Operating Results

Net Sales

In fiscal 2006, the year ended March 31, 2007, consolidated net sales rose 1.2% year on year to ¥908,059 million (US$7,695 million). By business group, sales increased in Energy & Electric Systems, which recorded sales from a large-scale electric power plant project, ED&C · Drive Systems, on sales growth both in Japan and overseas on the back of robust demand generated by private-sector capital investment, and Electronic Devices, thanks to increased sales from semiconductors and device media. However, Retail Systems reported lower sales due to declines in vending machines and currency handling systems.

Overseas sales declined 4.9% year on year to ¥194,244 million (US$1,646 million), with the ratio of overseas sales falling 1.4 percentage points from a year earlier to 21.4%. This included a ¥14,026 million impact arising from adjustments to the settlement date for certain consolidated subsidiaries with a fiscal year-end of December 31, made during the previous fiscal year. To more appropriately manage and provide disclosure of consolidated earnings, the settlement dates were altered by using a provisional account settlement date, or by making the end of the business year the same as the consolidated year-end settlement date. By region, Asia (excluding China) accounted for 58.9% of overseas sales, China 20.7%, Europe 8.6% and North America 8.61%.

Cost of Sales, SG&A Expenses, and Operating Income

Cost of sales amounted to ¥708,837 million (US$6,007 million), up 1.0% from the previous fiscal year. Despite negative factors such as rising prices for raw materials, the cost of sales ratio declined 0.1 of a percentage point from 78.2% a year earlier to 78.1%, reflecting an increase in sales from proactive measures to expand orders, along with cost reductions realized from business process reengineering. As a result, the gross profit margin improved 2.0%.

Selling, general and administrative (SG&A) expenses, despite an increase in higher research and development costs, declined 0.8% year on year to ¥153,014 million (US$1,297 million), mainly due to strategic reassignment of personnel in accordance with business process reengineering and resulting changes in the operating structure. SG&A expenses represented 16.8% of net sales, down 0.4 of a percentage point from 17.2% the previous year.

As a result, operating income rose 12.7% year on year to ¥46,208 million (US$392 million). By group, increased operating income was recorded in Energy & Electric Systems, ED&C·Drive Systems, and Electronic Devices, but declined in Retail Systems due to a drop in sales.

Non-operating Income (Expenses) and Ordinary Income

Non-operating income (expenses) increased ¥1,735 million from net income of ¥819 million in the previous year to net income of ¥2,554 million (US$22 million) for the fiscal year under review. This mainly reflected an increase in the gain on foreign currency translation adjustments, and a rise in earnings in equity-method affiliates stemming from the improvement in profitability of a domestic affiliate in the substation business.

As a result, ordinary income rose 16.6% year on year, to ¥48,762 million (US$413 million), a new record high for the Group.
Extraordinary Gains and Losses, and Net Income

The Fuji Electric Group posted extraordinary gains of ¥2,837 million (US$24 million) after recording a gain on sales of investment securities, and gain on withdrawing pension assets in trust. This represented a year-on-year decline of ¥1,543 million, mainly due to the absence of a gain on sales of property, plant and equipment booked in the previous fiscal year.

Extraordinary losses of ¥11,125 million (US$94 million) mainly consisted of loss on sales of property, plant and equipment, special termination benefits, and special repair expense. This represented a decline of ¥923 million from a year earlier, stemming mainly from a decrease in loss on sales of property, plant and equipment compared to the previous fiscal year.

As a result of the above, income before income taxes and minority interests increased 18.5% to ¥40,474 million (US$343 million). Net income, after deducting income taxes of ¥16,346 million (US$139 million) and minority interests in net income of consolidated subsidiaries of ¥986 million (US$8 million), rose 24.4% year on year to ¥23,142 million (US$196 million), a new record high for the Group.

For details on net sales and operating income by group, please refer to the Review of Operations section (pages 20 – 49 of Operational Review).

Plant and Equipment Investment

In its medium-term management plan covering fiscal 2006 through fiscal 2008, the Fuji Electric Group has earmarked investment in plant and equipment totaling ¥1.9 billion over three years. This investment is aimed at further business selection and concentration, along with promoting and accelerating proactive investment in specialty fields.

