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Important Disclaimer

Markets and Competitive Position

This report contains information, statistical data and predictions about our markets and our competitive position. We have not verified the accuracy of those statistical data or predictions contained in this report that were taken or derived from industry publications, public documents of our competitors or other external sources. We believe that the information presented in this report provides fair and adequate estimates of the size of our markets and fairly reflects our competitive position within these markets. However, our internal estimates have not been verified by an external expert, and we cannot guarantee that a third party using different methods to assemble, analyze or compute market data would obtain or generate the same results. In addition, our competitors may define our and their markets differently than we do.

Forward-Looking Statements

This report contains “forward-looking statements” regarding our assumptions, projections, expectations, intentions or beliefs about future events. We caution you that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward looking-statements. These forward-looking statements include, among others, statements concerning our financial position and results, business strategy, plans and objectives of management for future operations, including development plans and objectives relating to our business. Some, but not all, of the factors that could cause actual results to differ materially from those expressed or implied in any forward-looking statement include: our exposure to currency exchange rate fluctuations; changes in the market prices or availability of raw materials; changes in the political, social, trade, monetary, fiscal, taxation and environmental policies of governments, agencies and similar organizations in geographic areas where we operate; the impact of increasingly stringent environmental laws and their enforcement by the relevant authorities; changes in the competitive and regulatory framework in which we operate, in particular increased competition in the specialty chemicals industry; the consolidation of our customers or the loss of key customers; our ability to implement our business strategies, including our ability to maximize production yields and lower production costs; potential environmental or product liability claims, costs, liabilities or other obligations; the impact of legislative changes and fluctuations in the equity markets on the development of our pension and retirement obligations; changes in our relationships with workers’ councils and unions; challenges to, losses of or infringements on our intellectual property rights; difficulties we may encounter in implementing our new IT systems or in updating our current IT systems; changes in our insurance coverage; acts of terrorism generally and particularly in the countries in which we operate; our ability to claim tax losses; general economic and business conditions, including any decline in financial or equity markets; our high leverage and ability to generate sufficient cash to service our debt; the risks associated with our structure and our indebtedness; our ability to borrow additional funds and access capital markets; our ability to repurchase or settle the Senior Loans, Second Lien Loans, Second Lien Notes, Senior Notes and/or PIK Notes upon a change of control; and other factors beyond our control.

Forward-looking statements speak only as of the date of this report. We expressly disclaim any obligation or undertaking to release, publicly or otherwise, any updates or revisions to any forward-looking statement contained in this report to reflect any change in our expectations or any change in events, conditions, assumptions or circumstances on which any such statement is based unless so required by applicable law.

Management's Discussion and Analysis

Financial Highlights

Results and Cash Generation from Operations

€ millions	2006	2005
Sales	3,372	3,176
Operating profit (EBIT)	206	57
EBITDA ¹⁾	365	303
Adjusted EBITDA ¹⁾	394	356
Adjusted EBITDA margin	11.7%	11.2%
Net profit/(loss)	2	(136)
Operating cash flow	304	272

¹⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have not been affected materially by the adoption of IFRIC 4.

Sales growth of 6.2% in 2006

In 2006, Cognis¹⁾ generated sales of €3,372 million, 6.2%²⁾ more than in 2005. On an organic³⁾ basis, i.e. excluding foreign currency⁴⁾ effects and the effects of acquisitions and divestments, sales growth was +€184 million or +5.8%. Looking briefly at the organic sales performance of each Strategic Business Unit (SBU):

- Care Chemicals' sales growth amounted to +5.6% due to the strong performance of the high-margin specialty product portfolio achieved despite tough market conditions in relation to fatty alcohols
- Nutrition & Health reported +4.2% sales growth, reflecting a shift of the product portfolio toward the high-margin segments, particularly Sterols, CLA as well as Pharma & Health which helped overcome a difficult year in 2005 driven by the challenging Vitamin E business
- Functional Products reported significant sales growth of +10.4% mainly by regaining market share that was lost in 2005. Our efforts to regain these volumes have paid off, as we increased volumes and sales especially in the USA through our new-generation lubricant formulations, focusing on key accounts and entering new markets. These increased sales were accompanied by various successful initiatives in our affiliates around the world designed to decrease manufacturing costs
- Process Chemicals' sales increased by +4.1% mainly due to the solid performance of Leather Technology products, especially in Asia Pacific. Also the expansion of our Textile Technology facilities in China have helped increase sales in that segment, as have promising uptakes of our "Active Textiles" in the apparel industry
- Oleochemicals' sales decreased marginally by -0.7%, mainly reflecting lower selling prices in the Fatty Acids/Glycerin business

¹⁾ "Cognis" refers to Cognis GmbH and its consolidated direct and indirect subsidiaries.

²⁾ All percentages in this report are calculated based on the exact underlying figures.

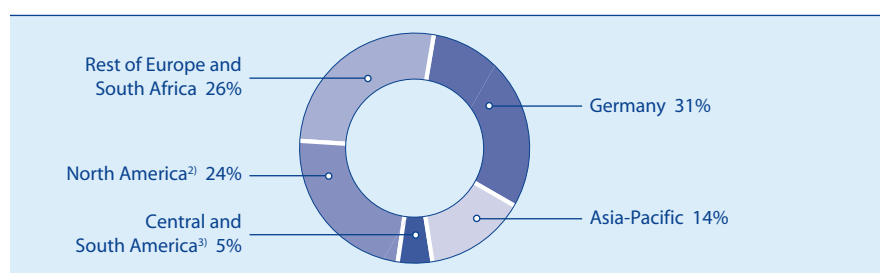
³⁾ We refer to the change from the prior period excluding foreign currency effects and excluding the effects of acquisitions and divestments as "organic growth". From a Strategic Business Unit (SBU) perspective, the change from the prior period excludes foreign currency effects, the effects of acquisitions and divestments and inter-SBU transfers.

⁴⁾ When discussing our results of operations, we often express a number as "excluding foreign currency effects". This phrase means that the current and comparative figures of Cognis' constituent legal entities have been translated into euros using the same foreign exchange rates. We have not adjusted for transaction gains and losses, which may arise when a company earns revenues or incurs costs in a currency that is not its functional currency. The transaction gains and losses represent the changes in value, resulting from changes in exchange rates, of these transactions as measured in the functional currency.

As such, the development of sales in 2006 underlines our commitment to our strategic focus, namely wellness and sustainability. The increase in sales reflects the strong growth of our higher-margin product portfolio in Care Chemicals, Nutrition & Health and Functional Products including significant market share regained in Functional Products. The strong performance of our high-end products has more than compensated for the tough market conditions faced in the fatty alcohols market. And, as a result of intensive market expansion in the Asia-Pacific region, Process Chemicals also reported improved results this year. Only Oleochemicals reported lower sales, reflecting continuing price pressure on the Fatty Acids/Glycerin business.

Sales by company jurisdiction

€ millions	2006 ¹⁾	2005 ¹⁾
Germany	1,034	988
Rest of Europe and South Africa	899	842
North America ²⁾	798	755
Central and South America ³⁾	163	152
Asia-Pacific	478	439
Total	3,372	3,176



¹⁾ Effective January 1, 2006, Cognis' regional reporting structure has changed. Cognis Colombia was transferred from North America to Central and South America. To ensure comparability, the 2005 figures in this report have been restated to reflect this change.

²⁾ North America including Mexico and excluding Colombia.

³⁾ Central and South America excluding Mexico and including Colombia.

On a regional⁵⁾ perspective, we achieved significant sales growth of +8.7% in Asia-Pacific⁶⁾ (in organic terms +7.4%), North America⁷⁾ of +5.7% (in organic terms +6.0%) and Europe⁸⁾ of 5.8% (in organic terms +5.7%). South America⁹⁾ recorded growth of 7.3% but reported slightly higher organic sales growth (+0.7%) compared to 2005.

⁵⁾ We define our regions according to the location of the selling legal entity. For example, products produced by a European legal entity and exported to the USA are considered to be European sales and earnings.

⁶⁾ Comprises Asia, excluding Turkey, and Australia.

⁷⁾ Comprises USA, Canada, Mexico, excluding Colombia.

⁸⁾ Comprises Europe, including Turkey, and South Africa.

⁹⁾ Comprises Central America and South America, including Colombia and excluding Mexico.

Adjusted EBITDA significantly higher than in 2005

Cognis' 2006 Adjusted EBITDA¹⁰⁾ was €394 million, +€38 million or +10.7% higher than in 2005. On an organic basis, Adjusted EBITDA grew by +€34 million or +9.7%. Accordingly, Adjusted EBITDA as a percentage of sales increased from 11.2% in 2005 to 11.7% in 2006, largely reflecting increased sales achieved through our focus on high-margin products, despite higher energy costs and partially higher raw material prices in 2006, and the success of various initiatives in optimizing manufacturing costs.

Adjusted EBITDA increase results in Net profit in 2006

Net profit increased +€138 million to +€2 million in 2006 from a net loss of –€136 million in 2005. This was primarily due to the strong development of Adjusted EBITDA in 2006 compounded by the absence of exceptional charges recognized in 2005, such as non-cash impairment charges to fixed assets (–€61 million) and non-cash foreign exchange losses on US-dollar denominated borrowings (–€49 million).

Our 2006 net profit includes €29 million exceptional charges, mostly related to restructuring (–€35 million), and other corporate consultancy fees and separation expenses (together –€10 million) as well as income from the release of pension provisions stemming from changes made to German pension plans and a curtailment of certain retirement benefits in the USA (together +€16 million).

Impact of IFRIC 4, effective January 1, 2006 on earnings

Our Adjusted EBITDA increased by roughly €1.4 million in 2006 (2005: €0.9 million), due to the application of IFRIC 4 as from January 1, 2006. IFRIC 4 requires the identification and reporting of embedded leases and is described in detail later in this report under the section "Consolidated Financial Statements".

Contribution of Oleochemicals and Plastics Technology businesses to joint venture in 2006

In February 2006, we transferred our global Oleochemicals and Plastics Technology businesses to our existing 50:50 Malaysian joint venture with Golden Hope Plantations Berhad, Malaysia. For more details concerning this transaction, please refer to "Strategic Business Units and Segment Results – Oleochemicals".

¹⁰⁾We use Adjusted EBITDA as our key performance indicator of operating results. Adjusted EBITDA is calculated by deducting certain income and gains and by adding certain expense and losses from or to EBITDA, that we believe are not indicative of Cognis' underlying operating performance. These items include significant gains and losses realized on the disposals of fixed assets, investments or businesses, restructuring expenses and other exceptional items which, in our opinion, are not indicative of our fundamental operating performance. In addition, you should not infer from our presentation of Adjusted EBITDA that our future results will be unaffected by unusual or non-recurring items. Adjusted EBITDA, as an analytical measure, is subject to all of the limitations applicable to EBITDA.

EBIT, EBITDA and Adjusted EBITDA

We derive EBIT¹¹⁾ and EBITDA¹²⁾ from net profit/(loss) as follows:

€ millions	2006	2005
Net profit/(loss)	2	(136)
Income taxes	40	–
Net financial result	164	193
Operating profit (EBIT)	206	57
Amortization and depreciation ¹¹⁾	159	246
EBITDA¹¹⁾	365	303

¹¹⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have not been affected materially by the adoption of IFRIC 4.

