Report and Analysis of Financial Conditions and Results of Operations for the Fiscal Year Ended March 2006 (Consolidated)

■ Operating Environment

I. DOMESTIC ECONOMIC CONDITIONS

Real GDP grew 3.2% in the fiscal year ended March 2006, marking the fourth continuous year of positive growth and the highest rate of growth since the 6.0% recorded in the fiscal year ended March 1991. Particularly noteworthy was the growth in private-sector capital investment, the financial indicator that most significantly affects the Tsubaki Group's business results. Capital investment is on an accelerating trend with the annual rate of growth at 6.6%, up from 5.6% in the fiscal year ended March 2005. The current wave of economic growth is expanding beyond the major centers to the local regions and from the corporate sector to the individual. Another major development in the operating environment in the fiscal year under review was the appearance of definite signs that the domestic economy may be breaking out of a deflationary cycle.

II. ECONOMIC CONDITIONS OVERSEAS

Despite concerns over higher oil prices and the effects of major hurricanes, the U.S. economy maintained real growth in GDP exceeding 3% on the back of strong consumer spending. Although results tended to vary according to region in Europe, the general trend was toward sturdy economic recovery. Economic growth in Asia continued at a fast pace fueled by growth in China amid ongoing concern about overheating.

■ Statements of Income

Supported by the favorable business environment, the Tsubaki Group recorded a solid business performance during the fiscal year under review.

I. OVERALL PERFORMANCE

1. Net Sales

Consolidated net sales reached ¥147.8 billion (up 14.0%), exceeding the target of ¥136.0 billion set in the initial plan formulated at the beginning of the fiscal year under review as well as the revised target of ¥145.0 billion included in the interim-term financial statements. Net sales results by business segment, which will be discussed later in this section, benefited from market share increases in industrial-use chains and automotive parts, the Tsubaki Group's mainstay products, in addition to the strong growth shown in private-sector capital investment and the strong performance of the automotive sector.

2. Operating Income

Operating income posted significant growth of 32.4% from the previous year, reaching ¥13.8 billion, a new record. Despite the adverse effects of steep rises in prices of raw materials, particularly steel, sales growth was supported by two factors. First, a significant increase in sales of chains and automotive parts, the most profitable in the Tsubakimoto Chain lineup, helped to improve the overall business segments and product mix. Second, price increases for power transmission units and components helped to offset higher raw material prices. These two factors combined to fuel a 1.3-point rise in the operating margin, from 8.1% to 9.4%.

3. Net Income

Net income for the fiscal year under review also reached a historic high of ¥6.6 billion. The balance of interest income and interest expenses (interest and dividend income minus interest expense) yielded a net expense for the year of ¥0.6 billion, down ¥0.4 billion from the previous year. Contributing to this improvement was a reduction in interest-bearing debt. Other relevant items included a gain of ¥0.5 billion on sales of property, plant and equipment, extraordinary profit of ¥0.5 billion, a loss of ¥0.3 billion due to modification of the retirement benefit plan, and an extraordinary loss of ¥0.5 billion.

II. PERFORMANCE BY BUSINESS SEGMENT

1. Business Segments

Please refer to pages 14 to 19 for detailed information on business segments.

① Power Transmission Products

Total sales in this segment came to ¥113.7 billion, an increase of 13.9% from the previous year. The operating margin also expanded, to 13.1% from 11.3% in the previous year.

In terms of product sales, vigorous, double-digit growth was registered by chain products (up 12.9%), automotive parts (up 14.4%), and power transmission units and components (up 12.8%).

Sales growth in chain products, in particular, was sustained by strong capital investment in plant and equipment by the domestic manufacturing sector and growth in market share. Across-the-board growth was recorded for various categories of chains, including ATC chains for machine tools, chains for small and large conveyor systems, and cableveyors. Growth in sales volumes was accompanied by price increases for certain products, productivity enhancements, and cost reduction measures, such as cell manufacturing, that combined to significantly increase profit margins.

In automotive parts, steady expansion of automobile production by domestic automakers helped to significantly expand sales of timing chain drive systems, one of the Company's leading product lines. Timing chain drive systems also showed favorable sales growth in the overseas five-point production network encompassing bases in Japan, North America, Europe, Thailand, and China, with very large orders received from several overseas automakers.

In power transmission units and components, such key products as reducers, linear actuators, and clutches registered growth in sales to the automotive, machine tools, injection molding equipment, steel, and LCD-related industries.

② Materials Handling Systems

Total sales of materials handling systems expanded 15.7%, to ¥35.5 billion. The operating margin was about the same as in the previous year, at 5.9%.

In terms of products, sales increased steadily for automotive body paint shop conveyor systems, automatic roll paper feeding systems for the newspaper industry, conveyor systems for the machine tools industry, and bulk conveyance systems for such granulated materials as grain and feed. While we have aggressively pursued measures to reduce costs, additional costs incurred in newly developed automotive body paint shop conveyor systems kept the operating margin at the level of the previous fiscal year.

2. Performance by Geographical Segment

Total sales in Japan increased 12.5%, to ¥117.4 billion, while the operating margin grew 1.3 points, to 12.3%. The principal factors contributing to this result included the increase in overall chain sales volume, success in implementing cost reduction measures, and the rationalization of productivity for such leading product lines as chains, automotive parts, power transmission units and components, and materials handling systems.

