

## To our Shareholders, Customers and Employees

# Top-Line Growth and Expansion through First-Class Products

I am convinced that winning the long-term trust of customers through rigorous adherence to our philosophy of “creation of value for customers” will spur sustained development of the SHI Group and build enterprise value, meeting the expectations of all our shareholders, employees and host communities. By providing products of a quality that our rivals cannot match, we can build customer satisfaction, and at the same time drive our growth by leveraging the trust that such products generate. My ambition is to transform SHI into a company that always supplies the market with internationally recognized first-class products in all its business categories.

As a result of our commitment to honing market competitiveness and maximizing profitability in the previous medium-term management plan launched in fiscal 2002, nearly all of our businesses are now positioned to generate profits. We aim to build on this success in our current medium-term management plan “Leap to Excellence '07”, launched in fiscal 2005, by shifting focus from bottom-line management to top-line growth, and by achieving stable high growth and expansion as a player in global markets. We have already achieved our initial targets a year ahead of schedule, and have effectively relaunched the current plan with new, more ambitious targets for the final year.

The Group’s fundamental mission is to provide first-class products — meeting our customers’ needs with the highest possible quality levels. If a business is operating in the red, I believe that is because it cannot offer appealing products or services, or satisfy the requirements of its customers. We are passionate about raising quality levels and cutting costs through reform of our manufacturing methods and by strengthening our “key component” businesses and developing new products and markets through business integration. Creating products that brighten the lives of our customers is the key to growing sales and earnings. Even products for industries that in Japan that have matured can find global markets if we look hard enough. I believe supplying first-class products to meet needs wherever they arise in global markets must become the basis of the growth strategy of the Group.



Chairman  
Yoshio Hinoh

President and CEO  
Yoshinobu Nakamura

## Fiscal 2006 in Retrospect

(Summary of the fiscal period April 2006 to March 2007)

Highlights of our business performance in fiscal 2006:

- Earnings increased for the fourth consecutive term
- Operating income and net income all hit record highs
- Orders received and net income hit record highs for the fourth consecutive term
- Interest-bearing debt was cut to ¥88.0 billion
- ROIC\* (after tax) was 12.2%

\* ROIC: Return on Invested Capital

This performance was driven chiefly by growth in our mainstay power transmission equipment markets and improved profitability in our traditional businesses of shipbuilding and heavy machinery, which outweighed weakness in demand from manufacturers of electronic components and optical disks, sectors which have suffered investment cutbacks lately, and slumping public-sector infrastructure investment in Japan. These achievements have brought greater stability to the Group's overall operations, and herald our gradual return to a growth trajectory. In fiscal 2006, we undertook various measures to achieve our targets under the following priority policies.

### Further Strengthening Mainstay Businesses

Creation of first-class products with global competitiveness is the prerequisite for sustainable growth for the Group. In this belief, we aggressively marketed our lineups during the term and invested in development of promising new products. We launched new models in the power transmission, injection molding machine and construction machinery categories. We also pursued vertical integration of our businesses to enable "fusion" of machine types based on our strength in components.

### Growth in Orders Received and Earnings in Heavy Machinery Businesses

Against a background of buoyancy in industries such as shipbuilding, steelmaking, energy technology and automaking, our heavy machinery businesses (material handling systems, turbines and pumps, forging presses) performed well, making a significant contribution to earnings improvement for the whole Group. We made investments to better respond to customer needs, enabling us to maintain improved earnings levels at these businesses.

### Adding Impetus to Overseas Sales

In the power transmission equipment business, we upgraded overseas production bases—for example, by completing a motor manufacturing plant in Vietnam—and strengthened marketing and service centers. In plastic injection molding machines, we likewise built up our business capabilities in overseas markets, by establishing a molding technology center in China and upgrading customer support operations in local markets. These initiatives strengthened our business in overseas markets.

