

# Analysis of Results of Operations and Financial Condition

## 1. Results of Operations

### 1. Overview

In the financial environment of this fiscal year, the primary causes for the decelerating tempo of growth were sharp rises in energy prices and climbing prices for raw materials, but general performance was stable due to the good shape of the digital sector and high growth in capital expenditures. In the second half a sense of ambiguity regarding future business exports and manufacturing conditions arose, due to uncertainty in the U.S. and Chinese economies.

In this economic environment, the Nitto Denko Corporation and its consolidated subsidiaries (the "Group") continued to expand its focus. While the Group continued to supply industrial materials, electronic circuit materials and macromolecular separation membranes to the FPD (Flat Panel Display) industry, it also shipped engineering plastics to the automobile and office automation machinery industries. Further, initiatives in medical materials for transdermal therapeutic patch products has yielded promising developments, resulting in net sales increasing 13.7% over the previous period, to ¥514,868 million. Operating income increased by 25.2% to ¥70,019 million, and net income increased by 25.3% to ¥41,843 million.

### 2. Analysis of Income Statement

#### Net Sales

Net sales were ¥514,868 million, an increase of 13.7% over the previous fiscal year. Excluding unfavorable effect of foreign exchange conversion due to a stronger yen, this represented a substantial growth rate of 15.4%. Among these results, the proportion of overseas sales of LCD related materials has grown significantly, and domestic sales held steady with a 1.5% growth over the previous year to ¥246,761 million. In turn, LCD materials for Asia and Oceania have grown and there were increased yields due to changes in scope of consolidation and equity method, resulted in the overseas sales ratio for total consolidated sales grew from 46.3% to 52.1%.

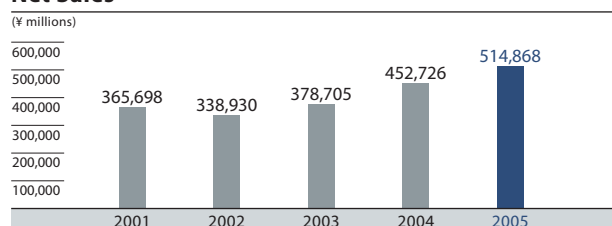
Sales in the Industrial Products segment increased by 8.2% over the previous year to ¥207,366 million, and the operating income for the segment was ¥16,539 million (up 23.1%). The trends were good for cellular phone and small format LCD module materials, and sales to East Asia for office automation products, consumer electronics and laptop computers were also firmer. Sales of surface protection products for machinery, equipment and construction materials for houses stayed at the prior level, but sales of those for the FPD industry benefited from the effect of increases in LCD panel production. Sales of sealing materials for cellular telephones and automobiles were satisfactory, and construction materials for house renovation and waterproofing of window surrounds were steady.

In the Electronic Products segment sales were up 19.0% in comparison to the previous year, for a record ¥261,542 million. Operating income reached ¥47,153 million, growth of 21.3% over

the previous year. In particular, LCD materials had favorable results due to the market's expansion and the enlargement of LCD panels. Despite the effect of lower prices, optical compensation films for LCD TVs went strong and sales of polarizing board with viewing angle compensation film for LCD TVs were also satisfactory. Positive developments in laptop computer production also resulted that the overall sales were good for high-grade optical films, including enhanced brightness polarized films. In the first half sales of semiconductor materials were strong led by our leading edge resin for package sealing, but these went slow in the second half as the effects of inventory adjustment in the marketplace. In circuit materials, sales were weak for small-format LCD modules used in cellular phones, but thin metal core board for magnetoresistive heads (MRH) used in hard disk drives sold well giving a positive result overall. In the second half, sales of electronic processing materials were affected by reduction of production in the electronic parts industry, but, throughout the year, sales of protection tapes and laminating device applicators for semiconductor processing went firmer.

