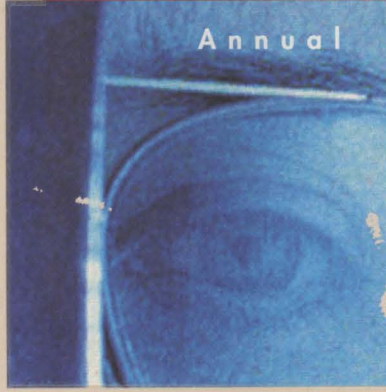



PENWEST



1994



Annual



Report

PENWEST develops, manufactures and markets specialty carbohydrate-based chemicals for the paper and textile industries. The Company also produces and markets specialty potato starch and dextrose-based food ingredients, agricultural nutrition supplements and pharmaceutical excipients (the inactive ingredients in tablets and capsules). • PENWEST's core competence is carbohydrate chemistry. This basic chemistry is applied to four carbohydrate groups through six distinct technologies. • The Company's operating units include: • Penford Products Co. based in Cedar Rapids, Iowa, serving the paper and textile industries. • Penwest Pharmaceuticals Group, based in Patterson, New York, serving the pharmaceutical, vitamin and nutritional industries. • And Penwest Foods Co. of Englewood, Colorado, serving food producers throughout North America.

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Selected Financial Data

PENWEST

THOUSANDS OF DOLLARS, EXCEPT PER SHARE DATA
YEAR ENDED AUGUST 31

1 9 9 4

1 9 9 3

1 9 9 2⁽¹⁾

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1 9 9 0

OPERATING DATA:

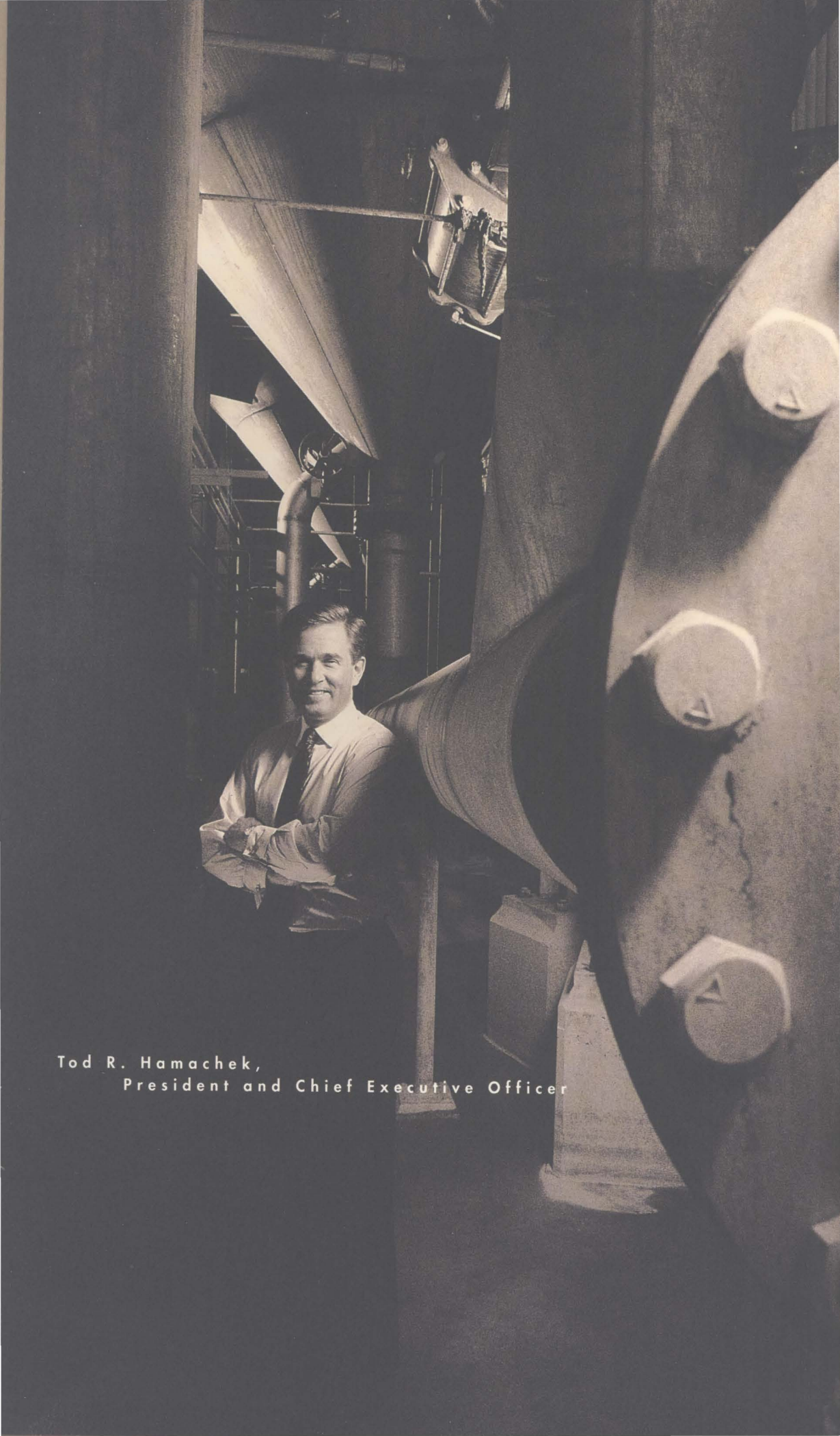
Net sales	\$158,787	\$135,517	\$125,952	\$110,910	\$ 91,998
Income from operations	6,120	6,315	7,505	8,813	7,950
Earnings per share	\$ 0.86	\$ 0.88	\$ 1.01	\$ 1.17	\$ 1.06
Dividends declared per share	\$ 0.20	\$ 0.20	\$ 0.15		
Average shares outstanding	7,110,953	7,175,855	7,461,439	7,558,910	7,514,637

