Special Feature:
Time to Catch the Big Wave

Addressing Changes in the Domestic Environment

Changes in the Domestic Environment

The Three Excesses

More than ten years have passed since the collapse of the so-called economic bubble. It would be no exaggeration to say that during that time the Japanese economy has been wandering through a dark tunnel with no sign of light at the other end. The government's numerous fiscal expenditure programs have failed to stimulate the economy to a genuine recovery. This was because the economy was weighed down by three excesses; over-capacity, over-employment, and excess debt.

Peaking Out of Over-Capacity and Improved Confidence in Growth

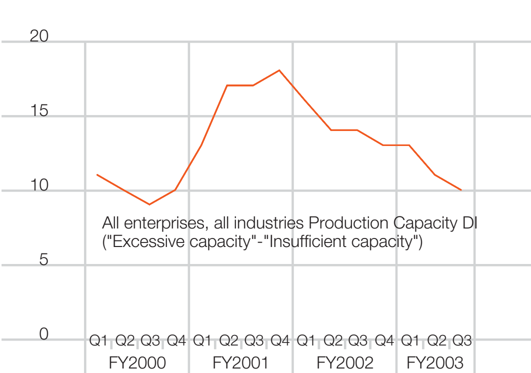
It has taken a long time, but Japan is finally making progress in resolving the problems of these three excesses. First, in terms of over-capacity the worst had passed in the first half of FY 2002. At that time, the determining factor for an improvement in private capital investment was corporate confidence in future business conditions. Japanese corporations were still apprehensive while the United States was the sole driver of the world economy. However, in FY 2003 economic recovery gained steam in China and other parts of Asia, leading more companies to believe that the recovery would be longer lived than they previously assumed.

In addition, changes were observed in the pattern of Japanese economic growth. After the collapse of the economic bubble, the Japanese economy remained fragile and was characterized by repeated downturns after small, export-led recoveries. Then, however, the "three new sacred treasures" i.e. DVD recorders, digital cameras, and flat-screen TVs, as well as related peripherals, began to show better-than-expected growth in the domestic market. Japan is the technological frontrunner of these highly popular products which still have vast potential for growth in the global market. This helped boost corporate confidence and led to a sharp increase in capital investment during the second quarter of FY 2003.

The Momentum of Economic Recovery Spreads to Employment

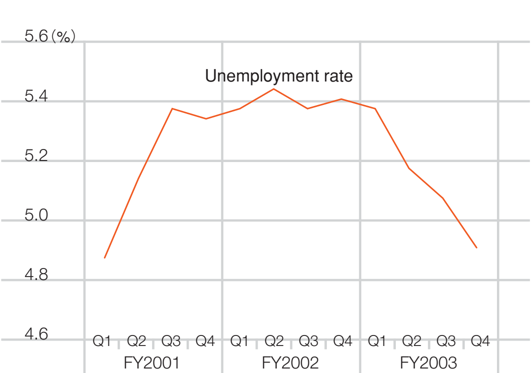
As a result of these conditions, Japan also saw changes in its employment situation, which had been mired in a vicious cycle. The unemployment rate finally started to drop in the second quarter of FY 2003. The decline in the unemployment rate had a positive impact on consumption, albeit with a time lag. In fact, in the fourth quarter, consumption-related statistics such as retail sales began to

Peaking Out of Excess Equipment



Source: Bank of Japan

Employment Situation Also Improving

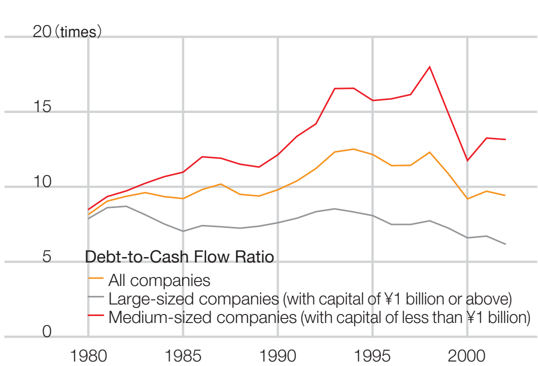


Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications show signs of bottoming out. This should stimulate domestic demand, which has been on a persistent downward path since the collapse of the economic bubble. Moreover, a positive cycle between corporate confidence for an economic recovery and rising capital investment has been borne.

