

Business Report 2005

April 1, 2005 – March 31, 2006

A Message to Our Shareholders

During the past consolidated fiscal year, we have seen a number of positive indicators in the Japanese economy, ranging from increases in capital investment as the result of improved corporate performance to a recovery in consumer spending due to favorable employment and income conditions.

The chemical industry generally enjoyed firm domestic demand and increased exports to China and other parts of Asia, but there were products where profits were negatively affected by increases in raw material costs which could not be passed on to product prices.

It was under these conditions that our Group entered the second year of our three-year mid-range management plan, "Innovation 88", focusing on directing resources to our core polyurethane materials and imaging materials businesses, and cutting costs to improve overall profitability. We also concentrated on developing the businesses of the future through our research and development efforts, as well as improving our fiscal strength overall.

As a result of these efforts, consolidated sales rose to 112,736 million yen, an increase of 6,421 million yen (6.0%) over the previous year.

Operating profit for this year was 9,516 million yen, an 851 million yen (8.2%) decrease from last year's levels. This is attributed to rising raw material prices, increases in fixed costs associated with capital investment, and softening export market conditions. Ordinary income, at 8,430 million yen, was also down by 843 million yen (9.1%). Although we did post a 1,524 million yen loss from the impairment of subsidiary assets, roughly 800 million yen in deferred tax assets from the partial assignment of Nippon Polyurethane Industry Co., Ltd. stock which took place on April 14th of this year allowed us to finish with a net profit of 4,665 million yen, down only 184 million yen (3.8%) from last year.

We hope that the Japanese economy will continue on the path to recovery. However, raw material costs are increasing and interest rates are starting to rise. Economic trends in the United States and China are also uncertain. For these reasons, we realize that we must continue to be vigilant.

Our Group embarked on a three-year mid-range management plan, Innovation 88, in our 88th year of business, 2004. Because of our sincere devotion to achieving the goals laid out in this plan, we have been able to meet the management objectives laid out in Innovation 88 as of the end of fiscal 2005, a year ahead of schedule. This being the case, we have established a new five-year mid-range management plan, Innovation 90 (2006-2010).

The new plan strives to create the New Hodogaya Group as a highly functional entity that creates high added value. Our first step towards this goal was the reorganization of Group management which took place in April of this year, when we completed the partial assignment of Nippon Polyurethane Industry Co., Ltd. stock to Tosoh Corporation, and made a third-party allocation of new shares to Tosoh.

The key concept of Innovation 90 is the creation of a firm foundation for profitable growth. We have a clear vision of where we would like to go, and are working as a group to get there. I thank our shareholders for their continuing support.

Takashi Okamoto, President

June, 2006

Overview By Business Segment

SPECIALTY POLYMERS DIVISION

Exports of polyurethane materials to China were affected by an influx of products from Europe and pre-marketing efforts associated with production expansions, causing the balance between supply and demand to be shaken and market conditions to soften. However, these problems were offset by firm demand in the first half of the year in the domestic automotive and construction markets. Overall, business in this sector grew.

We saw strong demand for one of our principal polymers, polyether glycol (PTG), in special applications, but overall results in this sector were down due to a drop in sales in commodity spandex and electronics materials applications.

The construction materials business grew, due to increased sales of waterproofing materials and efforts to win parking facility contracts.

The foundry business grew as well, as automotive exports increased and demand for machine tools and construction equipment rose.

Total sales in this division were 84,413 million yen, an increase of 3,348 million yen (4.1%) over last year.

FINE CHEMICALS DIVISION

Increases in sales of charge control agents for toner were seen as demand remained steady in both domestic and overseas markets. Sales of organic photoconductor (OPC) materials dropped because of production adjustments by major domestic and overseas customers. In the field of Organic Light Emitting Diode(OLED) materials, sales of hole transport materials rose as the result of vigorous business development efforts.

In our dyes and colors business, sales of Spilon dyes increased due to steady performance in the areas of stationery goods and aluminum coloring. Sales of Cathilon dyes fell as the domestic fiber dyeing industry continued to shrink. Sales of food additives grew as new markets were developed. In the custom manufacturing business, we were able to apply our strong capabilities in organic synthesis to business development, and as a result, sales of phosgene derivatives for pharmaceutical applications grew.

