

# Tuned into change

We are forecasting better growth patterns in the coming years with infrastructure that enables ubiquitous technological progress.

**The year ended March 2005 marked the completion of the midterm business plan that we formulated in the wake of the merger that formed KDDI. In this sense, we signed off on the post-merger reforms while establishing a clear platform for future growth. In this report, I focus on the strong results we have achieved so far and outline our business strategy.**

## **Post-merger performance targets achieved**

KDDI was formed in October 2000 through a three-way merger of the telecom carriers DDI Corporation, KDD Corporation and IDO Corporation. The aim of the merger was to leverage the strengths of each company to forge integrated telecom services spanning all fixed-line and mobile segments. Through the provision of high-value-added information services that combine security and convenience, we aimed to contribute to a more affluent society in every sense.

We formulated a four-year midterm business plan after the merger to allow sufficient time to develop the strong business base that would ensure high earnings plus healthy finances. We set three main structural reform objectives for the KDDI Group to realize this ambition: (1) business concentration and selectivity to create a platform to support sustained growth; (2) construction of a streamlined business structure to realize full merger synergy benefits; and (3) strengthening of the financial base to ensure high profitability and stable growth.

Japan's telecoms industry has changed significantly over the past four years. High ADSL penetration has made broadband Internet access commonplace, while

mobile handsets have acquired highly advanced functions amid the launch of 3G services.

The success of our au mobile business has driven our early growth, in part due to our marketing of 3G services ahead of rival carriers. A combination of advanced services plus flat-rate tariffs for data communications has enabled au to generate high rates of subscriber growth since the November 2003 introduction of CDMA 1X WIN mobile broadband handsets. The popularity of these services has made au the leading brand in terms of share of net increase in subscribers in Japan for two years running.

Our focus on concentration and selectivity has prompted us to scrap obsolete equipment, dispose of underutilized assets and institute structural reforms at subsidiaries. In October 2004, we transferred the DDI Pocket PHS-related operations to a consortium that we formed with the Carlyle Group and Kyocera Corporation. This served to focus the mobile operations of the KDDI Group on cellular phone services. In March 2005, we made the three firms in the TU-KA group, which offer 2G cellular phone services, into wholly owned subsidiaries. This move was aimed at creating an organizational structure with stronger and swifter decision making to boost operational efficiency and to realize a more dynamic business strategy. Another significant move was the establishment of KDDI Network & Solutions Inc. in November 2004 through the merger of four subsidiaries to target the corporate sector. We transferred fixed-line service sales functions for small- to medium-sized corporate clients from the parent company to KDDI Network & Solutions to enable the firm to offer a broad range of fixed-line communica-



Tadashi Onodera, President and Chairman

tions solutions. Elsewhere, in March 2005 we liquidated KDDI Submarine Cable Systems Inc. in view of the lack of prospective demand for undersea cable-laying services.

We achieved all the financial performance goals in the post-merger midterm business plan. Consolidated revenues and profits established record highs in fiscal 2004 (the year ended March 31, 2005). Operating revenues increased 2.6% year-on-year to ¥2,920.0 billion, and operating income rose 1.4% to ¥296.2 billion. Compared with fiscal 2000 (the year ended March 2001), our operating

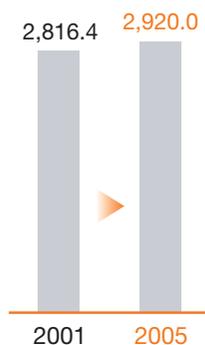
revenue performance in fiscal 2004 was 3.6% better, but operating income was about three times higher. Free cash flows have also improved substantially since the merger, going from a ¥170.0 billion outflow in fiscal 2000 to a ¥402.2 billion inflow in fiscal 2004. Significant positive cash flows helped us achieve the most important post-merger target, namely debt reduction. By March 2005 we had reduced consolidated interest-bearing debt to ¥864.6 billion, comfortably below the plan's target of ¥1,000 billion.

