GROUP MANAGEMENT REPORT

Foreword The management report and consolidated financial statements of the LANXESS Group constitute the first mandatory financial reporting in accordance with commercial and stock corporation law since the spin-off from Bayer AG on January 28, 2005. For the previous year, voluntary Group statements (Combined Financial Statements) and a voluntary Group management report were prepared. These were intended to portray the business operations that were spun off to LANXESS as though the LANXESS Group had existed previously in the structure defined for the spin-off. Since the spin-off took place by means of a carve-out, the reporting for 2005 had to be prepared as though the LANXESS Group had already been in existence at the beginning of the previous year – i.e. as of January 1, 2004 – and as though the Bayer Group's chemical business and part of its polymers business had already changed hands before then. For this reason the LANXESS Group Management Report and Consolidated Financial Statements as of December 31, 2005, contain prior-year figures for comparison. The preparation of the Combined Financial Statements required the use of estimates and assumptions affecting the classification and valuation of assets, liabilities, income and expenses. The effects on the financial data of the transition from the Combined Financial Statements to the Consolidated Financial Statements of the LANXESS Group are explained in the Notes.

The LANXESS Group

Business and strategy The LANXESS Group is a globally operating chemicals enterprise with a portfolio ranging from basic, specialty and fine chemicals to polymers and elastomers. As margins are currently unsatisfactory, it is essential to evolve lean, uncomplicated structures, and to systematically optimize plants and processes.

To raise profitability to the level typical of other companies in the industry, LANXESS has adopted a strategic package with four phases: quickly implementable performance improvements, targeted restructuring, portfolio adjustments and acquisitions. The company is currently taking steps in pursuit of the first three phases; the fourth, acquisitions, will come into play in the medium term. Another core feature of the strategy is selective organic growth in profitable markets.

The segments in brief Organizationally, the LANXESS Group is divided into four segments: Performance Rubber, Engineering Plastics, Chemical Intermediates and Performance Chemicals.

The **Performance Rubber** segment combines all the Group's activities in synthetic rubber production. Here LANXESS offers a broad portfolio of innovative products, many of which are international leaders. The segment comprises the Butyl Rubber, Polybutadiene Rubber and Technical Rubber Products business units, and has production sites in Dormagen, Leverkusen and Marl, Germany; Zwijndrecht, Belgium; La Wantzenau and Port Jérôme, France; Sarnia, Ontario, Canada; and Orange, Texas, United States. Its products have applications in areas ranging from tires and other automotive components through construction materials, leisure equipment and machinery to chewing gum.

LANXESS's **Engineering Plastics** segment makes it one of the world's most important suppliers of polymers. This segment's business units are Styrenic Resins, Semi-Crystalline Products and Fibers,* and its production sites are located in Dormagen, Hamm-Uentrop and Krefeld-Uerdingen, Germany; Antwerp, Belgium; Camacari, Brazil; Baroda, India; Tarragona, Spain; Map Ta Phut, Thailand; and at Addyston, Ohio and Bushy Park, South Carolina in the United States. The plastics that LANXESS produces are particularly used in household appliances, the automotive industry, electrical engineering, electronics, and medical equipment.

The operations that LANXESS combines in its **Chemical Intermediates** segment make it one of the world's leading suppliers of basic and fine chemicals and inorganic pigments. The business units in this segment are Basic Chemicals, Fine Chemicals and Inorganic Pigments, and its production sites are in Brunsbüttel, Dormagen, Leverkusen and Krefeld-Uerdingen, Germany; Sydney, Australia; Porto Feliz, Brazil; Shanghai, China; Branston, Staffordshire, United Kingdom; Vilassar de Mar, Spain; and at Baytown, Texas; Imperial, Pennsylvania; and New Martinsville, West Virginia in the United States. These products are used in such diverse sectors as agrochemicals, construction, dyes and pharmaceuticals.

* divested effective 2006

The **Performance Chemicals** segment embraces the Group's application-oriented specialty chemicals operations. The business units in this segment are Material Protection Products, Functional Chemicals, Leather, Textile Processing Chemicals, Paper,* RheinChemie, Rubber Chemicals and Ion Exchange Resins. It has numerous production sites: in Mannheim, Leverkusen, Krefeld-Uerdingen, Brunsbüttel, Bitterfeld and Kürten, Germany; Antwerp, Belgium; Merebank, Newcastle, Isithebe and Rustenberg, South Africa; Montreal, Quebec, Canada; Birmingham and Trenton, New Jersey, Wellford and Bushy Park, South Carolina, and Chardon, Ohio in the United States; Zarate, Argentina; Wuxi and Qingdao, China; Thane and Madurai, India; Filago, Italy; Ede, Netherlands; Lerma, Mexico; and Toyohashi, Japan. Its varied products are used in disinfectants, dyes, wood preservatives, the food and beverage industry, the leather and textiles industries, and more.

Organization LANXESS AG functions largely as a management holding company. Each business unit has global responsibility for its own operations. LANXESS Deutschland GmbH is a wholly owned subsidiary of LANXESS AG, and in turn owns the interests in the other subsidiaries and affiliates both in Germany and elsewhere.

The following are the principal companies directly or indirectly wholly owned by LANXESS AG:

- LANXESS Deutschland GmbH, Leverkusen, Germany: production and sales, all segments
- LANXESS Corporation, Pittsburgh, Pennsylvania: production and sales, all segments
- LANXESS Elastomères S.A.S., Lillebonne, France: production and sales, Performance Rubber
- LANXESS Inc., Sarnia, Ontario: production and sales, Performance Rubber
- LANXESS International SA, Fribourg, Switzerland: sales, all segments
- LANXESS N.V., Antwerp, Belgium: production and sales, Engineering Plastics and Performance Chemicals
- LANXESS Rubber N.V., Zwijndrecht, Belgium: production and sales, Performance Rubber
- RheinChemie Rheinau GmbH, Mannheim, Germany: production and sales, Performance Chemicals

The following major organizational changes in the segments were initiated or carried out during 2005:

The decision was made to spin off the Fine Chemicals business unit as a part of the first restructuring package. As of the second quarter of 2006, it will appear under the LANXESS umbrella as a legally autonomous, mid-sized enterprise named Saltigo. With a new focus and a new business model, the company will develop, produce and sell custom solutions for clients in the pharmaceutical, agrochemical and specialty chemical industries.

After restructuring the fibers operations in the spring of 2005, in December LANXESS sold the Dorlastan fibers business to Japan's Asahi Kasei Fibers (AKF), as the first step in streamlining the portfolio. The transaction was consummated in the first quarter of 2006. In early December 2005, Berlac AG, of Sissach, Switzerland, bought iSL-Chemie, a subsidiary of the RheinChemie business unit in the Performance Chemicals segment. Also in December, the Performance Chemicals segment's Paper business unit was sold to Finland's Kemira Group. Now that the antitrust authorities have approved the transaction, consummation is expected on March 31, 2006.

Value management/control system To achieve its strategic goals, the LANXESS Group needs concrete controlling parameters against which it can measure the success of its efforts. Such assessments are founded on a reliable, readily understandable financial and controlling information system. LANXESS is constantly working to improve the information provided by the Accounting and Controlling group functions, through consistent reporting of projected, expected and actual data.

The key controlling parameter for the LANXESS Group at present is EBITDA (earnings before interest, taxes, depreciation and amortization) pre exceptionals. It is calculated from EBIT by adding back depreciation and amortization relating to operations, leaving out any exceptional items. Each operating decision or achievement is measured in both the short and the long term by how it affects EBITDA.

* divested effective 2006

To monitor working capital, LANXESS uses two key performance indicators: DSI (days of sales in inventories) and DSO (days of sales outstanding). These represent inventories and receivables, respectively, as a function of sales. Another important performance indicator is free cash flow, which indicates the business units' direct contributions toward generating cash. It is calculated for the operating units by a simplified cash flow method.

To supplement and optimize the control system, LANXESS plans to introduce additional parameters in the coming years, including return on capital employed (ROCE) and the net debt ratio. ROCE is the ratio of EBIT pre exceptionals to capital employed. Capital employed can be derived from balance sheet data; it is defined as total assets less deferred tax assets and interest-free liabilities. Interest-free liabilities comprise provisions (not including provisions for pensions), tax liabilities, trade payables, and material items included under "other liabilities." The net debt ratio is defined as the total of current and non-current financial liabilities, less liquid assets, divided by EBITDA pre exceptionals.

Expenditures for property, plant and equipment are subject to rigorous capital discipline, and focus systematically on those product areas with the greatest potential for success. LANXESS is planning on capital expenditures of between €250 million and €270 million for fiscal 2006. The target EBITDA margin pre exceptionals for 2006 is 9 to 10%, based on 2004 sales.

Business Conditions

The economic environment The upswing of the global economy continued in 2005, albeit rather less dynamically than in 2004, with growth of more than 3%. The most significant positive factors were many countries' expansive monetary policies, low interest rates in the capital markets, and a broad-based improvement in corporate profits. The sharp rise in prices for crude oil and energies dampened growth rates, especially in the industrialized nations.

In absolute terms, the main growth driver last year was the United States. Despite a comparatively low growth rate, Europe contributed significantly to global economic development because of its size as an economic zone. Newly industrialized Asian countries, especially China and India, enjoyed steady and high growth rates.

The U.S. dollar gained significant ground against the euro over the course of 2005. At year's end, the euro was worth just under $1.18 – down 13.4% from a year earlier. On average, however, the exchange rate remained almost unchanged from 2004.

Prices of raw materials rose significantly again during 2005. In a highly volatile market, the price of oil climbed from about US$40 to about US$59 per barrel. The principal reason was market participants' growing uncertainty about a sustained, reliable supply.

GDP and chemical production in 2005

Change vs. prior year in % (projected)	Gross domestic product	Chemical production*
Americas	3.5	1.0
NAFTA	3.4	(0.5)
Latin America	4.7	7.5
EMEA	2.6	4.0
Germany	1.6	7.0
Western Europe	2.1	2.5
Central/Eastern Europe	5.4	5.5
Asia-Pacific	4.7	5.5
Japan	2.5	1.0
Greater China	8.9	9.0
India	7.8	12.0
World	**3.5**	**4.0**

* rounded to 0.5%

The chemical industry Global chemical industry production rose by about 4% in 2005.

The hurricanes in the United States barely affected the growth of the nation's economy, but the U.S. chemical industry suffered substantial losses. A recovery is expected, however. Chemical production in Europe was up 4%. Exports were a significant driver for the chemical industry's growth here. The strong economic growth of the emerging markets of central and eastern Europe, Latin America and – most especially – Asia was also reflected in the growth rates of the chemical industry, which were far above average. The rapid growth of the chemical industry in China and India highlights the trend toward local production. All the same, China remained a net importer of chemical products in 2005.

Evolution of major user industries The automotive industry performed robustly in 2005, with global production growing 3.5%. While the industry enjoyed especially high growth rates in South America, eastern Europe and Asia, it grew less vigorously in North America and western Europe. In western Europe particularly, the unsatisfactory performance of the economy in general, and consumers' resulting reluctance to spend, played a role; so did high fuel prices.