The agro-science business was down because of distribution-level inventory adjustments in herbicides for home gardening.

Total sales in this division were 13,094 million yen, a decrease of 280 million yen (2.1%) from last year.

BASIC CHEMICALS DIVISION

Sales of sodium chlorate increased as the shift to environmentally-friendly bleaching processes for paper pulp continued. Also, the 15-month accounting period that resulted from Nippon Peroxide's change of fiscal closing date contributed to increased sales.

Total sales in this division were 11,164 million yen, an increase of 1,127 million yen (11.2%) over last year's results.

INNOVATION 90

A NEW MID-RANGE MANAGEMENT PLAN

In April, 2006, marking our 90th year of business, our Group embarked on a new five-year mid-range management plan called “Innovation 90”.

Group Management Reorganization

As the first step in our plan, we made a partial assignment of Nippon Polyurethane Industry Co., Ltd. stock to Tosoh Corporation in April, and issued new shares to Tosoh as part of a third-party allocation. This transaction will be explained in further detail as follows:

1. Group Reorganization

1) Partial assignment of Nippon Polyurethane Industry Co., Ltd. stock

Having determined that the strategic strengthening of Nippon Polyurethane Industry Co. Ltd.'s relationship with Tosoh Corporation would increase its short- and mid-range competitive position, and thereby contribute to our corporate value as a whole, we assigned 500,000 of our 1,950,000 shares of Nippon Polyurethane stock to Tosoh on April 14th.

With this assignment, our ownership of Nippon Polyurethane dropped from 65.0% to 48.3%, changing its legal status from a consolidated subsidiary to an equity method affiliate. Further, the shares were sold for 8,000 million yen, resulting in a 6,700 million yen stock sale profit on a non-consolidated basis, and 4,800 million yen on a consolidated basis.

2) Allocation of New Shares to a Third Party

In order to strengthen our connection with Tosoh Corporation, and to secure funds for new investment in our growth segments, thereby improving our overall financial strength, we issued 10,050,000 new third-party shares to Tosoh on April 19th. With this transaction, we procured 6,200 million yen in funds. Following this capitalization, the number of shares issued rose to about 84million and Tosoh's ownership in Hodogaya rose from 24.29% to 33.34%.

2. Changes Resulting from the Group Reorganization

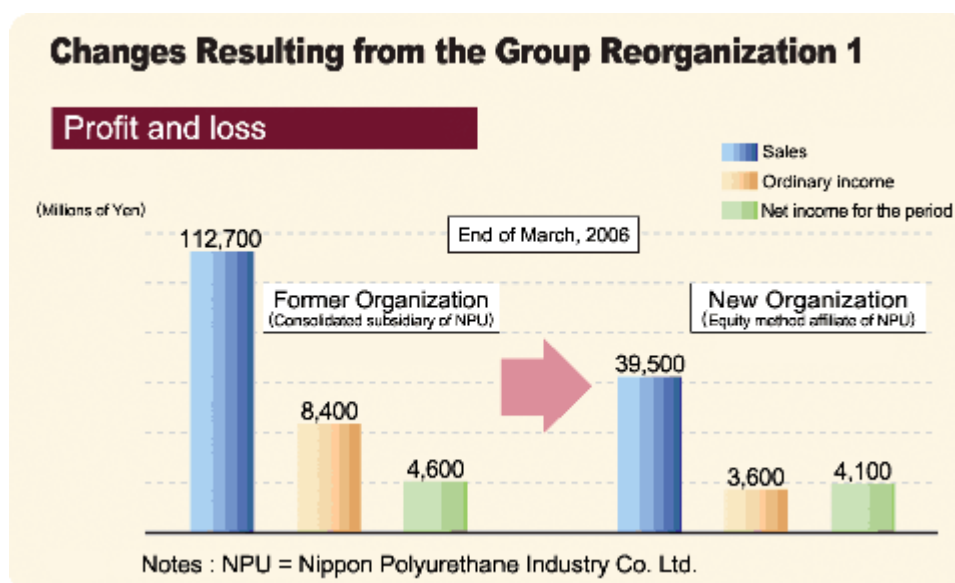
A preliminary calculation of the effects of the Group reorganization on our results as of March, 2006 is shown in the following graphs:

(Note: “Former Organization” refers to the previous structure in which Nippon Polyurethane Industry Co. Ltd. was a consolidated subsidiary. “New Organization” refers to the reorganized structure in which Nippon Polyurethane is an equity method affiliate.)

