

# A Message from the President

## Building Our Future from a Strong Business Base

OVERSEAS UNIT SALES ARE GROWING DRAMATICALLY, DOMESTIC UNIT SALES ARE STEADY AND, WITH STABLE INCOME FROM SALES, WE HAVE THE RESOURCES AND TALENT TO DEVELOP THE NEXT-GENERATION PRODUCTS THAT WILL ASSURE A PROSPEROUS FUTURE.

During the fiscal year just ended, our 58th year of operation, net sales remained virtually unchanged compared to the previous fiscal year, declining 0.4%. This was due to growth in overseas sales counteracting the slip in domestic sales. Against flat sales for the year ended March 31, 2004 (fiscal 2003), indirect cost overhead, principally research and development, increased by ¥1 billion. We succeeded in largely offsetting these costs with an increase in non-operating income and a reduction of extraordinary losses, with the result that net income declined by only ¥249 million. Per-share income declined by 10.6% to ¥79.47.

On a product segment basis, domestic net sales declined in pharmaceuticals and medical devices, of our major product segment, consisting mainly of sodium hyaluronate formulations. However, unit sales for these products remained essentially unchanged. There was a significant increase in research biologics and diagnostics. Sales were flat overall, but we remain highly optimistic about the continued growth in overseas sales (comprising exports and sales from our U.S. subsidiary), which increased by ¥268 million (6.1%) year on year. This performance raised the ratio of overseas sales from 21% to 22.4%.

Work continues on our major effort to develop follow-on products to drive growth and assure future profits. Recently Associates of Cape Cod, Inc. (ACC), our U.S. subsidiary received clearance from the U.S. Food and Drug Administration (FDA) to manufacture a diagnostic product. And, in Japan, application was submitted to the Ministry of Health, Labour and Welfare for a new medical device. Their development provided good experience, and the future sales revenues will help fund research on other promising themes.

**We were able to offset much of the domestic sales decline with increased overseas exports to the U.S., Taiwan and Austria, plus growth in research biologics and diagnostics sales.**

Export sales of ARTZ®/ARTZ Dispo® (for osteoarthritis in knee and shoulder joints) began in the U.S. market in 2001, under the name SUPARTZ®, and have risen rapidly. In fiscal 2003, sales of SUPARTZ® in the U.S. market grew by 50%, and Seikagaku was able to increase its market share there to beyond 10%. Total overseas sales of ARTZ® products increased by ¥200 million (10.7%) to ¥2,071

million. This growth helped to push our overseas sales of all products to ¥4,648 million and is spurring our U.S. sales partner, Smith & Nephew to rapidly expand its sales resources to support the rapid expansion in the U.S. We also increased our sales of ARTZ® products markedly in the markets of Taiwan and Austria.

Overseas growth substantially moderated the overall decline in sales caused by a reduction in reimbursement prices under the domestic Japanese National Health Insurance (NHI) system. The reduction took effect in April 2004, but impacted fiscal 2003 sales in the last quarter. Following the traditional practice of the Japanese pharmaceutical industry, we reduced prices on products shipped to our domestic sales partners as early as February because they would go on sale in April subject to the price reduction.

Our unit sales in Japan remain on a solid footing. Deliveries of our two hyaluronate products, ARTZ®/ARTZ Dispo® and OPEGAN®/OPEGAN Hi® (an aid for cataract surgery) to hospitals and medical clinics in Japan remained almost unchanged, indicating no weakening of our market position amidst strong competition.

Research biologics and diagnostics are also proving strong for ACC, our U.S. manufacturing and sales subsidiary, which has seen good response for its Contract Test Service (CTS) for endotoxins. Domestic reagent sales grew with the continuing introduction of food allergy test reagents to the food industry.

In Bulks, sales of sodium hyaluronate grew, while chondroitin sulfate sales declined.

**We seek maximum growth over the long term through balanced management of sales growth, cost control and new product development. the cost of achieving long-term benefits can reduce near-term results, as it has this year.**

Net income in fiscal 2003 declined ¥249 million from the previous fiscal year. The principal cause was an increase in selling, general and administrative expenses, primarily from an increase in R&D expenditure, reducing our operating income by ¥1,042 million to ¥4,242 million. However, the impact on profit was largely offset by improvements in non-operating and extraordinary losses. The bulk of non-operating losses consisted of currency exchange losses,

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including repayments on a long-term foreign-currency loan extended to ACC for construction of their new multi-purpose facility in the U.S. Improvements in this area were realized through further progress in the previously announced realignment of our investment securities portfolio. Extraordinary losses declined as well—for the third year in a row—despite a ¥373 million charge for disposal of inventories of Canadian bovine products (one source for chondroitin sulfate bulk product). The disposal was initiated as a precaution following the discovery of BSE-infected cattle in that country. Decreases from loss on securities revaluations combined to produce a ¥306 million improvement in extraordinary losses.