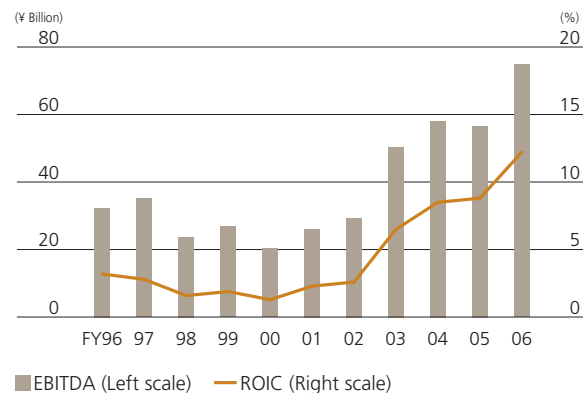
### Improving Human Resources Training

In addition to upgrading our established employee-education programs targeting senior managers and future Group leaders, we expanded such programs geared to nurturing expertise in specific fields, as part of our commitment to fostering the talent we need to create first-class products.

## Introducing Internal Control Systems

We are systematically putting into place new control mechanisms enabling us to meet related obligations under Japan's Corporation Law and the Financial Products Exchange Law, and to address revision and toughening of these new legal requirements, as well as changes in social norms that could affect our operations. We have also deepened our commitment to meeting compliance standards.

### EBITDA/ROIC



\*EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) = Operating income + Depreciation and amortization.

\*ROIC (Return on Invested Capital) =  $\frac{(\text{Operating income} + \text{Interest and dividend received}) \times 55\% (= 1 - \text{Effective tax rate})}{(\text{Average of stockholders' equity} + \text{Average of interest-bearing debt})}$

## Progress in the "Leap to Excellence '07" Medium-Term Management Plan

### The "Leap to Excellence '07" Medium-Term Management Plan (April 2005 to March 2008)

Fiscal 2006 was the middle year in this three-year plan, and as such was an important period for evaluating progress towards its targets. Our achievement of initial targets one year ahead of schedule admittedly owed much to favorable market conditions, but I am confident that the commitment of every single one of the Group's employees played a significant role. "Leap to Excellence '07" was intended to harness the collective expertise of Group employees, not just the special talents of certain individuals, and, as such, our goal was transformation into a knowledge-intensive company that systematically provides its customers with first-class products. First-class products means products that brighten our customers' lives and which cannot be rivaled by other companies. If our customers are pleased by our products, that means there will be a market for them somewhere. Our quest is better product quality, not greater market scale. Greater scale can only come from better product quality. This is the thinking that drives our earnings growth and business expansion.

## Targets "Leap to Excellence '07" Medium-Term Management Plan

- Transformation into a knowledge-intensive company that systematically provides its customers with first-class products: launch new core products
- A business model based on vertical integration: fusion of PTC (power transmission & controls) and mechatronics businesses
- Expand and strengthen key component businesses

### Numerical Targets (fiscal year ending March 31, 2008)

ROIC (after tax):	10%
Operating income:	¥60 billion
Interest-bearing debt:	¥150 billion

Progress in  
fiscal 2006:

