

## Message from the President

Japan's economy gradually expanded in the first half of fiscal 2006, ended September 30, 2006. With corporate earnings high, private-sector capital investment increased and personal spending went up, spurred by higher workers' incomes. The Chinese and other Asian economies remained strong.

On this background, Kobe Steel's consolidated net sales in the first six months rose ¥109.4 billion to ¥898.9 billion, in comparison to the same period last year. Operating income was ¥98.8 billion, a decrease of ¥9.4 billion, as the inventory valuation under the average method in fiscal 2005 had pushed up profits more for that year. In addition, from fiscal 2006 machinery and equipment depreciation was changed from the straight-line method to the declining-balance method, which increased the depreciation burden. However, ordinary income\* increased ¥1.9 billion to ¥87.4 billion in comparison to the same period last year owing to higher profits from equity-valued affiliates. As no extraordinary loss was posted in the half-year period, aftertax net income increased ¥14.9 billion to ¥51.6 billion.

Taking into consideration the trend of its business performance and the result of a comprehensive evaluation, Kobe Steel has decided to pay an interim dividend of 3 yen per share for the half-year period.

<Net Sales>	(in billions of yen)		
	FY2006 First Half	FY2005 First Half	%
Iron & Steel	397.1	366.4	8.4%
Wholesale Power Supply	34.4	31.1	10.6%
Aluminum & Copper	192.4	152.4	26.2%
Machinery	119.5	113.8	5.0%
Construction Machinery	133.1	106.4	25.1%
Real Estate	18.9	17.2	9.6%
Electronic Materials & Other Businesses	30.5	28.2	8.2%
Eliminations	(27.0)	(26.0)	-
<b>Total</b>	<b>898.9</b>	<b>789.5</b>	<b>13.9%</b>

<Operating Income>	(in billions of yen)		
	FY2006 First Half	FY2005 First Half	%
Iron & Steel	45.5	69.0	(34.1%)
Wholesale Power Supply	9.4	8.3	12.2%
Aluminum & Copper	18.1	12.2	47.8%
Machinery	5.5	3.1	77.3%
Construction Machinery	6.9	3.7	89.9%
Real Estate	2.8	1.4	101.8%
Electronic Materials & Other Businesses	8.2	8.5	(3.1%)
Eliminations	2.4	2.0	21.9%
<b>Total</b>	<b>98.8</b>	<b>108.2</b>	<b>(8.7%)</b>

### Iron & Steel

Domestic demand for medium- and high-grade steel products, used mainly in the automotive and shipbuilding industries, was strong in the period under review. In the overseas market, the supply and demand balance, which had worsened due to China's rising crude steel capacity, improved owing to growing worldwide demand for steel, leading to progress in market recovery. Domestic inventories, which had accumulated due to weak demand for general steel products, showed improvement and went down to more appropriate levels.

While focusing mainly on demand for upper-end products for the manufacturing sector, Kobe Steel controlled shipments to keep inventories at appropriate levels. As a result, our shipments of steel products decreased in comparison to the same period last year. Due to the order composition, the average sales price went down in comparison to the second half of fiscal 2005. Demand was brisk for steel castings, forgings and welding consumables

for the shipbuilding industry and for titanium products for the aircraft market, contributing to higher sales in comparison to the same period last year.

As a result, segment sales increased 8.4% to ¥397.1 billion, but operating income went down ¥23.5 billion to ¥45.5 billion, in comparison to the same period last year. Operating income was affected by the average method in fiscal 2005, which had pushed up profits higher for that year and by a change in the method of depreciation.

### Wholesale Power Supply

Sales rose 10.6% to ¥34.3 billion owing to an increase in the electricity price brought about by higher coal prices. Operating income rose ¥1.1 billion to ¥9.4 billion in comparison to the same period last year. The Shinko Kobe Power Station has an electricity generation capacity of 1.4 million kilowatts.

