Management's Discussion & Analysis

Business Environment

In the financial year ended March 31, 1999, the U.S. and major European stock market indexes continued to perform well, marking new all-time highs. Asian markets remained under pressure due to the continuing financial crisis although tentative signs of recovery were seen towards the end of the period. Unfortunately, other emerging markets in Latin America and Eastern Europe started to undergo their own financial crises.

The Japanese economy recorded its second consecutive year of negative growth amid a sharp decline in private equipment investment and an increase in unemployment, which can be partly attributed to a credit crunch and severe deterioration in corporate sentiment. The Tokyo Stock Exchange remained under pressure during the first part of the year but staged a recovery in the last several months of our financial year.

Corporate debt issues in Japan continued at reasonable levels reflecting the low interest rate environment. New equity financing activity was significantly up on the previous year due partly to a small number of large IPOs and issues.

Results of Operations

The former Daiwa Securities Co. Ltd. (the Company) reported consolidated revenues of ¥355.0 billion (US$2,934 million), down 32.2% from the ¥523.9 billion reported in the previous year. While the Company revenues rose marginally to ¥257.2 billion (US$2,125 million), a drastic reduction in revenue from overseas subsidiaries in Europe and America can be attributed to our decision to scale back our overseas operations and to refocus our operations on domestic securities business.

The Company managed to increase its operating and ordinary income by 179.9% and 224.8% respectively, to ¥17.1 billion (US$142 million) and ¥16.6 billion (US$137 million). In addition, the Asian subsidiaries managed to trim last year's losses at the operating income stage to ¥3.0 billion (US$25 million) from the ¥10.6 billion recorded in the previous year. The domestic subsidiaries also emerged broadly in line with the previous year. However, this could not make up for significant losses recorded by the European and American subsidiaries, meaning that consolidated operating losses amounted to ¥88.6 billion (US$732 million).

Consolidated other expenses of ¥165.9 billion (US$1,371 million) were taken during the year mainly in respect of restructuring measures taken ahead of the formation of the new holding company. The major losses realized related to financial assistance extended to domestic non-bank affiliates (¥115.8 billion (US$957 million)), valuation losses on fixed assets (¥15.9 billion (US$131 million)) and losses arising on liquidation of employees' retirement plans (¥12.8 billion (US$106 million)). The consolidated loss before income taxes thus emerged at ¥208.5 billion (US$1,723 million).
Using tax effect accounting, the Company took a credit of ¥79.0 billion (US$652 million) for deferred taxes. The net loss for the year therefore emerged at ¥127.9 billion (US$1,057 million).

Revenue Analysis

Commissions

Consolidated commission income fell to ¥185.5 billion (US$1,533 million) from ¥198.1 billion in the previous year. Although the Company benefited from improved underwriting and distribution commission income, brokerage income remained under pressure for much of the year. For the Company, total commission income consequently emerged at ¥177.1 billion (US$1,464 million), down 2.8% from the previous year.

1) Equity brokerage commission was ¥66.3 billion (US$548 million) under the average daily TSE volume of ¥410.0 billion (US$3.388 million). Our TSE equity market share rose to 9.1% from 7.4% despite the deregulation of commission rates for orders in excess of ¥50.0 million (US$413 thousand). On the bond front, brokerage commission remained at ¥6.5 billion (US$54 million).

2) Equity underwriting and distribution commission rose by 222.9% to ¥14.0 billion (US$116 million) owing to our involvement in several large equity issues such as NTT's 4th tranche offering and the NTT DOCOMO IPO.

3) Investment Trusts related income steadily increased. Sales commissions and asset management fees together were ¥70.5 billion (US$583 million), of which the percentage accounted for by asset management fees increased to 47.2%.

Net Gain on Trading

Although the Company recorded a healthy 150.6% improvement in its gains on securities trading to ¥45.8 billion (US$379 million), significant consolidated trading losses on securities trading were incurred in the American and European subsidiaries as a result of markdown of their holding in Russian related bonds, other emerging bonds, and CMBS. The Company consequently recorded a consolidated deficit of ¥20.7 billion (US$171 million).

