

Review of Operations

TIMBER
AND BUILDING
MATERIALS



Despite drooping domestic housing starts, conditions in the timber and building materials market in the first half remained robust, reflecting a reduced supply of imported products, particularly of plywood. In the second half, however, the re-emergence of substantial supply from overseas depressed prices and dampened the operating environment. For the full year, sales and contract revenues in the Timber and Building Materials segment climbed 5.1% over the previous fiscal year's result to ¥266,078 million, and operating profit rose 18.9% to ¥2,238 million.



INTERNATIONAL BUSINESS

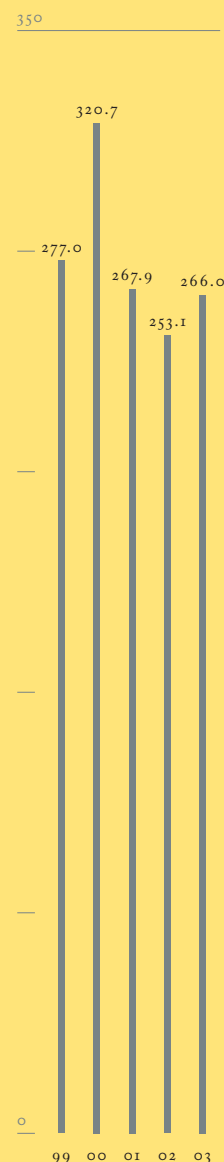
Sumitomo Forestry has identified overseas business as a key element in its strategy to ensure future growth. While carrying on with efforts to strengthen its existing building materials production business largely in the Pacific Rim, the Timber and Building Materials segment sharpened its focus on expanding and hastening new business overseas, beginning with distribution and housing in North America.

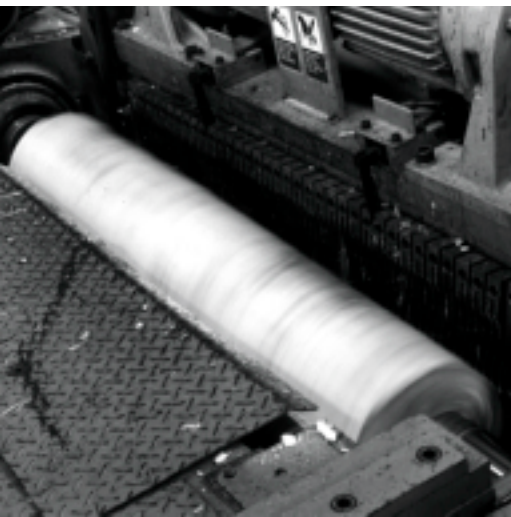
Briefly reviewing the segment's overseas business activities, Nelson Pine Industries Limited (NPIL), our wholly owned subsidiary in New Zealand, commenced commercial production of laminated veneer lumber (LVL) as a new strategic product. In December 2002, the Sumitomo Forestry Group acquired Dominance Industries Pty Ltd., a major manufacturer of medium-density fiberboard (MDF) in Australia. The company's name was changed to Alpine MDF Industries Pty Ltd. shortly after the acquisition. Combining Alpine MDF's activities with those of NPIL, Sumitomo Forestry now boasts four MDF production lines and a place among the top-three MDF producers in the Oceania region.

In Indonesia, Group company P.T. Rimba Partikel Indonesia (RPI) continued to manufacture particleboard using wood waste collected from local wood processors throughout Java. Meanwhile, subsidiary P.T. Kutai Timber Indonesia (KTI), located in East Java, stepped up manufacture of composite wood products and expanded exports to Europe, the United States and Asia.

In the United States, Sumitomo Forestry purchased Pacific Wood Products LLC, a building materials importer, to strengthen its foothold in the U.S. market. In a preparatory move for entering the American housing market, in September 2002 Sumitomo Forestry and Seattle-based housing company Bennett Homes, Inc. established a joint venture, Bennett-SFS LLC. Soon after its formation, the new company began construction on a pilot housing project.

SALES AND CONTRACT REVENUES
(Billions of yen)





KTI strictly avoids the harvesting of natural forests. The company actively promotes the planting of *falcata* to increase the use of plantation-grown wood as a source of building materials.