The following table shows Adjusted EBITDA as derived from our EBITDA by excluding restructuring charges and other exceptional items:

€ millions	2006	2005
EBITDA¹¹⁾	365	303
Restructuring charges²⁾	35	34
Other exceptional items		
Separation costs	3	11
Release of pension provisions	(16)	–
Sundry exceptional items	7	8
Total other exceptional items	(6)	19
Adjusted EBITDA¹¹⁾	394	356

¹¹⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have not been affected materially by the adoption of IFRIC 4.

²⁾ Excluding depreciation and amortization.

Restructuring charges excluding depreciation and amortization of €35 million in 2006 (2005: €34 million) essentially relate to severance pay, early retirement, pre-retirement part-time employment programs and other process and cost optimization programs such as our efficiency program in the USA, and expenses related to the Oleochemicals carve-out.

Other exceptional items comprise other income, expense, gains and losses which in our judgment, do not reflect normal business operations and include separation costs and sundry exceptional items:

- Separation costs comprise the costs of establishing our own stand-alone organization, particularly IT systems, subsequent to the separation from our former owner Henkel. We expect these costs to decline as the separation projects reach the end of their life cycles, as reflected by cumulatively lower costs reported in 2006 compared to 2005
- Release of pension provisions included in 2006 relates to a one-time past service gain due to changes made to the German pension plan. The changes involve measures taken to counter factors that are expected to increase the future cost of financing pension obligations. Also included in 2006, is a one-time gain resulting from the curtailment of certain future retirement benefits in the USA
- Sundry exceptional items mainly relate to the residual costs resulting from certain corporate consultancy fees and expenses, and also include a non-recurring gain from disposal of land in the USA recognized 2006

¹¹⁾ "EBIT" refers to net profit excluding financial result, taxes on income and minority interests.

¹²⁾ We define EBITDA as net income excluding income taxes, net financial result and amortization and depreciation. Our EBITDA figures are not necessarily comparable to other companies' EBITDA figures, as each is calculated in its own way and must be read in conjunction with the explanations that accompany it. EBITDA has limitations as an analytical tool, and you should not consider it in isolation, as a measure of cash available to us to invest at our discretion or as a substitute for an analysis of our results as reported under IFRS.

Financial Position

€ millions	December 31, 2006	December 31, 2005
Total assets ¹⁾	2,640	2,551
Trade working capital ²⁾	699	708
Equity ¹⁾	(120)	(148)
Pension provisions	444	464
Nominal net debt ^{1),3)}	1,530	1,608

¹⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have been restated accordingly.

²⁾ Trade working capital is comprised of trade receivables and inventories, net of trade payables.

³⁾ Excludes pension provisions, deferred financing fees and accrued interest.

Total assets

The increase in total assets by +€89 million from €2,551 million at December 31, 2005, to €2,640 million at December 31, 2006 was mainly a result of the following:

- Negative foreign exchange effects, most significantly the weakening of the US dollar relative to the euro to USD:EUR 1.3170 at December 31, 2006, from USD:EUR 1.1797 at December 31, 2005, decreased total assets by €92 million. Excluding this effect, total assets increased €181 million
- Adjusted for foreign currency effects, goodwill increased by +€46 million mainly due to the acquisitions of Cosmetic Rheologies UK Ltd., UK and Napro Pharma AS, Norway in 2006
- Liquid funds increased by +€126 million, mainly as a result of higher cash generated from operations and from financing activities
- Trade working capital decreased by –€9 million. Adjusted for foreign currency effects, trade working capital increased by +€26 million mainly due to our sales increase in 2006
- Capital expenditures of €100 million (2005: €132 million) on fixed assets were exceeded by net disposals of €2 million and amortization and depreciation of €159 million. Amortization and depreciation includes impairment charges of €2 million and amortization of €46 million of step-up¹³⁾

Trade working capital

The decrease of –€9 million in trade working capital is almost solely due to foreign currency effects, again particularly as a result of the weakening of the US dollar relative to the euro. Excluding these foreign currency effects, trade working capital increased by +€26 million, influenced by increased sales and volumes purchased as a result of higher business activity, as well as higher petrochemical prices.

¹³⁾ As a result of the acquisition of Cognis on November 30, 2001 and other subsequent acquisitions, the assets and liabilities of the acquired entities were recognized at their fair values on the acquisition date. We refer to the difference between the book value immediately prior to the acquisition and the fair value recognized upon acquisition as "step-up".

Movements in shareholders' equity and liabilities

Significant movements in shareholders' equity and liabilities from 2005 to 2006 were as follows:

- Shareholders' equity increased by +€28 million to negative €120 million. This was primarily due to the capital contribution from Golden Hope amounting to €40 million in exchange for the contributed and/or sold parts of the Oleochemicals businesses. Also, cash flow hedges relating to our interest rate risk exposure had a positive effect on equity (+€10 million). This effect was partially outweighed by the currency translation loss amounting to €23 million
Also, equity attributable to the shareholders of the Group decreased by €16 million as a result of a dilution effect from the contribution and/or sale of parts of the Oleochemicals business to Cognis Oleochemicals (Malaysia) Sdn. Bhd. ("COM"). Minority interests consequently increased by €16 million
- Provisions for pensions and similar obligations decreased by –€20 million to €444 million, mainly due to foreign currency effects (–€9 million), the release of provisions due to the restructuring of certain pension and post retirement healthcare plans (–€18 million), as well as cash paid to beneficiaries (–€28 million), and plan assets (–€13 million). These reducing effects more than offset the increase in pension costs (+€46 million) and other movements (+€2 million)
- Net nominal debt decreased in 2006 by €78 million, mainly because of cash generated before debt repayments and borrowings (+€21 million), and foreign exchange gains on our US dollar and Japanese yen Senior Facility borrowings (+€51 million)

Impact of IFRIC 4, effective January 1, 2006 on the balance sheet

As of January 1, 2006, embedded leases as described under IFRIC 4 have been identified and recorded subsequently on the Group's balance sheet. As such, 2005 figures have been restated to reflect €13 million more fixed assets, €14 million more finance lease liability, and €1 million less equity. As of December 31, 2006, fixed assets under these finance lease arrangements have a current net book value of €12 million.

Off-balance-sheet arrangements

Guarantees and warranties issued were nil as of December 31, 2006 (2005: €2 million).

Strategic Business Units and Segment Results

We manage our business through five strategic business units (SBUs) which are aligned with the core focus areas of our customers: Care Chemicals, Nutrition & Health, Functional Products, Process Chemicals and Oleochemicals. Certain intra-group (and hence inter-SBU) transfers, as well as contract manufacturing and other secondary activities, are included in "Other Activities".

Changes in structure

We changed the composition of our SBUs to reflect the transfer of the Oleochemicals and Plastics Technology businesses to Cognis Oleochemicals (Malaysia) Sdn. Bhd. ("COM"), our existing 50:50 Malaysian joint venture with Golden Hope Plantations Berhad, Malaysia ("Golden Hope"), in February 2006. Effective January 1, 2006, following the carve-out of these businesses, the changes noted below were made to each SBU:

- **Oleochemicals** now comprises the businesses transferred to COM, namely Fatty Acids, Glycerin, Oilfield Chemicals, Plastics Technology, Azelaic Acid and Pelargonic Acid, as well as all other business units represented by COM. In addition, Oleochemicals also includes fatty alcohols historically produced and traded in Malaysia. Further, COM trades other SBU products, which are now also reported under Oleochemicals
At the same time, we moved the Silicates business and the opportunistic trading of lauric oils, which were non-core businesses previously included in the Oleochemicals SBU, to the Care Chemicals SBU
- **CareChemicals** includes not only its original business units – namely Care Surfactants Alcohols ("CSA") and Care Performance Ingredients ("CPI"), but also the non-core Silicates business and the opportunistic trading of lauric oils previously reported under Oleochemicals. Also, Care Chemicals now excludes all Care Chemicals products traded by COM; this relates primarily to the trading of fatty alcohols produced by COM
- **Nutrition & Health** excludes all Nutrition & Health products traded by COM
- **FunctionalProducts** excludes the Azelaic and Pelargonic Acid business transferred to Oleochemicals, and all products related to this SBU traded by COM
- **Process Chemicals** excludes the Plastics Technology business transferred to Oleochemicals, and all Process Chemicals products traded by COM
- **OtherActivities** mainly includes the distribution of products from the Oleochemicals SBU by Non-Oleochemicals Cognis entities acting as a distributor or an agent. Further, Other Activities includes contract manufacturing, intra-group transfers of goods and services, and other secondary activities

As a result of this transaction, our SBU results include downstream inter-SBU sales and costs. These downstream transactions relate solely to sales and purchases of Oleochemicals products conducted between differing legal entities, and sales of other SBU products to Oleochemicals entities.

In line with consolidation principles, all inter-company sales and purchases are fully eliminated on a Group level.

In terms of Adjusted EBITDA, the Group's Adjusted EBITDA is prepared on a consolidated basis after the elimination of all intra-group profits and expenses. The Adjusted EBITDA of the SBUs now includes net earnings generated by each SBU from sales and purchases between Oleochemicals and other SBUs, in other words, between the Oleochemicals entities and Non-Oleochemicals Cognis entities.

For comparability, we have changed the prior-year figures in this report to take into account these changes as described above. The prior-year figures therefore differ from the figures published last year, which are also included in the following table for ease of reference.

In this report, we comment on variances between the 2005 and 2006 results by referring to amended prior-year SBU figures. Group figures are not affected by the amendment. Note however that the amended prior-year figures in this report were prepared using certain pro-forma assumptions which may differ from figures generated by a full accounting restatement of prior-year results. We caution you to take note accordingly.

The sales revenues of our SBUs for 2006 and for the comparative prior period were as follows:

Year ended December 31	2006		2005 ¹⁾		2005 ²⁾	
	€ millions	% of total	€ millions	% of total	€ millions	% of total
Sales Revenue						
Care Chemicals	1,356	40.2%	1,284	40.4%	1,262	39.8%
Nutrition & Health	316	9.4%	302	9.5%	303	9.5%
Functional Products	841	25.0%	763	24.0%	792	25.0%
Process Chemicals	258	7.6%	247	7.8%	359	11.3%
Oleochemicals	553	16.4%	557	17.6%	436	13.7%
Other Activities	48	1.4%	23	0.7%	24	0.7%
Total net external sales	3,372	100.0%	3,176	100.0%	3,176	100.0%

¹⁾ The 2005 figures have been changed to reflect the new SBU composition in place from January 1, 2006.

²⁾ 2005 figures as published last year.

Care Chemicals

Our Care Chemicals SBU, firmly focused on the wellness trend, has a deep understanding of world-wide consumer demands and is a leading global producer of various specialty ingredients. By developing innovative product concepts, Care Chemicals offers customers an extensive range of specialty ingredients from basic surfactants to high-performance additives and active ingredients for personal and home care markets.

Through the "Feelosophy" approach, Care Chemicals offers wellness-driven concepts and solutions by focusing on the main consumer demands, and above all on the four key dimensions of a holistic product experience: Perception, Feel, Effect and Usage. These dimensions take advantage of our key competencies, namely formulation technology and performance expertise, the use of natural renewable raw materials and active ingredients, and our comprehensive understanding of marketing techniques and consumer preferences across all our markets.

In 2006, Care Chemicals generated sales of €1,356 million, representing 40.2% of our Group sales.

Acquisitions, divestments and changes in structure

Effective January 1, 2006, as part of the changes made to the composition of the SBUs when the businesses described previously were transferred to COM, Care Chemicals also took over certain non-core activities from the Oleochemicals SBU. These activities consist of the production of silicates, which are mainly used to manufacture tires and washing powder, and the opportunistic trading of lauric oils.