### Achievement of targets for ROIC, operating income and interest-bearing debt one year ahead of schedule

ROIC:	12.2%
Operating income:	¥64.2 billion
Interest-bearing debt:	¥88.0 billion

## Our Core Product Lineups

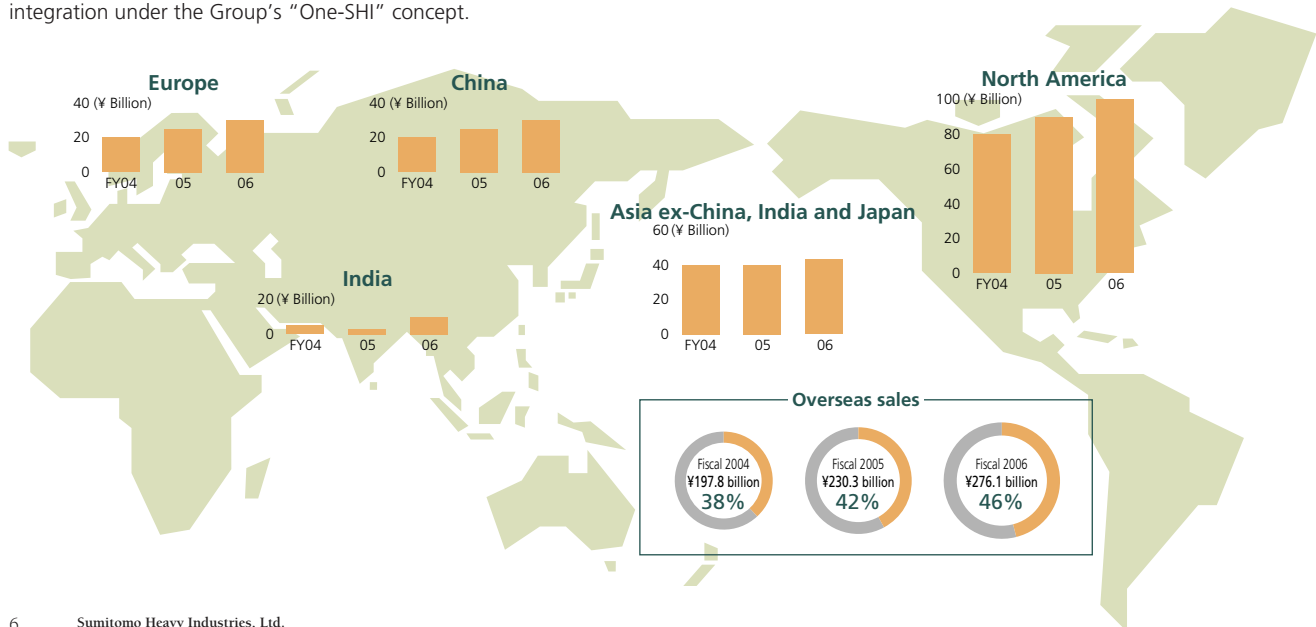
Each of our businesses nominates and aggressively markets established the core products that drive the growth of the Company, and also develops new products. This policy has strengthened our product appeal—a case in point being our speed reducers for robot applications in our power transmission equipment business. By simultaneously fusing this innovative product with our precision control technologies, we have built up a business in motion control drives. In our injection molding machines business, in addition to supplying automotive manufacturers, we have launched ultra high-speed injection molding machines for the IT sector. In precision machinery, we expanded overseas sales of our cyclotron for Positron Emission Tomography (PET), and launched a cryopump for next-generation semiconductor manufacturing devices.

In the Industrial machinery segment, we have marketed industrial steam turbines in overseas markets to meet increased demand for power-generation facilities using biomass, while in construction machinery, we launched new products compatible with the third tier exhaust emission standards recently issued in Japan to correspond to Western standards. As we continue to enhance the appeal of our products and aggressively penetrate new overseas markets, building up a synergistic value chain for our products, we are steadily realizing our ambition of vertical integration under the Group's "One-SHI" concept.



## Strengthening Overseas Businesses and Alliances

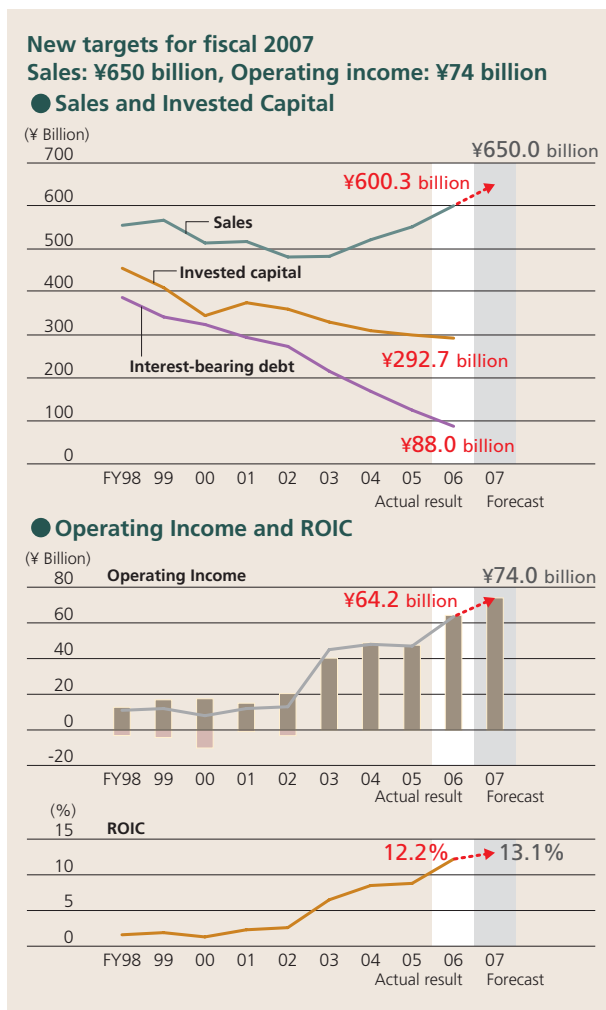
We are strengthening our networks of overseas sales and service centers, and ramping up production capacity in China, Vietnam and elsewhere. In Vietnam, we began operations in May at our PTC motor plant, and are now positioned to provide stable supplies to all our production bases around the world. We also set up a new plastic molding technology development center in Shanghai, enabling us to support our customers more effectively. The overseas proportion of total sales is steadily growing, and we expect this trend is to accelerate going forward.



