

ANNUAL REPORT 2017

For the year ended December 31, 2017



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Message from CEO

Performance for 2017

Consolidated performance for the period ending December 31, 2017 demonstrated favorable shifts for each business area, with net sales increasing by 18.1% year-on-year to 94 billion 661 million yen, and operating income increasing by 28.0% year-on-year to 11 billion 495 million yen and net income attributable to owners of parent is up 35.8% to 8 billion 167 million yen. These results show there has been an increase in both income and earnings, and we have set new records at each profit level.

The Group considers the most important issue to be achieving the targets laid out in the “Challenge to change” Medium-Term Management Plan that runs for the three years from fiscal 2016 to fiscal 2018, so as to enhance corporate value. The Group has steadily implemented the three basic policies of “Globally expand performance chemical sales,” “Enhance profitability of basic chemicals” and “Establish a base for the future,” which includes the expansion of production bases overseas and the development of new products, laid out in the Plan. While maintaining the Basic Chemicals field as a stable source of earnings, the Group will allocate management resources in a concentrated fashion to the Performance Materials field, where future growth can be expected, thus promoting the transformation to a business structure that allows it to secure high earnings consistently.

Fiscal 2018 is set to be a critical year for the completion of the Medium-Term Management Plan currently under way, and is also an important year for putting into effect our evolution to a new stage of development. The following four business activities, on which the Group is actively working, are considered to be the highest priority for fiscal 2018.

Firm in our belief that compliance is the basis to all things, KH Neochem Group will continue offering our customers throughout the world a stable supply of wide-ranging, high-quality, high-added-value products that are gentle on global environment and people in order to contribute to the abundant lifestyle of all.



President & Chief Executive Officer

Priority issues for 2018

Implement various measures aimed at raising profitability

- ▶ Promote an adequate pricing policy in response to changes in external circumstances.
- ▶ Move forward with measures to enhance the efficiency of management resources and carry out thoroughgoing cost-cutting measures.

Enhancing production capability of Performance Materials

- ▶ Construct new manufacturing facilities for refrigerant lubricants raw materials, which contribute to the protection of the global environment.
- ▶ Enhance capacities of existing facilities in order to deal with rapidly expanding demand.

Establish overseas production bases in preparation for the future

- ▶ Move forward steadily with preparations for beginning construction of a new plant for plasticizer raw materials in Taiwan.

Strengthen the production platform in order to consistently supply high-quality products

- ▶ Actively work on preventive measures to strengthen our future business platform, in addition to the usual periodic maintenance.
- ▶ Use the opportunity afforded by periodic maintenance to transmit technology to the next generation and to nurture human resources.

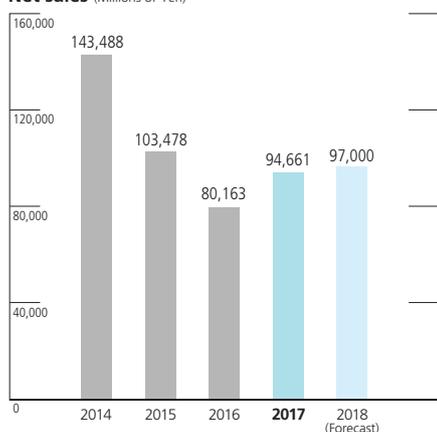


Financial Highlights

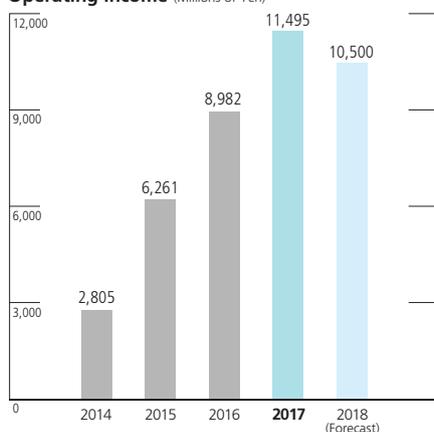
	Millions of Yen				Thousands of U.S. Dollars
	2014	2015	2016	2017	2017
For the year					
Net sales	¥ 143,488	¥ 103,478	¥ 80,163	¥ 94,661	\$ 837,339
Operating income	2,805	6,261	8,982	11,495	101,681
Net income attributable to owners of parent	2,604	7,712	6,013	8,167	72,243
Comprehensive income	2,311	7,239	5,878	8,903	78,759
At year-end					
Total equity	¥ 25,389	¥ 20,785	¥ 28,112	¥ 34,512	\$ 305,280
Total assets	106,746	85,831	87,674	95,247	842,528
Per share (Yen/U.S. dollar)					
Net assets per share (BPS)	¥ 657	¥ 517	¥ 672	¥ 842	\$ 7.45
Net income per share (EPS)	77	227	174	222	1.96
Financial ratios					
Shareholders' equity ratio	21%	21%	28%	33%	
ROE	12%	39%	28%	29%	
PER (Times)			7	13	
Cash flows					
Cash flows from operating activities	¥ 11,680	¥ 6,028	¥ 2,681	¥ 12,971	\$ 114,744
Cash flows from investing activities	(4,470)	1,434	(3,791)	(3,281)	(29,027)
Cash flows from financing activities	(7,254)	(9,659)	(1,373)	(9,338)	(82,602)
Cash and cash equivalents at end of period	16,714	14,636	12,135	12,666	112,043
Interest-bearing debt net, Capital expenditures and depreciation and amortization					
Interest-bearing debt		¥ 34,050	¥ 31,300	¥ 24,730	\$ 218,752
Capital expenditures		2,461	2,350	1,637	14,486
Depreciation and amortization		4,012	3,495	3,382	29,924

Note: The U.S. dollar amounts are translated from Japanese yen at the rate of ¥113.05 = U.S.\$1, the prevailing exchange rate at December 31, 2017.

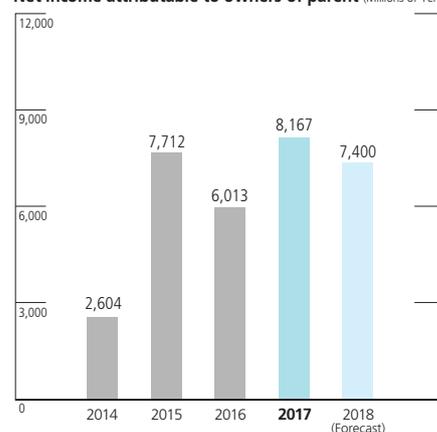
Net sales (Millions of Yen)



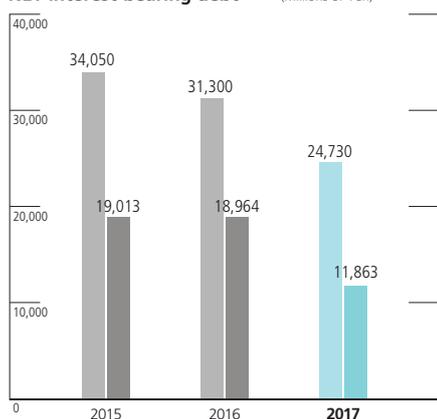
Operating income (Millions of Yen)



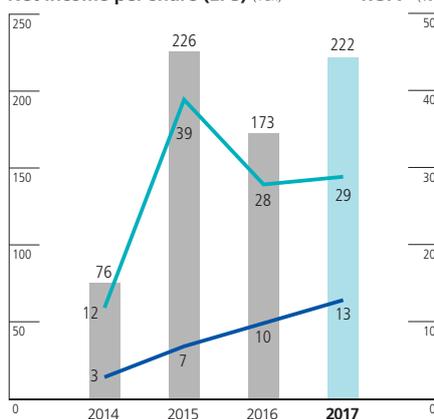
Net income attributable to owners of parent (Millions of Yen)



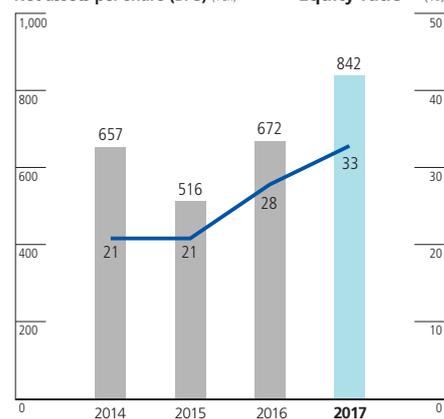
Interest-bearing debt (Millions of Yen)
NET interest-bearing debt (Millions of Yen)



Net income per share (EPS) (Yen)



Net assets per share (BPS) (Yen)



Management's Discussion and Analysis

Status of business operations for the current fiscal year

(i) Business progress and results

During the consolidated fiscal year under review, the tone of the Japanese economy was one of improvement, aided by a moderate recovery in the global economy that resulted in an expansion in exports, industrial production and capital investments, and by an improving trend in personal consumption triggered by firm conditions for employment and income. Also, towards the end of the year, due to rising expectations for further improvements in corporate earnings as a result of tax reforms in the U.S. and so on, a sense of optimism emerged in relation to business conditions going forward, and although concerns remain about the impact on various economies of the political situation in Europe and North America and about other geopolitical risks, there was an easing of the sense of uncertainty regarding the future.

The environment in which the chemical industry operates has been favorable, with demand for chemical products expanding steadily in the Asian market, and the impact of environmental regulations in China leading to restrictions primarily in the supply of basic chemicals, which has caused a tightening of the supply-demand balance and an improvement in market conditions etc. Meanwhile, towards the end of the year, following rises in the price of oil and naphtha, there was also a trend towards higher raw material prices. In addition, due to worldwide environmental restrictions on refrigerants there has been a movement towards using environmentally conscious refrigerants even in China and other emerging

nations, leading to growing demand for refrigeration lubricants that are compatible with such refrigerants.

It is against this background that the Group has steadily implemented an array of measures in accordance with the basic policies outlined in the Medium-Term Management Plan, namely "Globally expand performance chemical sales," "Enhance profitability of basic chemicals" and "Establish a base for the future." The Group also actively worked to strengthen its corporate governance and to further enhance its Corporate Social Responsibility (CSR) activities.

With regard to growth in the business, demand was favorable both in Japan and overseas, performance materials such as refrigerant lubricants raw materials expanded, and there was no large-scale periodic maintenance work in the consolidated fiscal year under review, which led to an increase in sales volumes. In addition, the Group managed to secure profit margins in overseas market conditions for basic chemicals as a result of a better supply-demand balance. The net effect of the above was that both net sales and profits grew compared to the previous fiscal year.

As a result, the Group's results for the current fiscal year included net sales of ¥94,661 million (up 18.1% year on year), operating income of ¥11,495 million (up 28.0% year on year), and net income attributable to owners of parent of ¥8,167 million (up 35.8% year on year), all hitting a record high.

Consolidated net sales	Consolidated operating income	Net income attributable to owners of parent
¥94,661 million	¥11,495 million	¥8,167 million
(Up 18.1% year on year)	(Up 28.0% year on year)	(Up 35.8% year on year)

Note: For the amounts shown in this part, figures less than one unit are rounded down.

Management's Discussion and Analysis

Results by business field are as follows.

Basic Chemicals

Net sales

¥45,637 million

(Up 19.2% year on year)

Gross profit

¥6,835 million

(Up 17.6% year on year)

As a result of factors such as rising demand both in Japan and overseas stemming from rising automotive production, the improvement in Asian market conditions caused by environmental regulations in China, and the small-scale periodic maintenance that is carried out every other year, both sales volumes and profits in Basic Chemicals surpassed those of the previous consolidated fiscal year, with net sales reaching ¥45,637 million (up 19.2% year on year) and gross profit coming in at ¥6,835 million (up 17.6% year on year).



Performance Materials

Net sales

¥37,300 million

(Up 23.0% year on year)

Gross profit

¥12,388 million

(Up 43.1% year on year)

Due to expanding demand, primarily in China, for refrigerant lubricants raw materials used in air conditioners and for raw materials for cosmetics, sales volumes and profits for Performance Materials both significantly exceeded those of the previous consolidated fiscal year, with net sales reaching ¥37,300 (up 23% year on year) and gross profit hitting ¥12,388 million (up 43.1% year on year).

Electronic Materials

Net sales

¥11,012 million

(Up 12.7% year on year)

Gross profit

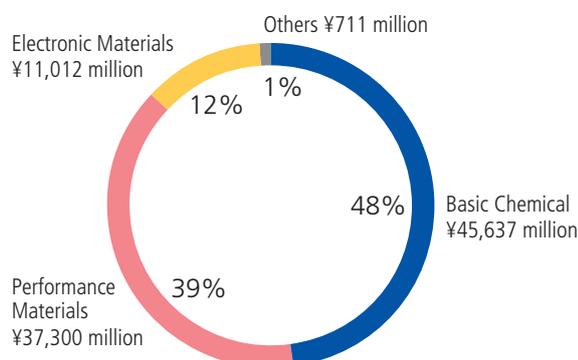
¥3,179 million

(Up 3.5% year on year)

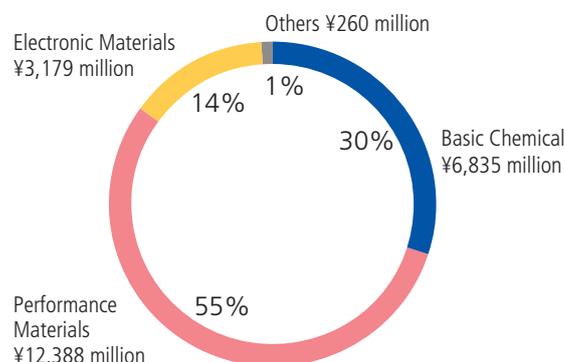
As a result of factors such as rising demand both in Japan and overseas stemming from increases in semiconductor and display production, and the small-scale periodic maintenance that is carried out every other year, both sales volumes and profits in Electronic Materials overtook those of the previous consolidated fiscal year, with net sales reaching ¥11,012 million (up 12.7% year on year) and gross profit reaching ¥3,179 million (up 3.5% year on year).



