



# ■ Review of Operations



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**167.8** billion cigarettes  
Total sales volume of JT products

**¥3,362.4** billion  
Net sales including excise tax

**¥306.7** billion  
EBITDA

**¥222.3** billion  
Operating income

### Business Performance

#### FY 3/2008 Business Performance Summary

- Total sales volume of JT products: 167.8 billion cigarettes\*, down 4.1%
- Net sales including excise tax: ¥3,362.4 billion, down 1.6%
- EBITDA: ¥306.7 billion, down 6.0%
- Operating income: ¥222.3 billion, down 9.4%

The domestic tobacco business faces an increasingly tough business environment as total tobacco demand in Japan continues to decline and competition with other tobacco manufacturers intensifies. In an effort to achieve top-line growth, we have been striving to strengthen our marketing capabilities while refreshing and enhancing existing brands as necessary and introducing new products in an effective manner. Moreover, we are making unceasing efforts to improve our productivity.

In FY 3/2008, we endeavored to enhance the value of our brands by introducing new products mainly in the Mild Seven family, which is our core brand, as well as by strengthening existing brands. Specifically, we introduced the "Mild Seven Aqua Menthol Super Lights Box" in July 2007 and the "Mild Seven D-spec Super Lights Box," a "D-spec" product developed using our odor reduction technology, in December 2007, both for nationwide release. Another example of our active sales promotion activity was the ongoing campaign to celebrate the 30th anniversary of the Mild Seven family's first market launch. Moreover, "Peace Infinity," a D-spec product initially released in limited regions, was launched nationwide in October, "Seven Stars Lights Menthol" was released in limited regions in February, and all nine products of the Caster family underwent package

redesigns in late December in order to create a uniform brand image. In May 2008, we released "Mild Seven Impact One 100's Box". In early July, we are scheduled to launch "Cabin Roast Blend 100's Box" and a new D-spec product called "Camel Nutty Lights Box" in limited areas of Japan.

The volume of our cigarette sales in FY 3/2008 decreased by 7.2 billion cigarettes (down 4.1%) from the previous year to 167.8 billion cigarettes\*. However, our market share rose to 64.9% (up 0.1 point), and we have achieved the first upturn in our market share since our privatization in 1985 thanks to active sales promotion campaigns and the introduction of new products. Net sales (excluding excise tax) per 1,000 cigarettes increased by ¥67 from the previous year to ¥4,057, due to a rise in unit sales prices caused by the revision of retail prices.

Consequently, net sales of the domestic tobacco business in FY 3/2008 declined by ¥53.9 billion from the previous year (down 1.6%) to ¥3,362.4 billion due to a drop in sales volume. Operating income fell by ¥23.0 billion from the previous year (down 9.4%) to ¥222.3 billion, depressed by increases in materials costs and sales promotion expenses.

\* In addition to the figure stated above, we also sold 3.5 billion cigarettes at duty-free shops in Japan as well as those in China, Hong Kong and Macau, markets that are under the control of our China Division.

### Strategy and Specific Measures

#### Optimizing our Marketing Mix toward Sustainable Growth

- Product strategy
- Distribution strategy
- Marketing strategy
- Improving productivity and fulfilling our responsibility as the market leader

We have achieved the first upturn in our market share since our privatization in 1985 thanks to active sales promotion campaigns and the introduction of new products.

The domestic tobacco business is positioned as the core source of profits for the JT Group. Competition for market share is becoming increasingly intense as total tobacco demand continues to decline, due to factors such as the ageing of Japanese society, growing awareness about the health risks associated with smoking and the tightening of smoking-related regulations. In this business environment, JT is resolved to boost the value of its domestic tobacco business by pursuing a strategy for sales growth and enhancing productivity simultaneously.