The construction industry grew slightly overall, with a worldwide growth rate of 3.0%. Central and eastern Europe showed the largest gain by far, 6.5%. In Asia, the construction industry benefited from general economic growth.

The electrical and electronics industries did very well in 2005, growing 6.5%. The principal drivers were the dynamic NAFTA and Asian markets.

The tire industry's regional performance reflected the shift of production to emerging nations. The downtrend in the NAFTA region was alleviated somewhat by higher production in Mexico. Western Europe also cannot escape the trend toward relocating standard tire production. However, production of high-quality tires is making up for the difference, so the market as a whole stagnated.

The world's textile industry performed very unevenly in 2005. It shrank in Germany and the rest of western Europe, as well as in North America, but showed very high growth rates in eastern Europe and South America, and most of all in Asia. The chief cause was the ongoing global trend toward transferring production sites to emerging economies. Overall, the textiles, apparel and leather sector grew 2.0% worldwide.

Evolution of major user industries in 2005

Change vs. prior year in % (projected)	Automotive	Construction	Electrical	Tires	Textiles, Apparel, Leather
NAFTA	1.0	2.0	6.0	(2.5)	(5.0)
Latin America	10.0	4.5	6.0	6.0	3.0
Western Europe	2.0	2.0	4.5	0.0	(3.0)
Central/Eastern Europe	7.0	6.5	8.5	6.5	4.0
Asia-Pacific	5.0	3.0	8.5	5.5	6.5
World	**3.5**	**3.0**	**6.5**	**2.5**	**2.0**

* rounded to 0.5%

Business Performance of the LANXESS Group

- EBITDA pre exceptionals climbs €134 million, to €581 million
- EBITDA margin pre exceptionals up from 6.6% to 8.1%
- "Price before volume" strategy consistently and successfully implemented
- Substantial exceptional items pull down operating result
- Net financial debt reduced by approx. 40% to €680 million
- EBITDA pre exceptionals expected to grow again in 2006
- Above-average sales growth, capital expenditures and business outlook in Asia-Pacific

Summary of the fiscal year In 2005, the LANXESS Group improved its operating result before depreciation and amortization (EBITDA) pre exceptionals by a substantial €134 million, or 30.0%, to €581 million. Major contributory factors were a favorable economic environment outside of Europe, improvements in efficiency, and the consistent pursuit of the "price before volume" strategy. Wherever possible, higher costs for raw materials and energy were passed on through higher selling prices. The EBITDA margin improved 1.5 percentage points, to 8.1%. This improvement was another step along the road to bringing profitability up to the market average, and was in line with LANXESS's own expectations for the year. But the restructuring measures and portfolio adjustments initiated during the year weighed heavily on the operating result. After further exceptional charges and a worsened financial result, the net loss for the Group was €51 million greater than in the previous year, at minus €63 million.

Key financial data	2004	2005	Change
€ million			in %
Sales	6,773	7,150	5.6
Gross profit	1,424	1,613	13.3
EBITDA pre exceptionals	447	581	30.0
EBITDA margin pre exceptionals	6.6%	8.1%	–
EBITDA	387	341	(11.9)
Operating result (EBIT) pre exceptionals	158	332	110.1
Operating result (EBIT)	59	28	(52.5)
Financial result	(79)	(145)	83.5
Loss before income taxes	(20)	(117)	*
Net loss	(12)	(63)	*
Earnings per share (€)	(0.16)	(0.75)	*

* change of more than 200%

Sales and earnings

Sales Group sales rose by 5.6% from the year before, to €7,150 million. Here a pricing-induced rise of €531 million, or 7.9%, in sales and a positive currency effect of €34 million, or 0.5%, were countered by a decrease in volume of €188 million, or 2.8%.

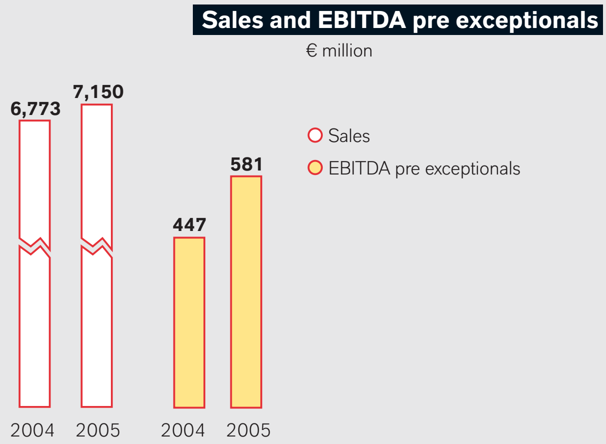
Effects on sales	2005
Approximate data	in %
Price	7.9
Volume	(2.8)
Currency	0.5
	5.6

These effects are in line with the purpose of the "price before volume" strategy that LANXESS pursued systematically in 2005. They also reflect the price increases adopted in some areas of the business to pass on the higher cost of raw materials and energy.

Sales by segment	2004	2005	Change
€ million			in %
Performance Rubber	1,431	1,678	17.3
Engineering Plastics	1,722	1,737	0.9
Chemical Intermediates	1,487	1,535	3.2
Performance Chemicals	1,910	1,977	3.5
Corporate Center, Services, Non-Core Business, Reconciliation	223	223	0.0
	6,773	7,150	5.6

The Performance Rubber segment posted a very substantial rise in sales that was mainly the result of higher prices. The other segments also reported sales increases, likewise resulting almost entirely from higher prices. Currency effects played only a minor role in all segments. From the geographical viewpoint, sales growth was concentrated in the Americas and Asia-Pacific regions.

Gross profit With the cost of sales increasing less strongly than sales revenues, gross profit advanced by 13.3% to €1,613 million. The gross profit margin rose 1.6 percentage points, to 22.6%. The cost of sales was particularly affected by higher prices for raw materials and energy.



EBITDA and operating result (EBIT) Despite the expanding volume of business, the selling costs and general administrative expenses remained almost unchanged from the prior year, rising 0.3% and 0.4% respectively, thanks largely to the cost-cutting and efficiency-enhancing measures implemented in the Group's sales and administrative departments in 2005.

Research and development costs decreased 17.9%, to €101 million. Thus R&D costs represented 1.4% of sales, compared to 1.8% a year earlier.

Other operating expenses less other operating income rose substantially from €98 million to €336 million, primarily as a consequence of the exceptional charges for restructuring measures and portfolio adjustments that are included under this item.

EBITDA pre exceptionals by segment	2004	2005	Change
€ million			in %
Performance Rubber	123	214	74.0
Engineering Plastics	49	66	34.7
Chemical Intermediates	202	211	4.5
Performance Chemicals	152	212	39.5
Corporate Center, Services, Non-Core Business, Reconciliation	(79)	(122)	54.4
	447	**581**	**30.0**

All operating segments of the LANXESS Group increased their EBITDA pre exceptionals in 2005. The Performance Rubber segment in particular achieved a substantial improvement amid favorable market conditions. Performance Chemicals – and beginning from a lower level, Engineering Plastics – also made earnings contributions that were more than 30% above the prior year.

The 2005 operating result (EBIT), which was substantially higher than a year earlier, was nevertheless pulled down by exceptionals totaling €304 million, all of which are included in the other operating result. This charge related particularly to the extensive package of measures to enhance the LANXESS Group's competitiveness, and were mostly the result of global restructuring programs and initiated portfolio adjustments. Additional exceptional charges of €71 million went for settlements related to antitrust investigations. The expenditures attributable to LANXESS and recognized in the Consolidated Financial Statements as a result of the settlements concluded by Bayer AG in the context of certain antitrust proceedings in 2005, fully used up the maximum reimbursement of €100 million that applies to most aspects of this litigation. Further details on this point are given in the Notes to the Consolidated Financial Statements. Additional exceptional charges of €64 million resulted from impairment losses on non-current assets, associated in part with the restructuring measures and portfolio adjustments already mentioned above. The total exceptional charges of €99 million for 2004 mainly included environmental protection expenses of €40 million, litigation-related expenses of €20 million, and goodwill impairments of €20 million.

After exceptionals, the operating result was down 52.5%, to €28 million.

Reconciliation of EBIT to net loss	2004	2005	Change
€ million			in %
Operating result (EBIT)	**59**	**28**	**(52.5)**
Loss from investments in affiliated companies	(2)	(32)	*
Net interest expense	(46)	(41)	10.9
Other financial income and expenses – net	(31)	(72)	(132.3)
Financial result	**(79)**	**(145)**	**(83.5)**
Loss before income taxes	**(20)**	**(117)**	*
Income taxes	13	63	*
Loss after taxes	**(7)**	**(54)**	*
of which:			
Minority interests	5	9	80.0
Net loss	(12)	(63)	*

* change of more than 200%

Financial result The financial result came in at minus €145 million, compared to minus €79 million for the prior year. A slight improvement in the net interest expense was countered by a loss from the at-equity valuation of Bayer Industry Services GmbH & Co. OHG (BIS), largely as a consequence of that company's allocations to non-current provisions for liabilities. A deterioration in the balance of exchange gains and losses, and the expenses for the repurchase and resale of the mandatory convertible bond issued in September 2004 also played a role.

Loss before income taxes The lower operating result and the deterioration in the financial result widened the loss before income taxes by €97 million, to €117 million.

Income taxes The pre-tax loss resulted in a tax credit of €63 million, compared to the previous year's tax credit of €13 million. The tax rate dropped from 65.0% in the previous year to 53.8%.

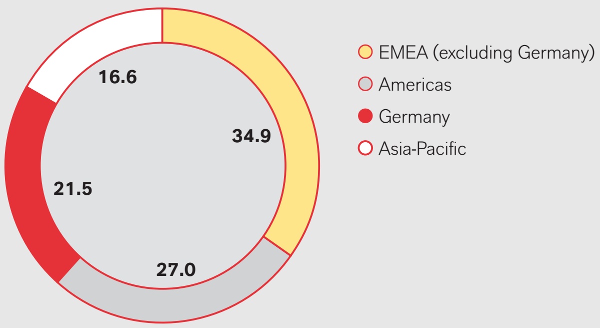
Net loss/Earnings per share After deductions of €9 million for minority interests, the LANXESS Group recorded a net loss of €63 million for 2005, due largely to the exceptional items mentioned above. The net loss for 2004 was €12 million, after minority interests of €5 million. Earnings per share were minus €0.75 in 2005, compared to minus €0.16 the year before.

Performance by Region

Sales by market	2004	2005	Change
€ million			in %
EMEA (excluding Germany)	2,419	2,494	3.1
Germany	1,610	1,538	(4.5)
Americas	1,757	1,928	9.7
Asia-Pacific	987	1,190	20.6
	6,773	**7,150**	**5.6**

LANXESS's foreign companies give it a presence in every important chemical and polymer market. It uses leading processes and technologies to manufacture products for the world market at some 50 locations in 18 countries, particularly Germany, Belgium, the United States, Canada and China. Nearly 50% of LANXESS employees work at its international locations. LANXESS generates 79% of its sales outside Germany.

