

To the Stockholders of The Dow Chemical Company:



Bill Stavropoulos
Chairman and CEO

2003 was a year of substantial progress for Dow. In the face of very difficult conditions, including an unprecedented \$2.7 billion increase in feedstock and energy costs, industry overcapacity, and a fragile economy, we increased earnings, improved cash flow and reduced net debt.

You'll recall that in last year's letter to shareholders we pledged that the entire Dow organization would focus on improving our financial results, regardless of how difficult industry conditions might be.

Dow people answered the call. 2003 earnings were \$1.87 per share, including a tax benefit of \$0.49 per share. These results compared with a loss of \$0.37 per share in 2002, which included a net charge of \$0.71 per share for restructuring and other items. Excluding all of the special items, earnings increased from \$0.34 per share in 2002 to \$1.38 per share in 2003.

We also made substantial progress on improving our cash flow. In 2002, free cash flow (cash from operations minus capital expenditures and dividends paid to stockholders) was a negative \$732 million. In 2003, it was a positive \$1.45 billion, a turnaround of \$2.2 billion—well beyond our turnaround target of \$1 billion. We also improved our financial ratios, including a reduction in our net debt to total capital ratio from 56 percent to 50 percent.

Meanwhile, Dow's stock rose 40 percent during the year. As measured by total shareholder return, Dow has outperformed the Standard & Poor's (S&P) 500 and the S&P Chemicals Index both in 2003 and over the past five years.

A disciplined approach

We achieved these results with two simple steps: first, by facing the fact that we could not count on industry conditions changing for the better; and second, by recognizing that the only reliable way to improve our performance was to control the things we can control. To do that, we implemented what we called our 2003 Action Plan:

- ◆ To manage the price of our products without sacrificing volume;
- ◆ To reduce structural costs by \$400 million and capital spending by \$400 million;
- ◆ To shut down under-utilized and non-competitive assets; and
- ◆ To accelerate changes in Dow's portfolio, including the divestiture of non-strategic assets with sales of \$1.5 billion.

We postponed or cancelled all initiatives that were not business critical so that employees could focus on these four things. As a result, we not only reached—but exceeded—our objectives.

In price/volume management, which was probably our most difficult challenge, we increased prices by 14 percent and volume by 4 percent. 2003 was the first year since the last industry peak in 1995 that we improved our profit margins, which is the spread between the price of our products and the cost of our feedstocks. Margins

improved by \$1.3 billion, which although considerable, constitutes just 15 percent of the \$8.9 billion in margin we've lost since 1995. Going forward, there is still plenty of opportunity to continue to improve margins, and we believe we have both the leverage and momentum to do so.

On the cost side, we also exceeded our goal, reducing structural costs by more than \$600 million, including the reduction of more than 3,500 jobs. With a 13 percent reduction in selling, general and administrative expenses, our total operating expense level as a percentage of sales now stands at its lowest level in more than 60 years.

Application of Six Sigma's proven approach to efficiency remains an essential part of the way we operate, helping to deliver productivity gains as well as adding other, sometimes surprising, contributions to our bottom line. Some of the tax benefits we gained in 2003, for example, were the direct result of the work of a dedicated Six Sigma team.

Our 2003 capital expenditures were \$1.1 billion, a reduction of more than \$500 million that exceeded our goal by \$100 million. And we did so without sacrificing the efficiency, safety and environmental performance of our plants.

Working capital management, an important aspect of our cash flow drive, also improved in 2003. We reduced Days Sales in Inventory (DSI) from 64 to 56 days and Days Sales Outstanding (DSO) from 45 to 42 days.

We also shut down non-competitive assets, including two Union Carbide ethylene plants that represented 4 percent of overall ethylene production on the U.S. Gulf Coast. And we closed more than a dozen other facilities across many different businesses in North America, Europe and Latin America.

In the divestiture part of our plan, we sold assets that represented approximately \$225 million in sales. We plan to continue divesting assets in 2004, and probably at a faster pace. In making divestitures, our goal is to make strategic transactions that will improve our company's overall position and competitiveness. And we will not sell or swap anything without realizing its full value.

Weathering high feedstock costs

No company in our industry has been unaffected by the enormous increases in feedstock and energy costs, particularly the high price of natural gas in the United States, a source of both energy and raw materials for our production plants. Having said that, few companies are better able to compete in this high-cost environment than Dow, as our 2003 results demonstrated. We were able to mitigate the effect of these costs due to several reasons.

Conservation—Since the early 1990s, we have added nine new co-generation facilities and improved overall manufacturing efficiency.

Global sourcing—Our global network of manufacturing plants allows us, at any given time, to supply export markets from the lowest cost site.

