

**FRUTAROM INDUSTRIES LTD.  
DIRECTORS REPORT TO THE SHAREHOLDERS  
FOR THE PERIOD ENDING MARCH 31, 2004<sup>1</sup>**

<b>General</b>
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Frutarom Industries Ltd. (“Frutarom” or “the Company”), a global company, was established in 1933 and became a public company in 1996. Frutarom develops, produces and markets flavors and fine ingredients used to produce food, beverages, flavors, fragrances, pharma/nutraceuticals, personal care and other products. Frutarom operates production facilities in Europe, North America, Israel and Asia, and produces, markets and sells over 14,000 products to more than 3,500 customers in more than 100 countries. Frutarom operates two divisions: the Flavors Division and the Fine Ingredients Division.

In recent years Frutarom has implemented a strategy for achieving rapid, above-industry average growth, through both internal growth and strategic acquisitions. Frutarom focuses on large multinational customers as well as mid-size and local customers, offering each customer the same superior service and tailor made products. Frutarom concentrates on developed markets such as Western Europe and the United States, as well as fast growing emerging markets such as CIS, Eastern Europe and Asia. Frutarom offers its customers a wide product range comprised mostly of natural and innovative, value-added products such as natural functional food ingredients, and continues to invest substantial resources in the Company’s research and development activities.

During the first quarter of 2005, Frutarom continued its trend of increased sales, profitability and profits for the twenty-second consecutive quarter, in both the Flavors Division and the Fine Ingredients Division. The consistent growth in the core activities of the two Divisions is an important element in the implementation of Frutarom’s growth strategy.

Frutarom’s sales for the first quarter of 2005 totaled US\$ 64.7 million, growing 47.3%, compared with the same quarter of 2004. Gross profit for the period rose 47.1% to reach US\$ 25.0 million, compared with US\$ 17.0 million in the same quarter of 2004. Operating profit rose 80.3% to US\$ 9.3 million, compared with US\$ 5.1 million in the same quarter of 2004. Operating margin rose to 14.3% compared with 11.7% for the same quarter of 2004. Net profit grew sharply by 90.6%, reaching US\$ 6.8 million compared with US\$ 3.6 million in the same quarter of 2004, and net margin reached 10.6%, compared with 8.2% in the same quarter of 2004. Profit per share also rose during the first quarter of the year and reached US\$ 0.13 compared with US\$ 0.08 during the first quarter of 2004.

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<sup>1</sup> Prepared in accordance with the consolidated financial reports of Frutarom Industries Ltd., which were prepared in accordance with the IFRS as required by the UKLA.

The cash flow from current activities achieved by Frutarom during the first quarter of 2005 totaled US\$ 5.5 million compared with US\$ 3.7 million in the first quarter of 2004.

In February 2005, the Company raised US\$ 80.9 million by issuing shares and GDRs on the London Stock Exchange Official List. The net proceeds received by the Company in connection with the Offering (net of underwriting commissions and other fees and expenses, which totaled US\$ 5.1 million), totaled US\$ 75.8 million. This offering adds leading international investors to Frutarom's shareholder portfolio, improves its equity structure, contributes to its positioning as a global company, and gives the Company the resources required to continue implementing strategic acquisitions as part of its rapid growth strategy.

Frutarom's equity as at March 31, 2005 totaled US\$ 167.4 million (67.1% of the balance sheet), compared with US\$ 62.5 million as at March 31, 2004 (43.2% of the balance sheet).

The increased net profit seen in recent years derive mainly from the rapid growth in Frutarom's activity – growth resulting from organic growth in core activities of both the Flavors and Fine Ingredients Divisions, and the successful integration of activities acquired in recent years. Another factor is the increased proportion of Frutarom's Flavors Division sales (which typically have higher margins than Fine Ingredients Division products) in Frutarom's overall sales. Flavors Division sales reached 64.3% of total sales in the first quarter of 2005, compared with 49.5% in the first quarter of 2004. The Fine Ingredients Division, which is focusing on developing and introducing new, innovative and value-added products with a higher margin, also contributed to the improvement in Frutarom's product mix, profitability and profit. Alongside the growth in activity in recent years, Frutarom has maintained a policy of closely controlling expense levels.

Frutarom will continue to invest considerable efforts and resources in successfully implementing its strategy of rapid growth in order to strengthen its positioning as one of the leading global companies in the field of flavors and fragrances.

