

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## SCOPE OF CONSOLIDATION

In fiscal 2006, ended December 31, 2006, three subsidiary companies and one equity-method affiliate were newly included in Sumitomo Rubber Industries, Ltd. and its consolidated subsidiaries' scope of consolidation, while 17 subsidiary companies were excluded. One of the three newly included subsidiary companies is regarded as being under the substantive control of Sumitomo Rubber Industries due to the transfer of directors. The remaining two are a tire sales subsidiary in Thailand and a production subsidiary making precision rubber parts for office automation equipment in Vietnam, both of which were established in 2006. The exclusion of the 17 subsidiaries was due to the sale of the Europe-based Oniris S.A.S. Group, which is engaged in the bed business; the liquidation of overseas subsidiaries involved in the LCD backlights business; and the merger of domestic sports sales subsidiaries.

## BUSINESS ENVIRONMENT

During fiscal 2006, although consumer spending was weak, growing exports and corporate capital investment contributed to the robust Japanese economy. Overseas, the U.S. and European economies remained strong and, led by China, Asian markets continued to enjoy high growth rates.

The Group's core Tire business recorded stagnant sales in the domestic replacement market due to unusual weather patterns. In contrast, the original equipment market saw favorable sales owing to year-on-year growth in domestic automobile production on the back of increased exports. In the Middle East and Latin America, solid sales were recorded thanks to the Group's aggressive sales promotion activities tailored to individual market characteristics. The earnings environment was harsh, however, due to record-high prices for natural rubber and petroleum-based materials.

## NET SALES

In fiscal 2006, consolidated net sales rose 4.1% compared with the previous fiscal year to ¥534,086 million. In the Group's mainstay Tire business, sales grew mainly in the overseas replacement market.

In addition, sales in the domestic original equipment market surpassed those of the previous fiscal year, owing to the efficient supply of products that address each automaker's needs. As a result, sales in the Tire business rose 8.1% year on year to ¥430,620 million. Sales in the Sports business grew 5.3% to ¥57,649 million, reflecting the release of the ALL NEW XXIO series, the remodeling of the hit XXIO golf brand, strong sales of new SRIXON brand products for competition use and robust sales in overseas markets. In the Industrial and Other Products business, the Group enjoyed strong sales of precision rubber parts for office automation equipment, anti-vibration equipment that utilizes high damping rubber and products for civil engineering and marine facility applications. Despite these favorable results, overall sales in this business dropped approximately ¥17,000 million due to the withdrawal from the European bed and LCD backlights businesses. Accordingly, sales in the Industrial and Other Products business declined 23.5% year on year to ¥45,817 million.

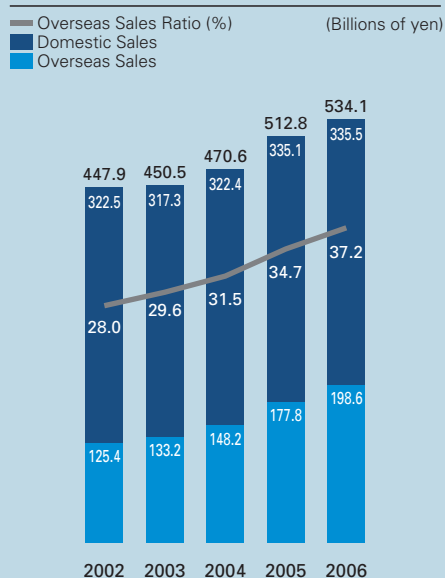
Overseas sales increased 11.7% to ¥198,622 million and the overseas sales ratio was up 2.5 percentage points to 37.2%. In North America, the Group's tire and sports goods sales subsidiaries reported increases. In Europe, however, revenues declined due to the sale of the Group's bed business. In Asia, sales grew on the back of a China-based tire production subsidiary's expansion of its production capacity.

## EARNINGS

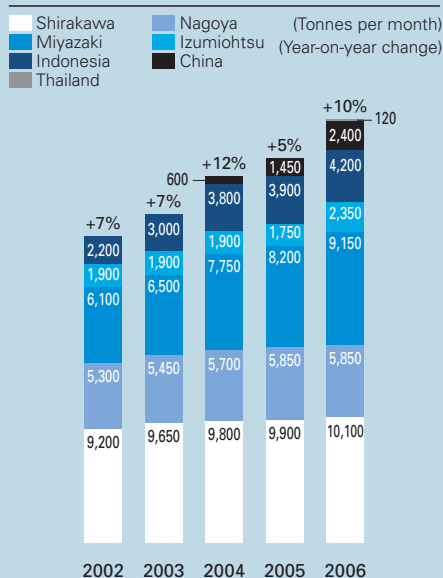
During the fiscal year under review, consolidated operating income decreased 26.3% to ¥36,790 million and the operating income ratio was down 2.8 percentage points year on year to 6.9%.

