

Report to shareholders

Business Report 2006

April 1, 2006 – March 31, 2007

A Message from our President

Our 90th year of business, 2006, was a landmark year in terms of our efforts to build a “new” Hodogaya Chemical Co.

The Hodogaya Group launched a five-year strategic management initiative called “Innovation 90” in April, 2006. This plan was designed to create a firm foundation for future growth by concentrating management resources on core and developing businesses.

This year, we dramatically improved our financial position through a partial assignment of Nippon Polyurethane Industry Co., Ltd. stock to Tosoh Corporation, and a third-party allocation of new shares to Tosoh. In addition, we have made a number of strategic investments: Nano Carbon Technologies Co., Ltd. was established as a joint venture between Hodogaya Chemical and Mitsui & Co., Ltd., and we acquired an organic photoconductor (OPC) materials business from Mitsubishi Paper Mills, Ltd. At the same time, we have taken steps to reorganize our business lineup, including a restructuring of our Yokohama Plant operations.

Our entire Group has been mobilized to pursue our goal of becoming a high performance and high value creation company. I would like to express my heartfelt gratitude to our shareholders for their continued support and loyalty.

June, 2007

Takashi Okamoto, President

“Innovation 90” Progress Report

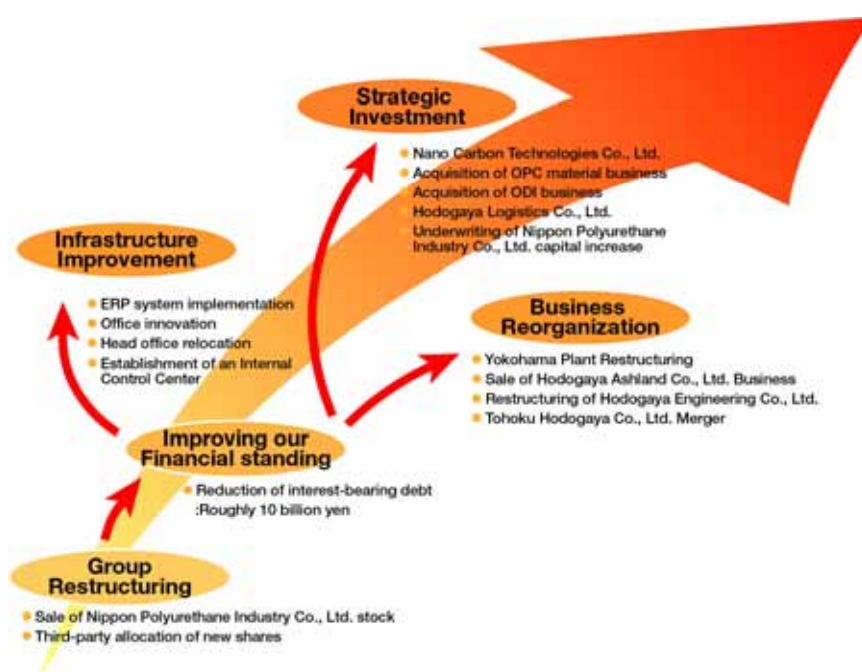
STRATEGY

Improving our financial standing and focusing management resources.

Aggressive management development to take us to the next stage of our journey.

In 2006, we tackled a Group restructuring (the partial assignment of Nippon Polyurethane Co. Ltd. stock, and a third-party allocation of new shares), the implementation of strategic investments (launching new projects and acquiring businesses), business restructuring, the dramatic improvement of our financial standing, and the strengthening of our management base.

In 2007, the following measures will be taken to continue to improve profitability:



GROUP REALIGNMENT

1) Group restructuring

Sale of Nippon Polyurethane Industry Co., Ltd. stock: 8,000 million yen

In order to improve Nippon Polyurethane’s mid- and long-range competitive position, we sold 500,000 of our 1,950,000 Nippon Polyurethane shares to Tosoh Corporation on April 14, 2006. The sale value of the stock was 8,000 million yen, with a profit of roughly 6,700 million yen (non-consolidated), or 5,000 million yen (consolidated basis).