Sales by region in %



In the EMEA region (Europe, Middle East, Africa), excluding Germany, sales were up 3.1% from the previous year, to €2,494 million. The Chemical Intermediates and Performance Rubber segments saw sales rise substantially, in part because they passed on the rising cost of raw materials. Sales growth was highly satisfactory in Belgium and Italy and also in eastern Europe, where LANXESS benefited from an improvement in the overall business conditions. The EMEA region accounted for 34.9% of total sales, compared to 35.7% in 2004.

In Germany, LANXESS sales declined 4.5% from the previous year, to €1,538 million. Although business in the Performance Rubber segment expanded, sales were down in the other LANXESS segments because the company has intentionally shed low-margin business. Germany's share of total sales was 21.5%, compared to 23.8% in 2004.

LANXESS sales in the Americas region grew 9.7% to €1,928 million, primarily because of business expansion in the Chemical Intermediates and Performance Rubber segments. The United States remained the region's growth driver, and LANXESS's total business there grew a substantial 14.7%. The temporary production cutbacks at two U.S. sites due to the hurricanes had no sustained adverse effects on business performance. Positive performance in Argentina and Mexico lifted sales in the Latin America region above the previous year's level. The Americas as a whole accounted for 27.0% of Group sales in 2005, compared to 25.9% the year before.

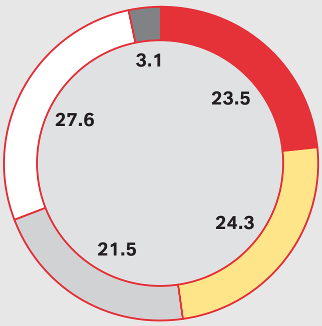
In the Asia-Pacific region, extremely robust economic growth boosted sales by a gratifying 20.6%, to €1,190 million, with all segments performing very well. Most notably, Performance Rubber and Engineering Plastics generated substantial double-digit increases in their sales in the Asian markets, where LANXESS foresees a particularly promising future. Demand for rubber products and polymer-based plastics remained strong in 2005. China has now replaced Japan as LANXESS's most important market in the Asian region. This is partly the result of strategic action to strengthen the company's market position in China, including technology and production joint ventures with a variety of Chinese partners. Business was also especially strong in Thailand, India and Indonesia. The Asia-Pacific region's share of Group sales rose from 14.6% to 16.6%.

Segment Data

- Performance Rubber: Leading market position consolidated
- Engineering Plastics: Slight improvement in performance
- Chemical Intermediates: Stable margins safeguard earnings contributions
- Performance Chemicals: "Price before volume" strategy bears fruit

Sales by segment

in %



Performance Rubber	2004		2005		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,431		1,678		17.3
EBITDA pre exceptionals	123	8.6	214	12.8	74.0
EBITDA	111	7.8	171	10.2	54.1
Operating result (EBIT) pre exceptionals	62	4.3	151	9.0	143.5
Operating result (EBIT)	50	3.5	108	6.4	116.0
Capital expenditures*	76		75		(1.3)
Depreciation and amortization	61		63		3.3
Number of employees (December 31)	3,163		3,119		(1.4)

* intangible assets and property, plant and equipment

In 2005 the **Performance Rubber** segment enjoyed 17.3% growth in sales over the prior year, to €1,678 million. Price increases averaging 18.1% served to pass on the higher costs of energy and raw materials – especially butadiene and isobutylene – to the market. Volumes dipped by 1.5% as a result of the "price before volume" strategy. Positive currency effects had only a minor effect of 0.7%. The LANXESS Group consolidated its strong market position in butyl rubber.

The segment's EBITDA pre exceptionals jumped by 74.0%, to €214 million thanks to the systematic pursuit of the "price before volume" strategy, especially in the Polybutadiene Rubber and Technical Rubber Products business units. Cost containment and efficiency enhancements also helped improve earnings throughout the segment. The restructuring measures that were initiated in the Technical Rubber Products business unit during 2005 will become fully effective in 2006. The EBITDA margin for the segment as a whole improved 4.2 percentage points, to 12.8%.

Exceptionals in this segment, at €43 million, related to expenditures for the aforementioned settlements in the context of antitrust investigations involving the Technical Rubber Products business unit. Provisions for such settlements gave rise to exceptional charges of €12 million in the previous year.

Engineering Plastics	2004		2005		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,722		1,737		0.9
EBITDA pre exceptionals	49	2.8	66	3.8	34.7
EBITDA	49	2.8	66	3.8	34.7
Operating result (EBIT) pre exceptionals	9	0.5	33	1.9	**
Operating result (EBIT)	12	0.7	10	0.6	(16.7)
Capital expenditures*	45		45		0.0
Depreciation and amortization	37		56		51.4
Number of employees (December 31)	3,652		3,479		(4.7)

* intangible assets and property, plant and equipment
** change of more than 200%

Sales in the **Engineering Plastics** segment, at €1,737 million, maintained the same high level as the prior year, gaining 0.9%. Price increases, at 6.7%, combined with a 0.5% positive currency effect, compensated for the expected adverse volume effect of minus 6.3%. Sales developed particularly well in the Semi-Crystalline Products business unit, where price increases were successfully implemented in the context of highly volatile raw material costs. The Fibers business unit was hampered all year by the global overcapacities in the fibers business and the resulting slump in prices and volumes.

A slight improvement in this segment's gross profit margin, combined with lower administrative and R&D expenses, enabled EBITDA pre exceptionals to climb 34.7%, to €66 million. Production facilities in the Semi-Crystalline Products business unit enjoyed very high levels of utilization all year. Concentrating on higher-margin business proved particularly beneficial in the Styrenic Resins business unit. However, the adverse performance of the Fibers business unit prevented a better segment result.

The segment's EBITDA margin, which remained at the low level of 3.8%, underscores the need for the restructuring measures that were launched during 2005 to realign the Styrenic Resins business unit. The production consolidations, along with capacity and portfolio adjustments, are already starting to bear fruit. The sale of the fibers business, which has now been completed, should likewise have a lasting positive effect on the performance of the Engineering Plastics segment.

The segment's operating result was diminished by impairment losses of €14 million in the Styrenic Resins business unit and €9 million in the Fibers business unit. In the previous year, earnings of the Styrenic Resins business unit were assisted by asset write-backs of €24 million, although this income was partially offset by further write-downs of €21 million.

Chemical Intermediates	2004		2005		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,487		1,535		3.2
EBITDA pre exceptionals	202	13.6	211	13.7	4.5
EBITDA	202	13.6	211	13.7	4.5
Operating result (EBIT) pre exceptionals	111	7.5	143	9.3	28.8
Operating result (EBIT)	89	6.0	129	8.4	44.9
Capital expenditures*	89		59		(33.7)
Depreciation and amortization	113		82		(27.4)
Number of employees (December 31)	3,819		3,353		(12.2)

* intangible assets and property, plant and equipment

The **Chemical Intermediates** segment generated a sales increase of 3.2% in 2005, to €1,535 million. Price increases, at 4.2%, together with a marginal 0.2% currency effect, more than made up for the 1.2% negative volume effect. Volumes were down in the Inorganic Pigments and Fine Chemicals business units. The Basic Chemicals business unit succeeded in implementing price increases, and thus was able to pass along some of the substantial rises in the cost of raw materials and energy. The Inorganic Pigments business unit experienced a weather-related drop in sales in the first quarter of 2005, which it was unable to make good during the rest of the year. The Fine Chemicals business unit saw a decline in sales of specialty chemicals in particular.

The EBITDA margin remained nearly constant at 13.7%, while EBITDA pre exceptionals rose 4.5%, primarily because of higher earnings in the Basic Chemicals business unit. By contrast, earnings in Inorganic Pigments were affected by the loss of sales in the first quarter, and an adverse product mix in the second half. The problem of the Fine Chemicals business unit's inadequate earnings contributions was addressed during the year by an extensive package of measures to restore the unit's international competitiveness. These included the closure of unprofitable facilities and, most importantly, a clearer positioning of this unit in the market for exclusive custom syntheses. LANXESS will be emphasizing the latter aspect during the current year by spinning off the unit into a legally separate company named Saltigo.

The exceptionals included in the segment's operating result comprised impairment losses of €14 million for the Fine Chemicals business unit. In the previous year this business unit accounted for €27 million in impairment losses, mitigated by asset write-backs of €5 million.

Performance Chemicals	2004		2005		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,910		1,977		3.5
EBITDA pre exceptionals	152	8.0	212	10.7	39.5
EBITDA	104	5.4	184	9.3	76.9
Operating result (EBIT) pre exceptionals	77	4.0	146	7.4	89.6
Operating result (EBIT)	9	0.5	118	6.0	**
Capital expenditures*	57		61		7.0
Depreciation and amortization	95		66		(30.5)
Number of employees (December 31)	5,140		4,743		(7.7)

* intangible assets and property, plant and equipment
** change of more than 200%

Sales in the **Performance Chemicals** segment grew 3.5% from the prior year, to €1,977 million. This increase derived from positive price and currency effects, amounting to 4.4% and 0.6%, respectively, combined with a 1.5% overall decrease in volumes. All business units except Paper raised their prices to pass on the higher costs of raw materials and energy, and these increases more than made up for the lower volumes. Sales were especially strong in the Rubber Chemicals, Leather and Ion Exchange Resins business units, while the Textile Processing Chemicals business unit saw a substantial sales decline as a consequence of lower volumes.

EBITDA pre exceptionals improved 39.5%, to €212 million, primarily because of better cost structures and the successful pursuit of the "price before volume" strategy. The EBITDA margin gained 2.7 percentage points, to 10.7%, particularly in light of the earnings contributions from the Rubber Chemicals and Leather business units. The sale of the Paper business unit to Finland's Kemira Group in the current year should have a positive effect on the segment's performance.

The segment's operating result was hampered by €28 million for settlements in the context of antitrust investigations already referred to above in the Rubber Chemicals business unit. In the previous year, such settlements led to exceptional charges of €8 million. Additionally, exceptional expenses for 2004 included a €20 million write-down of goodwill in the RheinChemie business unit, and expenses of €40 million for environmental protection measures in the Leather business unit.

Corporate Center, Services, Non-Core Business, Reconciliation	2004		2005		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	223		223		0.0
EBITDA pre exceptionals	(79)	(35.4)	(122)	(54.7)	54.4
EBITDA	(79)	(35.4)	(291)	(130.5)	**
Operating result (EBIT) pre exceptionals	(101)	(45.3)	(141)	(63.2)	39.6
Operating result (EBIT)	(101)	(45.3)	(337)	(151.1)	**
Capital expenditures*	12		11		(8.3)
Depreciation and amortization	22		46		109.1
Number of employees (December 31)	3,885		3,588		(7.6)

* intangible assets and property, plant and equipment
** change of more than 200%

Sales from non-core business operations remained constant compared with the prior year, at €223 million. Positive price effects, at 4.5%, almost entirely countered the negative volume effects of 4.9%. Currency effects came to 0.4%.