BALANCE SHEET DATA:

Cash (overdrafts) and short-term investment	\$ (635)	\$ 11,935	\$ 18,408	\$ 28,815	\$ 30,993
Long-term debt	42,897	46,998	30,877	31,550	23,050
Shareholders' equity	67,165	62,490	61,447	60,081	51,103
Capital expenditures	13,259	31,266	19,450	14,006	13,537
Current assets	42,075	41,543	44,117	51,110	47,671
Current liabilities	20,713	20,082	15,282	16,698	15,419
Working capital	21,362	21,461	28,835	34,412	32,252
Total assets	164,357	157,966	130,641	120,488	101,784
Total liabilities	97,192	95,476	69,194	60,407	50,681

1 During fiscal year 1992, the Company adopted FASB Statement No. 106 "Employer's Accounting for Postretirement Benefits Other Than Pensions." This change increased the annual pre-tax postretirement benefit expense by \$800,000 and decreased equity by \$5,900,000 (net of tax). During fiscal year 1992, the Company adopted FASB Statement No. 109 "Accounting for Income Taxes." This change resulted in a reduction of deferred taxes and an increase in equity of \$1,560,000.

2 During fiscal year 1991, the Company purchased the net assets of Edward Mendell Co., Inc. for \$8,090,000. Resulting operations for six months have been included in the consolidated financial data.



Tod R. Hamachek,
President and Chief Executive Officer

In 1994 PENWEST's strategic focus of the past four years began to bear fruit. Investment at PENWEST has been driven by our strategic vision: to become the preeminent global marketer of carbohydrate-based ingredients through innovative technologies in attractive markets.

To realize that vision we have put in place important building blocks. First, we completely integrated our R&D function, sharing information across divisions, tying research directly to the marketplace and making R&D expenditure decisions in accordance with our strategic plan. This is the foundation of our future. In addition, we made heavy investments in our facilities to provide for future growth. In each of our businesses, we are beginning to achieve realizable returns on our strategic, R&D, and manufacturing investments.