Third-party allocation of new shares: 6,200 million yen

In order to strengthen our ties with Tosoh Corporation, secure funds for new development in growth areas, and improve our financial standing, on April 19, 2006 we completed a third-party allocation of 10,050,000 new shares to Tosoh, for roughly 6,200 million yen.

IMPROVE BALANCE SHEET

2) Improving our financial standing

Reduction of interest-bearing debt: roughly 10,000 million yen.

With the assignment of part of our Nippon Polyurethane holdings to Tosoh, that company's legal status switched from consolidated subsidiary to equity method affiliate. We used part of the proceeds from the sale of stock and the third-party allocation of new shares to pay off some loans, reducing interest-bearing debt by nearly 10,000 million yen, from 26,700 million yen to 16,300 million yen (post-reorganization comparison).

INFRASTRUCTURE IMPROVEMENT

3) Infrastructure Improvement

ERP System Implementation

Our Group plans to begin using an SAP Enterprise Resource Planning (ERP) system in 2008. This will allow us to 1) improve our competitive position by consolidating and optimizing common office and administrative functions, 2) improve efficiency and accelerate the decision-making process by consolidating management data and making visualization possible, and 3) increase flexibility in response to changing management conditions through the implementation of a unified system.

Office Innovation

In order to achieve our "Innovation 90" goals, we must be able to adapt to an ever-changing business environment. To do this, we are changing the way we think about business, and streamlining our Group administrative processes.

Head Office Relocation

In July, 2007, our head office will relocate to an office in Minato-ku, Tokyo, where we can aggressively and efficiently pursue our management goals. This will allow us to interface with our clients more effectively, and improve the flexibility of our management structure.

Establishment of an Internal Control Center

In November, 2006, we established an internal control center to oversee Group compliance with the Corporation Code and the Financial Instruments and Exchange Law. Specifically, the center will implement internal control plans set forth by the Board of Directors, and ensure compliance with reporting requirements.

BUSINESS RECONSTRUCTION

4) Business Restructuring

Yokohama Plant restructuring

To create a solid platform for growth, we are reevaluating the product lines manufactured at this facility. We will sharpen our focus on high-value added, distinctive products, and phase out unprofitable products. Using the space created by this restructuring, we will expand Hodogaya Logistics Co., Ltd.'s hazardous materials warehouse. The expansion of the hazardous materials handling business will address client needs, and contribute to profitability.

Sale of Hodogaya Ashland Co., Ltd. Business

To further advance our growth strategy, we sold our holdings in Hodogaya Ashland Co., Ltd., to our joint venture partner, Ashland International Holdings, Inc. This business division supplies foundry sand molding agents in the domestic metal casting market.

Restructuring of Hodogaya Engineering Co., Ltd.

Hodogaya Engineering Co., Ltd. was restructured on October 1, 2006. We retained the engineering division through demerger. However, the pump division merged with our Group company, Tanishima Co., and the newly formed company, Hodoka Co., Ltd. will now manufacture and sell pumps.

Tohoku Hodogaya Co., Ltd. Merger

On March 1, 2007, we merged with our wholly-owned subsidiary, Tohoku Hodogaya Co., Ltd. Having achieved our original objectives with regard to the restructuring of our chloralkali business, we felt that this merger would improve the efficiency and flexibility of our organization, and strengthen the competitive position of this important business.

STRATEGIC INVESTMENTS

5) Strategic Investment

Underwriting of Nippon Polyurethane Industry Co., Ltd. capital increase: 4,800 million yen.

On June 15, 2006, we underwrote roughly 48% (corresponding to our share of ownership) of the 10,000 million yen capital increase through share allocation effected by equity method affiliate Nippon Polyurethane Industry Co., Ltd. The amount underwritten was approximately 4,800 million yen. This capital increase is intended to improve Nippon Polyurethane's financial standing, and to finance the large-scale expansion of its MDI manufacturing operations. Nippon Polyurethane expects its business to continue to expand, as demand from China and other parts of Asia increases.

