Special Feature

ITOCHU’s China Strategy

ITOCHU has positioned Asia as an A&P region. Focusing on China and aware of its role as “the world’s factory” and “the world’s market,” we are developing it as our most important market by expanding trade and aggressively investing in our businesses there through alliances with leading local groups.

In April 2003, we set up a China Market Global Development Office to aggressively expand trade between China and the rest of the world. A year later, in April 2004, for a more efficient and powerful organization we moved the office of our General Manager for China from Beijing to Shanghai, which is the optimal base for our Chinese business.

Simultaneously by tightening risk management, ITOCHU is reinforcing its profit structure and maintaining a policy of continuing to aggressively expand business in China.

<Key Areas and Developments>

Textile Company: For marketing inside China, in the materials business we set up an acrylic fiber manufacturing company with Mitsubishi Rayon Co., Ltd. In the apparel and fashion brand business, we are developing men’s suits and sports apparel brands. We also established a sales company in the U.S. with the Shandong Weiqiao Textile Group as a strategic step for the global marketing of textile products originating in China.

Machinery Company: We enjoyed a favorable performance in export sales of power generation equipment and automobiles. In addition, in the retail area we entered the car accessories business field jointly with Yellow Hat Ltd.

Aerospace, Electronics & Multimedia Company: By acquiring a stake in a Shanghai-based system integrator, we began providing IT solutions mainly to Japanese corporations that are expanding their businesses in China. We also embarked on a content distribution business for the rapidly expanding mobile phone market.

Energy, Metals & Minerals Company: We reached a general agreement with CNPC, a major player in the Chinese petroleum market, and are also focusing on expanding investment and trade in coal and iron ore related fields.

Chemicals, Forest Products & General Merchandise Company: We decided to enter the manufacture and sale of polyester fiber materials with Mitsubishi Chemical Corporation. In addition, we advanced into the pharmaceutical field through a business alliance with the Sanjiu Enterprise Group, China’s largest pharmaceutical group.

Food Company: Strengthening our ties with the Ting Hsin International Group, China’s largest food business group in the upstream area, we set up a joint venture with Asahi Breweries, Ltd. in the tea beverage manufacturing business, where Ting Hsin has the top share. Downstream, we are promoting the development of FamilyMart stores in Shanghai and our restaurant chain business.

Finance, Realty, Insurance & Logistics Services Company: We formed a joint venture with China Railway Modern Logistics Technology Co., Ltd., whose network extends throughout China. In addition, we are reinforcing our logistics functions inside China by, for example, acquiring a stake in the Ting Hsin International Group’s distribution company.

(For details, please refer to the section for each Division Company, pages 22-35.)

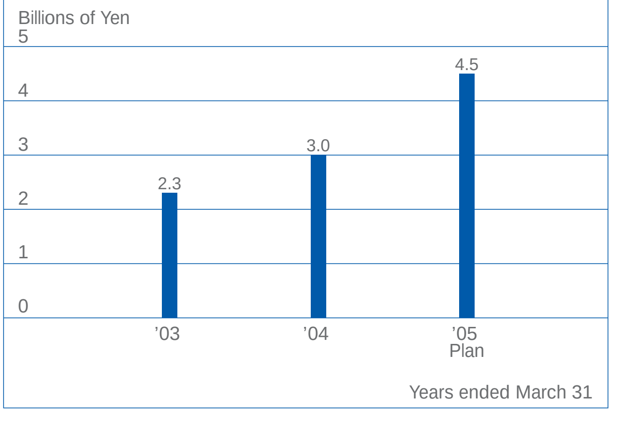
ITOCHU continues to expand business by deepening ties with provinces and cities. These efforts have included reinforcing relations with the city of Beijing and Jiangsu and a forming comprehensive alliance with the Shandong provincial government.

In response to the Chinese government’s recent Northeast Revitalization policy, in April 2004, we opened an office in the city of Shenyang as a base of operations for development in the northeastern region and plan to open offices in the cities of Harbin and Changchun later this year.

