

# Management Perspective



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## Message to Shareholders

In October 2004, Daikin Industries, Ltd., will celebrate the 80th anniversary of its founding. Having attained new record-high levels of consolidated net sales and operating income during fiscal 2004, ended March 31, 2004, we consider this year a highly significant landmark in Daikin's history. We hope for the continued support of our shareholders as we embark on a new stage of Daikin's corporate evolution.

Before discussing our business operations, we would like to express our sincerest regrets for the considerable concerns shareholders have had regarding the January 2004 explosion at a tetrafluoroethylene production plant at Daikin's Kashima plant in Japan. Restoration has proceeded smoothly, and of eight tetrafluoroethylene production facilities, five have resumed operation after receiving the requisite permission from the Ibaraki prefectural authorities. Construction is progressing rapidly at the other three facilities, and we expect those facilities to begin operating again at the start of 2005. We are taking this accident very seriously and the entire Company is working concertedly to further increase the rigor of safety management systems to preclude the recurrence of such an accident as well as to restore society's confidence in Daikin. We hope for your understanding in this respect.

Currently, the entire Daikin Group is proceeding with efforts to meet the targets set forth in the Fusion 05 strategic management plan, which covers the period through fiscal 2006. Fusion 05 calls for Daikin to employ management systems that emphasize total corporate value and that focus on human resources in a manner applicable worldwide so that the Company can develop into a "global top-tier company." Our performance during the first three years of the plan was negatively affected by large changes in our operating environment that differed from our original projections and assumptions, but we have made steady progress in making our air-conditioning and refrigeration equipment operations and chemicals operations No. 1 and No. 2, respectively, in the global market. We have also advanced smoothly with structural reform efforts aimed at increasing the share of our operations overseas and the share of "innovation businesses" within our operations. These efforts are generating a steady stream of benefits, as is reflected in our ability to sustain growth in consolidated operating income for a tenth consecutive fiscal year.

To ensure that we can realize the transformations called for in Fusion 05 by fiscal 2006, we are working to accelerate the plan's implementation. Based on our recognition that we now face excellent opportunities to achieve a large surge in corporate development, we are reforming our operations and speeding up our efforts to address numerous strategic tasks. In the following section, we present explanations of our fiscal 2004 business performance, the fundamental management measures we are focusing on in fiscal 2005, and the corporate governance reforms we are implementing with the objectives of maximizing the Company's dynamic power and further augmenting the transparency and soundness of its operations.

### Overview of Fiscal 2004 Results

During fiscal 2004, the dynamic growth of the U.S. and Chinese economies helped trigger a recovery in global demand for semiconductors and IT investment and promote generally robust conditions in the global economy. The Japanese economy also made steady progress toward recovery due to such factors as the expansion of private-sector capital investment—against the backdrop of recovering corporate performances—and strong exports to China and other Asian countries. Amid these conditions, the Daikin Group adopted a basic policy calling for greater recognition of and stronger emphasis on the many excellent opportunities currently available for achieving a large surge in business development. Based on this policy, the Group worked concertedly to realize the benefits of various reforms and attain its strategic goals.

Consolidated net sales amounted to ¥625,718 million, an increase of 9.3% from the previous year. The Air Conditioning and Refrigeration Equipment Division's sales rose 10.4% from the previous year. The division strove to expand its domestic net sales by promoting such distinctive high-value-added air-conditioning systems as the URURU & SALALA, for residential use, and the SUPER INVERTER ZEAS II, for commercial use. The division's overseas sales surged 127%, reflecting large gains in Europe, which had unusually hot summer weather, and China, where demand is rapidly increasing. Despite signs of recovery in semiconductor markets, the Chemicals Division's total sales advanced only 5.9% owing to the lack of a full-scale recovery in U.S. demand for LAN

cable. Sales of vessel-related products rose due to our receipt of large orders for marine container refrigeration units from P&ON, a leading Europe-based marine shipping company, as well as from Maersk Sealand, the world's largest marine shipping company. Despite various challenges—such as the weakness of domestic demand for air conditioners amid cool summer weather and warm winter weather and the impact of the explosion at the Kashima plant—the effectiveness of our various sales promotion activities enabled a rise in consolidated net sales.