Acquisition of OPC (organic photoconductor) materials business: 800 million yen.

On June 1, 2006, we acquired Mitsubishi Paper Mills, Ltd.'s OPC (organic photoconductor) materials business for roughly 800 million yen. OPC materials will play an important role in the expanding color copier and printer market, so this addition will improve our competitive position in the core business area of imaging materials.

Nano Carbon Technologies Co., Ltd.

On April 3, 2006, Nano Carbon Technologies Co., Ltd. was founded as a joint venture with Mitsui & Co., Ltd. The company will manufacture commercial quantities of multiwalled carbon nanotubes, and will allow us to take full advantage of our organic synthesis and manufacturing capabilities as we strive to become a market leader in this developing field.

Hodogaya Logistics Co., Ltd.

Having determined that management speed and flexibility would be necessary to strengthen and expand our hazardous materials handling business, we converted Hodogaya Logistics Co., Ltd. into a wholly owned subsidiary on February 15, 2007.

Acquisition of ODI Business

On April 2, 2007, we acquired API Corporation's ODI (octadecyl isocyanate) business. We plan to expand this as a basic business, so that we can become a top supplier to both the domestic and the overseas markets.

2007 Business Forecast

Transformation can be uncomfortable, but we will forge ahead and establish a solid footholding in the global marketplace.

The Japanese economy is expected to continue its gradual growth, but economic uncertainties remain. Fuel prices are increasing, and interest rates are on the rise as well. Against this unforgiving backdrop, our Group will be completing Phase I of our "Innovation 90" plan this year. The entire Group has devoted itself to building a firm foundation for future growth, as we work to improve our competitive position by accelerating growth in our core and developing business areas, strengthening our R&D capabilities, expanding through strategic mergers and acquisitions, and cutting costs.

The consolidated and non-consolidated forecasts for FY2007 are presented below (exchange rate: \$1 USD = 115 JPY).

The consolidated operating profit for 2007 is expected to be 3,300 million yen, below our goal of 4,000 million yen. This is because of 2007 tax revisions that added 200 million yen in depreciation costs, and front-loaded restructuring costs. In order to achieve steady growth in Phase II without slowing down the pace of our reforms, we will continue to implement various measures in this manner, and intend to reap the benefits of these efforts as soon as possible to meet our goals.

CONSOLIDATED FINANCIAL STATEMENT

CONSOLIDATED BALANCE SHEETS

Hodogaya Chemical Co., Ltd and its Consolidated Subsidiaries for the years ending March 31, 2007 and 2006

Fiscal year 2006 figures are based on new structure.

	MILLIONS OF YEN	
	2007	2006
ASSETS		
Current Assets	25,364	25,869
Cash and cash equivalents	5,847	4,909
Notes and accounts receivable	12,883	13,791
Inventories	5,544	5,478
Others	1,090	1,689
Fixed Assets	43,194	40,691
Tangible Fixed Assets	22,102	23,358
Intangible Fixed Assets	948	37
Investment	20,142	17,296
Total Assets	68,558	66,561
LIABILITIES		
Notes and accounts payable	6,762	6,756
Currents portion of bond	16,330	26,793
Others	8,752	6,190
Total Liabilities	31,845	39,740
SHAREHOLDERS' EQUITY		
Common stock	11,196	8,081
Capital surplus	9,594	6,478
Retained earnings	12,797	8,684
Less: Treasury share at cost, 567,734 shares in 2006		(251)
Less: Treasury share at cost, 2,366,213 shares in 2007	(936)	
	3,856	3,579
Minority interests	204	247
Total Shareholders' equity	36,712	26,820
Total Liabilities and Shareholders' equity	68,558	66,561

CONSOLIDATED STATEMENTS OF INCOME

Hodogaya Chemical Co., Ltd. and its Consolidated Subsidiaries for the years ending March 31, 2007 and 2006

Fiscal year 2006 figures are based on new structure.