The sales of the Functional Products segment grew 11.2% to ¥45,960 million, and operating income was a 76.1% improvement over the previous year's performance, reaching ¥6,327 million. While the overall market for medical goods is being influenced by political measures to restrain medical expenditure, main products in the medical-related materials, transdermal therapeutic patches used for the treatment of bronchial asthma, sold well as did cosmetic-related products in healthcare products. Accordingly, while there was a cost burden for research and development carried out by Aveva Drug Delivery Systems (ADS), our US manufacturer of transdermal therapeutic patches, the business overall moved to a positive position. Polymer separation membranes had reduced sales due to reductions in large-scale desalination projects and lowered prices for membranes used for water purification in the semiconductor industry, but since the sales for smaller scale desalination projects and sales for industrial water purification to East Asia were strong, the overall sales were stable. Functional materials such as engineering plastics for automobile parts and internal pressure-regulating membranes for office automation equipment sold well, as did sales of porous process materials for the electronics industry.

#### Net Sales



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

In line with the rise in net sales, the Cost of Sales (COS) grew 13.0% compared to the previous year to a total of ¥355,881 million. Due to efforts to reduce costs for raw materials and improved yields as well as improvement of production associated with the greater scale of sales, COS ratio against sales declined by 0.4% to 69.1% even though there was a reduction in the price of finished goods. Selling, General and Administrative expenses (SG&A) were 8.5% higher than the previous year, up to ¥88,968 million. This was mainly due to increases in personnel costs, freight, and outsourcing fees. The ratio of SG&A against sales was 17.3%, which was 0.8% less than the previous year.

## Operating Income

Along with the rise in sales, the reduction in COS and SG&A as a proportion of sales led to a dramatic increase in operating income by 25.2% over the previous year to ¥70,019 million.

Electronic Products segment made the greatest contribution to the increased profit, with a net increase of ¥8,271 million, a 21.3% growth rate. Secondary, Industrial Products contributed to a net increase of ¥3,102 million, which was a 23.1% growth rate. Operating income in Functional Products grew 76.1% in comparison to the previous period, a net increase of ¥2,734 million. LCD-related materials made the largest contribution to the increased income of Electronic Products followed by good performance of circuit materials, medical-related and engineering plastics materials contributed to Functional Materials' growth.

## Other Income (Expenses)

From the previous year's net other income of ¥1,163 million, the total declined to a net other expenses of ¥43 million. While equity in earnings of nonconsolidated subsidiaries and affiliates was ¥2,626 million and rose by 3.7% or an increase of ¥92 million, the decrease was due not having the one-time reversal of the allowance for pension and severance benefits which amounted to ¥1,958 million in the previous year. Also, in fiscal 2004 a special extraordinary loss of ¥683 million was written off for loss on evaluation of goodwill at our US subsidiary Graphic Technology, Inc. (GTI), and an additional loss on evaluation of goodwill at GTI of ¥258 million was accounted for in this fiscal year.

## Income before Provision for Income Taxes

As a result of the above items, income before provision for income taxes increased by 22.6% over the previous year to ¥69,976 million.

## Provision for Income Taxes

The total of corporate income taxes, local income taxes, enterprise taxes and adjustments to income tax was ¥26,616 million, up from ¥21,901 million in the previous year.

Tax reductions for research and development expense in Japan lowered the corporate tax rate. On the other, losses incurred in subsidiaries mainly in the U.S., could not be utilized to recognize deferred taxes, which increased the rate. As a result the effective tax rate became 38.0%, a small reduction of 0.4% from last year's rate, 38.4%.

## Net Income

Due to the above, the net income for the current period was ¥41,843 million, an increase of 25.3% over the previous year. The net income per share rose 27.6% to ¥252.72 (¥252.58 after dilution).