The Company equity trading income of ¥9.7 billion (US$80 million) can be attributed to the installment of advanced trading systems early last year. The improvement in pricing capability and positions management system contributed to the improved services to institutional accounts and subsequent increase in business volume.

Interest and Dividend Income

A reduction in overseas trading positions and a prolonged period of low interest rates resulted in a drop in interest and dividend income of ¥96.2 billion (US$795 million). This was offset by a similar reduction in interest expenses.

Diversification of Revenue Structure

Increase in trading, investment banking and asset management revenues are in line with our stated goal of diversifying our revenue stream as laid out in our Mid-term Business Plan announced in March 1998.

Cost Analysis

Selling, General and Administrative Expenses (SG&A) fell by 4.4% to ¥271.1 billion (US$2,240 million). Since revenues fell further, the ratio of SG&A expenses to revenues rose from 54.1% to 76.4%.

Interest expenses fell by 32.2% to ¥172.4 billion (US$1,425 million), offsetting the fall in financial income above, meaning that total operating expenses fell from ¥538.1 billion to ¥443.5 billion (US$3,666 million) or 17.6%.

The Company operating expenses emerged at ¥240.1 billion (US$1,984 million), 96.1% of the previous year's level. SG&A was ¥218.6 billion (US$1,807 million), up 0.7% year on year, and financial expenses were ¥21.4 billion (US$177 million), down 34.7% from the previous year. The reduction in the securities transaction tax rate and cost cutting measures offset the impact of an increase in compensation costs incurred in connection with a review of the retirement system. Savings of ¥3.0 billion (US$25 million) in entertainment, transportation and travel expenses were realized under a ¥40.0 billion (US$330 million) cost reduction plan launched last year. Rationalization of our branch network and introduction of low-cost mini-branches will yield a further positive contribution. In addition, more efficient use of office space and liquidation of an unused employees' dormitory will allow us to further shrink our balance sheet.

Liquidity and Financial Resources

Consolidated total assets at the financial year-end amounted to ¥6,268.6 billion (US$51,807 million), down ¥3,863.9 billion (US$31,933 million) from the previous year. The two principal reasons for this reduction were a ¥2,296.0 billion (US$18,975 million) reduction in trading assets representing a 57.8% fall from the previous year and a ¥1,297.5 billion (US$10,723 million) or 52.4% reduction in collateralized short-term financing agreements. Cash and time deposits were broadly unchanged from the previous year at ¥566.5 billion (US$4,681 million).

The reduction in total assets was matched by a broad-based reduction in current liabilities. Major features of this reduction included a reduction of ¥2,119.1 billion (US$17,514 million) in collateralized short-term financing agreements, a reduction of ¥637.5 billion (US$5,269 million) in trading liabilities, ¥222.3 billion (US$1,837 million) in time deposits received, and ¥201.8 billion (US$1,668 million) in short term bank borrowings outstanding.

Liquidity Management and Treasury

Further improvements were made to the organizational structure of our treasury operations. In addition to the "Global Treasurer" (head of the Treasury Department of the Holding Company), who is responsible for liquidity management across the entire group, an "International Treasurer" was appointed to supervise liquidity management for the main overseas offices. Furthermore, in January 1998, the International Treasury Section was established within the Finance Department. In cooperation with the International Treasurer, this section is responsible for the general management of the financial affairs and liquidity of key overseas offices, as well as for the formation of contingency planning policies.

Through such reorganization of our organizational structure and reporting lines, we believe that treasury management for the entire group, and in particular overseas locations, has been greatly improved.

System Development

Many of the areas in which the group wishes to evolve strategically have a large information systems component. The provision of information technology support to the operating divisions is thus a critical mission for the Company. Areas of particular importance include measures taken to address potential Y2K problems, improving our internal data communications systems, upgrading our equity trading systems support, and investing in new global risk management and derivatives capabilities. Finally, the Company is upgrading its online retail brokerage systems to support the increasing financial advisory role being undertaken.