### **Summary of the Company's Activity**

Frutarom operates in the global flavors and fine ingredients markets. In the flavors market, Frutarom is active in the segments of flavor compounds (sweet and savory) and food systems. In the fine ingredients market, Frutarom operates in the segments of natural flavor extracts, natural functional food ingredients, natural pharma/nutraceutical extracts, specialty essential oils, citrus products and aroma chemicals.

Based on the data published by SRI Consultants, Frutarom estimates that sales in 2003 in the markets in which it operates totaled US\$ 14.7 billion (excluding sales of natural functional food ingredients outside of the United States and Europe and sales of pharma/nutraceutical extracts) and that global sales in the flavor and fine ingredients markets in which Frutarom operates will grow at an annual rate of between 3% and 4% from 2005 to 2008, although the growth rate is expected to be significantly higher in certain emerging markets such as Eastern Europe, Russia,

China and India. In addition, the market for natural functional food ingredients is expected to grow at a higher rate of 9% in Europe and the United States.

The Company's activity is divided into two main divisions, each of which is a major field of activity:

- The Flavors Division develops, produces, markets and sells flavor compounds (sweet and savory) and Food Systems used mainly by manufacturers of food, beverages and other consumer products. Frutarom develops thousands of different flavors, most of which are tailor-made for specific customers, and continuously develops new flavors in order to meet changing consumer preferences and future customer needs. The Flavors Division is the most profitable of Frutarom's Divisions and has experienced accelerated growth in recent years as a result of both organic growth and the successful integration of a number of strategic acquisitions. The internal growth in the Flavors Division's sales derives mainly from the Division's focus on both developed and emerging markets by providing superior service to both multinational and mid-sized, local customers. The proportion of Frutarom's total sales represented by the Flavors Division has progressively increased from 37.3% in 2001 to 49.5% in 2004 and to 64.3% in the first quarter of 2005.
- The Fine Ingredients Division develops, produces, markets and sells natural flavor extracts, natural functional food ingredients, natural pharma/nutraceutical extracts, specialty essential oils, citrus products, aroma chemicals, natural gums and peptide building blocks. The products of the Fine Ingredients Division are sold principally to the food, beverage, flavor and fragrance, pharma/nutraceutical and personal care industries. The Fine Ingredients Division has experienced significant growth in recent years as a result of both internal growth and the successful implementation of several strategic acquisitions. The internal growth in the Fine Ingredients Division's sales is principally the result of the development of new, innovative value-added products, a higher margin and its focus on multinational, mid-sized and local customers worldwide.

The activities of Frutarom's two Divisions are greatly complementary and synergetic. This synergy is expressed in a number of main fields: (1) sales and marketing – Fine Ingredients Division products that are intended for the food and beverage market are sold through the Flavors Division's sales force; (2) research and development – the knowhow and familiarity of the Flavors Division's team with the needs of the food and beverage market enable the Fine Ingredients Division to develop and produce new and innovative products for the food and beverage industry; (3) operations – a substantial portion of Frutarom's production sites are jointly utilized by the Flavors Division and the Fine Ingredients Division; (4) fine ingredients – although the majority of fine ingredients produced by the Company are sold to third parties, a portion of the specialty fine ingredients are reserved solely for the Flavors Division to produce certain flavors, giving Frutarom a unique advantage.

<b>Results of Activity in the First Quarter of 2005</b>
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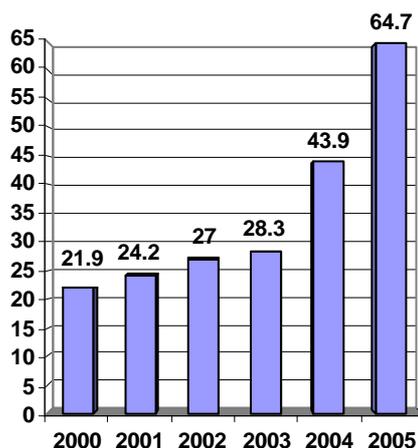
Following is a summary of the profit and loss report for the first quarter (US\$ million):

	2005	2004	Change (%)
Sales	64.7	43.9	47.3%
Gross profit	25.0	17.0	47.1%
R&D, Selling, Administration and General expenses	15.7	11.8	32.7%
Operating profit	9.3	5.1	80.3%
EBITDA	11.8	7.3	61.5%
Profit before tax	9.1	5.1	79.2%
Net profit	6.8	3.6	90.6%

### Sales

Frutarom's sales during the first quarter of 2005 totaled US\$ 64.7 million, showing growth of 47.3% compared with the first quarter of 2004, when sales totaled US\$ 43.9 million.