<Numerical Targets>

As a result of our management emphasis on capital efficiency, consolidated net income from China, including Hong Kong (subsidiaries, associated companies, and overseas trading subsidiaries), in the fiscal year ended March 2004 was ¥3.0 billion which is an about ¥1 billion increase from the previous fiscal year. For the fiscal year ending March 2007, we aim to raise net income to ¥10.0 billion or more.

Net Income of China Segment



Creating New Businesses with Innovative Technologies

ITOCHU's strength in the innovative technology field lies in its wide range of access to technology seeds and venture companies through its global strategic alliances. By taking full advantage of its diverse business capabilities and matching market needs to technology seeds through its multiple functions, ITOCHU pursues wide application of innovative technologies to the real economy.

<Reinforcing Our Global Strategic Alliance Network>

During fiscal year 2004 we reinforced our network of global strategic alliances. (See our *Annual Report 2003*, page 15, for strategic alliances formed prior to fiscal year 2004.) In October 2003, we formed a comprehensive alliance with Japan's largest public research organization, the National Institute of Advanced Industrial Science and Technology (AIST), for the purpose of assisting Japanese small and medium-sized enterprises (SMEs) in the innovative technology field. We will utilize our diverse capabilities, such as ample knowledge of markets as well as marketing skills and financing, together with AIST's research resources, and collaborate with SMEs to create new intellectual property (IP) and strengthen their international competitiveness. Additionally, in February 2004 we formed a comprehensive alliance with another large Japanese national research organization, the Institute of Physical and Chemical Research (RIKEN). RIKEN now increasingly pursues technology transfer to industry and the establishment of spin-off ventures. Together with RIKEN, we will jointly promote the development of IP, technology transfer, and investment in ventures in the field of innovative technology.

<Business Development>

In the medical biotechnology field, by making use of our relationship with our U.S. strategic partner, MPM Capital, investment was made in a U.S. biopharmaceutical venture, Metabasis Therapeutics, Inc. Negotiations to develop jointly business with a Japanese pharmaceutical company are under way. In the food and agri-biotechnology field, investment was made in a microbiological venture, Japan Applied Microbiology Research Institute Ltd. (Oubiken), and development of joint business is in progress. In the field of food safety, joint development of a non-destructive detection technology in conjunction with the U.S. Los Alamos National Laboratory has started. Meanwhile, in the nanotechnology field we have co-invested with the Gambare Japanese Company Fund, an SME-assisting fund established with ITOCHU playing a central part, in Cluster Technology Co., Ltd., a Japanese venture that develops nano-scale molds and inkjet heads, and we are jointly developing businesses in fields such as electronics.

<Outlook for Fiscal Year 2005>

In fiscal year 2005, ITOCHU will continue to position the innovative technology field, including biotechnology and nanotechnology, as one of its priority business areas, take advantage of its diverse capabilities and its relationships with numerous companies in a wide range of industries, and develop more businesses among ITOCHU, its customers, and its strategic partners. Using our global strategic alliances, we will pursue our strategy of (1) carrying out venture and SME investments and creating joint businesses with them, (2) investing in IP ownership and commercializing the technology, and (3) facilitating technology transfer and developing trade.

Performances in the Innovative Technology Field (Fiscal Year 2004)

Newly formed strategic alliances	• National Institute of Advanced Industrial Science and Technology (AIST), Japan • Institute of Physical and Chemical Research (RIKEN), Japan • Shinshu TLO, Japan • Wageningen University and Research Centre, The Netherlands • Tsinghua University, China • Beijing Technology Exchange Promotion Center, China
New venture and fund investments (Biotechnology ventures)	• Metabasis Therapeutics, Inc., U.S.A. • Japan Applied Microbiology Research Institute Ltd. (Oubiken), Japan • IBERICA CO., LTD, Japan • Carna Biosciences Inc., Japan
(Nanotechnology ventures)	• Cluster Technology Co., Ltd., Japan • Eikos Inc., U.S.A.
(IP-related investment)	• Intellectual Property Bank Corporation, Japan
(Venture capital fund investments)	• Bio Sight Incubation Fund I, Japan • Fast Track Initiative Fund I, Japan

Group Company Management and Strategies

In the fiscal year ended March 1999, the 1,027 subsidiaries and associated companies in the ITOCHU Group together reported a net loss* of ¥15.8 billion. Within the Group, 635 companies were profitable, contributing ¥40.8 billion in net income, while 392 were unprofitable, recording ¥56.6 billion in net losses. Only 61.8% of group companies were profitable, and their profits were offset by unprofitable companies. That was the Group's earnings structure five years ago.