The Problem of Excess Debt Has Been Partially Resolved

Excess debt peaked out before over-capacity. The debt-to-cash flow ratio for “all companies” declined significantly in the two-year period starting in 1999 and has fallen to pre-bubble levels (graph). This was mainly a result of the financial restructuring efforts by companies. When looking at the situation by company size, however, there are still some significant differences. For large companies with capital exceeding ¥1 billion, the debt-to-cash flow ratio has dropped to 1980 levels or even lower, while the ratio for small and medium-sized companies remain at early 1990 levels. This implies that small and medium-sized companies have not yet carried out sufficient financial restructuring. Nevertheless, one could probably say that for Japan as a whole the worst of the bad debt crisis is over.

Excess Debt Problem is Receding



Source: Ministry of Finance

Capital and Financial Restructuring Needs Becoming Increasingly Diverse and Complex

Amid this situation, we are starting to see an increase in funding needs for positive reasons such as for a full-scale expansion in equipment capacity and equipment replacement. However, while the worst is over in terms of excess debt, the number of companies that can afford to expand their balance sheets is limited. Thus, procurement of funds require ingenuity, leading to Japanese companies’ funding needs becoming even more diverse. Moreover, in this age of IT, timeliness has become extremely important. Thus, in addition to expanding capital expenditure and businesses as they have done in the past, companies also seek to acquire existing businesses. But at the same time, there are still deep-rooted needs for financial restructuring in domestic companies. As mentioned above, small to medium-sized firms in particular must undertake further reforms of their balance sheets.

The survival of financial institutions will depend on how they maximize points of contact with their customers and deal with increasingly diversified and complex customer needs.

Recovery and Diversification of Investment Needs

Let us now turn our attention to the situation surrounding the supplier of funds. In Japan, financial assets held by individuals expanded from ¥1.049 quadrillion at the end of 1990 to ¥1.412 quadrillion at the end of FY 2003. However, most of this increase was in cash deposits and not so much money had flowed into risk products. As a result, the deposit and cash equivalent percentage of total individual financial assets rose from 46% at the end of 1990 to 55% at the end of FY 2003. One reason for this is that under the long-running recession there was no surge in corporate demand for funds. In addition, individuals did not readily

Success in this industry hinges on
- **maximizing points of contact with customers,**
- **addressing their diversified and complex needs, and**
- **providing distinctive quality of service.**

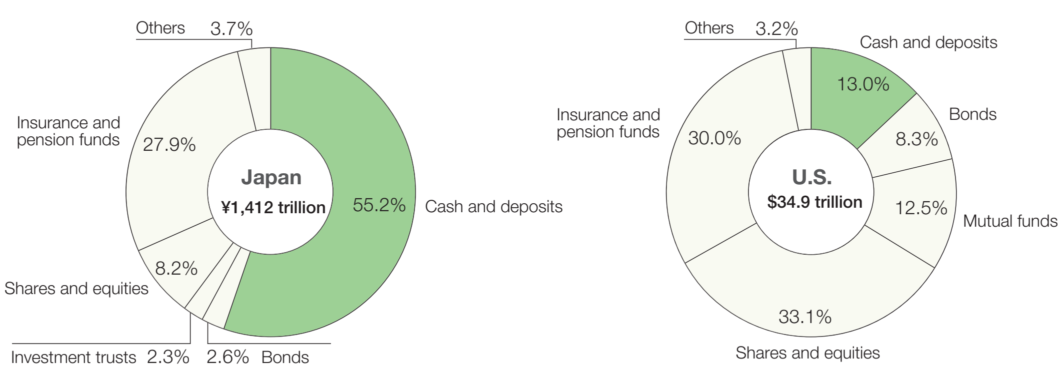
take to the idea of selecting investments by the rate of return, as interest rates remained high on the back of steady economic growth from the end of World War II until the mid-1980s.

Now, however, the situation is changing. Individual investors who are vexed by the extremely low interest rates are starting to seek higher yields, even if it means taking some risks. There is also a heightened awareness of holding investments in different currencies and building portfolios by purpose of investment. Therefore, in our retail business, it is crucial that we maximize opportunities to contact customers and satisfy their more diversified and complex needs. Furthermore, improving the quality of services provided before and after the sale of financial products is also important. Due to insufficient explanation about products and lack of efforts to follow-up, the industry has been unable to completely dispel the distrust of individual investors towards financial products.

Changes in the Framework of the Financial Industry

The growing need for financial services from both the supply side and demand side of funds provide various opportunities for securities firms. However, one must also note that with the financial “Big Bang,” deregulation is accelerating and competition is intensifying. Online securities brokerages have flourished by offering low commission rates. Moreover, financial barriers are steadily being torn down. In addition to the entry of non-financial firms into the financial businesses, the framework for regulating the financial industry — i.e., the banks, trust banks, securities companies, and insurance companies — is gradually being dismantled. We are aware that this trend will not stop but accelerate in the future. In other words, we must differentiate ourselves from the competition in order to survive.

