

Year ended December 31, 2005

**Flash Report on the Consolidated Results for the Year Ended December 31, 2005**

February 13, 2006

Company Name: OENON HOLDINGS, INC.

Code Number: 2533

(URL <http://www.oenon.jp>)

Stock Exchange Listings: Tokyo, Osaka, Nagoya and Sapporo

Location of Head Office (Prefecture): Metropolis of Tokyo

Representative: Yukio Nagai, President & CEO

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Date of the Board of Directors Meeting on the Closing of Accounts: February 13, 2006

Adoption of U.S. GAAP: No

1. Consolidated Performance for the Year Ended December 2005 (from January 1, 2005, to December 31, 2005)

(1) Consolidated operating results

Note: Amounts below one million yen are truncated.

	Net sales		Operating income		Ordinary income	
	¥ Million	%	¥ Million	%	¥ Million	%
Year ended December 2005	76,324	(5.0)	3,416	13.0	3,256	14.5
Year ended December 2004	80,313	6.6	3,022	33.3	2,843	38.5

	Net income		Net income per share	Fully diluted net income per share
	¥ Million	%	¥	¥
Year ended December 2005	1,253	117.6	18.36	17.92
Year ended December 2004	576	10.0	8.98	—

	Return on equity (ROE)	Ratio of ordinary income to total capital	Ratio of ordinary income to net sales
	%	%	%
Year ended December 2005	7.6	5.2	4.3
Year ended December 2004	4.0	4.4	3.5

Notes: 1. Equity in net income or loss of unconsolidated subsidiaries and affiliates: —

2. Average number of shares outstanding during the year (consolidated):

Year ended December 2005: 65,275,848 shares

Year ended December 2004: 58,889,941 shares

3. Change in accounting method: No

4. Percentage figures for net sales, operating income, ordinary income and net income indicate respective changes from the previous fiscal year.

(2) Consolidated financial position

	Total assets	Shareholders' equity	Equity ratio	Shareholders' equity per share
	¥ Million	¥ Million	%	¥
Year ended December 2005	62,360	17,156	27.5	261.58
Year ended December 2004	63,323	15,839	25.0	243.09

Note: Number of shares issued and outstanding at the end of the year (consolidated):

65,377,058 shares at December 31, 2005

64,965,832 shares at December 31, 2004

(3) Consolidated cash flows

	Cash flows from operating activities	Cash flows from investing activities	Cash flows from financing activities	Cash and cash equivalents at end of year
	¥ Million	¥ Million	¥ Million	¥ Million
Year ended December 2005	4,742	(1,889)	(2,036)	3,417
Year ended December 2004	6,508	(4,294)	(2,420)	2,601

(4) Scope of consolidation and application of the equity method

Number of consolidated subsidiaries: 12

Number of unconsolidated subsidiaries accounted for by the equity method: 0

Number of affiliates accounted for by the equity method: 0

(5) Change in the scope of consolidation and application of the equity method

Consolidation: (newly included): 0 (Excluded): 0

Equity method: (newly applied): 0 (Excluded): 0

2. Forecast Consolidated Performance for the Year Ending December 2006 (from January 1, 2006, to December 31, 2006)

	Net sales	Ordinary income	Net income
	¥ Million	¥ Million	¥ Million
Interim period ending June 30, 2006	37,500	1,300	200
Year ending December 31, 2006 (full year)	80,000	3,500	1,500

(Reference) Forecast net income per share (full year): ¥22.94

Note: These projected performance figures are based on information available to the Company's management as of the day for releasing the above data (February 13, 2006). There are many uncertain factors inherent in forecasting, and there might be cases in which actual results differ from forecast values. See page 10 of the Attachment for further information on forecasts.

## Management Policies

### **1. Basic Management Policy**

Our Group philosophy is, “From the bounty of nature and with biotechnology as our base, we aim to help people find enjoyment and health through food.” Based on this philosophy, the Oenon Group engages in biotechnology-based businesses around our core fermentation technology in such fields as alcohol and enzymes and pharmaceuticals.

In its business activities, first and foremost the Group aggressively pursues a combined customer and earnings orientation to ensure qualitative improvements in business administration, thereby maximizing Group corporate value, as its priority management policy while fulfilling the critical mission of delivering product security and safety to customers.

### **2. Basic Policy on Profit Distribution**

Distributing profits to shareholders is one of the Oenon Group’s top priorities. Consequently, our basic policy is to increase mid-term and full-year dividends gradually in a stable and ongoing manner. At the same time, we take into overall account the Company’s operating performance, consolidated accounting conditions, medium- and long-term profitability, capital expansion plans, the maintenance of adequate internal reserves and payout ratios. Based on these considerations, for the year ended December 31, 2005, we propose a cash dividend of ¥7 per share, up ¥2 per share from the previous year’s dividend.

### **3. Medium- and Long-Term Management Strategies and tasks ahead**

In line with its basic management policies, the Oenon Group has formulated the following medium- and long-term management strategies:

- 1) Prioritize shareholder-first management.
- 2) Strengthen areas of core competence to ensure earnings-focused management and further promote the restructuring of our business portfolio via selectivity and focus.
- 3) Optimize our sharing of functions among Company and Group members, in line with the holding company system.
- 4) Seek out values that customers demand and ensure customer loyalty by supplying differentiated products and services.
- 5) Demonstrate a cost leadership role in the industry by reducing total costs.
- 6) Continuously improve our financial structure and strengthen our management foundation.
- 7) Strengthen compliance management to ensure that we meet our corporate social responsibilities.

In keeping with these management strategies and to create future value for the Group, we aim to enhance our brands, bolster quality and strengthen our financial base by addressing our “5S” targets.

1) SWITCH <Move to profitability>

We will shift our market developments to businesses and products having a profit orientation. To this end, we will cultivate expanding customer and market segments.

