Financial Review

Financial Strategy

Showa Shell uses assets efficiently by divesting inefficient assets and minimizing working capital. The Company's financial policies are geared towards maximizing earnings and cash flow while repaying interest-bearing liabilities.

During the current fiscal year, we will continue to follow these basic strategies while rigorously examining capital investments and investigating the economic viability and growth potential of new businesses.

Operating Environment

During 2002, the Japanese economy remained sluggish as consumer spending was weak due to further downturns in employment and income, and private capital investment continued to decline. The price of Dubai crude oil was US$19 a barrel at the beginning of the year, but rose sharply at the end of February and remained at a high level, reflecting the tense situation in the Middle East. The general strike in Venezuela at the end of the year drastically reduced crude oil production, temporarily pushing prices up to US$28 a barrel.

In foreign exchange markets, the yen began the year at ¥131 to the dollar, and began appreciating in April, rising to ¥115 in July. The yen then reversed course, falling temporarily to ¥125 in October, but rose against the dollar again due to the gathering conflict with Iraq, ending the year at ¥119.

In domestic oil supply and demand, gasoline demand continued to increase steadily, but demand for gas oil was down and demand for kerosene weakened in comparison with last year's strong demand due to higher than average temperatures during the first quarter, the peak period for kerosene demand. Furthermore, demand for fuel oil for general use declined due to the delayed economic recovery, and demand for fuel oil for power generation was also down year-on-year, although it picked up considerably after September with the reopening of several thermal power plants.

The market for petroleum products has continued to slow due to intensifying sales competition caused by the construction of more self-service stations and other factors. Increases in crude oil prices resulted in higher procurement costs, which could not be fully incorporated into retail prices.

Profitability

Under these challenging economic conditions, the Showa Shell Group continued with its basic strategy of generating customer-led value, rationalizing the business portfolio and pursuing structural cost reductions, while working to maximize profitability.

However, total sales volume declined from the previous year despite efforts to improve the production ratio of highly profitable white oil products. As a result, net sales decreased 2.7 percent to ¥1,620.3 billion.

Despite a lower sales margin due to the fact that the increase in crude oil prices could not be fully incorporated into retail prices, income from operations increased 29.8 percent to ¥36.4 billion, due to increased sales of white oil products and the effect of inventory valuation. Ordinary income rose 38.0 percent to ¥40.1 billion, the result of an improved financial balance. However, excluding the effect of inventory valuation, ordinary profit on a current cost of supply (CCS) basis declined ¥10.8 billion to ¥29.3 billion. The Company recorded a special loss of ¥7.5 billion. This comprised an extraordinary profit of ¥5.0 billion generated by the sale of fixed assets, as well as a special loss relating to the disposal of fixed assets. In addition, ¥4.5 billion transferred to the special reserve for repairs designated for scheduled equipment repairs at Showa Yokkaichi Sekiyu Co., Ltd. and Toa Oil Co., Ltd. was recorded as a special loss during 2002.

As a result, net income after corporate, resident and enterprise taxes, with adjustments to deferred income taxes made by the tax effect accounting method, increased 615.0 percent to ¥18.6 billion. Net income per share increased from ¥6.95 in the previous year to ¥49.69.

Free cash flow, comprising cash flow provided by operating activities and investing activities, declined ¥101.8 billion to ¥12.5 billion due to the sharp increase in crude oil prices. Total borrowings at the end of the year were ¥150.5 billion, as the Showa Shell Group reduced its dependence on interest-bearing liabilities, thus further strengthening its financial structure.

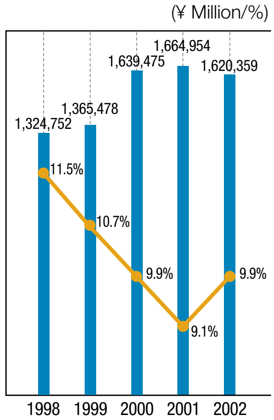
Segment results were as follows:

Petroleum

Total sales decreased 2.7 percent to ¥1,603.8 billion and income from operations rose 33.8 percent to ¥33.0 billion, an increase of ¥8.3 billion compared with the previous year. Factors included an improvement in the sales mix and the effect of inventory valuation. However, if the effect of inventory valuation were excluded, income from operations would have decreased by ¥13.5 billion to ¥22.3 billion, compared to ¥35.8 billion the previous year.

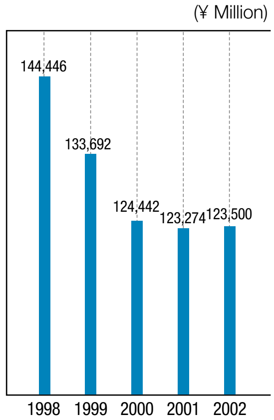
Net Sales/Gross Profit Margin

(¥ Million/%)



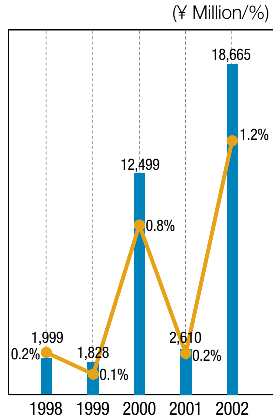
Selling, General and Administrative Expenses

(¥ Million)



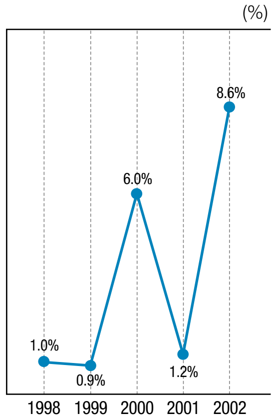
Net Income/Return on Sales

(¥ Million/%)



Return on Equity (ROE)

(%)



Real Estate

Large-scale redevelopment projects, primarily in urban areas, have created an oversupply of office buildings, increasing the vacancy rate and resulting in lower rent values. As a result, total sales decreased 3.7 percent to ¥4.6 billion. Income from operations fell 2.7 percent to ¥2.7 billion despite efforts to reduce expenses and raise operating efficiency.

