Message from the President

In fiscal 2001, the Japanese economy continued to deteriorate due to slumping exports, weak private-sector capital investment, stagnant personal consumption, and curtailed public-sector investment.

In this operating environment, Kobe Steel's consolidated sales fell 12.8%, to ¥1,198.0 billion, and operating income dropped 66.6%, to ¥35.5 billion, owing mainly to plummeting steel prices and the sale of a semiconductor subsidiary. After accounting for losses including the write-down of securities due to the weak stock market and the adoption of a new accounting standard for retirement benefits, net loss amounted to ¥28.5 billion, a worsening from the previous fiscal year.

Results by Business Segment

In the iron and steel business, steel inventories rose sharply in the first half of fiscal 2001 due to weak domestic demand, and market conditions deteriorated significantly. Overseas, the slowdown of the U.S. economy led to anxiety of an oversupply, and the market headed downward. Consequently, although we were able to maintain our volume of steel products, Iron and Steel Segment sales fell 10.5%, to ¥486.4 billion, owing to low steel prices. Operating income dropped 75.8%, to ¥11.3 billion, due to the substantial fall in steel prices coupled with hikes in raw materials prices.

In the Aluminum and Copper Segment, despite growing demand for aluminum can stock, sales of rolled aluminum products fell due to lower sales of aluminum plate for semiconductor manufacturing equipment brought about by sluggish IT demand. Sales of rolled copper products fell due to stagnant demand in the IT and automotive industries; reduced sales of copper strip for semiconductor leadframes and automotive electrical terminals; and weak domestic demand for copper tubing used in air conditioners due to increased overseas production by domestic air conditioner manufacturers. As a result, sales in the Aluminum and Copper Segment fell 5.3%, to ¥256.5 billion, and operating income dropped 35.9%, to ¥8.0 billion.

The Machinery Segment saw a substantial drop in demand for municipal solid waste treatment facilities, and dwindling private-sector capital investment led to reduced orders for compressors and crushers. Overseas orders also fared badly due to sluggish plant demand. As a result, overall orders received by the Machinery Segment fell 29.0%, to ¥166.7 billion, with a backlog of orders of ¥196.6 billion. Sales for the segment dipped 2.0%, to ¥232.2 billion. Although sales benefited from higher orders, mainly for municipal solid waste treatment facilities in fiscal 2000, sales from subsidiaries declined. However, operating income rose 120.1%, to ¥3.7 billion, thanks to cost-cutting efforts.

Construction machinery demand dropped considerably due to the decline in public works and private-sector construction. Overseas, the market in China expanded and signs of recovery were apparent in Southeast Asia, but conditions in the United States and Europe remained severe. Under these conditions, the Kobelco Construction Machinery Group worked to reduce fixed and other operating costs and expand overseas sales. However, reduced domestic shipments had a considerable impact on overall sales, which fell 6.4%, to ¥148.3 billion, and operating income declined 64.3%, to ¥1.9 billion.

In the real estate business, the number of new housing starts fell and the market remained sluggish despite such government stimulation measures as the extension of housing tax breaks and continued low interest rates. As a result, Real Estate Segment sales fell 23.7%, to ¥45.0 billion, and operating income went down 41.6%, to ¥8.0 billion, due to sluggish demand and lower sales prices brought about by significant drops in land prices.

In our Other Businesses Segment, sales dropped 49.6%, to ¥82.2 billion, and operating income fell 96.9%, to ¥900 million, mainly due to the sale of a semiconductor subsidiary.

Restructuring our Businesses

While undertaking the "selection and consolidation" of our businesses, we actively pursued alliances with other companies to sharpen the competitive edge of our core businesses.

In December 2001, Kobe Steel formed an alliance with Nippon Steel Corporation to increase the Company's competitive strength. The goals of the alliance include mutual support in steelmaking, collaboration in product distribution and raw material procurement, cooperation between nearby operations in supply procurement and equipment maintenance, and effective utilization of equipment between group companies. The alliance could expand should the two companies find other areas of mutual advantage.