2) SLIM <Improve productivity>

By carefully reviewing our activities from the viewpoint of intra-group functionality, we will pursue synergies in all business operations. We will streamline production, sales and administrative systems, leading to higher productivity.

3) SHARE <Work together>

We will effectively share assets and expertise among Group companies, and heighten Groupwide management quality. Furthermore, we will strive to maximize innovation and understanding through corporate communication activities that share our values with customers and shareholders.

4) SPEED <Respond quickly>

We will seek to develop a corporate culture that promotes quick and precise responses to the management issues facing the Group. We will revise social rules and review risks in the pursuit of speedy solutions.

5) SELECTION <Concentrate on selectivity and focus>

By taking into full account future values and radically reviewing existing businesses and products, we will strengthen our processes that ensure selectivity and focus.

We will endeavor to implement these corporate value enhancement targets throughout the Group. Specifically, our future measures will concentrate on four objectives.

- 1) In line with our role as a holding company, we will review the mission and role of each Group company, ensuring that each company is contributing as much as possible to the overall Group and is generating Group synergy.
- 2) Based on their individual corporate cultures and climates, we will carefully evaluate each Group company from the perspective of its contribution to the new corporate culture of the Oenon Group.
- 3) We will determine whether Group companies are responding to changes in the operating environment with a management focus on individual customers and characteristics.
- 4) We will implement dynamic and flexible policies that encompass both past and current conditions, through activities that practice three types of realism—real goods, real markets and real circumstances.

#### **4. Targeted Financial Indicators**

The Oenon Group aims to improve indicators of efficiency, while strengthening its revenue structure and financial base. The Oenon Group's priority targets are to raise operating income, ordinary income and net income, which are basic management indicators, ensure a certain level of free cash flow and reinforce shareholders' equity.

To that end, the Group has set specific medium- and long-term targets: net sales of ¥100 billion and ordinary income of ¥5.0 billion.

## **5. Basic Views on Corporate Governance and the Implementation of Governance Measures**

### **(1) Basic Views on Corporate Governance**

The Oenon Group's fundamental management concept is to be a good corporate citizen that complies with all laws and ordinances, and manages its operations in a transparent, impartial, flexible and speedy manner.

### **(2) Current State of Implementation for Corporate Governance Measures**

#### **1. The Company's Organization**

As the holding company responsible for overall Group management, the Company exercises management supervision while other companies in the Group concentrate on their respective business activities. As a result, the division between the Group management supervision and execution functions is clear.

By optimizing the number of directors, the Company has streamlined and raised the efficiency of its managerial system to allow swifter decision-making. We have also strengthened corporate governance by employing a corporate auditor system.

To ensure the accurate and appropriate execution of Group business, the Group Company Management Rules stipulate that Group companies must consult with us prior to taking certain actions and must provide management information reports. In addition, to promulgate shared goals throughout the Group the Company periodically holds Group Management Conferences, attended by the presidents of major Group companies. These meetings focus on specific measures and compliance-related subjects.

We have also implemented a variety of measures to ensure the thoroughness of our corporate governance. For example, we have distributed to all employees Group principles of behavior that include adherence to all laws and regulations and incorporate corporate ethics.

Corporate auditors attend monthly meetings of the Board of Directors and participate in other important Group management meetings, thereby overseeing the exercise of directors' duties. Corporate auditors fulfill their auditing duties by interacting with the Group's accounting auditor, Ernst & Young ShinNihon.

#### **2. Internal Control System**

To enhance our internal control system and put compliance into practice, in February 2006 we established the Compliance Committee to deliberate various compliance issues among Group companies. We have also created the Auditing Department, which audits the operations of Group companies in accordance with an annual plan.

Such information is transmitted to the Corporate Communications Department. Then, the information is passed on to the Corporate Planning Department to ensure uniform management and internal control.

## Operating Results and Financial Position

### 1. Review of Operations

#### (1) Overview of operations

During the year ended December 31, 2005, the operating environment exhibited overall signs of shifting to a recovery phase. Some concerns remained, such as sharp fluctuations in crude oil prices. However, corporate performance improved, capital investment and personal consumption levels gradually moved upward, and improvements in the employment scenario grew more widespread.

For the liquor industry, on the other hand, the operating environment remained problematic. The Japanese population continued to contract, owing to a high proportion of senior citizens and a low birthrate. In addition to decreasing overall, alcohol consumption continued to diversify, owing to increasing consumer health-consciousness and more diverse drinking styles. The liberalization of liquor sales licensing laws prompted a rise in the number of shops selling alcohol. Lower barriers to entry into the liquor business from other fields are prompting fierce competition from a variety of sales channels and in numerous categories. Despite continued efforts to fundamentally change liquor sales, prices continued to deteriorate and the operating environment remained severe.

By product category, sales of sweet potato-based *shochu* products remained robust, while sales of other varieties of Group B *shochu* (*Otsu*-type *shochu*) declined, clearly indicating an end to the knock-on effect that the overall category had enjoyed. Although sales of beerlike alcoholic beverages were vigorous, sales of beer and low-malt beverages suffered a major downturn, causing the overall beer beverages category to decline compared with the preceding term. Sales of *chu-hi* (a refreshing beverage mixed with the clear distilled spirit *shochu*), cocktails and other low-alcohol beverages, which have expanded in recent years, entered an adjustment phase. The year also saw a pullback in *sake* sales, contributing to the overall decrease in sales of alcoholic beverages.

In this environment, we focused on applying the holding company structure to spur dynamic business development and management optimization of the Oenon Group, applying our fundamental business orientations toward customers and profits. We sought to take a customer perspective in offering products that ensure security and safety, and tailoring Group business activities and expertise to match customer demand.