**Ichiro Kumakura**  
President, Tobacco Business

### Optimizing Our Marketing Mix to Gain Maximum Results

In the domestic tobacco market, total demand for cigarettes has continued to decline due to the aging of the Japanese population, growing awareness about the health risks associated with smoking and tightening of smoking-related regulations. Increases in the tobacco excise tax that took effect in July 2003 and July 2006 had an additional impact on the market, with Japanese smoking rate dropping to 26.0%, according to a May 2007 survey.

Meanwhile, as tobacco-related regulations are being strengthened in various ways, market share competition with foreign brands is intensifying. JT will overcome the impact of a future decline in sales volume by optimizing our marketing mix through our product, distribution and sales strategies.

#### [Product Strategy]

Our product strategy focuses on boosting the value of our main brands and introducing new products in an effective manner.

After redesigning the packages of 14 products in the Mild Seven family in 2006, we renewed the packages of all nine products in the Caster brand family in December 2007 as part of our effort to boost the value of our main brands. Moreover, we are seeking to raise unit prices by developing and introducing products with high value added, as represented by the D-spec brand family. We aim to expand our market share by pursuing a brand portfolio that suits the excellent value of our brands.

#### [Distribution Strategy]

We have a powerful, unrivalled domestic distribution network. About 60% of all tobacco sales in Japan go through cigarette vending machines, and JT owns more than 40% of all such machines installed in the country. We will continue to maintain our overwhelming competitive edge in sales through vending machines and step up efforts to increase sales through emerging sales channels such as convenience stores.

#### [Marketing Strategy]

Our marketing force, the vast size of which eclipses the marketing teams of our competitors, satisfies the multitude and variety of needs of retailers scattered across the country. We will continue to engage in efficient and effective marketing activities in ways linked to our product and distribution strategies, while complying with regulations and rules such as restrictions on tobacco advertising and prevention of youth smoking.

#### [Improving Productivity and Fulfilling Responsibilities as Market Leader]

Productivity improvement is a critical challenge for any manufacturing company. At JT, we will never cease our efforts to satisfy the increasingly diverse needs of our customers and to respond appropriately to any change in the supply-demand balance.

Moreover, we will continue to fulfill our responsibilities as the leading tobacco company in the Japanese market by endeavoring to achieve a harmonious co-existence between smokers and non-smokers. We will also engage in initiatives to improve smoking manners and strive to secure and create space and opportunity for smoking, for example by helping to provide comfortable smoking areas. Meanwhile, the tobacco industry, including JT, will continue to promote initiatives to prevent youth smoking, including the nationwide introduction of age verifying cigarette vending machines, scheduled for July 2008, in cooperation with local governments and other organizations concerned.

### As a Core Source of Profits for the JT Group

We will ensure that the domestic tobacco business continues to serve as the JT Group's core source of profits by overcoming challenges in the domestic market, such as the continuing decline in total tobacco demand and intensifying competition.

**385.6** billion cigarettes

Total sales volume

**203.2** billion cigarettes

GFB sales volume

**¥2,640.0** billion

Net sales including excise tax

**¥270.8** billion

EBITDA

**¥205.4** billion

Operating income

## Business Performance

### FY 2007 Business Performance Summary\*

- Total sales volume: 385.6 billion cigarettes, up 60.6%
- GFB sales volume: 203.2 billion cigarettes, up 40.0%
- Net sales including excise tax: ¥2,640.0 billion, up 164.1%
- EBITDA: ¥270.8 billion, up 140.3%
- Operating income: ¥205.4 billion, up 153.3%

\* The consolidated accounting period for the international tobacco business is from January 2007 through December 2007.

JTI will further enhance its role as the profit growth engine for the JT Group through top-line growth. In continuing its business integration with Gallaher, JTI seeks to gain both top-line synergy and cost saving synergy. JTI has identified eight brands which comprise the new portfolio of Global Flagship Brands (GFB): Winston, Camel, Mild Seven, Benson & Hedges, Silk Cut, LD, Sobranie and Glamour. JTI will actively explore opportunities for top-line growth based on the strength of the GFB.

