

# Management's Discussion and Analysis of Operations

## Performance

### Overview

In the year ended March 31, 2009, following a rise in raw material prices in the first half, the U.S. financial crisis sparked by the sub-prime loan problem snowballed during the second half into a global economic downturn. In Japan, exports tumbled because of weak overseas demand in the second half of the fiscal year, and capital investment and the labor market also stalled, ensuring that operating conditions for the Japan Vilene Group were extremely challenging.

### Sales

Consolidated net sales declined 14.9%, to ¥50,240 million, reflecting a rapid deterioration in the business situation and the ensuing inventory adjustments among users (corporate customers).

### Sales by Operational Segment

Sales of apparel and medical materials declined 7.9% from the previous year, to ¥10,517 million. Although sales of wadding materials for clothing rose from the previous year, sales of nonwoven and woven interlinings fell sharply, largely because of a further acceleration of the trend towards local procurement of secondary materials among leading apparel manufacturers. Sales of cold compress base materials fell slightly, and plaster base material sales rose significantly from the previous year. While industrial dust mask sales shrank because of falling demand, overall mask sales grew considerably as a result of the heightened interest in protection against new strains of influenza.

Sales of industrial and electrical materials decreased 18.3%, to ¥8,700 million. Sales of secondary battery separators for hybrid vehicles and photocopier cleaning rolls expanded. However, sales of secondary battery separators for general applications plummeted on the impact of the slump in demand for products used in power tools amid the slowdown in residential construction in North America. Shipments of printed circuit board substrates also slowed.

Sales of automotive materials, which account for more than 40% of consolidated sales, sank 18.8%, to ¥21,613 million. In China, revenue from floor mats grew considerably, spurred by the acquisition of new commercial rights, but elsewhere sales of automotive

headliner materials and floor mats tumbled, reflecting production adjustments by car manufacturers and falling demand in Japan, as well as lower vehicle sales and the impact of the strong yen in North America.

Sales of air filters slipped 6.7%, to ¥8,029 million. Shipments of general-use air filters fell, reflecting extensions to the filter exchange cycle as a result of user cutbacks and massive production reductions by car manufacturers. Sales of medium-and high-performance air filters for buildings and industrial applications decreased with the impact of reductions in major office building construction, extensions to the filter exchange cycle and the scaling-back of investments in new facilities. Car cabin air filter sales grew.

**Note:** The primary exchange rate used to convert the dollar-denominated performance of overseas subsidiaries into yen for the period from January through December 2008 was ¥103.49 = US\$1.00. A rate of ¥117.85 = US\$1.00 was used for the previous year.

### Cost of Sales, SG&A and Operating Income

The cost of sales ratio worsened 2.0 percentage points, to 80.4%. This increase is attributable to production adjustments the Company made in response to customer inventory adjustments. In addition, cost of sales rose ¥103 million as a result of application of the Accounting Standard for Measurement of Inventories from the fiscal year under review and ¥134 million due to a change in the useful life of machinery and equipments from nine years to seven.

Selling, general and administrative (SG&A) expenses shrank ¥380 million, or 4.3%, to ¥8,523 million as a result of a decrease in the provision for bonuses and cost-cutting efforts. Operating income declined ¥2,545 million, or 65.8%, to ¥1,324 million.

### Other Income/Expenses

Equity in earnings of associated companies fell ¥297 million, or 47.0%, from the previous year, to ¥337 million. Due to a worsening operating environment in apparel materials and falling market value of the idle assets and lease assets, the Company reduced the carrying value of these assets to the recoverable amount, and recorded this reduction of ¥250 million as an impairment loss in other expenses. As a result, total other income (net of other expenses) amounted to ¥153 million, down ¥135 million, or 46.9%, from the previous year.

### Income before Income Taxes and Minority Interests/Net Income

Income before income taxes and minority interests

sank ¥2,680 million, or 64.5%, to ¥1,477 million. Net income decreased ¥1,762 million, or 72.4%, to ¥672 million.

Earnings per share fell ¥27.14, to ¥10.36, and return on equity (ROE) decreased 4.9 percentage points, to 1.9%.

## Financial Position and Liquidity

### Assets, Liabilities and Shareholders' Equity

On March 31, 2009, total assets stood at ¥52,620 million, down ¥3,169 million, or 5.7%, from a year earlier. Total current assets grew ¥550 million, or 2.2%, to ¥25,189 million, due mainly to expansion of cash and deposits to increase the liquidity, despite a decrease in notes and accounts receivable. Property, plant and equipment and investments and other assets diminished ¥3,718 million, or 11.9%. This was mainly attributable to devaluations of property, plant and equipment and investment securities owing to the unfavorable exchange rates used to convert assets of overseas subsidiaries and associated companies that are denominated in local currencies into yen.

Total liabilities fell ¥203 million, or 1.1%, to ¥18,796 million. Current liabilities were down ¥2,553 million, or 18.0%, due mainly to declines in trade notes and accounts payable and the provision for bonuses, which offset a rise in short-term bank loans.