Results Although late in the fiscal year we saw signs of business improvement, the bottom-line suffered from an unusually poor second quarter, largely the result of a severe decline in paper shipments by our customers. We also had some isolated problems in the second half of the fiscal year that we are resolving during the first quarter of the new fiscal year. For example, our leased rail car fleet proved inadequate based on the new business we were able to convert, but we acted quickly and now are beginning to ship product more cost-effectively.

Detailed information about each of our operating divisions follows in the body of the report, but I would like to review certain highlights of the past year, particularly those that illustrate our strategic initiatives and their positive results.

Operating Highlights Penford Products Co., PENWEST's core business, continued to lead the industry in providing speciality chemical starch products to papermakers and textile manufacturers. Penford's advances this year illustrate the results we are seeing from our dual long-term investments in R&D and capacity.

As of year end, Penford was operating near capacity. Throughout the worst paper industry recession in years, Penford continued to grow volumes at double digit rates because of its focus on high value-added products and its superior technical service. We continue to convert unmodified starch customers to our specialty ethylated starches, Penford Gums®.

Penford Gums enhance our customers' productivity and product quality. In the near term, Penford will benefit from the combined forces of an upturn in the paper industry, tight capacity in sizing and high-end chemically modified starch coatings and stronger high-end margins.

Penford should also benefit in the coming year from the European market, where the paper industry has rebounded even faster than North America. As European manufacturers reduce exports to meet rising domestic demand, North American supply and pricing should tighten, both of which would benefit Penford.

The development of our innovative patented line of starch copolymers grew directly from our belief that research and development should be a customer service. These products continue to gain industry acceptance, providing particular qualities and characteristics that our customers require. We have had especially strong market acceptance of Pensize™, a size binder that enables papermakers to easily apply pigments at significantly higher levels than previously attainable. The benefit to papermakers is that they can maintain and/or improve opacity and brightness while decreasing the wood fiber content and therefore reducing the cost of the overall sheet. We are working on an agreement for the sale of a line extension of our starch copolymers in Europe, where this new application of PENWEST technology is ideally suited to a variety of advanced paper sizing processes currently in use.

Further, international markets are becoming increasingly important for Penford. We believe we can grow sales while keeping appropriate discipline on the bottom line by investing prudently overseas. Europe and Asia are already a factor for us, and we aim to be in most major and developing paper making regions within five years.

Penwest Foods Penwest Foods, our food ingredients business, continued to lose money in fiscal 1994. We believe the group should show improvement during fiscal year 1995.

The investment in the food division has been carefully monitored according to both our strategic plan and financial criteria. We are satisfied that its expertise in product application development and its capital investments will pay off.

The food division cannot disclose details of some of its most encouraging breakthrough contracts due to customer confidentiality agreements. We assure you, however, that the division has hit the mark with major food processors and important products specifically developed to serve particular customer needs.

Potato starch products, the cornerstone for Penwest Foods' creation of a food ingredients business, are selling well. We are in the process of tripling the size of our manufacturing facility in Richland, Washington, which will ultimately help us lower unit costs and increase both output and the variety of products that we can manufacture.

Our agricultural nutrition products, particularly our mushroom nutrients, peat product and compost biodegrader are now selling throughout the western hemisphere and in Europe.

Although financial results at Penwest Foods have been disappointing, overall, we are pleased with the progress made in fiscal 1994. They successfully landed several major new customers during the year and made solid progress toward securing significant sales volume with other major food processors.

Penwest Pharmaceuticals Group During 1994 we restructured Mendell and **TIMERx™**, creating the Penwest Pharmaceuticals Group as the umbrella organization. This new structure makes sound business sense. While both businesses share the same core customer base, each services a distinct segment of the pharmaceutical industry.