## Results by Geographic Area

### Japan

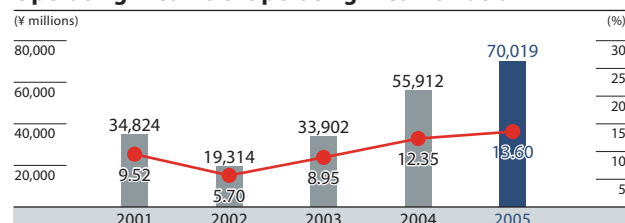
Bonding and joining materials performed well in the cellular phone and small LCD market. Sales of surface protection materials for the FPD industry increased, along with those increased production of LCD panels. Sales of sealing materials for the automobile industry and cellular phones also improved. For LCD-related materials, the growth in advanced compensation films and viewing angle compensation films in accordance with growing screen size of LCD TVs and monitors made a great contribution to the results. For medical materials, despite stagnation of the overall market due to the effect of political measures to restrain medical costs, our main transdermal therapeutic tape has performed well and cosmetic-related medical health products have also been satisfactory.

As a result of the above, sales increased by 3.1% to ¥295,115 million and operating income increased by 28.9% to ¥65,918 million

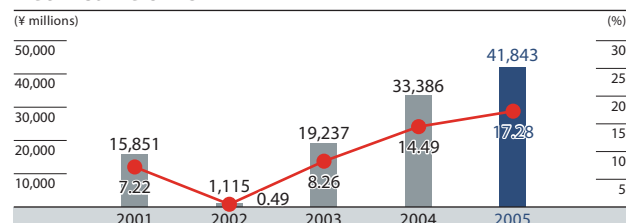
### North America

In North America, US-based transdermal therapeutic patch sales and manufacturing company Aveva Drug Delivery Systems (ADS), which was acquired by the "medical-related

## Operating Income & Operating Income Ratio



## Net Income & ROE



materials business" in the last fiscal year, faced delays in the launch of its new product and did not contribute to results. The high-polymer separation membrane business has shown signs of recovery thanks to orders from the Iraq reconstruction and the Indian Ocean tsunami relief efforts, but suffered from the effects of a slump in prices due to increased competition.

As a result of the above, sales decreased by 3.7% to ¥35,837 million and operating losses increased by 3.3 % to ¥2,479 million.

### Europe

In Europe, while the sales of its main industrial material products to the automobile industry were stable, bad debts losses incurred in the second half.

As a result of the above, sales increased by 5.9% to ¥17,393 million and operating income decreased by 51.6% to ¥247 million.

### Asia and Oceania

Bonding and joining materials for office automation and consumer electronics performed well. While the LCD-related materials segment suffered from the drop in prices for optical compensation films for LCD TVs, sales to LCD monitors and laptop computer manufacturers were strong. Circuit materials had good sales of thin metal core board for magnetro resistive heads (MRH) used in hard disk drives.

As a result of the above, sales increased by 47.7% to ¥166,523 million and operating income decreased by 9.3% to ¥5,937 million.

## 2. Analysis of Financial Condition

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

Total consolidated assets at the end of fiscal 2005 were ¥443,264 million, which exceeded the end of the previous fiscal year by 13.8% or ¥ 53,739 million. Of this amount, current assets increased by 7.5% or ¥15,912 million over the previous year-end to ¥227,206 million, tangible fixed assets (plant and equipment) increased by 19.5% or ¥27,194 million to ¥166,524 million, and investments and other assets increased by 27.3% or ¥10,633 million to ¥49,534 million.

The main factor in the increase in current assets is the increase in accounts receivable and inventories due to increased sales.

The major cause of the increase in tangible fixed assets

was the capital investment in manufacturing facilities to supply for the FPD industry, which is expected to continue to grow in the future. With regard to the increase in investment and other assets, long-term deferred tax assets decreased by ¥1,579 million but investments in nonconsolidated subsidiaries and affiliates increased by ¥2,033 million. Also, to give due consideration to the materiality of retirement severance allowances, which had been shown as netted-off amounts in the prior years, retirement allowance and prepaid pension costs were presented on a gross basis at this fiscal year's consolidated accounts. As a result, the prepaid pension cost increased by ¥10,524 million.

Total liabilities at the end of fiscal 2005 increased by ¥17,477 million or 11.3% over the previous year to a total of ¥171,905 million.