During the year under review, we continued to:

1. Allocate management resources optimally throughout the Group, thereby ensuring efficient Group management and maximizing sales and production synergies,
2. Improve our product mix and revise our business and product portfolio by consolidating low-profit products, weeding out unprofitable products, focusing on profitable products and nurturing new brands through an orientation toward selectivity and focus,
3. Shift entirely from a “product-out” to a “market-in” sales system, emphasizing market penetration and developing marketing activities,
4. Reduce total costs by conducting thorough reviews of functional cost items from procurement, purchasing and production to distribution and sales, and
5. Implement activities that closely impact our customers, such as optimizing our quality control system and improving communication functions.

During the year, we pushed forward with our structural reform efforts. In April 2005, we revised the Group structure by converting AKITAKENHAKKO KOGYO CO., LTD., to a direct subsidiary. Furthermore, as part of an effort to improve our financial base, in November we issued convertible type of warrant bonds.

As a result of these factors, consolidated net sales for the year under review decreased 5.0%, to ¥76,324 million, reflecting ongoing efforts to weed out unprofitable items. In terms of profits, the situation was more positive, evincing the success of our move toward differentiated, high-value-added products, strategic investments in marketing and other management expenses and the resultant Groupwide shift toward synergy and high profitability. In addition, profits from our highly profitable enzymes and pharmaceuticals products expanded. Consequently, despite the implementation of the size-based corporate tax system having an external standard taxable portion, we recorded a 14.5% increase in consolidated ordinary income, to ¥3,256 million, posting a new record for the fourth consecutive year.

The Company recorded an extraordinary loss in relation to its shift from a defined-benefit to a defined-contribution employee pension system. Even so, net income surged 117.6%, to ¥1,253 million—a record high.

## **(2) Operating results by business segment**

### **Alcoholic beverages:**

Overall sales of *shochu* products fell 4.6%, to ¥39,817 million. Within this category, sales of Group B *shochu* (*Otsu-type shochu*) remained roughly in line with the previous year. However, several Oenon Group products outpaced the industry average. Reflecting its ongoing popularity, sales of *Tantakatan*—flavored with the Japanese herb *shiso*—rose by approximately 10%. Such core products as the *Hakata no Hana* series and *Komezo* gained a growing foothold in the marketplace. In July, we launched *Katsumi Gyokuro shochu*, which is flavored by the refined leaves of domestically grown green tea. Created using techniques that are unique to the Oenon Group, *Katsumi Gyokuro* showcases our ongoing strategic focus on providing the drinks market with high-value-added products. Following a strategy we have employed with *Gokoku Shochu*, *Mugi no Kaori* and *Super Mugizo Cup*, in September we launched *Mugi Zakari*, which is sold only through specific sales channels, and this product has made steady inroads.

At the 2005 Monde Selection, our *Hakata no Hana* series earned five gold medals, and *Hakata no Hana Maromi no Toki* won the International High Quality Trophy—presented only to outstanding gold-medal winners—for the third consecutive year. Such honors attest to the high quality of the Oenon Group's flagship products.

Owing to the success of such products, in the year under review sales of Group B *shochu* products were approximately the same as one year earlier, despite our strategic weeding-out of unprofitable products.

In the category of Group A *shochu* (*Kou-type shochu*) products, we raised awareness steadily for *Grand Bleu*—made with deep-sea water—through transit advertising and consumer promotion campaigns. Sales of *Aibou*, a category mainstay, were also favorable. Nevertheless, in line with our profit-oriented management policy we have slashed marketing expenditures, which held down overall sales in this category.

In *sake* compounds, we employed brand-specific strategies. Sales of our market-leading *Genroku Bijin* continued to expand. To match growing customer sensitivity to price, we relaunched *Shujinko*, which enjoys a steadily expanding market. Although sales of private-brand products declined, we held the decrease in sales of *sake*

compounds to 4.5%, approximately matching the industry rate of decline, to ¥6,235 million. Oenon Group products in this category continue to enjoy top market share and wide popularity among consumers.

To match increasingly diverse consumer preferences and follow our profit-oriented strategy, we are revising our *sake* product groups. *Sake* sales therefore declined 11.8%, to ¥8,972 million. However, we are making inroads into markets for premium products that feature regional characteristics, such as the *Taisetsu no Kura*, *Nanbu Gura* and *Ono no Komachi* series. Furthermore, sales continue to grow for such original Oenon Group products as *Kanban Musume*, which features an in-can heating element. Strategic marketing activities for such high-value-added products are creating a firm basis for growth.

Three Group products earned gold medals during the "National Research Institute of Brewing *Sake* Awards 2004," and the Group was certified for "Production of High-Quality Traditional Sakes." *Taisetsu no Kura Junmai Ginjo Kinuyuki* was certified under the new Hokkaido Food Product Certification System, the first *sake* product to receive this certification. We believe that such designations attest to our successful ongoing efforts to launch high-quality premium products that highlight regional characteristics.

Sales of alcohol for brewing and other purposes surged 44.6%, to ¥2,674 million, owing partly to aggressive efforts to cultivate new customers and offer products with food and medical applications, including items in the *miso* (soybean paste) and soy sauce categories. In our view, such expansion also evinces the market's broad awareness of our high product quality, with its importance on safety and security, as well as cost performance.

In the category of low-alcohol drinks such as *chu-hi* (a refreshing beverage mixed with the clear distilled spirit *shochu*), we met increasingly diverse consumer tastes with products that offer new value, such as *Bin-Chu*, a bottled *chu-hi* product. However, our sales strategies are clearly delineated along profitability lines. As low profit product category faces ongoing price competitiveness, we have scaled back marketing efforts. Therefore, in this category sales fell 44.9%, to ¥1,782 million.

Owing to the factors described above, despite ongoing changes to our product portfolio, which includes *mirin* (sweet sake for cooking), overall sales of Japanese-style alcohol decreased 6.3%, to ¥61,124 million.

In the Western-style alcohol category, *Oshukubai Pack ume* (plum) liquor posted strong sales, as did *Zeitaku Umeshu*, which delivers a luxurious flavor. Another Group original, *Gokujo Umeshu*, posted strong sales to both the business and household markets. Such successes boosted category sales 8.4%.