We also signed a technology agreement with Austria's voestalpine Stahl GmbH that covers high strength automotive steel sheet and other coated steel sheet. In a similar move, we have been collaborating with United States Steel Corporation in automotive steel sheet technology. We are also conducting technical exchanges in specialty steel wire rod and bar for automobiles with Europe's Lucchini Group. Through these formations, we are able to establish a global network to supply high-quality products to automakers worldwide.

In May 2002, Kobe Steel and Kawasaki Steel Corporation agreed to explore areas of collaboration including R&D, production, and procurement of welding consumables.

In our wholesale electricity supply business, a potential core business, the No. 1 Power Plant of our Shinko Kobe Power Station began operating in April 2002. The construction of the No. 2 Power Plant is proceeding smoothly and the plant is scheduled to go on stream in April 2004. With each plant having a generating capacity of 700,000 kilowatts, the two together will be able to produce 1.4 million kilowatts. This is expected to substantially contribute to improving Kobe city's self-sufficiency rate for electricity.

We reorganized our real estate business by merging subsidiary Shinko Kosan, Ltd. in March 2002 with the Company's Land Development Department. This move strengthens our real estate business by integrating the know-how of two operations and effectively utilizing management resources.

Looking Ahead

Looking at the Japanese economy, the falling rate of exports appears to be bottoming out, continued progress is expected in inventory adjustments mainly in the IT industry, and signs of economic recovery are beginning to appear. However, a full-fledged recovery in private-sector capital investment and growth in personal consumption are not expected, and the economic future remains unpredictable.

Amid this environment, we are implementing the following strategies in our three core businesses.

Iron and Steel

We plan to leverage our alliances in the United States and Europe to meet our customers' global procurement needs. To increase our competitiveness, we are focusing on specialty steel, high strength steel sheet, and coated steel sheet—products in which we excel. We are also aggressively cutting costs and pursuing collaboration with Nippon Steel to enhance profitability.

In our wholesale electricity supply business, we are working to ensure stable power generation to build a stronger profit base.

Aluminum and Copper

We are working with Sumitomo Light Metal Industries, Ltd. in the field of extruded aluminum products. In copper sheet and strip, we are cooperating with Mitsubishi Materials Corporation and Mitsubishi Shindoh Co., Ltd. These alliances enhance our competitiveness. Recovery in IT demand is also anticipated to contribute to higher profits. In addition, as demand for aluminum in automobiles grows, we are working to solidify our position as one of Japan's top suppliers of aluminum products.

Machinery

In the growing environmental and energy fields, we are continuing our efforts to increase orders while cutting costs. We are also committed to creating new product lineups and entering new business fields. At the same time, we are refocusing our overseas engineering business, which faces difficult operating markets, by reducing personnel and concentrating on our most competitive products and services.

We strove to make further structural reforms in our operations and achieve an early recovery in our financial performance through our current midterm management plan. However, with the rapid deterioration of the operating environment, the Company implemented "Emergency Measures to Raise Profitability," a two-year plan unveiled in September 2001. This plan calls for lowering employees' salaries, increasing the rate of executive pay cuts, and reducing R&D costs. In addition to the ongoing management plan, the new measures will better enable us to achieve stable profitability, eliminate deficits at an early date, and shrink interest-bearing debt to improve our financial strength.

We also established a Corporate Ethics Committee, a corporate code of ethics, and risk management standards to enhance our corporate governance. To ensure strict observance of the law, we set up a Special Committee for Compliance, which includes outside lawyers, in preparation of a concrete system for compliance management. Through these measures, we are fully committed to establishing a complete compliance check system and promoting corporate governance.

As we embark on becoming a more responsible and more profitable company, we thank you for your understanding and look forward to your continued support.

August 2002

Koshi Mizukoshi
President and
Chief Executive Officer