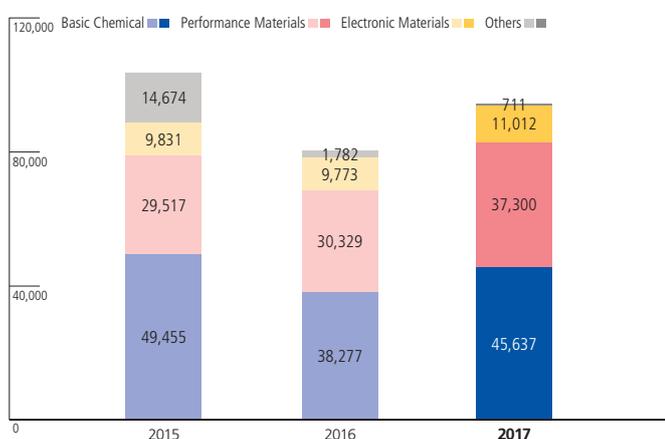
Net sales by business field



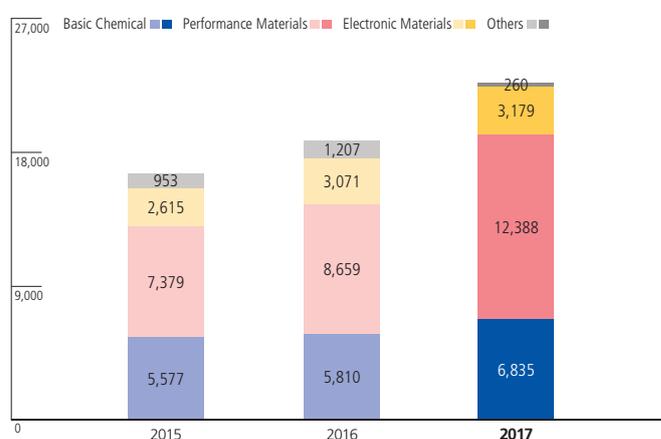
Gross profit by business field



Business fields (Net sales) (Millions of Yen)



Business fields (Gross profit) (Millions of Yen)



(ii) Capital investments

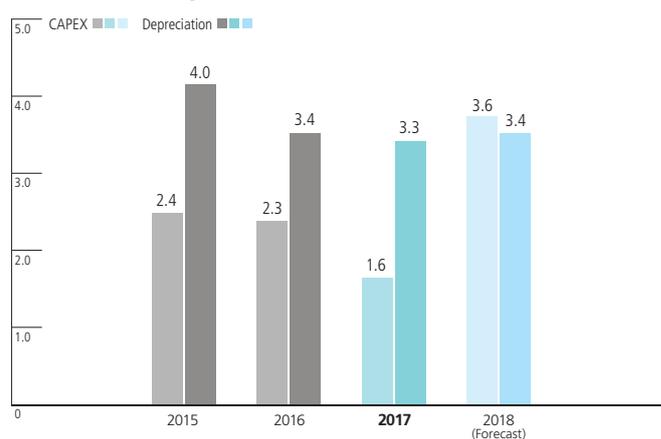
Total capital investments for the Group in the consolidated fiscal year under review were ¥1,637 million, and were focused on maintenance and upgrades for existing facilities.

The main component of the investment plan decided by the Group for the consolidated fiscal year under review consisted of expansions to the production facilities for refrigerant lubricants raw materials at the Yokkaichi Plant.

(iii) Financing

The Group raises funds through loans from financial institutions and through issuance of commercial paper. Also, during the consolidated fiscal year under review, the Group raised funds by concluding loan agreements totaling ¥27,800 million with financial institutions for the purpose of refinancing existing loans.

CAPEX and Depreciation (Billions of Yen)



KH Neochem's Main Products

Basic chemicals

Supporting the world's industries with a breadth of product lineup and solid quality

Solvents (coatings, inks, adhesives, etc.)

We provide a wide range of solvents of many different types for dissolving materials according to their uses. KH Neochem products are used in many different applications encountered in everyday life, including coating, printing, bonding, and other functions for buildings, motor vehicles, food packaging materials, and so on.

Plasticizer raw materials

Plasticizers are additives that give flexibility to materials and improve their workability. They are essential for plastic products. Oxalcohols from KH Neochem are used as raw materials for these plasticizers.

Detergents

These are high-performance and highly safe industrial detergents that do not damage the ozone layer because they are free of chlorofluorocarbons and chlorine. They are used to clean automobile parts, optical parts, and so on.

PRODUCTS	Butyl alcohol Butyl acetate and many more	2-Ethyl hexyl alcohol Oxocol 900 (Isononyl alcohol)	Kyowasol series
FEATURES			Ozone layer protection High safety

Performance materials Performance chemicals

Unique high-performance materials are friendly to people and the environment

Lubricant ingredients

The compressor units (outdoor units) of environmentally friendly air conditioners use special lubricants. Our products are used worldwide as the ingredients for these kinds of lubricant.

Cosmetic ingredients

The 1,3-Butylene glycol manufactured using our technology has a high level of quality that makes customers value it highly as a ingredient for cosmetics and other such products.

Ingredients for water-based coatings

DAAM is highly valued on the market as an epoch-making ingredient that achieves a balance between the reduction of volatile organic carbons (VOC) by shifting to water-based coatings and the formation of durable coating films.

PRODUCTS	2-Ethyl hexanoic acid KYOWANOIC-N (Isononanoic acid)	1,3-Butylene glycol	DAAM (Diacetone acrylamide)
FEATURES	Ozone layer protection Global warming mitigation	High moisture retention Antibacterial Low irritation	Low VOC

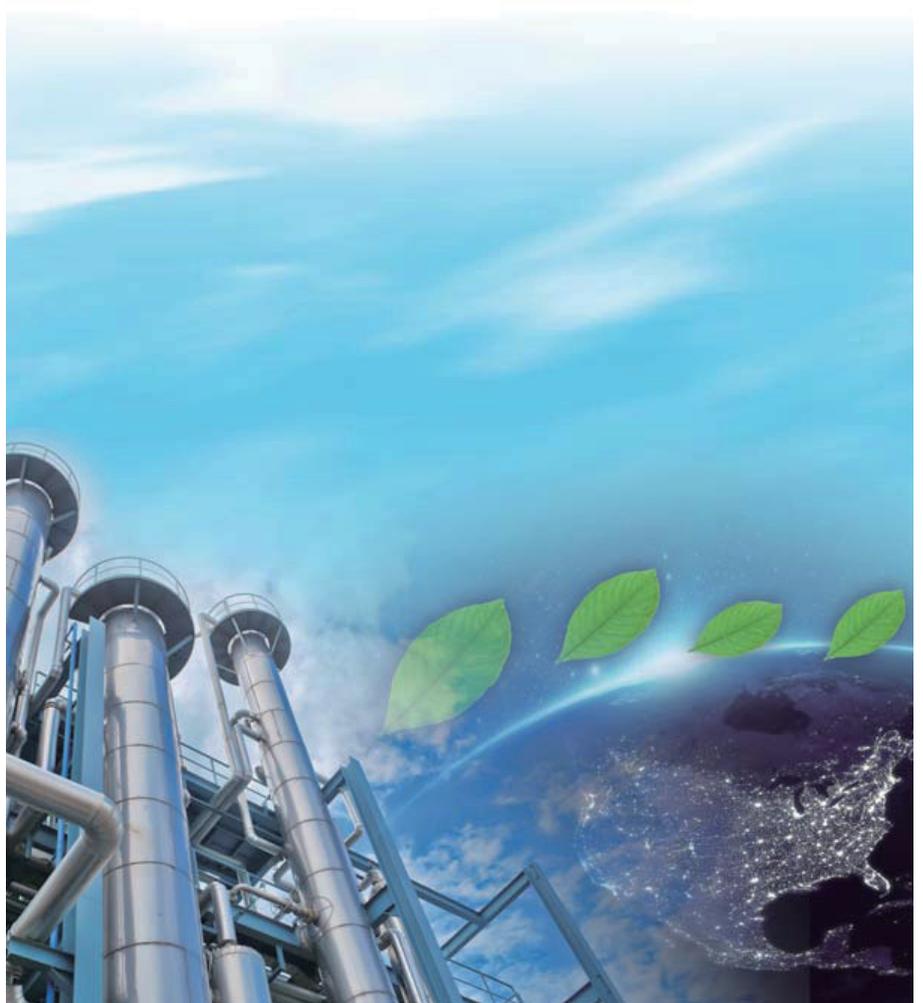
Electronic materials Performance chemicals

High-purity solvents (for semiconductors, liquid crystal display)

High-purity solvents are needed in manufacturing processes for semiconductors used in computer CPUs and memory, as well as for displays. In this sector, we make good use of the high purification technology and quality control technology cultivated over many years at KH Neochem to provide products of exceptionally high purity.

Contributing to the evolution of electronics with outstanding high purification technology

PRODUCTS	PMA-P (Propylene glycol monomethyl ether acetate-P) PM-P (Propylene glycol monomethyl ether-P)
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Consolidated Balance Sheets

	Millions of Yen		Thousands of U.S. Dollars
	As of December 31, 2017	As of December 31, 2016	As of December 31, 2017
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents (Note 14)	¥ 12,666	¥ 12,135	\$ 112,043
Time deposits with original maturities of over three months (Note 14)	200	200	1,769
Receivables—Trade notes (Notes 5 and 14)	963	955	8,526
Receivables—Trade accounts (Note 14)	22,104	18,621	195,525
Receivables—Unconsolidated subsidiaries and associated companies (Note 14)	2,728	2,736	24,131
Receivables—Other	942	711	8,341
Receivables—Allowance for doubtful accounts	(6)	(5)	(61)
Inventories (Note 4)	11,094	9,020	98,141
Deferred tax assets (Note 13)	1,093	492	9,669
Prepaid expenses and other current assets	374	287	3,311
Total Current Assets	52,161	45,155	461,398
PROPERTY, PLANT AND EQUIPMENT			
Land	17,549	17,549	155,236
Building and structures	29,891	29,978	264,411
Machinery and equipment	87,681	88,026	775,597
Furniture and fixtures	3,588	3,495	31,738
Construction in progress	870	424	7,699
Other	1,989	2,010	17,597
Total	141,570	141,485	1,252,280
Accumulated depreciation	(111,167)	(109,917)	(983,345)
Net Property, Plant and Equipment	30,403	31,567	268,935
INVESTMENT AND OTHER ASSETS			
Investment securities (Notes 3 and 14)	6,191	4,547	54,767
Investment in unconsolidated subsidiaries and associated companies	2,363	2,420	20,906
Goodwill	1,781	1,915	15,757
Asset for retirement benefits (Note 7)	1,585	1,260	14,023
Deferred tax assets (Note 13)	35	147	317
Other assets	727	660	6,439
Allowance for doubtful accounts	(1)	(1)	(16)
Total Investment and Other Assets	12,683	10,950	112,193
Total	¥ 95,247	¥ 87,674	\$ 842,528

Note: The U.S. dollar amounts are translated from Japanese yen at the rate of ¥113.05 = U.S.\$1, the prevailing exchange rate at December 31, 2017.

	Millions of Yen		Thousands of U.S. Dollars
	As of December 31, 2017	As of December 31, 2016	As of December 31, 2017
LIABILITIES			
CURRENT LIABILITIES			
Payables—Trade notes (Notes 5 and 14)	¥ 16	¥ 7	\$ 145
Payables—Trade accounts (Note 14)	20,187	15,381	178,572
Payables—Unconsolidated subsidiaries and associated companies (Note 14)	1,087	708	9,618
Payables—Other (Note 14)	2,696	2,911	23,848
Short-term bank loans (Note 6 and 14)	9,910	160	87,660
Short-term borrowings from unconsolidated subsidiaries and associated companies (Note 14)	970	890	8,580
Current portion of long-term debt (Note 6 and 14)	2,400	2,900	21,229
Commercial paper (Note 14)	999		8,845
Income taxes payable (Note 14)	2,856	1,950	25,265
Accrued expenses	551	92	4,874
Provision for repairs	1,837	370	16,251
Other current liabilities	446	456	3,945
Total Current Liabilities	43,958	25,828	388,839
LONG-TERM LIABILITIES			
Long-term debt (Notes 6 and 14)	10,450	27,350	92,436
Liability for retirement benefits (Note 7)	2,600	2,644	23,000
Provision for environmental measures	150	150	1,327
Provision for repairs		582	
Deferred tax liabilities (Note 13)	3,204	2,731	28,341
Other long-term liabilities	373	275	3,301
Total Long-Term Liabilities	16,777	33,733	148,408
Total Liabilities	60,735	59,561	537,248
COMMITMENTS AND CONTINGENT LIABILITIES (Notes 15 and 17)			
EQUITY (Notes 8 and 20)			
Common stock—authorized, 136,200,000 shares; issued, 36,849,400 and 36,749,400 shares in 2017 and 2016	8,772	8,745	77,602
Capital surplus	5,272	5,245	46,642
Retained earnings	16,072	10,438	142,171
Treasury stock, at cost, 70 shares in 2017	(0)		(1)
ACCUMULATED OTHER COMPREHENSIVE INCOME			
Unrealized gain on available-for-sale securities	712	303	6,302
Deferred gains or losses on hedges	(1)	(4)	(9)
Foreign currency translation adjustments	131	109	1,159
Defined retirement benefit plans	72	(124)	639
Total	31,032	24,713	274,506
Non-Controlling Interests	3,479	3,399	30,774
Total Equity	34,512	28,112	305,280
Total	¥ 95,247	¥ 87,674	\$ 842,528

Note: The U.S. dollar amounts are translated from Japanese yen at the rate of ¥113.05 = U.S.\$1, the prevailing exchange rate at December 31, 2017.