TIMERx, our patented controlled release technology, is benefiting from important trends in the pharmaceutical industry. Specifically, controlled release formulations, when applied to drugs coming off patent, could in

some cases, permit a new patent to be issued. Being first in the marketplace with a controlled release formulation also permits a pharmaceutical company to establish a market share beachhead, and then to retain a substantial share even as competition enters. As the industry consolidates and competition intensifies, these factors become increasingly important.

More generally, we are also beginning to see the pharmaceutical industry looking outside for expert help in formulations. The trend in the industry is to form more alliances in research and development, including formulation expertise. We intend to be increasingly proactive in tapping this trend – making pharmaceutical companies more aware of our expertise and willingness to work together.

Jack Talley, who came to PENWEST from the pharmaceutical industry to run the new group, fully understands these industry dynamics. We are very pleased with his progress and with his plans to capitalize on emerging trends in this highly competitive environment.

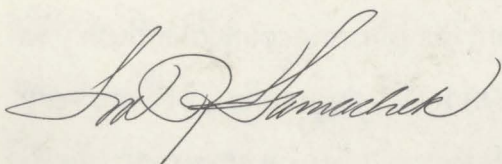
Mendell ended the year with increased microcrystalline cellulose, Emcocel® sales. The company attracted several major new customers, and we expect a contribution from our new microcrystalline cellulose plant in fiscal 1995. Mendell's progress is directly attributable to three factors: product quality, functionality and its ability to consistently broaden its Emcocel product line.

Each of the businesses illustrates the efficacy of our R&D effort. Driven by our underlying strategic planning, all research and development is strictly focused on key objectives – there is no free ranging R&D at PENWEST. At the same time, we have tightly controlled capital expenditures, so that our capacity is entirely appropriate for our current and anticipated level of activity in each area.

Efficiency Improvements We have several projects underway designed to improve efficiency and lower costs. These efforts have produced quantifiable results. In our procurement process alone for example, our changes

returned approximately \$600,000 on a \$100,000 investment. We recently completed a study of our manufacturing processes at Penford and hope to achieve significant returns on this project in the coming year. Perhaps most important, efforts like this one, throughout the Company, reinforce our commitment to the respective goals of our customers, our employees and our shareholders.

PENWEST possesses unique assets and resources with the potential to deliver significant value over time. We are focused singlemindedly on managing those assets as productively and efficiently as possible, growing the value of the corporation for all of its shareholders.

A handwritten signature in dark ink, reading "Tod R. Hamachek". The signature is fluid and cursive, with a large, stylized initial "T" and "H".

Tod R. Hamachek
President and
Chief Executive Officer

November 11, 1994

S t r a t e g i e s
I n v e s t m e n t s

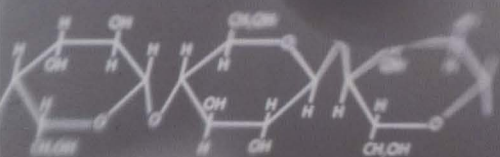
a n d R e s u l t s

Linking PENWEST's strategic vision,
research planning, and carbohydrate chemistry expertise
directly to the marketplace,

3RD GENERATION R&D

assures that R&D investments generate returns by
creating products directly responsive to customer needs.





**PENWEST has fully integrated its R&D portfolio
into its strategic objectives to optimally deploy its**

INTELLECTUAL CAPITAL

**and assure continuous development of
innovative technologies that advance the company's
productivity and growth.**

Targeting attractive markets in each strategic business segment, PENWEST is rapidly developing manufacturing and distribution capabilities with

GLOBAL REACH

to assure that PENWEST capitalizes on growth opportunities, with appropriate financial disciplines, in markets throughout the world.





PENWEST's commitment to quality and customer responsiveness extends beyond product development and into direct interaction with every customer through exceptional

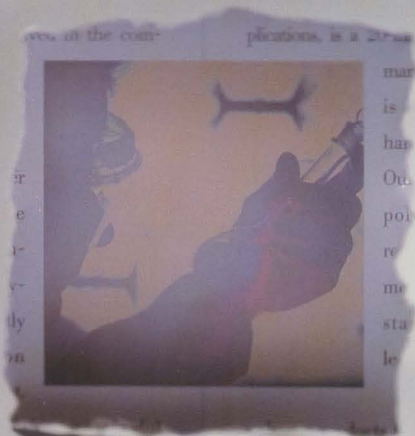
TECHNICAL SERVICE

that enhances and reinforces the long-term customer relationships that assure PENWEST's continuing growth and development.

