# Frutarom Industries Ltd.
# Directors' Report to the Shareholders
# for the Period Ending March 31, 2004

Frutarom Industries Ltd. ("Frutarom" or "the Company") founded in 1933, is a multi-national firm that became a public company in 1996. Frutarom has significant manufacturing and development centers on three continents and markets its products in 85 countries. Frutarom currently employs over 800 people around the world.

Frutarom showed record results in the first quarter of 2004, continuing its upward trend for the 18th consecutive quarter. The Company's two divisions, the Flavors and Fine Ingredients Divisions, achieved excellent results with improved sales, profitability, and an improved product mix. Continued fast organic growth is a central element in the ongoing implementation of Frutarom's strategy, which combines robust internal growth with targeted acquisitions, bringing know-how and extending Frutarom's core business activities within its geographical markets.

The first quarter of 2004 was further characterized by synergy effects inherent in the merger and acquisition of the Swiss company Emil Flachsmann AG ("Flachsmann"), purchased by Frutarom in June 2003 as part of the company's strategy of rapid growth. The integration of the two companies' activities, completed at the end of 2003, has created a synergetic relationship that leverages each of the companies' inherent and complementary strengths. Collaboration between research and development teams is enriching both companies' knowledge base and driving the development of new and innovative products. Operations and production staff are working diligently to increase efficiency and better utilize production capacity. Marketing and sales organizations have been unified, making the most out of Frutarom's and Flachsmann's relative advantages in each country. The Frutarom Group customer base has expanded and many new customers have been added, which include food and pharmaceutical market leaders. This integration of activities and the synergy between the firms has achieved considerable savings in expenditure, contributing to Frutarom's first quarter results and to the expectation of further improvement in the future.

The Flavors Division, the more profitable of Frutarom's activities, continued to show the same rapid growth this quarter as in previous years, with impressive performance by most of its subsidiaries worldwide. In the UK, accelerated growth was sustained, with increased performance in emerging markets such as Russia, Ukraine, Kazakhstan, Turkey and China. These factors contributed to Frutarom's continued increasing profitability, and are expected to continue to play a significant role in the Company's long term development.

Frutarom's sales in the first quarter of 2004 totaled US$ 43.9 million (NIS 196.1 million), a 55.8% increase compared to the same period in 2003. Gross profit rose by 66.1%, amounting to US$ 14.9 million (NIS 66.5 million), with the gross margin rising from 31.8% to 33.9%. Operational profit increased by 80.5% to US$ 5.7 million (NIS 25.6 million). Net profit rose sharply by 115.5%, reaching US$ 4.3 million (NIS 19 million), compared with approximately US$ 2 million (NIS 8.7 million) in the first quarter of 2003. Net profitability also rose to 9.7%, compared with 7% in the same period the previous year. Together with this surge in activity, Frutarom achieved in the first quarter of 2004 a positive cash flow from current activities that amounted to US$ 3.7 million (NIS 19 million).

At the close of the first quarter of 2004, the Company's equity capital amounted to US$ 63 million (NIS 286.7 million), in comparison with 2003's first quarter result of US$ 40.7 million (NIS 178.1 million). Total assets grew to US$ 146 million (NIS 661.4 million) from the same period in the previous year of US$ 95.3 million (NIS 417 million).

On March 2, 2004, the Company's Board of Directors approved a dividend of NIS 0.11 per share, totaling US$ 1.1 million (NIS 5.2 million).

Frutarom has invested much effort in the implementation of its successful growth strategy in recent years. The Company will continue to develop through swift organic expansion of the more profitable areas of its core activity, combined with the strategic acquisition of companies active in Frutarom's field of operations, with a view to becoming, within a few years, one of the ten global leaders in the flavor and fragrance industry.

## I. Brief Description of the Company and its Business Environment

Frutarom's Flavors Division develops, produces and markets flavors, seasonings and seasoning compounds. The Fine Ingredients Division develops, produces and markets raw materials intended mainly for producing these same flavors, as well as developing, producing and marketing plant extracts and natural products used in the flavor, fragrance, pharmaceutical, health, functional food, nutraceutical and cosmetic industries.

The Fine Ingredients Division is also involved in the development, production and marketing of building blocks in the peptide field, for use by the pharmaceutical industry in producing medicines using biotechnological methods.

A subsidiary, Frutarom Trade & Marketing (1990) Ltd., imports and markets to customers in Israel various raw materials that it does not produce itself.

Frutarom's products are produced in its plants in Israel, the USA, the UK, Switzerland, England, Denmark, China, and Turkey, and are sold to over 85 countries worldwide. Frutarom's international marketing infrastructure includes branches in Israel, the USA, the UK, Switzerland, England, Germany, Denmark, France, Romania, Russia, Ukraine, Kazakhstan, Turkey, Brazil, Mexico, China, Hong Kong, and India, as well as local agents and distributors worldwide.

