



## To the Stockholders of The Dow Chemical Company:

Against the mixed backdrop of better economic conditions and higher hydrocarbon costs, 2004 was a year of continued progress for Dow. On the positive side, global economic growth drove a significant increase in demand for both chemicals and plastics, and supply continued to tighten. But on the negative side, Dow's feedstock and energy costs rose by \$3.4 billion to unprecedented highs.

In this environment of countervailing forces, our Company met the objectives we set for the year, both substantially increasing earnings and reducing debt.

Overall 2004 earnings were \$2.93 per share, compared with 2003 results of \$1.87 per share. Excluding special items in both years, earnings were \$2.71 per share versus \$1.39 per share, a 95 percent increase that placed Dow well above the 19 percent growth in earnings estimated for the S&P 500 Index and the 41 percent increase in earnings estimated for the S&P Chemicals Index.

We continued to expand profit margins – the spread between product prices and feedstock costs – by a total of \$2 billion for the year. Over the past two years, we've improved margins by a total of \$3.3 billion, which is roughly one-third of the \$8.9 billion in cumulative margin we lost between the last peak of the industry cycle in 1995 and the industry trough in 2002.

We also further reduced debt, with our net-debt-to-total-capital ratio moving downward to 41 percent at year-end, compared with 50 percent at year-end 2003 and 56 percent in 2002. We are well on our way to achieving the financial flexibility we need to continue to invest in our Company at all stages of the industry cycle.

Meanwhile, Dow stock rose 19 percent during the year, and total shareholder return (stock appreciation plus the dividend) was 23 percent. Here again, Dow outperformed both the S&P 500 Index and the S&P Chemicals Index for the year. In fact, over the past year, three years and ten years, Dow's total shareholder return has outperformed both indices. On a five-year basis, Dow has outperformed the S&P 500 Index and tracked just slightly below the S&P Chemicals Index.

Throughout 2003 and again in 2004, the unpredictability of the price of oil and natural gas – to which our own costs are directly related – reinforced our conviction that our

success would depend on strict adherence to our Action Plan: controlling the things we could control. Given the impact of the things we could *not* control – in particular, the towering \$3.4 billion increase in our feedstock and energy costs (which came on top of the \$2.7 billion increase that occurred in 2003) – this Action Plan played a critical role in Dow's success.

### Action Plan Results

The Action Plan had five objectives for 2004, which are listed here, along with the results of each.

- **Aggressively manage the price of our products without sacrificing volume.** For the year, we increased sales 23 percent to an historic high of \$40 billion, with 17 percent from higher prices and 6 percent from increased volume.
- **Maintain discipline in discretionary spending and capital expenditures in order to improve both labor and capital productivity.** We did both. As a percent of sales, our SARD expenses (selling, administrative, research and development) reached their lowest level ever (6.1 percent). And we held capital expenditures to \$1.3 billion, well below depreciation – even as we improved our environmental, health and safety performance to all-time best levels.
- **Close non-competitive and under-utilized assets.** During the year, we shut down 12 small facilities – in most cases shifting production to more efficient facilities. Over the past two years, we have either announced or completed the shutdown of 33 facilities, with the overall result of utilizing the most efficient plants and lowest-cost feedstocks to supply our customers.
- **Make strategic divestitures.** We sold our Canadian ethylene glycol assets and our PET assets to form two 50/50 joint ventures, MEGlobal and Equipolymers, with PIC, our partner in Kuwait. These transactions generated roughly \$1 billion in cash for Dow and furthered a number of our long-term objectives: shifting our future asset base to a region with low-cost feedstocks; improving our ability to serve our global customers, particularly those in the growth markets of Asia; and reducing our capital intensity. In addition, we established a joint venture in Oman that combines that country's natural

gas resources with Dow's technology and global reach. The Omani venture will include a natural gas/ethane cracker and three polyethylene plants.

- **Streamline the organization.** We reduced our workforce by more than 3,100 positions for annual savings of \$350 million. This reduction, combined with the 3,600 job eliminations in 2003, translates to a 14 percent reduction in our workforce over the past two years. And what's important about 2004 is that we not only reduced headcount, we streamlined the organization so that we can operate under a more efficient business model going forward ... with greater leveraging, fewer top-down initiatives, better use of technology, less bureaucracy and enterprise-wide use of Six Sigma methodology ... all with the aim of creating a more simplified organization that concentrates only on the things that increase margins, improve safety and enhance our corporate governance.

We were once again reminded that a plan is only as good as the people who implement it. The success of the Action Plan, therefore, was testimony to the hard work and dedication of Dow people, who rose to the occasion, as they did in 2003.

### Building for the Future

Our results in 2004 give us some confidence that the global industrial recovery that gained traction in 2004 will continue in 2005. Feedstock and energy costs, however, remain a large question mark, and reasonable prudence persuades us that these higher costs – which accounted for 43 percent of our overall Company costs in 2004 – are now a permanent part of the industry landscape. As you've read on these pages from Bill Stavropoulos over the past two years, we cannot count on lower feedstock costs or better economic conditions for us to be successful. The world remains an uncertain place, both politically and economically. To be successful, we must make things happen on our own.