As expected, EBITDA pre exceptionals was down 54.4%, mostly because of the higher cost of sales, the cost of setting up LANXESS group functions, and expenditures for bonuses, pensions and other items. Departing from the presentation in the 2004 Annual Report, corporate costs are no longer allocated among the operating segments. As of fiscal 2005 they are instead reported collectively under the segment named "Corporate Center, Services, Non-Core Business, Reconciliation," facilitating a comparison of performance across LANXESS's operating segments. The previous year's amounts have been adjusted accordingly. The amount of corporate costs reclassified for 2004 was €64 million.

The €196 million in exceptional items for this segment related mainly to the extensive restructuring measures and portfolio adjustments initiated in fiscal 2005. The projects announced in recent months, which are supported by agreements with the employees in several countries, are designed to eliminate structural weaknesses and improve the LANXESS Group's international competitiveness. The expenses for restructuring measures and portfolio adjustments mainly comprise costs for headcount reductions, impairment charges, closures or partial closures of facilities, and the preparation of corporate transactions. Included in these expenses are impairment losses of €24 million. These expenses are included in the corporate cost segment because they relate to a Group-wide, cross-segment program of asset consolidations, process improvements and portfolio adjustments initiated by the Board of Management, and it is therefore not possible to allocate them properly among the operating segments.

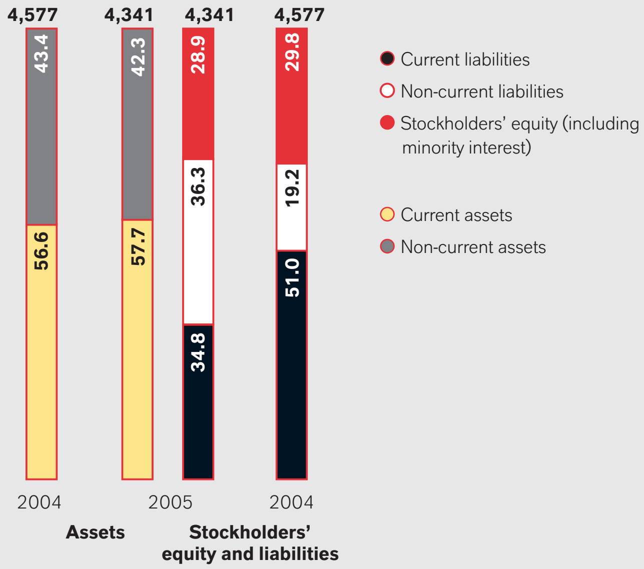
Financial Condition

Balance sheet structure

- Net financial debt significantly reduced
- Maturity structure of Group financing improves sharply
- Total assets down slightly from previous year

Balance sheet structure

€ million/in %



Total assets were down €236 million, or 5.2%, from the previous year, primarily because of a decrease in non-current assets. On the equity and liabilities side, there was substantial growth in non-current liabilities but a decrease in stockholders' equity and current liabilities.

Intangible assets and property, plant and equipment remained almost unchanged from the prior year. The most significant decreases in non-current assets – aside from the decline in the value of the interest in Bayer Industry Services GmbH & Co. OHG, which is included at equity – were in deferred taxes and other items. Both the decline in deferred tax assets and the increase in deferred tax liabilities resulted from an adjustment of these items – not recognized in income – necessitated by the transition from the Combined Financial Statements as of December 31, 2004, to the Consolidated Financial Statements of the LANXESS Group as of December 31, 2005. The capitalization of deferred tax assets as a consequence of recognizing in income certain restructuring expenses that were not yet tax-deductible, had the opposite effect. Other non-current assets decreased because Bayer Pensionskasse had to be accounted for as a defined-contribution pension plan after the spin-off.

Further details of the adjustment of deferred taxes, which does not affect the income statement, and of the accounting treatment of Bayer Pensionskasse are given in the Notes to the Consolidated Financial Statements.

Non-current assets accounted for 42.3% of total assets, compared to 43.4% in 2004.

Current assets decreased €83 million, or 3.2%. Although the cost of raw materials was up and foreign exchange rates acted to increase working capital, inventories decreased beyond projections by €83 million, or 7.2%, because of problems in obtaining deliveries from a raw material supplier. The picture is similar for trade receivables, which were down €72 million, or 6.3%, from the previous year. Days of sales in inventories and days of sales outstanding both improved against the previous year.

The LANXESS Group has no material off-balance-sheet assets.

On the equity and liabilities side, stockholders' equity, including minority interests, decreased €109 million, or 8.0%, from the year before. The equity ratio came in at 28.9%, compared to 29.8% for the prior year. The decrease in equity is a consequence of the net loss for the year, adjustments of deferred tax items not recognized in income, and a change in the method of accounting for certain pension plans. On the other hand, equity rose by €211 million due to the capital increase implemented out of contingent capital in the third quarter in connection with the exercise of conversion rights under the mandatory convertible bond. Further details of changes in equity and earnings-neutral adjustments are provided in the Statement of Changes in Stockholders' Equity and the Notes to the Consolidated Financial Statements.

Non-current liabilities increased significantly, by €698 million or 79.5%, to €1,576 million, accounting for 36.3% of total equity and liabilities. They include the €500 million Euro Benchmark Bond issued in fiscal 2005, which strengthened Group financing for the long term. Provisions for pensions and other post-employment benefits were up €79 million, or 18.9%, from the year before.

Current liabilities decreased €825 million, or 35.3%, to €1,509 million, largely because of the change in the Group's financing and the exercise of the conversion rights from the mandatory convertible bond that was included under this item in 2004. Other current provisions evolved in the opposite direction, rising €176 million, or 78.2%, primarily because of an increase in personnel-related provisions and restructuring provisions.

Net financial debt, defined as financial liabilities less cash and cash equivalents, came to €680 million as of December 31, 2005. This represents a substantial €455 million, or 40.1%, decrease from the previous year. The reduction is primarily the consequence of strong operating cash flow. Another contributor toward the improvement in the Group's capital and financing structure was the conversion of the mandatory convertible bond to stockholders' equity in July 2005.

The Group's key ratios are as follows:

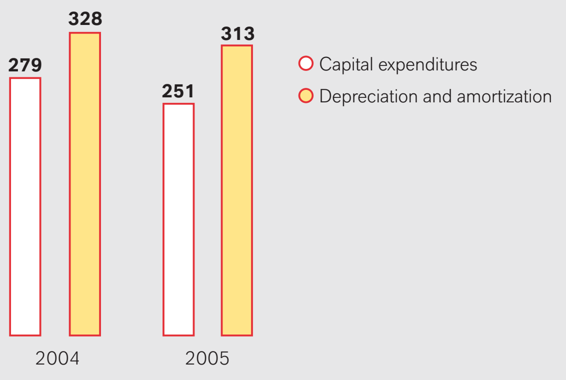
Ratios		2004	2005
in %			
Equity ratio	Stockholders' equity** / Total assets	29.8	28.9
Non-current asset ratio	Non-current assets / Total assets	43.4	42.3
Asset coverage I	Stockholders' equity** / Non-current assets	68.7	68.4
Asset coverage II	Stockholders' equity** and non-current liabilities / Non-current assets	112.8	154.3
Funding structure	Current liabilities / Total liabilities	72.7	48.9
Gross profit margin	Gross profit / Sales	21.0	22.6
EBITDA margin*	Operating result* before depreciation and amortization / Sales	6.6	8.1
Return on sales*	Operating result* / Sales	2.3	4.6
ROCE*	Operating result* / Capital employed	5.4	12.9

* pre exceptionals
** including minority interest

Capital expenditures LANXESS makes selective capital expenditures to increase its international competitiveness, focusing on profitable businesses with attractive growth opportunities. Funds are allocated to individual segments in keeping with strategic targets. As a rule, capital expenditures are financed out of the cash flow from operating activities, or if these funds are insufficient, from other cash and credit lines available. Additionally, capital expenditure projects are also pursued as part of technology and production joint ventures with international partners.

Capital expenditures vs. depreciation and amortization

€ million



Capital expenditures for property, plant and equipment and for intangible assets came to €251 million in 2005, compared to €279 million the year before. Thus capital expenditures were below depreciation and amortization, which came to €313 million. Depreciation and amortization included €64 million in write-downs, which were reported as exceptionals. The prior year's depreciation and amortization was €328 million, including write-downs of €39 million.

Capital expenditures focused primarily on measures to replace or maintain facilities or to enhance plant availability, and projects to improve equipment safety, improve quality or comply with environmental protection requirements. About 60% of the capital expenditures in 2005 were to preserve existing facilities, while the rest were for expansion or efficiency improvement measures.

In regional terms, about 46% of 2005 capital expenditures for property, plant and equipment were made in Germany, about 25% in the EMEA region outside Germany, about 19% in the Americas, and about 10% in Asia. The figure for Asia more than doubled compared with the previous year.

Capital expenditures in the Performance Rubber segment, at €75 million (2004: €76 million) exceeded depreciation and amortization of €63 million. In Belgium, expenditures served to increase butyl rubber production, and work to expand production of these materials has also begun at the Sarnia site in Canada. The world-scale Baypren® plant at the Dormagen site was modernized further with the opening of a new control center, and in Shanghai, China, LANXESS dedicated a new technical center. The segment invested in a thermoreactor in Zwijndrecht, Belgium, in the context of environmental protection measures.

Capital expenditures in the Engineering Plastics segment came to €45 million, as in the previous year. This was below the level of depreciation and amortization, which came to €56 million. In particular, construction was completed in Wuxi, China, of a compounding plant for polyamide and polybutylene terephthalate-based engineering plastics.

Capital expenditures in the Chemical Intermediates segment came to €59 million (2004: €89 million), and were thus less than depreciation and amortization, which amounted to €82 million. In the Fine Chemicals business unit, in particular, substantially lower capital expenditures were made than a year earlier. Major capital expenditures in this segment pertained to updating and expanding precursor stages for specialty isocyanate production at the Leverkusen site, and maintaining existing plants.

Capital expenditures in the Performance Chemicals segment, at €61 million (2004: €57 million), were below the depreciation and amortization of €66 million. Major expenditures related to the relocation of the hydrazine hydrate production plant from the Baytown, Texas site in the United States to Weifang, China, as well as the completion of a plant for a cold sterilization agent at the Dormagen site. This new facility is intended to address the growing international demand for a microbiological stabilization technology that LANXESS offers for beverages.