The Sumitomo Rubber Group's core Tire business faced record-high prices for natural rubber and petroleum-based materials in fiscal 2006. Natural rubber prices jumped approximately 50% from the previous fiscal year while those of such petroleum-based materials as synthetic rubber rose about 20%. The overall hike in raw materials prices contributed to a decline of approximately ¥293,000 million in Group profit. To counter the effects of these negative factors, the Group continued to work to contain costs while passing on a portion of the sharp increase in raw material prices to customers. Thus far,

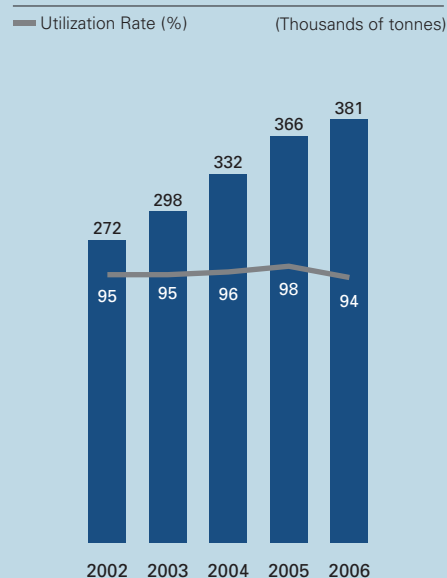
## DOMESTIC AND OVERSEAS SALES



## TIRE PRODUCTION CAPACITY



## TIRE PRODUCTION VOLUME



however, our efforts have not been far-reaching enough. As a result, operating income in the Tire business fell 33.6% from the previous fiscal year to ¥26,381 million.

The Sports business was also affected by the sharp raw material price increases, including for titanium and carbon fiber, with operating income declining 10.1% to ¥7,469 million. In contrast, in the Industrial and Other Products business, operating income surged 74.4% to ¥2,907 million due to higher sales of precision rubber parts for office automation equipment.

Net other income (expenses) went from an expense of ¥5,663 million in fiscal 2005 to income of ¥5,093 million in the year under review. Major expenses included a ¥3,557 million loss on asset impairment and ¥2,970 million in interest expenses. Equity in earnings of unconsolidated subsidiaries and affiliates leaped from ¥4,825 million in the previous fiscal year to ¥7,118 million due to a reversal of the reserve for income taxes that resulted in a significant increase in profits from European joint ventures established with The Goodyear Tire & Rubber Company. In addition, the Group recorded a ¥6,069 million gain on sales of investments in subsidiaries along with the public listing of its subsidiary in the Sports business, SRI Sports Limited.

Reflecting these factors, income before income taxes and minority interests declined 5.4% year on year to ¥41,883 million. Income taxes were also down, falling 23.0% to ¥13,522 million and representing an effective tax rate of 32.3%, a drop of 7.4 percentage points. As a result, net income rose 7.6% to ¥27,586 million, marking the fifth consecutive year of record profit.

Net income per share was ¥105.13, and ROE (net income base) fell 1.3 percentage points to 14.7%.

## R&D EXPENSES

Research and development expenses climbed 6.3% year on year to ¥17,291 million, representing 3.2% of consolidated net sales. The Tire business accounted for ¥14,215 million of these expenses, up 8.0% from the previous fiscal year, the Sports business ¥1,391 million, down 7.8%, and the Industrial and Other Products business ¥1,684 million, up 5.7%.

## DIVIDENDS

Sumitomo Rubber Industries, Ltd. recognizes the return of gains to shareholders as a priority issue. While comprehensively assessing the standards for dividend payout ratios on a consolidated basis as well as performance prospects and retained earnings, the Group has adopted a basic policy of steadily rewarding shareholders over the long term. To that end, the Company has decided to distribute retained earnings twice a year as dividends. The amount of the year-end dividend payment is resolved by the General Shareholders' meetings and that for the interim dividend payment by the Board of Directors.