## Building on our Momentum and Aiming still Higher

### Plan for fiscal 2007 (April 2007 to March 2008)

An enterprise never stops growing or expanding. At the SHI Group, we are setting ever-higher targets in an effort to transform ourselves into a company known globally for excellence, while creating peerless technologies and a resilient cost structure. In fiscal 2006, we beat all our initial forecasts, enabling us to meet all the initial targets in the "Leap to Excellence '07" medium-term management plan. Ahead of the next medium-term management plan, we have set a new sales target for fiscal 2007 of ¥650 billion, and an operating income target of ¥74 billion.

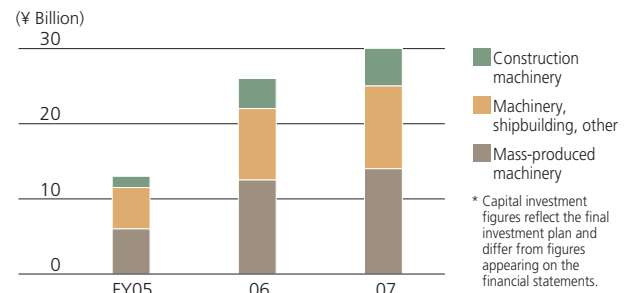


Although the outlook for our markets remains robust, we face a range of challenges such as global business expansion, cutting costs through innovative production, and further raising product appeal. We are carefully watching trends in our markets, and bringing to bear all Group capabilities as we prepare ourselves for our next great advance.

We are also aggressively investing in capital facilities on the back of our strong cash flow position. We are vigorously increasing our scale of operations and cutting costs by upgrading overseas business bases and raising production capacity.

To enable the Group to meet its social responsibilities, we continue to strengthen our risk management and ensure that all employees in all of our operations are fully aware of compliance requirements. We are also putting in place mechanisms for administering and evaluating internal control systems affecting our financial statements. In environmental initiatives, we are continuing our Companywide commitment to reducing usage volumes for electricity and paper as a measure to combat global warming, and are adopting "green" logistics to streamline transportation operations.

### ● Capital Investment



In line with the Group's environmental policy, we are taking care to minimize the impact of our activities on the areas around our plants, and aggressively taking measures to prevent environmental pollution, reduce generation of waste, and promote energy-saving, resource-saving and recycling.

We have declared a dividend for the year of ¥7 per share, a ¥2 increase from fiscal 2005. We plan to pay a dividend of ¥10 per share in fiscal 2007, subject to our earnings performance and financial position.

We would like to thank our shareholders for their continued support.

Finally, we regret to announce that the Company was deemed by one of Japan's high courts to have violated Japan's Antitrust Law with regard to construction of a steel-structure bridge and municipal organic waste treatment recycling facilities. As a result, we have been ordered to pay a fine of ¥160 million by Japan's Fair Trade Commission in relation to construction of the municipal organic waste treatment recycling facilities and sluices. We take this matter very seriously, and will make every effort to renew our commitment to compliance requirements and ensure that this kind of incident does not recur.

Chairman

Yoshio Hinoh

President and CEO

A. Nakamura