

# Financial Review

## Overview

In the year ended March 31, 2005, the pharmaceutical industry faced increasingly severe market conditions, partly owing to the April 2004 cut in NHI drug prices. Other factors included higher R&D costs and a drive by the Ministry of Health, Labour and Welfare to control medical treatment and pharmaceutical costs by promoting the use of generic drugs.

In such harsh conditions, consolidated operating income, income before income taxes and net income fell compared with the previous fiscal year, despite efforts to boost net sales and reduce the cost of sales ratio. The decline in income was a consequence of substantially higher R&D expenses and loss on sales and disposal of property, plant and equipment as well as retirement benefit plan changes.

## Net Sales

Consolidated net sales rose 1.9% compared with the previous fiscal year, to ¥66,296 million, reflecting steady sales of the bronchial asthma medicine Kipres and the mucoregulant Mucodyne, as well as stronger overseas sales of the broad-spectrum antibacterial eyedrops Zymar.

## Cost of Sales

Cost of sales rose as a consequence of expanding sales in Japan and overseas. Nevertheless, solid domestic sales of ethical drugs that cost little to produce helped reduce the cost

of sales ratio by 0.2 percentage point. As a result, cost of sales increased only 1.3%, to ¥22,682 million.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses climbed 11.3%, to ¥37,747 million. This reflected higher R&D expenses due to a drive to accelerate R&D by moving principal research products to the next stage of clinical trials. Such costs countered reductions in other selling, general and administrative expenses.

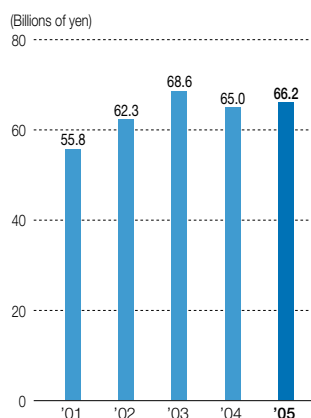
## Operating Income

Operating income fell 33.1%, to ¥5,866 million, as a consequence of the dramatic increase in R&D expenses, which countered higher net sales, the lower cost of sales ratio and decreases in selling, general and administrative expenses other than R&D expenses.

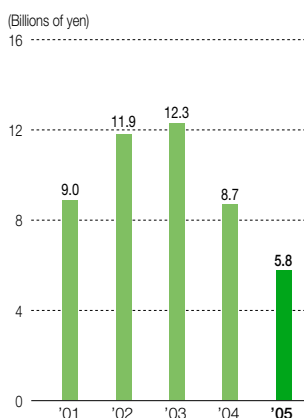
## Other Expenses

Other expenses totaled ¥1,854 million, mainly reflecting gains on sales of investment securities of ¥1,787 million, loss on sales and disposal of property, plant and equipment of ¥1,366 million—stemming from the disposal of bulk powder production facilities at the Noshiro Plant—and loss on retirement benefit plan changes of ¥1,625 million due to the restructuring of the Company's pension system.

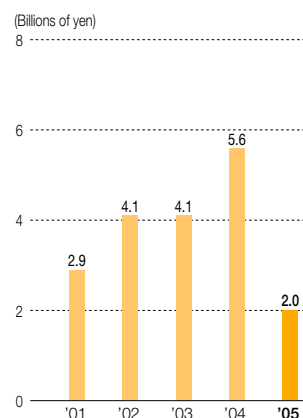
### Net Sales



### Operating Income



### Net Income



### Net Income and Income Taxes

Income before income taxes amounted to ¥4,012 million, down 57.7%. Current income taxes, which included corporate, enterprise and inhabitants tax, amounted to ¥147 million, an extremely small figure compared with income before income taxes. This was attributable to an ¥8,800 million one-time write-off of a shortfall in the reserve for retirement benefit liabilities. Net income dropped 64.6%, to ¥2,013 million.

### Cash Flows

Net cash used in operating activities totaled ¥7,346 million, owing to the decrease in income before income taxes, a provision for retirement benefits, net of payments, of ¥8,800 million, an increase in notes and accounts receivable and a smaller increase in notes and accounts payable.

Net cash used in investing activities was ¥21,521 million. This mainly resulted from payments for purchase of investment securities of ¥23,352 million, payments for purchase of property, plant and equipment of ¥5,767 million—part of which stemmed from the construction of new production facilities at the Noshiro Plant—and payments for purchase of intangible assets of ¥2,395 million. These negative factors offset the combined proceeds from sales of marketable securities, investment securities and mortgage securities, which came to ¥9,455 million.

Net cash used in financing activities amounted to ¥1,516 million, primarily reflecting cash dividends of ¥1,412 million.

As a consequence of the above, cash and cash equivalents at end of year were ¥11,361 million, down ¥30,380 million from ¥41,741 million a year earlier.

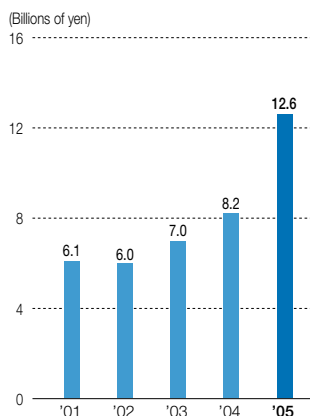
### Capital Requirements

The Group's operating capital is mainly used to fund purchases of raw materials and other materials for pharmaceutical production, and other items. The operating capital is also used to cover production, R&D and personnel expenses. We also make capital investments on a continuing basis. In the year ended March 31, 2005, such investments totaled ¥6,172 million.