Total sales in North America showed strong growth of 37.8%, with the chain and automotive parts operations of U.S. Tsubaki, Inc., making an important contribution. However, the operating margin remained at the modest level of 3.2%, up just 0.4 points. While productivity has improved significantly thanks to higher production levels, unprofitable projects in the area of automotive body paint shop conveyor systems (as mentioned above) had a hobbling effect on earnings growth during the fiscal year under review.

Total sales in Europe registered strong growth of 27.5%. Contributing to this success were major orders for conveyor chains destined for food processing companies in the United Kingdom. Nevertheless, the operating margin of 7.4% remained near the level of the previous fiscal year.

Total sales in Asia and Oceania remained flat, while the operating margin grew by 1.2 points, to 11.3%.

■ Cash Flows

1. Cash Flows from Operating Activities

Net cash from operating activities rose to ¥10.7 billion, from ¥9.7 billion in the previous fiscal year. Income before income taxes and minority interests rose to ¥12.6 billion, up significantly from the ¥8.6 billion in the previous year. Among other items, the growth in trade notes and accounts receivable accompanying increased business capacity and inventories (specifically related to Materials Handling Systems Operations) negatively affected growth. Depreciation came to ¥5.5 billion, about the same level as recorded in the previous year.

2. Cash Flows from Investing Activities

Net cash used in investing activities totaled ¥5.6 billion, compared with net cash of ¥2.5 billion used in the preceding year. Principal factors leading to the sharp increase in cash outflow included an aggressive program of investment in plant and equipment centered on the key growth area of automotive parts. This included payments for purchases of property, plant and equipment, which grew to ¥6.8 billion from ¥3.0 billion in the previous year. On the positive side, proceeds from sales of property, plant and equipment in the form of idle plant property came to ¥1.2 billion.

3. Cash Flows from Financing Activities

Net cash used in financing activities totaled ¥5.6 billion, compared with net cash of ¥9.4 billion used in the preceding year. An inflow of cash of ¥7.0 billion from issuance of bonds was exceeded by an outflow of ¥8.2 billion for repayment of long-term loans. While, in terms of direction, the Tsubaki Group continues to maintain a special focus on reducing interest-bearing debt, the current favorable business environment has also led the Group to adopt a somewhat more positive business stance.

Balance Sheets

1. Assets

Total assets increased to ¥198.5 billion, from ¥179.3 billion at the previous year-end.

Due to growth in trade notes and accounts receivable and inventories accompanying the expansion in business capacity described previously, total current assets increased ¥6.7 billion, to ¥78.9 billion. Affected by the assessment of non-recoverability of deferred income tax assets on property revalued previously, property, plant and equipment, net, was reduced ¥2.1 billion. In investments and other assets, a significant gain on valuation of investment in securities accompanying a rise in share prices contributed to an overall increase of ¥12.5 billion in noncurrent assets, bringing their total to ¥119.6 billion.

2. Liabilities

Ongoing efforts during the fiscal year under review to improve the Company's financial position helped reduce interest-bearing debt by ¥4.4 billion, bringing the total down to ¥39.0 billion. This represents a reduction in interest-bearing debt of approximately half from the ¥78.7 billion recorded at the close of the fiscal year ended March 2001. Total liabilities for the fiscal year under review increased ¥13.6 billion, to ¥117.3 billion. This result reflected such factors as a rise in deferred income tax liabilities by ¥6.8 billion, which is associated with the assessment of non-recoverability of deferred income tax assets (see the discussion in the Assets section), an increase in deferred income tax liabilities on market valuation of securities, and an increase in trade notes and accounts payable accompanying the growth in business capacity.

3. Shareholders' Equity

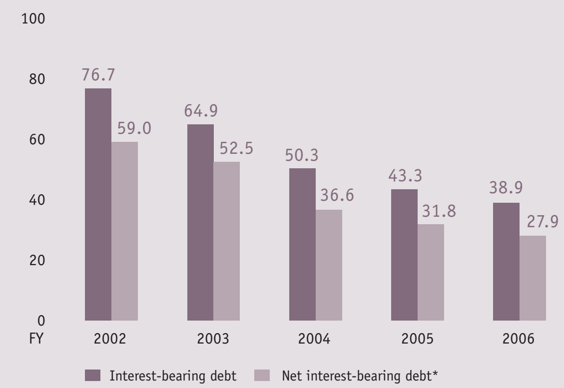
Total shareholders' equity expanded ¥5.5 billion, to ¥77.1 billion. This was due to a combination of factors. On the positive side was the significant growth in retained earnings accompanying growth in net income and an increase in net unrealized holding gain on securities accompanying the gain on valuation of investment in securities. On the negative side were the interplay between the accounting procedures that apply to revaluation of land under the assets and the liabilities sections that reduced the property revaluation surplus by ¥9.0 billion. As a result, the equity ratio fell to 38.8%, from 40.0%. At the same time, however, the debt-equity ratio (total interest-bearing liabilities divided by total shareholders' equity) improved to 0.51, from 0.61 at the previous year-end.

Total Assets and Shareholders' Equity

Billions of yen

Interest-Bearing Debt

Billions of yen



* Net interest-bearing debt = interest-bearing debt – cash and cash equivalents

ROE

%