The full-year dividend for fiscal 2006 was ¥20.00 per share, an amount equal to that of the previous fiscal year. The dividend payout ratio on a consolidated basis was 19.0%.

## FINANCIAL POSITION

Total assets as of December 31, 2006, were up 7.7% year on year to ¥606,938 million.

Total current assets climbed 8.8% to ¥245,019 million, reflecting the increase in inventories caused by higher sales.

Total investments and other assets rose 7.0% to ¥145,096 million. This was largely due to an increase in investments in securities that reflected the application of the equity method and growth in prepaid pension cost.

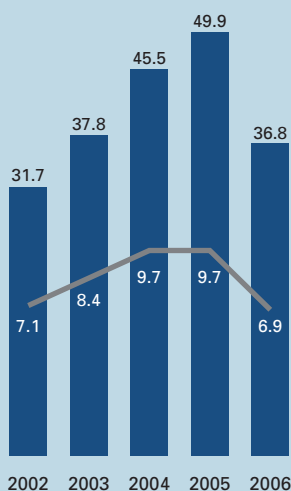
Total property, plant and equipment expanded 7.0% year on year to ¥216,823 million due to a rise in buildings and structures as well as machinery and equipment in connection with capital expenditures aimed at increasing production.

As of the end of the fiscal year under review, total liabilities were up ¥2,667 million. Current liabilities declined 5.3% to ¥203,018 million while long-term liabilities grew 8.5% to ¥180,068 million. Interest-bearing debt as of fiscal 2006 year-end increased ¥13,621 million compared with the previous fiscal year-end to ¥219,372 million.

Total net assets at the fiscal year-end stood at ¥223,852 million and net assets per share were ¥769.86. From fiscal 2006, Sumitomo Rubber Industries has adopted a new accounting standard regarding the presentation of net assets in the balance sheet whereby minority

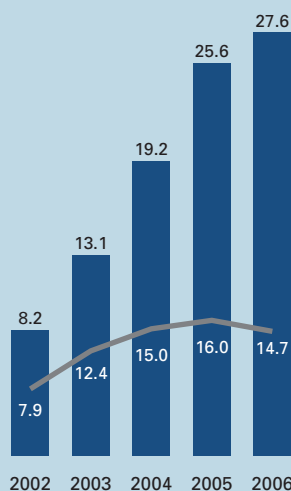
### OPERATING INCOME

Operating Income Ratio (%) (Billions of yen)



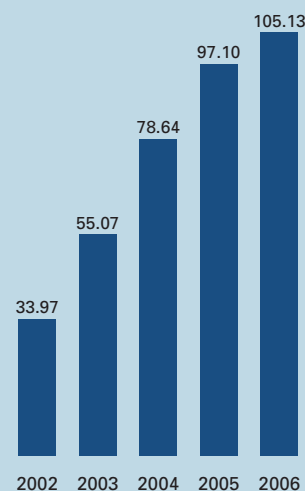
### NET INCOME

ROE (%) (Billions of yen)



### NET INCOME PER SHARE

(Yen)



interests in consolidated subsidiaries are included in net assets.

The ratio of equity (net assets minus minority interests in consolidated subsidiaries) to total assets at the end of fiscal 2006 rose 2.4 percentage points to 33.3%. ROA (operating income base) decreased 2.9 percentage points to 6.3%, and the debt-to-equity ratio improved by 0.1 of a point from a year earlier to 1.1 times.

### CAPITAL EXPENDITURES

During the fiscal year under review, Sumitomo Rubber Industries made capital expenditures totaling ¥45,308 million, focusing mainly on the Tire business. This represented a 12.1% increase from the previous fiscal year. The Tire business accounted for ¥42,253 million in expenditures used for facility renovation aimed at boosting production through streamlining and the improvement of labor efficiency. The Sports business used ¥1,199 million for the improvement of golf ball production efficiency at SRI Sports Limited and the Industrial and Other Products business employed ¥1,854 million to improve production facilities for precision rubber parts for office automation equipment at SRI Hybrid Limited. The necessary funds were furnished by a combination of cash on hand and borrowings. In the fiscal year ending December 31, 2007, the Company plans to make ¥49,500 million in capital expenditures, primarily for the upgrading of tire factories in Thailand and China.