Faring extremely well in the Western-style alcohol category was *La Tomato*, a fruity and crisply refreshing Oenon Group original that launched in 2003. Sales of *La Tomato* more than doubled during the period. We see this product as a successful example of the Oenon Group's ability to meet diversifying consumer demand in an original manner.

For wine products, the Company carefully selects quality wines in the medium-priced and premium ranges from various chateaux. We concluded a sales contract with Dominique Laurent, who has become known as a producer of some of the most popular wines from France's Burgundy region. Through such promotions, we continue to concentrate on selecting and promoting highly profitable products. This Groupwide strategic focus resulted in lower sales volumes in this category, however, and sales declined 7.0%.

Market demand for Western-style alcohol for processing continues to fall, and our sales in this category dropped 7.7%. Convinced that demand will remain for high-value-added products that demonstrate technical expertise, we have shifted our primary focus to such products.

Sales of Western-style alcohol, a category that remains lackluster, were ¥6,340 million, down 5.5%. This level was in line with our initial forecasts.

We continued our strategy of reconfiguring our product portfolio for both Japanese- and Western-style alcohol, eliminating low-profit items. As a result, we stemmed the overall decline in sales of alcoholic beverages to 6.3%, to ¥67,464 million.

### **Food products:**

In the food products segment, the Group continued to benefit from the market's recognition of our consistent production capabilities and superior product quality in processing starch. Ongoing and proactive efforts to propose new applications and cultivate new customers succeeded in expanding these sales, compared with the preceding term.

In seasonings, we focused on high-end products and continued to discontinue sales of unprofitable items, which had a slight impact on revenues. Overall, however, sales of food products increased 1.0%, to ¥4,420 million.

### **Enzymes and Pharmaceuticals:**

In this segment, we continued to cultivate new customers for our mainstay lactose-splitting enzyme among milk-product manufacturers throughout the world, particularly in North America, Central and South America, Asia and Oceania. We also proactively proposed new applications for this enzyme to existing clients. The combination of these efforts resulted in an approximately 50% increase in lactose-splitting enzyme sales. New products, such as our protein-splitting enzyme, also contributed, helping boost sales of enzymes 42.3% during the year.

Sales of bulk pharmaceuticals benefited from a growing interest in treatments for lifestyle-related illnesses and the growing acceptance of generic drugs. Sales of hyperlipidemia treatments grew substantially, and we saw a steadily increasing response to our newly introduced bulk pharmaceutical for diabetes treatments. Similar to the buoyant growth in mainstay enzyme sales, bulk pharmaceutical sales expanded approximately 50%.

In diagnostic pharmaceuticals, sales expanded for our flagship reagent to test for blood in the stool. We also introduced a reagent to test for periodontal disease, which fared well. Such successes underscore our conviction that introducing new products that match increasingly diverse customer needs is key to increased profits.

Health food sales showed signs of emerging from the doldrums, but our vanguard products were the real drivers of growth during the term, fueling a 22.8% increase in net sales of enzymes and pharmaceuticals, to a historic high of ¥2,804 million.

### **Real estate and others:**

Lower revenues in the real estate segment partly reflected proactive second-half efforts to improve the Group's internal utilization of owned real estate. Sales in the others segment declined, affected by adverse weather. In combination, net sales in the real estate and others segments fell 2.4%, to ¥1,635 million.

### **(3) Outlook**

In 2006, we expect personal consumption to be affected by such factors as high crude oil prices and a decrease in temporary tax cut levels. At the same time, corporate profitability should remain strong, thereby supporting domestic demand. Therefore, we anticipate ongoing movement toward economic recovery.

The liquor industry will continue to be affected by Japan's decreasing population, characterized by a growing number of senior citizens and low birthrates. These demographic changes will cause ongoing changes to consumer lifestyles—with a growing emphasis on leisure and abundance—as well as values. Institutional changes will include revisions to the Liquor Tax Law and the entrenchment of the new liquor sales system. Affected by such factors, we expect corporate competition to intensify and shift from a price orientation to a focus on profits.

The Oenon Group will respond to such changes in its business environment by reinforcing Group management and clearly emphasizing our dual orientation toward customers and profits. In line with our medium- to long-term management strategy, we will concentrate on creating future corporate value and enhancing management quality.

In our quest to raise future corporate value, we will focus on our roles as a holding company. By clearly exercising management supervision while other companies in the Group concentrate on their respective business activities, we will enhance Group synergy, giving top priority to the optimal working of the entire Group. We will also spearhead the creation of a new company culture, based on the current cultures at individual companies.

As we implement policies in a 21<sup>st</sup>-century environment that is fraught with changes, especially in eating habits, we will recognize the importance of individuality as it applies to individual customers and individual characteristics. Our customer-oriented approach to providing goods and services will mean treating our customers as individuals. Our Group management will respect the individual characteristics of Group companies, and our personnel training will involve an awareness of employees as individuals. In fiscal 2006, we will address the management issues that are inherent in implementing such policies.

More concretely, from a marketing perspective we will apply the Oenon Group's technical expertise to develop and launch differentiated products, and promote them in a highly targeted way. We will reduce expenses in cost-center areas, such as production and distribution, while raising quality levels as befits a food products company. Through this total management approach, we will aim to provide better quality products at lower prices.

In profit-center areas such as sales, we will invest strategically in sales promotion. We will endeavor to employ more efficient and effective sales activities, applying better selectivity and focus to highly profitable products and customers.

From a financial perspective, we will work to expand business operations while maximizing profits. To strengthen our financial structure, we will hold down our debt ratio to ensure financial stability and safety, and raise management efficiency while keeping a close eye on the cost of capital.

We will reform our personnel system with the aim of concentrating IT infrastructure and Group expertise. While pushing forward through the various management issues that these moves entail, we will seek to always practice three types of realism—real goods, real markets and real circumstances.