OVERSEAS MANUFACTURING BUSINESS

NELSON PINE INDUSTRIES LIMITED (NPIL) NPIL was established in 1986 as an MDF manufacturing base. With an annual production capacity of approximately 330 thousand cubic meters, NPIL boasts the largest single-site production capacity of MDF in the world. Compared with other timber building materials, MDF offers an array of attractions. For instance, MDF is manufactured almost entirely from radiata pine, the premier species for large-scale tree planting in New Zealand. And unlike other timber building materials, MDF can be manufactured from small branches and curved sections of the tree, thereby reducing waste. In 2002, NPIL commenced production of LVL, a structural composite lumber known for its strength, dimensional stability and processibility. LVL is gaining popularity in Japan and other parts of Asia, as well as in Oceania and North America, and NPIL is actively working to meet the growing demand. In an effort to reduce raw materials waste, NPIL uses radiata pine to produce LVL and the residual to manufacture MDF.

ALPINE MDF INDUSTRIES PTY LTD. Sumitomo Forestry purchased Australia-based Dominance Industries Pty Ltd. (now Alpine MDF Pty Ltd.) in December 2002 with the aim of satisfying growing demand for MDF in the Pacific Rim. With this purchase, Sumitomo Forestry established itself as a leading MDF manufacturer in Oceania, with the combined annual production capacity of Alpine MDF and NPIL exceeding 500,000 cubic meters. Sumitomo Forestry anticipates additional synergistic benefits to accrue between Alpine MDF and NPIL.

P.T. KUTAI TIMBER INDONESIA (KTI) Established in 1970 and one of the oldest companies in Indonesia in which a foreign company has a part interest, KTI has since 1975 been engaged in the manufacture of plywood and wooden building materials. This company has been increasing the percentage of plantation-grown wood used in the manufacture of its value-added post-processed plywood, which it sells to environmentally conscious markets including the United States and Europe. Its fire doors, exported to England, are receiving especially high marks for quality. KTI received ISO14001 certification in 2001 for its environmental management program, which includes extensive use of plantation-grown trees as part of the company's commitment to operating as an environmentally conscious building materials enterprise.



P.T. RIMBA PARTIKEL INDONESIA (RPI) RPI, an affiliated company established in 1990 and located near Semarang, Indonesia, produces low-formaldehyde-emission particleboard that conforms to strict Japanese standards. This particleboard, manufactured from sawmill residue and the peeled cores of logs discarded by plywood factories, finds applications in furniture and speaker boxes. RPI sells its products locally and exports to such countries as China. Taking a proactive approach to the environment, the company promotes reforestation in cooperation with local residents in an effort to ensure a stable supply of raw materials.

P.T. AST INDONESIA (ASTI) Established in 1996, ASTI uses particleboard supplied by RPI in the manufacture of speaker boxes.

DOMESTIC BUSINESS

The timber and building materials distribution market in Japan has matured. Accordingly, Sumitomo Forestry has worked hard in recent years to reduce inventories, and we continue to undertake strict credit assessments of trading partners. More positively, in an effort to increase market share the Company has strengthened alliances with its principal trading partners and expanded existing sales routes. Moreover, amid ongoing industry restructuring we are actively seeking out new trading partners, cultivating new businesses and enhancing our competitive advantage generally. As a part of these efforts, Sumitomo Forestry during the year implemented changes to its INOS Group business system in an effort to more efficiently share know-how and offer support, in addition to revitalizing and differentiating the activities of individual member builders.



Indonesia-based employees of KTI subsidiary.

HOUSING AND
HOUSING-RELATED
BUSINESSES

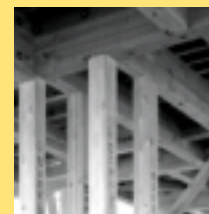


Prolonged recession and uninspiring short-term prospects dominated conditions in the domestic housing and housing-related markets during the year under review. In such an operating environment, the Company carried out activities in accordance with its customer-first management policy. With an eye toward bringing up the bottom line, we critically reviewed our materials procurement and production processes in order to cut costs, all the while implementing our firm resolve to reduce selling, general and administrative (SG&A) expenses. As a result, despite a 3.1% drop in sales and contract revenues to ¥369,885 million, the Housing and Housing-Related segment's operating profit nearly doubled to ¥9,920 million.