Profit and loss are affected as follows: (Fig. 1)

- (1) Sales are reduced by nearly two-thirds, from 112,700 million yen to 39,500 million yen.
- (2) Ordinary income drops by 60%, from 8,400 million yen to 3,600 million yen.
- (3) Net income for the period drops by only 10%, from 4,600 million yen to 4,100 million yen. This is because a portion of Nippon Polyurethane's earnings, corresponding to the percentage of Hodogaya Chemical's holdings (from 65.0% to 48.3%), is included in the company's consolidated earnings as per accounting regulations.

(Figure1)



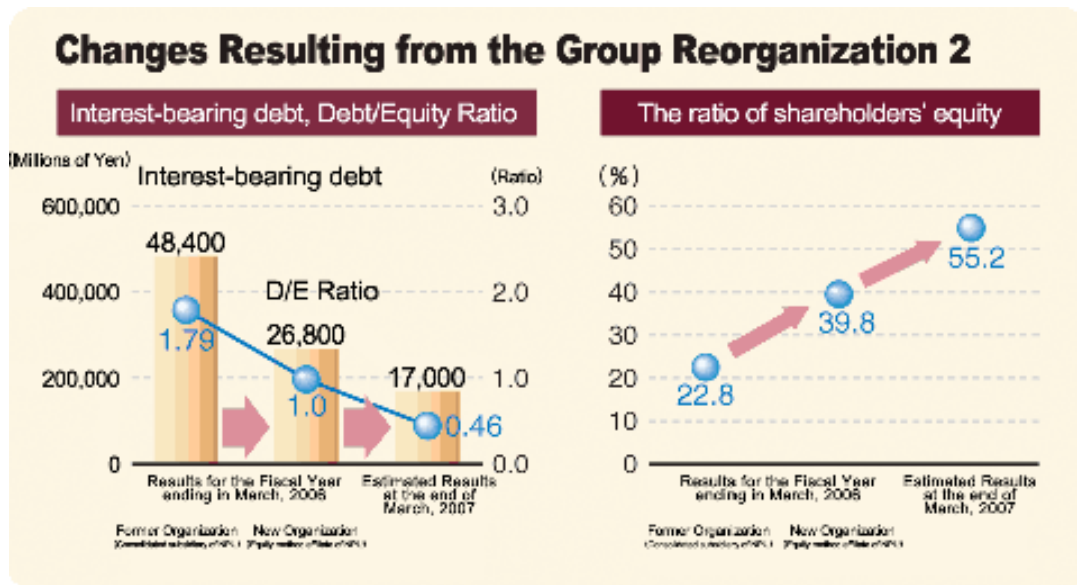
Regarding our financial status, please refer to Figure 2.

- (1) Interest-bearing debt is cut nearly in half, from 48,400 million yen to 26,800 million yen, and our Debt/Equity Ratio improves, going from 1.79 to 1.0. (We expect our interest-bearing debt to be further reduced to 17,000 million yen, and our debt/equity ratio to reach 0.46 by the end of fiscal 2006 (March, 2007).)
- (2) The ratio of shareholders' equity to total assets is improved, reaching 39.8% from 22.8%. We expect this to improve further in fiscal 2006, reaching 55.2% by March, 2007.

As described above, the scale of our operations has been reduced, but this move dramatically improves both profitability and our financial standing.

By restructuring in this way, we are better prepared to deal with fluctuations in profitability brought on by such factors as rising raw materials prices, a stronger yen, increasing interest rates and other changes to our business environment. This reorganization gives us a solid foundation and a measure of stability on which to build future growth.

(Figure2)



ABOUT “INNOVATION 90”

Basic Concept

“Innovation 90” is based on the concept that a strong and profitable foundation is necessary as the basis for future growth, and is designed to help us achieve our goals of becoming a highly functional value added entity.

The plan is divided into two parts, Phase I which covers the first two years (2006-2007), and Phase II, which covers the latter three years (2008-2010).