During fiscal 2006, the first year of this medium-term management plan, plant and equipment investment amounted to ¥71,450 million (US$606 million), including lease acquisitions of ¥36,828 million (US$312 million). By group, plant and equipment investment totaled ¥9,050 million (US$77 million) in Energy & Electric Systems, ¥6,529 million (US$55 million) in ED&C·Drive Systems, ¥48,367 million (US$410 million) in Electronic Devices, ¥5,593 million (US$47 million) in Retail Systems, ¥1,879 million (US$16 million) in Others, and ¥32 million (US$0.3 million) in shared Group investment.

The major components of plant and equipment investment included the following.

In Energy & Electric Systems, the Group installed and began operating a production line for solar cells at the Kumamoto Plant run by Fuji Electric Systems Co., Ltd., aimed at full-scale entry into the solar cell business. In the measuring equipment business the Company established a production plant in Wuxi, China, to provide a platform for entry into the Chinese market.

In ED&C·Drive Systems, the Group updated its short-circuit generators in order to strengthen development capabilities in the ED&C components business. Equipment and facilities were also expanded to enhance production capacity for low-voltage circuit breakers. The inverter division at the Kobe Plant was also integrated into the Suzuka complex, and production launched.

In Electronic Devices, in the disk media field the Group expanded production lines for glass and aluminum substrate disks at the Matsumoto and Yamanashi plants operated by Fuji Electric Device Technology Co., Ltd., and at Fuji Electric (Malaysia) Sdn. Bhd. These steps were taken to respond to rising demand in the HDD market, which continues to see growth in both computer and consumer electronics applications. In semiconductors, the Group installed new production facilities at the Matsumoto Plant operated by Fuji Electric Device Technology Co., Ltd. for PDP ICs and power devices for industrial applications and automotive operations.
components. In imaging devices, the Group expanded and relocated production lines at Fuji Electric (Shenzhen) Co., Ltd., to consolidate facilities for organic photoconductive drums (OPCs) in China.

In Retail Systems, the Group completed constructing a new integrated office building at the Saitama Plant run by Fuji Electric Retail Systems Co., Ltd., and began undertaking efforts to strengthen development capabilities and enhance operational efficiency. The Group also built a new R&D facility at the Mie Plant to shorten development lead times and raise product development quality.

In research and development, the Group installed prototype and testing equipment for new processes for next-generation magnetic recording media. Process development equipment was also upgraded to raise the quality of organic light-emitting displays (OLEDs).

Depreciation and amortization expense in the fiscal year under review amounted to ¥17,544 million (US$149 million). Lease expense for production equipment totaled ¥25,034 million (US$212 million).

R&D Expenditures

The Fuji Electric Group makes strategic investments in key product lines to enhance the technology development and basic research that strengthens the core technology in which it specializes, and to accelerate the process of bringing distinctive new products to market.

R&D expenditures in fiscal 2006 amounted to ¥32,554 million (US$276 million), representing 3.6% of net sales. By group, expenditures totaled ¥9,886 million (US$84 million) in Energy & Electric Systems, ¥4,097 million (US$35 million) in ED&C·Drive Systems, ¥14,368 million (US$122 million) in Electronic Devices, ¥4,150 million (US$35 million) in Retail Systems and ¥53 million (US$0.4 million) in Others.

Major R&D projects included the following.

Energy & Electric Systems: in power electronics the Group focused on building design platforms, using them to successfully commercialize such products as medium-capacity inverters for variable-speed motors, and accelerate the rate of development. It also expanded its product range in uninterruptible power supplies (UPS) with the development of the 8000 Series of large-capacity, high-voltage UPS that counter momentary voltage drops, and completed the product lineup in the GX 100/200 Series of high-efficiency mini-UPS. In measuring equipment, the Group utilized micro-processing technology to develop a combined differential pressure/pressure sensor, and created smaller, more accurate flowmeters. The Group also completed development of a direct laser gas analyzer capable of continuous measurement and monitoring. Going forward, the Fuji Electric Group will continue to develop products for the environmental measurement field.