Our profitability was negatively affected by a continued downtrend in sales prices for air-conditioning and refrigeration products in Japan, but this was offset by large sales increases in overseas air-conditioner markets along with our emphasis on comprehensive cost-cutting programs. As a result, operating income rose 7.1%, to ¥47,988 million. This rise and such factors as a reduced tax burden enabled a 32.5% surge in net income, to ¥28,611 million.

Thus, consolidated net sales and operating income reached record highs for the fourth and tenth consecutive year, respectively.

Regarding future trends in our operating environment, there are some causes for concern about such developments as a rise in raw materials costs and the appreciation of the yen, but we expect that the world economy will sustain a steady recovery, helped by strong demand from the rapidly growing Chinese economy as well as by the healthy U.S. economy. In fiscal 2005, Daikin is aiming to attain ¥710 billion in consolidated net sales, up 13.5%; ¥51 billion in consolidated operating income, up 6.3%; and ¥30 billion in consolidated net income, up 4.9%.

### Priority Management Measures for Fiscal 2005

For Daikin, fiscal 2005 is a time of opportunity for continuing to increase its consolidated profitability while scattering the business seeds that can be expected to support a rapid surge in corporate development in the near future. We are looking closely at huge and highly promising business opportunities in Europe, China, North America, and Japan. To take full advantage of these opportunities and ensure rapid progress toward our goal of making Daikin a truly global company, we are resolutely making the requisite investments in capital as well as in such areas as human resources.



Although this proactive approach to business development is not without risks, we are confident that the time is ripe for dynamically expanding our operations.

In Europe, extremely hot summer weather last year spurred considerable changes in the structure of local air-conditioner markets. The new structure prevailed even after the usual air-conditioner sales season ended in September, and shows no signs of reverting even now. While we had originally projected that our principal marketing companies in such countries as France, Spain, and Italy would achieve double-digit sales growth during the first four months of 2004, the companies outperformed that projection by large margins, and rapid growth in sales is expected to be sustained throughout the current fiscal year.

The Chinese market is changing more rapidly than any other market that Daikin has ever operated in, and there are huge opportunities for the Group to expand its business there. In fact, all segments of China's air-conditioning market—including those involving products for office buildings, factories, shops and offices, and households—are quickly growing. If we were to be satisfied with our current rate of business expansion in China, it could mean turning our backs on very favorable opportunities. Accordingly, we are promoting rapid Chinese business development by setting ourselves ambitiously high performance goals.

Aiming to make the most of these opportunities and raise the overseas business share of our consolidated net sales to above 50% by fiscal 2006, we are proactively

investing in overseas manufacturing and marketing bases throughout the world. In line with the principle of locating manufacturing operations close to target markets, we are proceeding with measures to greatly increase our air-conditioner manufacturing capacity in the Czech Republic and China. We expect the total value of our capital investments and financial investments during the three years through fiscal 2005 to exceed ¥130.0 billion. Overseas investment accounts for approximately 60% of this figure, and we anticipate a further acceleration of the pace of overseas business expansion centered on the European and Chinese markets. The considerable improvement in market trends seen recently suggests a need for more product supply capabilities, and we are therefore preparing for an additional strengthening of our manufacturing capacity.

Daikin has for some time been working to maximize its corporate value by focusing on such financial ratio-oriented management strategies as those aimed at improving free cash flow (FCF), Daikin economic value added (DVA), return on equity (ROE), return on assets (ROA), and return on investment (ROI). Among the various ratios, we give particular emphasis to FCF, a comprehensive indicator that reflects both profitability and the efficiency of asset utilization, and we have taken numerous steps to boost FCF. We have sustained this focus on FCF during the past two years and sought to take advantage of opportunities to maximize our future corporate value by making various investments aimed at expanding operations while maintaining a basic policy of moderating the scale of investment to within the scope of FCF. This policy was adopted in view of our assessment that the levels of principal financial ratios—ROA of 5.7%, ROE of 13.0%, and ROI of 12.7% during the fiscal year under review—are still not high enough, although we do recognize that they are relatively high compared with other Japanese manufacturers.

While employing an array of financial ratio-oriented management systems, we continue to place strong emphasis on FCF. In the next two years, we will expand our operations while maintaining a basic policy of moderating the scale of investment to within the scope of FCF.