For the fiscal year ending December 31, 2006, we forecast consolidated net sales of ¥80.0 billion, a 4.8% increase; ordinary income of ¥3.5 billion, up 7.5%; and net income of ¥1.5 billion, up 19.7%.

## 2. Financial Position (Consolidated Cashflow Situation)

During the year, net cash provided by operating activities increased to ¥4,742 million. Of this amount, income taxes paid required ¥1,337 million. Income before income taxes and minority interests provided ¥2,550 million, and depreciation and amortization generated ¥2,207 million. The liquidation of receivables helped create a ¥1,367 million decrease in trade receivables.

Net cash used in investing activities was ¥1,889 million. This change was primarily attributable to ¥1,429 million in payments for the acquisition of fixed assets and payments for additional acquisition of stock in subsidiaries.

Net cash used in financing activities was ¥2,036 million. Principal factors included a ¥1,350 million net increase in short-term loans payable and ¥4,000 million in proceeds from the issuance of bonds with warrants. Payments for long-term loans payable required ¥2,634 million, and the payment for redemption of bonds used ¥5,000 million.

As a result, cash and cash equivalents as of December 31, 2005, totaled ¥3,417 million, up ¥816 million from the ¥2,601 million recorded at the end of the previous fiscal year.

Cashflow indicators of the Group's activities are as follows:

	Year ended December 31, 2003	Year ended December 31, 2004	Year ended December 31, 2005
Equity ratio (%)	20.3	25.0	27.5
Equity ratio at market valuation (%)	19.6	27.5	46.2
Debt redemption (years)	6.0	2.9	2.8
Interest coverage ratio (times)	10.4	19.1	16.2

Notes: **Equity ratio:** Shareholders' equity/total assets

**Equity ratio at market valuation:** Total market capitalization/total assets

**Debt redemption:** Interest-bearing debt/operating cash flow

**Interest coverage ratio:** Operating cash flow/interest payments

1. All of the above indicators are calculated on a consolidated basis.
2. Total market capitalization is calculated by multiplying the closing price of the Company's shares at the end of the year by the number of shares issued and outstanding at the end of the year.
3. Operating cash flow is the value stated as "cash flows from operating activities" in the consolidated statements of cash flows. Interest-bearing debt indicates the portion of balance-sheet liabilities on which interest is paid. Interest payment corresponds to the amount of interest paid in the consolidated statements of cash flows.

### **3. Operating and Other Risks**

#### **(1) The Operating Environment Surrounding the Alcoholic Beverages Business**

##### **a. Alcoholic Beverages Business**

The alcoholic beverages business is inherently susceptible to changing preferences. In recent years, the trends toward reduced prices and a growing health orientation have affected overall sales of alcoholic beverages. The operating environment is also undergoing tumultuous change, affected by the liberalization of liquor sales licenses and other changes to the Liquor Tax law.

The possibility exists that such changes in the market environment will affect the Group's operating performance.

##### **b. Liquor Tax Law and Other Legislation**

The Liquor Tax Law provides defining legislation that governs the Group's alcoholic beverage business, such as licenses on the production and sale of alcoholic beverages, and liquor taxes.

The possibility exists that changes to Liquor Tax Law legislation, as well as the liquor tax rate, could affect alcohol sales prices and trends.

#### **(2) Group Strategies**

##### **a. Subsidiary Acquisitions during the Year under Review**

In January 2000, we acquired all the shares in Yamashin Trading Co., Ltd., which imports and sells wine and other products. In January 2001, we acquired 80% of the outstanding shares in FUKUTOKUCHO CO., LTD. (As of December 31, 2005, we owned a 100% stake in this company.) We have converted both companies into consolidated subsidiaries. In so doing, we also converted to a consolidated subsidiary AKITAKENHAKKO KOGYO CO., LTD., a subsidiary of FUKUTOKUCHO CO., LTD. (In April 2005, we split off AKITAHAKKEN KOGYO, turning it into a direct subsidiary of the Company.) In July 2003, we acquired from Asahi Kasei Corporation all shares in FUKUMUSUME SAKE BREWERY CO., LTD., and converted this company to a consolidated subsidiary.

Primarily owing to increases in their sales and total assets, in the fiscal years ended December 31, 2000, 2001 and 2003, we began treating the four companies indicated above as consolidated subsidiaries.

##### **b. Subsidiary Acquisitions and Other Group Strategies**

One of the Company's aggressive business expansion strategies has been to acquire shares in companies that we believe will employ Group management assets efficiently and effectively, and converting them to subsidiaries. In April 2005, we split AKITAKENHAKKO KOGYO CO., LTD., off from FUKUTOKUCHO CO., LTD., turning the former into our direct subsidiary. At this stage, the Company has no plans to acquire new subsidiaries. Rather, we intend to strengthen the functions that exist within the current Group structure, thereby achieving total cost reductions for the Group.

Over the medium to long term, however, we do expect to acquire subsidiaries in line with the Group's business expansion policy. In the event that we acquire additional subsidiaries, the possibility exists that changes in the operating environment temporarily could cause the Company to post additional losses. It is also possible that the positive effects of such acquisitions may be less than the Company has anticipated.

### **(3) Enzymes and Pharmaceuticals Business**

The Group's enzymes and pharmaceuticals business divides in to four major product areas: enzymes, diagnostics, bulk pharmaceuticals and health foods. We plan to expand our bulk pharmaceuticals production capacity and to promote the development of new enzymes. To this end, between September 2003 and December 2005 we directed capital investment into the construction a second refinery, which should enable use to organize our fermentation facilities more efficiently.

In line with growing demand for bulk pharmaceuticals and health foods, it is possible that competition will become more stringent. As a result, it is possible that the Group's enzyme-based pharmaceuticals business may be affected more severely than we anticipate.

## Consolidated Balance Sheets

(Amounts below one million yen are truncated.)