Current liabilities at the end of fiscal 2005 increased by 5% or ¥6,945 million compared to the previous year-end, and reached ¥145,219 million due to growth of ¥2,833 million in accounts payable for equipment and an increase of ¥3,516 million for accrued income taxes.

Long-term liabilities increased by 65.2% or ¥10,532 million over the previous year-end to reach ¥26,686 million, due to an increase of ¥5,388 million in the allowance for severance and pension benefits, as well as increase of long-term debt of ¥2,756 million.

Consolidated shareholders' equity at the end of fiscal 2005 totaled ¥261,091 million, a 17% or ¥37,977 million increase from the previous year-end.

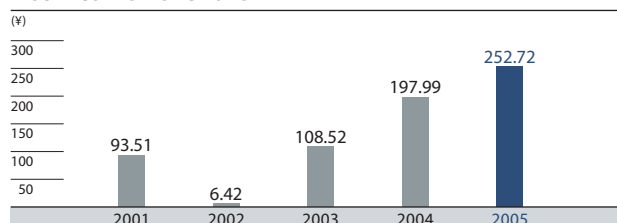
This is because retained earnings have increased by ¥32,331 million or 16.4% over the previous year-end to ¥228,927 million from growth in net income, etc.

Consequently, the shareholder equity ratio has risen from 57.3% to 58.9%.

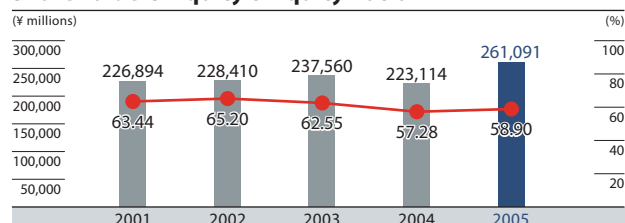
### 2. Cash Flow Analysis

Consolidated cash and cash equivalents (hereafter "cash") reduced by ¥47,594 million (the previous fiscal year featured a ¥27,085 million reduction) due to vital capital expenditure for fixed asset acquisition, despite a growth in income before provision for income taxes of 22.6% to ¥69,976 million. Further reduction of ¥7,854 million due to increased dividends (the previous fiscal year dividends were ¥5,034 million), the Group's cash was reduced by 0.5% or ¥266 million in comparison to the previous year-end to ¥48,278 million. Also, changes in the scope of consolidation in this fiscal year increased cash by ¥1,250 million.

#### Net Income Per Share



#### Shareholders' Equity & Equity Ratio



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Net cash provided by operating activities increased by 21.2% or ¥9,800 million over the previous year-end to ¥56,068 million. This was because while on the one hand income before provision for income taxes, which is the principal source of cash inflow, increased by 22.6% over the previous term's result to ¥69,976 million. There were also depreciation of non-cash items increased by 15.4% as compared to the previous year to ¥24,681 million and there was a huge change in the increase in trade notes and accounts receivable of 56.4% compared to the previous year of ¥8,041 million, which is usually caused by sales.

Net cash flow used in investing activities increased by 57.0% or ¥17,859 million to ¥49,171 million. This was primarily because expenditures for acquisition of plant and machinery increased by 75.7% or ¥20,509 million to ¥47,594 million.

Net cash flow used in financing activities greatly decreased by ¥30,015 million from the previous year to ¥9,155 million. There were cash inflows due to the exercise of stock options in contrast to ¥39,111 million of cash outflows mainly for the purchase of treasury stock in the previous year. In addition, payment of dividends increased by 56.0% to ¥7,854 million.

## 3. Business and Other Risks

### 1. Exchange Rate Fluctuations

The Group manufactures and sells in various areas of the world. 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, Asian currencies 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. Worldwide Expansion of Business

The Group is advancing operations in the United States, Europe and Asia and actively promoting global business development through marketing activities and reduction of the production cost of each area. On the other hand, in the Asian region, there are unavoidable inherent risks such as unexpected changes of laws, tax systems and regulations, or social disruption due to undeveloped social infrastructure such as transportation delays and power cuts, as well as political changes, war and terrorism. If these risks eventuate, there is a possibility that they will affect the performance of the Group.