### Aluminum & Copper

Shipments of aluminum rolled products decreased over the same period last year. Although shipments were strong for aluminum sheet for automotive panels and aluminum disk blanks for hard drives, the cool summer led to a considerable decrease in shipments of aluminum can stock for beverage cans.

Demand for copper rolled products was the same as the first half last year. Demand continued to be strong for copper strip for automotive electrical parts and semiconductor leadframes. Demand for copper tube was the same as the first half last year.

Aluminum castings and forgings saw strong shipments to the automotive and semiconductor markets.

Under these conditions, although overall sales volume decreased, high aluminum ingot and copper cathode prices boosted sales prices. As a result, segment sales increased 26.2% to ¥192.4 billion in comparison to the same period last year. Operating income increased ¥5.9 billion to ¥18.1 billion with the use of the average method of calculating inventories.

### Machinery

Domestic orders increased 27.9% to ¥87.7 billion in comparison to the same period last year. On the back of strong private-sector capital investment, orders were strong for compressors, rolling mills and other products. In the environmental business, Kobe Steel received orders for large waste treatment projects.

Overseas orders shot up 111.6% to ¥88.5 billion. Capital investments were active in the oil refining, petrochemical and energy fields in the Middle East and Asia, leading to strong demand for non-standard compressors, plastics processing machinery and pressure vessels. Orders were also awarded for gas-based direct reduction plants.

As a result, total orders increased 59.7% to ¥176.2 billion, and the backlog of orders was ¥317.2 billion.

Owing to strong orders, machinery segment sales rose 5.0% to ¥119.5 billion in the first half of fiscal 2006, in comparison to the same period last year. Operating income increased ¥2.4 billion to ¥5.5 billion due to mainly cost reductions.

### Construction Machinery

Domestic demand for construction machinery was brisk, supported by strong private-sector capital investment, although public works

projects continued to shrink. The overseas market was also strong. Demand was firm in Europe and North America, and the Chinese market rapidly recovered and expanded. The crane business was also robust, centered on the Middle East and Southeast Asia.

As a result, segment sales increased 25.1% to ¥133.1 billion in comparison to the same period last year. Operating income increased ¥3.2 billion to ¥6.9 billion.

### Real Estate

With the completion and handing over of condominiums, mainly in the Kansai (western) region of Japan, segment sales went up 9.6% to ¥18.9 billion in comparison to the same period last year. Operating income increased ¥1.4 billion to ¥2.8 billion.

### Electronic Materials & Other Businesses

Due to inventory adjustments of liquid crystal displays, demand slowed for target material used in LCDs. However, the materials analysis business continued to be strong. As a result, segment sales rose 8.2% to ¥30.5 billion in comparison to the same period last year. Operating income was roughly the same at ¥8.2 billion.

### Outlook

In the second half of the fiscal year, Japan's economy is forecast to continue improving gradually. Although trends in the U.S. economy and other factors are of concern, domestic demand in the private sector is expected to continue increasing and the Chinese and other Asian economies are anticipated to be strong.

In Kobe Steel's Iron & Steel segment, there is concern that supply pressure will increase due to higher steel production in China. However, demand in Japan and overseas is anticipated to continue being robust. Demand is expected to be brisk for steel castings and forgings, titanium products and welding consumables. In the Machinery segment, we anticipate that orders will continue to be strong from the oil refining, petrochemical and energy fields.

Looking to the future, we are implementing our Fiscal 2006-2008 Medium-Term Business Plan, launched in April 2005. Under this plan, we are increasing sales of "Only One" high-end products and creating more such products. We are boosting our manufacturing capabilities. At the same time, we are strengthening our financial position. By doing so, we will improve profitability and create a stronger corporate structure that is capable of dealing effectively with the changing business environment.

December 2006



Yasuo Inubushi  
President, CEO &  
Representative Director

(\* Ordinary income is operating income after adjustments of net financial revenue and net expenses generated on a regular basis, including seconded employees' salaries net of reimbursement.)