Besides the above, the acquisition of Cosmetic Rheologies UK Ltd. ("CRL") was completed in March 2006. This acquisition will enable Care Chemicals to enhance its product portfolio in the rapidly growing polymers sector. CRL's business promises an innovative pipeline and strong synergies with Care Chemicals' customer base. The acquisition is now included in the reported figures of 2006 below.

Business development in 2006¹⁴⁾

In 2006, Care Chemicals achieved net external sales of €1,356 million, representing an increase of +€72 million or +5.6% over 2005. Organic sales growth amounted to €71 million or 5.5%. Care Chemicals' sales performance in 2006 underlines the remarkable double-digit growth of its highly innovative performance ingredients as well as solid sales of primary surfactants and silicates, over-coming tough market conditions in the fatty alcohols business. All regions contributed to this positive development, particularly Europe, NAFTA and Asia-Pacific.

In Europe, Care Chemicals recorded above-average growth. Penetration of the rapidly expanding Eastern European market for specialties was especially successful. More importantly, Care Chemicals shifted the European product mix portfolio toward specialties in 2006 through successful launches of new products including those mentioned below. Within the specialties segment, active ingredients were the main contributor of sales. The newly acquired business of Cosmetic Rheologies UK Ltd. ("CRL") was also successfully integrated into the existing distribution channels of Care Chemicals.

In the Asia-Pacific region, Care Chemicals grew in line with the market despite a very competitive environment. With the start-up of Thai Ethoxylates Company in Thailand this November, Care Chemicals was in line with its aim of keeping pace with the international expansion of its key accounts. Thai Ethoxylates is a joint venture with Thai Olefins Public Company Ltd., well known in this industry. This joint venture provides Care Chemicals with important feedstock necessary to manufacture surfactants used in cosmetics, laundry and household cleaning products. Another related joint venture with Thai Oleochemicals Company Ltd. is expected to secure the availability of this raw material. This joint venture is expected to be operational in 2008. Both joint ventures underline Care Chemicals' strategic growth plans in this region.

North America achieved organic sales growth through capacity expansion and increased sales of high-margin specialty products. Capacity increased when a large sulfonation plant manufacturing wash-active substances became operational in Q1/2006. Strong growth in Canada and Mexico coupled with continued penetration of the USA supported sales positively. Care Chemicals, helped by its reputable products, has an established position and is recognized in the North American personal and home care markets.

In South America, Care Chemicals achieved double-digit organic sales growth. A new marketing and sales structure, focused on local requirements and necessary in this fast-growing market, was successfully implemented.

Care Chemicals continuously develops new product concepts and formulations aligned to consumer needs. This is appreciated by customers and reflected in the operating results of 2006. In addition, innovations focusing on end-consumer needs and offering measurable advantages, together with a comprehensive marketing approach, provided the specialty product portfolio with growth well above market average and contributed materially to Care Chemicals' increased profitability for the full year.

Care Chemicals recently showcased its marketing activities through the presentation of a new concept, "Feelosophy", based on the wellness trend. The Feelosophy concept, highly rated by both communication professionals and our customers, stresses Care Chemicals' marketing concepts in simplified yet convincing terms, and demonstrates Care Chemicals' understanding of the markets and consumers served. Care Chemicals' Feelosophy offers wellness-driven concepts and solutions by focusing on the main consumer demands, and above all on the four key dimensions of a holistic product experience: Perception, Feel, Effect and Usage.

Recent highlights of Care Chemicals' innovation pipeline include a new comprehensive solubilizer portfolio designed to provoke a positive emotional response by supporting a pleasant feel, both during and after application. This product portfolio has been successfully promoted and fits well with consumer demands for stimulation. Furthermore, this portfolio addresses consumer expectations for products to contain a considerable amount of essential oils or perfumes in air-sprays and bath products for a relaxing experience.

¹⁴⁾ The 2005 figures in the commentary on the business development in 2006 reflect the new SBU composition in place from January 1, 2006. As such, 2006 figures and the 2005 figures amended for the new SBU composition are comparable.

Care Chemicals likewise attracts considerable interest with its SPA concepts introduced to the personal care market. New products using the SPA concept and including active ingredients effectively meet consumer expectations. Such products include DERMICAN™ with proven anti-aging properties. This new product keeps skin looking and feeling younger by using a specific mechanism able to optimize the functionality of collagen fibers. Another such product is LITCHIDERM™, which is prepared using extracts from the lychee fruit. This multi-functional active ingredient protects and hydrates the skin, leaving a fruity-fresh feeling.

These days key claims for performance shampoos include “gloss enhancement” and “anti-hair breakage”. Such shampoos usually contain silicone-based oils to meet these expectations. However, LAMESOFT™ Care, a power conditioning concept, is formulated to meet these claims without the use of silicone-based oils. This unique wax dispersion is a blend of micronized lipids containing performance waxes and emollients.

The market for hard surface cleaners in the home care segment is also moving toward more sophisticated products – consumers want cleaners that clean thoroughly and quickly while also providing a broad range of convenience benefits. Polyquart™ PRO is the first cleaner additive to provide these convenience benefits and remains effective even at extreme pH values.

Nutrition & Health

The Nutrition & Health SBU, also focused on the wellness trend, is a leading supplier in the fields of Food Technology and Dietary Supplements. The Food Technology business involves the production and global supply of emulsifiers, whisking agents, enzymes, fats and powders into the various sales channels of the nutrition business. Nutrition & Health also produces and markets a broad range of scientifically proven ingredients for the functional food and the dietary supplements markets, including phytosterols, conjugated linoleic acids (CLA), vitamin E and other natural-source products such as carotenoids and plant extracts. In addition, Nutrition & Health produces and sells a wide range of excipients and carriers based on natural renewable raw materials for the pharmaceutical and life-science industries.

In 2006, Nutrition & Health generated sales of €316 million, representing 9.4% of our Group sales.

Acquisitions, divestments and changes in structure

Nutrition & Health was only marginally affected by the Oleochemicals transaction, and now excludes the trading of Nutrition & Health products by COM and its constituent entities.

In June 2006, Cognis acquired the Norwegian producer of high-quality omega-3 fish oils, Napro Pharma AS, which broadens the Nutrition & Health product portfolio in the Dietary Supplements sub segment and in Functional Food business.

Business development in 2006

2006 net external sales of our Nutrition & Health SBU increased by +€14 million or +4.2% to €316 million, from €302 million in 2005. On an organic basis, net external sales grew by +€7 million or +2.4%, reflecting a shift of the product portfolio toward the high-margin segments particularly Sterols, CLA and Pharma & Health, which helped overcome a difficult year in 2005 driven by the challenging Vitamin E business.

High sales of Nutrition & Health's fastest growing Sterols business were due to higher production capacities in our new esterification plant in Illertissen, Germany, which began operations mid 2005, and growing demand from key customers in Europe. Also, the Functional Food trend in Europe continues to expand, providing new opportunities in food applications with European-based customers.

The other high-margin product lines CLA and Pharma & Health showed strong growth in 2006, particularly in Europe. This was a result of higher demand from key customers for CLA as well as new customers acquired in Europe. Also, the Pharma & Health business benefited from the trend of complying with quality standards and continues to offer growth opportunities for pharma-grade specialties.

Sales of the Food Technology business decreased slightly compared to 2005 as a result of tough market conditions in the Baked Goods and Dessert market segments.

The natural-based Vitamin E business was still affected by general market sentiment for Vitamin E. As a result, sales in the first half of 2006 were slightly below 2005 levels but started recovering in the second half of 2006.

Nutrition & Health successfully integrated the 2006 Napro Pharma acquisition, supporting sales growth with omega-3 products sold to the dietary market.

On a regional perspective, sales in Europe grew by around +9% in 2006 on an organic basis. This was mainly due to increased sales for sterols as a result of ongoing high demand for health ingredients in the Functional Food market. Sales in North America decreased by around -13% compared to 2005, mainly as a result of lower sterol sales to the pharmaceutical market, where key accounts reduced inventories significantly. However, North America as the biggest market for Vitamin E, recorded Vitamin E sales at comparable 2005 levels. Sales in Asia-Pacific were -5.4% below 2005. Most of the reduction in sales stemmed from the Food segment as European-based production costs and unfavorable foreign exchange conversions led to a difficult price situation in Asia-Pacific.

Functional Products

The Functional Products SBU, focused on the sustainability trend, is a leading supplier in our strategic technology-driven market segments. Functional Products provides customers with innovative solutions through the application of Cognis' core technological platforms across the coatings, polymers and inks, synthetic lubricants, agriculture and mining industries. Its key competitive advantage, acknowledged by customers around the world, lies in its expertise in the "chemistry of surfaces" together with a proven track record in developing ecologically sound solutions.

In 2006, Functional Products generated sales of €841 million, representing 25.0% of our Group sales.

Acquisitions, divestments and changes in structure

As part of the SBU changes described previously, Functional Products now excludes the Azelaic Acid and Pelargonic Acid business which was transferred to Oleochemicals, and all Functional Products traded by COM and its constituent entities.

Business development in 2006

The 2006 net external sales of Functional Products increased by +€78 million or +10.4%, from €763 million in 2005 to €841 million. Organic sales growth amounted to +€76 million or +9.9% and was strongest in Asia-Pacific. North America grew by regaining lost volumes in 2005 and by expanding market share. Europe achieved growth above GDP whereas Central and South America generated sales slightly below 2005.

Efforts to regain volumes that were lost due in 2005 have paid off, primarily in the European Synthetic Lubricants business and the Polymer, Coatings and Inks ("PCI") business in the USA. Also, Functional Products generated new business by focusing on key accounts and by entering new markets, geographically as well as technologically. While high raw material costs continued to affect margins in 2006, energy prices decreased toward the end of the year. Operational improvements at various manufacturing sites led to lower operating costs.

Net external sales of the PCI business grew in all regions and were mainly driven by strong market growth in Asia-Pacific and regained market share in NAFTA. Growth in Asia was a result of increased capacity from a local manufacturing joint venture for UV curing agents, and our own production of defoamers in China. In the USA, sales volumes were regained especially for the dimer and polyamide-based products used in adhesives, inks and polymer building blocks. Sales in Europe were above the 2005 level mainly due to higher sales of defoamers and green surfactants. Also, market share regained for the methacrylates business in Europe and Asia contributed to the sales increase.

The Synthetic Lubricants business expanded its worldwide sales. A particular feature was gains in the US transportation market driven by the introduction of new generation of transmission fluids. In NAFTA, Europe and Mercosur, Functional Products further strengthened ties to major international key accounts and continued to grow with existing as well as new products. European growth mainly resulted from regained market share for ester lubricants and from business with new customers for acrylates.

Sales of the AgroSolutions business were significantly above the prior-year level, mainly due to strong demand from global agrochemical key accounts. In Europe, Functional Products responded to increasing demand for green solvents and for specialty solutions for the road and construction industry. The North American region grew as new capacity for green surfactants came on stream. In Central and South America, sales were close to 2005 levels.

In the Mining Technology business, Functional Products experienced yet another year of solid organic sales growth resulting from continued strong demand for base metals. The main driver of the 2006 performance was a high number of new copper-producing installations requiring initial plant fill-ups of solvent extraction chemicals. The Mining Technology business has successfully maintained its position as a global leader in copper solvent extraction.