Consolidated Statements of Income

	Millions of Yen		Thousands of U.S. Dollars
	Fiscal year ended December 31, 2017	Fiscal year ended December 31, 2016	Fiscal year ended December 31, 2017
NET SALES	¥ 94,661	¥ 80,163	\$ 837,339
COST OF SALES (Note 10)	71,997	61,413	636,859
GROSS PROFIT	22,664	18,749	200,479
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (Notes 11 and 12)	11,169	9,766	98,797
OPERATING INCOME	11,495	8,982	101,681
OTHER INCOME (EXPENSE)			
Interest and dividend income	171	72	1,512
Interest expense	(122)	(203)	(1,079)
Foreign exchange loss—net	(7)	(47)	(66)
Equity in earnings of associated company	259	252	2,298
Other—net	185	(107)	1,642
Other income (expense)—net	486	(32)	4,307
INCOME BEFORE INCOME TAXES	11,982	8,950	105,989
INCOME TAXES—Current	3,940	2,664	34,856
INCOME TAXES—Deferred	(267)	50	(2,370)
TOTAL INCOME TAXES (Note 13)	3,672	2,715	32,486
NET INCOME	8,309	6,234	73,503
NET INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	142	221	1,260
NET INCOME ATTRIBUTABLE TO OWNERS OF THE PARENT	¥ 8,167	¥ 6,013	\$ 72,243

	Yen		U.S. Dollars
	2017	2016*	2017
PER SHARE OF COMMON STOCK (Notes 2 and 19)			
Basic net income	¥ 222.12	¥ 173.57	\$ 1.96
Diluted net income	¥ 220.44	¥ 172.24	\$ 1.95
Cash dividends applicable to the year	54.00	50.00	0.48

* Per share figures have been restated, as appropriate, to reflect a hundred - for - one stock split effected June 10, 2016.

Consolidated Statements of Comprehensive Income

	Millions of Yen		Thousands of U.S. Dollars
	Fiscal year ended December 31, 2017	Fiscal year ended December 31, 2016	Fiscal year ended December 31, 2017
NET INCOME	¥ 8,309	¥ 6,234	\$ 73,503
OTHER COMPREHENSIVE INCOME (Note 18)			
Unrealized gain (loss) on available-for-sale securities	409	76	3,619
Deferred gain (loss) on derivatives under hedge accounting	3	(2)	30
Foreign currency translation adjustments	(15)	(13)	(134)
Defined retirement benefit plans	196	(417)	1,740
Total Other Comprehensive Income (Loss)	594	(356)	5,256
COMPREHENSIVE INCOME	8,903	5,878	78,759
TOTAL COMPREHENSIVE INCOME ATTRIBUTE TO :			
Owner of the parent	8,761	5,656	77,499
Noncontrolling interests	¥ 142	¥ 221	\$ 1,260

Note: The U.S. dollar amounts are translated from Japanese yen at the rate of ¥113.05 = U.S.\$1, the prevailing exchange rate at December 31, 2017.

Consolidated Statements of Changes in Equity

	Thousands	Millions of Yen			
	Number of shares of common stock issued*	Common stock	Capital surpluses	Retained earnings	Treasury stock
BALANCE, JAN. 1, 2016	34,050	¥ 7,013	¥ 3,513	¥ 6,425	
Issuance of stock	2,614	1,708	1,708		
Issuance of stock (Exercising share option)	85	23	23		
Cash dividend, ¥58.74 per share				(2,000)	
Net income attributable to owners of parent				6,013	
Net change in the year					
BALANCE, JAN. 1, 2017	36,749	8,745	5,245	10,438	
Issuance of stock					
Issuance of stock (Exercising share option)	100	27	27		
Cash dividend, ¥75 per share				(2,756)	
Net income attributable to owners of parent				8,167	
Increase in treasury stock (70 shares)					¥ (0)
Change of scope of consolidation				223	
Net change in the year					
BALANCE, DEC. 31, 2017	36,849	¥ 8,772	¥ 5,272	¥ 16,072	¥ (0)

	Millions of Yen						
	Accumulated other comprehensive income				Total	Non-controlling interests	Total equity
	Unrealized gain on available-for-sale securities	Deferred gains (losses) on hedges	Foreign currency translation adjustment	Defined retirement benefit plans			
BALANCE, JAN. 1, 2016	¥ 226	¥ (1)	¥ 122	¥ 293	¥ 17,593	¥ 3,191	¥ 20,785
Issuance of stock					3,416		3,416
Issuance of stock (Exercising share option)					46		46
Cash dividend, ¥58.74 per share					(2,000)		(2,000)
Net income attributable to owners of parent					6,013		6,013
Net change in the year	76	(2)	(13)	(417)	(356)	207	(149)
BALANCE, JAN. 1, 2017	303	(4)	109	(124)	24,713	3,399	28,112
Issuance of stock							
Issuance of stock (Exercising share option)					55		55
Cash dividend, ¥75 per share					(2,756)		(2,756)
Net income attributable to owners of parent					8,167		8,167
Increase in treasury stock (70 shares)					(0)		(0)
Change of scope of consolidation					223		223
Net change in the year	409	3	21	196	630	79	710
BALANCE, Dec. 31, 2017	¥ 712	¥ (1)	¥ 131	¥ 72	¥ 31,032	¥ 3,479	¥ 34,512

* Shares and per share figures have been restated, as appropriate, to reflect a hundred - for - one stock split effected June 10, 2016.

Thousands of U.S. Dollars

	Common stock	Capital surpluses	Retained earnings	Treasury stock
BALANCE, JAN. 1, 2017	\$ 77,359	\$ 46,399	\$ 92,334	
Issuance of stock				
Issuance of stock (Exercising share option)	243	243		
Cash dividend, \$0.66 per share			(24,380)	
Net income attributable to owners of parent			72,243	
Increase in treasury stock (70 shares)				\$ (1)
Change of scope of consolidation			1,974	
Net change in the year				
BALANCE, DEC. 31, 2017	\$ 77,602	\$ 46,642	\$ 142,171	\$ (1)

Thousands of U.S. Dollars

	Accumulated other comprehensive income				Total	Non-controlling interests	Total equity
	Unrealized gain on available-for-sale securities	Deferred gains (losses) on hedges	Foreign currency translation adjustment	Defined retirement benefit plans			
BALANCE, JAN. 1, 2017	\$ 2,683	\$ (40)	\$ 971	\$ (1,101)	\$ 218,605	\$ 30,068	\$ 248,673
Issuance of stock							
Issuance of stock (Exercising share option)					486		486
Cash dividend, \$0.66 per share					(24,380)		(24,380)
Net income attributable to owners of parent					72,243		72,243
Increase in treasury stock (70 shares)					(1)		(1)
Change of scope of consolidation					1,974		1,974
Net change in the year	3,619	30	188	1,740	5,578	705	6,284
BALANCE, DEC. 31, 2017	\$ 6,302	\$ (9)	\$ 1,159	\$ 639	\$ 274,506	\$ 30,774	\$ 305,280

Consolidated Statements of Cash Flows

	Millions of Yen		Thousands of U.S. Dollars
	Fiscal year ended December 31, 2017	Fiscal year ended December 31, 2016	Fiscal year ended December 31, 2017
OPERATING ACTIVITIES			
Income before income taxes	¥ 11,982	¥ 8,950	\$ 105,989
Adjustment for:			
Income taxes—paid	(3,157)	(3,489)	(27,926)
Depreciation and amortization	3,382	3,495	29,924
Changes in assets and liabilities:			
Decrease (increase) in notes and accounts receivable	(3,377)	(7,899)	(29,872)
Decrease (increase) in inventories	(1,582)	2,953	(14,001)
Increase (decrease) in notes and accounts payable	5,177	(1,769)	45,796
Increase (decrease) in provision for repairs	884	(449)	7,823
Other—net	(337)	890	(2,988)
Total Adjustments	989	(6,268)	8,754
Net Cash Provided by Operating Activities	12,971	2,681	114,744
INVESTING ACTIVITIES			
Increase in time deposits	(200)	(205)	(1,769)
Decrease in time deposits	200	405	1,769
Purchases of property, plant and equipment	(2,249)	(3,115)	(19,897)
Purchase of investment securities	(1,058)	(508)	(9,359)
Purchase of unconsolidated subsidiaries' and associated companies' stock		(350)	
Other—net	25	(16)	229
Net Cash Used in Investing Activities	(3,281)	(3,791)	(29,027)
FINANCING ACTIVITIES			
Increase (decrease) in short-term bank loans & borrowings—net	9,829	149	86,951
Increase (decrease) in commercial paper—net	998		8,835
Proceeds from long-term debt	14,650		129,588
Repayments of long-term debt	(32,050)	(2,900)	(283,502)
Proceeds from stock issuance		3,359	
Proceeds from stock issuance (Exercising share option)	55	46	486
Dividends paid	(2,745)	(2,000)	(24,287)
Purchases of treasury stock	(0)		(1)
Other—net	(76)	(28)	(673)
Net Cash Used in Financing Activities	(9,338)	(1,373)	(82,602)
FOREIGN CURRENCY TRANSLATION ADJUSTMENTS ON CASH AND CASH EQUIVALENTS	(18)	(18)	(163)
NET INCREASE IN CASH AND CASH EQUIVALENTS	333	(2,501)	2,949
NET INCREASE IN CASH AND CASH EQUIVALENTS OF NEWLY CONSOLIDATED SUBSIDIARIES, BEGINNING OF YEAR	197		1,748
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	12,135	14,636	107,345
CASH AND CASH EQUIVALENTS, END OF YEAR	¥ 12,666	¥ 12,135	\$ 112,043

Note: The U.S. dollar amounts are translated from Japanese yen at the rate of ¥113.05 = U.S.\$1, the prevailing exchange rate at December 31, 2017.

Notes to Consolidated Financial Statements

1. BASIS OF PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS

The accompanying consolidated financial statements have been prepared in accordance with the provisions set forth in the Japanese Financial Instruments and Exchange Act and its related accounting regulations and in accordance with accounting principles generally accepted in Japan ("Japanese GAAP"), which are different in certain respects as to the application and disclosure requirements of International Financial Reporting Standards.

In preparing these consolidated financial statements, certain reclassifications and rearrangements have been made to the consolidated financial statements issued domestically in order to present them in a form which is more familiar to readers outside Japan. In addition, certain reclassifications have been made in the 2016 consolidated financial statements to conform to the classifications used in 2017.

The consolidated financial statements are stated in Japanese yen, the currency of the country in which KH Neochem Co., Ltd. (the "Company") is incorporated and operates. The translations of Japanese yen amounts into U.S. dollar amounts are included solely for the convenience of readers outside Japan and have been made at the rate of ¥113.05 to \$1, the approximate rate of exchange at December 31, 2017. Such translations should not be construed as representations that the Japanese yen amounts could be converted into U.S. dollars at that or any other rate.

Japanese yen and U.S. dollar figures less than a million yen or thousand dollars are rounded down to the nearest million yen or thousand dollars, except for per share data.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Consolidation—The consolidated financial statements as of December 31, 2017 include the accounts of the Company and its four significant (three in 2016) subsidiaries (together, the "Group").

Under the control and influence concepts, those companies in which the Company, directly or indirectly, is able to exercise control over operations are fully consolidated, and those companies over which the Group has the ability to exercise significant influence are accounted for by the equity method.

Investment in one (one in 2016) associated company is accounted for by the equity method.

Investments in the remaining unconsolidated subsidiaries and associated companies are stated at cost. If the equity method of accounting had been applied to the investments in these companies, the effect on the accompanying consolidated financial statements would not be material.

The consolidated financial statements for the fiscal year ended December 31, 2017 included the financial position of KH Neochem Americas, Inc., the results of its operations and its cash flows. The

company was a nonconsolidated subsidiary in the consolidated financial statements for the fiscal year ended December 31, 2016 due to the company's materiality.

All significant intercompany balances and transactions have been eliminated in consolidation. All material unrealized profit included in assets resulting from transactions within the Group is also eliminated.

b. Unification of Accounting Policies Applied to Foreign Subsidiaries for the Consolidated Financial Statements—Under Accounting Standards Board of Japan ("ASBJ") Practical Issues Task Force ("PITF") No. 18, "Practical Solution on Unification of Accounting Policies Applied to Foreign Subsidiaries for the Consolidated Financial Statements," the accounting policies and procedures applied to a parent company and its subsidiaries for similar transactions and events under similar circumstances should in principle be unified for the preparation of the consolidated financial statements. However, financial statements prepared by foreign subsidiaries in accordance with either International Financial Reporting Standards or generally accepted accounting principles in the United States of America (Financial Accounting Standards Board Accounting Standards Codification) tentatively may be used for the consolidation process, except for the following items that should be adjusted in the consolidation process so that net income is accounted for in accordance with Japanese GAAP, unless they are not material: (a) amortization of goodwill; (b) scheduled amortization of actuarial gain or loss of pensions that has been recorded in equity through other comprehensive income; (c) expensing capitalized development costs of R&D; and (d) cancellation of the fair value model of accounting for property, plant and equipment and investment properties and incorporation of the cost model of accounting.

c. Cash Equivalents—Cash equivalents are short-term investments that are readily convertible into cash and exposed to insignificant risk of changes in value.

Cash equivalents include time deposits, certificates of deposit, commercial paper, and bond funds, all of which mature or become due within three months of the date of acquisition.

d. Marketable and Investment Securities—Marketable and investment securities are classified and accounted for, depending on management's intent, as follows: (1) trading securities, which are held for the purpose of earning capital gains in the near term, are reported at fair value, and the related unrealized gains and losses are included in earnings; (2) held-to-maturity debt securities, for which there is a positive intent and ability to hold to maturity, are reported at amortized cost; and (3) available-for-sale securities, which are not classified as either of the aforementioned securities, are reported at fair value, with unrealized gains and losses, net of applicable taxes, reported in a separate component of equity.

Nonmarketable available-for-sale securities are stated at cost

determined by the moving-average method. For other-than-temporary declines in fair value, investment securities are reduced to net realizable value by a charge to income.