The addition of medicinal plants to food and beverages, known as functional foods, is a developing global trend. This trend fits well with Frutarom's expertise in flavors and natural botanical extracts. Frutarom's knowledge of food systems, proven ability in combining botanical extracts in foodstuffs, and access to food manufacturers all ensure that Frutarom has significant competitive advantage and differentiation, which the Company is striving to exploit.

## II. Results of Activities

Frutarom's sales rose 55.8% during the first quarter of 2004 to US$ 43.9 million, compared with US$ 28.2 million during the same quarter in 2003.

The following contributed to the growth in sales and profitability:

A. The successful merger of Flachsmann Switzerland and its subsidiaries in Germany, Denmark, Hungary and Canada with the Frutarom Group's global activity. Flachsmann's activity complements Frutarom's in its geographical reach (Flachsmann had a substantial presence mainly in Western Europe, Scandinavia, Japan and Korea) as well as its products and target customers. Frutarom continues working diligently to fulfill and utilize the considerable synergies inherent in the complementary Flachsmann and Frutarom activities.

B. The continued accelerated growth trend in recent years in the Flavors Division. Frutarom will continue to invest in and strengthen all of the Flavors Division's sites in coming years, and regards this Division as a central element in its business' development strategy for the future.

C. Growth of the Fine Ingredients Division's sales, with the contribution of new products developed by Frutarom's research and development laboratories. These new products have a higher than average margin in markets in which Frutarom has a competitive advantage.

D. Continued consolidation and strengthening of Frutarom's global research, development, sales and marketing network. This includes the emerging market regions where Frutarom has begun activity in recent years.

**Breakdown of Sales by Activity 1999-2004**

| | 1999 | 2000 | 2001 | 2002 | 2003 | 1/04 – 3/04 |
|---|---|---|---|---|---|---|
| Flavors Division | 28.4% | 32.4% | 38.8% | 42.3% | 48.8% | 49.5% |
| Fine Ingredients Division | 62.8% | 59.8% | 55.6% | 52% | 46.7% | 46.6% |
| Trade & Marketing | 8.8% | 7.8% | 5.6% | 5.7% | 4.5% | 3.9% |

Frutarom's ***gross profit*** rose 66.1% during the first quarter of 2004 to reach US$ 14.9 million compared with US$ 9 million during the first quarter of 2003. The gross margin rose from 31.8% to 33.9% over the same period.

***Selling, administration and general expenses*** for the first quarter of 2004 totaled US$ 9.2 million, compared with US$ 5.8 million during the same quarter in 2003. The increase in expenses is largely a result of the merger of the Flachsmann Group's activity, overall growth in activity and the continued consolidation of Frutarom's global network.

***Operating profit*** for the first quarter of 2004 continued the upward trend of past years to reach US$ 5.7 million, growing 80.5% compared with the first quarter of 2003. The operating margin reached 13.1% compared with 11.3% for the same period in 2003.

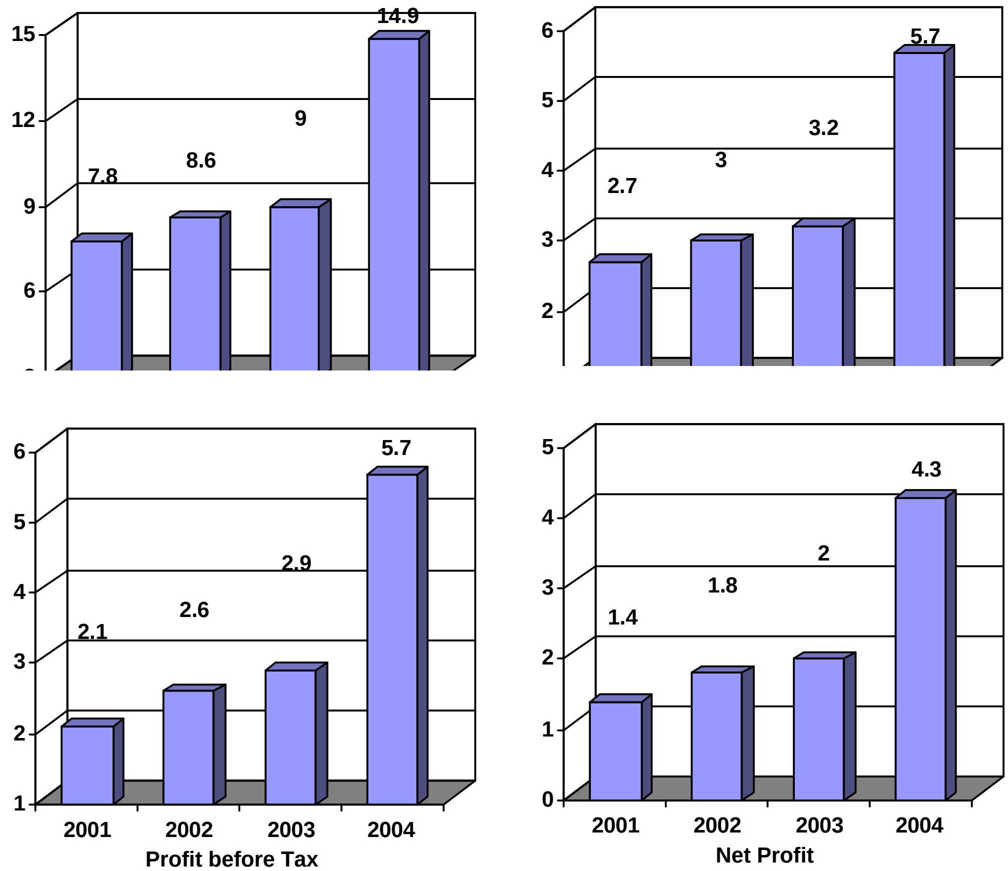
***Finance expenses*** for the quarter totaled US$ 0.1 million, compared with US$ 0.3 million in the parallel quarter last year. The decrease was due mainly to lower interest rates globally, and exchange rate differences of non-US currency balances.

