Taking It to the Next Level

Our goals are to continue expanding our customer base while cultivating new business domains based on the watchwords "Strategy and Speed."

The fiscal year ended March 2006 marked the start of a new phase for KDDI. Based on the watchwords "Strategy and Speed", we focused on expanding our customer base in preparation for the next stage of profit growth. Here, I review the achievements of the year and discuss our strategy for future business development.

I. Analysis of Results for the Year Ended March 2006

The year under review marked a new phase in the evolution of KDDI's business. In the fixed-line market, we established our new direct-access services, where we collect basic monthly line charges from customers rather than from NTT. The mobile communications market, meanwhile, was where we focused on upgrading and expanding our services and pricing plans ahead of the planned introduction in autumn 2006 of mobile number portability (MNP), which will enable users to switch mobile carriers without changing numbers.

It was also a year in which the public debate about the monopolistic hold of NTT over the Japanese telecommunications market heated up. Regulators and appointed experts began discussing how to promote fair, healthy competition. The details of KDDI's consolidated operating performance for the year are discussed elsewhere in this report, in the "Overview of Operations" and in the "Financial Review." The key points of that performance are as follows:

* A strong performance from our Mobile Business absorbed the operating loss posted by our Fixed-line Business. At the consolidated level, operating revenues increased 4.8% compared with the previous year, to ¥3,060.8 billion. Operating income edged up 0.1%, to ¥296.6 billion, while net income fell 5.0%, to ¥190.6 billion.
* In the Mobile Business, we achieved steady growth in the number of 3G subscribers. Operating revenues in this segment rose 8.6% on a year-on-year basis, to ¥2,510.4 billion, and operating income surged 21.3%, to ¥354.4 billion.
* Operating revenues from our Fixed-line Business increased 3.9% on a year-on-year basis, to ¥619.3 billion, due mainly to expanded sales of KDDI Metal Plus services and our merger with POWEREDCOM Inc. The rise, however, in the subcontracting and subscriber acquisition costs of KDDI Metal Plus led to an operating loss in this segment of ¥61.3 billion.

Based on these results, we elected to return more profits to shareholders and increased our total annual dividends to ¥8,000 per share, from ¥6,900 in the previous year. On a non-consolidated basis, the dividend payout ratio was 20.8%, slightly higher than our management target of 20% for this indicator. We continue to invest for future growth, and our policy is to maintain a high and stable dividend payout.

II. Activities in the Year Ended March 2006

1. Mobile Business

Our au-branded mobile phone service has always been particularly popular for its music download capabilities. We focused during the year on gaining even more au customers by taking it to the next level with the launch of au LISTEN MOBILE SERVICE (LISMO), which makes the most of the characteristics of 3G phones. The top-rank customer satisfaction rating for au reflects high customer retention, and we also posted a further fall in this service's churn rate. In fact, we exceeded our growth targets for customer base and profits for our au mobile phone service in the year under review.

In October 2005, KDDI Corporation absorbed the three TU-KA subsidiaries of TU-KA Cellular Tokyo, Inc., TU-KA Cellular Tokai, Inc., and TU-KA Phone Kansai, Inc. That same month, we began offering TU-KA subscribers the opportunity to transfer to the au service without having to change their numbers. We heightened the attractiveness of this offer in February 2006 by allowing TU-KA customers to keep the same e-mail address as well. Migration from TU-KA to au continues to proceed smoothly.

The migration process, moreover, has been an extremely valuable experience for us. It has enabled us to construct systems for the smooth transfer of user contracts. And that will help us to benefit quickly once MNP becomes a reality for all mobile phone users in Japan in late 2006.

2. Fixed-line Business

We encountered delays in the first half of the year in expanding the coverage area for our KDDI Metal Plus service. The result was a larger-than-forecast operating loss in our Fixed-line Business, mainly because the subcontracting costs and commission-related sales expenses were front-loaded.