### CASH FLOWS

Net cash provided by operating activities declined 38.8% from the previous fiscal year to ¥23,872 million, with outflows mainly comprising an increase in inventories, equity in earnings of unconsolidated subsidiaries and affiliates, a gain on sales of investments in subsidiaries and an increase in prepaid pension costs, net of payment.

Net cash used in investing activities fell 20.9% to ¥33,923 million. Although capital expenditures increased, reflecting efforts to increase production, overall outflows declined, owing to proceeds from sales of investment in a consolidated subsidiary associated with the listing of SRI Sports Limited.

Free cash flow (net cash provided by operating activities less net cash used in investing activities) was a negative ¥10,051 million. This

was attributable to the aforementioned increase in capital expenditures aimed at increasing production and a rise in working capital.

Net cash provided by financing activities grew from being a payout of ¥3,376 million in the previous fiscal year to a revenue source of ¥14,687 million in fiscal 2006. Primary sources of revenue were proceeds from long-term debt and newly issued bonds of ¥31,503 million. Major outflows included the net repayment of ¥15,733 million of interest-bearing debt and dividends paid totaling ¥6,035 million.

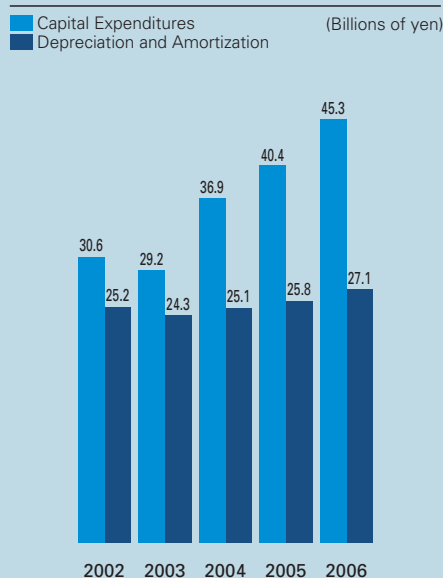
Due to these activities and the effect of exchange rate changes in cash and cash equivalents as well as changes in the scope of consolidation and reporting entities, cash and cash equivalents at the end of the fiscal year surged 41.5% to ¥18,152 million.

The Sumitomo Rubber Group will continue to adhere to a high standard of capital investment for the purpose of accomplishing the Medium-Term Management Plan for Fiscal 2006–2008. In addition, the Group will make every effort to both ensure business growth and secure cash fluidity as well as to enhance its financial standing. This will be carried out through measures aimed at expanding the inflow of cash from operating activities by increasing sales volumes and improving profitability.

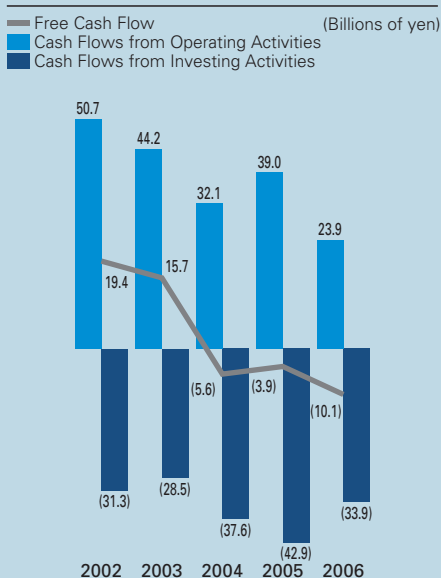
### OUTLOOK

In the fiscal year ending December 31, 2007, the domestic economy is expected to grow steadily. Forecasts for North America and Europe, however, are for sluggish conditions and growth in Asian economies will possibly decelerate, thus, the business prospects can hardly be called rosy. The Sumitomo Rubber Group is anticipating a harsh business environment in the wake of price hikes in its main raw materials, including natural and synthetic rubbers. Against this backdrop, the Group is accelerating its overall cost reduction measures while implementing sales price adjustments in response to spiraling raw materials costs. In the course of doing so, the Group is implementing a variety of measures aimed at improving profitability and reversing profit declines. In addition, the Group will make across-the-board efforts to tackle medium- and long-term issues as it works to increase enterprise value for all the stakeholders, including customers and shareholders.