Based on these results, we increased returns to share-

## Post-merger performance

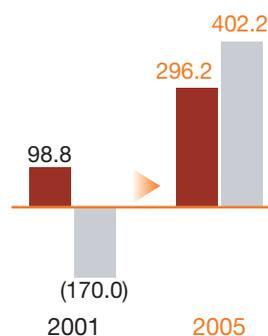
### Operating revenues

(billions of yen)



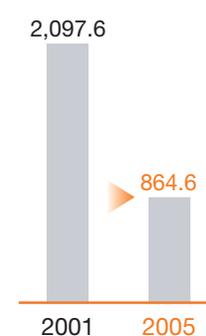
### Operating income Free cash flows (FCF)

(billions of yen)



### Interest-bearing debt

(billions of yen)



The results for KDD and IDO in the first half of the year ended March 31, 2001 were simply added to each consolidated results.

holders substantially. Including a special dividend of ¥1,000 to commemorate the 20th anniversary of the founding of DDI, we raised total dividends for the year to ¥6,900 per share, compared with ¥3,600 in fiscal 2003. This raised the unconsolidated payout ratio to 21.2%, above the 20% level targeted in our plan. Our policy remains to pay a stable dividend that reflects continued growth.

**An intensely competitive market**

Since the merger in 2000, we have achieved good operating results, largely by implementing structural reforms even within an intensely competitive business environment. I believe, however, that competition will only intensify.

**1) Serious competition in 3G cellular phone services intensifying**

Rivalries in 3G mobile services are intensifying just as growth in the Japanese market is beginning to taper off. The advent of mobile number portability (MNP) in fiscal 2006 will create a system in which customers will easily be able to switch carriers without having to change numbers. We also expect competition to heat up in the coming years as new market entrants commence operations. For our au operations, these changing conditions represent a good opportunity to reinforce and expand the customer base.

**2) Fresh competition in fixed-line market**

In February 2005, we launched the KDDI Metal Plus service. This service uses the latest Internet Protocol (IP) technology to create an efficient, low-cost network that offers high-quality phone connections to customers at discounted prices. With KDDI Metal Plus, we have broken NTT's monopoly on the basic monthly fee levied for a fixed-line

connection. Other companies are offering similar services, and NTT is trying to preserve its market share by cutting prices. These various developments have injected a serious dose of competition into the fixed-line sector within the Japanese telecoms industry. Subsidiaries of electric power utilities and cable TV companies are also trying to make inroads into the market by offering FTTH (Fiber to The Home) services using fiber-optic connections. In all, it adds up to a highly competitive business environment.

**Three key phrases for new growth**

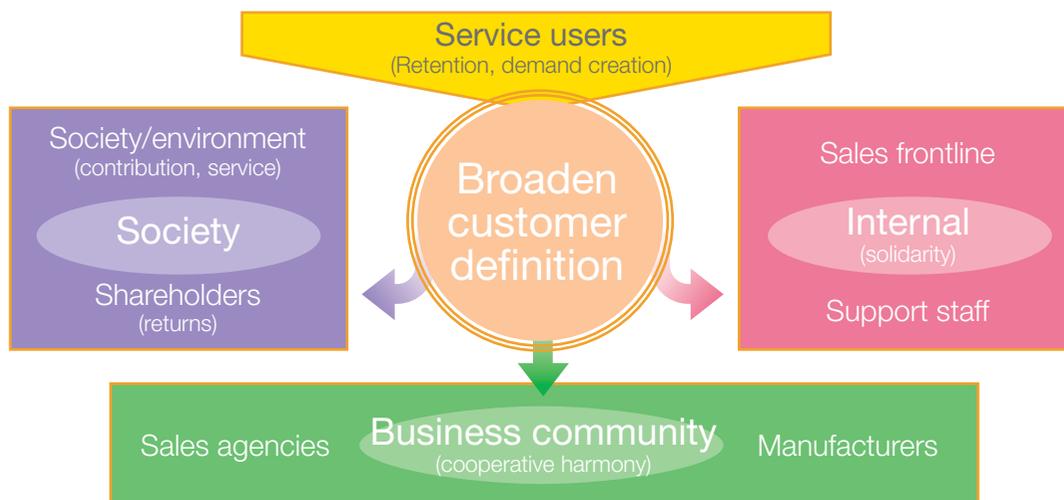
I believe the phase of KDDI's post-merger consolidation is finished. Now we must move on to a new phase of generating new and higher earnings. Three phrases summarize the stance we need to take at KDDI to ensure further growth by expanding the customer base within a harshly competitive business environment.

