Financial Review

Financial Strategy

Showa Shell has taken numerous actions to establish a sound financial position that permits the productive use of assets. Primary actions have been the sale and disposal of inefficient assets, minimizing working capital and interest-bearing debt, and the execution of policies aimed at maximizing earnings and cash flows. The Company will continue to take steps to strengthen its financial position. Concurrently, based on a rigorous examination of potential returns and growth prospects, the Company will consider making substantial investments in projects that management believes are needed to sustain growth.

Japan's Economy and the Operating Environment

During 2003, Japan's economy was held back as consumer spending remained flat amid consistently high unemployment. However, there were emerging signs of rebound from Japan's prolonged economic slump, primarily in the form of increasing exports. Crude oil prices climbed steadily early in 2003 due to tension in the Middle East and other factors. The price of Dubai crude oil exceeded US$31 per barrel at one point, but then dropped rapidly following the start of hostilities in Iraq to reach approximately US$22 when the war ended. The price of crude oil then moved upward again as OPEC cut its output due to fears about an oversupply of oil and as inventories of crude oil in the United States remained low. As a result, crude oil was US$28 per barrel at the end of 2003, about the same as one year earlier.

The yen began 2003 at about ¥118 to the U.S. dollar and was relatively stable through the summer, remaining in a trading range of ¥116 to ¥122. The yen then gained strength from September onward, rising to about ¥107 to the U.S. dollar at the end of the year as the U.S. trade deficit grew and Japan's economy improved.

In Japan, sales of gasoline for automobiles remained solid, but demand for diesel oil fell due to a decline in the number of diesel-engine vehicles. Demand for kerosene used for heating was higher than in 2002 as temperatures in the first quarter of 2003, the primary heating season, were well below normal in Japan. Furthermore, while demand for fuel oil for general use remained soft, there was a sharp increase in demand for fuel oil for power generation because of a series of suspensions in operations at nuclear power stations.

Turning to petroleum products, prices were persistently low because of fierce competition that prevented companies from raising prices in a timely manner as the price of crude oil climbed.

Profitability

In this environment, the Showa Shell Group focused on the fundamental strategies of creating value in line with customers' needs, realigning its business processes and executing structural cost reductions. By enacting numerous business reforms covering all aspects of operations, progress was made toward building a sounder operating base and increasing earnings.

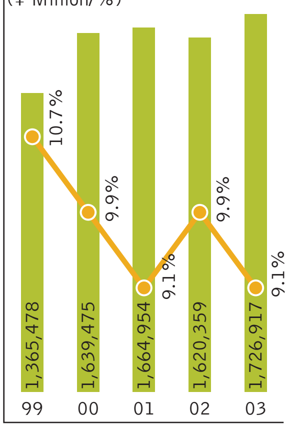
Consolidated net sales increased 6.6 percent to ¥1,726.9 billion, mainly a reflection of higher sales prices and growth in sales volumes of gasoline, kerosene and fuel oil for power generation.

Income from operations decreased 1.2 percent to ¥35.9 billion. The negative effect of delays in price increases to pass on the higher cost of crude oil was largely offset by cost-cutting initiatives and valuation gains on inventories. The decline in income from operations along with a lower exchange gain caused ordinary income to decrease 4.8 percent to ¥38.1 billion. However, ordinary income on a current cost of supply (CCS) basis, which excludes the effect of changes in inventory valuations, was up ¥7.0 billion, or 24.0 percent, to ¥36.3 billion. There was a substantial improvement in extraordinary items from a net special loss of ¥7.5 billion in 2002 to a loss of ¥1.2 billion. The main reasons were the posting in 2002 of a special reserve for repairs designated for scheduled equipment repairs at Showa Yokkaichi Sekiyu Co., Ltd. and Toa Oil Co., Ltd., and a 2002 charge for the reassignment of some employees of Showa Yokkaichi Sekiyu.