1)Phase 1

The initial phase of our plan focuses on identifying the role of each business in the formation of a “growth-oriented management foundation”, strengthening core and developing businesses, initiating new businesses and reorganizing our business base in a proactive manner.

2)Phase 2

In this phase, we will build on the results of our Phase I efforts in order to speed up the transformation into a highly profitable organization. In the final year 2010, we plan to reach sales of 50,000 million yen, with an operating profit margin of 13%.

BASIC STRATEGY

1. Establishment of a business portfolio that will contribute to dramatic growth

Imaging materials and construction materials will be designated as core businesses, while OLED materials and carbon nanotube products will be designated as developing businesses. Management resources will be allocated accordingly to ensure the fortification and growth of each business.

Other existing businesses will be restructured and reorganized to maximize profitability.

1) Development of a Growth Strategy

(1) Accelerated Growth in Core Business Areas

(1.1) Imaging Materials

Regarding charge control agents for toner, we will continue to expand our product line and develop products that address both environmental issues and the proliferation of color systems. Regarding organic photoconductor (OPC) materials, we will strive for synergy through business acquisition. By adding new materials that build on our current competitive advantage in this way, we will be able to expand the scope of our imaging materials business.

(1.2) Construction Materials

It will be expanded through the proactive development of environmentally friendly products.

(2) Increased Focus on Developing Businesses

(2.1) OLED Materials

This business will be expanded as we refine our ability to supply key components for OLED, such as hole transport and electron transport materials.

(2.2) Establishment of Carbon Nanotube Business

We intend to be a world leader in the promising field of multilayered carbon nanotubes through the manufacturing and sales of nanotubes and nanotube composite products.

2) Increasing Profitability of Basic Businesses

By promoting optimization, cost-cutting and alliances, we will strive for the expansion of high value-added and differentiated product lines.

2.Fortifying Research & Development Efforts to Promote Growth

In addition to allocating resources to our core businesses (imaging materials & construction materials), and our developing businesses of the future (OLED materials & carbon nanotubes, etc.), we will reevaluate our research and development efforts, with the goal of having new products account for more than 20% of our non-consolidated sales by 2010.

3.Financial Health and Investment Strategy

1)Financial Health

With the recent reorganization of our Group management, we will continue to pursue profitability and asset efficiency, to insure that our financial standing is on a par with the top companies and continues on an upward trajectory.

2)Investment Strategy

Using the results of our fiscal improvement efforts as an underlying asset, we will undertake a course of strategic investments. In order to aggressively promote our growth plan, we are prepared to strategically invest a total of 15,000 million yen in the development of new businesses, and in the fortification of our core businesses. This plan may include M&A activity.

As we began FY2006, we carried out the following strategic investments:

1)Establishment of Nanocarbon Technologies Co., Ltd.

On April 3rd of this year, we established a joint venture company with Mitsui & Co., Ltd., dedicated to the development, manufacture and sales of multilayer carbon nanotubes and nanotube-composite polymer products.

2)Acquisition of OPC Materials Business

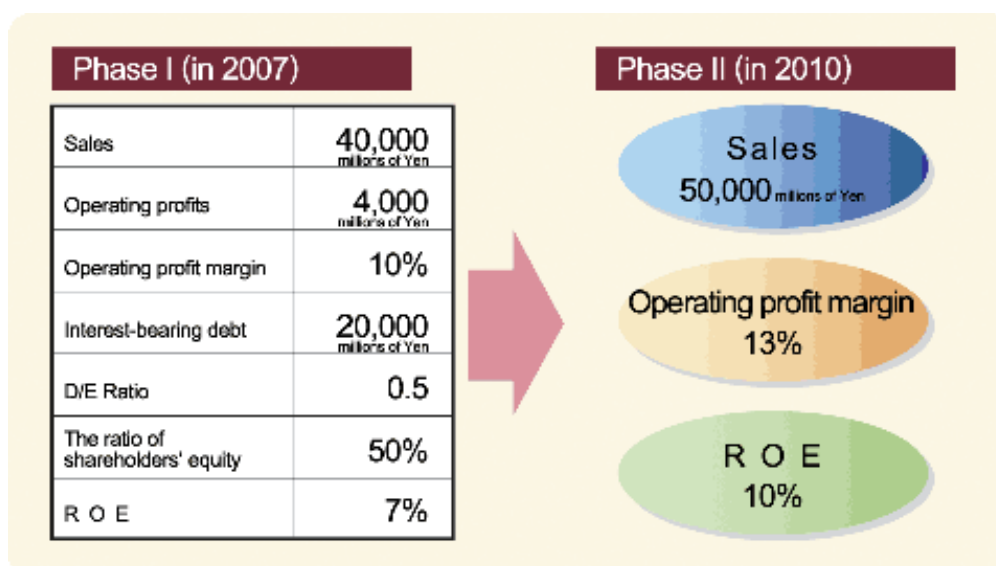
On June 1st of this year, in order to strengthen the competitive and technical position of OPC materials as one of our core businesses, and to better meet customer needs, we acquired Mitsubishi Paper Mills, Ltd's OPC Materials business.