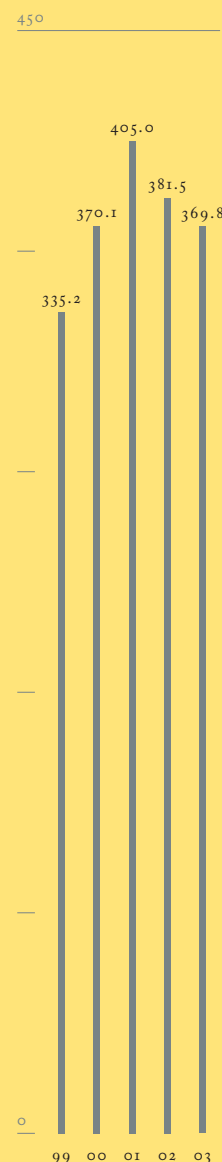
In the market for custom-built wooden homes incorporating traditional post-and-beam architectural methods, Sumitomo Forestry worked to bolster its sales capabilities and at the same time enhance its brand value by developing products that accurately address market needs. After reviewing our marketing structure at sales bases nationwide, we introduced a team manager system emphasizing on-the-job training oriented toward improving sales capabilities. In August, we launched the Rialt series, targeting the relatively buoyant first-time buyer market. This new series is based on a fresh design that ensures cost performance while maintaining quality standards. As a result, the Rialt series has rapidly become a mainstay product. We also introduced other products to meet the market's diverse needs. For example, in November we began marketing our new GODAI Waraku model, which generously displays the calming and harmonizing qualities of wood so central to the ambience of the traditional Japanese home. The GODAI One's Story II, launched in January, offers added security features and a 24-hour ventilation system. A quick market favorite, GODAI One's Story II is positioned to become a next-generation mainstay product.

In the market for custom-built wooden homes incorporating nontraditional construction principles, such as the two-by-four method, we focused on upgrading the development of customer-oriented products, the reduction of production costs including SG&A expenses, and enhancing management efficiency. At the same time, we worked to eliminate accumulated deficits through the increase and decrease of capital. Despite the impact of a difficult operating environment, Sumirin Two-By-Four Homes Co., Ltd., renamed Sumitomo Forestry Two-By-Four Homes Co., Ltd. in April 2003, managed to increase orders by specializing in luxurious Western-style houses.

The GODAI One's Story II, a major product of the Company, offers standard low-emissivity double-insulating glass for all ground-floor windows for added security.



SALES AND CONTRACT REVENUES (Billions of yen)





The collective housing business offers a complete range of services including comprehensive site and building planning for enhanced asset value.

In prefabricated wood-frame houses, Sumirin Component House Co., Ltd. merged its production and marketing companies with Sumitomo Forestry Component House Industry Co., Ltd. in an effort to streamline operations and improve information-sharing and began operations under the name Sumitomo Forestry Component House Co., Ltd. In addition, we undertook a comprehensive review of production methods with the aim of improving our earnings structure.

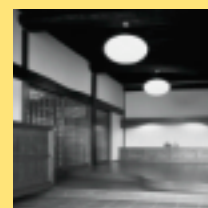
Although orders for new detached homes throughout the Group dropped 1.3% to 10,538 units, and the number of housing completions fell 4.1% to 10,552 units compared with the previous fiscal year, Sumitomo Forestry achieved its annual target of 10,000 units despite the contraction in the housing market. In the collective housing business, we worked to increase orders by flexibly offering alternative solutions as required by specific projects, from reinforced concrete construction to two-by-four wood-frame methods. As well, we concentrated on developing innovative products, including day-care centers for the elderly and soundproof dormitories for students of music. As a result of these activities, new construction orders increased 14.1% to 1,227 units and the number of completed projects jumped 48.4% to 1,220 units compared with the previous fiscal year.