Comparison of Financial Assets Held by Households in Japan and the United States (as of end of March 2004)



Source: Bank of Japan

Source: Federal Reserve Board

The Group's Business Strategies

The Daiwa Securities Group was early in predicting the aforementioned changes in the external environment and was ahead of its competitors in undergoing the reforms listed below. Going forwards, we will continue formulating new strategies to consolidate and strengthen our competitive position. (For more details, please see the Review of Operations and Outline of the Group Companies section from page 26.)

1. Infrastructural Reforms

(1) Reforms to Marketing

We conducted two types of marketing reforms: one is the implementation of a sales channel and attribute-based customer segmentation strategy to better understand our customer needs, and the second is reforms related to our product and service strategy to better satisfy our customers' diverse and complex needs.

1) The Marketing System

First, in the retail business we set up a system that combines the area marketing ("Satellite Branch System") and the multiple channel systems. The Daiwa Securities Group is the only firm in the Japanese securities industry that has combined these two systems.

We are further upgrading our marketing system in FY 2004. Although our current system is already organized according to customer segments, we have developed a consulting system that will enable us to deal with customer segments more effectively and respond to their needs. Under the new marketing system, we assigned 170 senior consultants with a wide range of specialized knowledge in areas such as finance and accounting to branches in and around major metropolitan areas. We plan to increase the number of these consultants to 600 by the end of FY 2005. Accompanying this move, the sales structure in each branch have been divided into three sections. This will allow the branch offices to conduct detailed follow-ups of transactions with customers in accordance with the needs of each group, including high net-worth individuals and major corporations, general investors and investors that fall in between these two categories. This will not only strengthen our marketing efforts (i.e., expand our points of contact with customers), but will also improve our ability to provide services and increase marketing efficiency, thereby killing "three" birds with one stone.

> Under our new marketing system,
> we will be able to **kill three birds with one stone:**
> In addition to expanding our customer base,
> it will improve the quality of our services
> and increase operating efficiency.

In FY 1999 we became the first securities company in Japan to establish a joint venture with a "megabank" (the Sumitomo Mitsui Banking Corporation (SMBC)) for the wholesale business. The success is reflected in numbers: revenues generated from this alliance has increased consistently since the first year of the venture and has expanded six folds to almost ¥50 billion in FY 2003. This is due to the complementary nature of the alliance between two major financial firms, with SMBC providing the customer base and the Daiwa Securities Group contributing its ability to supply products and services. The alliance is benefiting businesses such as underwriting, initial public offerings (IPOs), mergers and acquisitions (M&A), structured finance, and derivatives. We are constantly reviewing our evaluation system and organizational structure so that the effects of the alliance will expand.

This strong alliance between a securities company and a bank clearly works to our advantage over competitors. This alliance has provided us with numerous advantages. Thus in FY 2004, we will add Daiwa Securities Co. Ltd. (Daiwa Securities) to this cooperative framework and strengthen our business relationship with corporate clients in all regions of the country.

We form alliances that complement our strength. The effectiveness of an alliance, however, depends upon how it is executed.

2) Product Strategy

The keys to success are product line-up and consulting capabilities. This is because the easiness of replicating products makes it difficult for a company to distinguish itself through new products alone in the financial industry. In the retail business, we have a unique strategy of providing the same products regardless of the channels through which they are delivered. Moreover, by improving the information infrastructure within the Group — the Research & Advisory Department at Daiwa Securities SMBC Co. Ltd. (Daiwa Securities SMBC), Daiwa Institute of Research Ltd. (DIR), etc. — we are making further improvements to the Group's capabilities to offer products and services. In other words, amalgamate the Group's expertise to create distinctive products.

We are **differentiating ourselves from competitors through our product line-up and consulting capabilities.**

(2) Business Portfolio Reforms

Growth potential, profitability, and consideration to the stability of earnings is vital to maximize corporate value. The Daiwa Securities Group will endeavor to ensure stable earnings by diversification of its business portfolio. However, diversification can sometimes lead to a decline in growth potential and profitability. The Daiwa Securities Group is resolving this dilemma by adding value through a "value chain" consisting of its retail, wholesale, and asset management businesses, as well as the various segments within those businesses.

For example, the asset management business, although currently not highly profitable on its own, has a relatively stable source of earnings in the form of management fees. Therefore, if they are able to develop financial products that attract customers and can offer these products to the retail business, it would be possible for the Group as a whole to maintain a high level of profitability. In addition, DIR by providing high-level research, analysis, and systems development, will contribute to increasing overall profitability of the Group.