ED&C·Drive Systems: in ED&C components the Group developed the G-Twin Series of global MCCB/ELCB (wiring and earth leakage circuit breakers), a single unit that meets new JIS/IEC standards (Japan and Europe), GB standards (China), and UL standards (United States). This environmentally-friendly product is fully compliant with the EU RoHS Directive. In control and drive systems the Group developed the FRENIC-MEGA Series, general-purpose inverters that comply with the electromagnetic compatibility (EMC) regulations, a key requirement for global products, and have internal harmonic suppression functions. This series has control capabilities on a par with the best in the industry, and incorporates functions suited to a wide range of applications.

Electronic Devices: in power semiconductors the Group commercialized IGBT-IPM (Intelligent Power Modules) incorporating optimized packages on low-loss, highly durable, compact U-series
IGBT chips developed using proprietary technology. These IGBT-IPMs are used in power control units for hybrid vehicles. In disk media the Group continued to develop perpendicular magnetic recording media that meet the need for large-capacity, high-density data storage, establishing the technology for a surface recording density of 270Gbps. The Group is also preparing to begin volume production of 2.5 inch hard disk drives with a capacity of 160GB, the largest in the world.

Retail Systems: in vending machines the Group developed a series of can vending machines with extremely low global warming potential thanks to the use of a safe carbon dioxide (CO2) refrigerant in cooling system. The Group also developed the FOOD-X series of general-purpose vending machines, which can accommodate a wide range of products in various sizes, including sandwiches and rice balls. In currency handling systems the Group developed the ECS07 automatic coin dispenser that enables accurate cash management, as well as payment terminals for electronic money and credit cards using contactless ICs, the use of which is spreading rapidly.

In the new business and basic technology field, 17 phosphoric acid fuel cell power generation systems are now operating in the field, reducing primary energy usage and contributing to a reduction in CO2 emissions. Going forward, the Group will work to bring down costs and open new markets to promote the uptake of these systems.

The Group began trial operations of polymer electrolyte fuel cell (PEFC) power generation systems in Mie Prefecture and other locations, with the aim of verifying their durability and reliability under actual operating conditions. In September 2006 the system exceeded 11,000 hours of operation—the top level in the industry—and is still in continuous operation. Development is proceeding with the aim of commercializing the system.

To increase efficiency and speed in product development and design operations the Group is working to build technology platforms for electronics and other technologies, the results of which will be systematically implemented across the Group.

Financial Position

Total assets as of March 31, 2007 stood at ¥1,024,832 million (US$8,685 million), ¥34,778 million more than a year earlier.

Current assets totaled ¥483,401 million (US$4,097 million), an increase of ¥41,352 million compared to a year earlier. This was mainly attributable to increases of ¥259,107 million in trade receivables, and ¥149,716 million in inventories.

Net property, plant and equipment increased ¥19,207 million from a year earlier to ¥169,557 million (US$1,437 million). This was mainly for strategic capital investments centered on the Electronic Devices Group. Total investments and other assets declined ¥25,781 million to ¥371,874 million (US$3,151 million). This mainly reflected a corresponding decline in the market value of investment securities, other, from the previous fiscal year.

Total liabilities were ¥740,279 million (US$6,274 million), ¥35,114 million more than one year earlier. This was attributable to a ¥7,651 million decrease in deferred tax liabilities due mainly to a corresponding decline in the market value of investment securities, other, outweighed by a ¥16,279 million increase in trade payables and an increase in bonds following the issue of ¥30,000 million in euro-denominated convertible corporate bonds with share warrants maturing in 2016.

The balance of consolidated interest-bearing debt at the end of fiscal 2006 was ¥299,908 million (US$2,542 million), an increase of ¥24,862 million from a year earlier. The ratio of this balance to total assets was 29.3%, up 1.5 percentage points from the previous fiscal year.
Total net assets at March 31, 2007 were ¥284,553 million (US$2,411 million). Of this amount, ¥274,861 million was equivalent to the shareholders’ equity item used until the previous fiscal year, representing a year-on-year decline of ¥211 million. This was mainly due to an increase in retained earnings of ¥16,784 million, outweighed by a decrease in unrealized gain on other securities, net of taxes, of ¥17,466 million. As a result, the equity ratio fell 1.0 percentage point from the end of the previous fiscal year to 26.8%.