HOME REMODELING, HOME LANDSCAPING AND OTHER BUSINESSES

In contrast to the slump in new housing starts, the market for home remodeling continues to grow, with homeowners trending toward the refurbishment of existing dwellings and away from the purchase of new homes.

At Sumitomo Forestry Home Tech Co., Ltd., the Group's principal home remodeling company, we have positioned home remodeling as a future mainstay business. Accordingly, we have opened seven new locations, for a total of 41 stores, and are collaborating with the new housing construction business to enhance marketing activities. Sumitomo Forestry Home Tech is unique in that the majority of its employees are qualified architects. Backed by qualified specialists and offering comprehensive after-sales service—and reaping the harvest of trust sown over the years as a specialized builder of a large number of the existing post-and-beam detached houses in Japan—Sumitomo Forestry Home Tech is progressively increasing the volume of new orders. Interestingly, Sumitomo Forestry's specialized skills accumulated over the years are attracting market demand for our services in remodeling homes more than 70 years old.

In the tree-planting and home landscaping businesses, we have worked to develop new products and continue to actively market our flat-rate system garden-care services. Despite a drop in the number of custom-built houses completed and its impact on operating results, we have developed new techniques for landscaping on building rooftops buoyed by growing concerns regarding the “urban heat island” phenomenon.



OTHER

Elephant training center in the Way Kambas National Park in Indonesia.



SALES AND CONTRACT REVENUES
(Billions of yen)

Sales and contract revenues in the Other segment for the year under review decreased 8.5% to ¥9,136 million, and operating profit fell 28.3% to ¥415 million.

The Sumitomo Forestry Group includes companies engaged in real estate brokering and in the production and marketing of compost for agricultural and gardening use, as well as a variety of service-oriented businesses including information system development, general insurance and leasing agency services.

Similar to our activities in the home remodeling business and for existing dwellings, we have positioned Sumitomo Forestry Home Service Co., Ltd. and the real estate brokerage business as a future mainstay business. Accordingly, we are accelerating our activities in this field and expanding our network by focusing on activities appropriate to specific regions and markets.

With regard to environmental preservation efforts, Sumitomo Forestry has continued the afforestation project commenced during the previous fiscal year as part of Japan's Official Development Assistance (ODA) program for the replanting of the Way Kambas National Park in Indonesia. In addition, we have been commissioned by Japan's Ministry of the Environment to commence preliminary studies of the Clean Development Mechanism (CDM) in an effort to achieve reduction targets for greenhouse gas emissions, as defined under the Kyoto Protocol.



Environmental Stewardship and Corporate Citizenship

As global environmental issues become increasingly important, Sumitomo Forestry is actively engaging in environmental businesses that take advantage of its forestry management experience accumulated over 300 years. As a responsible corporate citizen, we are promoting activities in harmony with the environment, focusing not only on economic gain but also environmental protection and contributing to a sustainable society. In every aspect of our business from timber and building materials through housing and afforestation, a Groupwide spirit of environmental conservation underpins our conduct and activities.

ENVIRONMENTAL MANAGEMENT SYSTEM

Sumitomo Forestry has actively pursued ISO 14001 certification, the international standard for environmental management systems, in an effort to promote efficient environmental management.

The Business Administration Division, the Business Headquarters, Collective Housing Headquarters, and other divisions acquired ISO 14001 certification in August 2001. Together with the Housing Headquarters and the Forestry & Environment Headquarters, all divisions and departments of Sumitomo Forestry in Japan have obtained certification. We are the first in our industry to attain certification in Japan for all housing functions from product design through construction.

Sumitomo Forestry is now working to acquire ISO 14001 certification for all its Group companies. In November 2002, four Group companies* acquired accreditation namely Sumitomo Forestry Landscaping Co., Ltd., Sumitomo Forestry Home Service Co., Ltd., Sumitomo Forestry Component House Industry Co., Ltd., and Sumirin Component House Co., Ltd.

** Sumitomo Forestry Component House Industry Co., Ltd., and Sumirin Component House Co., Ltd. merged on January 1, 2003 to form Sumitomo Forestry Component House Co., Ltd.*



Regeneration project
in Way Kambas
National Park in
Indonesia.