Process Chemicals

Process Chemicals is a global supplier of comprehensive solutions providing performance and precision in textile and leather processes. This SBU offers deep-rooted expertise in process and applications engineering, and provides high-performance products and system solutions for improving productivity and the environmental compatibility of complex manufacturing processes in the textile and leather industries. Through its Active Textiles segment, Process Chemicals offers specific finishing products and innovative technologies for functional textiles with high end-consumer benefits.

In 2006, Process Chemicals generated sales of €258 million, representing 7.6% of our Group sales.

Acquisitions, divestments and changes in structure

The Plastics Technology business was among the businesses transferred to COM; as such, this activity is no longer represented by Process Chemicals. Also, all Process Chemicals products traded by COM and its constituent entities are now excluded.

Business development in 2006

2006 net external sales of Process Chemicals increased by +€11 million or +4.1% to €258 million from €247 million in 2005. Likewise, the organic sales growth amounted to +€10 million or +4.2%, primarily driven by Asia-Pacific growing by 16.4%, and steady growth in Europe. The 2006 sales development underlines Process Chemicals strategy of growing in China, improving profitability in mature markets and penetrating apparel markets with Active Textiles.

In terms of business segments, Textile Technology's sales increased in 2006, overcoming uncertain market conditions upon expiration of the WTO agreement on textiles and clothing in late 2004. The sales increase was driven mainly by strong demand in Asia-Pacific, and Process Chemicals' ability to keep up with demand through additional capacity provided by the new facility in China as from Q3/2006. Even in more mature markets such as Europe, sales grew as raw material price increases were passed on through higher selling prices. Further, Process Chemicals had considerable success with the penetration of Active Textiles worldwide, concluding significant contracts with well-known apparel manufacturers. In NAFTA however, sales decreased slightly in the first half of the year because of capacity constraints in a US plant, although with partial recovery occurring during the second half of 2006.

The Leather Technology business significantly exceeded 2005 sales by double digits, growing in all regions, but most importantly in Asia-Pacific facilitated by additional capacity provided by the new plant in China.

Oleochemicals

The Oleochemicals SBU now includes Fatty Acids, Glycerin, Oilfield Chemicals, Plastics Technology, Azelaic Acid and Pelargonic Acid, as well as all other business units represented by COM such as Fatty Alcohols historically produced by COM and the trading of other SBU products. This new structure was put in place on January 1, 2006, in anticipation of the transfer of these businesses to COM.

In 2006, Oleochemicals generated sales of €553 million, representing 16.4% of our Group sales.

Acquisitions, divestments and changes in structure

In February 2006, Cognis transferred its global Oleochemicals and Plastics Technology businesses to its existing 50:50 Malaysian joint venture with Golden Hope Plantations Berhad, Malaysia ("Golden Hope"). Specifically, the Fatty Acids, Glycerin, Oilfield Chemicals, Azelaic Acid and Pelargonic Acid business, as well as the Plastics Technology business, were transferred to Cognis Oleochemicals (Malaysia) Sdn. Bhd. ("COM").¹⁵⁾

Silicates and the opportunistic trading of lauric oils, previously included in the Oleochemicals SBU, were both transferred to Care Chemicals.

Further, the earnings generated from selling Oleochemicals products to other SBUs downstream, are now accounted for in the Oleochemicals SBU results.

The transferred businesses have around 750 employees, mostly in Germany, the USA and Canada, and in 2006 generated €564 million in revenues, including €113 million of sales to Cognis' downstream businesses. After this expansion, COM already ranks as one of the leading global Oleochemical companies, having total revenues of €710 million in 2006 (including sales to Cognis) and around 1,100 employees.

In exchange for the businesses contributed, Cognis received common shares in COM and cash of €87 million, which in turn was funded by COM through a cash capital contribution of €40 million from Golden Hope and external borrowings of €42 million. In addition, COM borrowed €18 million for its own funding requirements, and €1 million in banking and transaction fees were paid. The transaction impacts Cognis' financial statements through an increase in Cognis' consolidated minority's share of equity of €40 million, representing the additional interest, the equity investment of Golden Hope in Cognis' consolidated business, and cash.

Subsequent to the transaction, COM remains a 50:50 joint venture of Cognis and Golden Hope, and, since Cognis retains management control, remains fully consolidated in Cognis' accounts.

Events after the balance sheet date

In February 2007, COM paid an additional purchase price of €8 million due to a settlement agreement and the achievement of certain targets as agreed in the share purchase agreement.

Business development in 2006

The rights to trade and distribute Oleochemicals' products have now transferred to COM and its constituent entities ("COM sub-group"). Following the carve-out of these businesses, new supply agreements govern the transfer of goods and services between the COM sub-group and all other entities within the Cognis GmbH Group ("Non-Oleochemicals Cognis entities").

Oleochemicals generated net external sales of €553 million in 2006, representing a slight decrease of –€4 million or –0.7% and on an organic basis of –€6 million or –1.0% compared to 2005. Despite the intense price competition in the fatty alcohols market, sales of Malaysian Fatty Alcohols increased, along with sales of azelaic and pelargonic acids, fueled by strong demand. However, these increases were offset by decreased Fatty Acids/Glycerin sales, affected by lower selling prices.

¹⁵⁾ The Azelaic Acid and Pelargonic Acid business was part of the Functional Products SBU, and Plastics Technology was part of the Process Chemicals SBU.

Pressure on glycerin prices continues to be intense as increasing biodiesel production leads to global oversupplies of glycerin in the market. The Fatty Acids business is also affected by lower selling prices caused by over-capacities newly constructed in Asia. In North America, production volumes were affected by operational inefficiencies; however, the business recovered slightly in Q4/2006.

The Oilfield Chemicals business was badly affected by the impact of hurricanes in the Gulf of Mexico during the latter part of 2005. A gradual rebuilding and recovery process has been observed in 2006.

Malaysian Fatty Alcohols showed a stable sales performance, with lower selling prices caused by intensive price competition in the market somewhat mitigated by higher sales volumes.

Other Activities

Other Activities mainly includes the distribution of products from the Oleochemicals SBU by Non-Oleochemicals Cognis entities acting as a distributor or an agent. Further, Other Activities includes contract manufacturing, intra-group transfers of goods and services, and other secondary activities. This reporting unit also includes certain non-recurring costs described in detail below.

For intra-group transfers, Other Activities includes the results of internal deliveries from one Non-Oleochemicals Cognis group company to another Non-Oleochemicals Cognis group company. The seller allocates to Other Activities the revenues and costs (including production, transportation, selling and overhead costs) relating to the internal delivery. The EBIT earned on the internal delivery by the seller – which is included in Other Activities – is offset by a cost allocation to Other Activities by the purchaser, with the result that the net EBIT in Other Activities resulting from the internal delivery is nil.

Acquisitions, divestments and changes in structure

When the Oleochemicals and Plastics Technology businesses were transferred to COM, new supply agreements were put in place to govern the flow of goods and services between the COM sub-group and all Non-Oleochemicals Cognis entities. Therefore, Other Activities now also includes the earnings generated by Non-Oleochemicals Cognis entities in their capacity as a distributor or an agent of the Oleochemicals business, as well as the earnings from contract manufacturing activities performed for the COM sub-group by such entities.

Business Development in 2006

Other Activities in 2006 includes net external sales of €30 million, generated by Non-Oleochemicals Cognis entities acting as distributors of Oleochemicals' products, primarily Plastics and Fatty Acids. Contract manufacturing activities performed by the Non-Oleochemicals Cognis entities for the COM sub-group amounted to €43 million in 2006, reported under net total sales.

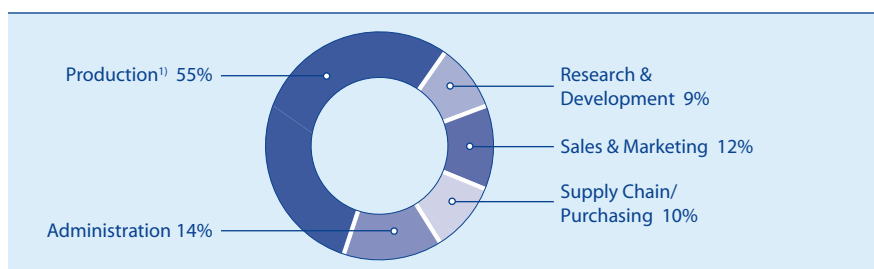
Employees

Cognis' worldwide number of employees, excluding trainees, apprentices, interns and strikers decreased by 69 employees from 7,788 at year-end 2005 to 7,719 at December 31, 2006. This was mainly the result of a global hiring freeze and, to a lesser extent, the implementation of restructuring programs. The number of trainees, apprentices and interns was 198 in 2006, increasing by 3 from 2005 (2005: 195).

From a regional perspective, the number of employees decreased by 68 in Germany and in the rest of Europe including South Africa by 18. The number of employees in Central and South America, fell by 24 and decreased in Asia-Pacific by 18. In North America, the number of employees increased by 59, of which 40 in the USA. This increase was primarily because of the change in headcount reporting (see footnote 1 in table below). On a comparable basis, headcount in the USA decreased by 20.

Workforce by corporate function at balance sheet data

Number	2006	2005
Production ¹⁾	4,218	4,197
Research & Development	739	716
Sales & Marketing	917	933
Supply Chain/Purchasing	766	742
Administration	1,079	1,200
Total	7,719	7,788



¹⁾ Cognis changed the reporting of headcount as a result of the strike in the USA in 2005. In 2005, we included 171 strikers and excluded 231 replacement workers. In 2006, we excluded 123 strikers and included 229 additional workers. The increase in the Production headcount is primarily due to this change in reporting.

Capital Expenditures

In 2006, capital expenditures amounted to €100 million, €32 million lower than in 2005. This decrease was primarily due to two factors:

- First, as expected, previous years' investments in growth projects in Germany provided adequate additional capacities to meet market demands thereby significantly reducing the need for capital investment in 2006
- Second, regulatory approval processes for a major investment in the USA took longer than anticipated, resulting in delays. We are investing in a new and more efficient boiler to generate cost-effective energy for production needs in the USA

From an SBU perspective, we mainly invested in growth projects in Care Chemicals, Nutrition & Health, and Functional Products. In contrast, we focused investments in the Oleochemicals SBU on cost improvement and replacement activities such as the new boiler in the USA.

