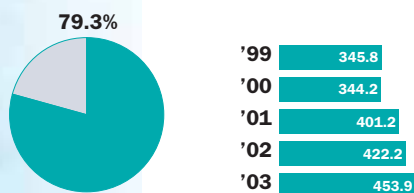


# Review of Operations

## Air Conditioning

Sales (% of net sales, ¥ billion)



In fiscal 2003, ended March 31, 2003, sales in the Air Conditioning and Refrigeration Equipment Division amounted to ¥453.9 billion, a 7.5% increase compared with the previous term. The division's sales accounted for 79.3% of consolidated net sales. Operating income increased 6.8% compared with the previous term, to ¥34.4 billion. The ratio of operating income to segment sales was 7.6%, as in the previous term.

### The Japanese Market

#### Overview

Although demand for air-conditioning systems was boosted in the late part of the summer, which was very hot, poor prospects for recovery in the economy held down new office and housing starts, causing sales of both commercial and residential air-conditioning systems to decline compared with the previous fiscal year.

However, in unit terms, Daikin sales outperformed average growth rates in the industry, reflecting an overall prowess based on a creative specialized retailer-centered marketing strategy, launches of distinctive products tailored to consumer requirements, and the excellence of our service, distribution, and supply networks. These strengths earned us the approval of both customers and partners in the retail industry.

In commercial air-conditioning systems, Daikin outperformed the industry in unit sales terms but was unable to increase sales revenues compared with the previous fiscal year due largely to a slackening of demand. At the same time, our high-value-added store- and office-use SUPER INVERTER ZEAS II and RAKU PITA ZEAS systems were well received and maintained robust sales. Working through retail channels, we focused marketing efforts on raising end-user awareness of the capabilities of our products.

In residential air-conditioning systems, demand for room air conditioning was down year on year across the industry, but Daikin outperformed the industry in terms of unit sales growth. However, a fall in retail prices meant, overall, that Daikin's revenue in this segment was comparable with the previous term.



The popularity of URURU & SALALA air-conditioning systems helped drive an increase in unit sales of residential air-conditioning systems. The URURU & SALALA, launched four years ago, is capable of drawing moisture from the air outside to humidify air inside without a water supply. With demand rising across the sector in the second half compared with the previous fiscal year, its humidification function proved particularly popular during winter. Daikin increased market share both in terms of sales through large-scale electronics retailers and systems sold through the housing construction industry as pre-installed units, which is a strength and a priority area.

#### Outlook

In fiscal 2004, the air-conditioning industry is expected to continue to face an extremely harsh operating environment due chiefly to ongoing deflation in the Japanese economy, a delay in recovery in housing starts, and reduced capital investment.

Although there is little prospect of an increase in demand for commercial air-conditioning systems, we are confident that business opportunities remain. New demand is being created as enormous volumes of systems delivered during the bubble economy period of the 1980s reach replacement age, environmental and energy-saving awareness grows, and factors such as the falling birthrate and rising numbers of aged people take effect. To respond to these trends, Daikin will adopt a total solutions approach of offering products tailored even more closely to individual customers. For example, in April 2003, we launched the SUPER INVERTER ZEAS for stores and offices, a product concept developed to satisfy a range of market demands for lower

energy consumption, compactness, convenience, and environmental friendliness. In addition to energy-saving features, we will continue to provide individually tailored solutions to customers in a way that other companies cannot match.

Little increase in demand can be expected for residential air-conditioning systems, reflecting the uncertainty regarding a recovery in housing starts for detached units and the sales boom caused by the very hot summer of 2002. A change in the operating environment came in October 2003 with the enactment of the revised Law Concerning the Rational Use of Energy. Because a high Coefficient of Performance point is required, air-conditioning system manufacturers will have to reorient their business to energy-saving models as their mainstay products. Daikin will continue to focus marketing efforts on URURU & SALALA systems, which have excellent energy-saving properties. Also, Daikin is focusing marketing efforts on ventilation systems and hot water supply systems that mainly use CO<sub>2</sub> refrigerants in response to an increase in demand for ventilation equipment. This follows a July 2003 revision of construction legislation and a rise in demand for



ventilation equipment and hot water systems for housing that uses only electricity, a growing trend which is changing the operating environment for the construction industry.