	MILLIONS OF YEN	
	2007	2006
Net Sales	37,033	39,501
Cost of sales	27,141	29,375
Selling, general and administrative expenses	7,029	7,111
Operating income	2,863	3,014
Other income	1,137	2,175
Other expenses	1,380	1,509
Ordinary income	2,620	3,681
Extraordinary income	5,695	8
Extraordinary expenses	1,624	119
Income before income taxes	6,690	3,570
Current	2,020	267
Deferred	556	(856)
Minority interests	(84)	13
Net income	4,198	4,146

STOCK

AUTHORIZED NUMBER OF SHARES (AS OF MARCH 31, 2007)

200,000,000

NUMBER OF COMMON SHARES ISSUED (AS OF MARCH 31, 2007)

84,137,261

NUMBER OF SHAREHOLDERS

9,665

MAIN SHAREHOLDERS (TOP 10 COMPANIES)

Shareholder	Number of Shares Held (in thousands)	Percentage of Shares Held (%)
Tosoh Corporation	28,049	34.78
Mizuho Corporate Bank, Ltd.	2,987	3.70
Hodogaya Chemical Co., Ltd.	2,367	-
The Norinchukin Bank	2,274	2.81
The Master Trust Bank of Japan, Ltd.	1,849	2.29
Meiji Yasuda Life Insurance Company	1,645	2.03
Asahi Mutual Life Insurance Company	1,643	2.03
Mitsui Sumitomo Insurance Company, Limited	1,414	1.75
Japan Trustee Services Bank, Ltd.	1,210	1.50
The Bank of Tokyo-Mitsubishi UFJ, Ltd.	1,201	1.48

TOP INTERVIEW

Q1. What is the direction of the “new” Hodogaya Chemical?

Our Group’s primary goal is to become a high performance and high value creation company. To accomplish this, we must create a highly profitable business structure. We have designated our imaging materials and construction materials businesses as core businesses, and our OLED materials and carbon nanotube as developing business areas. Management resources will be allocated to promote growth in each of these areas.

Completion of “Innovation 88”, a three-year management initiative undertaken in 2004, a year ahead of schedule has allowed us to embark on the current five-year strategic initiative, “Innovation 90”.

With the idea of building a foundation of high profitability for future growth as our basic concept, we have bolstered our core and developing businesses through Group reorganization and new investment. We have also put great effort into assuring the soundness of our finances, our organization, and our research and development operations.

“Innovation 90” is a two-part plan: Phase I covers the first two years (2006-07), and Phase II covers the remaining three years (2008-10).

Phase I is devoted to establishing a firm foundation for growth. During this time we will evaluate the position and mission of each business, further strengthen core and developing business areas, launch new projects, and restructure our basic businesses. In Phase II, we will build on the results of our Phase I efforts to firmly establish a trajectory of growth.

Our goals for the final year of the program, 2010, are 50,000 million yen in sales, with a 13% operating profit margin. We intend to expand our core and developing business areas, and increase the ratio of new product sales to over 20% of overall sales (non-consolidated basis). “Innovation 90”, with its emphasis on performance, quality, and distinction, is designed to propel us towards our vision of high performance and high value creation.

Q2. What have been the results of the reorganization of the Group?

We are in the process of reorganizing Group management to facilitate the establishment of a highly profitable business portfolio.

As the first step in this process, we assigned a part of our Nippon Polyurethane Industry Co. Ltd. stock holdings to Tosoh Corporation in 2006, after we determined that cooperation with Tosoh would help Nippon Polyurethane expand its core MDI business. (MDI: methyl diphenyl diisocyanate, used in polyurethane manufacturing.)