3)Underwriting of Nippon Polyurethane Industry Co. Ltd.'s Capital Increase through Shareholder Allocation

Nippon Polyurethane Industry Co. Ltd. has started on a project to expand production of MDI, an ingredient of polyurethane materials. In order to help Nippon Polyurethane secure investment funds and strengthen its financial standing, on June 15th of this year we underwrote its capital increase through shareholder allocation in accordance with our

percentage of ownership (roughly 48%). The underwritten amount was approximately 4,800 million yen.

Management Objectives



By undertaking the measures described above, we hope to achieve the following goals:

Before this mid-range plan is completed, we will have achieved our objective of transforming into a highly functional, high-value added organization, top class in both profitability and financial standing.

By faithfully carrying out the “Innovation 90” plan, the new Hodogaya Group will improve its corporate value as a whole, establish a stable management base for future growth, and meet the expectations of stockholders and other stakeholders.

Estimated Consolidated Results (Effects of the Reorganization)

Millions of Yen						
Account	Results for the Fiscal Year ending in March, 2006 (Estimated)		Estimated Results for the Fiscal Year ending in March, 2007		Rise and fall (Rate)	
Sales	39,500		37,000		△2,500	△6.3%
Operating profits	3,000	7.6%	3,100	8.4%	100	3.3%
Ordinary income	3,650	9.2%	3,800	10.3%	150	4.1%
Net income for the period	4,150	10.5%	4,700	12.7%	550	13.3%

Account	Results at the end of March, 2006 (Estimated)	Estimated Results for the Fiscal Year ending in March, 2007	Rise and fall
Total assets	66,500	67,000	500
Interest-bearing debt	26,800	17,000	△9,800
Shareholders' equity	26,500	37,000	10,500

We expect to see increases in sales resulting from the acquisition of the OPC materials business and from our imaging materials business, but overall sales are only expected to reach 37,000 million yen, a 2,500 million yen (6.3%) decrease from the previous period. This is because of the change in reporting period of Nippon Peroxide Co., Ltd, which contributed to last period's sales increase, and because of other temporary spikes in sales not seen in the current period.

Note: “(Estimated) Results for the Fiscal Year ending in March, 2006” and “(Estimated) Results at the end of March, 2006” are calculated using the same standards as those used to calculate “Estimated Results for the Fiscal Year ending in March, 2007” and “Estimated Results at the end of March, 2007” (i.e., calculations are based on the new corporate structure following the reorganization of the group.)

Millions of Yen

Account	Results for the Fiscal Year ending in March, 2006 (Estimated)		Estimated Results for the Fiscal Year ending in March, 2007		Rise and fall (Rate)	
Sales	22,458		23,300		841	3.7%
Operating profits	1,981	8.8%	2,200	9.4%	218	11.0%
Ordinary income	2,337	10.4%	2,100	9.0%	△237	△10.2%
Net income for the period	3,000	13.4%	5,200	22.3%	2,199	73.3%

Account	Results at the end of March, 2006 (Estimated)		Estimated Results for the Fiscal Year ending in March, 2007		Rise and fall
Total assets		50,124		54,500	4,375
Interest-bearing debt		24,558		15,500	△9,058
Shareholders' equity		20,180		32,500	12,319