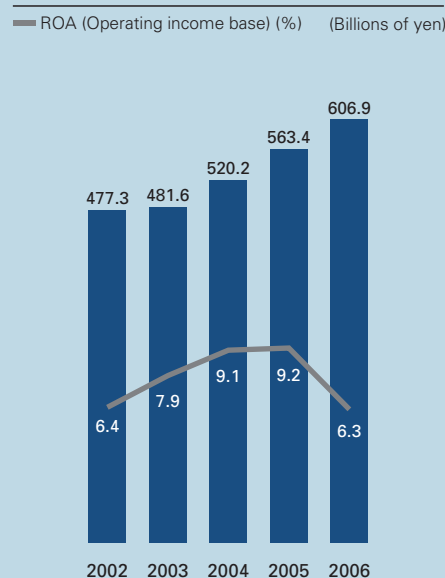
#### CAPITAL EXPENDITURES/DEPRECIATION AND AMORTIZATION



#### CASH FLOWS



#### TOTAL ASSETS



## RISK INFORMATION

The Sumitomo Rubber Group has identified the following key risk factors that it considers may impact business performance and financial position.

Risk factors relating to the future were determined based on information available to management as of the end of the fiscal year under review. The Group recognizes that such risks may occur and strives to address them accordingly.

### Exchange Rate Fluctuations

Exchange rate fluctuations impact the value of the Group's exports, raw materials, foreign currency-denominated assets, liabilities and financial statements. The appreciation of the yen against foreign currencies such as the U.S. dollar may have an adverse effect on the Group's business performance and financial position. Since the Group has raised its consolidated overseas sales ratio from 25.2% in fiscal 2001 to 37.2% in fiscal 2006, the possibility exists that its results may be further affected by exchange rate fluctuation. The Sumitomo Rubber Group utilizes forward-exchange contracts and maintains a balance in its export and import activities on an individual currency basis with the aim of minimizing its exposure to exchange rate fluctuation. Such precautions, however, may not be sufficient to avoid all possible exchange rate fluctuation risks.

### Changes in Raw Material Prices

The Sumitomo Rubber Group's principal raw materials are natural rubber, petrochemicals and metals. The Group's operating results may thus be affected by price increases in natural rubber, crude oil, steel and other related materials.

### Changes in Interest Rates

Promoting the reduction of interest-bearing debt to improve its financial standing, the Group also implements countermeasures to minimize the risk of changes in interest rates such as diversified financing methods and interest rate swaps. Despite these efforts, the Group's operating results and financial position may be affected in the event of rising fund procurement costs due to an increase in interest rates in the medium and long term.

## Product Quality

In accordance with prescribed quality standards, the Sumitomo Rubber Group undertakes full-scale measures to assure product quality. Yet it is difficult to reduce the number of defective products and customer complaints to zero. To offset the possibility of any claims for damages resulting from defective products, the Group retains appropriate casualty insurance. Despite this initiative, there is the possibility that a claim may occur that cannot be compensated by insurance. Furthermore, costs may arise associated with the resolution of claims as well as product recalls or exchanges. Such incidences may affect the Group's operating results, financial position and social standing.

## Alliance with Goodyear

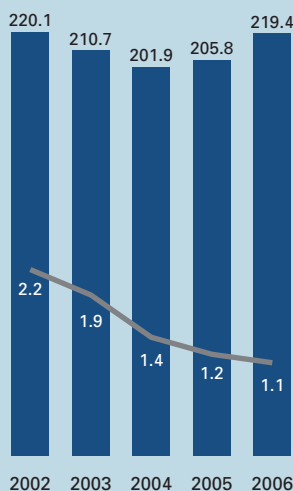
Based on its alliance with The Goodyear Tire & Rubber Company (Goodyear), the Group operates several joint ventures. Under the alliance, these joint ventures engage in tire production and sales in Europe and North America and tire sales in Japan as well as the promotion of tire technology exchanges and procurement. The Group also maintains cross-shareholdings with Goodyear. As each joint venture is included in the Group's scope of consolidation as either a consolidated subsidiary or an equity-method affiliate, changes in the alliance with Goodyear or the operating results of joint ventures may impact the Group's operating results.

## Disasters

Centering on Japan and other Asian countries, the Sumitomo Rubber Group develops its business on a global scale. The Group's operating results may be affected directly or indirectly by such events as natural disasters, disease, war and terrorism. Such events may have a negative impact on the Group's operating results.

## INTEREST-BEARING DEBT

— Debt-to-Equity Ratio (Times) (Billions of yen)



## EQUITY RATIO

(%)