- e. Inventories**—Inventories are stated at the lower of cost, determined by the average cost method, or net selling value.
- f. Property, Plant and Equipment**—Property, plant and equipment are stated at cost. Depreciation of property, plant and equipment of the Company and its consolidated domestic subsidiaries is computed by the declining-balance method based on the estimated useful lives of the assets, while the straight-line method is applied to buildings (excluding building improvements) acquired on or after April 1, 1998, building improvements and structures acquired on or after April 1, 2016 by the Company and its consolidated domestic subsidiaries, and substantially all property, plant and equipment of consolidated foreign subsidiaries. The range of useful lives is principally from 7 to 60 years for buildings and structures, and from 4 to 15 years for machinery and equipment.
- g. Long-Lived Assets**—The Group reviews its long-lived assets for impairment whenever events or changes in circumstance indicate the carrying amount of an asset or asset group may not be recoverable. An impairment loss is recognized if the carrying amount of an asset or asset group exceeds the sum of the undiscounted future cash flows expected to result from the continued use and eventual disposition of the asset or asset group. The impairment loss would be measured as the amount by which the carrying amount of the asset exceeds its recoverable amount, which is the higher of the discounted cash flows from the continued use and eventual disposition of the asset, or the net selling price at disposition.
- h. Amortization of Goodwill**—The differences between the cost and underlying net equity of investments in consolidated subsidiaries at acquisition are amortized on a straight-line basis over 20 years.
- i. Other Assets**—Intangible assets are carried at cost less accumulated amortization, which is calculated by the straight-line method.
- j. Allowance for Doubtful Accountss**—The allowance for doubtful accounts is estimated based on the Groups's past credit loss experience and an evaluation of potential losses in the receivables outstanding.
- k. Provision for Environmental Measures**—The Group estimates a provision for future expenses resulting from the treatment of Polychlorinated Biphenyl ("PCB") wastes required by the law for "Special Measures for Promotion of Proper Treatment of PCB Wastes."
- l. Provision for repairs**—Provision for repairs of production facilities at plants is recorded based on estimated expense at the end of the year.

m. Retirement and Pension Plans—The Company adopts a lump-sum severance payment system and an agreement-type defined benefit corporate pension plan (including a cash balance plan) as defined benefit plans, and some consolidated subsidiaries adopt a lump-sum severance payment system and the smaller enterprise retirement allowance mutual aid scheme.

The Company accounts for the liability for retirement benefits based on the projected benefit obligations and plan assets at the balance sheet date. The accounting method of retirement and pension plans is as follow.

- ① Period attribution method of expected amount of retirement benefits
To calculate retirement benefit obligations, the expected amount of retirement benefits is attributed to the period prior to the end of the consolidated fiscal year under review on a benefit formula basis.
- ② Method of expensing actuarial gains and losses
Any actuarial gain and losses that are yet to be recognized in profit or loss are recognized within equity (accumulated other comprehensive income), after adjusting for tax effects and are recognized in profit or loss over a certain period (10 years) within the average remaining service period of employees at the time of the accrual using the straight-line method.
- ③ Adoption of a simplified method at small-sized businesses, etc.
Some consolidated subsidiaries apply a simplified method using the amount of payments required for retirement benefits for voluntary retirement at each balance sheet date as retirement benefit obligations for the calculation of liability for retirement benefits and net periodic retirement benefit costs.

Retirement allowances for directors are recorded as a liability (Other long-term liabilities) at the amount that would be required if all directors retired at each balance sheet date.

n. Research and Development Costs—Research and development costs are charged to income as incurred.

o. Leases—Finance lease transactions are capitalized by recognizing lease assets and lease obligations in the balance sheet. All other leases are accounted for as operating leases.

p. Income Taxes—The provision for income taxes is computed based on the pretax income included in the consolidated statement of income. The asset and liability approach is used to recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Deferred taxes are measured by applying currently enacted income tax rates to the temporary differences.

The Company applied ASBJ Guidance No. 26, "Guidance on Recoverability of Deferred Tax Assets," effective January 1, 2017. There was no impact from this for the year ended December 31, 2017.

q. Accounting for consumption taxes—The tax exclusion method is adopted for accounting for consumption taxes and local consumption taxes. Consumption taxes not subject to deduction and local consumption tax are treated as expenses for the current consolidated fiscal year.

r. Foreign Currency Transactions—All short-term and long-term monetary receivables and payables denominated in foreign currencies are translated into Japanese yen at the exchange rates at the consolidated balance sheet date. The foreign exchange gains and losses from translation are recognized in the consolidated statement of income to the extent that they are not hedged by forward exchange contracts.

s. Foreign Currency Financial Statements—The balance sheet accounts of the consolidated foreign subsidiaries are translated into Japanese yen at the current exchange rate as of the consolidated balance sheet date except for equity, which is translated at the historical rate. Differences arising from such translation are shown as "Foreign currency translation adjustments" under accumulated other comprehensive income in a separate component of equity. Revenue and expense accounts of consolidated foreign subsidiaries are translated into yen at the average exchange rate.

t. Derivatives and Hedging Activities—The Group's significant hedge accounting method is as follows.

① Hedge accounting method

In principle, deferred hedge accounting is adopted. In addition, a method (allocation treatment) for translating foreign currency receivables and payables based on yen-value cash flows fixed by forward contracts is adopted in cases where the requirements for using said method are fulfilled.

② Hedging instrument and hedged items

Hedging instrument: exchange contracts
Hedged items: foreign currency receivables and payables and anticipated foreign currency transactions

③ Hedging policy

The Group uses derivative transactions for the purpose of managing the risk of exchange rate fluctuations arising in the ordinary course of business. The Group does not engage in derivative transactions for speculative purposes. The Group does not use derivative transactions with a leverage effect that create large volatility in the market price of transactions compared with changes in the price of underlying products in the transactions. The Group conducts derivative transactions in accordance with the basic policy and internal regulations.

④ Method for assessing hedging effectiveness

An assessment of hedging effectiveness on the balance sheet date is omitted because exchange contracts with the same amount in a foreign currency and the same due date are assigned to each hedged item when concluding exchange contracts according to the risk management policy, so that correlations with subsequent changes in exchange rate fluctuations are completely assured.

u. Per Share Information—Basic net income per share is computed by dividing net income attributable to common shareholders by the weighted-average number of common shares outstanding for the period, retroactively adjusted for stock splits.

Diluted net income per share reflects the potential dilution that could occur if securities were exercised or converted into common stock. Diluted net income per share of common stock assumes full conversion of the outstanding convertible notes and bonds at the beginning of the year (or at the time of issuance) with an applicable adjustment for related interest expense, net of tax, and full exercise of outstanding warrants.

Cash dividends per share presented in the accompanying consolidated statement of income are dividends applicable to the respective fiscal years, including dividends to be paid after the end of the year.

On June 10, 2016, the Company effected a hundred-for-one stock split by way of a free share distribution based on the resolution of the Board of Directors meeting held on April 25, 2016. All prior year share and per share figures have been restated to reflect the impact of the stock split, and to provide data on a basis comparable to the year ended December 31, 2017. Such restatements include calculations regarding the Company's weighted-average number of common shares, basic net income per share, diluted net income per share, stock option data of the Company's common stock, and cash dividends per share.

3. MARKETABLE AND INVESTMENT SECURITIES

Marketable and investment securities as of December 31, 2017 and 2016 consisted of the following:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Non-current:			
Equity securities	¥6,191	¥4,547	\$54,767
Debt securities	—	—	—
Other	—	—	—
Total	¥6,191	¥4,547	\$54,767

The costs and aggregate fair values of marketable and investment securities at December 31, 2017 and 2016 were as follows:

	Millions of Yen				
	December 31, 2017	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities classified as:					
Available-for-sale:					
Equity securities		¥1,852	¥1,019	—	¥2,872
Debt securities		—	—	—	—
Other		—	—	—	—
December 31, 2016					
Securities classified as:					
Available-for-sale:					
Equity securities		¥794	¥433	—	¥1,227
Debt securities		—	—	—	—
Other		—	—	—	—

December 31, 2017	Thousands of U.S. Dollars			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities classified as:				
Available-for-sale:				
Equity securities	\$16,387	\$9,018	–	\$25,405
Debt securities	–	–	–	–
Other	–	–	–	–

There were no available-for-sale securities which were sold during the years ended December 31, 2017 and 2016.

There were no impairment losses on available-for-sale equity securities for the years ended December 31, 2017 and 2016.

4. INVENTORIES

Inventories at December 31, 2017 and 2016 consisted of the following:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Merchandise	¥ 1,151	¥ 327	\$10,183
Finished products	8,021	7,253	70,951
Work in process	336	255	2,980
Raw materials	1,295	1,035	11,457
Supplies	290	148	2,568
Total	¥11,094	¥9,020	\$98,141

5. PROCESSING METHOD OF BILLS MATURED AT THE END OF THE FISCAL YEAR

Bills matured at the end of the fiscal year are settled as of the clearing day.

Since the last day of the previous consolidated fiscal year and the last day of the current consolidated fiscal year are holidays for financial institutions, bills matured at the end of the fiscal year are included in the balance in the following fiscal years.

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Receivables—Trade notes	¥214	¥191	\$1,893
Payables—Trade notes	¥ 1	¥ 2	\$ 17

6. SHORT-TERM BANK LOANS AND LONG-TERM DEBT

Short-term bank loans at December 31, 2017 and 2016, consisted of term loans. The annual interest rates applicable to the short-term bank loans ranged from 0.32% to 0.70% and 0.49% to 0.70% at December 31, 2017 and 2016, respectively.

Long-term debt at December 31, 2017 and 2016 consisted of the following:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Loans from banks and other financial institutions, due serially to 2022 with interest rates ranging from 3-month Tokyo Inter Bank Offered Rate (TIBOR) plus 0.25% to 0.55% (2017) and from 0.30% to 0.55% (2016):			
Collateralized		28,000	
Unsecured	12,850	2,250	113,666
Total			
Less current portion	(2,400)	(2,900)	(21,229)
Long-term debt, less current portion	¥10,450	¥27,350	\$ 92,436

Annual maturities of long-term debt at December 31, 2017 were as follows:

Year Ending December 31	Millions of Yen	Thousands of U.S. Dollars
2018	¥ 2,400	\$ 21,229
2019	2,400	21,229
2020	2,400	21,229
2021	2,400	21,229
2022	3,250	28,748
2023 and thereafter		
Total	¥12,850	\$113,666

At December 31, 2017, land and buildings of ¥100 million (\$891 thousand) were pledged as collateral for short-term bank loans of ¥150 million (\$1,326 thousand) and no assets were pledged as collateral for the above long-term debt.

As is customary in Japan, the Company maintains substantial deposit balances with banks with which it has borrowings. Such deposit balances are not legally or contractually restricted as to withdrawal.

General agreements with respective banks provide, as is customary in Japan, that additional collateral must be provided under certain circumstances if requested by such banks and that certain banks have the right to offset cash deposited with them against any long-term or short-term debt or obligation that becomes due and, in case of default and certain other specified events, against all other debt payable to the banks. The Company has never been requested to provide any additional collateral.

The Company has current overdraft contracts and commitment line agreements with several banks to efficiently secure working capital. The balance of unexecuted loans etc. concerning current overdraft contracts and commitment line agreements at the end of the previous consolidated financial year are as follows.

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Maximum amount of current overdraft contracts and lines of credit	¥22,025	¥8,291	\$194,831
Outstanding borrowings	9,910	–	87,660
Balance	¥12,115	¥8,291	\$107,170

7. RETIREMENT AND PENSION PLANS

The Company adopts a lump-sum severance payment system and an agreement-type defined benefit corporate pension plan (including a cash balance plan) as defined benefit plans, and some consolidated subsidiaries adopt a lump-sum severance payment system and the smaller enterprise retirement allowance mutual aid scheme.

The Company accounts for the liability for retirement benefits based on the projected benefit obligations and plan assets at the balance sheet date. Some consolidated subsidiaries apply a simplified method using the amount of payments required for retirement benefits for voluntary retirement at each balance sheet date as retirement benefit obligations for the calculation of liability for retirement benefits and net periodic retirement benefit costs.

(1) The changes in defined benefit obligation for the years ended December 31, 2017 and 2016 were as follows (excluding the

amounts recorded by the simplified method):

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Balance at beginning of year	¥5,217	¥4,823	\$46,148
Current service cost	278	243	2,461
Interest cost	31	81	276
Actuarial (gains) losses	(101)	548	(898)
Benefits paid	(409)	(479)	(3,622)
Others			
Balance at end of year	¥5,015	¥5,217	\$44,364

The changes in defined benefit obligation for the years ended December 31, 2017 and 2016 were as follows (amounts which were recorded by the simplified method):

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Balance at beginning of year	¥297	¥273	\$2,630
Retirement benefit cost	44	33	389
Benefits paid	(46)	(4)	(412)
Contributions from the employer	(5)	(5)	(47)
Balance at end of year	¥289	¥297	\$2,559

(2) The changes in plan assets for the years ended December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Balance at beginning of year	¥4,131	¥4,191	\$36,543
Expected return on plan assets	103	104	913
Actuarial (gains) losses	163	(19)	1,447
Contributions from the employer	124	128	1,097
Benefits paid	(232)	(274)	(2,055)
Others			
Balance at end of year	¥4,289	¥4,131	\$37,947

(3) Reconciliation between the liability recorded in the consolidated balance sheet and the balances of defined benefit obligation and plan assets as of December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Defined benefit obligation	¥ 2,704	¥ 2,870	\$ 23,923
Plan assets	(4,289)	(4,131)	(37,947)
Total	(1,585)	(1,260)	(14,023)
Unfunded defined benefit obligation	2,600	2,644	23,000
Net liability (asset) arising from defined benefit obligation	¥ 1,014	¥ 1,383	\$ 8,976

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Liability for retirement benefits	¥ 2,600	¥ 2,644	\$ 23,000
Asset for retirement benefits	(1,585)	(1,260)	(14,023)
Net liability (asset) arising from defined benefit obligation	¥ 1,014	¥ 1,383	\$ 8,976

(4) The components of net periodic retirement benefit costs for the years ended December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Service cost	¥ 278	¥ 243	\$2,461
Interest cost	31	81	276
Expected return on plan assets	(103)	(104)	(913)
Recognized actuarial (gains) losses	16	(40)	147
Retirement benefit cost (Simplified Method)	44	33	389
Redundancy pay		13	
Net periodic retirement benefit costs	¥ 266	¥ 227	\$2,360

(5) Amounts recognized in other comprehensive income (before income tax effect) in respect of defined retirement benefit plans for

the years ended December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Actuarial (gains) losses	¥(281)	¥607	\$(2,493)
Total	¥(281)	¥607	\$(2,493)

(6) Amounts recognized in accumulated other comprehensive income (before income tax effect) in respect of defined retirement benefit plans as of December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Unrecognized actuarial (gains) losses	¥(103)	¥178	\$(915)
Total	¥(103)	¥178	\$(915)

(7) Plan assets

a. Components of plan assets

Plan assets as of December 31, 2017 and 2016 consisted of the following:

	2017	2016
Debt investments	70%	72%
Equity investments	30	28
Others	0	0
Total	100%	100%

b. Method of determining the expected rate of return on plan assets

The expected rate of return on plan assets is determined considering the long-term rates of return which are expected currently and in the future from the various components of the plan assets.