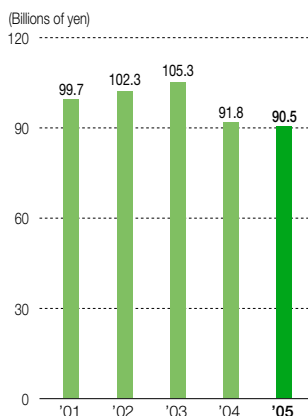
### Financing Policies

The Group uses its own financial resources, such as cash flows from operating activities and internal reserves to generate all its operating capital as well as funds for capital investment. In the year ending March 31, 2006, in addition to R&D expenditure, we plan to invest approximately ¥4,300 million on the construction of new production facilities at our Noshiro Plant and improvements to information technology (IT) systems and research equipment. We also expect to spend approximately ¥3,300 million on the acquisition of Toyo Pharmar. It is our belief that all of the above investments can be financed with our own capital.

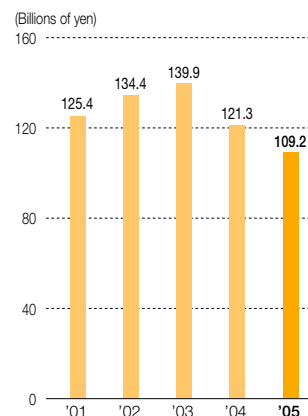
#### R&D Expenses



#### Total Shareholders' Equity



#### Total Assets



# Business Risk

We have described below the risk factors that could affect the business performance or financial health of the Group.

Although the Group has taken organizational and systematic measures to minimize risk, the outline does not include every risk or variable that could impact its business.

Any forward-looking statements contained in the following text are based on management's rational assumptions and beliefs in light of information available as of March 31, 2005.

## (1) Legal Regulation

Legal regulation in Japan such as the Pharmaceutical Affairs Law, the NHI system, NHI drug prices and also laws in other countries can affect the Group's business. Every stage of our operations, including pharmaceutical development, production, import and distribution is regulated by various approval and licensing systems. Unforeseen substantial shifts in future healthcare administration policy could impact our business performance and financial health.

## (2) Pharmaceutical R&D

Ethical drug development requires substantial R&D investment over lengthy periods. Furthermore, the success rate of companies seeking to discover original compounds and bring pharmaceutical products to market is anything but high. Currently, several of the Group's ethical drugs are undergoing clinical trials. The R&D of such drugs could be terminated, as a consequence of various factors, such as unforeseeable side effects or failure to achieve intended results.

## (3) Increased Competition

The pharmaceutical industry is experiencing rapid technological change. Sales of the Group's principal products could be impacted if a competitor develops and brings to market drugs that are more useful or produce the same effects.

## (4) NHI Drug Price Revisions

Japan's NHI drug prices are usually revised every two years. When forecasting business results, the Group does its best to predict and factor in the effects of such changes. Nevertheless, our performance could suffer as a result of greater than expected NHI drug price revisions or changes to the NHI system. Following NHI drug price revisions in April 2004, the industry's average drug price fell 4.2% and Kyorin Pharmaceutical's average drug price decreased 3.7%.

## (5) Side Effects

Information concerning the safety of new pharmaceuticals is based only on clinical trials using a limited number of subjects and therefore cannot eliminate the possibility of every side effect. If a drug in general use is found to have unknown and unreported side effects after launch, its use may be restricted or, in some cases, it would be withdrawn from sale.

## (6) Generic Drugs

The launch of generic drugs when patents for the Group's ethical drugs expire could impact business results.

## (7) Slowdown or Delays in Production

Technical or regulatory problems, natural disasters and accidents including fires could cause slowdowns or delays in production or a cessation of operations, impacting the Group's performance.

## (8) Pharmaceutical Recalls

If pharmaceuticals are shown to be defective due to imperfections or other causes they will be recalled. Such a situation would harm the Group's business results.

## (9) Intellectual Property Protection

There is a risk that the Group may become unable to protect its intellectual property effectively in Japan or overseas. In this event, third parties could exploit the Group's technology and reduce demand for its principal products and related pharmaceuticals. In March 2004, Kyorin Pharmaceutical and its licensing partner Bristol-Myers Squibb filed a lawsuit against the Israeli company TEVA Pharmaceutical Industries Ltd. and its U.S. subsidiary TEVA Pharmaceuticals USA, Inc., in the United States District Court for the Southern District of New York alleging infringement of Kyorin's U.S. patent covering gatifloxacin, a new-quinolone antibacterial agent. We will continue in our full-fledged efforts to resolve this issue.

On the other hand, if our activities are seen to infringe on another company's patents or threaten intellectual property rights, we may become involved in legal disputes and have to terminate some business operations.

## (10) Lawsuits

The Group could become the subject of a lawsuit for alleged patent infringements, violations of the Product Liability Act or the Antimonopoly Act, or as a result of environmental issues or labor disputes.

## (11) Exchange Rate Fluctuations

Since the Group exports pharmaceutical products, its sales are vulnerable to exchange rate fluctuations. In the year ended March 31, 2005, overseas sales accounted for 13.3% of consolidated net sales.

## (12) The Cancellation of Tie-up Agreements

The Group promotes strategic alliances to make efficient use of external capital. Through tie-up agreements with other pharmaceutical companies, it allocates sales rights for some of its products, and collaborates in sales, R&D and other activities. A cancellation of these tie-up agreements for any reason could hamper the Group's ability to achieve its intended business results.