Account item	Fiscal year 2004 (As of Dec. 31, 2004)		Fiscal year 2005 (As of Dec. 31, 2005)		Change	
	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)	
(Assets)						
Current assets						
Cash and deposits	2,605		3,421			816
Notes and accounts receivable	21,974		20,607			(1,367)
Inventories	9,271		8,422			(848)
Deferred tax assets	324		338			13
Prepaid expenses	146		143			(3)
Other current assets	438		464			26
Allowance for doubtful accounts	(47)		(45)			1
Total current assets	34,714	54.8	33,353	53.5		(1,360)
Fixed assets						
Tangible fixed assets						
Buildings	17,813		18,058			244
Accumulated depreciation	(9,100)	8,712	(9,653)	8,404		(552)
Structures	3,875		3,961			86
Accumulated depreciation	(2,342)	1,532	(2,478)	1,483		(135)
Machinery, equipment and vehicles	24,724		25,001			277
Accumulated depreciation	(18,963)	5,760	(19,591)	5,410		(627)
Tools, furniture and fixtures	1,913		1,930			16
Accumulated depreciation	(1,522)	391	(1,578)	351		(56)
Land		7,704		7,700		(3)
Construction in progress		193		669		476
Total tangible fixed assets	24,295	38.4	24,020	38.5		(275)
Intangible fixed assets						
Leasehold	11		11			—
Consolidation adjustments	1,037		1,001			(35)
Software	174		142			(31)
Other intangible fixed assets	420		399			(20)
Total intangible fixed assets	1,643	2.6	1,554	2.5		(88)
Investments and other assets						
Investment securities	1,624		2,239			614
Long-term loans receivable	22		10			(12)
Long-term prepaid expenses	190		204			14
Deferred tax assets	444		398			(45)
Other investments and other assets	440		639			199
Allowance for doubtful accounts	(51)		(60)			(8)
Total investments and other assets	2,670	4.2	3,432	5.5		761
Total fixed assets	28,609	45.2	29,007	46.5		397
Total Assets	63,323	100.0	62,360	100.0		(963)

(Amounts below one million yen are truncated.)

Account item	Fiscal year 2004 (As of Dec. 31, 2004)		Fiscal year 2005 (As of Dec. 31, 2005)		Change
	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)
(Liabilities)					
Current liabilities					
Notes and accounts payable	7,196		6,639		(556)
Short-term debt	7,784		8,670		886
Bonds redeemable within 1 year	5,000		—		(5,000)
Other payables	4,561		5,035		473
Accrued liquor tax	7,867		7,398		(468)
Accrued consumption tax	584		521		(62)
Accrued income tax	831		704		(126)
Allowance for employees' bonuses	78		73		(5)
Accrued expenses	215		209		(5)
Deposits payable	208		316		108
Other current liabilities	785		1,028		243
Total current liabilities	35,111	55.4	30,598	49.1	(4,513)
Long-term liabilities					
Warrant Bonds	—		4,000		4,000
Long-term debt	3,472		1,902		(1,570)
Long-term deposits payable	3,143		3,205		62
Allowance for employees' retirement benefits	1,450		938		(512)
Allowance for directors' retirement benefits	271		214		(57)
Other long-term liabilities	1,778		2,502		724
Total long-term liabilities	10,116	16.0	12,762	20.4	2,645
Total liabilities	45,228	71.4	43,361	69.5	(1,867)
(Minority Interests)					
Minority interests	2,255	3.6	1,843	3.0	(412)
(Shareholders' Equity)					
Common stock	6,938	11.0	6,938	11.1	—
Capital surplus	5,540	8.7	5,568	8.9	28
Retained earnings	3,043	4.8	3,973	6.4	929
Valuation difference of other securities	351	0.6	717	1.1	365
Treasury stock	(34)	(0.1)	(41)	(0.0)	(7)
Total shareholders' equity	15,839	25.0	17,156	27.5	1,316
Total Liabilities, Minority Interests and Shareholders' Equity	63,323	100.0	62,360	100.0	(963)

## Consolidated Statements of Income

(Amounts below one million yen are truncated.)

Account item	Fiscal year 2004 (Jan. 1, 2004 – Dec. 31, 2004)		Fiscal year 2005 (Jan. 1, 2005 – Dec. 31, 2005)		Change		
	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)	Percent of total (%)	Amount (Millions of yen)		
Net sales		80,313	100.0		76,324	100.0	(3,989)
Cost of sales		57,547	71.7		54,306	71.2	(3,240)
Gross profit		22,766	28.3		22,017	28.8	(748)
Selling, general and administrative expenses		19,743	24.5		18,600	24.3	(1,142)
Operating income		3,022	3.8		3,416	4.5	394
Nonoperating income							
Interest income	1			0			(0)
Dividend income	26			28			1
Rental income	76			73			(3)
Foreign currency exchange gain	2			5			2
Other nonoperating income	104	211	0.2	85	192	0.3	(19)
Nonoperating expenses							
Interest expenses	344			285			(58)
Other nonoperating expenses	45	390	0.5	67	353	0.5	21
Ordinary income		2,843	3.5		3,256	4.3	412
Extraordinary income							
Gain on sales of fixed assets	16			0			(16)
Gain on sales of investment securities	0			42			42
Reversal of allowance for doubtful accounts	9			1			(8)
Others	1	27	0.1	0	44	0.0	(1)
Extraordinary loss							
Directors' retirement benefits	20			—			(20)
Transfer to directors' retirement benefits reserve	138			—			(138)
Loss on sales and disposal of fixed assets	429			152			(276)
Loss on disposal of inventories	306			355			49
Loss on revaluation of memberships	115			—			(115)
Loss on sales of investment securities	3			—			(3)
Loss on revaluation of investment securities	51			3			(47)
Loss on transition to defined contribution pension plan	—			168			168
Others	122	1,187	1.5	69	749	1.0	(52)
Income before income taxes and minority interests		1,684	2.1		2,550	3.3	866
Income, residential and enterprise taxes	1,241			1,144			(96)
Reversal of income taxes payable for previous periods	(43)			—			43
Adjustment for income taxes	(257)	940	1.2	14	1,158	1.5	271
Minority interests		167	0.2		138	0.2	(28)
Net income		576	0.7		1,253	1.6	677

## Consolidated Statements of Retained Earnings

(Amounts below one million yen are truncated.)