In 2007, JTI's total sales volume increased by 145.5 billion cigarettes (up 60.6%) from the previous fiscal year, to 385.6 billion cigarettes. This was due to Winston's sales growth in Russia, Ukraine, Turkey and Spain; Camel's sales growth in Spain, France, Italy and Russia; in addition to the contribution of Gallaher's sales. GFB sales volume totaled 203.2 billion cigarettes. As a result, net sales of the international tobacco business increased by ¥1,640.3 billion from the previous fiscal year (up 164.1%) to ¥2,640.0 billion, and operating income increased by ¥124.3 billion (up 153.3%) to ¥205.4 billion.

Note: The foreign exchange rate in 2007 was ¥117.85 per dollar, compared with ¥116.38 per dollar in the previous fiscal year.

## Key Strategies of JTI

- Building outstanding brands
- Enhancing productivity
- Responsible behavior
- Developing people

Continuous Improvement is embedded across the organization in addressing these key strategies.

### [Building Outstanding Brands]

Brands are the engine of JTI's business as the company continues to focus on product quality and excellence in execution. JTI's objective is clear: offering to consumers brands that deliver greater satisfaction than those offered by its competitors. JTI believes that active investment in brands is essential to making the most of its new brand portfolio and accelerating its top-line growth. JTI plans to start spending an additional 100 million dollars per year on its marketing activities in 2008, mainly in markets derived from the acquisition of Gallaher.

### [Enhancing Productivity]

JTI is devoting its efforts to optimizing its cost base and improving business processes. This will ensure that the energy, time and money invested yield the highest possible return.

In continuing its integration of Gallaher, JTI will accelerate efforts to optimize its manufacturing footprint and procurement, integrate distribution and sales organizations, and optimize its entire range of business processes.

By the end of December 2007, JTI had announced around

JTI International (JTI), the international tobacco division of JTI, enjoys the fastest organic growth among all global tobacco manufacturers. The acquisition of Gallaher in April 2007 has brought JTI significant scale benefits as well as an enhanced portfolio of brands and talent base. The business integration of JTI and Gallaher has proceeded quickly and smoothly without causing any disruptions to JTI's existing business momentum. The new JTI, strengthened by the integration of Gallaher, will continue to actively pursue further opportunities for quality top-line growth.



**Pierre de Labouchere**  
President & CEO, JTI International S.A.

1,000 headcount reduction and the closure of four factories: Linz in Austria, Cardiff in Wales, Bucharest in Romania and its Turkish factory.

#### [Responsible Behavior]

JTI believes that pursuing excellent corporate governance and social responsibility is essential to a successful organization. The company is committed to the highest standards of corporate governance and socially responsible practice in all of its corporate activities.

In December 2007, JTI signed a cooperation agreement with the European Commission (the executive branch of the European Union), and 26 EU member states\* in the fight against the illicit trade of tobacco. JTI believes that this agreement will help to establish a more efficient and constructive framework for cooperation between JTI, the EU, and member states in order to combat organized tobacco smuggling and counterfeiting.

\* The EU member states that agreed to participate in the cooperative initiative as of December 14, 2007 are as follows:  
Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden

#### [Developing People]

In order to successfully take on any future challenges, JTI endeavors to attract and retain the best people. Taking advantage of cultural diversity, a strongpoint in JTI, the company develops people to enable them to take leadership positions in the future, irrespective of their nationalities.

### Toward Sustainable Organic Growth

JTI's strong business performance and growth have been supported by key commitments: focusing on the GFB portfolio and enhancing brand equity through continuous quality improvement.

JTI more than tripled its EBITDA over the seven-year period from 2000 to 2007, through organic growth. Furthermore, the company more than doubled its profits in 2007 alone via record high levels of organic growth and the contribution of Gallaher.