With this assignment, our ownership of Nippon Polyurethane dropped from 65.0% to 48.3%, changing its legal status from consolidated subsidiary to equity method affiliate. However, we continue to take an active role in the management of this important Group company: for example, we underwrote a capital increase through shareholder allocation in connection with the construction of Nippon Polyurethane's new manufacturing facility. At the same time, we continue to strengthen our relationship with Tosoh Corporation, enhancing the long-term value of the Group as a whole.

By shifting Nippon Polyurethane to an equity method affiliate, our Group's consolidated sales and pretax earnings fell to roughly a third of their previous levels, but our financial position has improved greatly. Interest-bearing debt dropped from 48,400 million yen to 16,300 million yen, and our Debt/Equity Ratio fell from 1.79 to 0.45. These improvements have made it possible for us to invest aggressively in new business development.

We are also making progress with the screening and consolidation of our existing businesses. We divested our holdings in Hodogaya Ashland Co., Ltd., which supplies foundry sand molding agents, and reorganized Hodogaya Engineering Co., Ltd. and Tohoku Hodogaya Co. Ltd. to optimize management efficiency. In addition, we are restructuring our Yokohama plant to establish a line of high-value added, unique products, and expand the hazardous materials handling business.

Q3. How were this year's results?

(The comparative results below reflect the post-organizational changes effected by our Group restructuring.)

This year, because of divestiture from low-performing businesses and fiscal closing date revisions within the Group, consolidated sales fell 6.2% to 37,033 million yen. Operating profits, affected by higher raw material costs and up-front investment in the carbon nanotube business, fell 5.0% to 2,863 million yen. The drop in operating profits, combined with equity method investment loss, caused pretax earnings to drop by 28.8% to 2,620 million yen. Despite the drop in pretax earnings, increased corporate taxes, and an extraordinary loss on the retirement of fixed assets from our business restructuring, net profit increased by 1.3% to 4,198 million yen, thanks to the posting of extraordinary profits from the allocation of Nippon Polyurethane Industry Co., Ltd. stock, and profits from the sale of affiliate stock.

Net assets increased by 9,892 million yen to 36,712 million yen because of third-party allocation of new shares and the posting of current net profits. As a result, our capital ratio has improved greatly, increasing from 39.9% to 53.3%.

With increased profits and reduced interest-bearing debt from our reorganization, our end-of-term balance was 16,330 million yen. We are already ahead of schedule in reaching our "Innovation 90" Phase I goals (interest-bearing debt: 20,000 million yen, D/E ratio: 0.5, capital ratio: 50%).

Q4. How is "Innovation 90" progressing?

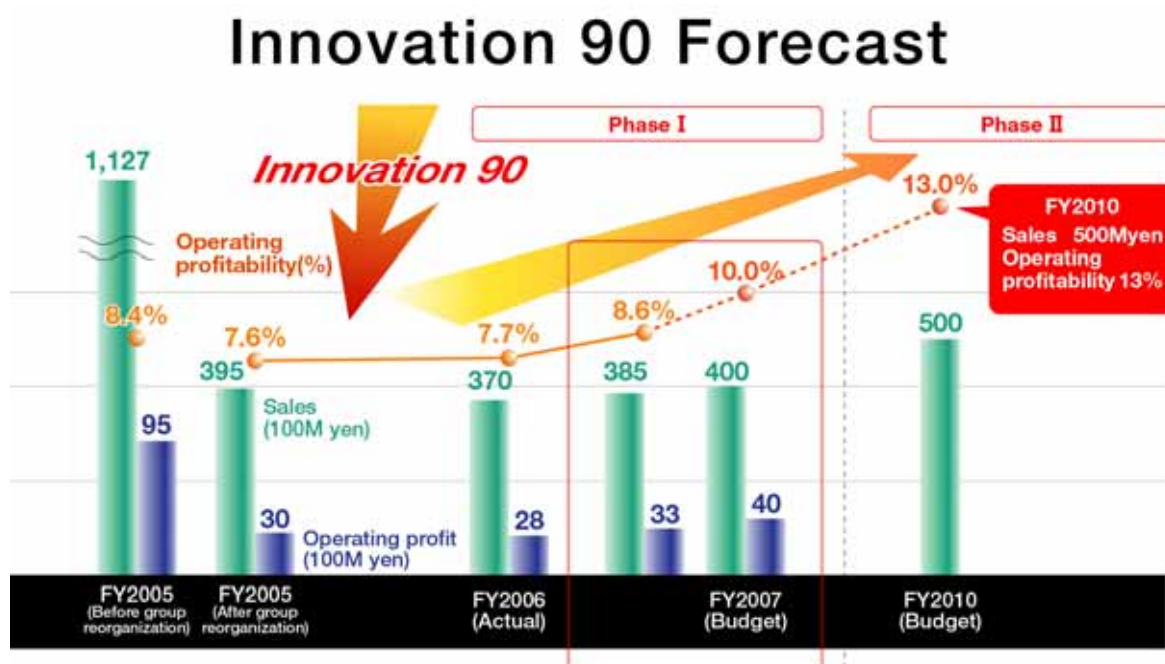
Using the resources garnered by the sale of Nippon Polyurethane Industry Co., Ltd. stock and the third-party allocation of new shares to Tosoh Corporation, we were able to earmark about 15,000 million yen for strategic investment. We will use these funds to step up investment in future growth, from the development of new businesses to the fortification of our core businesses, possibly through mergers and acquisitions.