Account item	Fiscal year 2004 (Jan. 1, 2004 – Dec. 31, 2004)		Fiscal year 2005 (Jan. 1, 2005 – Dec. 31, 2005)		Change	
	Amount (Millions of yen)		Amount (Millions of yen)		Amount (Millions of yen)	
(Capital surplus)						
Capital surplus at beginning of year		4,477		5,540		1,063
Increase in capital surplus						
New issue of stock due to capital increase	1,062		—		(1,062)	
Gain or loss on disposal of treasury stock	0		0		0	
Gain on corporate separation of subsidiary	—	1,063	27	28	27	(1,035)
Capital surplus at end of year		5,540		5,568		28
(Retained earnings)						
Retained earnings at beginning of year		2,779		3,043		264
Increase in retained earnings						
Gain on corporate separation of subsidiary	—		48		48	
Net income	576	576	1,253	1,301	677	725
Decrease in retained earnings						
Dividends paid	279		324		44	
Bonuses to directors and corporate auditors	31	311	47	372	15	60
Retained earnings at end of year		3,043		3,973		929

## Consolidated Statements of Cash Flows

(Amounts below one million yen are truncated.)

Account item	Fiscal year 2004 (Jan. 1, 2004 – Dec. 31, 2004)	Fiscal year 2005 (Jan. 1, 2005 – Dec. 31, 2005)	Change
	Amount (Millions of yen)	Amount (Millions of yen)	Amount (Millions of yen)
<b>Cash flows from operating activities:</b>			
Income before income taxes and minority interests	1,684	2,550	866
Depreciation and amortization	2,408	2,207	(200)
Amortization of consolidation adjustments	139	76	(62)
Increase (decrease) in allowance for employees' retirement benefits	196	(512)	(708)
Increase (decrease) in allowance for directors' retirement benefits	187	(57)	(244)
Increase (decrease) in allowance for doubtful accounts	(21)	7	28
Interest and dividend income	(27)	(29)	(1)
Interest expenses	344	285	(58)
Loss (gain) on sales of investment securities	3	(42)	(45)
Loss on revaluation of investment securities	51	3	(47)
Gain on sales of fixed assets	(16)	(0)	16
Loss on sales and disposal of fixed assets	429	152	(276)
Loss on revaluation of memberships	115	—	(115)
Loss on disposal of inventories	306	355	49
Loss on transition to defined contribution pension system	—	168	168
Decrease (increase) in trade receivables	1,471	1,367	(103)
Increase in inventories	(45)	492	538
Increase (decrease) in accounts payable	(376)	(556)	(179)
Increase (decrease) in accrued liquor tax	(130)	(468)	(337)
Decrease (increase) in other current assets	160	(26)	(186)
Increase (decrease) in other current liabilities	(187)	255	442
Increase (decrease) in other fixed liabilities	1,678	552	(1,125)
Others	(285)	(439)	(154)
Subtotal	8,086	6,344	(1,741)
Interest and dividends received	28	29	1
Interest paid	(340)	(293)	47
Income taxes paid	(1,264)	(1,337)	(72)
Net cash provided by operating activities	6,508	4,742	(1,766)
<b>Cash flows from investing activities:</b>			
Decrease in time deposits	(4)	(4)	—
Increase in time deposits	4	4	—
Payments for acquisition of fixed assets	(4,250)	(1,429)	2,821
Payments for (proceeds from) disposal or sales of fixed assets	24	(47)	(71)
Payments for acquisition of investment securities	(42)	(38)	4
Proceeds from sales of investment securities	13	80	67
Proceeds from collection of loans	7	15	7
Others	(46)	(470)	(423)
Net cash used in investing activities	(4,294)	(1,889)	2,404

**Consolidated Statements of Cash Flows (continued)**

Cash flows from financing activities:			
Net decrease (increase) in short-term loans payable	(1,060)	1,350	2,410
Proceeds from long-term loans payable	—	600	600
Payments for long-term loans payable	(3,174)	(2,634)	540
Proceeds from issuance of new shares	2,133	—	(2,133)
Proceeds from issuance of warrant bonds	—	4,000	4,000
Payment for redemption of bonds	—	(5,000)	(5,000)
Dividends paid	(279)	(324)	(45)
Dividends paid to minority interests	(12)	(20)	(7)
Others	(28)	(7)	21
Net cash used in financing activities	(2,420)	(2,036)	384
Net increase (decrease) in cash and cash equivalents	(206)	816	1,022
Cash and cash equivalents at beginning of period	2,807	2,601	(206)
Cash and cash equivalents at end of period	2,601	3,417	816

**(Segment Information)**

## (a) Business segments

(Amounts below one million yen are truncated.)

Item	Fiscal year 2004 (January 1, 2004 – December 31, 2004)							
	Alcoholic beverages	Food products	Enzymes and pharmaceuticals	Real estate	Others	Total	Elimination or corporate	Consolidated
<b>1. Sales and operating income/expenses</b>								
Sales:								
Sales to outside customers	71,977	4,377	2,282	409	1,266	80,313	—	80,313
Inter-segment sales/transfers	78	0	—	482	7,449	8,011	(8,011)	—
Total sales	72,056	4,377	2,282	891	8,716	88,325	(8,011)	80,313
Operating expenses	70,207	4,025	1,981	442	8,646	85,302	(8,011)	77,291
Operating income (loss)	1,849	352	301	449	70	3,022	(—)	3,022
<b>2. Assets, depreciation and amortization, and capital expenditures</b>								
Assets	48,933	3,116	2,621	3,276	5,010	62,959	364	63,323
Depreciation and amortization	1,872	75	182	84	193	2,408	—	2,408
Capital expenditures	1,671	59	778	45	150	2,705	—	2,705

## Notes:

1. Segmentation: Businesses of the Oeon Group are categorized into five segments (alcoholic beverages, food products, enzymes and pharmaceuticals, real estate and others), depending on product types and characteristics, as well as similarities of their respective markets.