#### Outlook

**We base our forecast of growth in revenue and profits for the year ending March 31, 2005 on anticipated increases in overseas sales of ARTZ® products, especially in the U.S.**

We also anticipate reductions in R&D costs and currency-exchange losses and positive returns on investment portfolios. Encouragingly, the products that are showing sales growth have good profit margins.

There will be an extraordinary loss of ¥241 million, reflecting the estimated loss on disposal of inventory assets (U.S. bovine products and related bulk items) that will not be saleable due to the discovery of BSE-infected cattle in the United States. However, this will be offset by the aforementioned sales growth, centered on overseas sales growth of ¥1.4 billion, and profit growth factors. As a result, profit is expected to rise. We project that, as a result, net income will rise from the current level of ¥2.1 billion to around ¥3.7 billion. Good performance trends are starting to emerge, and the balance sheet is also sound.

**The fact that overseas sales of ARTZ®/SUPARTZ® products have reached ¥2.0 billion and continue to surge, further reinforces our status as essentially a one-product company. Management is keenly focused on addressing this situation.**

From a medium-term perspective, it will take time to bring to market the next generation of major products that will diversify our product portfolio and drive us to new levels of growth. The strategy for our future success is a sustained effort to expand our foundation through



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the following three steps. 1. Continued maintenance of domestic sales revenues; 2. Expansion of overseas sales; 3. Development of new products.

The market in Japan remains a challenge because of curbs on medical expenditure and inroads by competing products. However, we are very proud of the high quality of our products, which have gained an excellent reputation in the medical community. We are working with reliable sales partners to leverage this advantage to maintain our sales.

The U.S. market for sodium hyaluronate formulations for osteoarthritis in knee joints is on an expansionary trend. Smith & Nephew, our sales partner in the United States, is rapidly strengthening its sales systems to keep pace with growth of SUPARTZ®. They have committed to double their sales staff in a new Clinical Therapies Group, established to provide specialized, value-added support for SUPARTZ®. We, in turn, are providing research findings and clinical knowledge that they can use to support our products.

We are also moving to increase sales in other markets. Sales partners were changed in China and Italy during the year under review. The aim of these moves was to strengthen sales structures in these countries.

ACC, our subsidiary in the United States, has become a valuable new manufacturing and sales branch for research biologics and diagnostic products, with powerful local knowledge. Production has now begun at the new building in the United States, following FDA manufacturing clearance. Key changes were made to ACC's management structure in fiscal 2003, to focus on strengthening operational management while augmenting existing service and product offerings and quickening its response to the marketplace. We will continue to improve ACC's earning potential by developing its business operations, including its sales and manufacturing activities.

**While the increase in sales of SUPARTZ® in the U.S. will propel profits in the immediate future, the next growth step will obviously be the development and introduction of new products.**

On May 21, 2004, the FDA cleared ACC for manufacture and sales of Fungitell™, a diagnostic used in the in vitro serum diagnosis of invasive fungal infections (known as Fungitec® G test in Japan). And, on July 20, 2004, we filed an approval application with the Japanese Ministry of Health, Labour and Welfare for an aid for Endoscopic Mucosal Resection based on the use of hyaluronic acid.

Seikagaku is seeking new products through research, licensing and co-development. Our success or failure will define our prosperity in the coming decades. A number of promising themes are undergoing clinical trials and several others are progressing through the pre-clinical stage.

To accelerate development projects and gain early approvals, we target themes based on stringent assessment and evaluation of projects in progress. The targeted themes receive priority for the allocation of new product development resources. This approach has led to our withdrawal from a project to develop an anti-allergy drug in cooperation with Biogen Idec Inc. of the United States. We have also suspended development of an interstitial cystitis drug and a meniscus injury therapy based on the expanded use of ARTZ®.

**As part of an aggressive campaign to improve shareholder value and increase management accessibility and transparency, we achieved listing on the Second Section of the Tokyo Stock Exchange, after long listing on the JASDAQ market.**

This listing on a major international exchange will increase the liquidity of the Company's stock by enhancing the level of the Company's recognition. To mark our new listing, at the regular general shareholders meeting on June 29, 2004 shareholders approved adding a commemorative dividend of ¥10 to the ¥10 dividend at the end of fiscal 2003 and, with the interim dividend of ¥10, bringing the total for the year to ¥30. We plan to ask shareholders to approve maintaining the regular annual dividend of ¥20 per share following the 1.5-for-1 stock split that took place on May 31, 2004, effectively increasing the dividend pay-out ratio by 50%, to ¥30 on a pre-split basis.

We received shareholder approval for buyback of up to 3 million shares at a price not exceeding ¥4 billion at some point in the future. We are also taking steps to encourage ownership by small investors, whom we consider to be a stable base of support, and to increase corporate transparency through improvements to corporate governance.

I would like to express our appreciation for the support of all concerned, especially our shareholders, without which this achievement would not have been possible. We look forward to your continuing support and guidance in the future.

Shirow Enoki