Long-term liabilities climbed ¥2,350 million, or 49.1%. This was largely attributable to long-term borrowing to increase liquidity. Long-term debt increased ¥2,663 million, to ¥3,417 million.

### Net Assets

Net assets at fiscal year end stood at ¥33,824 million, down ¥2,966 million, or 8.1%, from the previous year-end figure. This decrease reflects a decline in foreign currency translation adjustments due to progressive yen appreciation.

Retained earnings edged down ¥107 million. As a result, the equity ratio slipped 1.7 percentage points from the previous year, to 63.7%.

### Capital Expenditures and Depreciation

In the year under review, the Japan Vilene Group had

planned capital expenditures for the construction and renovation of facilities totaling ¥3,600 million, but, in response to the dramatic change in the operating environment caused by the downturn in the second half of the year, the Group sought to postpone and scale back capital investment and, as a result, total capital expenditures amounted to ¥2,213 million. A large portion of this amount was used to expand nonwoven processing facilities at the Tokyo Plant. Depreciation and amortization grew ¥205 million, or 8.0%, to ¥2,770 million.

### Cash Flows

Net cash provided by operating activities amounted to ¥4,083 million, down ¥682 million, or 14.3%, from the previous year. The decrease stemmed mainly from a ¥2,680 million decline in income before income taxes and minority interests as a result of a deterioration in performance and a ¥2,102 million reduction in trade notes and accounts payable, which offset the ¥2,904 million increase attributable to a decrease in trade notes and accounts receivable.

Net cash used in investing activities amounted to ¥2,394 million, down ¥821 million, or 25.6%, from the previous year. This decrease was due mainly to declines in expenditure of ¥1,008 million for the purchase of property, plants and equipment, ¥57 million for the purchase of intangible fixed assets, and ¥66 million for the purchase of investment securities.

Net cash provided by financing activities was ¥3,052 million. This reflected proceeds from the issuing of long-term debt of ¥2,950 million.

As a result of the above, cash and cash equivalents stood at ¥7,301 million at year-end on a consolidated basis, up ¥4,562 million from a year earlier.

## Business Risks

The various risks that may potentially affect the business performance and the 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 the submission of the annual securities report (June 26, 2009).

## **Economic Conditions**

Demand for the Group's core nonwoven fabrics and items processed from nonwoven fabrics as well as for the Group's other products and for its materials used in other companies' products is affected by economic conditions in markets where the Group sells such products. For these reasons, economic recessions in the Group's major markets, including Japan, North America, and Asia, could cause demand to fall, which may have a negative impact on the Group's business performance and financial position.

## **Procurement of raw materials**

The Group uses many petroleum products as raw materials and since the prices of such products are affected by international commodity market conditions, depending on market conditions, raw material costs may rise, which may affect the Group's business performance.

## **Foreign Exchange Fluctuations**

The Japan Vilene Group's business includes overseas production and sales operations primarily in North America and Asia. Sales, expenses, assets, and other items relevant to each region that are denominated in local currencies 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, 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 terms, however, exchange rate fluctuations can make it impossible to undertake procurement, manufacturing, 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 and appealing products. However, product development and sales processes, due to their nature and complexity, involve uncertainties and risks. For example: (1) there is no guarantee that the Group can adequately obtain the capital and resources required to invest in new products and technologies; (2) 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; and (3) rapid technological advances and changes may cause the Group's products to be superseded. The unpredictability of industry and

market changes could prevent the Group from developing attractive new products, which could cause future growth and profits to decline. The Group's business performance and financial positions could be adversely affected as a result.

## **Risks Associated with Overseas Expansion**

The Group's production and sales operations also extend outside Japan to such regions as North America and Asia. The Group has consolidated subsidiaries in the United States, China and Hong Kong, as well as equity-method affiliates in the United States, China, Hong Kong, South Korea, Taiwan and Thailand. Establishing operations in overseas markets involves a number of risks: (1) unpredictable changes in laws and other regulations; (2) the impact of discrepancies between the tax systems of the various countries; (3) difficulties in recruiting and retaining staff; (4) aspects of the political system and economy that are different from those in Japan; and (5) social upheaval caused by terrorist and 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 calculated based on discount rates and other preconditions for actuarial calculations, as well as expected return on pension assets. Actual results may differ from these preconditions, and the preconditions themselves may have to be changed. The Group's business performance and financial position could be affected as a result.

## **Impairment Accounting**

If the fair value of the Group's assets falls sharply or if business profitability worsens, as a result of impairment accounting, impairment losses on fixed assets may be incurred and the Group's business performance and financial position could be affected as a result.

## **Action for Damages**

An action brought by ITOCHU PLASTICS INC. and another company against the Company and three other companies, seeking damages of ¥704 million in connection with fraud involving a former employee of the Company in past years is pending. The claim for damages being made against the Company in this action is without grounds. The Company plans to fight the claim in court, and at the present stage has estimated the amount of losses that could be incurred in the future and posted a contingent loss reserve for the amount considered necessary. Depending on the outcome, however, losses exceeding the reserve may be incurred.