CONSOLIDATED FINANCIAL STATEMENT

CONSOLIDATED BALANCE SHEETS

Hodogaya Chemical Co., Ltd and its Consolidated Subsidiaries for the years ending March 31, 2006 and 2005

ASSETS	MILLIONS OF YEN	
	2006	2005
Current Assets		
Cash and cash equivalents	¥15,472	¥16,469
Notes and accounts receivable	30,159	28,530
Marketable securities	1,230	1,345
Inventories	14,632	14,301
Others	4,926	3,414
Allowance for doubtful accounts	(102)	(87)
Total Current Assets	66,320	63,974
Fixed Assets		
Tangible Fixed Assets		
Depreciable assets	24,551	23,040
Land	12,907	12,904
Construction in progress	655	906
Others	1,193	1,029
Total Tangible Fixed Assets	39,307	37,880
Intangible Fixed Assets	178	221
Investment		
Investment securities	8,459	6,169
Long-term loans receivable	911	1,095
Others	4,394	3,803
Less allowance for doubtful accounts	(683)	(680)
Total Investment	13,082	10,387
Total Fixed Assets	52,568	48,490
Total Assets	¥118,888	¥112,464

LIABILITIES/MINORITY INTERESTS AND SHAREHOLDERS' EQUITY	MILLIONS OF YEN	
	2006	2005
Current liabilities		
Notes and accounts payable	¥23,165	¥20,677
Currents portion of bond	580	100
Short-term bank loans	27,507	27,489
Others	6,868	8,839
Total Current Liabilities	58,121	57,106
Long-term liabilities		
Long-term debt less current portion	20,408	20,842
Reserve for employees' retirement benefits	2,542	2,528
Reserve for directors' retirement benefits	304	262
Others	3,985	3,835
Total Long-term liabilities	27,240	27,469
Total liabilities	85,361	84,576
Minority interests	6,418	5,834
Shareholders' equity		
Common stock	8,081	8,081
Capital surplus	6,478	6,479
Retained earnings	8,936	4,408
Revaluation reserve	2,416	2,416
Securities valuation surplus	1,435	756
Translation adjustment	11	(8)
Less: Treasury share at cost, 274,225 shares in 2005		(77)
Less: Treasury share at cost, 567,734 shares in 2006	(251)	
Total shareholders' equity	27,108	22,054
Total liabilities minority interests and shareholders' equity	¥118,888	¥112,464

CONSOLIDATED STATEMENTS OF INCOME

Hodogaya Chemical Co., Ltd. and its Consolidated Subsidiaries for the years ending March 31, 2006 and 2005

	MILLIONS OF YEN	
	2006	2005
Net Sales	¥112,736	¥106,315
Cost of sales	85,298	79,141
Selling, general and administrative expenses	17,921	16,805
Operating income	9,516	10,368
Other income	1,090	1,132
Other expenses	2,176	2,226
Ordinary income	8,430	9,273
Extraordinary income	26	116
Extraordinary expenses	1,869	990
Income before income taxes	6,587	8,400
Current	2,197	3,202
Deferred	(1,277)	(1,201)
Minority interests	1,001	1,549
Net income	¥4,665	¥4,850

STOCK

AUTHORIZED NUMBER OF SHARES (AS OF MARCH 31, 2006)

200,000,000

NUMBER OF COMMON SHARES ISSUED (AS OF MARCH 31, 2006)

74,087,261

NUMBER OF SHAREHOLDERS

8,973

MAIN SHAREHOLDERS (TOP 10 COMPANIES)

Shareholder	Number of Shares Held (in thousands)	Percentage of Shares Held (%)
Tosoh Corporation	17,999	24.88
The Master Trust Bank of Japan, Ltd.	3,163	4.37
Mizuho Corporate Bank, Ltd.	2,987	4.13
Japan Trustee Services Bank, Ltd.	2,581	3.57
The Norinchukin Bank	2,274	3.14
Morgan Stanley and Company International Limited	1,739	2.40
Meiji Yasuda Life Insurance Company	1,645	2.27
Asahi Mutual Life Insurance Company	1,643	2.27
Mitsui Sumitomo Insurance Company, Limited	1,414	1.95
Japan Securities Finance Co., Ltd.	1,244	1.72