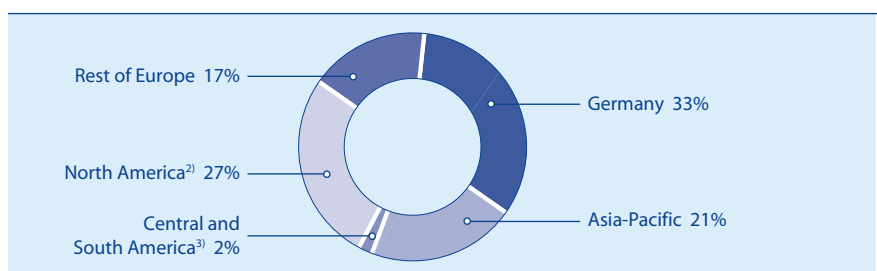
Significant capital investments in 2006:

- At the start of 2006, we initiated a project to improve the supply of steam in the largest US site. This involves replacing two worn-out 30-year-old coal-fired boilers with four new, modern units operating on the basis of multiple liquid and gaseous fuels including production residues and landfill gas. Besides operating with cleaner energy, these new units are fully automated, cost-effective and highly reliable, as required for generating sufficient steam at optimal costs to meet production processes needs. These new units are scheduled to begin operations late in 2007
- Also in early 2006, a sulfation plant began operations in one of our US sites. This new plant strengthens the presence of Care Chemicals in North America, providing a balance to Care Chemicals' global asset portfolio
- In order to modernize and improve the efficiency of Functional Products' ester production in Cincinnati, USA, we initiated a debottlenecking project to improve production yields
- We invested in a new production facility for refrigeration lubricant esters, which went on stream in spring 2006 in Shanghai, China. With this facility, Cognis is able to service the Asia-Pacific market, the largest market in the world for these products, thereby strengthening Functional Products' position in its aim to become one of the leading refrigeration polyol ester (POE) suppliers worldwide
- Another facility began operations in the Shanghai site, this time to enhance the growth of our Leather Technology and Textile Technology production in China. This new plant includes special technologies required to produce Leather and Textile intermediate compounds as well as final blends, customized to the needs of our customers in the Asia-Pacific region
- During 2006, together with Thai Olefins Public Company Ltd., we invested in a joint venture in Thailand called Thai Ethoxylates for the production and marketing of ethoxylated fatty alcohols. This involved the construction of a green-field plant close to a chemical complex in an industrial area in the south-east of Bangkok. With this additional capacity, the presence of Cognis, and specifically of Care Chemicals' in Asia-Pacific is enhanced, and a supply of cost competitive raw materials for the production of Primary Surfactants is secured

- We invested in another joint venture by the name of Thai Fatty Alcohols together with Thai Olefins for the production and marketing of fatty alcohols. As part of this joint venture, we will invest in a new plant producing refined fatty alcohols, the first such facility in Thailand. The fatty alcohols produced by the joint venture will both be used for downstream activities, and sold on the open market, primarily to customers in the personal and home care industries
- At our largest production site in Düsseldorf, Germany, we initiated a project to increase capacity in the production of specialty ethoxylates as used in the production processes of both Functional Products and Care Chemicals. This investment is intended to replace an older production facility, resulting in production cost savings
- We also started a project in the Illertissen, Germany site related to the production of Nutrition & Health's sterol esters. This project will enhance the previous successful expansion by increasing product quality and improving the supply chain

Capital expenditure by region¹⁾

€ millions	2006	2005
Germany	33	55
Rest of Europe	17	19
North America ²⁾	27	38
Central and South America ³⁾	2	3
Asia-Pacific	21	17
Total¹⁾	100	132



¹⁾ Effective January 1, 2006, Cognis' regional reporting structure has changed, Cognis Colombia was transferred from North America to Central and South America. The impact of the changes are not material on prior-year figures.

²⁾ Including Mexico and excluding Colombia.

³⁾ Excluding Mexico and including Colombia.

Research & Development and Technical Service

Research & Development and Technical Service Expenditure

€ millions	2006	2005
Research and development expense	94	92
Less: Amortization included in R&D expense	(36)	(37)
Add: Capitalization of development costs	6	7
Total research & development expenditure	64	62
Add: Technical service costs	31	30
Total research & development expenditure	95	92

Care Chemicals

For Care Chemicals, our focus on the market not only drives innovation processes but also defines targets and development areas for R&D and Application Technology. This allows us to respond to time-to-market needs and provide tailor-made solutions for our customers worldwide in terms of innovative products as well as product and formulation concepts. In developing new products, Care Chemicals constantly ensures the use of natural renewable resources, crucial to Cognis' sustainability strategy. Further, concerning the application of products and formulations, Care Chemicals substantiates product efficacy claims through various state-of-the-art investigations including physico-chemical, mechanical and biological tests, as well as comprehensive sensory assessments.

In order to strengthen and complement our existing technology platforms, we have extended our external co-operations with research institutions and start-up companies in various fields including computer-aided molecule and formulation design, catalysis, and specific delivery of effects as part of formulation technology. Major areas of focus are mild and multi-functional surfactant formulations, for example for ethylene oxide- and sulfate-free product concepts, new wax components for dispersions and skin emollients based on innovative molecule structures, and new polymers for hard-surface treatment and new sensorial perceptions on the skin.

The recent acquisition of Cosmetic Rheologies UK Ltd. further strengthens our polymer portfolio and competence particularly in the field of specialty rheology modifiers. In the area of skin and hair biology, we have continued to investigate peptides as the raw material base for biologically active ingredients that deliver specific properties and action mechanisms. A recent outcome of these developments is an oligopeptide of defined structure which we believe provides a new breakthrough for anti-aging products. Myoxinol, a peptide complex extracted from the seeds of the hibiscus plant and used for anti-wrinkle treatment, was awarded with the Cognis Innovation Prize in 2006.

Nutrition & Health

Throughout all market segments, Nutrition & Health continued with its customer-focused product development and technical service system. Additional science-based solutions and support in product safety and efficacy in the form of further human clinical studies for Conjugated Linoleic Acid (Tonalin® CLA) and Luteinesters (Xangold®) have strengthened this approach. Overall, Nutrition & Health's product development concentrates on tailor-made formulations and on close contact to our key customers.

The portfolio of Tonalin® CLA has been further expanded with products for beverages such as juices (Tonalin® 35 WDP), offering easy handling and good sensory properties. Our immobilized-enzyme system leads to process improvements and so, to higher efficacy and lower costs.

A wide range of high-quality plant sterols from non-genetically modified (non-GM) sources for fat-containing and dairy products, high-potency water-dispersible powdered sterol esters for liquid applications, and ultra-fine-powders for food supplements continue to enlarge our portfolio. Ground plant sterols have been developed with excellent sensory properties for the dairy industry and for water-based systems (beverages). Deodorized plant sterol esters further allowed us to provide high-quality products to the dairy and beverage industry.

Following the acquisition of Napro Pharma AS in 2006, our product portfolio now also comprises omega-3 products, enabling Nutrition & Health to access this fast-growing market. Our self-developed, high quality solutions offer excellent sensory qualities for the functional food market.

Further process and cost improvements were achieved with food ingredients in the area of Food Technology. We continued to focus on consistently high quality based on customers' market needs by ensuring that our product portfolio is extensively standardized and carefully controlled, from raw materials to final products.

Functional Products

The key elements of Functional Products' strategy are sustainability and innovation. We are passionate in our aim to create and maintain an innovative culture throughout the organization. Our innovative products are characterized by two qualities. First, they meet the high performance requirements of the market. Second, they provide benefits through their sustainable properties offering sustainable alternatives.

One major focus of our R&D efforts was on a new generation of energy efficient transmission lubricants which extend the oil change intervals in heavy duty trucks up to 500,000 miles. We are therefore the first in the market to offer truck OEMs (Original Equipment Manufacturers) the ability to provide their customers in turn, a five-year or 750,000-mile warranty on transmission components in new vehicles. This innovative product was awarded the silver prize in the 2006 Cognis Innovation Awards, emphasizing our commitment to high performance and sustainability.

In 2006, we developed different types of associative thickeners, which were implemented in various types of our DSX® sustainable rheology modifier compounds. These thickeners were further enhanced to include low-shear effectiveness and high-performance product properties.

Our new coalescing agent, Edenol® EFC 100 based on natural renewable raw materials, is another example of Functional Products' innovative pipeline. This agent is used primarily in paints and coatings characterized by reduced odor and lower VOC (Volatile Organic Compounds) emissions.

These days, coatings for marine and civil engineering applications are required to combine environmental compatibility with the high performance that users have come to expect. Cognis' patented Versamine® S (S stands for speed) range of curing agents do just that. They enable coatings manufacturers to develop high-solid epoxy coatings that are easy to apply and cure very quickly.

A further area of focus in Functional Products is wind turbine power generation, a fast-growing and sustainable market. Our recently introduced Breox® SL 320 is a lubricant specially developed for gear boxes used in wind turbines and is characterized by its wear-resistant performance, which extends the life time of gear boxes.

At major trade shows in Europe and the Americas in 2006, we took the opportunity to showcase our solutions in the fields of solvent extraction and phase transfer catalysis. One particular reagent, Aliquat 134 (formerly known as Aliquat 336) was identified as a versatile and commercially available source of cations for ionic liquids. Cognis expects to publish the results of new research in this area in 2007.

Process Chemicals

For the Textile Technology business of Process Chemicals, most of the R&D efforts have been dedicated to further developing the "Active Textiles" technologies aimed at increasing garment functionality.

The micro-encapsulation technology used in our Skintex® products was scaled up successfully to generate a few tons of such products in one batch. Further, Skintex® Supercool, a finish based on encapsulated cooling substances including menthol, was well accepted by the market due to its superior performance with a few well-known sportswear manufacturers including this product in several of their product lines. We also obtained US Environmental Protection Agency (EPA) approval for Skintex® MR III, a mosquito repellent finish, based on solid evidence of safety and efficacy. This product is now ready for a global roll-out. Also, Belfasun™, a new nanoparticle-based composite finish, was developed to overcome the shortcomings of cotton garments in terms of sun protection. Leading outdoor textile brands have shown a strong interest in including this product in garments, thereby increasing protection against the sun's ultra-violet (UV) radiation.

We also made progress in reload systems for the refreshment of initial effects of Skintex® products. Newly developed foam sprays are likely to become the preferred approach for many brands.

As for conventional auxiliaries, our efforts were directed toward denim finishing as well as hydrophilic silicones for terry towels.

In the Leather Technology business of Process Chemicals, the focus was on satisfying local market needs, with many new products introduced for this purpose in 2006. Among the most important innovative products for local markets was Trianol RE a silicone-enhanced fat liquor generating a special feel and shine, a flame retardant for leather, and a liquid slipping agent. From a global perspective, we introduced Trianol USP worldwide, an innovative fatty polymer with simultaneous fat liquoring and retanning properties.

Oleochemicals

Oleochemicals became operational as a separate legal entity effective on January 1, 2006. Having our own research and development activities for Fatty Acids including Azelaic and Pelargonic Acids, Glycerin, Oilfield Chemicals and Plastic Additives, we focus mainly on application technology and technical sales support.

In 2006, we concentrated our efforts on the revision of existing products, new products and modifications, as well as on cost saving measures – for example, energy savings in manufacturing processes. In the Oleobasics segment, our focus was on developing and manufacturing new Glycerin derivatives. We also looked into the market receptiveness for certain applications of Fatty Acids.

As for the Oilfield Chemicals business, activities were primarily related to variations of carrier fluids and additives for on- and offshore drilling. We developed a new high-performance lubricant for on-shore drilling applications, as well as an environmentally friendly emulsifier which began field trials in late 2006.

In our Plastics Technology business, the focus was on developing new applications for existing products, as well as new additives with improved migration to the surface of polymers. Innovative plastics products include anti-fogging agents for the production of food packaging, and anti-static flooring agents.

Patents

In 2006, Cognis filed some 105 new patent applications and was granted around 110 patents by the European, US and German patent offices.