With that in mind, we recently completed a thorough review of our Company's strategy going forward. While we made no fundamental changes in the strategy, we identified four specific areas where we need to sharpen our focus and accelerate implementation to keep our Company strong during the peaks and troughs of the industry cycle – and all points in between.



Andrew Liveris  
President and Chief Executive Officer

### Strategic Themes

The first is *financial discipline and low-cost-to-serve*. Even as the industry outlook improves, and with it our sales and profit margins, we will resist the impulse to increase overhead and to overbuild. Since 1992, we have increased productivity by more than 8 percent a year, and we will continue to find ways to improve through better work processes, greater precision in resource allocation and Six Sigma, which is fast becoming a part of our collective DNA.

The second is *setting new standards in sustainability*, including not only workplace safety and environmental stewardship, but excellence in corporate governance and corporate responsibility. When all is said and done, any organization's most valuable asset is its reputation and what that means to its investors, employees, customers and communities. With a sterling reputation, anything is achievable; with a bad reputation, nothing is possible.

The third theme is *building a culture around people and performance*, including leadership development, performance management and diversity. This means attracting and retaining the most talented people from throughout the world, developing them, and rewarding them for the results they achieve. This may sound simple in theory, but in practice, especially in a large organization like ours, it is difficult. Given the fact that the quality of the workforce is the one true lasting source of competitive advantage, this theme warrants the full participation of every Dow senior executive, starting with me.

The fourth theme is *investing for strategic growth*, and in this area we have made significant progress during 2004, some of it well-publicized, such as our commitments in Kuwait, Oman and China, and some of it less obvious. An example of the latter is portfolio management, where we have characterized all of our profit centers by their investment potential: from businesses that we will grow at above-industry levels ... to businesses that we will run for cash ... to those that we must rehabilitate or divest. The most important part of portfolio management is not the characterization itself, but the use of comprehensive criteria to allocate resources appropriately. A run-for-cash business will receive fewer resources than a grow-above-industry

business, but the two will share one important measurement: they (and the people responsible for them) must contribute to Dow's profitability.

Investing for strategic growth also means selecting strategic customers – those with whom Dow can develop strong relationships for our mutual profitability. A large part of that relationship involves new products and new technology developed for specific markets and specific customers. Toward that end, we have reorganized our commercial, R&D and geographic organizations so that, collaboratively, we can offer greater value to our customers – and pass on that value to our investors. Every Dow senior manager is required to participate in this effort. Meanwhile, we are placing new emphasis on R&D – not by spending more money, but by improving R&D productivity through greater market and customer knowledge – and greater accountability for results.

In addition, we have targeted areas of growth by country and region. Going forward, we will ratchet up our focus on China, Southeast Asia, Eastern Europe, the Middle East, India, Russia and Brazil – not only to increase sales and profits, but to secure low-cost sources of feedstocks and energy. That does not mean we are abandoning our long-established markets in North America, Japan and Europe. Our intent is to build upon our ongoing success in those regions, just as we did 60 years ago when we built assets on the U.S. Gulf Coast to capture low-cost manufacturing, 50 years ago when we entered Japan with our first overseas joint venture and 40 years ago when we expanded in Europe to achieve stronger growth.

As we pursue geographic growth, we will do so using various business models, including joint ventures, where we have a proven track record of success and which last year accounted for about 25 percent of our earnings. Joint ventures offer many advantages: lower capital intensity, access to regional expertise and advantaged feedstocks; the ability to leverage our technology and know-how; and accelerated penetration in high-growth markets.

We believe that our strategy is sound and we are on the right track. But we are mindful that the best strategy in the world is only as good as how well it is implemented. So you can expect an intense focus on implementation and accountability in 2005 and beyond.

### Leadership

This is my first letter to you as CEO of Dow. I am both thrilled and humbled at the opportunity to lead this great Company and, especially, its dedicated and talented people. I think I speak for all Dow stakeholders – particularly investors and employees – in thanking Bill Stavropoulos (who continues as chairman of the Board of Directors) for leading this Company over the past two years. Under Bill's leadership, our Company has improved its results across the board, creating a strong foundation for future growth and profitability.

Now the task before us is to build on that strong foundation. Given the current outlook for higher demand and tightening supply in 2005, we will work to further restore margins going forward – both in our Basics businesses and in our Performance businesses.

We are approaching 2005 the same way we approached 2003 and 2004, taking it one quarter at a time and maintaining our discipline and focus on results.

By doing so, and by building on our strengths – our global reach, our diverse customer base and end-use markets, our ability to remain the low-cost producer (to name just a few) – we have it in our power to take Dow to an even higher level of performance, so that we continue to be both a great company and a great investment.

Andrew Liveris  
President and Chief Executive Officer  
February 9, 2005