Sales Development in the First Quarters of 2000-2005 (US\$ million)  
(2000-2003 figures are based on Israeli GAAP)



The following factors influenced the growth in sales:

- A. The merger of the Food Systems activity acquired from IFF in Switzerland, Germany and France with the Frutarom Group's global activity.
- B. The continued accelerated growth trend in recent years in the Flavors Division (which typically has higher margins compared to fine ingredients products), due to the consolidation and strengthening of activity in its subsidiaries worldwide.
- C. Growth in the Fine Ingredients Division's sales, to which new, innovative high margin products developed in Frutarom's R&D labs contributed.

Sales Breakdown by Fields of Activity in the First Quarters of 2000-2005 (in % and US\$ million)

		2000	2001	2002	2003	2004	2005
<b>Flavors Division</b>	<b>Sales</b>	6.8	9.1	10.8	12.8	21.7	41.6
	<b>%</b>	31.0%	37.4 %	40.0%	45.1 %	49.5 %	64.3%
<b>Fine Ingredients Division</b>	<b>Sales*</b>	13.8	13.9	14.9	14.2	21.1	22.1
	<b>%</b>	61.2%	56.2%	54%	48.6%	46.6%	32.9%
<b>Trade &amp; Marketing</b>	<b>Sales</b>	1.7	1.5	1.6	1.8	1.7	1.8
	<b>%</b>	7.8%	6.4%	6.0%	6.3%	3.9%	2.8%

\* Including intercompany sales

In recent years, the growth in the Flavors Division's sales, which typically generate higher margins than fine ingredients products, as a proportion of Frutarom's total sales has progressively increased, reaching 64.3% of total sales in the first quarter of 2005 compared with 31.0% in 2000. The increase in the Flavors Division's portion of Frutarom's total activity in the first quarter of the year results from the more rapid internal growth in recent years in its sales and the growth in this Division resulting from the inclusion of the Food Systems activity acquired from IFF during the second half of 2004.

#### Gross Profit

Gross profit grew 47.1% during the first quarter of 2005 to reach US\$ 25.0 million compared with US\$ 17.0 million in the first quarter of 2004. This increase is the result of the growth in activity turnover due to the sales growth and the acquisition of the Food Systems activity from IFF.

#### Selling, Marketing, Research and Development, Administration and General Expenses

Selling, marketing, research and development, administration and general expenses totaled US\$ 15.7 (24.3% of sales) in the first quarter of 2005, compared with US\$ 11.8 million (27.0% of sales) during the first quarter of 2004. The growth in expenses is mainly the result of the growth in Frutarom's activity and the addition of the Food Systems activity acquired from IFF.

#### Operating Profit

Operating profit grew sharply by 80.3% during the first quarter of 2005 compared with the first quarter of 2004, totaling US\$ 9.3 million. Parallel to the growth in operating profit, the growth trend in operating margin also continued, reaching 14.3% during the first quarter of 2005, compared with 11.7% in the first quarter of 2004.

The Flavors Division's operating profit for the first quarter of 2005 was US\$ 6.8 million (operating margin 16.3%), compared with US\$ 3.6 million (operating margin 16.5%) during the same quarter in 2004. The growth rate of 89.3% is mainly the result of the merger of the Food Systems business acquired from IFF (whose profitability was slightly more marginal than the average for the Flavors Division but similar to Frutarom's group) and improvement in the Flavors Division's operating margin.

Improvement to the Fine Ingredients Division's operating profit continued and during the first quarter of 2005 reached US\$ 2.3 million (operating margin 10.3%), compared with US\$ 1.7 million (operating margin 8.0%) in the first quarter of 2004. The 46.9% growth rate results from the introduction of new innovative products with higher than average margins, and close control over expenses.

Finance Expenses

Finance expenses for the first quarter of 2005 totaled US\$ 0.2 million (0.3% of sales), compared with US\$ 0.1 million (0.2% of sales) in the first quarter of 2004.

Profit Before Tax

Profit before tax for the first quarter of 2005 grew 79.2% to reach US\$ 9.1 million (14.0% of sales), compared with US\$ 5.1 million during the same period in 2004 (11.5% of sales).