One of the areas that we are developing for the next generation of new business is our carbon nanotube business. Nano Carbon Technologies Co., Ltd., established as a joint venture between Hodogaya Chemical and Mitsui & Co., Ltd., will develop and market multilayer carbon nanotube materials (CNT) for use in a variety of applications. By making the best use of Mitsui & Co., Ltd.'s sales force and our organic synthesis and manufacturing capabilities, we will move rapidly toward industrial-scale production and the development of new applications. Our intention is to become a world leader in this new and exciting field.

In the field of imaging materials, one of our core business areas, we acquired Mitsubishi Paper Mills, Ltd.'s OPC (organic photoconductor) materials business, which will be a great asset in the expanding color copier and printer market. This acquisition will strengthen our existing OPC material business, and when combined with our CCA (Charge Control Agent) product line, (in which we hold the top share of the world market), will complement the synergy between the two product lines, and further improve our competitive position in this area.

In the basic business segment, we acquired API Corporation's octadecyl isocyanate (ODI) business. ODI is used in a wide variety of applications, ranging from tape release agents to fabric softeners to paint and ink additives. The acquisition included the existing customer base, which we will build upon to further expand the business.

We have also allocated funds to support research and development efforts in our core and developing business areas.



Q5. What is organic EL technology, and what is going on in the organic EL market?

EL stands for 'electroluminescence'. These materials emit light when electric current is applied.

Right now, organic EL materials are attracting a great deal of attention for their use in OLED (organic light-emitting diode) displays. OLED displays can be made much thinner than LED and other conventional displays. Because they use very little energy, have high picture quality and faster response time, they are a promising candidate for next-generation flat-screen televisions. Major appliance manufacturers are mapping out plans for commercial production of EL televisions, and development is proceeding rapidly. Demand is also being driven by such applications as cellular phone and car audio displays. This is one of our key developing businesses, and we are working to develop our business along with the expanding market.

OLED displays are created from hole transport materials (HTM), emitter, and electron transport materials (ETM), among others. We have been able to draw on our unique organic synthesis technologies utilized in charge transport material for OPC, our experience with organic semiconductors and our expertise in molecular design to develop HTM and ETM products.

To keep up with our clients' ever-evolving requirements, we are working on a variety of new materials, including next-generation HTM materials for OLED panels. We are also working with industry, government and academic researchers to develop new ETM materials.

Our goal is to furnish a full product line, including new emitter and hole injection materials. At the same time, we are addressing such issues as the longer lifetime and durability of the OLED materials. We believe that we are well-positioned to supply the key parts of this rapidly developing technology.