**Cash Flows**

In fiscal 2006, free cash flow (the sum of operating and investing cash flows) on a consolidated basis amounted to a negative ¥21,676 million (US$184 million), compared to positive free cash flow of ¥53,603 million in the previous fiscal year and representing a deterioration of ¥75,279 million. This was due mainly to the impact of the fiscal year-end falling on a holiday, and proactive investment in growth fields.

**Cash Flow From Operating Activities**

Operating activities provided net cash and cash equivalents (cash) of ¥12,764 million (US$108 million), compared to net cash provided in the previous fiscal year of ¥60,200 million. Cash was mainly provided by income before income taxes and minority interests.

This represented a deterioration of ¥47,436 million from the previous fiscal year.

**Cash Flow From Investing Activities**

Investing activities used net cash of ¥34,440 million (US$292 million), compared to net cash used in the previous fiscal year of ¥6,597 million. Cash was mainly used for strategic capital investment centered on the Electronic Devices Group.

This represented a deterioration of ¥27,843 million from the previous fiscal year.

**Cash Flow From Financing Activities**

Financing activities provided net cash of ¥18,756 million (US$159 million), compared to net cash used in the previous fiscal year of ¥49,470 million. This mainly reflected an increase in corporate bonds.

As a result of the above, cash and cash equivalents on a consolidated basis at March 31, 2007 amounted to ¥19,135 million (US$162 million), ¥2,278 million less than a year earlier.

**Risk Factors**

The Fuji Electric Group works to mitigate business risk and other risks in a systematic and methodical manner. However, there are various risks, such as those listed below, which could have a negative impact on the operating results and financial position of the Fuji Electric Group. As of March 31, 2007, the following factors were judged to have a potential future impact on the operations of the Fuji Electric Group.

1. **Risks related to changes in the operating environment**
   (a) Material and component prices in international markets have been rising due to rapidly increasing demand for raw materials associated with economic expansion in the BRIC countries, particularly in China, and protracted geopolitical instability related to conditions in the Middle East. Operating results could be negatively affected in the event the Group is unable to adequately respond to further increases in raw material and component prices.
(b) The Fuji Electric Group’s sales are affected by domestic economic trends, including public and private sector investment. The performance of the Electronic Devices business is closely correlated to market conditions in the electronics industry. Consequently, the Group’s operating results could be affected in the event of sudden changes in the supply-demand balance or intensified competition resulting in sharp declines in prices in the electronics industry.

(c) The Fuji Electric Group is seeking to expand its overseas presence, with a particular focus on the Chinese market. Specifically, the Group is actively working to increase sales of magnetic contractors, control and drive systems, semiconductors and other products in China. Consequently, the Group’s operating results could be affected in the event of deterioration in the Chinese economy or unexpected changes to economic policy.

(d) Based on an established set of management criteria, the Fuji Electric Group systematically employs forward-exchange contracts to minimize the risk of exchange rate fluctuations on its operating results. However, the forward-exchange contract policy is not capable of entirely mitigating exchange-rate risk. Consequently, fluctuations in exchange rates, primarily between the yen and the U.S. dollar, may have a negative impact on the operating results and financial position of the Group.

(e) The Fuji Electric Group’s interest-bearing debt totaled ¥2,999 million as of March 31, 2007. A higher-than-anticipated increase in interest rates may lead to a significant additional interest payment burden, which could have an impact on the operating results of the Group.

(2) Risks related to product quality

The Fuji Electric Group has put in place a quality assurance system designed to ensure the highest level of quality for all products it manufactures and sells. Although the Group has taken precautions in the form of insurance to provide compensation for product liability claims, in the event that major defects are found in any Fuji Electric Group products due to unforeseen factors, this may have a negative impact on the Group’s operating results and financial position.

(3) Risks related to technology development

The Fuji Electric Group makes a concerted effort to develop technology that matches the needs of the market. However, there is a possibility that competing companies will gain an advantage through faster development, or that the Group will be unable to bring products to market in a timely manner should development not progress according to plan. Such events could have a negative impact on the Group’s operating results.