Moreover, the Daiwa Securities Group has adopted a shared information system to avoid the pitfalls of diversification. One example can be seen in the relationship between the online and face-to-face sales channels of the retail division. Although crucial to remain competitive, investing in information infrastructure is a heavy burden for the online business, due to the low commissions it generates. In order to solve this problem, the information infrastructure is shared between both sales channels.*

* We share only core information; the contents and quantity of information provided vary according to the channel.

In this way, the online business's burden of investing in developing an information system is lightened. Furthermore, it can differentiate itself from its competitors by providing customers with a level of sophistication not available at other online securities brokerage companies.

We are optimizing our business portfolio through the creation of a "value chain."

2. Reforms to Personnel and Information Systems

(1) Reforms to Personnel

Without competent managers and employees, improving our infrastructure is pointless. It is not an exaggeration to say that the greatest asset in the financial industry is human resources. Now that customer needs have become so varied, we can no longer just act "by the book." To maximize the capabilities of each and every Group employee, it is necessary to instill an independent spirit rather than merely rely on an organizational structure. This is why Daiwa Securities is, for example, transferring authority to the head of each area or group. Moreover, a merit-based compensation system was introduced throughout the Group in FY 2003. The shift to the new system was carried out in phases and has been fully implemented from the beginning of FY 2004. We believe this will promote greater independence among employees.

(2) Reforms to Information Infrastructure

We have explained our strategy of raising profitability by sharing information infrastructure among business lines in the previous section. The information-related reforms we discuss here are aimed at boosting our sales and marketing capabilities by upgrading our information infrastructure and functions. For instance, at Daiwa Securities we continue to make progress using the CRM (Customer Relationship Management) system, which was introduced in FY 2001. The current system contains not only customer information, but also cases of marketing success together with actions and processes that led to those results. This is an indispensable tool for each of our sales staff. Moreover, we have set up a division at Daiwa Securities SMBC specializing in industry research (the Research & Advisory Department at present) in July 2002. The research and analysis conducted at this division have made a substantial contribution to obtaining major deals for Daiwa Securities SMBC's investment banking businesses.

We are working to distinguish ourselves through improvements to our human resources and informational capabilities.

The Daiwa Securities Group's management reforms
are **based on lessons learned by studying examples of past successes.**

3. Learning from the Successful Reforms in the United States

In some respects, the current situation in Japan's financial industry is quite similar to that seen in the United States during the mid-1990s. In the United States, companies began to reform their business models during the mid-1990s when the bad debt problem started to be resolved. The companies that were successful in differentiating themselves in this process were able to expand their market share quickly. Major winners were Citigroup and Wells Fargo, which are well known for their cross-sell marketing utilizing CRM. The common characteristics of the winners are efficient management and a new marketing method that prioritizes the customers' point of view.

These actions are comparable to the reforms carried out by the Daiwa Securities Group. In the retail business, area marketing, multiple channels, and a concentration of back office work were introduced. Moreover, for the overall group, we increased the sophistication of our information infrastructure and made it available throughout the Group. Furthermore, we are recruiting and training specialist professionals and have introduced a performance-based compensation scheme. We will continue to implement reforms with complete confidence.

4. Reinforcing Our Capital Base: The Next Stage

We are constantly keeping our eyes on the next stage. The US financial industry has entered a new phase of financial reforms as seen by the merger of Bank One and JP Morgan. In Japan as well, we believe that once the winner of differentiation emerges, the financial industry will move to a stage characterized by the acquisition of growth potential. Companies will of course need to have sufficient capital to move on to the next stage. Fortunately, the Daiwa Securities Group is hereafter likely to have excess capital resulting from improvement in its ability to generate profits. We will prevent a decline in ROE by either returning profits to our shareholders or raising our growth rate and profitability by purchasing growth potential from outside the Group.

The Daiwa Securities Group
is ahead of its competitors in preparation for
the next stage of financial reforms.

Addressing Changes in the International Environment

Changes in the International Environment

The Economic Growth Potential of Asia Is Rapidly Increasing

While the economies of developed countries or regions such as the United States, the EU, and Japan have reached a mature stage, the growth potential of Asian countries continues to be strong. The GDP of the East Asian economic region (Japan, China, Korea, and the ten ASEAN countries) now amounts to US$6.3 trillion and is approaching the combined GDP of the 15 EU countries of US$8 trillion (as of 2003; the EU has 25 member countries as of end of June 2004).