Liquidity and Capital Resources

Trade Working Capital

€ millions	December 31, 2006	December 31, 2005
Annual net external sales	3,372	3,176
Trade receivables	537	521
% Annualized sales	15.9%	16.4%
Inventories	495	477
% Annualized sales	14.7%	15.0%
Trade payables	(333)	(290)
% Annualized sales	-9.9%	-9.1%
Trade working capital	699	708
% Annualized sales	20.7%	22.3%

Our trade working capital decreased by –€9 million compared to December 31, 2005. Foreign currency effects, particularly from a 12% weakening of the US dollar against the euro, affected the balance sheet values of trade working capital, causing a foreign exchange effect of +€35 million. Excluding foreign currency effects of +€35 million, trade working capital increased by +€26 million, from €708 million in 2005 to €734 million in 2006. This was mainly the result of the following partially countervailing factors:

- Trade receivables were higher because of the increased sales performance compared to prior year and also due to delayed and slower receivables collection at the year-end
- Inventories increased as production output continued to be high in anticipation of expected growth in January. Also, our new joint venture in Thailand started operations and we expanded our business with a certain key account
- Trade payables increased, reflecting more volumes purchased due to higher business activity and also as a result of higher petrochemical prices
- The first-time consolidation of our recent acquisitions Napro Pharma AS and Cosmetic Rheologies UK Ltd. (CRL) contributed +€4 million to our trade working capital in 2006
- We purchase and hold inventory including lauric oils according to a strategic procurement program. The objective of this program is to optimize our lauric oil feedstock by purchasing based on our expectations of overall market supply, demand and pricing. Our stocks of lauric oils under the strategic procurement program decreased by –€4 million, mainly due to lower quantities purchased. Excluding foreign exchange effects (+€35 million), lauric oils (–€4 million) and the above mentioned acquisitions (+€4 million), trade working capital increased by +€26 million.

Net Cash Flow

€ millions	2006	2005
Adjusted EBITDA ¹⁾	394	356
Cash restructuring expense ²⁾	(36)	(39)
Other exceptional items ^{3),7)}	6	(19)
Change in trade working capital ^{4),5)}	(19)	(1)
Change in other working capital ⁵⁾	4	(5)
Income taxes paid	(42)	(19)
(Gains)/losses on disposal and other adjustments	(3)	(1)
Cash flow from operating activities	304	272
Capital expenditures	(100)	(132)
Other investing cash flows	(36)	3
Cash flow from investing activities	(136)	(129)
Free Cash Flow	168	143
Cash interest ⁶⁾	(121)	(109)
Capital contributions ⁶⁾	40	–
Capital repayments and distributions ⁶⁾	(1)	(2)
Pension payments net of service cost ^{6),7)}	(41)	(27)
Derivatives, FX gains/(losses) and other ⁶⁾	(24)	(17)
Cash flow before debt borrowing/repayment	21	(12)
Net debt borrowing/(repayment) ⁶⁾	101	14
Net cash flow	122	2

¹⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have been restated accordingly.

²⁾ Restructuring cash-out excluding restructuring capital expenditure.

³⁾ Excluding depreciation and amortization.

⁴⁾ Cash change in trade receivables, inventories and trade payables.

⁵⁾ Excluding change in restructuring provisions.

⁶⁾ Part of financing cash flows.

⁷⁾ Including release of pension provisions of €16 million.

Cash flows from operating activities

2006 operating cash flow of €304 million was +€32 million higher than in 2005. The following factors contributed to the cash flow movement:

- A significantly higher Adjusted EBITDA of +€38 million
- Lower cash restructuring expense of +€3 million
- Lower other exceptional items of +€25 million, mainly due to lower costs related to the labor strike at our Cincinnati, USA plant, and lower separation costs. Note that other exceptional items were also lower in 2006 because of one-time non-cash gains resulting from changes to the pension plan in Germany, and a curtailment gain of certain US pension plan benefits. Both gains are neutralized in the cash flow statement under pension payments net of service cost (included in cash flow before debt borrowing/repayment) as they are non-cash
Also, a non-recurring gain from a disposal of land in the USA is included in other exceptional items. This gain is neutralized in the cash flow statement under (gains)/losses on disposal and other adjustments (included in cash flow before debt borrowing/repayment) as it is non-cash
- Change in trade working capital was below the 2005 level by –€18 million, mainly due to higher trade receivables and higher inventories resulting from the better sales performance, somewhat mitigated by higher payables
- Change in other working capital was higher than in 2005 by +€9 million, mainly due to higher employee bonus accruals reflecting the better business performance in 2006
- Income taxes paid of –€42 million were –€23 million higher than in 2005, mainly due to higher taxable earnings and also due to a payment of –€4 million to the seller for prior-year taxes related to our acquisition of Laporte Performance Chemicals in 2003

Cash flows from investing activities

In 2006, we had a mixed picture for our net investment expenditure. Capital expenditures decreased by +€32 million in 2006, whereas other investing cash flows increased by –€39 million. As such, our total cash outflows from investing activities increased by –€7 million, from –€129 million in 2005 to –€136 million in 2006.

The lower capital expenditures in 2006 resulted from the following factors:

- First, as expected, previous year' investments in growth projects in Germany provided adequate additional capacities to meet market demand, thereby significantly reducing the need for capital investment in 2006
- Second, regulatory approval processes for a major investment in the USA took longer than anticipated, resulting in delays. We are investing in a new and more efficient boiler to generate cost-effective energy for production needs in the USA

The higher cash flow from other investing activities in 2006 mainly included the net effects of the following:

- Cosmetic Rheologies UK Ltd., enhancing the Care Chemicals specialty polymers product portfolio, was acquired in March 2006
- The divestment of a minor investment in Turkey in April 2006
- Napro Pharma AS, enabling Nutrition & Health to enhance various sub-segments, was acquired in June 2006
- Disposal proceeds related to the sale of land in the USA in November 2006

Cash flows from financing activities

In February 2006, we transferred our global Oleochemicals and Plastics Technology businesses to COM. The cash inflows resulting from this transaction are described below.

In exchange for the contributed businesses, we received a combination of common shares in COM and cash amounting +€87 million funded by COM as follows:

- Through a cash capital contribution from Golden Hope amounting to +€40 million reported as a net cash inflow in dividends and capital contributions
- Through external borrowings amounting to +€42 million reported as a cash inflow under net debt borrowings and repayments

COM also paid related banking and transaction fees of –€1 million.

Net cash inflows from debt borrowing and repayment include the following:

Cash interest of –€121 million includes

- The interest payments of –€33 million on Senior Notes, –€18 million on Second Lien Notes and –€14 million on Second Lien Loans
- The interest payments of –€56 million on various Senior Facility Loans

Capital contributions include the above mentioned capital contribution of +€40 million from Golden Hope.

Pension payments net of service cost include cash payments related to pensions of –€41 million in both retirement benefits and cash contributions to plan assets. Our cash contribution to the US plan assets amounted to –€8 million in 2006.

Also, net pension costs of nil are included in EBITDA. Pension costs in 2006 include a –€12 million one-time past-service gain resulting from changes made to German pension plans, as well as a –€4 million one-time gain resulting from the curtailment of certain future retirement benefits in the USA. The remaining pension costs include +€18 million current service expense and another –€2 million recurring past-service gains.

Derivatives, FX gains/losses and other financing cash flows include settlements on interest and currency derivatives of –€7 million, as well as commitment and banking fees.

Net debt borrowing/(repayment) was higher by +€87 million compared to 2005 and includes

- The drawing of +€100 million of Senior Loan Facility D, the restructuring and investment facility. +€50 million was drawn in February, and another +€50 million in December
- The +€42 million debt drawn by COM to partially fund the Oleochemicals transaction, and an additional +€27 million drawn for its own funding needs in March
- The voluntary prepayment of –€50 million of Senior Facility A in March, which made the scheduled repayment in June redundant, as well as a scheduled repayment of –€20 million in December

Net Debt

Our nominal net debt, translated at foreign exchange rates in effect on the balance sheet dates, has developed as follows:

€ millions	December 31, 2006	December 31, 2005
Senior Facility Loans ¹⁾		
Facility A (amortizing)	248	325
Facility B	268	289
Facility C	232	245
Facility D (restructuring and investment)	150	50
Total Senior Facility Loans	898	909
Second Lien Loans ¹⁾	157	168
Second Lien Notes ¹⁾	235	235
Senior Notes ¹⁾	345	345
Finance lease obligations ²⁾	33	36
Oleochemicals borrowings	69	–
Other bank debts	26	22
Total debt²⁾	1,763	1,715
Cash and equivalents	(233)	(107)
Net debt of Cognis GmbH	1,530	1,608
PIK Notes of Cognis Holding GmbH ³⁾	663	589
Cash and equivalents of Cognis Holding GmbH	(1)	(3)
Net debt of Cognis Holding GmbH Group	2,192	2,194

¹⁾ Excludes deferred financing fees and accrued interest.

²⁾ Includes embedded leases qualifying as finance leases under IFRIC 4. 2005 figures have been restated accordingly.

³⁾ Excludes deferred financing fees and includes accrued interest.

Cognis' net debt decreased by €78 million from December 31, 2005, to December 31, 2006. This was a result of the following factors:

- We generated a net cash inflow, before debt borrowing and repayment, of €21 million in 2006 as described above
- Between December 31, 2005, and December 31, 2006, a 12% weakening of the US dollar and a 13% weakening of the Japanese yen compared to the euro (USD from 1.1797 to 1.3170, and JPY from 138.90 to 156.93) resulted in a €51 million non-cash foreign exchange gain, which reduced the euro carrying value of USD556 million and JPY2,274 million of debt

In 2006, the following movements are included in total debt and cash:

- €50 million of Facility A was voluntarily prepaid in March. We also paid another €20 million of Facility A as scheduled in December
- We drew on €50 million of Facility D in February and another €50 million in December, to fund capital and restructuring expenditures
- The Oleochemicals joint venture drew external debt amounting to €69 million

Under IFRIC 4 "Determining whether an arrangement contains a lease", adopted since January 1, 2005, additional finance lease obligations in the Cognis Group amounted to €13 million as of December 31, 2006 (2005: €14 million).

Cognis GmbH is a wholly-owned subsidiary of Cognis Holding GmbH formerly known as Cognis Holding GmbH & Co. KG. In January 2005, Cognis Holding Luxembourg S.à.r.l. contributed and sold its shares in Cognis GmbH to Cognis Holding GmbH. On January 14, 2005, Cognis Holding GmbH issued €530 million in floating rate Senior Pay-In-Kind ("PIK Notes"). The PIK Notes are not included in the net debt of Cognis GmbH and are neither guaranteed by any of the constituent entities nor secured by any assets of the Cognis GmbH Group. As of December 31, 2006, a total of €627 million in PIK Notes had been issued, including issuances made as payment of interest.

Throughout 2006, Cognis was fully compliant with its various financing agreements and maintained significant headroom over all financial covenant ratios.

Net debt is reconciled to balance sheet borrowings in the following table:

€ millions	December 31, 2006	December 31, 2005
Net debt	1,530	1,608
Accrued interest ¹⁾	12	10
Deferred financing fees	(71)	(87)
Cash and equivalents	233	107
Borrowings²⁾	1,704	1,638
Thereof current ²⁾	129	65
Thereof non-current ²⁾	1,575	1,573

¹⁾ On Senior Facility Loans, Second Lien Notes and Loans and Senior Notes.

²⁾ Includes minor effects resulting from the identification of certain supply, maintenance, service and long-term purchasing contracts qualifying as finance leases under IFRIC 4. 2005 figures have been restated accordingly.

Pensions

€ millions	2006	2005
Provisions for pensions and similar obligations at January 1	464	451
Current service cost	18	17
Other costs for obligations similar to pensions	(18)	(2)
Pension costs included in EBITDA	-	15
Interest expense	41	40
Expected return on plan assets	(21)	(19)
Actuarial losses	8	3
Net pension costs included in net financial result	28	24
Total cost of pensions and similar obligations	28	39
Cash utilized	(41)	(42)
Other movements	2	3
Translation differences	(9)	13
Provisions for pensions and similar obligations at December 31	444	464

We offer our employees various defined benefit retirement plans around the world. In 2006, we made cash payments related to pensions of €41 million (2005: €42 million) in both retirement benefits and cash contributions to plan assets. Our cash contribution to the US plan assets amounted to €8 million in 2006 (2005: €8 million).