## Global Market

### Overview

In fiscal 2003, world economies were deeply affected by the clear signs of slowdown in the United States, the driving force of the global economy, due to the broadening recession in the IT industry and dampened consumer sentiment. Particularly impacted were Japan and Europe, which are mired in deflationary recessions, and the economies of Asia, which have been unable to escape stagnation. Reflecting these worldwide trends, growth in global demand for air-conditioning systems in fiscal 2003 was slightly lower than the high levels of recent years.

Turning to global trends in the air-conditioning market, with the increasing pace of expansion of manufacturers in South Korea and China, there are signs of further intensification of price competition, particularly in the market for small residential units.

Despite these challenges, Daikin continues to steadily expand revenue. Daikin strengthened its European marketing capacity through measures such as the purchase of an Italian distributor in fiscal 2002 and its subsequent conver-



sion into a wholly owned subsidiary. Sales in Europe grew notably in Spain, France, and Italy. In Australia, where demand is relatively robust, sales of residential air-conditioning systems grew solidly. In China, where demand has risen steeply, Daikin promoted strong sales of Variable Refrigerant Volume and commercial air-conditioning systems.

As a result, Daikin posted higher revenue and income in both residential and commercial air-conditioning systems and also expanded its share of the global market. However, in recent years, price competition has grown increasingly severe. In meeting the need to respond to faster and more flexible production methods amid changing markets and to create measures to reduce exchange-rate risk, Daikin is striving to reform its sales routes. Output from our production operations in Thailand used to be bought up entirely by Daikin, but now we have shifted to a new framework in which this production base directly supplies overseas marketing bases to maximize cost-competitiveness.

In fiscal 2002, Daikin began to see the concrete benefits of synergies from its tie-ups with Matsushita Electric Industrial and Trane, which have enabled the Company to expand its lineup of air-conditioning products and enhance customer convenience. Simultaneously, Daikin has expanded sales by marketing products through Matsushita Electric Industrial and Trane.

## Outlook

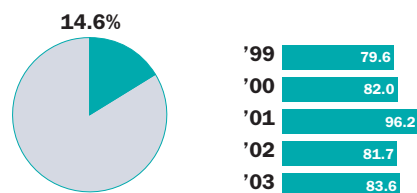
Robust growth in demand for air-conditioning systems is expected to continue in overseas markets, which are anticipated to grow steadily despite the uncertainties generated by factors such as terrorism and the SARS outbreak. Looking ahead to fiscal 2004, Daikin is confident of steady expansion of sales in the now huge European and Chinese markets, and in Australia, which is expected to show steady growth. But competition is also likely to intensify in these markets, as it did in fiscal 2003, not only with leading companies in Japan and the United States but also entrants from South Korea, China, and elsewhere, which are advancing rapidly in the sector.

To meet these challenges, Daikin will strengthen its competitiveness across the board, chiefly by further expanding production bases in Thailand and China and honing their cost-competitiveness, putting in place a production system capable of responding flexibly to market change and exchange rate fluctuation and launching new products for all overseas markets by using high-quality common parts and instruments under a single concept. Daikin also plans to meet service demand at a regional level by getting closer to its markets and is considering setting up production bases in Eastern Europe, South America, and other emerging regions.

In marketing strategy, the focus is on Europe, China, and Australia, where we plan to further strengthen marketing networks and business frameworks. We are also aggressively launching new products to stimulate new demand. In addition to supplying hardware, Daikin also plans to expand revenue by developing peripheral business fields such as solutions businesses and maintenance services finely tuned to customer wishes. We also aim to pursue a strategy of closer collaboration with other companies to achieve greater synergies.