(8) Assumptions used for the years ended December 31, 2017 and 2016, were set forth as follows:

	2017	2016
Discount rate	0.6%	0.6%
Expected rate of return on plan assets	2.5	2.5

8. EQUITY

Japanese companies are subject to the Companies Act of Japan (the "Companies Act"). The significant provisions in the Companies Act that affect financial and accounting matters are summarized below:

a. Dividends

Under the Companies Act, companies can pay dividends at any time during the fiscal year in addition to the year-end dividend upon resolution at the shareholders' meeting. Additionally, for companies that meet certain criteria including (1) having a Board of Directors, (2) having independent auditors, (3) having an Audit & Supervisory Board, and (4) the term of service of the directors being prescribed as one year rather than the normal two-year term by its articles of incorporation, the Board of Directors may declare dividends (except for dividends-in-kind) at any time during the fiscal year if the company has prescribed so in its articles of incorporation. However, the Company does not meet all the above criteria.

The Companies Act permits companies to distribute dividends-in-kind (noncash assets) to shareholders subject to a certain limitation and additional requirements.

Semiannual interim dividends may also be paid once a year upon

resolution by the Board of Directors if the articles of incorporation of the company so stipulate. The Companies Act provides certain limitations on the amounts available for dividends or the purchase of treasury stock. The limitation is defined as the amount available for distribution to the shareholders, but the amount of net assets after dividends must be maintained at no less than ¥3 million.

b. Increases/Decreases and Transfer of Common Stock, Reserve and Surplus

The Companies Act requires that an amount equal to 10% of dividends must be appropriated as a legal reserve (a component of retained earnings) or as additional paid-in capital (a component of capital surplus), depending on the equity account charged upon the payment of such dividends, until the aggregate amount of legal reserve and additional paid-in capital equals 25% of the common stock. Under the Companies Act, the total amount of additional paid-in capital and legal reserve may be reversed without limitation. The Companies Act also provides that common stock, legal reserve, additional paid-in capital, other capital surplus and retained earnings can be transferred among the accounts within equity under certain conditions upon resolution of the shareholders.

c. Treasury Stock and Treasury Stock Acquisition Rights

The Companies Act also provides for companies to purchase treasury stock and dispose of such treasury stock by resolution of the Board of Directors. The amount of treasury stock purchased cannot exceed the amount available for distribution to the shareholders, which is determined by a specific formula. Under the Companies Act, stock acquisition rights are presented as a separate component of equity. The Companies Act also provides that companies can purchase both treasury stock acquisition rights and treasury stock. Such treasury stock acquisition rights are presented as a separate component of equity or deducted directly from stock acquisition rights.

On October 11, 2016, the Company issued and publicly offered 2,614,400 shares at ¥1,306.86 per share. The amount of the issuance of shares totaled ¥3,416 million, and the Company increased its common stock by ¥1,708 million and additional paid-in capital by the same amount.

During the years ended December 31, 2017 and 2016, stock options have been exercised and 100,000 shares and 85,000 shares have been issued, respectively, at ¥550 per share. The amount of the issuance of shares totaled ¥55 million and ¥46 million for 2017 and 2016, respectively, and the Company increased its common stock by ¥27 million and ¥23 million and additional paid-in capital by the same amount.

On June 10, 2016, the Company made a hundred-for-one stock split by way of a free share distribution based on the resolution of the Board of Directors' meeting held on April 25, 2016.

9. STOCK OPTIONS

The stock options outstanding as of December 31, 2017 are as

follows:

Stock Options	Persons Granted	Number of Options Granted	Date of Grant	Exercise Price	Exercise Period
2015 Stock Option	1 director	550,000 shares	2015.2.24	¥ 550 (\$ 4.8)	From Feb. 25, 2015 to July 31, 2020

Note

Related to the stock split on June 10, 2016, the number of shares mentioned above is converted to the number after the stock split.

The stock option activity is as follows:

	2015 Stock Option
	(Shares)
<u>Year Ended December 31, 2016</u>	
<u>Non-vested</u>	
January 1, 2016—Outstanding	-
Granted	-
Canceled	-
Vested	-
December 31, 2016—Outstanding	-
<u>Vested</u>	
January 1, 2016—Outstanding	550,000
Vested	-
Exercised	(85,000)
Canceled	(65,000)
December 31, 2016—Outstanding	400,000
<u>Year Ended December 31, 2017</u>	
<u>Non-vested</u>	
December 31, 2016—Outstanding	-
Granted	-
Canceled	-
Vested	-
December 31, 2017—Outstanding	-
<u>Vested</u>	
December 31, 2016—Outstanding	400,000
Vested	-
Exercised	(100,000)
Canceled	-
December 31, 2017—Outstanding	300,000
Exercise price	¥ 550 (\$ 4.8)
Average stock price at exercise	¥ 2,661 (\$ 23.5)
Fair value price at grant date	-

a. Method of estimating a fair unit price of stock options

The Company calculates stock options using an intrinsic value per unit, instead of a fair unit price, because the Company was privately-owned when it granted stock options.

The assessed value of its shares, which is the basis of estimating the intrinsic value per unit, is calculated by comprehensively taking into account prices calculated by the comparable industry method, the dividend discount method and the net asset value method.

b. Method of estimating the number of vested stock options

Estimating the number of lapsed stock options is essentially difficult. Therefore, the Company has applied a method that reflects only the number of actually lapsed stock options.

c. The sum of intrinsic values at the balance sheet date under review in the case where the calculation is made using the intrinsic value per unit of stock options and the sum of

intrinsic values on the date of exercise of stock options that were exercised in the consolidated fiscal year under review

- (i) Sum of intrinsic values at the balance sheet date under review
¥700 million
- (ii) Sum of intrinsic values exercised in the year under review
¥211 million

10. LOSS ON DEVALUATION OF INVENTORIES

The Company recorded the following loss on devaluation of inventories held for ordinary sales purposes due to impairments reflecting a drop in profitability for the years ended December 31, 2017 and 2016:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Cost of sales	¥ 103	¥ 41	\$ 911

11. SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses for the fiscal years ended December 2016 and 2017 consist of the following:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Salary	¥ 1,116	¥ 1,018	\$ 9,874
Freight	3,893	3,289	34,441
Container packaging	1,227	1,057	10,856
Others	4,931	4,401	43,625
Total	¥11,169	¥ 9,766	\$98,797

12. RESEARCH AND DEVELOPMENT COSTS

Research and development costs charged to income were ¥939 million (\$8,306 thousand) and ¥898 million for the years ended December 31, 2017 and 2016, respectively.

13. INCOME TAXES

The Company and its domestic subsidiaries are subject to Japanese national and local income taxes which, in the aggregate, resulted in a normal effective statutory tax rate of approximately 30.4% and 32.6% for the years ended December 31, 2017 and 2016, respectively.

The tax effects of significant temporary differences which resulted in deferred tax assets and liabilities at December 31, 2017 and 2016 are as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Deferred tax assets:			
Liability for retirement benefits	¥ 797	¥ 811	\$ 7,050
Provision for repairs	558	289	4,943
Valuation loss on investment securities	4	4	36
Excess depreciation	44	52	396
Inventories	50	—	443
Unpaid enterprise tax	134	134	1,186
Accrued bonus	105	—	929
Other	470	390	4,165
Less valuation allowance	(180)	(64)	(1,600)
Total	¥ 1,984	¥ 1,618	\$ 17,551
Deferred tax liabilities:			
Land	¥ (2,606)	¥ (2,606)	\$ (23,053)
Revaluation of investment securities	(584)	(584)	(5,172)

Asset for retirement benefits	(478)	(380)	(4,233)
Unrealized gain on available-for-sale securities	(307)	(130)	(2,715)
Other	(82)	(8)	(731)
Total	(4,059)	(3,709)	(35,906)
Net deferred tax assets	¥ (2,074)	¥ (2,090)	\$ (18,354)

A reconciliation between the normal effective statutory tax rates and the actual effective tax rates reflected in the accompanying consolidated statement of income for the year ended December 31, 2016, is as follows:

	2016
Normal effective statutory tax rate	32.6%
Change in tax rate	(1.3)
Gain not taxable for income tax purposes	(0.0)
Increase or decrease of valuation allowance	(0.3)
Refundable tax credit	(0.7)
Expenses not deductible for income tax purposes	0.7
Gain on equity method	(0.9)
Other—net	0.2
Actual effective tax rate	30.3%

The reconciliation for the year ended December 31, 2017 is omitted since the difference between the tax rates is 5% or less of the normal effective statutory tax rate.

14. FINANCIAL INSTRUMENTS AND RELATED DISCLOSURES

(1) Group Policy for Financial Instruments

With respect to fund management, the Group manages funds using safe and secure financial assets, such as deposits. The Group also raises short-term funds mainly by borrowing from financial institutions and the issuance of commercial paper. The Group uses derivative transactions to avoid the risks described below and will not carry out speculative transactions.

(2) Nature and Extent of Risks Arising from Financial Instruments

The Group tries to reduce the credit risk of customers related to trade notes and accounts receivable according to regulations on the collection of receivables and credit management, etc. Investment securities are primarily shares in companies with which the Company has business relationships and are exposed to the risk of market price fluctuations. Trade notes and accounts payable and other accounts payable are payables that will become due within a year. The derivatives are forward exchange contracts whose purpose is hedging exchange fluctuation risks related to foreign currency operating receivables and payables.

(3) Risk Management for Financial Instruments

- (i) Management of credit risk (risk relating to contractual default of customers)

In the Group, the sales and marketing divisions and others regularly monitor the situation regarding operating receivables of main customers according to regulations on the collection of receivables and credit management for management of due dates and the balance of each customer and promptly comprehend and mitigate concerns about collection caused by the deterioration of financial standing and other factors.

To reduce credit risk, derivative transactions are only

conducted with financial institutions with a high credit rating.

(ii) *Management of market risk (risk of exchange rate and interest rate fluctuations)*

Foreign currency operating receivables and payables are hedged against the risk of exchange rate fluctuations by using forward exchange contracts as needed.

The situation regarding investment securities held is continuously reviewed by regularly monitoring market prices and the financial standings of issuers (customer companies), while taking into consideration relationships with customer companies.

Derivative transactions are executed and managed in accordance with regulations on market risk and others.

(iii) *Management of liquidity risk related to financing (risk that payment cannot be made on due date)*

In the Group, the liquidity risk is managed by the division in charge that maintains liquidity on hand, in addition to preparing and updating a management plan in a timely manner based on reports from each division and group.

(4) Fair Values of Financial Instruments

Fair values of financial instruments are based on quoted prices in active markets. If a quoted price is not available, another rational valuation technique is used instead.

(a) *Fair value of financial instruments*

December 31, 2017	Millions of Yen		
	Carrying Amount	Fair Value	Unrealized Gain/Loss
Cash and cash equivalents	¥ 12,866	¥ 12,866	¥ -
Notes and accounts Receivable	24,642	24,642	-
Investment securities	2,872	2,872	-
Total	¥ 40,381	¥ 40,381	¥ -
Notes and accounts Payable	¥ 21,285	¥ 21,285	¥ -
Short-term borrowings	10,880	10,880	-
Current portion of long-term debt	2,400	2,400	-
Commercial paper	999	999	-
Payables—Others	2,701	2,701	-
Income taxes payable	2,856	2,856	-
Long-term debt	10,450	10,450	-
Total	¥ 51,573	¥ 51,573	¥ -
Derivative transactions	¥ (1)	¥ (1)	¥ -

December 31, 2016	Millions of Yen		
	Carrying Amount	Fair Value	Unrealized Gain/Loss
Cash and cash equivalents	¥ 12,335	¥ 12,335	¥ -
Notes and accounts Receivable	21,536	21,536	-
Investment securities	1,227	1,227	-
Total	¥ 35,099	¥ 35,099	¥ -
Notes and accounts Payable	¥ 16,089	¥ 16,089	¥ -
Short-term borrowings	1,050	1,050	-
Current portion of long-term debt	2,900	2,900	-
Payables—Others	2,918	2,918	-
Income taxes payable	1,950	1,950	-
Long-term debt	27,350	27,350	-
Total	¥ 52,259	¥ 52,259	¥ -
Derivative transactions	¥ (6)	¥ (6)	¥ -

December 31, 2017	Thousands of U.S. Dollars		
	Carrying Amount	Fair Value	Unrealized Gain/Loss
Cash and cash equivalents	\$ 113,812	\$ 113,812	\$ -
Notes and accounts Receivable	217,980	217,980	-
Investment securities	25,405	25,405	-
Total	\$ 357,198	\$ 357,198	\$ -
Notes and accounts Payable	\$ 188,286	\$ 188,286	\$ -
Short-term borrowings	96,240	96,240	-
Current portion of long-term debt	21,229	21,229	-
Commercial paper	8,845	8,845	-
Payables—Others	23,899	23,899	-
Income taxes payable	25,265	25,265	-
Long-term debt	92,436	92,436	-
Total	\$ 456,204	\$ 456,204	\$ -
Derivative transactions	\$ (13)	\$ (13)	\$ -

Note

Receivables and payables from derivative transactions are presented on a net basis and numbers in parentheses denote net payables.