Also, pension costs of nil (2005: €15 million) are included in EBITDA. Besides the €18 million current service cost, pension costs in 2006 also include a –€12 million one-time past-service gain resulting from changes made to German pension plans, as well as a –€4 million one-time gain resulting from the curtailment of certain future retirement benefits in the USA and other recurring past-service gains of –€2 million mainly in the USA.

€ millions	December 31, 2006	December 31, 2005
Present value of unfunded defined benefit obligations	510	533
Present value of funded defined benefit obligations	326	352
Fair value of plan assets	(281)	(277)
	555	608
Unrecognized actuarial (losses)/gains	(128)	(164)
Unrecognized past service (costs)/gains	17	20
Provisions for pensions and similar obligations	444	464

%	2006	2005	2006	2005
	Germany		USA	
Discount rate	4.6	4.5	5.75	5.5
Future salary increase (in USA, including benefit increase)	2.5	2.5	4.5	4.5
Future benefits increase	1.0 – 1.5	1.0 – 1.5	–	–
Medical cost trend	–	–	10.0	10.0
Expected return on plan assets	–	–	8.5	8.5
Actual return on plan assets	–	–	11.4	8.6

Certain Factors Affecting our Business

Our net assets, financial position and results of operations in the consolidated financial statements have been affected by a number of factors, including the effects of the acquisition of Cognis in 2001, industry trends, exchange rate fluctuations, the cost of raw materials, acquisitions and divestments, business realignment and cost reduction programs.

Effects of the Acquisition

As a result of the acquisition of Cognis on November 30, 2001, and other subsequent acquisitions, the assets and liabilities of the acquired entities were recognized at their fair values on the acquisition date. We refer to the difference between the book value immediately prior to the acquisition and the fair value recognized upon acquisition as "step-up".

The depreciation and amortization related to the step-up of the carrying values of the assets (excluding goodwill) and liabilities as a result of the buy-out of Cognis and other acquisitions increased our depreciation and amortization expense, including minor impairment losses, in 2006 by €46 million (2005: €69 million).

Exchange Rate Fluctuations

The translation effect¹⁶⁾ on our Adjusted EBITDA resulting from the weakening of the US dollar and other non-euro currencies against the euro in 2006, as compared to 2005, is +€1 million.

The transaction effect¹⁷⁾ on our EBITDA is not directly quantifiable.

Acquisitions and Divestments

In March 2006, the acquisition of Cosmetic Rheologies UK Ltd., UK, was completed. Details related to the nature of this acquisition may be found under the SBU commentary for Care Chemicals.

In June 2006, Napro Pharma AS, Norway, enabling Nutrition & Health to enhance various sub-segments, was acquired. Details related to the nature of this acquisition may be found under the SBU commentary for Nutrition & Health.

In April 2006, the investment in Desbas Deri Sebest, Turkey, was sold. The contribution of this investment to total assets and liabilities and consolidated profit and loss was not material.

There were no significant acquisitions or divestments in 2005. A purchase price adjustment of €2 million relating to the acquisition of the Cognis Group was paid; this adjustment was included in the 2005 cash flow from investing activities.

¹⁶⁾ Our financial results are impacted by both translation and transaction currency effects resulting from changes in currency exchange rates. Translation currency effects occur when the financial results of our subsidiaries outside the euro region, as measured in their non-euro, local currencies, are translated into euros using the exchange rate prevailing during the relevant period. Consequently, the results of these subsidiaries as expressed in euros for different periods have been translated using different exchange rates.

¹⁷⁾ Transaction currency effects occur when one of our subsidiaries incurs costs or earns revenues in a currency different from its functional currency. Since transactions in foreign currencies are generally translated into the functional currency using the exchange rates in effect when the transactions occur, changes in exchange rates affect the measurement of foreign currency revenues and costs in the functional currency, and so influence the profitability of the subsidiary and thereby Cognis.

Costs of Our Raw Materials

Cognis is exposed to commodity price risks relating to raw materials which comprise the majority of our cost of sales. We purchase raw materials from a variety of sources and, in certain cases, enter into long-term purchase contracts. Our target is to immediately pass through increases in levels of raw material prices. Nevertheless, in some cases our sales prices and our margins can suffer from volatility and temporary strength in raw materials.

Natural renewable oils and fats represent a substantial portion of our total raw material purchases (about 32% in 2006). The single most significant raw material we use are natural lauric oils, particularly palm kernel and coconut oil, which represented about 19% of our total raw material purchases in 2006. We also use a broad range of petrochemical derivatives (about 42%), most significantly ethylene oxide (about 12%). Other chemicals represented about 26% of total raw material purchases in 2006.

The availability and price of these raw materials may be affected by increased market demand, new regulations, production capacity in the market, interruptions in production by suppliers and other market conditions. Our exposure to raw materials and other input prices is partially mitigated by our high degree of vertical integration into specialty products. The benefits of this integration include the ability to spread margin fluctuations over various production stages, high plant utilization rates, the efficient use of by-products, shared infrastructure and transportation costs and shared customer service.

Natural renewable oils and fats

Cognis uses about one million metric tons of oils and fats globally. The largest component of our oils and fats requirement are lauric oils, namely palm kernel and coconut oil, which are near substitutes for each other. Unlike petrochemical raw materials, lauric oils are derived from natural renewable and biodegradable resources. We also use animal fats and other vegetable oils. We are a major consumer in most of these product categories on a global basis.

Prices for lauric oils, which in 2006 accounted for approximately 19% of our total raw material purchases, have been particularly volatile and unpredictable in the past, due to adverse climate conditions, natural disasters, regional political events and other factors.

The market price of lauric oils is denominated in US dollars. On average, market prices have decreased slightly in recent years. Both in US dollars and euros, we observed on average a decrease of 4% in 2006 versus 2005.

In 2006, we purchased €248 million (2005: €312 million) of lauric oils. These oils are purchased on a centralized basis with the exception of Cognis Oleochemicals Malaysia. Natural renewable oils and fats are commodities that are traded globally on market exchanges. Standard exchange-traded futures contracts on the products we use are not available, and thus we manage commodity price risk through a mix of spot and forward buying in the relevant cash markets.

We also use animal fats, such as tallow, primarily in the USA, and non-lauric vegetable oils. As a result of the broad availability of other natural renewable oils and fats, most of the strategic purchasing decisions are centralized, while execution is local. We purchased €106 million (2005: €85 million) of animal fats and €68 million (2005: €50 million¹⁸⁾) of non-lauric vegetable oils in 2006.

¹⁸⁾ The prior-year figure has been amended to reflect additional vegetable oils not included in 2005.

Petrochemical derivatives and other chemicals

We purchased €560 million (2005: €484 million¹⁹⁾) of a wide variety of petrochemical raw materials in 2006, the most significant being €154 million (2005: €142 million) of ethylene oxide and €38 million (2005: €40 million) of acrylates. Additionally, we purchase LAB (Linear Alkyl Benzene), soda ash, TOFA (tall oil fatty acids), acetic anhydride, and ethylene amines. We also purchased €338 million (2005: €324 million) of other chemicals.

The overall prices of our other raw materials comprising largely petrochemical derivatives increased by 6.2% in 2006 compared to 2005.

Energy

In 2006, we purchased about €149 million (2005: €122 million) of energy, primarily in the form of electricity, coal, steam and natural gas.

Restructuring programs

€ millions	December 31, 2006	December 31, 2005
Restructuring expenses	35	34
Less: Depreciation and amortization	-	-
Less: Additions to restructuring provisions	(24)	(28)
Add: Restructuring provisions released	1	1
Add: Use of restructuring provisions	24	32
Cash restructuring expense	36	39
Restructuring capex	12	9
Restructuring Cash Out	48	48

Cognis has implemented, and continues to implement, various restructuring initiatives in order to streamline processes and reduce costs. In 2006, we spent €48 million (2005: €48 million) in cash on restructuring, €12 million (2005: €9 million) of which was for capital expenditures.

¹⁹⁾ Due to shifts in petrochemical derivatives categories, prior-year figures for "Petrochemical Derivatives and other Chemicals" have been amended to comply with the current presentation.

Risk Management

In a changing market environment, Cognis continuously adapts processes and organization to ensure business success.

Management System

Cognis regularly undertakes comprehensive risk management procedures with the aim of identifying and quantifying risk exposure. We constantly review the level of entrepreneurial risk tolerated so that our risk management systems are able to respond effectively.

Our main business processes "Management", "Market Management", "Innovation", "Supply Chain Management" and "Supporting Processes" are described in our global "Corporate Integrated Manual" and in additional guidelines and procedures, providing a comprehensive overview of Cognis' process landscape and strategies.

Efficient corporate management mainly hinges on rational and transparent management systems. Our management system is based on the quality and environmental standards ISO 9001 and ISO 14001.

Furthermore, annual international audits are planned within a Global Audit Program to assess the progress of our SHEQ (Safety, Health, Environment & Quality) system and to monitor the implementation of new requirements and processes. Additionally, internal, supplier and customer audits of our safety, health, environmental and quality systems are carried out in all our sites worldwide. After five years of implementing an international matrix, certification of ISO 9001 and ISO 14001 of all production sites worldwide is now complete.

In 2006, we started an audit program at dedicated sites in Europe involving the implementation of new requirements of the EFCI GMP cosmetic ingredients standard, which had been published at the end of 2005. Hygiene, product realization, equipment, documentation and cleanliness are major areas of focus for this standard. Corrective action and investments have been planned to improve awareness of hygiene and cleanliness issues and, in certain cases, to upgrade work environment.

Entrepreneurial Risks

Cognis operates in competitive markets. If we do not continue to maintain our leading market positions by constantly developing innovative products and responding effectively to the demand of consumers and customers, we may lose focus and this could affect our net assets, financial position and results of operations adversely.

Our business units compete across global markets, and are constantly strengthening their focus on the wellness and sustainability trends. Our business may be adversely affected if we do not:

- continue to develop highly innovative products that satisfy customer needs and preferences
- continue to develop new technology or enhance existing technology that helps product development or provides cost or other advantages over our competitors
- continue to attract and retain skilled employees who are vital to achieving these objectives

Because we are subject to price competition, we must also continue to satisfy these objectives while maintaining a competitive cost base.

For example, in 2006, we conducted a customer survey involving around 1,100 interviews aimed at gaging and strengthening customer satisfaction. The results indicate that our customers are satisfied, for example, with our technical know-how, our global position and, most importantly, with the quality of our products.

We also received many important customer awards for our sites, including those in Germany, Indonesia and Thailand. Novartis classified Cognis Germany as “Preferred Supplier for PharmaLine products” and we received the “Purchasing Award 2006” from Syngenta, the world leader in the agro business. Another important award was the “2006 BDI Environmental Award” from the Federation of German Industries for our environmentally friendly surfactant systems Disponil AFX. In Thailand we were selected from a group of 264 companies to receive the “Best Employer Award on Welfare” and in Indonesia we were chosen as a “Preferred Supplier of Unilever” for the fifth year in a row.

The price volatility of certain raw materials Cognis uses could adversely affect our net assets, financial position and results of operations.