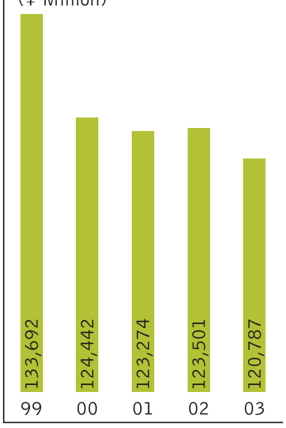
Due to these factors, net income after corporate, resident and enterprise taxes, with adjustments to deferred income taxes made by the tax effect accounting method, increased 12.5 percent to ¥21.0 billion. The return on average shareholders' equity (ROE) was 9.2 percent. Net income per share increased from ¥49.69 to ¥55.96.

Free cash flow, the sum of net cash provided by operating activities and investing activities, increased from ¥12.5 billion to ¥46.8 billion due to growth in operating cash flows. Total interest-bearing debt at the end of 2003 was ¥120.9 billion, ¥29.6 billion less than the ¥150.5 billion at the end of 2002, as the Showa Shell Group continued to strengthen its balance sheet.

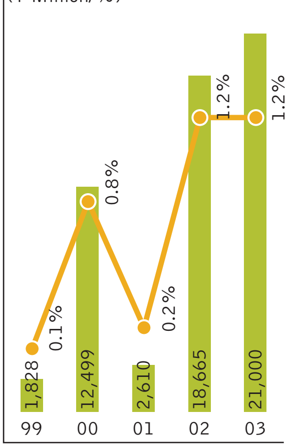
Net Sales/Gross Profit Margin
(¥ Million/%)



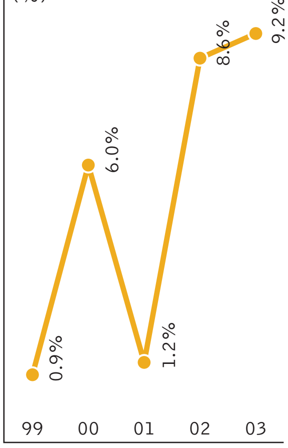
Selling, General and Administrative Expenses
(¥ Million)



Net Income/Return on Sales
(¥ Million/%)



Return on Equity (ROE)
(%)



Segment results were as follows.

Petroleum ▶ Total sales increased 6.7 percent to ¥1,710.7 billion and income from operations decreased 1.5 percent to ¥32.5 billion. Excluding the effect of inventory valuations, income from operations increased by ¥8.4 billion from ¥22.3 billion to ¥30.7 billion.

Real Estate ▶ In the building leasing sector, results were impacted by falling leasing rates for office space in central Tokyo due to the large volume of newly completed buildings, the so-called "2003 problem." Leasing income was further held back by lower occupancy rates in other large cities in Japan. As a result, total sales decreased 4.7 percent to ¥4.4 billion. Although steps were taken to cut costs and boost operating efficiency, income from operations was down 7.3 percent to ¥2.5 billion.

Others ▶ Results were soft in the sales and leasing of automobile-related products, and the construction of petroleum and other facilities. The result was a 0.3 percent decrease in total sales to ¥18.8 billion. However, an improvement in profit margins on sales of solar batteries led to a 37.2 percent expansion in income from operations to ¥0.8 billion.

Assets and Liabilities

Total assets decreased ¥34.3 billion to ¥882.2 billion. Current assets declined ¥17.8 billion to ¥394.9 billion, mainly because of measures to reduce trade notes and accounts receivable. Fixed assets decreased ¥16.5 billion to ¥487.3 billion, primarily because of a drop in property, plant and equipment resulting from sales of idle and inefficient assets.

Current liabilities decreased ¥51.4 billion to ¥490.4 billion because of a sharp decline in notes and accounts payable. The decline in long- and short-term borrowings, bonds, commercial paper and other interest-bearing debt continued as this figure fell from ¥150.5 billion at the end of 2002 to ¥120.9 billion, demonstrating the ongoing progress by the Showa Shell Group in building a stronger balance sheet.