JTI will further build on this broadened business base and capitalize fully on the resources acquired via the business integration. At the same time, JTI will continue to make investments in order to achieve sustainable top-line growth and thus act as the profit growth engine for the JTI Group. JTI remains committed to the goal of reaching an annual EBITDA growth rate of at least 10% over the coming three years.

¥49.1 billion  
Net sales

-¥6.3 billion  
EBITDA

-¥9.6 billion  
Operating income

### Business Performance

#### FY 3/2008 Business Performance Summary

- Net sales: ¥49.1 billion, up 7.9%
- EBITDA: -¥6.3 billion, up ¥1.9 billion
- Operating income: -¥9.6 billion, up ¥1.6 billion

In the pharmaceutical business, we are striving to further improve and strengthen our in-house R&D capabilities. Although we abandoned the development of anti-diabetes compound JTT-551, the development of anti-obesity compound JTT-553, anti-diabetes compound JTT-651, anti-Hepatitis C compound JTK-652, JTS-653 — a compound for pain relief and treatment of overactive bladder, and anti-diabetes compound JTT-654 have advanced to the clinical trial stage, bringing the number of compounds developed in-house that are under clinical development to 11.

Moreover, we are exploring strategic opportunities to conclude licensing agreements to acquire rights to drugs developed by other companies, or give others rights to our drugs. In September 2007, we concluded a licensing agreement with Keryx Biopharmaceuticals Inc. under which JT and Torii Pharmaceutical Co., a subsidiary of JT, have acquired the exclusive rights to develop and commercialize Keryx's hyperphosphatemia drug in Japan, which is currently in phase II clinical study in the United States.

Regarding the business performance of Torii Pharmaceutical, the company suffered declines in sales of its mainstay products, the Futhan protease inhibitor and the Stronger Neo-

Minophagen C agent for treatment of liver and allergic diseases. On the other hand, sales grew for Antebate, a topical adrenocortical hormone, and Truvada, an anti-HIV drug, leading to an increase in Torii Pharmaceutical's overall sales.

Consequently, sales of JT's pharmaceutical business increased by ¥3.6 billion from the previous year (up 7.9%) to ¥49.1 billion, as the decrease in royalty revenue from the Viracept drug was more than offset by the milestone revenue related to the progress made in the development of anti-dyslipidemia agent JTT-705, licensed to Roche Group in October 2004, and an increase in Torii Pharmaceutical's sales. Operating loss decreased to ¥9.6 billion from the previous year's ¥11.2 billion, despite an increase in R&D expenses, including a down payment made for Keryx's hyperphosphatemia drug.

### Strategy and Specific Measures

- To steadily advance the development of compounds and expand and enhance the R&D pipeline
- To explore for strategic opportunities for licensing agreements

#### [Steady Advance of Drug Development and Expansion/Enhancement of R&D Pipeline]

In the pharmaceutical business, JT will maintain its strategy of further expanding and enhancing its R&D pipeline by promoting drug discovery research and advancing the development of compounds currently in the pipeline.

JT aims to develop the pharmaceutical business into one of the pillars of its diversified operations in the future.

To this end, we have been striving to establish a solid business foundation by building world-class, unique R&D capabilities and increasing our market presence through the development of innovative drugs.



**Noriaki Okubo**  
President, Pharmaceutical Business

While making use of our accumulated knowledge, we have narrowed our R&D focus, allocating our resources mainly to areas such as (1) glucose and lipid metabolism, (2) virus research, (3) immune disorders and inflammation and (4) bone metabolism.

#### [Quest for Strategic Opportunities for Licensing Agreements]

In the face of intensifying global R&D competition, it is becoming increasingly important to speed up R&D activity and bring new products to market quickly. Therefore, JT is exploring strategic opportunities for licensing agreements to acquire rights to drugs developed by other companies (in-licensing) or give others rights to its own drugs (out-licensing) so that we can rapidly increase the value of the business.