Others

Total sales increased 1.0 percent to ¥18.9 billion, as sales of solar batteries, sales and leasing of automobile-related products, and the construction business were slow due to the overall weak tone of the oil industry. Income from operations decreased 8.2 percent to ¥0.6 billion due to efforts to streamline operations and increase efficiency in all areas.

Assets and Liabilities

Total assets increased ¥6.7 billion to ¥916.6 billion. Current assets increased ¥26.0 billion to ¥412.7 billion. The primary reasons were an increase in trade notes and accounts receivable due to the effect higher crude oil prices had on sales of crude oil and jointly marketed products. The increase in inventories was also an influential factor.

Current liabilities rose ¥33.1 billion to ¥541.9 billion, due to an increase in notes and accounts payable, despite a decline in short-term borrowings.

Fixed assets decreased ¥19.2 billion to ¥503.9 billion. Factors included a decrease in property, plant and equipment due to a decrease in depreciation and sales of land. Long-term liabilities decreased ¥35.7 billion to ¥149.2 billion due to the repayment of long-term borrowings. Interest-bearing liabilities decreased ¥20.4 billion from the previous year to ¥150.5 billion.

Shareholders' equity increased ¥9.4 billion to ¥221.6 billion, and the ratio of shareholder's equity to total assets improved 0.9 percentage points to 24.2 percent. Return on average total shareholders' equity (ROE) increased 7.4 percentage points to 8.6 percent, and ROE on a CCS basis was 7.8 percent. Shareholders' equity per share increased from ¥565.36 in the previous year to ¥592.18.

Cash Flow

Net cash provided by operating activities decreased 72.0 percent to ¥23.2 billion. Income before income taxes and minority interests rose compared to the previous year. However, the effect of the change in accounting standards regarding the reserve for retirement benefits that was introduced in 2001 did not carry over into 2002, and there was an increase in inventories as well as corporate taxes and other payments.

Net cash used in investing activities decreased 134 percent to ¥10.7 billion. This was due to higher investment spending compared with the previous year on property, plant and equipment, as scheduled repairs at refineries resulted in changes of equipment. In addition, proceeds from the sale of idle assets and marketable securities declined.

Net cash used in financing activities totaled ¥30.4 billion. The Company worked to centralize fund management and procurement for the entire Group and to reduce interest-bearing liabilities on a consolidated basis. In addition, Showa Shell purchased ¥1.0 billion worth of treasury stock to be used in the Company's stock option system and paid ¥8.9 billion in previous year-end dividends (¥14.00 per share) and interim dividends (¥10.00 per share).

Cash and cash equivalents as of December 31, 2002 totaled ¥7.1 billon, a decrease of ¥17.9 billion compared with the previous year.

Dividend Policy

During 2002, the Company was able to offer a year-end dividend of ¥15.00 per share. Combined with the interim dividend of ¥10.00 per share, this resulted in a total annual cash dividend of ¥25.00 per share, compared to ¥20.00 per share in 2001. As a result, the payout ratio was 50.0 percent, and dividend return calculated using shareholders' equity was 4.5 percent.

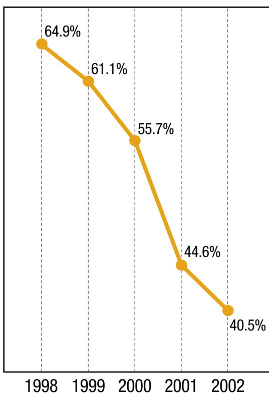
Outlook for 2003

Developments in 2003 will be affected by major uncertainties such as the influence of the situation in the Middle East. Against this backdrop, and with overcapacity in sales and refining, conditions in the oil industry are expected to remain challenging.

Reflecting this difficult business environment, the Company is targeting consolidated net sales of ¥1,650 billion, ordinary income of ¥30 billion, and net income of ¥16 billion, assuming crude oil prices of US$25 a barrel and an exchange rate of ¥120 to the dollar. In addition, the Company projects ordinary income on a CCS basis of ¥35.0 billion, an increase of ¥5.7 billion compared to ¥29.3 billion in 2002.

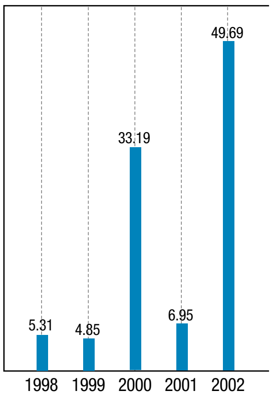
Gearing Ratio

(%)



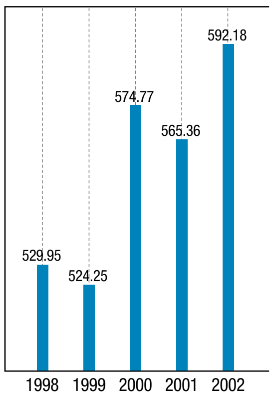
Net Income per Share

(¥)



Shareholders' Equity per Share

(¥)



Free Cash Flow

(¥ Million)