Cash and Cash Equivalents, Receivables

The carrying values of cash, cash equivalents and receivables approximate fair value because of their short maturities.

Investment Securities

The fair values of investment securities are measured at the quoted market price of the stock exchange. Fair value information for investment securities by classification is included in Note 3.

Payables, Short-term borrowings, Commercial paper, Payables – Others, Income taxes payable

The carrying values of these approximate fair value because of their short maturities.

Current portion of long-term bank loans, Long-Term debt

These financial instruments are borrowed at floating interest rates and reflect market interest rates in the short term. Their market prices are deemed to approximate their book value because the credit standing of the Company does not change much after the borrowing. The fair values are therefore deemed equal to their book values.

Derivatives

Fair value information for derivatives is included in Note 12.

(b) *Carrying amount of financial instruments whose fair value cannot be reliably determined*

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Unlisted equity securities that do not have a quoted market price in an active market	¥ 5,682	¥ 5,740	\$ 50,268

(5) Maturity Analysis for Financial Assets and Securities with Contractual Maturities

December 31, 2017	Millions of Yen			
	Due in 1 Year or Less	Due after 1 Year through 5 Years	Due after 5 Years through 10 Years	Due after 10 Years
Cash and cash equivalents	¥ 200	¥ -	¥ -	¥ -
Receivables	24,642	-	-	-
Total	¥ 24,842	¥ -	¥ -	¥ -

December 31, 2016	Millions of Yen			
	Due in 1 Year or Less	Due after 1 Year through 5 Years	Due after 5 Years through 10 Years	Due after 10 Years
Cash and cash equivalents	¥ 200	¥ –	¥ –	¥ –
Receivables	21,536	–	–	–
Total	¥21,736	¥ –	¥ –	¥ –

December 31, 2017	Thousands of U.S. Dollars			
	Due in 1 Year or Less	Due after 1 Year through 5 Years	Due after 5 Years through 10 Years	Due after 10 Years
Cash and cash equivalents	\$ 1,769	\$ –	\$ –	\$ –
Receivables	217,980	–	–	–
Total	\$ 219,749	\$ –	\$ –	\$ –

15. DERIVATIVES

The Group enters into foreign currency forward contracts to hedge foreign exchange rate risk associated with certain assets and liabilities denominated in foreign currencies.

All derivative transactions are entered into to hedge foreign currency exposures incorporated within the Group's business. Accordingly, market risk for these derivatives is basically offset by opposite movements in the value of hedged assets or liabilities.

Because the counterparties to these derivatives are limited to major international financial institutions, the Group does not anticipate any losses arising from credit risk.

Derivative transactions entered into by the Group have been made in accordance with internal policies which regulate authorization and credit limit amounts.

Derivative Transactions to Which Hedge Accounting Is Not Applied

There are no derivative transactions to which hedge accounting is not applied.

Derivative Transactions to Which Hedge Accounting Is Applied

December 31, 2017	Hedged Item	Millions of Yen		
		Contract Amount	Contract Amount Due after One Year	Fair Value
Foreign currency forward contracts:				
Buying U.S.\$	Forecast transaction	¥ 193	¥ –	¥ (0)
Selling U.S.\$	Forecast transaction	302	–	(0)
Foreign currency forward contracts appropriated to specific debts and credits:				
Buying U.S.\$	Payables	¥ 346	¥ –	(Note)
Selling U.S.\$	Receivables	1,991	–	(Note)
Selling Euro	Receivables	31	–	(Note)

December 31, 2016				
Foreign currency forward contracts:				
Buying U.S.\$	Forecast transaction	¥ 219	¥ –	¥ 2
Selling U.S.\$	Forecast transaction	449	–	(8)
Foreign currency forward contracts appropriated to specific debts and credits:				
Buying U.S.\$	Payables	¥ 64	¥ –	(Note)
Selling U.S.\$	Receivables	1,805	–	(Note)
Selling Euro	Receivables	98	–	(Note)

December 31, 2017	Hedged Item	Contract Amount	Thousands of U.S. Dollars	
			Contract Amount Due after One Year	Fair Value
Foreign currency forward contracts:				
Buying U.S.\$	Forecast transaction	\$ 1,708	\$ –	\$(7)
Selling U.S.\$	Forecast transaction	2,675	–	(6)
Foreign currency forward contracts appropriated to specific debts and credits:				
Buying U.S.\$	Payables	\$ 3,066	\$ –	(Note)
Selling U.S.\$	Receivables	17,614	–	(Note)
Selling Euro	Receivables	276	–	(Note)

Note

The fair values of allocation treatment are included in the fair values of accounts receivable because they are accounted for as an integral part of accounts receivable and payable which are hedge items.

The fair value of derivative transactions is measured at the quoted price obtained from the financial institution.

The contract or notional amounts of derivatives which are shown in the above table do not represent the amounts exchanged by the parties and do not measure the Group's exposure to credit or market risk.

16. RELATED-PARTY TRANSACTIONS

Transactions between the Company for the years ended December 31, 2017 and 2016 were as follows:

J-PLUS Co., Ltd. (Associated company. The Company owned 50% of the common stock of J-PLUS Co., Ltd. at December 31, 2017)

Transactions:	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Sales (Note 1)	¥ 5,454	¥ 4,679	\$ 48,244
Borrowing (Note 2)	–	–	–
Purchases of raw materials (Note 1)	10,333	8,608	91,403
Balances:			
Receivables—accounts	1,571	1,439	13,897
Short-term borrowings	970	890	8,580
Payables—accounts	1,079	697	9,549
Receivables—other	¥ 1,153	¥ 777	\$ 10,203

Keiichi Asai(President & CEO of the Company)

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Transactions:			
Exercise of stock option (Note 3)	¥ 55	¥ 46	\$ 486
Balances:			
	—	—	—

Notes

- Transaction terms for sales and purchase of raw materials are determined in the same manner as regular transaction terms based on their market prices.
- Interest rates have been reasonably determined considering the market rate of interest. We have omitted transaction amounts because these borrowings were for working capital, and we perform this operation frequently in the short term.
- Stock price is calculated by comprehensively taking into account prices calculated by the comparable industry method, the dividend discount method and the net asset value method.

17. CONTINGENT LIABILITIES

At December 31, 2017, the Group had no material contingent liabilities:

18. OTHER COMPREHENSIVE INCOME (LOSS)

The components of other comprehensive income (loss) for the years ended December 31, 2017 and 2016 were as follows:

	Millions of Yen		Thousands of U.S. Dollars
	2017	2016	2017
Unrealized gain (loss) on available-for-sale securities:			
Gains arising during the year	¥ 586	¥ 102	\$ 5,184
Reclassification adjustments to profit or loss	—	—	—
Amount before income tax effect	586	102	5,184
Income tax effect	(176)	(25)	(1,565)
Total	¥ 409	¥ 76	\$ 3,619
Deferred gain (loss) on derivatives under hedge accounting:			
Gains arising during the year	¥ 5	¥ (3)	\$ 44
Reclassification adjustments to profit or loss	—	—	—
Amount before income tax effect	5	(3)	44
Income tax effect	(1)	1	(13)
Total	¥ 3	¥ (2)	\$ 30
Foreign currency translation adjustments:			
Adjustments arising during the year	¥ (15)	¥ (13)	\$ (134)
Reclassification adjustments to profit or loss	—	—	—
Total	¥ (15)	¥ (13)	\$ (134)
Defined retirement benefit plan(s):			
Adjustments arising during the year	¥ 265	¥ (567)	\$ 2,346
Reclassification adjustments to profit or loss	16	(40)	147
Amount before income tax effect	281	(607)	2,493
Income tax effect	(85)	190	(752)
Total	¥ 196	¥ (417)	\$ 1,740
Total other comprehensive income (loss)	¥ 594	¥ (356)	\$ 5,256

19. NET INCOME PER SHARE

A reconciliation of the differences between basic and diluted net income per share ("EPS") for the years ended December 31, 2017 and 2016 is as follows:

	Millions of Yen	Thousands of Shares	Yen	U.S. Dollars
	Net Income Attributable to Owners of the Parent	Weighted-Average Shares	EPS	
Year Ended December 31, 2017				
Basic EPS—Net income available to common shareholders	¥8,167	36,768	¥222.12	\$1.96
Effect of dilutive securities:				
Warrants		279		
Diluted EPS—Net income for computation	¥8,167	37,048	¥220.44	\$1.95
Year Ended December 31, 2016				
Basic EPS—Net income available to common shareholders	¥6,013	34,646	¥173.57	
Effect of dilutive securities:				
Warrants		267		
Diluted EPS—Net income for computation	¥6,013	34,913	¥172.24	

Note 1

On June 10, 2016, the Company made a hundred-for-one stock split by way of a free share distribution. The value for the year ended December 31, 2016 is calculated on the assumption that the stock split had occurred on January 1, 2016.

Note 2

Because KH Neochem Co., Ltd. has been listed on the Tokyo Stock Exchange since October 12, 2016, the average stock price since then is used in calculating Diluted EPS for the year ended December 31, 2016.

20. SUBSEQUENT EVENTS

Appropriation of Retained Earnings

The following appropriation of retained earnings at December 31, 2017, was approved at the Company's shareholders' meeting held on March 27, 2018:

	Millions of Yen	Thousands of U.S. Dollars
Year-end cash dividends, ¥29 (\$0.25) per share	¥1,068	\$9,452

21. SEGMENT INFORMATION

Under ASBJ Statement No. 17, "Accounting Standard for Disclosures about Segments of an Enterprise and Related Information," and ASBJ Guidance No. 20, "Guidance on Accounting Standard for Disclosures about Segments of an Enterprise and Related Information," an entity is required to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available and for which such information is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. Generally, segment information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments.

(1) Description of Reportable Segments

Information by segment is omitted as the Group has only one reportable segment, which is related to the chemical business, for the years ended December 31, 2017 and 2016.

(2) Information about Products and Services

For the years ended December 31, 2017 and 2016, a description is omitted as the Group has only one reportable segment.

(3) Information about Geographical Areas

a. Sales

Millions of Yen			
2017			
Japan	Asia	Other	Total
¥71,019	¥18,567	¥5,074	¥94,661

Millions of Yen			
2016			
Japan	Asia	Other	Total
¥58,316	¥17,765	¥4,081	¥80,163

Thousands of U.S. Dollars			
2017			
Japan	Asia	Other	Total
\$628,211	\$164,239	\$44,888	\$837,339

Note: Sales are classified by country or region based on the location of customers.

b. Property, plant and equipment

A description is omitted as the Group operates mainly in Japan and total tangible fixed assets in foreign countries were less than 10% of consolidated tangible fixed assets as of December 31, 2017 and 2016.

(4) Information about Major Customers

2017		
Millions of Yen		
Name of Customers	Sales	Related Segment Name
Idemitsu Kosan Co., Ltd.	¥11,041	Chemical business

2016		
Millions of Yen		
Name of Customers	Sales	Related Segment Name
Idemitsu Kosan Co., Ltd.	¥9,181	Chemical business
Miyako Kagaku Co., Ltd.	¥8,227	Chemical business

2017		
Thousands of U.S. Dollars		
Name of Customers	Sales	Related Segment Name
Idemitsu Kosan Co., Ltd.	\$97,673	Chemical business

(5) Information about impairment loss on fixed assets

For the year ended December 31, 2017, a description is omitted as the Group has only one reportable segment.

For the year ended December 31, 2016, there was no impairment loss on fixed assets.

(6) Information about Amortization of Goodwill and Balance of Goodwill

For the years ended December 31, 2017 and 2016, a description is omitted as the Group has only one reportable segment.



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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of KH Neochem Co., Ltd.:

We have audited the accompanying consolidated balance sheet of KH Neochem Co., Ltd. and its consolidated subsidiaries as of December 31, 2017, and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, all expressed in Japanese yen.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in Japan, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of KH Neochem Co., Ltd. and its consolidated subsidiaries as of December 31, 2017, and the consolidated results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in Japan.

Convenience Translation

Our audit also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in accordance with the basis stated in Note 1 to the consolidated financial statements. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

March 27, 2018

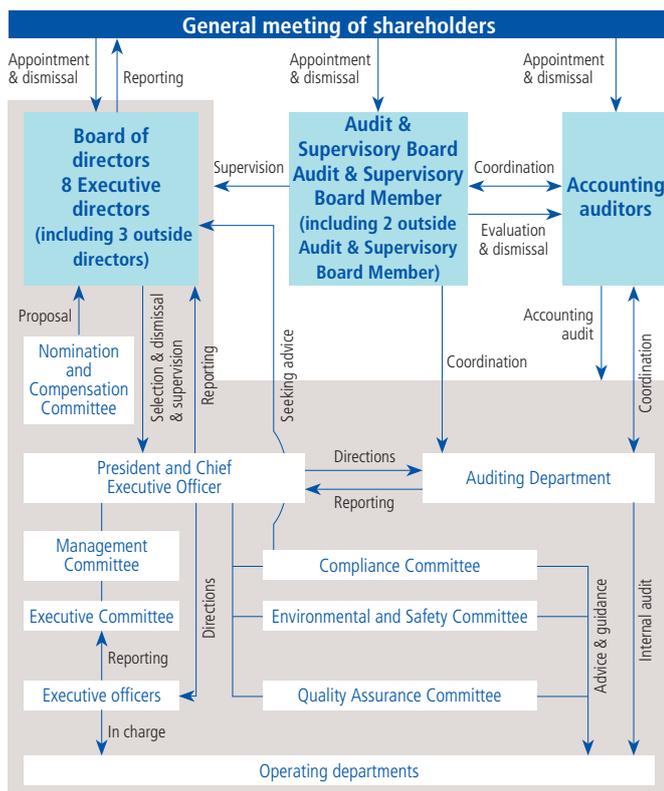
About Management

Corporate governance

Basic conceptual approach

The KH Neochem Group is committed to engaging in the realization of corporate governance in accordance with the Corporate Mission of “Realizing a brighter tomorrow for society through the power of chemistry” and with a view to achieving sustained growth and medium to long-term heightening of corporate value, together with sound management that assures transparency and fairness. We do this on the basis of constructive dialogue with our shareholders, substantive assurance of the rights and equality of our shareholders, appropriate disclosure of information, and appropriate cooperation with stakeholders other than our shareholders, all founded upon effective oversight in execution.