## Chemicals

### Sales (% of net sales, ¥ billion)



**In fiscal 2003, sales in the Chemicals Division amounted to ¥83.6 billion, a 2.3% increase compared with the previous term. The division accounted for 14.6% of consolidated net sales. Operating income increased 3.4% compared with the previous term, to ¥9.6 billion. The ratio of operating income to sales was 11.5%.**

### Overview

The operating environment in the fluorochemical business remained harsh in fiscal 2003. Since its peak in fiscal 2000, this market has contracted sharply. There was little recovery in fiscal 2003, and Daikin estimates sales to have been flat from that year.

Sales of fluoropolymers and fluoroelastomers declined partly as a result of falling demand for plenum LAN cable due to stagnation in IT investment in the United States and the slow pace of recovery in demand for semiconductor products. Sales of fluorocarbons increased again, as Japanese air-conditioning manufacturers switched to R-410A and R-407C and other alternative refrigerants. This, in combination with a marketing drive, resulted in a 1.6-fold increase in sales.

In chemical products, sales of all oil- and water-repellent products rose sharply, reflecting increased production capacity in Japan and the United States and advances into global markets. Sales also increased for semiconductor-etching products thanks to buoyant exports to other Asian countries.

### Outlook

The operating environment for fiscal 2004 is likely to remain uncertain. However, Daikin expects stable long-term growth from fluorine-based materials, which have a wide range of applications in fields from semiconductors and IT to automobiles, consumer electronics, and textiles.

Under the "Fusion 05" strategic management plan, Daikin is developing new applications for its products, accelerating its global expansion, and creating new fluorochemical application businesses. As we enter fiscal 2004, the final year of our medium-term plan, we are committed to business management with a strict emphasis on attaining numerical targets. In tandem with our policy of growing by expanding sales of, and creating new markets for, priority products such as oil- and water-repellent products, fluoroelastomers, and PTFE resins, we are reducing fixed costs and taking other measures to overhaul our business structure and strengthen its operating base.

In order to accelerate global development, we are increasing capacity at each production base and establishing new production bases to enhance supply systems. Simultaneously, we are strengthening our operating base by upgrading our marketing frameworks. Daikin Fluorochemicals (China) Co., Ltd., currently under construction in Changshu, Jiangsu Province, China, will start manufacturing operations in fall 2003, supplying China and the rest of the Asian region with high-quality, price-competitive fine fluorochemicals. By combining these operations with the expansion of operations of Daikin Chemical International Trading (Shanghai) Co., Ltd., which is nurturing the fluorine materials processing industry in China, Daikin Fluoro Coatings



(Shanghai) Co., Ltd., and Daikin Chemical (Hong Kong) Ltd., Daikin is building an overwhelming lead in both the Chinese and other Asian markets.

In Europe, Daikin Chemical France S.A.S. will begin production of fluoroelastomers in early 2004. By combining this operation with the pre-compound fluoroelastomer production of Daikin Chemical Netherlands B.V. and fluorochemical production and marketing activities of Daikin Chemical Europe GmbH, Daikin is creating a unified network for fluoroelastomer operations in Europe from production to marketing.

Under its growth strategy, Daikin America, Inc., is increasing production capacity for oil- and water-repellent agents as well as strengthening technological services and developing new product applications. It aims to further consolidate its market position by expanding business areas through resource investment in areas selected on the basis of examination of the latest technological trends in the semiconductor industry and environmental regulations affecting the automobile industry.

In the U.S. market, the world's largest and one of the most advanced in terms of the development of new product applications, Daikin is developing products in close partnership with the customer through its technological services. In addition, R&D company Daikin Institute of Advanced Chemistry and Technology, Inc., considers ways of commercializing promising innovations and is building up a network of personal contacts and a global R&D network.