Taxes on Income

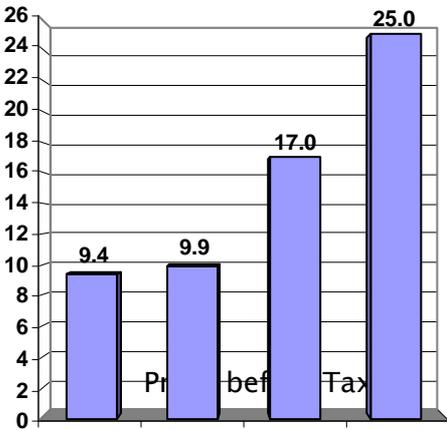
Taxes on income in the first quarter of 2005 totaled US\$ 2.2 million (24.6% of profit before tax) compared with US\$ 1.5 million during the same period in 2004 (29.2% of profit before tax).

Net Profit

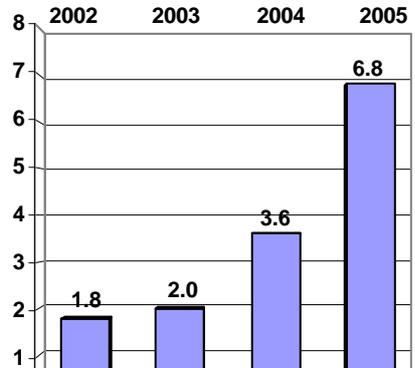
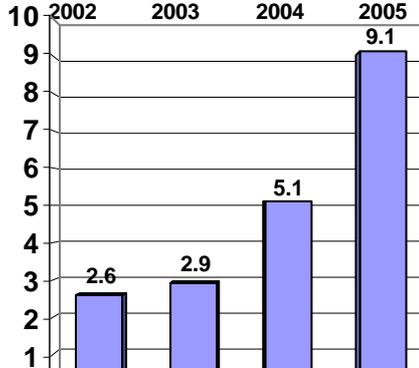
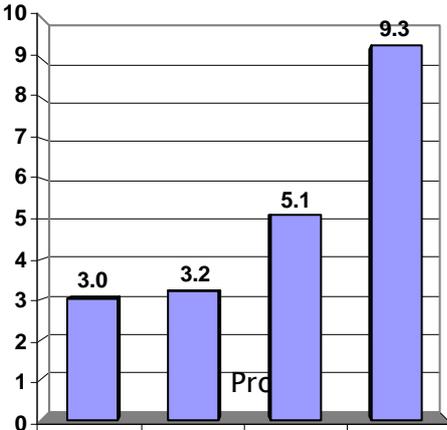
Net profit for the first quarter of 2005 rose sharply by 90.6% to reach US\$ 6.8 million, compared with US\$ 3.6 million in the first quarter of 2004. Net margin also rose, reaching 10.6%, compared with 8.2% in the same quarter in 2004.

Profit Development - First Quarter - 2002-2005 (US\$ million)  
(2002-2003 figures based on Israeli GAAP)

Gross Profit



Operating Profit



The Company's business is subject to seasonal fluctuations, generally with higher sales and profitability (due to product mix) in the first half of a given year and lower sales and profitability in the second half of a given year. A substantial portion of the Company's products are used by its customers in the manufacture of beverages and dairy products such as soft drinks, ice cream and yogurts, for which demand generally increases markedly during the summer months. As a result, sales of certain flavors and fine ingredients produced by Frutarom rise in the first half of the year, as manufacturers of beverages and dairy products re-stock their inventories and increase production in advance of rising demand during the summer months.

The impact of seasonality on the Company's results has steadily decreased in recent years as the Company has increased its sales of products such as savory flavors, functional food ingredients and natural pharma/nutraceutical extracts, which generally have lower seasonality in demand.

#### **Financial Status**

Total assets on March 31, 2005 amounted to US\$ 249.4 million, compared with US\$ 144.8 million at March 31, 2004.

The Company's current assets totaled US\$ 134.5 million, compared with US\$ 77.9 million at the end of the same quarter of 2004.

Fixed assets minus accumulated depreciation and net other assets totaled US\$ 107.7 million on March 31, 2005, compared with US\$ 61.8 million at the end of the same quarter of 2004.

The growth in overall assets, and particularly in current assets, resulted mainly from the acquisition of IFF's Food Systems activity, the offering made in February 2005 and the growth in activity turnover.

#### **Liquidity**

During the first quarter of 2005, Frutarom achieved cash flow from operating activity of US\$ 5.5 million, compared with US\$ 3.7 million in the first quarter of 2004. The cash flow was used to finance the growth in working capital resulting from the growth in activity, reduce debt, make investments and increase the cash balance.

