operating income rise of ¥20,783 million or 114.8% year-on-year. Industrial Products was second, for a net increase of ¥3,185 million or 31.1% over the previous year. Operating income in Functional Products declined by ¥1,958 million, or 35.3%. Besides LCD-related materials, the major contributor to the increase in Electronic Products income was circuit materials. The main factors for the decreased income in Functional Products were the full depreciation of the acquisition cost and increase in research & development costs incurred due to the acquisition of Aveva Drug Delivery Systems (ADS), a U.S. manufacturer of transdermal therapeutic patches, aimed at the expansion of our future medical business. This acquisition impacted earnings in fiscal 2004.

### Other Income (Expenses)

The net amount of other income and expenses increased from a net expense of ¥377 million in fiscal 2003 to a net income of ¥1,163 million in fiscal 2004. The main factors in the increase were an investment gain of ¥672 million or 36.1% to ¥2,534 million for equity in earnings of non-consolidated

subsidiaries and affiliates, and a decrease of ¥301 million or 38.3% in foreign exchange losses to ¥1,088 million.

In addition, while the one-time fiscal 2003 item, ¥3,732 million for gains on the return of the substitutional portion of employee pension fund, did not occur in fiscal 2004, a gain of ¥1,958 million was recorded for reversal of allowance for severance and pension benefits due to changes in the plan. A restructuring charge of ¥1,821 million and loss on evaluation of marketable securities and investments of ¥1,658 million were incurred in the previous year, while in fiscal 2004 ¥683 million was written off for loss on evaluation of fixed assets by our U.S. subsidiary, Graphic Technology, Inc. (GTI).

### Income before Provision for Income Taxes

As a result of the above items, income before provision for income taxes increased by 70.2% over the previous year to ¥57,075 million.

### Income Taxes

The total of corporate income taxes, local income taxes, enterprise taxes and adjustments to income tax increased from ¥13,352 million the previous year to ¥21,901 million.

Although tax reductions for research and development expense in Japan lowered the corporate tax rate, due to the losses of our subsidiaries in the U.S. and other factors the Group was unable to recognize a significant tax benefit. As a result, the effective tax rate for accounting purposes was 38.4%, a 1.4 percentage-point decrease compared to 39.8% the previous year.

### Net Income

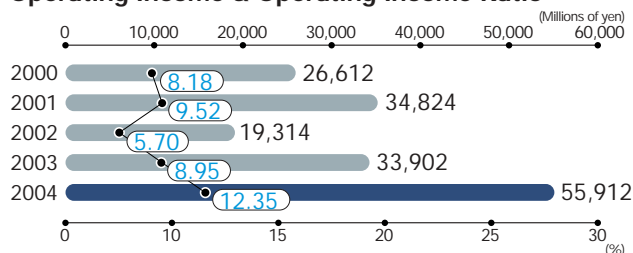
Net income for fiscal 2004 increased 73.6% to ¥33,386 million. Net income per share rose 82.4% to ¥197.99 (¥197.93 after dilution).

## 2. Analysis of Financial Condition

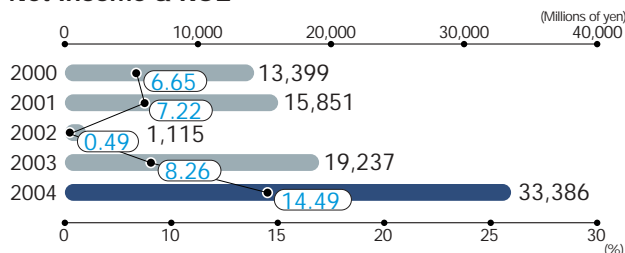
### 1. Assets and Liabilities & Shareholders' Equity

Total consolidated assets at the end of fiscal 2004 were ¥389,525 million, ¥9,714 million or 2.6% higher than at the

### Operating Income & Operating Income Ratio



### Net Income & ROE



end of the previous year (hereafter "previous year-end"). Of this amount, current assets decreased by ¥5,146 million or 2.4% to ¥211,294 million, tangible fixed assets (Plant and Equipment) increased by ¥11,884 million or 9.3% to ¥139,330 million, and investments and other assets increased by ¥2,976 million or 8.3% to ¥38,901 million.

The major factor in the decrease in current assets was the sale of all marketable securities, valued at ¥19,027 million at previous year-end, to meet demand for funds to acquire treasury stock. However, accounts receivable, accrued receivables and inventories all increased due to the increase in sales.

The increase in tangible fixed assets (Plant and Equipment) was primarily due to capital investment in manufacturing equipment to supply the FPD industry, which is expected to continue growing. Regarding the increase in investment assets (Investment and Other Assets), although long-term deferred tax assets decreased by ¥5,028 million, investment securities increased by ¥5,168 million due to the change in current market value, which was mainly the result of a recovery in the stock market.

Total consolidated liabilities at the end of fiscal 2004 were ¥154,428 million, an increase of ¥22,423 million or 17.0% compared to the previous year-end. Current liabilities were ¥138,274 million at year-end, an increase of ¥29,070 million or 26.6% over the previous year-end. Trade notes and accounts payable increased by ¥25,481 million over the previous year-end as a result of the increase in sales.