Corporate governance structure



Measures to strengthen corporate governance

Composition of board of directors

KH Neochem added one outside director in March 2017, moving to a complement of three such directors, in order to further strengthen the supervisory function of the board of directors as well as heighten the transparency and soundness of management and the growth potential of the corporation. We are also taking steps to build up our system of corporate

auditors in a way that will lead to a heightening of the supervisory function of the board of directors, by such measures as the March 2017 appointment of full-time in-house corporate auditors who have abundant finance and accounting experience along with appropriate knowledge.

The Nomination and Compensation Committee

To enhance the transparency and fairness of the decision-making process for the nomination and compensation of the board of directors and executive officers, the Company has established the Nomination and Compensation Committee. More than half of the membership of this committee is composed of outside directors. In March, 2018, the Company abolished the retirement benefit plan for officers. At the 8th Ordinary General Meeting of Shareholders the company approved the introduction of a new performance-linked share-based remuneration plan for the board of directors excluding outside directors. The new plan clarifies the linkage between remuneration for the directors and corporate performance, and the stock value of the Company. The Company implemented the compensation plan for the directors based on the suggestion from the committee.

Board of directors

In addition to functioning as a decision-making body with regard to matters set forth by legal statute, the corporate charter, and other such legal mandates, the board of directors of KH Neochem functions as a supervisory body over the execution of duties by the executive directors. The board is made up of eight executive directors, among them three outside directors. The term of service of the executive directors is set as one year in order to promote prompt response to change in the management environment, as well as to make clear the management responsibility of the executive directors within the business year. As a rule, the board of directors meets regularly once a month and once each quarter to approve the financial statement. The system also provides for extraordinary meetings of the board of directors to be convened as necessary in order to allow management decisions to be made without delay.

Audit & Supervisory Board

KH Neochem has adopted a corporate auditor system with a Audit & Supervisory Board made of up three corporate auditors, among whom are two outside Audit & Supervisory Board Member meet with the board of directors, the Management Committee, and other important committees, where they audit the execution of duties by executive directors by stating their views as required, by examining important documents under consideration for approval, and so on. They also take steps for mutual coordination with the Auditing Department and accounting auditors by regularly exchanging views and information, and then holding discussions with them. As a rule, Audit & Supervisory Board holds regular meetings once a month and also holds extraordinary meetings as necessary to formulate auditing plans, examine audit implementation status, audit results, and related matters, taking steps for mutual information sharing with Audit & Supervisory Board Member.

Compliance

Basic conceptual approach

At KH Neochem, we consider compliance to be one of the essential and crucial components of CSR. We formulate our rules and regulations, then inspect our legal compliance status on the basis of Compliance Guidelines and compliance regulations, and we make every effort toward strict implementation. Those activities and their results are confirmed by the Compliance Committee, and we take the proper measures suited to the results of inspections.

Compliance Guiding Principles

We take action according to a high ethical standard that is embraced by the Corporate Mission of "Realizing a brighter tomorrow for society through the power of chemistry" and the management stance of, "Making our dream a reality through reliable technology and new inventions." Our aim is to be a corporation that earns the trust of society.



A corporate overview is available on the KH Neochem website

Measures for compliance

Compliance Committee

KH Neochem has established a Compliance Committee in order to plan and formulate basic guidelines regarding compliance, provide opinions to the board of directors, address serious problems concerning compliance, to provide compliance-related advice, guidance, education, and consciousness raising, and to deliberate on rules and regulations relating to other aspects of compliance in the company. The membership of this committee is made up of full-time directors, full-time corporate auditors, executive officers, managers of departments and offices at corporate headquarters, and managers of operating facilities. As a rule, the committee meets twice a year.

Internal notification system

This company acts to prevent acts that violate laws and regulations, the Compliance Guidelines, and so on, before they are committed. In the unlikely event that such acts are committed, however, we have in place an internal notification system called the Hotline as a way to address such situations appropriately. We make hotlines available for use by executive officers, employees, temporary employees, and any others concerned. These lines include the hotline for executive officers responsible for corporate ethics,



Internal notification system poster

the hotline for full-time corporate auditors, the corporate attorney's hotline, and the operating facility compliance complaints and suggestions box.

Hotline notification form that allows for anonymity



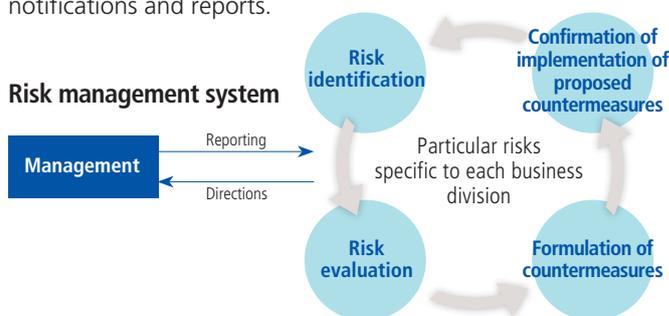
Risk management

Basic conceptual approach

The KH Neochem Group has established risk management rules, and we are involved in risk management so that we can earn the trust of our customers and people in the community.

Risk management system

All of our business divisions extract risks that could affect business activities of companies in the KH Neochem Group. We identify the risks, list possible solutions, and take measures to prevent risks from materializing, as well as to reduce their impact. We assign risk levels according to the status of progress with those countermeasures and evaluations of the measures. The Risk Management Office determines the appropriateness of measures formulated and risk levels assigned based on results of risk inventories. For items considered high priority, management is provided with notifications and reports.



Cybersecurity measures

At KH Neochem, we operate our information systems based on internal management rules and appropriately to the importance of the system concerned. In this way we make every effort to prevent improper external access to company information, the loss of recorded data media, and so on. Since the chemical sector has been newly included as part of the critical infrastructure designated by the Cabinet Office, we have conducted risk assessments of the control systems for our plants.

Industrial Safety Action Plan

In response to a requirement from the Ministry of Economy, Trade and Industry, the Japan Petrochemical Industry Association put together an Industrial Safety Action Plan intended to prevent industrial accidents. KH Neochem is taking measures to reduce the risk of accidents of all types based on that action plan.



Back row, from left: Kenji Ito, Atsuo Inagaki, Tokuo Oodo, Tatsuro Niiya, Katsu Harashima, Manabu Fujise, Mitsuhiro Nagata
 Front row, from left: Kenichi Hirai, Michio Takahashi, Keiichi Asai, Toshihiro Matsuoka

Member of Director Board

Keiichi Asai

President & CEO

Michio Takahashi

Executive Vice President

Toshihiro Matsuoka

Managing Director

Kenichi Hirai

Managing Director & CFO

Tatsuro Niiya

Board Director

Katsu Harashima

Outside Director

Manabu Fujise

Outside Director (Independent Officer)

Mitsuhiro Nagata

Outside Director (Independent Officer)

Audit & Supervisory Board Member

Tokuo Oodo

Audit & Supervisory Board Member

Atsuo Inagaki

Audit & Supervisory Board Member
 (Independent Officer)

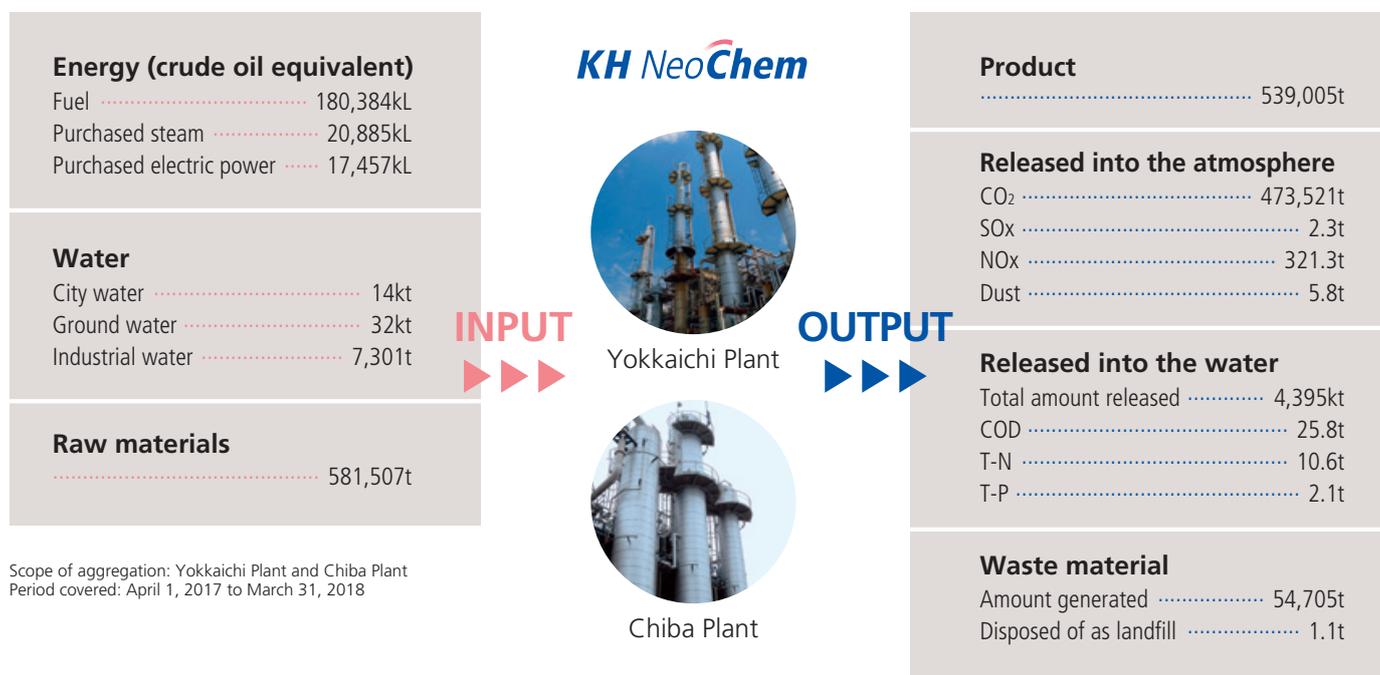
Kenji Ito

Audit & Supervisory Board Member
 (Independent Officer)

Environmental Conservation

Flow of environmental impact results

This shows an overall image of inputs and outputs that occur when manufacturing our products.



Environmental accounting

This refers to environmental accounting that quantitatively determines and evaluates the amounts of investments and expenses involved in environmental conservation.

Environmental conservation costs

			Millions of Yen	
Classification	Substance of main measures	Investment amounts	Expense amounts	
Costs within business area		69	2,030	
Breakdown	Pollution prevention costs	Air pollution prevention, water pollution prevention, etc.	15	668
	Global environmental conservation costs	Global warming prevention, energy conservation measures, etc.	0	255
	Resource recycling costs	Efficient use of resources, recycling of waste, etc.	54	1,086
Upstream and downstream costs	Purchase of recycled stationery (eco-label goods), etc.	0	2	
Management program costs	Environmental management system maintenance, operation, etc.	0	29	
Research and development costs	Research and development, etc. for products contributing to environmental conservation, etc.	0	168	
Social program costs	Contributions and supports to groups engaging in environmental conservation, etc.	0	0	
Environmental remediation costs	Oil spill liability insurance, levies on pollution loads.	0	1	
Total		69	2,235	

* Some totals may not tally due to rounding.

Economic impact

		Millions of Yen
Description	Amount	
Profit	Sales of waste material (waste catalysts, scrap, etc.), sales of recovered containers	9

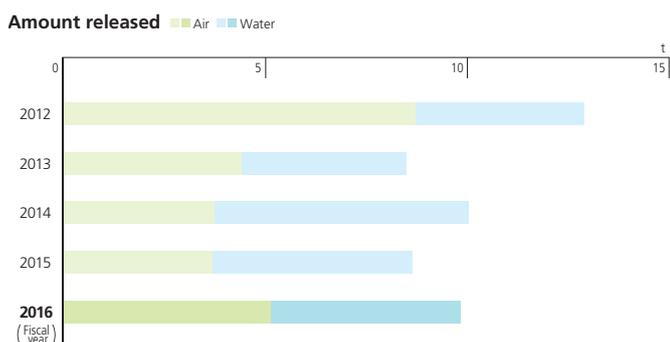
Scope of aggregation: Yokkaichi Plant and Chiba Plant
Period covered: January 1 to December 31, 2017

Reduction of amount released into the environment

Chemical substances

KH Neochem makes reports to the Japanese government in accordance with the PRTR Act* on the amount of Type 1 designated chemical substances manufactured, or used annually, that is released into the environment and on changes in those amounts. As shown in the below figure, the amounts released have been successfully reduced relative to fiscal year 2012, by approximately 20% to 35% since fiscal year 2013. Particularly notable is the amount of 2-aminoethanol released into the atmosphere. Improvements to the equipment in 2012 brought the figure down significantly from 13.1 t in fiscal year 2011 to 0.7 t in fiscal year 2016.

* PRTR Act: Act on Tracking the Amounts of Specific Chemical Substances Released into the Environment, and Promoting Improvement in the Management of Such Substances

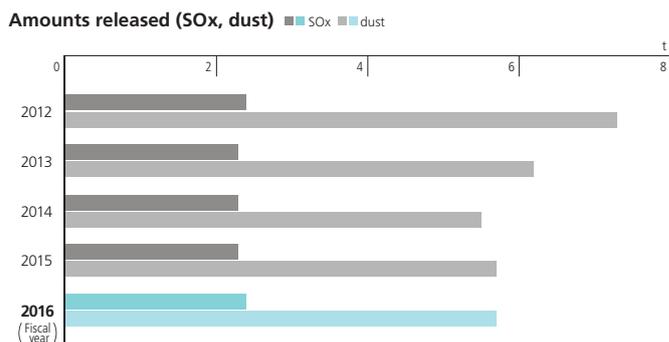


Amount of PRTR Act Type 1 designated chemical substances released (fiscal year 2016) [Top five substances by amount released]

Ordinance number	Substance name	Amount released				Total
		Air	Water	Soil		
12	Acetaldehyde	1.7	1.1	0.0	2.8	
35	Isobutyl aldehyde	0.4	1.7	0.0	2.1	
300	Toluene	1.7	0.0	0.0	1.7	
20	2-aminoethanol	0.7	0.8	0.0	1.5	
132	Cobalt and its compounds	0.0	0.6	0.0	0.6	

Air pollutants

With regard to sulfur oxides (SOx), nitrogen oxides (NOx), and dust discharged from boilers, liquid waste incinerators, sludge incinerators, and other such facilities, KH Neochem of course complies with emissions standards based on the Air Pollution Control Act, and additionally complies with levels that have been agreed upon with local communities.