SUSTAINABLE FORESTRY MANAGEMENT

Based on over 300 years of unbroken tradition, Sumitomo Forestry has practiced responsible management of woodlands with “Sustainable Forestry” as its underlying philosophy. We have nurtured stable forests through a deliberate process of afforestation. With the aim of preserving the forest ecosystem, Sumitomo Forestry harvests only certain sections at a time, instead of harvesting all the trees in a widespread area at once. Conscious that our forests remain the property of society at large and of sustained timber production over subsequent generations, we divide woodlands into areas of 0.05 to 0.1 hectares and implement a deliberate pattern of tree-planting, maintenance and harvesting. With this initiative, we strive to preserve the ecosystem of surrounding areas, prevent sediment damage and at the same time to increase the volume of carbon dioxide CO₂. As a result, over the 40,497 hectares of woodlands owned by Sumitomo Forestry, we have restricted the volume of CO₂ absorbed to between 250,000 and 280,000 tons per year, helping to alleviate the problems caused by global warming.

TIMBER AND BUILDING MATERIALS

The Sumitomo Forestry Group companies that produce building materials are responding to the heightened awareness of environmental issues by efficiently utilizing waste materials in the production process.

RPI, located near Semarang Indonesia, produces particleboard from plywood discarded by factories across Java. The company has developed a high-quality particleboard mixing sawmill residues and the peeled cores of logs under pressure with adhesive agents at high temperature. This particleboard has wide application in the manufacture of speaker boxes and furniture.

RPI effectively utilizes by-products, or materials discarded in the product manufacturing process. Dust called wood flour is produced as a by-product in the particleboard manufacturing process. In the past, RPI had disposed of most of this wood flour, but now efficiently uses the dust as fuel for a dryer boiler refitted for this purpose in March 2002. Consequently, in one year we will be able to cut the amount of diesel oil fuel by approximately 90%.

In Indonesia, wooden building material manufacturer KTI and RPI are striving to stabilize the supply of raw wood materials from afforestation, which have a low impact on the environment. Accordingly, we are proactively promoting afforestation in cooperation with local communities, including universities and regional and municipal governments. KTI is planting trees in Eastern Java in an aim to increase the ratio of plantation-grown wood to 70% by fiscal 2005. Since the end of 2000, we have jointly planted fast-growing *falcataria* trees with an Indonesian state-owned plantation company. We are also promoting reforestation with the cooperation of local governments, public institutions and local citizens, including the city of Probolinggo, where KTI has a plant, Universitas Surabaya and the Livestock Research Center. At our more than 20 joint tree plantations, we have planted 1,626,000 saplings of mainly the *falcata* variety, which mature in 5-7 years. Wood will be supplied to KTI from these tree plantations as early as 2006.

Clean Development
Mechanism (CDM)
survey.



At RPI, we have begun to cooperate with local residents to plant acacia mangium, gmelina arborea and other fast-growing trees. As with KTI's afforestation operations, RPI contributes to regional economic independence by bringing in cash revenues while ensuring a source of raw materials by planting trees.

Located in New Zealand, Nelson Pine Industries Limited (NPIL) produces medium density fiberboard (MDF). Generally, about 65-70% of the original tree is used in making wooden building materials. MDF, on the other hand, can be made from small-diameter trees and twisted tree branches. NPIL operates with zero emissions by drastically holding down the emission of waste and using nearly 100% radiata pine trees that are grown on carefully planted and nurtured tree plantations.

PROMOTING DOMESTICALLY PRODUCED WOOD The use of domestically produced wood is being promoted from the standpoint of preventing the decimation of forests. Sumitomo Forestry actively encourages the use of domestically produced wood as building materials for the development of housing products.

In the Housing Headquarters, Super Cypress, a glued laminated timber composed of cypress, popular among Japanese builders, is a primary building material for the GODAI One's Story II home model. Cypress wood excels in durability and resistance to rotting. Ideal for the foundations, posts and beams of homes, Super Cypress retains all the good qualities of this wood while offering greater precision and strength. Backed by the accumulated technologies of the Sumitomo Forestry Group, we have devel-

oped an innovative production plant able to effectively process cypress trees of relatively small diameter and thickness, enabling the efficient employment of materials that had previously been discarded, such as trees cut during thinning work.