### 4. Operational Developments in the North American Region

The Group is developing industrial materials and functional products (films, medicines) in North America region. While the Group is taking active measures such as integrating the production of local affiliates, the Group posted an operating loss in fiscal 2005. Although the Group is making efforts to increase efficiency and aiming for profits, there is a possibility that it will affect the performance of the Group.

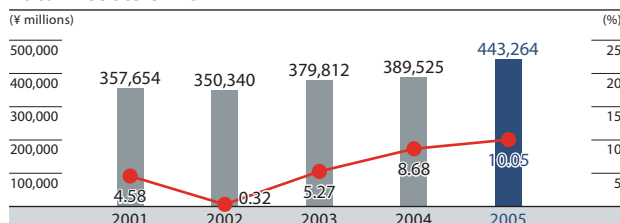
### 5. Capability of New Products Development

In the areas in which the Group develops products, there are difficult demands for technical innovation and cost competition. Therefore, under the Global Niche Top strategy the Group is making investments in research & development and equipment that is necessary for new technology, new product development and production process innovation. However as it is not easy to forecast market changes and technology innovations, there is a possibility that it will affect the future corporate management if conditions change more than expected.

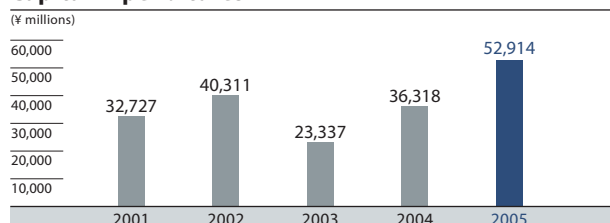
### 6. Intellectual Property

The Group owns, maintains and manages a number of intellectual properties. There is a possibility that they may be invalidated by third parties or they may not be protected

## Total Assets & ROA



## Capital Expenditures



enough in particular regions, and could be imitated. In the case of protection on intellectual property being significantly impaired, it is possible that the performance of the Group will be impacted.

### 7. 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, the Group believes it is unlikely to find itself 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 if the Group is claimed o compensate final consumers for defective products or make product recalls to the extent exceeding product liability insurance coverage.

### 8. Environmental Issues

Environmental conservation activities have always been an important element of the 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 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 environmental regulations.

### 9. Laws and Regulations

The Group’s business includes licensed medicines like transdermal therapeutic patches (for asthma and ischemic heart disease) and items for medical use such as surgical tapes. In conducting the Group’s business activities the Group has applied the various laws and regulations. In case of major changes in related laws and regulations, it is possible that the Group’s results may be impacted due to restrictions of the Group’s activities and additional costs.

### 10. Impact of Accidents and Disasters

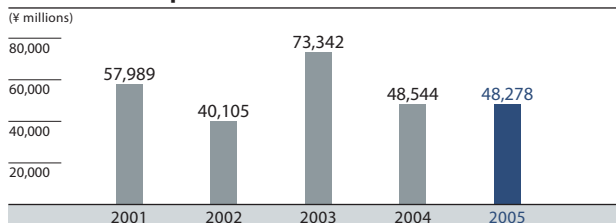
In order to prevent damages arising from accidents or disasters caused by fires, explosions and the like, the Group is

committed to ensuring that facilities inspections, safety equipment and fire extinguishing equipment are adequate, and to engage in various kinds of safety activities. One of the 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.

### 11. 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 recorded at some future time because in cases where actual results differ from the assumptions, or the assumptions are altered, the cumulative impact is recognized in the future period. The Group acts as a welfare pension agent, and despite intending to restore part of the pension funds to the Japanese Government and by means of this reduce the risk of a lack of deposits arising, if in future the lowering of market interest rates or deterioration in the return on pension assets occurs there is the possibility of the Group’s results being influenced by increased retirement benefit liabilities or by forecasts of insufficient deposits.

#### Cash & Cash Equivalents



#### Depreciation & Amortization