As for out-licensing, we concluded licensing agreements with Roche Group with regard to anti-dyslipidemia agent JTT-705 and with Gilead Sciences of the United States with regard to anti-HIV agent JTK-303 in fiscal 2004. In fiscal 2006, we licensed a new pre-clinical trial stage compound to GlaxoSmithKline and licensed a pre-clinical trial stage antibody drug candidate to MedImmune. We have sped up the development of our drugs by tapping external R&D resources through these out-licensing deals.

Regarding in-licensing, meanwhile, we concluded a licensing agreement in fiscal 2003 to acquire rights to commercialize three anti-HIV drugs developed by Gilead Sciences in Japan. These drugs are now sold by Torii Pharmaceutical. Moreover, in fiscal 2004 the JT-Torii group agreed with Toray Industries, Inc. to jointly develop Toray's antipruritic agent, TRK-820, for

treatment of severe uremic pruritus in hemodialysis patients. The three companies agreed on the joint development and sales of the same drug for treatment of severe uremic pruritus in hepatic disease patients in fiscal 2006. In fiscal 2007, the JT-Torii group signed a licensing agreement with Keryx Biopharmaceuticals of the United States under which we have acquired the exclusive rights to develop and commercialize Keryx's hyperphosphatemia drug in Japan.

#### Pursuit of Innovative Drugs

We are engaged in an unceasing quest to develop innovative and globally competitive drugs, which we regard as the most critical mission for our pharmaceutical business. The development of new drugs is a tough challenge, which we are tackling with a sense of pride and high motivation. We are endeavoring to make the kind of achievements that we alone can realize and make available drugs that we alone can offer, so that we may deserve the respect and appreciation of patients and medical staff around the world.

¥336.4 billion

Net sales

¥8.4 billion

EBITDA

¥0.7 billion

Operating income

### Business Performance

#### FY 3/2008 Business Performance Summary

- Net sales: ¥336.4 billion, up 17.4%
- EBITDA: ¥8.4 billion, down 30.5%
- Operating income: ¥0.7 billion, down 90.1%

We have positioned the foods business as a pillar of our diversified operations, devoting efforts to three areas-beverages, processed foods and seasonings. We take seriously the food-poisoning cases involving frozen foods products contaminated with pesticide that came to light in January 2008. Based on our renewed recognition of the importance of food safety, we have been striving to establish a safety control system of the highest standard. We have also been endeavoring to consolidate our business foundation as an integrated foods manufacturer. In the beverage sector, we have steadily expanded our vending machine sales channels, mainly through Japan Beverage Inc., a JT Group company, and actively launched new products developed for the purpose of achieving differentiation from competitors, focusing mainly on the flagship Roots brand. In the processed foods sector, sales of frozen food products slumped after February due to the impact of the pesticide contamination cases. We will strive to regain the trust of our customers by steadily and promptly implementing measures to significantly enhance our safety control system. In addition, we will steadily proceed with the integration of the Katokichi Group, which we turned into a subsidiary on January 8, 2008. In the seasonings sector, we have been strengthening our business foundation by focusing on the development of natural seasonings such as high-value yeast products, based on our in-house technology, and expanding sales of such products. To sum up the financial results of the foods business, net sales increased by ¥49.9 billion, or 17.4%, from the previous year to ¥336.4 billion, with the con-

tribution of the Katokichi Group and other factors offsetting a decline in sales of processed food products. However, operating income decreased by ¥6.0 billion, or 90.1%, to ¥0.7 billion, due to factors such as an increase in raw materials costs and the cost of goodwill amortization related to the acquisition of the Katokichi Group.

### Strategy and Specific Measures

Aiming to establish a global competitive advantage as an integrated foods manufacturer, we will endeavor to:

- establish a competitive advantage.
- gain synergy effects as an integrated foods manufacturer.

**Beverages Business:** In the beverages business, we will further develop the core Roots brand in order to achieve sustainable growth. Moreover, we will promote the development and market launch of new products, focusing on achieving differentiation from rival products and high quality using our original technologies. We will also steadily expand our vending machine sales channels, mainly through Japan Beverage Inc., a JT Group company.