Expansion of the coverage area proceeded to plan in the second half of the year. And as of the end of 2006, the subscriber base for KDDI Metal Plus had grown to 1.8 million, exceeding the target figure of 1.7 million that we had set for the year. I believe that we have secured an excellent foothold in this market, putting us in a good position to achieve further growth in the year ahead.

In October 2005, we took a significant step forward in strengthening our base of fixed-line operations for growth. We completed a comprehensive alliance in the telecommunications field with The Tokyo Electric Power Co. (TEPCO). In November 2005, as a prelude to the launch of an integrated service with TEPCO, we began a joint promotional campaign — the KDDI & TEPCO Hikari Campaign Plan — to market Fiber to the Home (FTTH) services for residential customers. Then, in January 2006 in a move related to this alliance, we merged with POWEREDCOM, Inc., the leading player in the Japanese market for corporate wide-area Ethernet services.

3. Fixed and Mobile Convergence Business

In May 2005, we took the first step toward building our Fixed and Mobile Convergence (FMC) Business when we began offering customers a consolidated billing service for fixed-line and mobile services. We followed this up in January 2006 with the launch of LISMO, the industry's first comprehensive music service suite for mobile phones. LISMO seamlessly integrates music between au handsets and personal computers. Toward further seamlessness, in June 2005 we publicized our Ultra 3G integrated capability, which provides for an advanced IP network that can realize complete fixed-mobile convergence.

We have also initiated organizational reforms to prepare for FMC. On December 1, 2005, we rearranged our divisional structure to ensure new market-based separation between individual and corporate customers. The Consumer Business sector now contains both our mobile and fixed-line businesses for consumers, while the Solution Business sector incorporates mobile and fixed-line communications solutions for corporate clients. This reform involved a significant exchange of personnel between the mobile and fixed-line sectors.

III. Future Business Developments and Prospects

Our aim remains to generate continuous growth. In this respect, we believe that the prospects for the industry are excellent. We envision two principal developments in the coming years:

* Within the overall telecommunications sector, we see FMC and communications merging with broadcasting. This will result in new opportunities for growth from a second tier of services related to content and media, in addition to the revenue generated from conventional traffic-based services.
* To maximize KDDI's strengths amid such a merger, we plan to consolidate our mobile and fixed-line operations.

I believe that KDDI faces three challenges to its success. First is MNP. Second is the way that we extract strategic value from FTTH in our Fixed-line Business. Third is content and media. The "Feature" section of this annual report contains discussions with key senior managers of our ongoing moves in each of these areas. Those discussions offer further insight into our medium-term business strategy.

Tadashi Onodera, President and Chairman

1. Mobile Communications Business

The year under review witnessed rapid change. New carriers decided to enter Japan's mobile telecommunications market in November 2005, and then Softbank announced its acquisition of Vodafone Japan in March 2006. We have responded to changing business conditions by maintaining our focus on making our overall product offerings more competitive over the long term and on improving our customer services. Moreover, although there is no way of knowing exactly how many users will switch carriers following the planned introduction of MNP in autumn 2006, we view the expected increase in customer mobility as an opportunity to expand our subscriber base. In leveraging our high-quality network infrastructure, we seek to draw users from other carriers with an attractive package of handsets, content, and tariffs.

Before the end of 2006, we plan to upgrade our data network to EV-DO Revision A. This improved version of our existing protocol offers broadband users greater bandwidth and faster connection speeds. We are developing original and innovative services that enable au to take advantage of the technical enhancements of EV-DO Revision A. The shift to the new system will maintain the technical superiority of our data communications service infrastructure, which, in turn, will help us to retain the competitive advantage of our overall product offerings.

At the end of March 2006, our share of the Japanese mobile communications market, by cumulative contract, had increased to 27.7%. We seek next to raise this figure to 30%, or about 30 million subscribers.

A major issue for us is developing and cultivating business domains to generate fresh sources of income. Our main areas of interest are content and media and mobile solutions for corporate users, and we are determined to move aggressively in these fields.