In Japan, Daikin uses tie-ups and collaborative arrangements—over joint development and similar projects—with leading companies in all fields and universities as well as other institutes to speed up its development of cutting-edge technologies and make more efficient use of its management resources. Achievements in R&D include commercialization of a string of products including PCTFE film, the first use of such material in Japan was for pharmaceutical blister films, the fluorine cleaner HFE-S7, and the world's first adhesive fluoropolymer Neoflon EFEP.

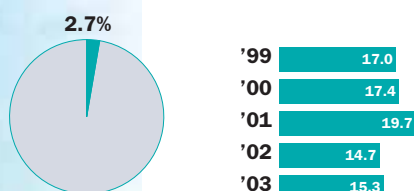


# Review of Operations

While continuing to assure the safe operation of its business with due consideration of the environment, Daikin will contribute to society by strengthening its global supply and service systems to assure a stable supply of high-quality products.

## Oil Hydraulics

Sales (% of net sales, ¥ billion)



In fiscal 2003, sales in the Oil Hydraulics Division amounted to ¥15.3 billion, a 4.1% increase compared with the previous term. Segment sales accounted for approximately 2.7% of consolidated net sales.

### Overview

#### • Oil Hydraulics Equipment

Demand in Japan again declined in tandem with the protracted deflationary economy in fiscal 2003 but recovered in the rest of Asia, largely due to the expansion of demand in China. Overall shipments in the oil hydraulics equipment industry increased 2.9%, to ¥200.0 billion.

In oil hydraulics products for industrial machinery, Daikin continued to develop a distinctive line of products with energy-saving features and leveraged its technological strength in high-performance motors for air conditioning to develop the new high-pressure super unit and other lines of coolant pumps and inverter-regulated oil cooling units. Efforts to raise awareness of these distinctive new products were focused on research of the end-user market and on creation of new markets in terms of clients and requirements.



In oil hydraulics products for construction machinery, Daikin embarked on a global collaborative strategy, establishing joint ventures in fiscal 2001 with Sauer-Danfoss to target a substantial market share in the promising Asian region and expand applications of hydrostatic transmissions.

#### • Parking Systems

Demand for multilevel car-parking systems for condominiums, the main source of demand in this segment, is diversifying. Daikin aims to create distinctive hydraulic multilevel car-parking systems that can take more vehicles in a limited space using proprietary technologies for lower noise, less vibration, higher operating speeds, and greater energy saving. In fiscal 2003, sales were approximately 20.0% higher than in the previous term, reflecting strong market approval.

#### • Lubrication

Lubricant sales declined compared with the previous fiscal year amid a slackening of demand in the iron and steel industry, which is a major customer.

### Outlook

#### • Oil Hydraulics Equipment

The operating environment in Japan for oil hydraulics equipment is expected to remain harsh. Shipments in fiscal 2004 are likely to rise 5.4% compared with the previous fiscal year, to ¥210.8 billion, reflecting the positive impact of accelerated global growth of companies making the products in which Daikin oil hydraulics equipment is installed, with account taken of the negative impact of the spread of electrically driven and other competing systems. To ensure our success in this industry, Daikin is adopting the following strategies.

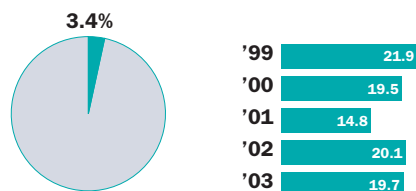
1. We will produce new hybrid products through the fusion of our conventional hydraulics technologies with those using electrical and pneumatic platforms, shifting the center of our operations from power control devices to power motion control devices that regulate power and location.
2. Daikin will extend operations to promising Asian markets, possibly in alliances or tie-ups with other companies. As part of this strategy, we have strengthened our relationship with Sauer-Danfoss and, drawing on both companies' strengths, established two joint ventures. Our aim is to become the market leader by fiscal 2005 in the Japanese and other Asian oil hydraulics equipment markets.