<"Exit" Benchmarks>

In order to improve the earnings structure and increase net income, we initially undertook a major streamlining and restructuring of unprofitable and inefficient companies. Those companies posting losses for three or more consecutive years were, in principle, targeted for withdrawal. Other companies were subject to "exit" benchmarks, such as profits, return on assets (ROA), and risk-return index (RRI), as well as trends of such indicators. We review those companies against their benchmarks every year and identify candidates for "exit."

Next, we analyze the growth, future and potential for profit recovery of the exit candidates. For those with weak prospects, we prepare a primary exit plan containing recommendations for liquidation, merger, sale, or other actions. This plan is then subject to meticulous re-examination at both the Division Company and the headquarters levels, whereupon a final decision—exit or drastic restructuring—is made.

<New Investments in Subsidiaries and Associated Companies and Post-Investment Control>

Decisions on whether or not to invest in new businesses are determined by our New Investment Benchmarks in Subsidiaries and Associated Companies, which are based on indicators such as RRI and ROA. Of course, those who make the final investment decisions will depend on the size of the investment. In some cases, businesses that initially meet the investment benchmarks may later fail to satisfy those standards when macroeconomic conditions change. To address this possibility, each group company sets its own independent benchmarks, such as expense ratio targets, and works to improve operating efficiency accordingly. Their progress is monitored at the headquarters level by the Group Profits Improvement Committee, so that results vis-à-vis projections are constantly checked. Regular assessments are also made based on the aforementioned exit benchmarks.

<Fostering Managerial Talent>

The ITOCHU Group strives to secure and reinforce managerial resources. In 1999, for example, we opened our ITOCHU Business School, in which outside speakers hold seminars on management, marketing, financial, and personnel strategies, as well as conduct case study analyses of group companies. Over the 10 semesters since the school was opened, around 80 people have graduated and the majority currently serve as managers in group companies.

<Demonstrating Group Strengths>

In 2001, the Group Management Committee (GMC) was established to help reinforce group management and ensure consistency in policies and values among group companies. The committee consists of presidents of the parent company and 23 major group companies and meets quarterly to discuss and share group policies and values and exchange opinions about mutual problems, as well as to debate strategic areas common to group members.

<Results of the Fiscal Year Ended March 2004>

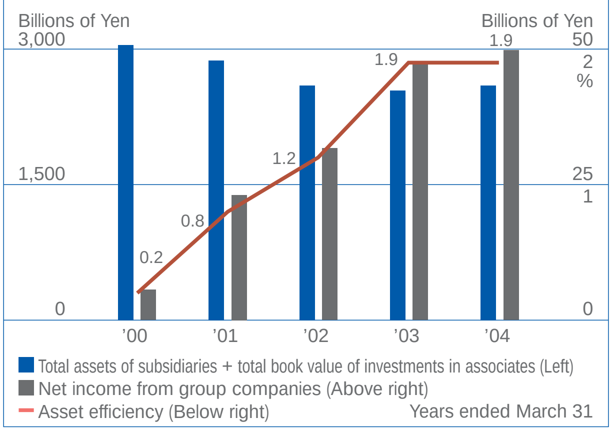
Thanks to the aforementioned actions, we have reduced the number of group companies to 645 as of March 31, 2004—a decrease of around 40% from March 31, 1999. If we exclude the effects of impairment losses for fixed assets under Japanese GAAP, which we adopted earlier than mandated, the number of profitable companies represented 82.8% of the total, while net losses of the unprofitable ones were limited to ¥19.6 billion. As a result, net income of group companies in fiscal year 2004 reached ¥49.8 billion. The asset efficiency of group companies (net income from group companies ÷ [total assets of subsidiaries + total book value of investments in associates]) was 1.9% in fiscal year 2004, a dramatic improvement from 0.2% in fiscal year 2000. (Please refer to page 11 for the details of "net income from group companies.")