Feedstock flexibility—Our manufacturing flexibility allows us to optimize our feedstock mix, reducing our exposure to any one feedstock.

Hedging—We use both financial and physical hedging that enable us to reduce the negative effect of feedstock price volatility and to consistently lower our cost-to-serve.

Innovation—We continue to develop alternative sources of energy, including the use of one of the world's largest hydrogen fuel cell installations at one of our Texas plants. This facility will use hydrogen—a Dow byproduct—to generate electricity.

Bottom line improvement across the Company

Although discipline and austerity were crucial to our success in 2003, they were not the only factors contributing to our improved earnings. Virtually all Dow businesses improved their bottom lines. Performance Plastics' earnings increased by 145 percent; and Performance Chemicals, which has been a bulwark of our Company during tough conditions, increased earnings by 5 percent. Earnings in both Plastics and Chemicals also improved substantially. Agricultural Sciences had a banner year, posting record sales and earnings, the result of its strategy of the past few years of increasing productivity, making selective acquisitions and developing successful products in niche markets.

Dow's direct sales in Asia continued to grow and now account for nearly \$4 billion, with an additional \$1.5 billion from non-consolidated joint ventures. And although many people think of Asia as primarily a commodity market, the fact is, about 60 percent of Dow's sales in that region are in Performance businesses.

Sales in China increased by 25 percent from 2002; and today China, with \$1.6 billion in sales, ranks third among the countries Dow serves, behind only the United States and Germany.

Joint ventures are an increasing part of Dow's presence in the marketplace. In 2003, Dow's portion of joint venture earnings was \$322 million, compared with \$40 million in 2002, with particularly strong performances from Dow Corning and EQUATE.

We reached an agreement with Celanese to purchase its acrylates business, establishing Dow as a major player in the downstream applications of what is now a complete, integrated acrylic chain for our company.

Union Carbide's joint venture operations in Kuwait and Malaysia continued to provide an important source of low-cost basic materials in 2003, and we will continue to build our franchise Basics businesses on low-cost foundations like these. In 2003, we announced an agreement with Union Carbide's partners in Kuwait to build an addition that will double existing production capabilities and add new styrene capacity.

Of all of our accomplishments, our environmental, health and safety results are probably what Dow people are most proud of, because they represent our concern for one another and for the communities where we work and live.

We improved our injury and illness rate by 19 percent in 2003, and 70 percent of our plants had no injuries at all. Overall, we have reduced our injury and illness rate by 78 percent from 1994 when we set our ambitious 2005 environmental, health and safety goals. We also posted a 23 percent yearly reduction in leaks, breaks and spills, a 63 percent improvement from 1994.

Additionally, it is noteworthy that in two countries—Brazil and Germany—Dow was recognized as one of the top companies to work for in 2003.

Outlook for 2004 and beyond

The economic expansion now underway appears to be gaining momentum, which could lead to an increase in volume and an improvement in the overall supply/demand balance in 2004. But feedstock costs remain stubbornly high and volatile. If the past three years have proven anything, it is that difficult conditions can have remarkable staying power, and we must prepare ourselves to do well despite them.

So just as we did last year, we will continue to be disciplined in our capital spending; and we will sustain the gains we have made on structural cost reductions. We will focus on our customers and on managing price and volume. We will continue to sell assets that are not a strategic fit, and we will shut down plants that are not competitive. And we will work safely.

New leadership

In November, the Board of Directors named Andrew N. Liveris as president and chief operating officer. Andrew brings a wealth of experience to his new role, including many years working in Dow's Asian operations and as head of Performance Chemicals. He is leading our effort to further improve the Company's productivity and to increase our ability to act more quickly and with greater accountability.

The Board added two new members in 2003: Keith R. McKennon, retired chairman and chief executive officer of PacifiCorp and former Dow director; and Jeff M. Fetting, president and chief operating officer of Whirlpool Corporation. Keith and Jeff bring a wealth of valuable experience to our Board. We also formed the Office of the Chief Executive, a group of senior managers that oversees the Company's strategic priorities and assures their timely implementation.

Driving ahead—one quarter at a time

As I mentioned earlier, 2003 was a year of substantial progress for our Company. The task now before us is to build on our progress and continue to improve our financial performance. Our ultimate objective remains what it has always been: to maximize long-term shareholder value.

So we are approaching 2004 in the same way we approached 2003—taking it one quarter at a time and continuing to improve earnings and increase our financial strength. I am confident that, just as we did in 2003, Dow people will once again rise to the occasion and meet our objectives.



William S. Stavropoulos
Chairman and Chief Executive Officer
February 11, 2004