(4) Risks related to overseas business activities

The Fuji Electric Group is seeking to expand its overseas presence, with a particular focus on Asia, including China. Consequently, the Group is exposed to the following risks, which may have a negative impact on the Group’s operating results and financial position:

- Unforeseen changes in laws and regulations and tax systems that may have a detrimental effect on the Group
- Disadvantages arising from political conditions
- Social turmoil related to terrorist incidents, war and other events.
(5) Risks related to intellectual property

The Fuji Electric Group effectively manages its intellectual property rights and develops new products and technologies in a manner that does not infringe on third-party patent rights. However, since the pace of technological innovation is accelerating and the Group’s operations are becoming more global, the possibility of disputes over intellectual property rights is increasing. A dispute of this nature may have a negative impact on the Group’s operating results and financial position.

(6) Risks related to human resources

The business activities of the Fuji Electric Group depend heavily on its human resources. Retaining and training superior personnel in such fields as technology, production, sales and administration is essential to the growth of the Group. Should the Group be unable to retain and/or train such necessary human resources, this could have a negative impact on the Group’s operating results.

(7) Risks related to leak of personal information

As a part of its business activities, the Fuji Electric Group handles personal information about numerous individuals, including customers, suppliers and employees. The Fuji Electric Group has formulated and strictly enforces thorough internal regulations regarding the gathering, use and management of personal information. However, the Group cannot entirely rule out the possibility that such information may be leaked due to unforeseen circumstances. Any leak of this kind could damage trust in Fuji Electric and have a negative impact on the Group’s operating results.

(8) Risks related to major natural disasters

The Fuji Electric Group has a network of bases throughout the world. In the event of a major natural disaster, production facilities may be damaged, operations at manufacturing facilities may be halted, shipments of products may be delayed, and other problems may occur. These events could have a negative impact on the operating results and financial position of the Group.

(9) Risks related to soil contamination

Based on the international standard for environmental protection systems, the Group works to prevent, measure and monitor soil contamination at its operating sites. Prior to selling any land, the Group carries out soil surveys and takes other appropriate steps in accordance with relevant laws and regulations. However, as a result of these measurements and surveys, the Group may incur costs for soil remediation measures, which could have a negative impact on the operating results of the Group.

(10) Risks related to retirement benefit liabilities

The Fuji Electric Group has a lump-sum payment plan and a corporate pension plan for its employees when they retire. Retirement benefit costs and liabilities are calculated on the assumption that they are accepted as reasonable on the basis of actuarial calculations. Fuji Electric and certain domestic consolidated subsidiaries have also entrusted listed marketable securities to employee retirement benefit trusts. Consequently, changes in the discount rate, the expected rate of return on pension assets and stock prices that are used as the basis of computing pension benefit obligations, differences between these expectations and actual performance, changes in the prices of entrusted listed marketable securities and other items, could have a negative impact on the operating results and financial position of the Fuji Electric Group.
(11) Risks related to compliance

The Fuji Electric Group conducts business in a variety of fields and regions throughout the world, and as such is subject to the laws and regulations of numerous countries. The Group has put in place an appropriate internal control system to ensure compliance, but the possibility of legal violations cannot be discounted entirely. Should such a violation occur, this could have a negative impact on the Group’s social credibility and/or operating results.

(12) Risks related to lawsuits and other legal proceedings

The Fuji Electric Group, in the course of its business, could become the subject of a lawsuit or other legal proceeding, and may unexpectedly be liable for the payment of large amounts of compensation. Depending on the content of such a decision, this could have a negative impact on the Group’s operating results.

On February 9, 2007, Fuji Electric Holdings Co., Ltd. and Fuji Electric Systems Co., Ltd. received notice from the European Commission of its decision (dated January 24, 2007) to impose a fine of 2.40 million euros for anti-competitive activities in the European market relating to gas-insulated switchgear. In addition, the Group’s equity-method affiliate (30% equity investment) Japan AE Power Systems Corporation, together with Hitachi, Ltd., has been ordered to pay a fine of 1.35 million euros. After review of the decision, the Fuji Electric Group filed an appeal with the European Court of First Instance on April 19, 2007, on the basis that the facts stated in the decision are inconsistent with those recognized by the Group. The Group will be stating its argument at court.