<Moving Ahead>

As part of our business growth plans under the A&P strategy, we have made focused investments aimed at strengthening core group companies and expanding profits from growth areas such as consumer and retail related businesses, natural resource development, and business in China. As a result, we have built a solid earnings structure, in which profitable companies consistently generate net income of between ¥60 billion and ¥70 billion. However, growth in net income of group companies has stemmed mainly from actions to reduce the number of unprofitable companies or curtail their losses. Therefore, much more needs to be done to further improve the earnings power of profitable companies. We must position A&P growth strategies as core strategies for group company management for the future, while continuing our emphasis on rigorous business risk management and optimal asset reallocation. Going forward, we will formulate growth strategies for each group company and carefully monitor the implementation of those strategies. At the same time, we will provide increased business, personnel, and funding support and deploy group strengths more effectively to further reinforce the earnings power of profitable group companies.

*net income (loss) from group companies
= The Company's share of [net income (loss) from subsidiaries, excluding minority interests + Equity in earnings (losses) of associates]

Asset Efficiency of Group Companies



Years ended March 31

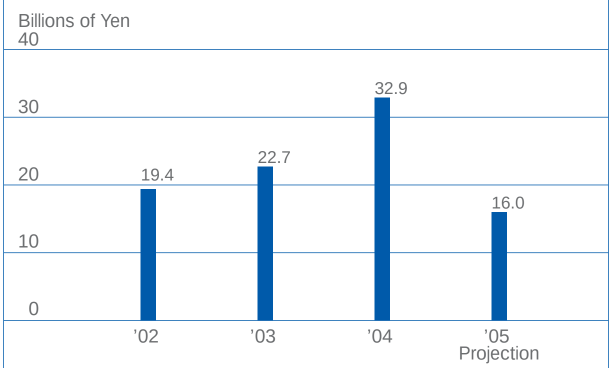
Results of Retirement Pension Plan Reform

Since fiscal year 2002, ITOCHU has undertaken a full-scale revision of the retirement and severance plan for its employees. The aims of the revision are to address employees' diversifying opinions and values, and to reduce management risk by lowering consolidated projected benefit obligations (PBO) and the risks associated with such obligations. In the year under review, we revised the retirement and severance plan of the parent company, which represents the major portion of total consolidated PBO, following an agreement with the labor union in March 2003. Details and results of the revisions are outlined below.

1. Returning the public pension portion held by the employee pension fund to the government: In January 2004, we received approval from the Ministry of Health, Labor and Welfare to return the past portion. Based on this approval, in March 2004 we cleared off the minimum liability reserve. As a result, total PBO and pension assets declined by around ¥39.0 billion and ¥18.4 billion, respectively. The return of the public pension portion also incurred a one-time cost of around ¥2.2 billion, which was expensed in the year under review.
2. Revising the supplementary portion of the employee pension fund: Following the return of the aforementioned past public pension portion, we introduced a "cash balance plan" that links benefit amounts with market interest rates for the remaining supplementary portion. We also made some perpetual annuities terminable. These actions together reduced PBO by around ¥26.0 billion.
3. Revising the tax-qualified pension: In July 2003, we shifted part of the future portion of the tax-qualified pension plan to a defined contribution pension plan, thus reducing PBO by around ¥5.0 billion.

In addition to the above revisions undertaken by the parent company, we made good progress in managing our assets in the year under review. We therefore project a large improvement in consolidated net periodic pension cost of retirement and severance benefits, from ¥32.9 billion in fiscal year 2004 to around ¥16.0 billion in fiscal year 2005.

Net Periodic Pension Cost of Retirement and Severance Benefits



Years ended March 31