2. Fixed-line Business
We expect the KDDI Metal Plus service to post significantly better profitability in the year to March 2007. This is because the year ahead will realize a full-year sales contribution from the customers that we signed up in the year under review. Based on our projections, we expect KDDI Metal Plus to start making money in the year to March 2008.

In the year to March 2007, meanwhile, we will continue to move steadily forward with our preparations for the full-scale development of our FTTH business. At the start of June 2006, we launched Hikari one, an integrated FTTH service supplied in cooperation with TEPCO. We are also talking with TEPCO about a complete merger of its FTTH operations with ours at the beginning of January 2007. Initially, we aim to establish a successful business model for FTTH services in cooperation with TEPCO within the Kanto region surrounding Tokyo, an area where household penetration for broadband is high relative to other areas of the nation.

For corporate users, we have positioned KDDI Powered Ethernet as our main brand in the market for wide-area Ethernet services, a segment with excellent growth potential. Following the merger, we will expand our corporate business by fully exploiting POWEREDCOM's high-quality services and customer service systems.

3. FMC
We continue to make steady progress in preparing for fixed and mobile convergence based on our Ultra 3G concept. Our construction of a next-generation content delivery network (CDN) — a high-quality IP network incorporating packet prioritization and control technologies for voice, image, and other content — is well advanced. By the end of March 2008, we plan to become one of the first carriers in the world to have a fixed telephony network that has undergone complete IP conversion.

Among the most significant aspects of this conversion is that we are constructing a network that achieves full fixed-mobile convergence, eliminating dependence on a particular method of access. Besides 3G mobile phone and wireless LAN services, this network will accommodate wireless systems, such as next-generation CDMA2000, and fixed-line technologies, such as ADSL and FTTH. This will provide users with an ideal communications environment where they can enjoy ubiquitous access to high-speed data communications and high-quality multimedia, without being aware of any distinction between fixed-line and mobile communications.

IV. Activities Related to Corporate Social Responsibility

Because KDDI is a vital public utility, we realize that our most important social obligation is to make our service environment as good as possible for all users. Additional corporate social responsibility (CSR) objectives at KDDI include maximizing the value of the company and strengthening its brand through initiatives to raise total customer satisfaction (TCS). This applies to shareholders, investors and other stakeholders, and customers.

KDDI has a clear policy on corporate governance. We actively seek to clarify and strengthen our corporate governance through efforts to bolster efficiency and to increase transparency. In the year ending March 2007, we plan to formulate a basic policy on internal control systems to reinforce the transparency and integrity of KDDI Group operations. Part of this initiative includes a plan to establish a department responsible for internal controls. This initiative should help to improve our corporate governance and to boost the quality of our operations overall. We are, for example, also planning improvements in our information security, disclosure, and risk management and the like.

In addition, we recognize that protection of the global environment is a crucial obligation for large companies, such as KDDI. We have for this purpose instituted the KDDI Environment Charter, which is our basis for promoting various eco-friendly activities that target the development of a more affluent society.

On June 13, 2006, we announced to the media that data leakage had occurred relating to information on approximately four million subscribers to DION, our Internet access service. This information consisted of details about subscribers as of December 18, 2003. On behalf of the company, I apologize sincerely to customers for this breach of privacy. We are implementing measures across the company to ensure that we handle all customer information properly and that there is no recurrence of this event.

As the Ubiquitous Solution Company, KDDI continues to upgrade and expand its existing businesses while cultivating businesses in new areas. I believe that the two most critical things for us in our corporate activities are, first, to be a "value-creating enterprise" that grows by anticipating the needs of customers and, second, to be a "customer-oriented enterprise" that focuses assiduously on raising customer satisfaction. In my opinion, maximizing customer satisfaction is the quickest route to maximizing corporate value. I believe that at KDDI we are truly united in striving toward the attainment of this challenging common goal. I sincerely ask our shareholders, investors, and other stakeholders for their continued support and understanding.

July 2006

T. Onodera

Tadashi Onodera
President and Chairman