**Realizing TCS**

Our first objective is to frame the KDDI service mindset in terms of realizing total customer satisfaction (TCS). In this respect, besides those who use KDDI services, we also include all stakeholders within "customers": shareholders, sales agents, manufacturers, employees and the rest of society. I believe we can engineer major qualitative improvements in our services if we listen to the varied opinions of our customers and take on board what they want.

In an August 2004 survey conducted by "J.D. Power Asia Pacific 2004 Japan Mobile Telephone Service Satisfaction Study<sup>SM</sup>", KDDI placed first in the mobile phone sector. I believe that our high consumer ranking was the result of a good balance between handsets, content and price and the provision of easy-to-use, convenient services.

**Total customer satisfaction (TCS)**



The result also showed that KDDI is perceived as a carrier that considers customers important. We must continue to build on this success by offering truly customer-oriented services and by reinforcing a TCS-grounded approach.

### Strategy and Speed

In order to raise performance and outstrip our rivals amidst an ever-changing business environment, it is imperative to swiftly implement a specifically targeted strategy for each function and each competitor. In other words, I think we need to become more aggressive in our business stance. DDI, one of the predecessors of KDDI, was from its inception a venture firm whose goal was to shake up the Japanese telecoms industry. I think we need to readopt that pioneering corporate culture to reinvigorate our business. A clear-cut strategy and speed of response are the keys to generating new growth.

### Promoting FMC services

With the expansion of the overall market stalled, our strategy for growth at KDDI is focused primarily on capturing greater market share. The strengths of KDDI extend across both the fixed-line and mobile sectors. I believe that we can differentiate our brand most effectively by offering new FMC (Fixed and mobile convergence) services that combine the advantages of both. We are developing this strategy from a number of angles.

The first part of this FMC strategy was unveiled in May 2005, when we began billing customers that subscribe to KDDI fixed-line and au mobile services with a single invoice. We also offered these customers a discount for using the joint-billing service. Based on this example, we plan to offer more combined FMC-style services to individual subscribers. In the corporate market, we also plan to offer telecom solutions that combine fixed-line and mobile coverage. Mobile services for corporate customers remain an underdeveloped segment, and we intend to boost our share of the corporate market through FMC initiatives.

As we move toward the so-called "ubiquitous network society," I believe that the distinction between fixed line and mobile will fade. Convergence will create a unified means of access to digital content and related services. KDDI aims to be a leading carrier in this new world as a single integrated telecoms operator in Japan, offering convenient services for the entire household based on a contract that includes fixed-line and mobile services. I see this strategy helping us to expand market share and to build the KDDI customer base. Please refer to the feature section of this annual report for more details of the possibilities that FMC opens up and of our vision for FMC services from KDDI.

### Corporate governance and the TCS mindset

I regard corporate governance as an extremely important topic in the context of our business activities. At KDDI, we have tried to accelerate decision making through the intro-

duction of an executive officer system. We have also promoted efficiency and transparency via the corporate auditor system, which provides effective oversight of senior management. With the April 2005 enactment of the Personal Information Protection Law in Japan, we have tightened up our data management and compliance controls to ensure that the confidentiality of customer records is protected at all times. We also have established the Corporate Risk Management Division to provide coordinated supervision and administration of all the risks we face across the company, and we have stepped up efforts to strengthen related systems. However, what I believe is most critical in all these matters is respect for customers. We must continue to work to create a TCS mindset throughout our organization to build trust in the KDDI name and to increase brand value. I believe that deepening the TCS mindset and strengthening corporate governance are intimately linked as key obligations that will result in our greater competitiveness—not to mention higher enterprise value.

In closing, I want to express my heartfelt and sincere appreciation for the support of all our shareholders and other stakeholders in helping us to achieve so much in the past four years. We will continue working to offer high-quality, convenient services to earn the trust and satisfaction of all our customers. KDDI aims to become Japan's preeminent "Ubiquitous Solution Company." As we strive to achieve this goal, I ask for your continued support and understanding.

July 2005



Tadashi Onodera  
President and Chairman