Management's Discussion and Analysis of Operations

Performance

Overview

In the period under review—the year ended March 31, 2006—the Japanese economy showed steady-albeit moderate-recovery, supported by improved corporate results and firm capital expenditures, as well as strong employment conditions and personal consumption. This was despite unabated surges in crude oil prices.

It was the final period of the Japan Vilene Group's three-year business plan. Guided by the plan, we developed new products and tapped new markets, while enhancing quality and productivity to reduce costs. To meet growing demand overseas, we upgraded the production systems of subsidiaries in North America and affiliates in East Asia.

Consolidated net sales for the year amounted to ¥51,865 million, up 5.1% from the previous fiscal year. Operating income grew 12.8%, to ¥3,111 million, and net income climbed 4.9%, to ¥2,495 million.

Foreign Exchange Effect

In addition to the Japanese yen, the Group is exposed to fluctuations of various foreign currencies, mainly the U.S. dollar. Because the Group's consolidated financial statements are reported in yen, its performance is affected by foreign exchange and transaction risk. In the year under review, the U.S. dollar appreciated against the yen. In general, a weak yen has a beneficial effect on our revenue and earnings.

Our car floor mat business in North America is showing particularly strong growth. Business expansion and foreign exchange factors had a positive impact on this area of our operations. The exchange rate in the year under review was ¥110.26 per U.S. dollar, up ¥2.03 from the previous year.

Revenue

Consolidated net sales grew 5.1%, to ¥51,865 million.

In Japan, the Automotive Materials segment and Medical and Consumer Materials segment generated increased revenue. However, in the Electrical Materials segment, which grew significantly in the previous year, sales of separators for rechargeable nickel-cadmium batteries declined. This was despite growth in sales of separators for rechargeable nickel-metalhydrate batteries, including those used in hybrid vehicles.

Overseas, VIAM Manufacturing, Inc., a subsidiary that makes car floor mats in North America, reported substantial business growth owing to firm orders from Japanese automakers with local operations.

Expenses

Cost of sales rose 5.8%, to ¥39,860 million, reflecting the increase in net sales. The cost-of-sales ratio rose 0.5 points, due to expansion of our North American car floor mat business, which has a relatively high cost-of-sales ratio. Gross profit grew 2.8%, to ¥12,005 million.

Selling, general, and administrative (SG&A) expenses edged down 0.3%, to ¥8,894 million. A revision to our retirement benefit system in the previous year led to a ¥187 million decline in the retirement benefit expense component of SG&A expenses. However, the personnel expense component increased due to a rise in bonuses, which are linked to our business results. Nevertheless, total SG&A expenses were down ¥30 million, and the SG&A expense ratio improved 1.0 point, to 17.1%.

Research and Development

R&D costs grew 1.2%, to ¥1,729 million, equivalent to 3.3% of net sales.

The Japan Vilene Group's R&D activities center on research into core technologies related to nonwoven materials, as well as the development of function-enhancing technologies and high-level processing technologies aimed at improving the competitiveness of our existing businesses. In the fiscal year ending March 2007, we plan a slight increase in R&D costs, to ¥1,800 million.

Other Income/Expenses

Total other income (net of other expenses) amounted to ¥715 million, up 32.5% from the previous year. This was mainly due to an ¥86 million rise in foreign exchange gain. (The exchange rate at March 31, 2006, was ¥118.01 per U.S. dollar, up more than ¥10 from a year earlier.)

Equity in earnings of associated companies grew 5.1%, to ¥833 million, owing to favorable performances by equity-method affiliates in East Asia. We also reported a ¥110 million impairment loss on fixed assets slated for sale in the future.

Earnings

Income before income taxes and minority interests grew 16.0%, to ¥3,826 million. This stemmed from a ¥352 million rise in operating income, as well as a ¥175 million increase in other income (net of other expenses).

After adding the net effects of

income taxes and minority interests, net income for the year was up 4.9%, to ¥2,495 million.

Distribution of Profits

A year-end cash dividend of ¥6.00 per share was approved at the 2006 Annual General Meeting. After adding the ¥4.00 interim dividend already paid, this brings total annual dividends for the year to ¥10.00 per share.

Financial Position and Liquidity

Balance Sheets

At March 31, 2006, total assets stood at ¥55,338 million, up 3.8% from a year earlier.

The major factor in this increase was a 17.2% rise in investments and other assets, to ¥12,111 million, stemming mainly from a 25.5% jump in investment securities, which were bolstered by equity in earnings of associated companies. By contrast, current assets remained mostly unchanged, at ¥24,754 million. Property, plant, and equipment grew 2.7%, to ¥18,473 million, owing to increased capital expenditures in the North American car floor mat business.