We are confident that our current investments will be seeds for a future surge in business growth and that realizing the benefits of these investments will help maximize Daikin's corporate value over the medium term. We

believe it is important to prepare the basis for utilizing and maximizing the benefits of our investments during the current fiscal year, and we have already begun taking the requisite steps. Before the start-up of any new manufacturing base, for example, we make sure the products we make are regularly selling out, even when the manufacturing capacities of existing facilities are being fully utilized. Accordingly, we are bolstering our marketing capabilities, expanding our marketing networks, and further upgrading service capabilities in areas where Daikin has traditionally been particularly strong. We are also hurrying to increase the appeal of our product lineups for each market.

One of the measures we are taking to bolster marketing capabilities in Europe is to acquire marketing agents and convert them into marketing subsidiaries. Having acquired Italian and U.K. marketing agents in 2002 and 2003, respectively, we are building a network of marketing subsidiaries in all the principal countries of Europe. This year, we will increase our marketing staff by approximately 200 people. We are also rapidly proceeding with the development of products tailored to the diverse needs of Europe's various regional markets. Besides appealing to highly environmentally conscious Europeans by, for example, offering products that use new environment-friendly refrigerants and high-performance inverters to reduce energy consumption, we are seeking to develop new products in response to a projected rapid rise in Russian demand for room air conditioners.

In China, we have made our regional headquarters company the hub of Groupwide strategic implementation measures that provide for the continued comprehensive development of local air-conditioning product operations based on coordinated production, sales, and service operations. We are aiming to further develop and expand our marketing activities in China, much of which has been concentrated in the Shanghai area, by establishing presences in the Beijing and Guangzhou areas and then rapidly extending our operations into other regional cities. To do this, we are increasing the number of regional marketing offices from 17 to 30 and hiring approximately 300 additional marketing staff. Regarding our product strategies, we are working to further increase our market share for office-building-use multiunit air-conditioner systems and other commercial-use systems. At the same time,

following the start-up of additional Daikin Group manufacturing companies in China, we are seeking to expand our sales of large-scale air-conditioning equipment as well as medium- and small-scale air-conditioning products for residential applications.

These various initiatives are designed to make the most of the huge opportunities we have identified, and we think they have the potential for enabling us to earn top shares of the air-conditioning product markets of Europe and China in the near future. In the current fiscal year, we are aiming to boost our sales in Europe and China to ¥147.0 billion and ¥60.0 billion, respectively.

In the U.S. market, which is the world's largest, consciousness of ductless air conditioners has been rapidly increasing, and we see an excellent opportunity to create a local market for such products in the near future. While ductless air conditioners currently account for a very small share of the market, their superior energy-saving, low-noise operation and other advantages make it highly likely that their market share will grow. In view of this, Daikin is planning to establish a strong presence in ductless air conditioners as soon as possible.

In its home market of Japan, last year Daikin won the top share of the room air-conditioner market, which it had avidly been seeking for some time. Taking advantage of this momentum, we are striving to further augment our product, marketing, and supply capabilities so that we can earn an overwhelming share of the



domestic market for all types of air-conditioning products, including packaged air conditioners, and thereby become generally acknowledged as Japan's true No. 1 air-conditioner maker.

### **Daikin's Corporate Governance**

To maximize our capabilities for quickly and effectively addressing the various management tasks we have described, we decided to reform our corporate governance systems with an eye to further boosting the transparency and soundness of our operations. The new corporate governance systems were launched in June 2004.

For some time, Daikin has aimed to increase management efficiency and strengthen its consolidated Group management systems by progressing toward the following four objectives: (1) renovating management systems in a way that promotes strategic management and speedier management decisions; (2) implementing measures related to unique personnel and organizational management systems needed to realize a "fast & flat" Group management framework; (3) using the virtual company system to promote strong management emphasis on corporate value and give divisional managers greater authority and responsibility; and (4) ensuring that management emphasizes openness, transparency, and responsiveness to stakeholders.

In line with the first objective, we have introduced an executive officer system designed to promote autonomous judgments and decisions in each business, regional, and functional area, thereby quickening strategic implementation. At the same time, we reduced the number of directors by half to help the board of directors better perform its roles of quickly making strategic decisions for the entire Daikin Group and rigorously overseeing the execution of those decisions. We also integrated the board with the executive officer system by introducing a system in which all inside directors concurrently serve as executive officers. This system is strengthening our decision-making and strategic execution capabilities by placing directors at the front lines of operations, allowing them to gain a more accurate understanding of business conditions and thereby create and execute strategies designed to respond to them.