Cognis is exposed to commodity price risks relating to raw materials which account for the largest portion of our cost of sales. We purchase natural renewable oils and fats, petrochemicals and other raw materials from a variety of sources and in certain cases enter into long-term purchase contracts. Our raw materials inventory is managed based on expectations of price and availability. The availability and price of raw materials may be affected by increased market demand, new regulations, production capacity in the markets, interruptions in production by suppliers and other market conditions.

Cognis’ diverse portfolio of value-added products provides some ability to pass on higher input prices to our customers, depending on market conditions. There may be times when we are not able to recover increases in the cost of raw materials for some products due to weakness in demand for such products or the actions of our competitors. This could adversely affect our net assets, financial position and results of operations.

Operational Risks

The occurrence of significant operational problems could have an adverse effect on Cognis’ net assets, financial position and results of operations.

Our revenues are dependent on the continued operation of various manufacturing facilities. Operational risks include among others: failure to comply with relevant regulations and standards and to maintain necessary permits and approvals; raw material supply disruptions; labor force shortages or work stoppages; and any disruption caused by third parties.

While we maintain insurance at levels that we regard as economically appropriate, some of these operational risks could result in losses and liabilities stemming from limited insurance coverage or in uninsured losses or liabilities. The occurrence of major operational problems resulting from the above or other events may have an adverse effect on the net assets, financial position and results of operations of a particular manufacturing facility, or concerning certain of these risks, the net assets, financial position and results of operations.

Violations of environmental, health and safety and other laws, regulations and standards could limit our operations, expose us to liability, increase our costs and have an adverse effect on our net assets, financial position and results of operations.

As a major employer, chemicals producer and provider of substances used internally and externally by consumers, Cognis' key operational risks are in the areas of occupational safety, employment standards, production safety, environmental protection and product safety. Along with ensuring compliance with numerous national and international regulations and standards, we maintain strict safety, health, environmental protection and quality control programs to monitor and control these operational risks. These programs are designed and monitored by our Corporate Operations teams in accordance with our corporate standards.

The advent of the new EU legislative framework known as REACH (Registration, Evaluation & Authorization of Chemicals) means that companies will be obliged to register any substance that they import or produce in quantities of one metric ton per year or more. Therefore, chemical companies such as Cognis are affected by REACH in their capacity both as a manufacturer and as a downstream user of substances.

We participated in national and international committees, meetings and workshops enabling us to secure information as to the forthcoming developments. Our team is currently introducing a range of measures to ensure that we are well prepared for the new regulations. These include identifying all substances that are relevant for the process of pre-registration, modifying IT systems and obtaining detailed information such as how and under what conditions Cognis products are used further down the value chain, and what sort of safety information already exists on the many and varied substances in question. We are also holding regular meetings with our business partners and customers, who will be similarly affected by REACH, in order to ensure that the extra costs and work load involved are kept to a minimum.

As many of our manufacturing facilities have a long operating history, sometimes predating Cognis' ownership, we may be liable for legacy contamination of soil and groundwater, irrespective of causation, negligence or knowledge. Our policy on safety, health and environmental standards and procedures as well as our central oversight seek, at minimum, to mitigate risk and ensure compliance with the laws and regulations in the jurisdictions in which we operate.

We have established provisions related to future environmental, health and safety liabilities where these are not covered by contractual indemnities from third parties, where expenditure is probable and where the cost can be estimated within a reasonable range of outcomes. However, such liabilities are essentially difficult to predict and to quantify. Existing provisions could therefore be insufficient to cover these liabilities, and costs incurred in meeting such obligations could have an adverse effect on our net assets, financial position and results of operations.

The well-being of our employees, and occupational, plant and environmental safety are given permanently high priority at Cognis. Measures implemented resulted not only in the absence of critical or fatal incidents but also in a very low incidence rate of 0.4²⁰⁾ in 2006. We are however aware that there is a constant need for communication, training and accident analysis to improve the safety process, and particularly to keep the incidence rate as low as possible – even and especially at those sites with records of more than three years without any accidents causing lost time.

Loss of a considerable number of key employees could adversely affect Cognis' net assets, financial position and results of operations.

We rely on important employees such as senior business managers and technical experts whose knowledge is critical to our success. Although we have procedures in place to identify and retain key employees, events beyond our control may lead to loss of such personnel. Where this happens, there are processes designed to enable the transfer of knowledge from key employees. However, failure to transfer such knowledge prior to the loss of important employees and an inability to replace such key employees on time could have an adverse effect on our net assets, financial position and results of operations.

Financial and Other Risks

Cognis' key financial risks derive from exposure to changes in foreign exchange rates and interest rates, and the risk of insufficient liquidity (cash resources).

Changes in foreign exchange rates can affect Cognis on two counts. First, we are exposed to "transaction risk" when products produced in one currency region are exported to another currency region. Our main transaction risk results from net exports from the euro region into the US dollar region (including the USA and much of Asia). Cognis controls this risk by hedging the forthcoming year's expected foreign currency exposures using derivative financial instruments such as forward contracts.

Second, we have major operations in non-euro jurisdictions, most significantly in the USA, Latin America and Asia. The financial positions and results of these operations are translated into euros using prevailing exchange rates. As such, the financial positions and results of these foreign operations – as expressed in euros – are affected by changes in exchange rates. This "translation risk" is controlled by the currency composition of our financial debt, so that foreign currency earnings and cash flows service debt denominated in the same foreign currencies. While this means of controlling translation risk protects our ability to service our debts and the relationship between earnings and cash flows to indebtedness, it does not reduce the impact of changes in foreign exchange rates on operational earnings figures (such as EBITDA and EBIT) or on operating cash flows as expressed in euros. We monitor the currency composition of operating earnings, operating cash flows and indebtedness on an ongoing basis, and can synthetically adjust the currency composition of our debts using derivative financial instruments, particularly cross-currency swaps (as was done in 2005).

²⁰⁾ The incident rate relates to a method of computing accident experience, established under the Occupational Safety and Health Act (OSHA) whereby the number of incidents causing days away from work, death, restricted work activity, and work-related illness is calculated. The total of recordable injuries and illnesses per 100 employees equals the incident rate.

Concerning interest rate risk, we are exposed to changes in interest rates because €1,290 million of Cognis' debts²¹⁾ bear interest at variable exchange rates (Euribor in the case of Euro-denominated debt, USD-Libor in the case of USD-denominated debt and JPY-Libor in the case of debt denominated in Japanese Yen). Increases in these interest rates result in increased interest expense and increased interest payments (while decreases in interest rates result in the opposite). We control these interest rate risks through the use of derivative financial instruments, specifically interest swaps and collars. The application of these instruments economically converts interest on hedged portions of variable-interest debt from variable interest to fixed interest or interest variable only within a defined range. As of December 31, 2006, about 76% of our variable-interest debt was hedged in this way.

Significant cash outflows result from the funding of business operations – including working capital such as trade receivables and inventories – from investments in production facilities, from servicing pension and other post-employment benefit obligations and, especially, from making interest payments and principal repayments on our debts. In order to fund these cash outflows, we must either have sufficient liquid funds from operating activities or available lines of credit. The risk that we are unable to meet a payment obligation is mitigated by a significant undrawn and available debt facility, particularly a revolving credit facility (€204 million including cash pool indemnities available as of December 31, 2006). This source of funding, however, is subject to various conditions and restrictions, including concerning the purpose for which the funds have been drawn, so that this source of funding may not be available in full or immediately.

Cognis has given undertakings and guarantees relating to pension funds. This could have an adverse effect on our net assets, financial position and results of operations.

Cognis provides retirement benefits in certain countries (mainly Germany und USA) for our former and current employees through a variety of defined benefit and defined contribution schemes. The following factors could all serve to increase or decrease the pension fund deficit:

- Future investment returns on scheme assets that are below expectation
- Changes in actuarial assumptions including mortality of participating members
- Higher rates of inflation and/or falling bond-return rates used to discount the defined benefit obligations

Increased future funding contributions may result in an adverse effect on Cognis' net assets, financial position and results of operations.

²¹⁾ Excluding bank overdrafts and minor local loans.

Outlook

The results of 2006 were encouraging with sales of our high-margin specialty products significantly improved overcoming higher raw material costs and the tough market conditions in the fatty alcohols market. We also saw operational improvements in North America, and successfully recovered significant volumes lost in 2005. Also, we reinforced our commitment to the wellness and sustainability trends with strategic acquisitions successfully integrated into our operations.

Moving on to our expectations for 2007 and 2008, in the light of currently increasing prices, we have factored in higher lauric oil and petrochemical raw material costs. The US dollar is forecasted to slightly strengthen its value relative to the euro as compared to 2006 year-end rates.

We expect economic growth for both years to be moderate in Europe, and slightly higher in North and South America, with the strongest growth coming from Asia-Pacific. Overall, we anticipate moderate growth in line with our expectations for the economy in the various regions, with the most significant volume-driven growth from Asia-Pacific and North and South America, and an increased focus on high-margin products in Europe and Asia-Pacific. Growth rates in 2007 and 2008 are expected to be similar. In terms of business performance, we expect opportunities to arise from the wellness and sustainability trends. We anticipate further avenues of growth from increasing consumer demand for sustainable products made from natural renewable raw materials and highly innovative products based on the wellness concept.

Our expectation for the sales performance of the individual SBUs is as follows:

- Care Chemicals is expected to continue the solid performance of its innovative high-margin products while coping with the tough conditions prevailing in the fatty alcohols segment and the likelihood of further raw material price increases. We expect growth opportunities to come from Care Chemicals' innovative and customer-orientated product pipeline. Further opportunities are expected from synergies in our customer base as well as an enhanced product portfolio in the fast-growing polymers sector resulting from the integration of our CRL acquisition
- Nutrition & Health also expects strong performances from its branded ingredients and especially its newly acquired omega-3 business. The Vitamin E business being quite volatile, has been moderately planned. The Sterols business with its solid and robust products and the newly acquired omega-3 business are expected to provide most of Nutrition & Health's growth opportunities. Other prospects include optimizing the manufacturing cost base through better usage of Vitamin E's production capacity
- Functional Products expects to build on its volume recovery and its new generation products, especially lubricants, which are expected to offset higher petrochemical prices. Further, the Mining business is typically influenced by irregular timing of orders which may affect this business, depending on the number of orders received in 2007. Our chances in Functional Products are mainly in growing demand for new generation lubricants as well as a lower manufacturing cost base through optimization measures in the USA, the UK and Brazil
- Process Chemicals is expected to focus on its strategy of expansion in China, on improving profitability in mature markets and on intensifying its penetration of the apparel markets with innovative Textile Technology solutions
- Oleochemicals expects to gain from improved US operations benefiting the Fatty Acids/Glycerin business and from better market conditions in the Oilfield Chemicals business

In terms of Adjusted EBITDA, both in 2007 and 2008 we expect overall growth to be in line with the sales development, driven primarily by sales increases of our high-margin products and by expansion in Asia-Pacific. We also anticipate further organizational improvements mentioned above would lead to a lower cost base. These factors are expected to counter the challenges posed by increases in raw material and energy costs and the continued softening of the fatty alcohols market.

We expect an overall improvement in our cash generation capability in 2007 and 2008 with an increase in cash inflows primarily from operating activities. Cash restructuring charges are expected to be in line with previous years as we seek to implement further initiatives to improve our operations globally. Capital expenditures are expected to increase, especially in Germany. Our cash financing activities including net pension contributions are forecasted at levels similar to previous years, with our debt repayments continuing as scheduled.