**Processed Foods Business and Seasonings Business:** We plan to put all of our operations related to processed foods - including frozen foods - and seasonings products, as well as JT subsidiaries such as JT Foods Co., under the control of Katokichi. Through realignment of the foods business, Katokichi will aim to establish itself as a unique processed foods manufacturer with a leading position in the frozen foods market and with superior expertise in seasonings.

### Direction of Future Enhancement of Food Safety Control

We would like to offer our sincere apologies not only to people who suffered health problems after consuming certain frozen foods products sold by the JT Group, but also to our customers who have cooperated with our nationwide product recall, to business

We have positioned the foods business as a pillar of our diversified operations, devoting efforts to three areas: beverages, processed foods and seasonings.

We will strive to establish a safety control system of the highest standard, through improving our in-house inspection system and utilizing the knowledge and skills of outside experts, among other measures, and consolidate our foundation as an integrated foods manufacturer. We will also proceed steadily with the integration of the Katokichi Group and seek to expand the size of our foods business and enhance its profit-generating capability.



**Sadao Furuya**  
President, Food Business

partners and consumers throughout Japan. Taking the incident very seriously, we will implement drastic measures to ensure the safety of our foods and maintain customers' trust in this safety.

#### Enhancement of the System for Checking All Processes from Manufacturing to Delivery

- We will introduce stricter criteria for selecting partner manufacturing plants in and outside Japan and make sure to consign food production only to plants that meet the new criteria. In addition, we will make more active use of JT Group plants in cooperation with Katokichi, whose operations we are in the process of integrating.
- We will subject all domestic and foreign manufacturing plants, including partner plants, to spot audits as well as biannual periodic audits, and promote the acquisition of ISO22000 certification, an international standard for food safety management.
- We will appoint officers in charge of quality control in China and have them inspect manufacturing operations. In addition, we will properly examine the manufacturing processes from the production of raw materials onward, inspecting the cultivation conditions for agricultural products and the management of agrochemicals, testing the soil and water quality and checking for agrochemical residues.
- Regarding frozen food products, we will check for residues of organic phosphorous agrochemicals, with imports from China in particular being double-checked, both in China and Japan.
- In Japan, we opened an in-house inspection center in Sashimagun, Ibaraki Prefecture, in late April. We will also establish an inspection center in China in order to enable self-checks for chemical substances and other items.
- We will gradually expand the scope of check items from organic phosphorous agrochemicals to agrochemicals in general, antibiotics and heavy metals.

#### Enhancement of Response to Customers' Complaints and Inquiries

- We will respond to inquiries from customers all year round and, when contacted by people concerned about health problems related to the consumption of JT food products, take appropriate measures such as inquiring about their health condition or visiting them at their homes, and cooperating closely with our business partners, administrative authorities and medical institutions to gather accurate information.
- If any quality problems regarding JT products are found, we will conduct analysis and investigation from every possible angle and with every conceivable possibility in mind and promptly take appropriate measures, such as withdrawing the products in question from the market.
- On our website, we have started disclosing information concerning the manufacturing plants for frozen food products for retail sale and the production location of major raw materials. We will also start to indicate such information on product packaging as soon as we are ready.
- In order to enhance our safety control systems with expert knowledge and from various viewpoints, we have invited third-party experts to serve as our advisers and provide assessment and advice on a regular basis regarding the systems.

In the future, we will strive to provide delicious foods that people can consume safely. Based on our renewed recognition of the principle that safety is the top priority for food products, we will strengthen our R&D and product development capabilities, along with our sanitary control and quality control systems, in order to keep our product quality at an appropriate level. As part of these efforts, we will devote ourselves to ensuring the procurement of high-quality raw materials, enhancing the traceability of our products, developing technologies essential for maintaining product quality and strengthening our internal control systems.