Shareholders' equity increased ¥13.1 billion to ¥234.7 billion due to growth in retained earnings. As a result, the ratio of shareholders' equity to total assets improved by 2.4 percentage points to 26.6 percent. ROE increased 0.6 percentage point to 9.2 percent. Shareholders' equity per share increased from ¥592.18 to ¥627.07.

Cash Flows

Net cash provided by operating activities increased from ¥23.2 billion to ¥54.7 billion. This was mainly attributable to the growth in income before income taxes and minority interests, a decline in trade receivables due to initiatives to reduce receivables, and a decline in income taxes paid.

Net cash used in investing activities decreased from ¥10.7 billion to ¥7.8 billion. This was mainly the result of a decline in sales of idle assets, a decline in scheduled repairs at refineries, which is a component of payment for property, plant and equipment, and an increase in proceeds from sale of investments in securities.

Net cash used in financing activities increased from ¥30.4 billion to ¥39.1 billion. This was mainly attributable to ongoing progress in centralizing fund management and procurement activities for the entire Group. The most noteworthy change was a decrease in interest-bearing debt at subsidiaries.

Cash and cash equivalents as of December 31, 2003, including an increase of ¥0.3 billion due to newly consolidated subsidiaries , totaled ¥15.1 billion, an increase of ¥7.9 billion compared with the end of 2002.

Dividend Policy

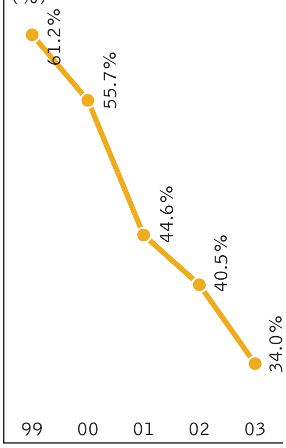
During 2003, the Company paid a year-end dividend of ¥15.00 per share and an interim dividend of ¥10.00 per share. The result was a total annual cash dividend of ¥25.00 per share, the same as in 2002. The payout ratio was 46.9 percent, and dividend return calculated using shareholders' equity was 4.3 percent.

Outlook for 2004

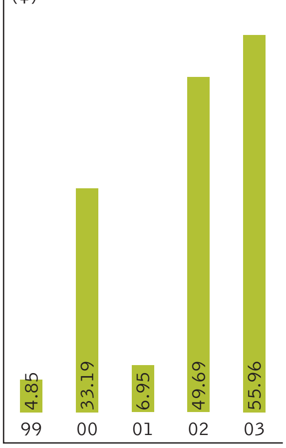
Based on forecasts of US$26 for the average price of crude oil and an exchange rate of ¥110 to the U.S. dollar, the Group's business plan calls for consolidated net sales of ¥1,650.0 billion (¥1,580.0 billion on a non-consolidated basis), consolidated ordinary income of ¥32 billion (¥28 billion on a non-consolidated basis), and consolidated net income of ¥18 billion (¥16 billion on a non-consolidated basis). On a CCS basis, which excludes the effect of changes in inventory valuations, the Group forecasts ordinary income of ¥40 billion compared with ¥36.3 billion in 2003.

Regarding dividends, the Company plans to increase the annual dividend by ¥5.00 in 2004 to ¥30.00, the sum of interim and year-end distributions of ¥15.00 each.

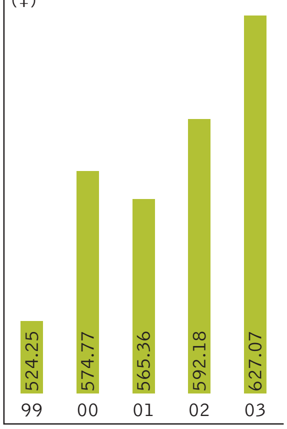
Gearing Ratio
(%)



Net Income per Share
(¥)



Shareholders' Equity per Share
(¥)



Free Cash Flow
(¥ Million)