Among the major individual projects for 2005 were:

Segment	Description
Performance Rubber (BU: Butyl Rubber)	Expansion of butyl rubber production in Zwijndrecht, Belgium, and Sarnia, Canada
Performance Rubber (BU: Technical Rubber Products)	Inauguration of a Technical Center in Shanghai, China
Engineering Plastics (BU: Semi-Crystalline Products)	Compounding plant for engineering plastics, Wuxi, China
Chemical Intermediates (BU: Basic Chemicals)	Modernization and expansion of a facility to manufacture precursors for specialty isocyanates, Leverkusen, Germany
Performance Chemicals (BU: Material Protection Products)	New facility for the production of cold sterilants for beverages, Dormagen, Germany
Performance Chemicals (BU: Functional Chemicals)	Joint venture for hydrazine hydrate, Weifang, China

Liquidity and capital resources

Financial condition

- Operating cash flow more than doubled
- Capital expenditures for property, plant and equipment financed out of operating cash flow
- Successful €500 million benchmark Eurobond issue
- Syndicated credit line refinanced on favorable terms

The cash flow statement shows cash inflows and outflows by type of business operation.

Cash flow statement	2004	2005	Change
€ million			
Loss before income taxes	(20)	(117)	(97)
Depreciation and amortization	328	313	(15)
Change in working capital and other assets and liabilities	(2)	378	380
Other items	5	50	45
Net cash provided by operating activities	**311**	**624**	**313**
Net cash used in investing activities	**(39)**	**(241)**	**(202)**
Net cash used in financing activities	**(214)**	**(319)**	**(105)**
Change in cash and cash equivalents from business activities	58	64	6
Cash and cash equivalents as of December 31	72	136	64

Cash provided by operating activities more than doubled in 2005 compared to the year before. Depreciation and amortization remained on a par with the previous year, but decreases particularly in working capital and in other assets and liabilities generated a high cash inflow. Reductions in inventories and trade receivables generated cash inflows of €262 million, compared to a cash outflow of €221 million the year before. This is a noteworthy success, since raw material prices and business volume both increased from the prior year. In 2005, pre-tax income was weighed down by allocations to provisions for restructuring and litigation. However, most of these provisions will not result in cash outflows until fiscal 2006 and thus did not affect operating cash flow for 2005.

Cash used in investing activities in 2005 was €202 million above the prior-year figure. In 2004 this item included repayment of a short-term loan of €256 million granted to the Bayer Group. Expenditures for property, plant and equipment and for intangible assets were down €28 million, or 10.0%, to €251 million and thus at the level budgeted for fiscal 2005. Sales of property, plant and equipment brought in cash of €8 million, compared to €26 million the year before.

Cash used in financing activities for 2005 came to €319 million, compared to €214 million in 2004. Most of this outflow resulted from a net loan repayment of €241 million. Details of the successful Euro Benchmark Bond issue in June 2005 and other steps taken to refocus and enhance the financing structure can be found in the chapter on the financing of the LANXESS Group. Interest expenses and other disbursements for financing activities, including those associated with the repurchase and resale of the convertible bond in June 2005, resulted in a net outflow of €76 million.

Allowing for changes in the scope of consolidation and in foreign exchange rates, cash and cash equivalents came to €136 million on the reporting date. This was a significant increase of €64 million, or 88.9%, from the previous year.

Financing of the LANXESS Group Financing activities in 2005 focused on strengthening the capital structure, safeguarding long-term liquidity, and taking advantage of attractive terms available on the capital markets.

In May 2005, in the period leading up to LANXESS's first issue on the Eurobond market, the company obtained an additional investment-grade rating (Baa3, with stable outlook) from Moody's Investor Services that further enhanced transparency for capital market participants. This rating is on a par with the BBB– initial rating assigned by Standard & Poor's in October 2004.

The company's first bond issue in the nominal amount of €500 million, successfully launched in June 2005, improved the maturity profile of financial liabilities and further diversified the financing portfolio. The proceeds from the €500 million issue – which was three times oversubscribed – were used to retire bank loans. The bond's volume qualified it as a benchmark bond for inclusion in the major European bond indices. It was issued with a seven-year maturity and a 4.125% annual interest coupon by LANXESS Finance B.V., an indirectly wholly owned subsidiary of LANXESS AG. The bond is underwritten by LANXESS AG and received investment-grade ratings of BBB– from Standard & Poor's and Baa3 from Moody's Investor Services, both with stable outlook. The bonds are traded on the Luxembourg Stock Exchange under the securities identification code A0E6C9.

An important indicator for industrial bonds, apart from the absolute change in price, is the relative valuation of the risk specific to the issuer in comparison to a reference interest rate. This valuation is expressed in what is known as the "credit spread." The chart below shows the evolution of the credit spread of the LANXESS bond in comparison to the interest-rate swap curve. The spread showed above-average improvement during the year in comparison both to LANXESS's own BBB rating class and to other chemical companies.

Bond Performance – Evolution of Credit Spread

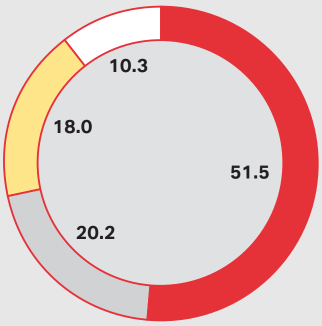
Also in June 2005, LANXESS AG repurchased the €200 million mandatory convertible bond it had issued in September 2004 to Bayer AG. Immediately after the repurchase, the bond issue was resold to an investment bank, which then promptly placed the minimum 11.6 million shares that would result from conversion. The total proceeds from the issue thus came to €211 million. Upon the bondholder's exercise of the conversion rights under the mandatory convertible bond, the capital stock of LANXESS AG was increased on July 20, 2005 by €11,586,478 to €84,620,670 out of contingent capital. A total of 11,586,478 bearer shares of no-par stock were issued, each representing a pro-rated share of €1 of the capital stock. These new shares, which are entitled to any dividend as of January 1, 2005, have been traded on German stock exchanges since July 22, 2005. Besides eliminating the "stock overhang" of at least 11.6 million and at most 13.3 million shares that would have had to be issued no later than September 2007 in order to service the mandatory convertible bond, this transaction was also intended to enhance the liquidity of LANXESS stock and strengthen the company's equity base. Since the mandatory convertible bond carried a 6% p.a. interest coupon, the repurchase and resale also eliminates an interest expense of €12 million per year from fiscal 2006 onward.

In October 2005, LANXESS AG agreed with an international syndicate of banks on a new credit line of €1.25 billion. The agreement has a five-year term, and includes two extension options, each of which makes it possible to extend the credit line for another year with the banks' consent. This credit line completely replaced the €1.5 billion line arranged in December 2004. The latter had comprised a one-year tranche of €500 million and two five-year tranches totaling €1 billion. The October 2005 transaction was more than two times oversubscribed, and keen interest on the part of banks made it possible to increase the original target volume of €1 billion by a further €250 million. LANXESS views this successful early refinancing of the credit line on substantially more favorable terms as strong evidence of the banks' confidence in LANXESS. The new credit line will serve largely to safeguard liquidity, and is likely to be drawn on only to a limited degree.

Employees As of December 31, 2005, the LANXESS Group had a total of 18,282 employees. This was 1,377 fewer than a year earlier. Here it should be borne in mind that in the Combined Financial Statements at December 31, 2004, about 600 employees of Bayer companies were allocated statistically to the LANXESS Group because they worked for LANXESS in an agency capacity. Once the spin-off took effect, these employees were no longer assigned to the LANXESS Group.

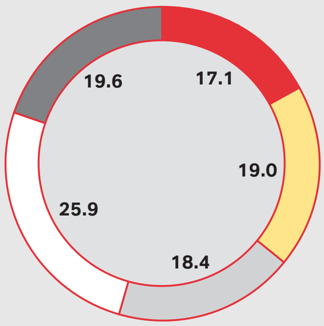
Employees by region

in %



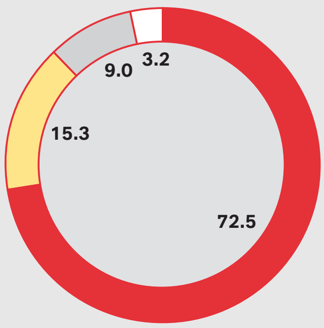
Employees by segment

in %



Employees by functional areas

in %



As of December 31, 2005, the LANXESS Group employed 3,290 individuals in the EMEA region (not including Germany), compared to 3,717 the year before. The number of employees in Germany was down substantially, from 10,098 to 9,410. Staff in the Americas was down to 3,694 from the previous year's 3,920, while there was only a slight decline in the Asia-Pacific region, from 1,924 to 1,888 as of December 31, 2005.

Personnel expenses totaled roughly €1,333 million, or 18.6% of sales, an increase of 10.9% from the previous year. Wages and salaries, at €1,040 million, accounted for most of this figure. Social security contributions were €185 million, pension plan expenses were just under €104 million, and social assistance benefits came to €4 million. Personnel expenses include substantial expenses associated with the restructuring measures carried out in fiscal 2005.

Procurement and Production

Procurement LANXESS uses a centrally managed global procurement organization to ensure a reliable supply of materials and services. Global procurement teams coordinate with the business units to pool requirements. A global procurement network enables them to leverage purchasing synergies, so that LANXESS can move efficiently in the market and exploit price advantages. LANXESS systematically applies best practice processes. These include e-procurement tools, such as e-catalogs and electronic marketplaces, many of which are integrated into the company's internal IT systems. About 30% of all items ordered are now handled through e-procurement.

Procuring petrochemical raw materials is a top priority at LANXESS. The biggest suppliers here in 2005 included BP, Chevron Phillips, Dow, Exxon Mobil, Huntsman, Ineos, Innovene, Lyondell, Shell Chemicals and Total. Other important suppliers of basic inorganic and organic chemicals are BASF, Bayer, Degussa and Rhodia.

Among the most important petrochemical raw materials by far for the LANXESS Group's production operations are 1,3-butadiene, styrene, cyclohexane, acrylonitrile, C4 raffinate 1, toluene, isobutene, benzene, ethylene and n-butane. The basic chemicals ammonia, aniline, chlorine, caustic soda, and sulfur are also important, as are ferrous raw materials. In all, the ten most important petrochemical raw materials accounted for a purchasing volume of about €1.3 billion in fiscal 2005, or roughly 50% of total raw materials expenses for the LANXESS Group.

Production LANXESS is one of Europe's major producers of chemical and polymer products. Its production facilities can make anywhere from very small batches of custom-synthesized products to basic, specialty and fine chemicals, polymers and elastomers in quantities of several thousand tons.

Each of the Group's production facilities is organizationally assigned to an individual business unit. The most important production sites are at Leverkusen, Dormagen and Krefeld-Uerdingen, Germany; Antwerp, Belgium; Bushy Park and Addyston, United States; Sarnia, Canada; and Wuxi, China. LANXESS also has other production sites in Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Mexico, the Netherlands, South Africa, Spain, Thailand, the U.K. and the U.S.

Many production sites were affected by LANXESS's restructuring packages. Plants and capacities were reconfigured, rationalized, expanded or even closed. The two European locations of the Styrenic Resins business, Tarragona and Dormagen, have shifted focus. Tarragona will become the business unit's main location, while capacity will be cut back more sharply at Dormagen, which will now produce only high-grade products for Bayer MaterialScience.