Y2K*

We have been addressing the Y2K issue since 1996. After the transformation into a holding company structure, the Y2K work conducted by the former Daiwa Securities Co. Ltd. was fully inherited by Daiwa Securities Group Inc., Daiwa Securities Co. Ltd. and Daiwa Securities SB Capital Markets Co. Ltd. The holding company has been conducting a range of actions for itself and its affiliated firms, each of which bears responsibility for its own compliance.

The Y2K Compliance Project Committee reports directly to the Board of Directors and meets basically on a monthly basis to review progress in our efforts to prevent the Y2K bug from disrupting normal business operations. Verification of our core systems was completed by the end of 1998. However, since we are presently upgrading our equity trading systems, reassurance tests would be carried out during 1999. We are actively involved in joint tests with other financial industry organizations. Also we have been promoting data processing tests with our customers, counterparties and overseas offices.

For both computer systems and communications equipment such as telephones, facsimiles and PBX, as well as office facilities such as vaults, air-conditioners, and elevators, we have requested letters of compliance from each of our vendors. Items whose compliance remains in doubt are being replaced with compliant equipment.

Finally, facing the fact that elements of the social or financial infrastructure over which we have less control may in the end prove non-compliant, we are preparing contingency planning mainly based on "what-if" scenario analyses. Such analyses cover the effects of breakdowns in basic elements of social infrastructure such as electrical power supply and transportation systems. We are also collaborating with the stock exchanges, Bank of Japan and other financial entities to identify potential critical problems at an early stage.

The total cost of this project for the holding company and retail/wholesale securities subsidiaries is estimated at ¥4.0 billion (US$33 million). We believe this is a relatively minor sum compared with that incurred by other banks and brokerages, since our systems were extensively upgraded in 1988 around when the Japanese Showa period ended and the Heisei period began. All systems installed since then have been Y2K compliant, leaving only a relatively small portion of our systems potentially vulnerable to the Y2K bug.

* The information provided herein is just intended to inform you of our actions being taken for Y2K compliance, and is under no circumstances construed as a warranty of any kind whatever. You shall use the above information at your responsibility, and we are not liable for any loss or damage arising from the use thereof.

Equity Trading Support

In preparation for the advent of liberalized equity markets, the Company has invested in our proprietary ATRAS and POWERTRADE systems in order to boost the systems support extended to our trading operations. These systems lie at the heart of our "Daiwa Market" online trading capability. The ATRAS system, for example, supports continuous bids and offers in around 100 Japanese securities.

Retail brokerage systems

All branches of Daiwa Securities Co. Ltd. have been equipped with terminals having access to our POET system, to aid our sales staff in the provision of investment advice to individuals and regional corporations.

System Development Costs

In spite of our heavy investment in strategic systems, the Company believes that it can reduce overall systems costs by eliminating unnecessary or peripheral investments and, if necessary, by outsourcing.

Risk Management

The Risk Management Department is responsible for establishing policies for risk management (both market risk and credit risk), approving rules and position limits and procedures for daily reporting to top management.

Development of the current Daiwa Market Risk Management System began in June 1997. The first phase of the development program was completed in June 1998 and became operational in August 1998. The second development phase was completed in March 1999, going online in April.

Currently, the system calculates daily VaR (Value at Risk) and other risk measures (such as delta, gamma, theta and vega) for all domestic trading accounts. Products covered by the system include equity spot and derivative products, bond products, interest rate derivatives and exchange rate related products.

The model is capable of such calculations as VaR measurement using variance and covariance methods, Monte Carlo simulation, and historical simulation. In addition, the system is capable of conducting stress testing to include such scenarios as Black Monday, the Asian currency crisis and the financial crisis in Russia.

Planned future developments include improvements in the efficiency of the calculation methods, incorporation of an interest rate term structure model, provision of a capability to deal with exotic options, and access to data of the London and New York branch offices.

Since equity capital regulations for securities companies prescribe limits on market risk equivalent values, the risk management system is also a key feature of our ability to promote appropriate response to regulation.