## **Sources of Finance**

### Sources of the Company's Equity

The Company's equity at March 31, 2005 totaled US\$ 167.4 million (67.1% of the balance sheet) compared with US\$ 62.5 million (43.2% of the balance sheet) during the same quarter in 2004. The growth in the Company's equity during 2004 derives mainly from the capital raised in February, when the Company raised the net amount of US\$ 75.8 million. The growth in profit also contributed to the growth in equity.

The growth in equity enables Frutarom to leverage its capital structure and continue to execute strategic acquisitions in accordance with its growth strategy.

### Long Term Loans Including Current Maturities of Long Term Loans (Annual Average)

The average scope of long term credit from banks totaled US\$ 27.1 million. During the same period last year, the Company had US\$ 39.6 million at its disposal.

### Short Term Loans Excluding Current Maturities of Long Term Loans (Annual Average)

The average scope of short term credit from banks totaled US\$ 15.1 million. During the same quarter of 2004, the Company had US\$ 2.0 million at its disposal. The growth in short term loans at the Company's disposal is mainly the result of the acquisition of the Food Systems activity from IFF, which was financed with loans from banks in Switzerland. These loans were repaid during the quarter following the offering in London.

### Credit From Suppliers and Customers (Annual Average)

During the first quarter of 2005 the average scope of credit from suppliers and other creditors was US\$ 42.2 million (US\$ 33.3 million during the same quarter of 2004). During the first quarter of 2005, the Company granted average credit of US\$ 47.6 million to receivables, compared with US\$ 33.1 million during the same quarter of 2004. Most of the growth in customer credit results from the significant growth in activity, to which to the acquisition of the Food Systems activity from IFF contributed.

## **Disclosures about Market Risk**

The Company's activity is characterized by extensive dispersal. Through its two Divisions, the Company produces thousands of products intended for thousands of customers throughout the world, using thousands of raw materials purchased from a wide range of suppliers worldwide. The Company is not significantly dependent on any of its customers, products or suppliers.

The Company operates in a multi-currency environment. Currency exposure is reviewed as needed, on at least a quarterly basis. The Company does not generally take external hedging actions or use other financial instruments for protection against currency fluctuations. The Chief Financial Officer is responsible for managing market risks as relates to exchange rates and interest.

The Managers of the two Divisions are responsible for managing market risk as it relates to changes in raw material prices. The Company's management and Board of Directors are updated on material changes in the Company's exposure to various risks, and conduct discussions as needed.

Currency Exposure Report Based on Main Linkage Bases at March 31, 2005 (in US\$ 000)

	USD	GBP	Euro	CHF	Other	NIS	Total US\$
<b>Assets</b>							
Cash and equivalents	22,791	1,997	2,708	852	1,089	545	29,982
Customers	13,109	5,127	11,457	6,117	3,608	10,682	50,100
Other debtors	2,065	955	3,451	2,589	520	953	10,533
Inventory	25,484	5,316	2,843	10,223			43,866
Other, long term	4,662			2,539			7,201
Fixed assets, net	24,715	7,073	9,877	51,948			93,613
Other assets, net	1,791	7,062	3,379	1,895			14,127
<b>Total assets</b>	<b>94,617</b>	<b>27,530</b>	<b>33,715</b>	<b>76,163</b>	<b>5,217</b>	<b>12,180</b>	<b>249,422</b>
<b>Liabilities</b>							
Bank credit		474		897		72	1,443
Suppliers	4,893	2,451	6,224	3,216	178	4,915	21,876
Other creditors	3,279	3,134	1,603	5,584	447	10,625	24,672
Bank loans (including current maturities)	8,078			11,604			19,682
Employee retirement rights liabilities	914		6,229 (1,056)	1,155			8,298
Deferred taxes	4,214	1,061	)	1,806	(5)		6,020
Other, Long term							
<b>Shareholders equity</b>							<b>167,431</b>
	21,377	7,120	13,000	24,262	620	15,612	249,422
<b>Net assets (Liabilities)</b>	<b>73,239</b>	<b>20,410</b>	<b>20,715</b>	<b>51,901</b>	<b>4,597</b>	<b>(3,432)</b>	<b>0</b>
<b>Events Following the Balance Sheet Date</b>							

On March 23, 2005, upon approval of the annual financial reports, the Board of Directors of the Company decided to distribute a cash dividend in the amount of NIS 0.13 per share for an overall total of NIS 7,497,926.

There were no other significant events following the balance sheet date.

The Board of Directors of the Company held three meetings during the report period.

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

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Dr. John J. Farber  
Chairman of the Board

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Ori Yehudai  
President & CEO  
Member of the Board

May 24, 2005