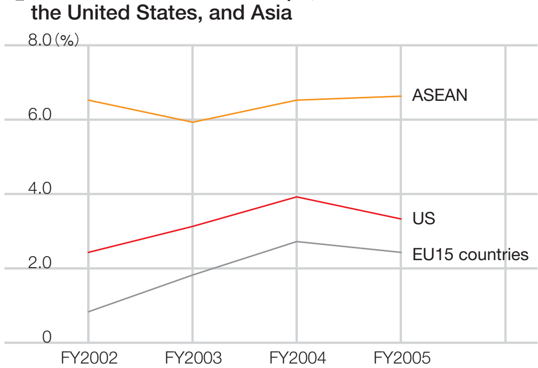
Stability Has Improved Dramatically

The rapid expansion of economic growth in the Asian region excluding Japan is nothing new. In recent years, however, we have noticed that the characteristics of that growth has changed significantly. Up to now, the Asian region has served the role of the “world’s factory” and was affected by the demand trends in developed countries, which were the main recipients of Asian exports. As a result, the Asian economies suffered from sharp fluctuations. However, in addition to its importance as a production base, Asia is increasingly becoming important as a world consumption center. This is because having become a major economic region centering on China, the standard of living there is rising. As a result, Asia has become one of the world’s most important markets.

Activating the Inflow of Funds

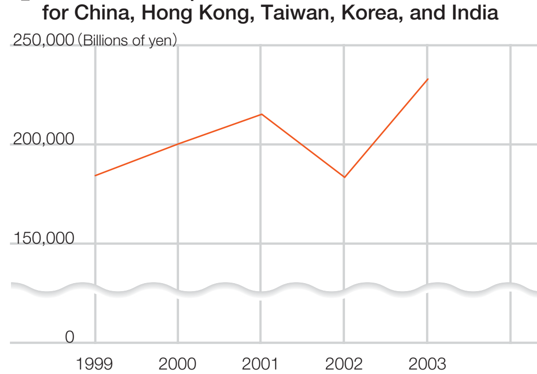
Asia has also become an important region for the securities industry. The total market capitalization of the stock markets in China, Hong Kong, Taiwan, Korea, and India has grown to match that of the First Section of Tokyo Stock Exchange. Not only has Asia’s economic growth potential improved, but the balance of foreign reserves has increased sharply and their currencies are under pressure to revaluate. This situation is attracting investment funds into Asia. Corporate fund raising is also becoming active as stock market prices within each of the regions continue to rise. Within Asia, we are paying particularly close attention to China as a new market.

GDP Growth Rates in Europe, the United States, and Asia



Source: ADB, OECD, DIR

Total Market Capitalization for China, Hong Kong, Taiwan, Korea, and India



Note: Market capitalization is the total for companies listed on all stock exchanges in Korea and Hong Kong, the Bombay Stock Exchange, the First and Second Section of Taiwan Stock Exchange, and on A-share and B-share markets in China.
Source: ADB, OECD, DIR

The Daiwa Securities Group's Achievements in Asia

Solidifying Our Position

The Daiwa Securities Group is steadily strengthening its business base in Asia. We already have an impressive record, as evidenced in Euroweek magazine's awards for 2003. In the Asian bond market, we ranked No. 1 for lead-managing yen-denominated issues and No. 3 in US-dollar-denominated issues following Citigroup and Goldman Sachs (we were top among Japanese securities companies). We were also ranked No. 1 in sales to domestic investors. In China, the potential major market in Asia, the Daiwa Securities Group is steadily elevating its position. China Ton-Fei, which was established by Daiwa SB Investments Ltd., became the largest Chinese-equity-related investment trust ever launched in Japan.

The Asian region has not only been a source of deals for the Daiwa Securities Group. Its contribution to earnings cannot be ignored. We are leading the other Japanese securities companies in profitability in the Asian region. Daiwa Securities SMBC was bookrunner for five out of eight Asian companies that raised equity via POWL* (public offering without listing) in FY 2003. In the future as well, we would like to actively invest management resources in this region, especially China.

* POWL (public offering without listing) is a public offering allowing foreign companies to sell their shares without being listed in Japan.

We have also taken the lead in Asia in both business volume and earnings.

Net Asset Value of China-related Investment Trusts (As of end of June 2004)

Daiwa Asset Management

Daiwa Hybrid Equity Open (Digital Kama)	¥55.7 billion
Daiwa China Fund	¥18.5 billion
China-related Japanese Equity Open (China Power)	¥38.9 billion

Daiwa SB Investments

China Ton-Fei	¥98.1 billion

Daiwa Securities Group's Performance in the Asian Pacific Region (Ordinary income)