Due to changes in the pension plan, reduction in severance allowances decreased long-term liabilities by ¥6,647 million or 29.2% to ¥16,154 million.

Consolidated shareholders' equity at the end of fiscal 2004 decreased by ¥14,446 million or 6.1% compared to the previous year-end to ¥223,114 million. Retained earnings increased by ¥27,964 million or 16.6% to ¥196,596 million with the increase in net income. As a result of acquisition of treasury stock, the cost of treasury stock increased by ¥39,109 million or 3665.2% to ¥40,176 million.

As a result, the shareholder equity ratio decreased from 62.5% at previous year-end to 57.3% at the end of fiscal 2004.

## 2. Cash Flow Analysis

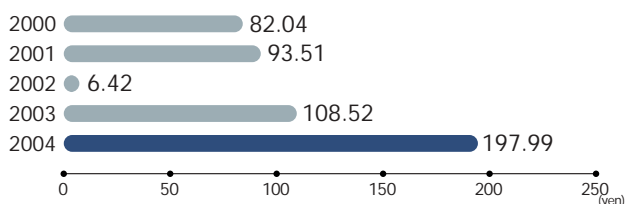
The change in consolidated cash and cash equivalents (hereafter "cash") was a net decrease in cash of ¥25,162 million compared to an increase of ¥32,409 million in the previous year. The main factors of the decrease were outflows of cash to acquire treasury stock and increase in trade notes and accounts receivables. The resulting cash balance decreased by ¥24,797 million or 33.8% to ¥48,544 million. Also, there was a cash balance increase of ¥364 million due to changes in scope of consolidation in fiscal 2004.

Net cash provided by operating activities decreased by ¥12,957 million or 21.9% compared to the previous year to ¥46,268 million. Net income before provision for taxes increased dramatically by 70.2% compared to the previous year. In non-cash items, depreciation and amortization increased by 1.1% to ¥21,386 million, and the increase in trade notes and accounts payable grew by 114.7% to ¥15,566 million. However, due to the sales increase and other factors, the increase in trade notes and other receivables grew by a large 500.4% to ¥18,458 million, and due to higher income, income taxes paid also rose dramatically to ¥19,858 million.

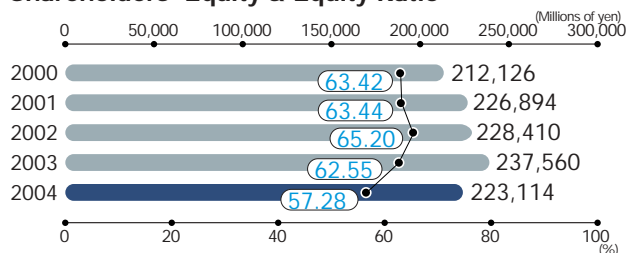
Net cash flow used in investing activities increased by ¥6,704 million or 27.2% to ¥31,312 million. This was primarily due to a 10.8% rise in acquisitions of plant and equipment to ¥27,085 million and investment of ¥7,660 million for the acquisition of subsidiary equities.

Net cash flow used in financing activities increased significantly by ¥37,532 million to ¥39,170 million. The main factors in this rise were payments for the acquisition of treasury stock, representing a major increase of 3,632.2% or ¥39,709 million. In addition, payments of dividends increased by 31.8% to ¥5,034 million.

### Net Income Per Share



### Shareholders' Equity & Equity Ratio



### 3. Business and Other Risks

The risks that could affect the Group's performance, stock price and financial position include the following. The forward-looking statements within the text are based on the Group judgments as of the end of fiscal 2004.

#### 1. Exchange Rate Fluctuations

Overseas sales account for 46% of group sales and overseas production for 17% of group production. As a result, the Group's performance is affected by exchange rate fluctuations — yen appreciations have an unfavorable impact and yen depreciations have a favorable impact. Although the Group makes every effort to minimize the impact of exchange rate fluctuations between key currencies such as the US dollar, the euro and the yen, they may have an adverse effect on the Group's performance over the long term.

#### 2. Optical Business

The cumulative build-up of transactions with the world's key LCD panel manufacturers has enabled the Group's optical business to take the number one global market share in the sector, giving it a core role in our overall operations. We are working to expand our market share and maintain and enhance our profitability by continually launching new products and expanding our production capacity in a timely fashion. However, the intensified competition and sharply lower prices that result from the continuing influx of new competitors could affect the Group's performance adversely.

#### 3. Business Development in the Asian Area

The Group is proactively engaged in expanding its business at the global level through area-specific marketing activities and cost-cutting efforts as it advances into North America, Europe and Asia. Asia is especially vulnerable to various unavoidable risks, including unexpected changes in the legislative, taxation and regulatory frameworks, transportation delays, power cuts and other social disruptions arising from inadequate infrastructures, political changes, war and terrorism, and SARS epidemics. Should

any of these risks actually arise, the Group's performance could be adversely affected.