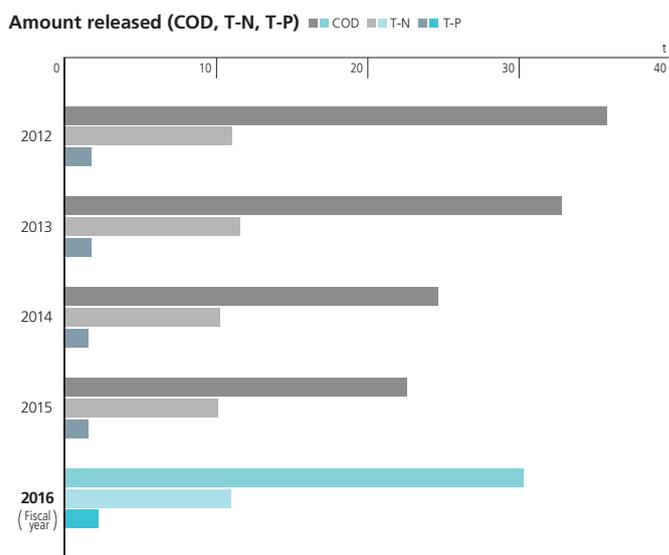
Levels agreed upon with local communities and annual maximum values

	Sox		Dust*	
	Agreement level	Maximum value	Agreement level	Maximum value
Yokkaichi Plant	1.0 Nm ³ /h	0.0 Nm ³ /h	0.025 g/Nm ³	0.001 g/Nm ³
Chiba Plant	9.0 Nm ³ /h	0.2 Nm ³ /h	4.5 kg/h	0.7 kg/h

* Dust: At the Yokkaichi Plant, density controls are set per item of equipment. Here, the generator boiler figure is shown as a typical example.

Water pollutants

KH Neochem complies with emissions levels based on the Water Pollution Prevention Act as well as with levels agreed upon with local communities for chemical oxygen demand (COD), total nitrogen (T-N), and total phosphorus (T-P) in wastewater.



Levels agreed upon with local communities and annual maximum values

	COD		T-N		T-P	
	Agreement level	Maximum value	Agreement level	Maximum value	Agreement level	Maximum value
Yokkaichi Plant	201.2	133.9	46.0	28.1	13.00	9.18
Chiba Plant	124	58	90	38	12.5	1.5

Working with Local Communities and Society as a Whole

Tour of the Yokkaichi Industrial Complex



We held a tour of the Yokkaichi Industrial Complex jointly with Yokkaichi City and two other, neighboring companies. Local university students majoring in mechanical, electrical, and electronic systems were invited to take part, and we endeavored to stimulate their interest in corporations at the industrial complex as places of possible future employment.

Satoyama woodland conservation activity in the southern zone of Nanbu Kyuryo Park



At the urging of the Yokkaichi City Nature Conservation Promotion Committee, we took part in activities for conservation of traditional satoyama woodland resources in the southern zone of Nanbu Kyuryo Park. We are working side by side with local residents on restoration of the satoyama resources here.

New social contribution activities underway in Yokkaichi City, Mie, where we have our plant

We have started new social contribution activities by developing our previous activities for protecting the environment and engaging with local communities. In November 2017, we carried out the first of the activities at Yokkaichi Sports Land, a sports facility in Yokkaichi City, Mie. We used paints for the event as we manufacture many kinds of the raw material. We invited local children to The KH Neochem Day, held at the Sports Land, and it was designated as a Project Commemorating the 120th Anniversary of the Incorporation of Yokkaichi as a City by the municipal government of Yokkaichi City.

Paint presentation ceremony



We invited Deputy Mayor Nobuo Fujii of Yokkaichi City to the paint presentation ceremony. He granted us a certificate of appreciation.

Painting work by our employees



Our employees refinished the roller-skating rink of Yokkaichi Sports Land by painting it themselves. They worked hard together, imagining local children playing vigorously there.

KH Neochem Day



We invited local children to the beautifully refinished roller-skating rink. Konyudo-kun, the local mascot character of Yokkaichi City, came to the venue and warmed up the event wonderfully.

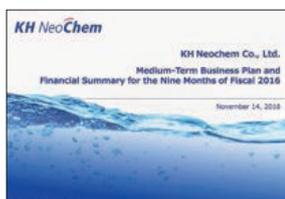
Working with Our Shareholders and Investors

Financial results briefings and other IR activities

KH Neochem was listed on the First Section of the Tokyo Stock Exchange in October 2016, and the financial briefing we held the following month included an explanation of our three-year Medium-Term Business Plan as well as our financial results and forecast. This is a three-year plan geared to further progress, combining growth and stability. The plan sets forth strategies for achieving that objective by globally expanding sales of performance chemicals, enhancing the profitability of basic chemicals, and establishing a base for the future. At the same time, we also gave an overview of our technology, our business environment, and other such matters.



Financial results briefing for analysts and institutional investors



Announcement of Medium-Term Business Plan at financial results briefing

In February 2017, we exhibited at the Tokyo Stock Exchange IR Festa, where we gave individual investors an overview of our business, our Medium-Term Business Plan, and our performance. We took steps to communicate with large numbers of people during the two days of this event, which proved to be an extremely significant occasion.



IR presentation for individual investors at IR Festa



KH NeoChem booth at the IR Festa

In April, we invited analysts and institutional investors on a tour of the Yokkaichi Plant. As our guests, they had the opportunity to observe KH Neochem quality manufacturing onsite, and to learn about the various fields in which our products are contributing to society. We also



Yokkaichi Plant in Mie Prefecture where the plant tour was held

introduced our guidelines and initiatives for safe operation and environmental concerns, among other matters.

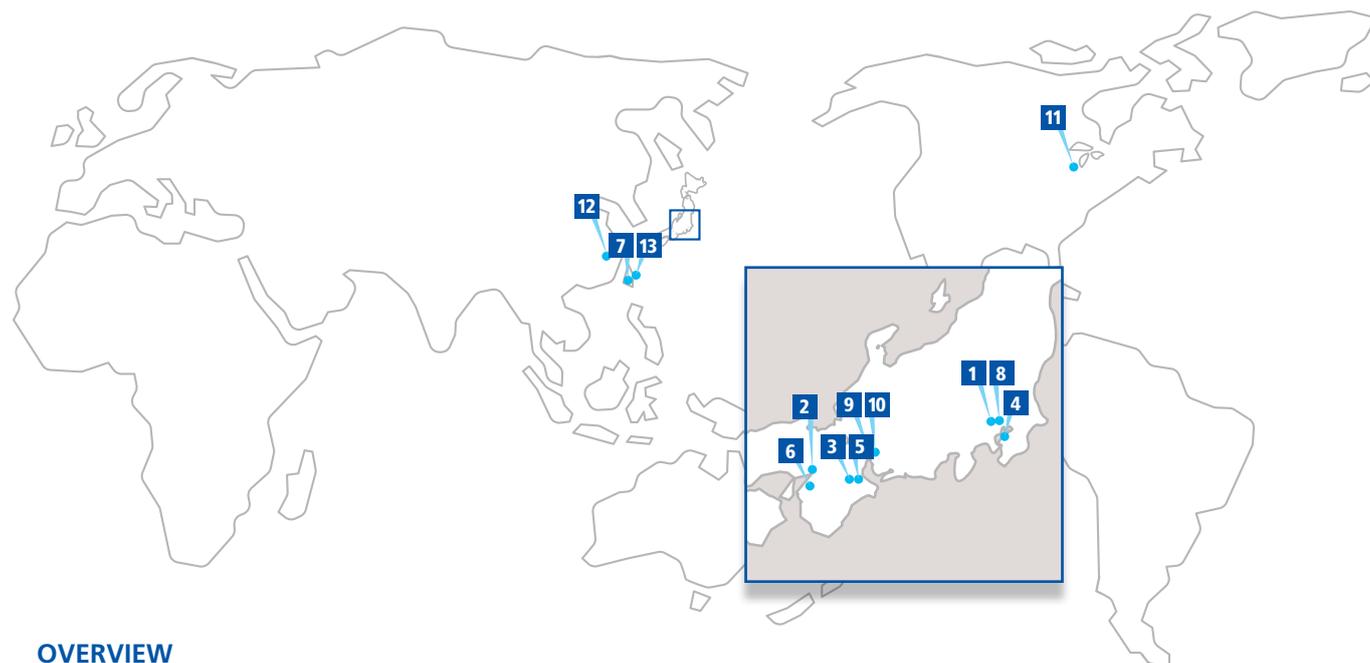
Furthermore we held overseas IR activities. Since inquiries from other countries about the KH Neochem business, our future potential, and so on, have been increasing, we communicated with investors in EU, USA, and Asia. The people we met with expressed great interest in our technology infrastructure, the large share we hold in growth markets, and other such points.

In this way, we have positioned dialogue with shareholders and investors as an important management issue. Going forward, our management team will be at the forefront in continuing this initiative.



Kenichi Hirai
Managing Director & CFO

Global Network



OVERVIEW

DOMESTIC

1 Head Office

1-6-5, Nihonbashi-Honcho, Chuo-ku,
Tokyo 103-0023, Japan

2 Osaka Branch Office

1-1-4 Shibata, Kita-ku, Osaka-city,
Osaka 530-0012, Japan

3 Yokkaichi Plant

Umaokoshi Plant

2-3 Daikyo-cho, Yokkaichi-city, Mie 510-8502, Japan

Kasumigaura Plant

1-4 Kasumi, Yokkaichi-city, Mie 510-0011, Japan

4 Chiba Plant

11-1 Goi Minami-kaigan,
Ichihara-city, Chiba 290-8560, Japan

5 Yokkaichi Research Lab

2-3 Daikyo-cho, Yokkaichi-city, Mie 510-8502, Japan

6 Sakai Logistics Center

3-39 Chikko Shinmachi, Nishi-ku,
Sakai-city, Osaka 592-8331, Japan

OVERSEAS

7 Taiwan Representative Office

31F., No. 8, Minquan 2nd Rd., Qianzhen Dist,
Kaohsiung City, 806, Taiwan

AFFILIATIONS

DOMESTIC

8 J-Plus Co., Ltd.

Higashiyama Bldg. 6F, 4-4-2, Nihonbashi-Honcho,
Chuo-ku, Tokyo 103-0023, Japan

9 Kurogane Kasei Co., Ltd

1-6-17 Nishiki, Naka-ku, Nagoya, Aichi 460-0003, Japan

10 Kurogane Fines Inc.

1-5-28 Nishiki, Naka-ku, Nagoya, Aichi 460-0003, Japan

OVERSEAS

11 KH Neochem Americas, Inc.

1515 East Woodfield Road,
Suite 710 Schaumburg, IL 60173, U.S.A

12 Shanghai Seika Trading Co., Ltd.

Room1116,Bldg.B,Far East International Plaza, No.317
Xianxia Rd. Changning District, Shanghai, 200051, China

13 Taiwan-Japan Oxo Chemical Industries Inc.

31F., No. 8, Minquan 2nd Rd., Qianzhen Dist,
Kaohsiung City, 806, Taiwan

Investor Information and Corporate Data

Founded:	December 8, 2010 (Predecessor Kyowa Yuka Co., Ltd. established in November 1966)
Capital:	8.7 billion yen (as of December 31, 2017)
Employees:	739 (as of December 31, 2017; on a consolidated basis)
Number of Shares Authorized:	136,200,000
Number of Shares Issued:	36,849,400
Number of Shareholders:	6,911
Trading Unit:	100 shares

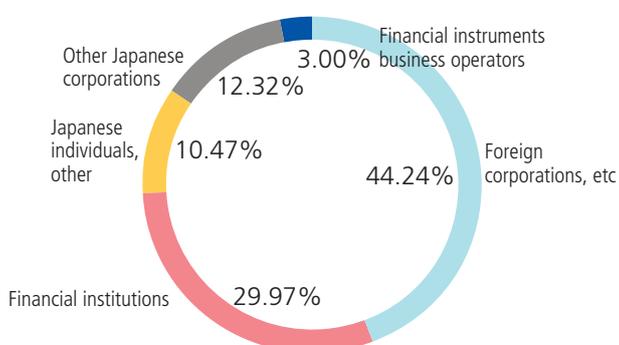
Major Shareholders (as of December 31, 2017)

Name of shareholders	Number of shares (Thousand shares)	Shareholding (%)
Japan Trustee Services Bank, Ltd. (Trust account)	5,089	13.81
SHEPHERDS HILL CAPITAL PARTNERS	2,038	5.53
THE CHASE MANHATTAN BANK 385036	1,674	4.54
Japan Industrial Fund III	1,596	4.33
Mizuho Bank, Ltd.	1,466	3.98
JP MORGAN CHASE BANK 380634	1,435	3.89
MANASLU FUND, L.P.	1,180	3.20
The Master Trust Bank of Japan, Ltd. (Trust account)	1,137	3.09
SONORA FUND, L.P.	781	2.12
STATE STREET BANK AND TRUST COMPANY	766	2.08

* No. of shares excludes any amounts lower than 1000.

* Share percentage rounds off percentages lower than displayed unit.

Status by Ownership (as of December 31, 2017)



Rating Information

Rating agency

Rating and Investment Information, Inc. (R&I)

Issuer rating

BBB

Short-term rating

a-2



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