Total liabilities declined 5.1%, to ¥22,311 million. Current liabilities were down 5.8%, to ¥14,850 million. As a result, the current ratio improved from 158.7% to 166.7%. Interest-bearing debt fell 16.0%, to ¥6,824 million.

Total shareholders' equity increased 10.8%, to ¥32,738 million. Major factors included a rise in retained earnings owing to the higher net income figure, as well as the lessened impact of foreign currency translation adjustments owing to the weakened yen. Treasury stock rose ¥20 million, to ¥92 million, due to share buybacks during the period. Consequently, the equity ratio grew to 59.2%, from 55.4%, and the debt-to-equity ratio improved from 0.3 times to 0.2 times. Net assets per share, based on the number of shares issued at fiscal year-end, rose from ¥454.57 to ¥503.48.

Capital Expenditures and Depreciation and Amortization

In the year under review, the Group made total capital expenditures of ¥2,213 million, down 0.6%. A large portion of this amount was used to expand car floor mat production facilities in Tennessee, U.S.A., similar to the previous year.

Depreciation and amortization declined from ¥2,002 million to ¥1,913 million.

Cash Flows

At the end of the year, cash and cash equivalents stood at ¥3,043 million on a consolidated basis, down ¥452 million from a year earlier.

Net cash provided by operating activities amounted to ¥3,414 million, down ¥655 million from the previous year. The decline stemmed primarily from an ¥851 million increase in income taxes paid.

Net cash used in investing activities totaled ¥2,010 million, up ¥237 million, due mainly to a ¥262 million decrease in proceeds from sales of property, plant, and equipment.

Net cash used in financing activities was ¥1,942 million, down ¥496 million. This was attributable mainly to a ¥670 million decrease in short-term bank loans—net.

Business Risks

The various risks that may potentially affect the business performance and financial position of the Japan Vilene Group are summarized below. Information contained therein is based on the Group's interpretation of information available at the time of its results announcement. Readers are advised that the following does not cover all of the risks that could influence the Group's operations.

Economic Conditions

Practically all of the Japan Vilene Group's revenues are generated by sales of nonwoven fabrics and items processed from nonwoven fabrics, which in turn are affected by economic conditions in the countries and regions of sale. Moreover, customers are not necessarily obliged to purchase products made by the Group.

Similarly, demand for the Group's products and for Vilene-brand products made by other companies is affected by economic conditions in the various markets where such products are sold. For these reasons, economic recessions in the Group's major markets, including Japan, North America, and Asia, could cause a decline in demand, which may have a negative impact on the Group's business performance and financial position.

Foreign Exchange Fluctuations

The Japan Vilene Group's business includes production and sales operations in North America and Asia. Sales, expenses, assets, and other items relevant to each region are translated into yen in the course of preparing the Group's consolidated financial statements. Even if the local value of such items does not change, therefore, the value after translation into yen may be affected. In general, an appreciating yen has a negative effect on the Group's business, and a depreciating yen has a positive effect. Over the medium- and long-term, however, fluctuating exchange rates make it impossible to undertake procurement, manufacturing, distribution, and sales activities exactly as planned. Therefore, exchange rate fluctuations can potentially have a negative influence on the Group's business performance and financial position.

Product Development Capabilities

The Group is confident of its ability to continue developing innovative, appealing products. However, product development and sales processes, due to their nature and complexity, involve uncertainties and various risks. For example, there is no guarantee that the Group can adequately obtain the capital and resources required to invest in new products and technologies. In addition, the Group cannot predict without fail that its new products and technologies will win market support, and also cannot guarantee that the sale of such products will be successful. Moreover, rapid technological advances and changes may cause the Group's products to be superseded. Due to the aforementioned risks, the Group may not be able to adequately foresee changes to its industry and markets. This could prevent it from developing attractive new products, which could cause future growth and profits to decline. The Group's business performance and financial position could be affected as a result.

Foreign Country Conditions

Outside of Japan, the Group is engaged in production and sales in such regions as North America and Asia. For example, the Group has consolidated subsidiaries in the U.S., mainland China, and Hong Kong, as well as equity-method affiliates in the U.S., mainland China, Hong Kong, and Taiwan. Establishing operations in such overseas markets involves a number of risks, including unpredictable changes in laws and other regulations, unfavorable political and other internal factors, difficulties in hiring and keeping staff, potentially unfavorable tax regimes, and social upheaval caused by terrorism or other acts. The Group's business performance and financial position could be affected as a consequence.

Retirement Benefit Obligations

The Group's employee retirement benefit expenses and obligations are computed based on discount rates and other preconditions for actuarial calculations, as well as expected return on pension assets. Actual results achieved may differ from such expectations, and preconditions themselves may also change. The Group's business performance and financial position could be affected as a result.