## 2. Major products of each business segment

Business segment	Major product/business lines
Alcoholic beverages	<i>Shochu, chu-hi, sake</i> compounds, <i>sake</i> , Western-style alcohol for processing, wines
Food products	Processing starch, seasonings
Enzymes and pharmaceuticals	Enzymes, diagnostics, bulk pharmaceuticals, health foods
Real estate	Purchase and sale, leasing and rental of real estate
Others	Food services, warehousing, packaging, cargo handling

3. Within assets, the “elimination or corporate” category amounted to ¥3,287 million. Major items were funds for surplus fund management (cash and marketable securities), long-term investments (investment securities) and assets related to administrative departments.

(Amounts below one million yen are truncated.)

Item	Fiscal year 2005 (January 1, 2005 – December 31, 2005)							
	Alcoholic beverages	Food products	Enzymes and pharmaceuticals	Real estate	Others	Total	Elimination or corporate	Consolidated
1. Sales and operating income/expenses								
Sales:								
Sales to outside customers	67,464	4,420	2,804	371	1,263	76,324	—	76,324
Inter-segment sales/transfers	73	2	—	533	7,231	7,841	(7,841)	—
Total sales	67,538	4,422	2,804	905	8,494	84,165	(7,841)	76,324
Operating expenses	65,629	4,112	2,202	398	8,406	80,748	(7,841)	72,907
Operating income (loss)	1,908	310	602	507	88	3,416	(—)	3,416
2. Assets, depreciation and amortization, and capital expenditures								
Assets	46,597	3,137	2,655	3,181	5,112	60,683	1,676	62,360
Depreciation and amortization	1,665	89	194	78	179	2,207	—	2,207
Capital expenditures	1,547	42	232	3	18	1,844	—	1,844

Notes:

1. Segmentation: Businesses of the Oeon Group are categorized into five segments (alcoholic beverages, food products, enzymes and pharmaceuticals, real estate and others), depending on product types and characteristics, as well as similarities of their respective markets.

2. Major products of each business segment

Business segment	Major product/business lines
Alcoholic beverages	<i>Shochu, chu-hi, sake</i> compounds, <i>sake</i> , Western-style alcohol for processing, wines
Food products	Processing starch, seasonings
Enzymes and pharmaceuticals	Enzymes, diagnostics, bulk pharmaceuticals, health foods
Real estate	Purchase and sale, leasing and rental of real estate
Others	Food services, warehousing, packaging, cargo handling

3. Within assets, the “elimination or corporate” category amounted to ¥4,411 million. Major items were funds for surplus fund management (cash and marketable securities), long-term investments (investment securities) and assets related to administrative departments.

(b) Geographical segments

As assets and sales in Japan account for more than 90% of total assets and sales in each category for the year under review (January 1, 2005 – December 31, 2005) and the preceding term (January 1, 2004 – December 31, 2004), segment assets and sales by geographical region are omitted.

(c) Overseas sales

As overseas sales account for less than 10% of total net sales for the year under review (January 1, 2005 – December 31, 2005) and the preceding term (January 1, 2004 – December 31, 2004), information on overseas sales is omitted.

## Production, Orders Received and Sales Performance

### 1. Production

The production performance by major product category is as follows:

Business segment		Fiscal year 2004 (Jan. 1, 2004 – Dec. 31, 2004) (Kiloliters)	Fiscal year 2005 (Jan. 1, 2005 – Dec. 31, 2005) (Kiloliters)	Change (%)
	Item (Major product category)			
Alcoholic beverages	<i>Shochu</i>	100,842	87,766	87.0
	<i>Chu-hi</i>	16,566	9,030	54.5
	<i>Sake</i>	28,881	25,032	86.7
	<i>Sake compounds</i>	32,982	31,883	96.7
	Brewing alcohol	20,778	30,240	145.5
	<i>Mirin</i> (sweet <i>sake</i> for cooking)	5,241	4,691	89.5
	Western-style alcohol	5,513	5,437	98.6
	Total	210,806	194,082	92.1
Food products	Seasonings	6,223	5,306	85.3

Note: The production in the enzymes and pharmaceuticals segment is not stated, as quantitative computation is difficult. The real estate and others segments are not listed, as these segments had no production outputs.

### 2. Orders received

The Oeon Group does not conduct production on a made-to-order basis.

### 3. Sales performance

The sales performance by item (major product category) is as follows:

(Amounts below one million yen are truncated.)

Business segment		Fiscal year 2004 (Jan. 1, 2004 – Dec. 31, 2004) (Millions of yen)	Fiscal year 2005 (Jan. 1, 2005 – Dec. 31, 2005) (Millions of yen)	Change (%)
	Item (Major product category)			
Alcoholic beverages	<i>Shochu</i>	41,731	39,817	95.4
	<i>Chu-hi</i>	3,232	1,782	55.1
	<i>Sake</i>	10,177	8,972	88.2
	<i>Sake compounds</i>	6,526	6,235	95.5
	Brewing alcohol	1,849	2,674	144.6
	<i>Mirin</i> (sweet <i>sake</i> for cooking)	1,751	1,641	93.7
	Western-style alcohol	6,709	6,340	94.5
	Total	71,977	67,464	93.7
Food products		4,377	4,420	101.0
Enzymes and pharmaceuticals		2,282	2,804	122.8
Real estate		409	371	90.8
Others		1,266	1,263	99.7
Total		80,313	76,324	95.0

Notes:

- The above amounts do not include consumption taxes.
- As sales performance at each destination accounts for less than 10% of total sales performance, sales performance by destination is omitted.