#### 4. Deficits in North America

The Group has been making forward-looking investments in the North American market, purchasing Aveva Drug Delivery Systems (ADS) with a view to expanding its healthcare business in the region, and consolidating production at the Pleasant Prairie Plant of Permacel (PC) to establish a more efficient production system and deal more effectively with the need for clean product handling systems. As a result of the expenses arising from these efforts, the Group's North American operations posted an operating loss in fiscal 2004. This means the Group's performance could be affected adversely if the environment facing its businesses followed an unexpected course that caused these investments to lose their viability.

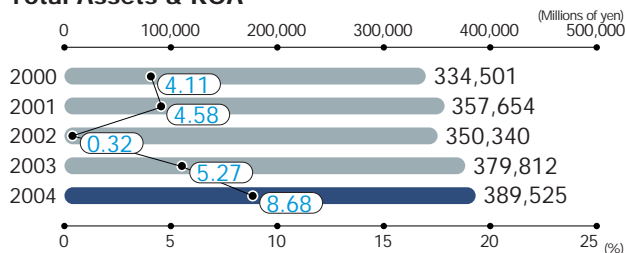
#### 5. Product Defects

The Group is endeavoring to earn customer trust by manufacturing products in accordance with the ISO 9000 series of quality management standards. Since producer goods transactions are the basis of our business, we believe we are unlikely to find ourselves in a position of compensating end-users or recalling our products. However, the Group and its products would lose trust and its performance could be affected adversely should we find ourselves in the position of having to compensate final consumers for defective products or make product recalls that result in compensation exceeding product liability insurance coverage.

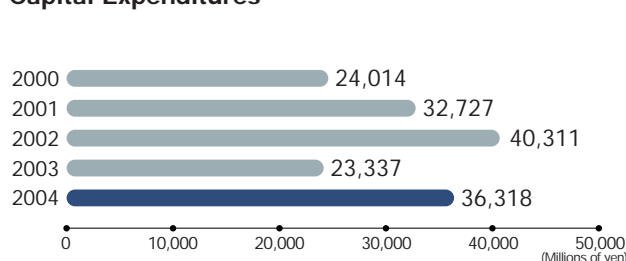
#### 6. Environmental Issues

Environmental conservation activities have always been an important element of our Group's management policy and as a result of our efforts to reduce waste, prevent global warming and atmospheric pollution, and engage in ISO 14000 activities, we have never caused a major environmental problem. The Group uses large quantities of toluene, disclosing this fact in the PRTR (Pollutant Release and Transfer Register) and environmental reports, and is

**Total Assets & ROA**



**Capital Expenditures**



implementing a reduction plan that it drew up voluntarily. However, there is a possibility that it would incur large environment-related expenses under the provisions of newly-enacted legislation.

### 7. Laws and Regulations

The Group's pharmaceutical-related business requires the approval of the Ministry of Health, Labour and Welfare (MHLW) for the manufacture and sales in Japan of transdermal therapeutic patches (for asthma and ischemic heart disease) and "Yukiban" surgical tapes. In fiscal 2004, as part of its program to develop its pharmaceuticals business at the global level, the Group also acquired ADS, which has received approval to manufacture and sell pharmaceuticals in the United States. Pharmaceutical-related products are therefore subject to certain regulations, and since there is a possibility that these regulations may change in Japan and the United States in the future, this could affect the Group's performance.

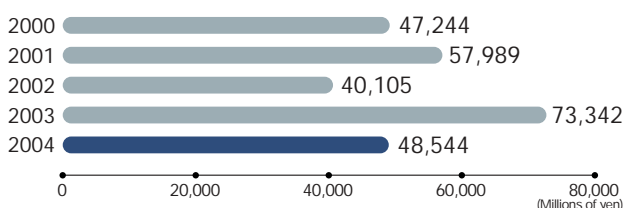
### 8. Impact of Accidents and Disasters

In order to prevent damages arising from accidents or disasters caused by fires, explosions and the like, we are committed to ensuring that facilities inspections, safety equipment and fire extinguishing equipment are adequate, and to engaging in various kinds of safety activities. One of our most important production centers, the Toyohashi Plant, is located in an "Area under Intensified Measures against Earthquake Disasters." To prevent direct damage and secondary disasters, the plant has improved its facilities by reinforcing them against earthquakes and installing automatic shutoff devices, and carries out periodic emergency drills. Yet there is still a possibility that the Group's performance could be adversely affected. Accidents and disasters could still occur despite these efforts, while the scope of the compensation payable under the earthquake insurance taken out for the Toyohashi Plant in the earthquake-prone Tokai region is limited.

### 9. Retirement Benefit Obligations

Expenses for the Group employees' retirement benefits are calculated on the basis of assumptions established for discount ratios and other actuarial calculations or on the basis of expected returns on pension assets. Generally speaking, this affects the expenses recognized and the obligations posted at some future time because in cases where actual results differ from the preconditions, or the preconditions are altered, the cumulative impact is recognized systematically going forward. The Group's performance could therefore be adversely affected by such factors as weaker pension asset investment performance or further reductions in discount rates.

#### Cash & Cash Equivalents



#### Depreciation & Amortization