***Profit before tax*** for the first quarter rose 100.2% to US$ 5.7 million, compared with US$ 2.9 million during the same quarter in 2003. This represents 13% of revenues compared with 10.1% during the same period in 2003.

***Tax expenses*** for the first quarter of 2004 totaled US$ 1.4 million, compared with US$ 0.9 million in the same quarter of 2003. Growth in the profits of subsidiaries located in countries with a low tax rate contributed to the decrease in the Company's tax rate.

***Net profit*** for the first quarter grew 115% compared with the first quarter of 2003, reaching US$ 4.3 million compared with US$ 2 million during the same quarter in 2003. The net profit margin also grew to reach 9.7% compared with 7% during the first quarter of 2003.

**Profit Development – First Quarters 2001-2004 (US$ million)**



## III. Financial Status

Total assets on March 31, 2004 amounted to US$ 146.1 million, compared with US$ 95.2 million at March 31, 2003. The consolidation of Flachsmann's assets significantly contributed to this growth.

The Company's current assets totaled US$ 78 million, compared with US$ 55.4 million at the end of the parallel quarter. The main contributors to the growth in current assets were the growth of US$ 3.1 million in cash balances, US$ 9.7 million in receivables and US$ 7.5 million in inventory. The increase in current assets is due to the consolidation of Flachsmann's current assets and the growth in Frutarom's activity. Parallel with the growth in activity and assets, Frutarom succeeded in achieving a decrease in the number of credit days granted to customers and in the number of inventory days.

Net fixed and other assets totaled US$ 65.5 million on March 31, 2004, compared with US$ 39.8 million at the end of the same quarter in 2003. Again, most of the increase in fixed assets comes from the consolidation of Flachsmann's fixed assets.

## IV. Liquidity

During the first quarter of 2004, cash flow from operating activity reached US$ 3.7 million, compared with a negative cash flow of US$ 0.3 million during the same quarter last year. Most of the cash flow generated during the quarter was used for investments, to reduce the Company's debt and to increase the cash balance.

## V. Sources of Finance

### A. Equity

The Company's equity as of March 31, 2004 totaled US$ 63.3 million (43% of the total balance sheet). The increase in the Company's equity during the first quarter derives from the quarter's profit in the amount of US$ 4.3 million, and was partially offset by the dividend that was declared amounting to US$ 1.1 million.

B. <u>Long Term Loans Including Current Maturities of Long Term Loans (Quarterly Average)</u>

The average long term credit from banks totaled US$ 39.6 million. During the same quarter last year, the Company had long term credit of US$ 28 million at its disposal. Most of the growth in long term credit comes from the Flachsmann long term credit.

C. <u>Short Term Loans Excluding Current Maturities of Long Term Loans (Quarterly Average)</u>

The average short term credit from banks totaled US$ 2 million. During the same period in 2003, the Company had short term credit of US$ 1.1 million at its disposal.

D. <u>Credit From Suppliers and Customers (Quarterly Average)</u>

The average credit from suppliers and other creditors was US$ 33.3 million (US$ 20.1 million during the same period in 2003). During the report period, Frutarom granted average credit of US$ 33.1 million to receivables (US$ 23.7 million during the same period in 2003). Most of this growth was due to the consolidation of Flachsmann and the growth in Frutarom's scope of activity.

## VI. Disclosures about Market Risk

No significant events or changes have occurred in the Company's exposure to market risk compared with December 31, 2003, as presented in the Directors Report of that date.

## VII. External Influences

There have not been any changes since the Directors Report issued for the period January to December 2003 as stated in the Directors Report as at December 31, 2003.

## VIII. Events Following the Balance Sheet Date

There were no significant events following the balance sheet date.

The Board of Directors of the Company held one meeting during the period under report.

The Board of Directors thanks Frutarom's employees and management for their contribution to the Company's achievements and success.

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| Dr. John J. Farber<br>Chairman of the Board | Ori Yehudai<br>President & CEO<br>Member of the Board |

May 17, 2004