### • Parking Systems

At the moment, Daikin is among the top producers of parking systems. To further strengthen our position, we intend to expand sales through alliances and tie-ups with manufacturers of electrically driven multi-level car-parking systems. By developing service businesses drawing on our industry-leading service structures, we will nurture this business into a pillar of profitability for the division.

## Defense

### Sales (% of net sales, ¥ billion)



**In fiscal 2003, sales in Daikin's defense-related operations amounted to ¥19.7 billion, a 2.0% decrease compared with the previous term. The division's sales accounted for approximately 3.4% of consolidated net sales.**

### Overview

Sales declined in defense-related operations. In fiscal 2003, Japan's defense budget remained fairly constant, and there were no significant changes in the operating environment. The private-sector business is currently undergoing structural reform. In home-use oxygen therapy equipment, Daikin increased sales by supplementing its range of conventional fiber-reinforced plastic composite vessels and oxygen conservers with a newly launched two-liter oxygen concentration system.

### Outlook

The operating environment for defense-related business is likely to remain harsh, with the fiscal 2004 defense budget related to combat equipment being set at ¥763.0 billion, down ¥3.0 billion from the previous term. In home-use oxygen therapy equipment, competition is likely to intensify as the number of hospital patients is expected to decline partly

because of an increase in personal medical expenditure mandated by reforms of the health insurance system in Japan.

**Defense-Related Business:** Daikin expects continued robust orders for tank practice ammunition, for which mass production began in fiscal 2002, as it has proved capable of raising the efficiency of exercises for many sections of the armed forces. Daikin is developing new technologies for armor-piercing ammunition and a new rifle grenade and expects to further increase orders.

**Private-Sector Business:** In home-use oxygen therapy equipment, blunted growth of conventional products such as oxygen vessels due to intensified competition has prompted Daikin to greatly expand sales of a new two-liter oxygen concentration system launched in the term under review. Daikin also expects to expand sales of its intensive care unit device for small animals, the DEAR M10, which has earned industrywide acclaim since its launch in fiscal 2002.



### Electronics

In fiscal 2003, Daikin was able to bring this operation to profitability by shifting from sales-agency-based operations to a solutions-provider paradigm, despite the harsh operating environment caused by a worsening of the malaise in the IT sector.

The mainstay product of this division, software for computer graphics animation production, was hit by slowed demand growth and increased use of compact computers and PCs over the last few years. This business sector has been undergoing structural change, therefore, Daikin is accelerating the transformation of the division into a solutions-provider business driven by the development of new products and services, under the key concepts of professionalism, speed, and technological strength.

In network solutions, Daikin developed the proprietary SpaceFinder system for display of data analysis for R&D knowledge management systems.

In the field of digital content production systems, Daikin speeded up deliveries of the Vi[z] Virtual Studio, a low-cost, highly functional virtual studio service for broadcasters launched in 2001.

Daikin's FILDER software retains its No. 1 share of the market for CAD design software. Now we are moving beyond this field to create a new business offering a full range of services from estimates to process management.

In engineering, Daikin also expects to increase investment in corporate systems, supplying IT environments optimized for the business models of individual companies. Focusing on products for visual R&D solutions, IT total asset management, network security management, ASP businesses delivering software via the Internet, CALS-oriented information exchange, and sharing using networks, Daikin will work to understand the real needs of customers and develop full-fledged businesses based on these needs.

Daikin aims to enhance its position in the digital content field by developing industry-leading, high-value-added functions, such as incorporating 3-D features into the Sport-corder display system for scores from sports programs and image profiles of athletes.

In the content data management business, Daikin, in fiscal 2003, developed the MOSPY software product for simply compiling text from videotape, taking the business beyond software marketing to system integration.

In addition, Daikin is perfecting support services for its full range of products in existing businesses, such as the Softimage/DS nonlinear editing system that enables users to digitize and edit images and the SCENARIST DVD-authoring system. We are also working to anticipate customer needs by adding value and distinctive features.