Regarding the second objective, we have broadened

the scope of responsibilities of Daikin officers serving as vice presidents and corporate advisors as well as executive officers. In addition to their usual responsibilities, they are now given Groupwide responsibilities for "mission items" related to their personal fields of expertise. This new system helps utilize and consolidate the total capabilities of our directors and top executives, and we expect it to generate tangible benefits in the near future.

In line with the third objective, four years ago, we introduced eight virtual companies with the aims of maximizing the benefits of having managers with autonomous responsibility, promoting long-term perspectives on strategic business decisions, and preventing the bloating of support and administrative departments. Recently, with the principal goal of optimizing the efficient allocation and utilization of Group resources, we consolidated the eight virtual companies into four—the Domestic Air Conditioning Company, the Global Air Conditioning Company, the Chemicals Company, and the Business Development Company. We have also established a clear-cut system for using such quantitative performance indices as operating income, ROA, and FCF to evaluate the virtual companies. By strengthening our emphasis on results-oriented management, we are doing our utmost to increase Daikin's overall corporate value.

The fourth objective is to implement measures that boost management transparency and soundness. Aiming to increase the participation of people with independent and neutral perspectives in management decision making, two years ago we welcomed two outside directors to our board—Tadasu Tachi, who also serves as counsel for Kaneka Corporation, and Chiyono Terada, who also serves as president and CEO for Art Corporation—and they have continued to serve as Daikin directors since that time. Under the Management Advisory Council system we adopted five years ago, council members provide opinions and guidance based on their broad range of perspectives on many business issues, and this input has proved to be highly valuable due to the difficulty of forecasting future trends amid a diversely changing business environment. Accordingly, we have retained all the council members to serve in the current fiscal year and expect them to play a role in boosting the quality of our management capabilities. We have also

established a Personnel and Remuneration Committee, which provides advice to the CEO and works to promote highly transparent discussions and consultations and also helps to foster the development of top executives.

Daikin has for many years assigned directors to proactively handle issues related to workers' safety, product quality, and the global environment. In June 2003, we established the Corporate Ethics Committee, which is chaired by Daikin's president and COO, and assigned a director to take responsibility for corporate ethics oversight, with top priority on ensuring the rigorous enforcement of strict compliance standards throughout the Group. We recently assigned another director to take responsibility for corporate social responsibility (CSR) oversight. Daikin recognizes that companies have diverse responsibilities to society related to environmental protection, safe operations, honest relations with customers, human rights, and corporate openness and transparency. We are proactively working to ensure exemplary CSR performance that meets standards higher than mere legal compliance.

On October 25, 2004, Daikin will celebrate the 80th anniversary of its founding. Over its long history, Daikin has established numerous venerable traditions and a dynamic corporate culture that includes our creed of "people-oriented management" and diverse other philosophical approaches to management issues. Drawing on these accumulated strengths, we are setting ambitious corporate development goals and making sustained efforts to respond to the changing times, one step at a time. In this way, we are seeking to realize a major surge in corporate development.

One of our dreams is developing an air conditioner that will keep rooms warm even when it is -20°C outside. Currently, about one-third of the world's heating needs are met by burning such fuels as wood, coal, or kerosene. If we can develop air conditioners that use electric power to effectively and efficiently heat rooms even in severely cold climates, we can expect the market for such products to expand rapidly and also make a major contribution to protecting the global environment. We are working hard to improve our technological capabilities—emphasizing such themes as "creating comfortable spaces and environments," "health," and "energy"—



and we are confident that our unique technologies will enable us to make meaningful contributions to society through our business operations, products, and services.

Regarding cash dividends, the June 29th Regular General Meeting of Shareholders approved the proposal of increasing dividends per share applicable to the year under review to ¥14, up ¥2 from the previous fiscal year. In addition, from October 1, the minimum trading unit for our shares will be reduced from 1,000 shares to 100 shares. We expect this change to offer greater investment opportunities to individual investors and others, thereby further broadening Daikin's solid shareholder base.

As we work toward our goals, we hope for the continued support and understanding of our shareholders.

June 29, 2004

*Noriyuki Inoue*

Noriyuki Inoue, Chairman of the Board and CEO

*Yukiyoshi Okano*

Yukiyoshi Okano, President and COO,  
Member of the Board