In the Leather business unit, restructuring measures enhanced efficiency in both administration and production. Most production of tanning auxiliaries was moved from Germany to Italy. In 2007 LANXESS will close the site in New Martinsville, West Virginia, U.S., where the Inorganic Pigments business unit produces yellow pigments. Before the end of 2006, production at the site of the Textile Processing Chemicals business unit in Wellford, South Carolina will cease. Production from RheinChemie's site in Trenton, New Jersey, will be moved to Chardon, Ohio, and the Trenton site will be closed.

The restructuring process also involved shutting down several unprofitable facilities in the Fine Chemicals business unit. LANXESS has also begun restructuring the Technical Rubber Products business unit's site at La Wantzenau, France. Process optimization is among the steps that are yielding large savings here.

LANXESS successfully increased production of neodymium-catalyzed polybutadiene rubber. During 2005 it also made all the necessary preparations to consolidate polybutadiene rubber production at Orange, Texas, from four to three production lines as of January 1, 2006, at a substantial cost advantage to the company.

Capacity is also being expanded in Zwijndrecht, Belgium, and Sarnia, Ontario, Canada to meet the growing demand for butyl rubber. To maintain its global lead in polychloroprene production, the company opened a new process control center for its chloroprene rubber unit in Dormagen – the largest facility of its kind in the world.

During the year LANXESS also invested in new production capacity at a number of Asian sites. Among these projects, it built a new production facility for high-tech engineering plastics; it started up two new facilities for leather chemical production at the Wuxi site; and it prepared for the fiscal 2006 startup of rubber antioxidant production as part of a joint venture in China.

Since the beginning of 2005, the company has been producing numerous chemicals in China on a contract basis for the textile industry worldwide. Additionally, by moving a hydrazine hydrate plant from the United States to China and setting up a joint venture with a Chinese partner, LANXESS has become one of the leaders in the Chinese hydrazine hydrate market. A new facility for polymer-bound chemicals at the Qingdao site has doubled the RheinChemie business unit's production capacity in China.

Sales Organization and Customers

Sales organization LANXESS sells its products all over the world, to several thousand customers in more than 140 countries across all continents. LANXESS's long-standing customer base includes leaders in each of its user industries. The company's well-established customer relationships are especially extensive in Europe and North and South America. To meet its customers' needs, LANXESS has set up very flexible marketing and sales structures. Sales are managed through 36 legal entities owned by LANXESS itself, 37 Bayer sales agencies, and independent sales partners throughout the world. Additionally, orders worth some €1.3 billion, or 18.2% of total sales, were processed via e-business in 2005. This capability is provided by the LanxessONE Internet tool and the ELEMICA Web portal for chemical products.

To keep as close as possible to customers and ensure they receive individual support, the LANXESS business units each manage their own sales organizations. Another competitive advantage for LANXESS is its approximately 50 production sites in 18 countries. Wherever possible, customers are supplied from production sites in the same region, saving both time and money.

Selling costs for fiscal 2005 came to 12.1% of LANXESS Group sales, compared to 12.7% for the previous year.

Customers Because of its many products and lines of business, LANXESS has business relationships with a vast range of customers all over the world. They need an individualized, well-focused approach, which the company is able to provide because its sales organizations are managed through the business units. Individual marketing strategies are reviewed on the basis of customer satisfaction surveys.

LANXESS serves the following industries: tires, automotive supply, chemicals, plastics, electronics, agrochemicals, pharmaceuticals, food, textiles, water treatment, and furniture. Until the end of 2005, it served the paper industry as well.

Shares of sales by industry sector	2005
in %	
Chemicals	> 15
Automotive, construction, electrical/electronics, life science, tires	5–15
Leather/shoes, textiles, apparel	< 5
Others	~ 15

The LANXESS Group's top five customers accounted for about 14% of all sales in fiscal 2005. 18 customers account for sales of between €20 million and €50 million. About 15,000 LANXESS customers contribute sales of up to €100,000.

The number of customers varies widely by segment. The Performance Rubber segment has some 2,000 customers, Engineering Plastics has about 4,000, Chemical Intermediates has more than 7,000, and Performance Chemicals has about 14,000. However, one customer may do business with more than one segment. Each segment includes all customer groups and sales volumes.

The comparatively low sales per customer in the Performance Chemicals segment, as well as its broad customer base, reflect the way in which its business often involves custom-tailored solutions in specialty chemistry. The substantially lower number of customers in the Performance Rubber segment, which generates relatively high sales, is likewise typical of the synthetic rubber products business. This extensive customer base means that no segment can be considered dependent on just a few customers.

Research and Development Most of the LANXESS Group's research and development activities are directed toward enhancing the existing product portfolio and improving product cost and quality by optimizing production processes. LANXESS research and development makes its contribution toward the company's growth by developing new products for existing markets, and by tapping new markets for existing products. LANXESS does not conduct fundamental research. Instead, where necessary the appropriate knowledge is obtained from outside partners. A strict focus on the needs of each business unit and a critical approach to selecting projects enable LANXESS to maintain efficient research and development operations at a low cost overall.

LANXESS research and development units worldwide had about 600 employees as of December 31, 2005 (compared with about 700 the previous year). Research and development spending for the year was about 1.4% of sales. This figure is also consistent with LANXESS's medium-term needs and the proportion of its business that comprises commodities. The company has research and development units at a number of locations worldwide, foremost among them Leverkusen, Dormagen, and Krefeld-Uerdingen, Germany, and Sarnia, Canada. Additional R&D centers are located in Madurai, India; Woodbridge, Connecticut, U.S., and Ede, Netherlands.

LANXESS currently has 117 research and development projects in progress. 91 of these projects are in product development, either to improve existing products or create new ones. Their strategic focus is on optimizing existing products and applications. 26 projects are concerned with processes, with the aim of cutting costs, improving yields or increasing capacity. About 80% of current projects are expected to be implemented by the end of 2006. The results of LANXESS research and development are protected by patents. Since January 1, 2004, LANXESS has filed 220 priority patent applications all over the world. The full patent portfolio includes 1,664 “live” patent families with about 10,000 family members.

Most of the LANXESS Group’s research and development expenditures are in the Fine Chemicals, Semi-Crystalline Products and Technical Rubber Products business units. In 2005, these accounted for 40.6% of the Group’s total research and development spending. Their share in 2004 was 43.1%.

Organizationally, the LANXESS Group’s research and development units are assigned to the individual business units. This approach is intended to ensure that development activities are always closely allied to the business units’ own strategies, markets and customers. For example, business units with a large proportion of commodities (products in very mature markets), such as Basic Chemicals, concentrate on constantly improving their production facilities and processes (process optimization). Other business units, such as Material Protection Products, Semi-Crystalline Products and Leather, focus their R&D activities more on optimizing products and product quality, and developing new products to meet the market’s requirements and customers’ special needs. There is also a Board initiative to coordinate research and development work across business unit boundaries, thereby promoting especially innovative products from an overall LANXESS perspective and coordinating the exchange of R&D expertise and staff among business units.

In keeping with LANXESS’s structure, research units must meet specific requirements. Research expenditures must yield a large contribution to profits within as short a time as possible. Research and development must also be closely tied into the business unit’s particular strategy. Also, the field of activity must be closely related to the market. Research and development units form a development network with customers, suppliers and outside institutions.

Research and development in the **Performance Rubber** segment is conducted mainly by the Technical Rubber Products business unit. Its R&D work concentrates on optimizing existing products and processes, and on the ecological aspects of production processes. It also develops new products and product lines, providing support until they are ready for market launch. In these efforts, LANXESS cooperates with research institutes at various universities. One current example of research and development work is rubber gels to serve as a novel additive for tires and many other products. Jointly with RheinChemie, there are 25 patents and patent applications in this field. Production is based at an existing facility in La Wantzenau, France.

Research and development activities in the **Engineering Plastics** segment concentrate on identifying and developing new areas of application for existing products. This is particularly true of the thermoplastics Durethan® and Pocan® and the plastic-metal hybrid technology that has been developed for Durethan®. The benefit to customers lies in tapping new applications and reducing weight. The R&D units also support day-to-day business, mainly in compound products – for example by improving the products’ processability. Additionally they work on projects to optimize quality and efficiency.

In the **Chemical Intermediates** segment, R&D work is concentrated mainly in the custom manufacturing sector of the Fine Chemicals business unit, which develops processes for customers’ specific intermediates as a service and manufactures the resulting products. Custom manufacturing enables clients to focus on their own core areas of expertise and save on development time. Consequently, by contrast to all the rest of the LANXESS Group’s R&D activities, here development is an integral part of the services sold. The customers are primarily pharmaceutical companies, manufacturers of agrochemicals, and companies that market chemical specialties such as electronic chemicals, fragrances and flavorings.

In the **Performance Chemicals** segment, the emphasis is on applications development to optimize products. In many markets – such as textiles or leather – product life cycles are short, and products are subject to rapid change, in part because of fashion trends. It takes constant, flexible development work to respond quickly to such market changes. For that reason, the development units in the Performance Chemicals segment work very closely with the market, sometimes in joint projects with customers. One new project in the Leather business unit is the LANXESS X-Grade system. This smoothes out minor defects on raw hides and promises high sales potential, especially in the furniture industry. In another example, the Material Protection Products business unit is currently working on replacing copper in wood preservatives, in response to market wishes. It has already found suitable combinations that offer a satisfactory solution for the short to medium term. They will reach the market in 2008, and offer sales potential of about €25 million. The first patent applications are also being made for a long-term solution. Projects under way in the Ion Exchange Resins business unit include a special ion exchanger for metal extraction. This has annual sales potential of more than €10 million.

In 2005 LANXESS largely completed the organizational and technical repositioning of its research activities in line with the LANXESS strategy. Products with attractive sales and earnings potential are expected to emerge from the research pipline in the near future. Research and development strategy calls for shorter times to market, a broader use of licenses, and carefully selected alliances with other companies and research institutes.

Corporate Responsibility

Corporate values As a chemical corporation that operates all over the world, LANXESS strives for safety, environmental protection and quality in all its activities everywhere. It supports the principles of sustainable development and Responsible Care. These require every employee to act responsibly in respect of people, the environment and capital. LANXESS always applies its high sustainable business standards in making entrepreneurial decisions.

The principles of Responsible Care and sustainable development are given high priority at LANXESS, and are accordingly firmly rooted in its corporate organization. Corporate guidelines, such as the “Code for Legal Compliance and Corporate Responsibility at LANXESS” and “HSE Management at LANXESS,” set standards for all employees worldwide regarding law-abiding and responsible action. They contain rules for legal compliance and ethical conduct in interactions with fellow employees and with neighbors, customers, suppliers, other interested parties, and competitors, for occupational, product and plant safety, and for environmental protection.

A Compliance Committee appointed by the Board of Management handles all referrals concerning violations of the corporate code, with the goal of promptly counteracting illegal or unethical conduct within the LANXESS Group, and averting misconduct through appropriate measures. The Compliance Committee includes the heads of the group functions (Law and Intellectual Property, Human Resources, Industrial and Environmental Affairs, Technical Services, Procurement) and the head of Internal Auditing as the LANXESS Compliance Officer.