Our original strong and ventilated Kizure panels are used as exterior wall substrates by arranging narrow slats of Japanese cedar in a lattice pattern. Compared with conventional plywood, Kizure panels offer stronger strength and better ventilation. Kizure panels are made from materials such as end scraps from sawmills and small diameter trees cut during thinning work, thereby contributing to the utilization of domestically produced wood. Sumitomo Forestry has boosted the percentage of domestic material in GODAI One's Story homes from 7% to 41% by using Super Cypress and Kizure panels. Sumitomo Forestry will continue to encourage the use of domestically grown trees and aim to stimulate the forestry sector in Japan. In this way, we hope to contribute to the preservation of the environment by fostering forest resources, increasing the CO₂ absorption volume of trees, cultivating water resources and preventing landslides.

INTERNATIONAL AFFORESTATION OPERATIONS Taking advantage of its accumulated expertise in afforestation, Sumitomo Forestry participates in CDM surveys and supports ODA reforestation projects overseas.

Sumitomo Forestry has been asked by the Ministry of the Environment to begin surveying the business feasibility of CO₂ removal using clean development mechanisms (CDM) in industrializing countries. The Company has

been conducting CDM surveys since 1999 in East Kalimantan in Indonesia. At our tree plantations in Eastern Java, we conduct economic feasibility studies and survey the potential CO₂-storing capacity of trees through the sustainable management of forests, while evaluating the effect of reforestation on ecosystems, society, the economy and local residents. As a result of our efforts, we were able to confirm the viability of CDM businesses. We reported the results of our research at an international conference, and based on our data, communicated the potential for afforestation activities to accelerate in various countries through CDM businesses.

Sumitomo Forestry is involved in the Way Kambas National Park Afforestation Project, which is attracting attention as Japan's first Official Development Assistance (ODA) grant for an afforestation project. The project calls for planting 55,000 trees on 360 hectares of parkland that was the site of a forest fire. At the same time, an initiative was launched in May 2001 to reestablish facilities for managing seedlings, tree planting and fire prevention, and to plant trees along a fire prevention buffer.

A MEMBER OF LOCAL COMMUNITIES

In its corporate aim to help create a sustainable society, Sumitomo Forestry believes it is important for business activities to be in harmony with local communities. The Company is working towards the creation of a sustainable society in its capacity as a corporate citizen.

Launched by Sumitomo Forestry in 1991, the Tropical Rain Forest Regeneration Project in Sebulu, East

Kalimantan (Indonesia) marked its 12th anniversary in fiscal 2002. The project receives assistance from the Indonesian Ministry of Forestry and the Japanese Forestry Agency and guidance from Tokyo University's agricultural department of afforestation research. Started in cooperation with KTI, the project has planted trees of mainly the dipterocarp family on a test plot of 3,000 hectares of land that had been illegally deforested and subjected to slash and burn farming and mountain fires. In fiscal 2002, we planted trees on 48 hectares of land, bringing the total plantation size to approximately 503 hectares. Striving to improve awareness of responsible farming in the region, the project aims to create a framework where local residents can live without excessive slash and burn farming.

KTI celebrated the 30th anniversary of its foundation in 2000 by launching the KTI Educational Foundation, which aims first and foremost to increase the school attendance of children who will become the future of Indonesia someday. There are approximately 6 million children in Indonesia that are unable to go to elementary school due to poverty. The KTI Educational Foundation encourages school attendance by giving scholarships to children of poor families. In fiscal 2002, the KTI Educational Foundation provided support to children and contributed KTI-made plywood to help in the repair of elementary school buildings and desks. In February 2002, the KTI Educational Foundation deepened its connection to local communities by providing assistance in the form of food and clothing to families displaced by floodwaters that struck East Java, and also by supplying plywood for repair work.



In 2001 and 2002, the KTI Educational Foundation provided 60 and 70 scholarships respectively, to elementary school children living in Probolinggo and Sebulu, adjoining the Company's plants.