Global Health, Safety and Environmental Management (HSE Management) at LANXESS Health, safety and environmental protection are important components of global management in the LANXESS Group. For that reason, it must be ensured that all LANXESS locations throughout the world apply the same environmental and safety standards. That is why a comprehensive global process of aligning and controlling HSE management was initiated in 2005. The process should be complete by the end of 2006.

The HSEQ Committee, headed by Management Board member Dr. Martin Wienkenhöver, is the central steering committee for HSE management worldwide. It aims to further improve the company’s performance in this area. At the same time, the committee is to establish the worldwide strategy for the LANXESS Group’s integrated quality and environmental management system in compliance with ISO 9001 and ISO 14001 (the Q in the committee’s title refers to this quality aspect). The committee includes all heads of business units and group functions. The HSEQ Committee establishes and regularly reviews globally binding HSE directives, strategies and programs for LANXESS, as well as the

LANXESS HSEQ objectives. The programs initiated are implemented worldwide with support from corporate HSEQ management and the regional HSEQ units, and are regularly tracked by means of internal audits. Compliance with the standards set by the guidelines is reviewed in compliance checks.

During 2005, LANXESS established key performance indicators (KPIs) for HSE management, to help measure corporate HSE performance worldwide. In keeping with a transparent information policy, LANXESS will in future regularly publish a summary report of how the KPIs are evolving, and thus offer every interested party a chance to track the company's progress in health, safety and environmental protection.

Occupational safety Occupational safety is a top priority at LANXESS. The Safety Master Plan systematically identifies and corrects weak points in every organizational unit. Additionally, last fiscal year the Thousand-Day Program to improve occupational safety worldwide was completed, and proved to be a great success. The accident rate per million work hours for the LANXESS Group as of October 26, 2005, was 2.6 – a 67% reduction in accidents from the starting date three years earlier.

Environmental protection As LANXESS sees it, conserving natural resources – for example, through the most efficient possible use of raw materials and energies – and identifying further potential for reducing emissions and waste is an ongoing mission, an inherent part of its ecological obligations to which it must apply its expertise. The continuous improvement of environmental performance is a key corporate goal.

It is not yet possible to separately report consolidated environmental protection spending for all LANXESS subsidiaries and affiliates worldwide. For LANXESS Deutschland GmbH (not including subsidiaries), expenditures for waste disposal, water protection, noise abatement, clean air and other environmental protection measures came to 4.9% of total operating costs.

LANXESS Group integrated management system as per ISO 9001 and ISO 14001 LANXESS applies an integrated, process-oriented management system to achieve continuous improvement in all the Group's corporate processes. In fiscal 2005, LANXESS continued the process of establishing this integrated quality management and environmental management system, and made further progress in its efforts to earn global certification to ISO 9001 and ISO 14001. This process is expected to be completed in 2007.

LANXESS is concerned that its products in all segments must be environmentally compatible. It made further progress in this respect in many areas during the past year, and won numerous awards for its work. For example, in Austria the biodiesel stabilizer Baynox® won the "no harm" certificate from Österreichische Mineralöl-Verwaltung AG (ÖMV). Also in 2005, the maleic anhydride unit in Baytown, Texas, won the Responsible Care® prize from the Synthetic Organic Chemical Manufacturers Association (SOCMA) for the third time in a row.

Idea management When LANXESS employees have good ideas for improving work processes, safety and environmental protection, or preventing mistakes, those ideas pay off. An idea management system encourages suggestions for improvements to ensure that LANXESS will constantly be provided with new ways to improve cost-effectiveness, occupational safety and environmental protection. During 2005, some 3,000 suggestions were submitted at LANXESS Deutschland GmbH alone – about 600 of them in the areas of occupational safety and environmental protection. They saved the company a total of about €3.5 million for the year. Since a viable suggestion has a mean useful life of about five years, it yields a similarly sustained improvement in cost-effectiveness, safety and environmental protection.

Risk Report

Risk management Risk management is important for LANXESS because business activity necessarily entails risks as well as opportunities. Success is significantly dependent on identifying both opportunities and risks and actively managing them. Effective risk management is therefore a core element in safeguarding the company's existence for the long term and ensuring its successful future development.

LANXESS's risk management approach is based on clearly defined business processes, the precise assignment of responsibilities throughout the Group, and reporting systems that ensure the timely provision of the information required for decision-making to the Management Board or other management levels. LANXESS views risk management as an integral part of corporate controlling. Risk management is incorporated into business processes primarily through the company's organizational structure, its planning, reporting and communication systems, and a body of detailed management regulations and technical standards. Various committees and other bodies discuss and monitor opportunities and risks.

At LANXESS, the business units each conduct their own operations, for which they have global profit responsibility. Group functions support the business units by providing financial, legal, technical and other centralized services. Complementing this global alignment of the business units and group functions, the country organizations ensure the required proximity to markets and the necessary organizational infrastructure. In line with this division of duties, LANXESS has assigned responsibility, i.e. defined the risk owners, for the following:

- risk identification and analysis,
- risk prevention (measures taken to avoid, minimize or diversify risk),
- risk monitoring (watching for early warning signs) and
- risk mitigation (measures to minimize damage upon occurrence of a risk event).

Risk transfer transactions (hedging transactions or insurance) are entered into and managed centrally at LANXESS via the Treasury Department.

In connection with the decentralized organization of its risk management, LANXESS has established a central risk database to which the risk owners contribute structured data about identified risks. To this end, risk categories have been defined along with parameters for probabilities of occurrence and damage levels. The central risk database therefore provides a complete overview of LANXESS's risk profile. The Management Board receives a regular report on any material changes to this risk database. There is also provision for immediate internal reporting on specific risk issues such as significant corporate compliance violations. In 2005 there was no cause for immediate reporting of this kind on significant risks at LANXESS. In addition to the standard risk reporting system required by the German Law on Corporate Control and Transparency (KonTraG), LANXESS has a hierarchical communication system for appraising potential opportunities and risks and making them known to the Management Board. To supplement the central risk database, those risks and opportunities considered relatively likely to materialize are presented as worst-case/best-case scenarios in the context of corporate planning.

LANXESS's risk management principles are laid down in a Group directive. Risk management also includes obtaining extensive legal advice concerning business transactions and obligating employees by means of the corporate compliance code to observe the law and to act responsibly.

Monitoring of risk management and of LANXESS's internal control system (ICS) by means of process-independent testing is part of the risk management system. Within the Group, the Internal Auditing group function is tasked with overseeing both the functionality of the internal control and monitoring system and compliance with organizational safeguards. In addition, the risk management system is evaluated by the auditor as part of the audit of the annual financial statements.

LANXESS has acknowledged that managing the company necessarily involves managing risk. Steps have been taken to ensure that potential risks or opportunities relevant to the attainment of corporate goals are fully identified and quantified at an early stage. Preventive measures and safeguards minimize the probability that risks will materialize and limit their potentially adverse effects. The management of opportunities and risks is one of LANXESS's goals and therefore constitutes an integral part of decision-making processes.

Risks of future development

Market risks LANXESS is exposed to the general economic and political opportunities and risks of the countries and regions in which its companies operate. As a chemical enterprise, LANXESS is subject to the risks typical of this industry sector. The volatility and cyclicality of the global chemical and polymer markets and their dependence on developments in customer industries harbor opportunities and risks with respect to LANXESS's business volume. LANXESS anticipates future growth to come from a continuing increase in demand on Asian markets, particularly in China. If the general business environment in this region should deteriorate due to economic or other factors, one of LANXESS's key growth drivers could be weakened or eliminated.

LANXESS's risk profile is influenced by structural changes in markets, such as the entry of new suppliers, particularly those based in emerging economies; the migration of customers to countries with lower costs; and product substitution or market consolidation trends of the kind already occurring in some sectors, particularly rubber. LANXESS counters such trends by restructuring operations to achieve a sharper focus and arrive at a product portfolio with which it can operate successfully for the long term. At the same time, LANXESS systematically manages costs.

On the procurement side, the principal risk lies in the volatility of raw material and energy prices. LANXESS mitigates this type of procurement risk by entering into long-term supply contracts for most raw materials and agreeing price escalation clauses with customers. LANXESS also hedges this risk in some cases via derivatives transactions where liquid futures markets are available. To guard against possible supply bottlenecks due to factors such as the failure of an upstream operation at a networked site, LANXESS pursues an appropriate inventory strategy and lines up alternative sources of supply.

Foreign exchange risks Changes in the euro exchange rate, particularly against the U.S. dollar, can affect LANXESS's results. Such risks are documented, monitored and managed centrally for the entire Group. This enables LANXESS to offset the various foreign exchange effects of procurement and sales activities, and the foreign currency balances of the individual LANXESS companies, against one another. The goal is to hedge the residual amounts with derivative financial instruments. LANXESS only hedges foreign currency items that have arisen from the company's core businesses or are considered highly likely to arise. Long-term changes in currency parities can negatively or positively affect competitiveness in relation to suppliers outside the euro zone.

Interest rate and credit risks The risk of interest rate changes is centrally managed by the Treasury Department for the entire LANXESS Group. The majority of the company's debt was raised at fixed terms. Possible interest rate shifts in the coming years will therefore only have a limited effect on LANXESS. The Treasury Department also verifies customers' creditworthiness in close cooperation with our sales departments to minimize the default risk.

Legal risks Companies in the LANXESS Group are parties to various litigations. The outcome of individual proceedings cannot be predicted with assurance due to the uncertainties always associated with legal disputes. To the extent necessary in light of the known circumstances in each case, LANXESS has set up risk provisions for the event of an unfavorable outcome of such proceedings.

Taking into account existing provisions and insurance along with the agreements reached with third parties on liability risks from legal disputes, the company currently estimates that none of these proceedings will materially affect the future earnings of the LANXESS Group. The risk level could be heightened, however, by certain antitrust proceedings brought against Bayer AG by regulatory authorities or civil courts in the United States, Canada and Europe with respect to businesses that were transferred to LANXESS AG or its subsidiaries. As part of the spin-off, the activities of Bayer AG's former Rubber Business Group were transferred to the LANXESS Group. Investigations by the antitrust authorities and several private class-action and individual suits are or were pending in connection with various products that are or were attributable to these business activities. LANXESS AG and Bayer AG have agreed on specific rules with regard to such investigations, actions and suits. With regard to all liabilities arising out of, or in connection with, proceedings that had at least been initiated prior to July 1, 2004, LANXESS AG has to bear 30% of all such liabilities vis-à-vis Bayer AG, and Bayer AG has to bear 70% of all such liabilities vis-à-vis LANXESS AG. LANXESS AG's liability is, however, limited to a maximum amount of €100 million plus possible defense costs and proportionate reimbursement of additional taxes that may be payable if the tax deductibility of expenses is restricted. Current estimates indicate that in 2005 and 2006 LANXESS will make total payments equal to the €100 million maximum.

Production and environmental risks Although LANXESS applies high technical and safety standards to the construction, operation and maintenance of production facilities, interruptions in operations, including those due to external factors, such as natural disasters or terrorism, cannot be ruled out. These can lead to explosions, the release of materials hazardous to health, or accidents in which people, property or the environment are harmed. In addition to systematically monitoring compliance with quality standards aimed at avoiding such stoppages or accidents, LANXESS is also insured against the resulting damage to the extent usual in the industry.

Possible tightening of safety, quality and environmental regulations or standards can lead to additional costs and liability that are beyond the control of LANXESS. Particularly noteworthy in this regard is the planned implementation of the E.U. regulation on the registration, evaluation, authorization and restriction of chemical substances (REACH). In addition to direct costs that could arise due to additional measures necessary to comply with these standards, market structures could change to LANXESS's disadvantage as a result of a shift by suppliers and customers to regions outside Europe.

LANXESS is responsible for numerous sites and landfills in which chemicals have been produced or stored for periods that in some cases exceed 140 years. The possibility cannot be ruled out that pollution occurred during this time that has not been discovered to date. LANXESS is committed to the Responsible Care initiative and actively pursues environmental management. This includes constant monitoring and testing of the soil, groundwater and air. Sufficient provisions have been set up within the scope permitted by law for necessary containment or remediation measures in areas with identified contamination.

LANXESS's product portfolio includes substances that are classified as hazardous to health. In order to prevent possible harm to health, LANXESS systematically tests the properties of its products and draws its customers' attention to the risks associated with their use. We have also arranged for adequate product liability insurance.

Other risks In the course of the spin-off from Bayer, LANXESS acquired structures and circumstances that will in the future be subject to assessment by the tax authorities. Even if LANXESS believes that all circumstances have been reported correctly and in compliance with the law, the possibility cannot be ruled out that the tax authorities may come to a different conclusion in individual cases.

The provision of correct information at the correct time to the correct addressee is one of LANXESS's success factors. LANXESS is dependent on its integrated IT systems to manage this information. In order to ensure constant availability of its data, LANXESS maintains data back-up systems, mirrored databases, anti-virus and access restriction systems, along with other state-of-the-art security and monitoring tools.

LANXESS plans to continue with its restructuring and its realignment toward strategic core businesses. The success of the associated investments and divestments is naturally subject to forecasting risk, which LANXESS counters by carefully and systematically processing key decision-making information. Moreover, industrial actions resulting from disputes about the implementation of restructuring measures or in connection with negotiations concerning future collective bargaining agreements cannot be ruled out.

Overall risk Based on an overall evaluation of risk management information, LANXESS has not identified any sufficiently likely risks or risk combinations that would jeopardize the continued existence of LANXESS.

Subsequent Events The sale of the fibers business to Japan's Asahi Kasei Fibers, transacted in December 2005 and approved by the antitrust authorities in January 2006, was consummated legally and economically as of February 28, 2006.

The December 2005 sale of the paper chemicals business to Finland's Kemira Group was approved by the antitrust authorities in February 2006. The transaction is expected to be consummated as of March 31, 2006.

In January 2006, ongoing supply problems with a supplier of raw materials led the LANXESS Group to temporarily cut butyl rubber production at the plant in Sarnia, Ontario, Canada, and to declare force majeure. Once it had obtained the raw materials needed for production, the LANXESS Group was able to lift this declaration on March 13, 2006.

Outlook

Expected changes in business conditions

Future economic environment In 2006, LANXESS expects the world economy to keep growing well. Once again the developing markets of Asia and of central and eastern Europe will see the fastest growth rates. Prospects are good for a slight economic upswing in Germany and the other western European countries. However, Germany's growth is expected to be well below the international average.

Expected growth in GDP	2006	2007
Change vs. prior year in % (projected)	Gross domestic product	
Americas	3.5	3.5
NAFTA	3.4	3.4
Latin America	4.1	4.1
EMEA	2.6	2.4
Germany	1.6	1.0
Western Europe	2.1	1.9
Central/Eastern Europe	5.4	5.3
Asia-Pacific	4.6	4.5
Japan	2.3	2.2
Greater China	8.9	8.1
India	7.1	6.8
World	**3.5**	**3.3**

One cloud on the business horizon is the possibility that the euro might remain strong against the U.S. dollar. Regional crises also represent a risk to the global economy. Additionally, further increases in the cost of raw materials, especially petrochemical products, could slow economic growth. The price of crude oil can be expected to remain volatile, in part as a consequence of market participants' uncertainty about the reliability of future supplies.

LANXESS's business projections assume an average exchange rate of about US$1.25 to the euro.

Future performance of the chemical industry Buoyed by the ongoing strength of the world economy, the chemical industry is expected to continue expanding in fiscal 2006. LANXESS anticipates global chemical production to grow about 4% (source: VCI). The NAFTA region will make up for the production lost to the hurricanes of 2005, and can be expected to grow further. No significant changes in growth rates are expected in the other regions. Accordingly, Asia, and especially China, will still be the market with the most dynamic growth.

Expected growth in chemical production	2006	2007
Change vs. prior year in % (projected)	Chemical production	
Americas	3.0	3.5
NAFTA	2.5	3.0
Latin America	5.0	4.5
EMEA	3.0	3.0
Germany	2.5	2.0
Western Europe	2.5	2.0
Central/Eastern Europe	5.0	5.0
Asia-Pacific	6.5	6.5
Japan	1.5	2.0
Greater China	11.0	11.0
India	9.0	8.5
World	**4.0**	**4.0**

* rounded to 0.5%

Future evolution of selling markets Growth is expected to remain stable in 2006 in all major selling markets for LANXESS products. The automotive industry in particular is expected to provide positive impetus; there are signs here that the downtrend in the major markets of western Europe and North America is at an end. As in previous years, the electrical industry will show strong growth across all regions. Stronger growth in the tire industry, characterized in part by new capital expenditures, is expected in central and eastern Europe and in Asia.

Expected evolution of major user industries										
Change vs. prior year in % (projected)	Automotive		Construction		Electrical		Tires		Textiles, Apparel, Leather	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
NAFTA	0.5	2.0	1.5	0.5	6.0	5.5	(1.5)	(2.0)	(4.0)	(4.0)
Latin America	4.0	2.5	4.0	3.5	6.0	5.0	4.0	7.0	2.0	2.5
Western Europe	0.0	1.0	2.0	1.5	4.5	4.0	0.5	1.0	(2.5)	(2.5)
Central/Eastern Europe	9.0	9.0	5.5	4.0	8.0	8.0	4.0	5.0	4.0	3.5
Asia-Pacific	6.0	6.5	4.0	4.0	7.5	7.0	5.0	5.5	5.5	5.0
World	**3.0**	**4.0**	**3.0**	**2.5**	**7.0**	**6.5**	**2.0**	**2.5**	**2.0**	**2.0**

* rounded to 0.5%

Future focus of the LANXESS Group The expansion of the world economy and the associated rising demand for LANXESS products will offer business opportunities. The company is well positioned to profit from sustained trends, such as the increasing demand for high-quality products (high-performance tires, for example) in the mobility sector.

For that reason, LANXESS will hold steady to its course, based on its clear-cut four-phase strategy (short-term measures to quickly improve performance, targeted restructuring, portfolio management, acquisitions). The ongoing restructuring of all parts of the company offers opportunities for corporate strategy that LANXESS has already acted upon and will continue to pursue in the future. There are also opportunities inherent in the current consolidation of the chemical industry in Europe. LANXESS is monitoring this process closely and will systematically exploit such opportunities at the appropriate time.

As a global player, LANXESS is already present in every market of relevance to its industry. Nevertheless, the still-growing Asian market will continue to gain importance for LANXESS's business focus. Germany and Europe as a whole will also benefit from increased investment and the recovery in consumer spending, which will create new business opportunities for the chemical industry.

The broad diversification of its product portfolio makes LANXESS independent from any one product or process. In that regard, no product or process innovations are expected in 2006 that would individually have a significant influence on the LANXESS Group's performance. Instead, opportunities in procurement, production and sales will derive from the continuous improvement of a large number of products, processes and structures. LANXESS will systematically pursue this optimization process with an eye to market requirements.

LANXESS's application-oriented research and development activities focus on improving product characteristics and maximizing customer benefits. Examples include improving the thermal stability and flow properties of plastics, developing alternatives to heavy metals in material protection products, and enhancing the biodegradability of ingredients. Product formulations will also be optimized, and new customer-oriented formulations will be developed. Another important aspect is the ongoing review of production methods to reveal any still unused potential for enhancing efficiency and cutting costs.

Expected financial condition LANXESS keeps its capital and financing structures under constant review. At present, no additional measures are planned in the aftermath of the refinancing transactions of 2005, which also safeguard the Group's liquidity for the long term. LANXESS intends to finance planned capital expenditures out of current cash flow and has sufficient lines of credit available to cover any additional need for financial resources.

Capital expenditures for 2006 will be slightly higher than in 2005. LANXESS will have invested about €40 million by 2007 in expanding butyl rubber production capacity in Sarnia, Canada, and Antwerp, Belgium. It will also invest during 2006 and 2007 in expanding capacity in Tarragona, Spain, as part of the restructuring of the Styrenic Resins business unit. Plans also call for expenditures of about €50 million for Saltigo (the former Fine Chemicals business unit) through the end of 2007, with a further optional €50 million through mid-2010.

Expected results of operations In 2006, assuming business conditions remain stable for the chemical industry, LANXESS expects a further year-on-year rise in EBITDA pre exceptionals. With consistent implementation of the "price before volume" strategy, the company assumes that sales in continuing business activities will grow only moderately, but that the EBITDA margin pre exceptionals will rise significantly to between 9 and 10 percent, based on 2004 sales. The improvement in EBITDA margin pre exceptionals will also be supported by savings on function costs as a consequence of the restructuring measures that have been introduced.

In the Performance Rubber segment, the restructuring measures in the Technical Rubber Products business unit particularly will begin to take hold, and will help improve the segment's performance.

As of the second quarter of 2006, the sale of the Fibers business will eliminate a factor that had held back profits in the Engineering Plastics segment. The company also anticipates positive effects from the restructuring of the Styrenic Resins business unit, and from volume growth in the Semi-Crystalline Products business unit in China.

LANXESS expects profits to improve in the Chemical Intermediates segment. While the Basic Chemicals and Inorganic Pigments business units will benefit from the ongoing expansion of the market, repositioning Saltigo as a separate legal entity will improve the earnings contribution of the Fine Chemicals business unit.

The absence of the low-margin Paper business unit and the restructuring measures that have been implemented in the Performance Chemicals segment are expected to improve that segment's profitability.

Summary of Group's projected performance In 2006, LANXESS expects the Group EBITDA margin pre exceptionals to reach 9 to 10 percent, based on 2004 sales. Assuming that economic conditions remain conducive, the company will aim to improve profitability further in 2007, bringing it closer to normal levels for the industry.

Based on the above expectations regarding business performance, the Management Board and the Supervisory Board are examining the possibility of a dividend payment for 2006 to reward the confidence and support of LANXESS stockholders over the medium term.