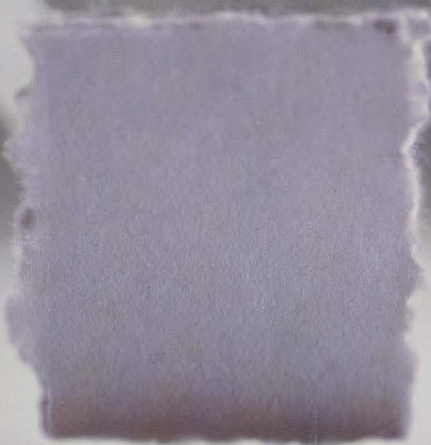
By harnessing its knowledge of key strategic markets,
together with its technical expertise, PENWEST
invented its remarkable line of

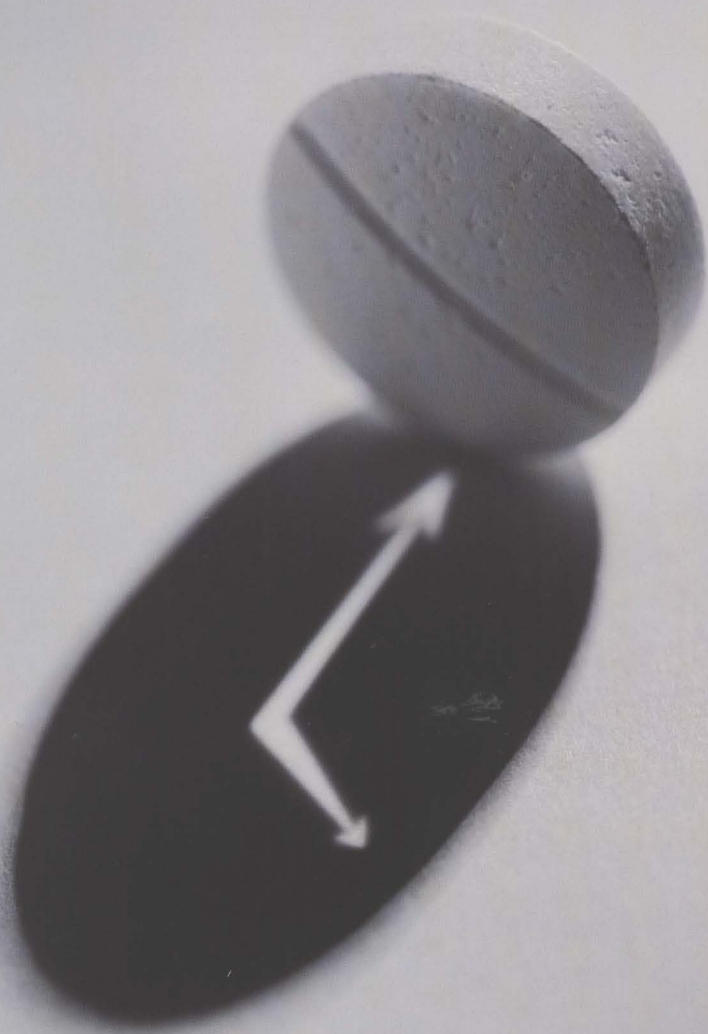
STARCH COPOLYMERS

that is finding increasing acceptance in the marketplace
among paper and textile manufacturers worldwide.



starches from reinforce
Here the pulp is little
water. Starches are ad
ternal strength. After
passes over a series of
is on the size press that
nt of starch — and it is i
its





**Capitalizing on developing trends in the
pharmaceutical industry, PENWEST's pharmaceutical
group is aggressively developing**

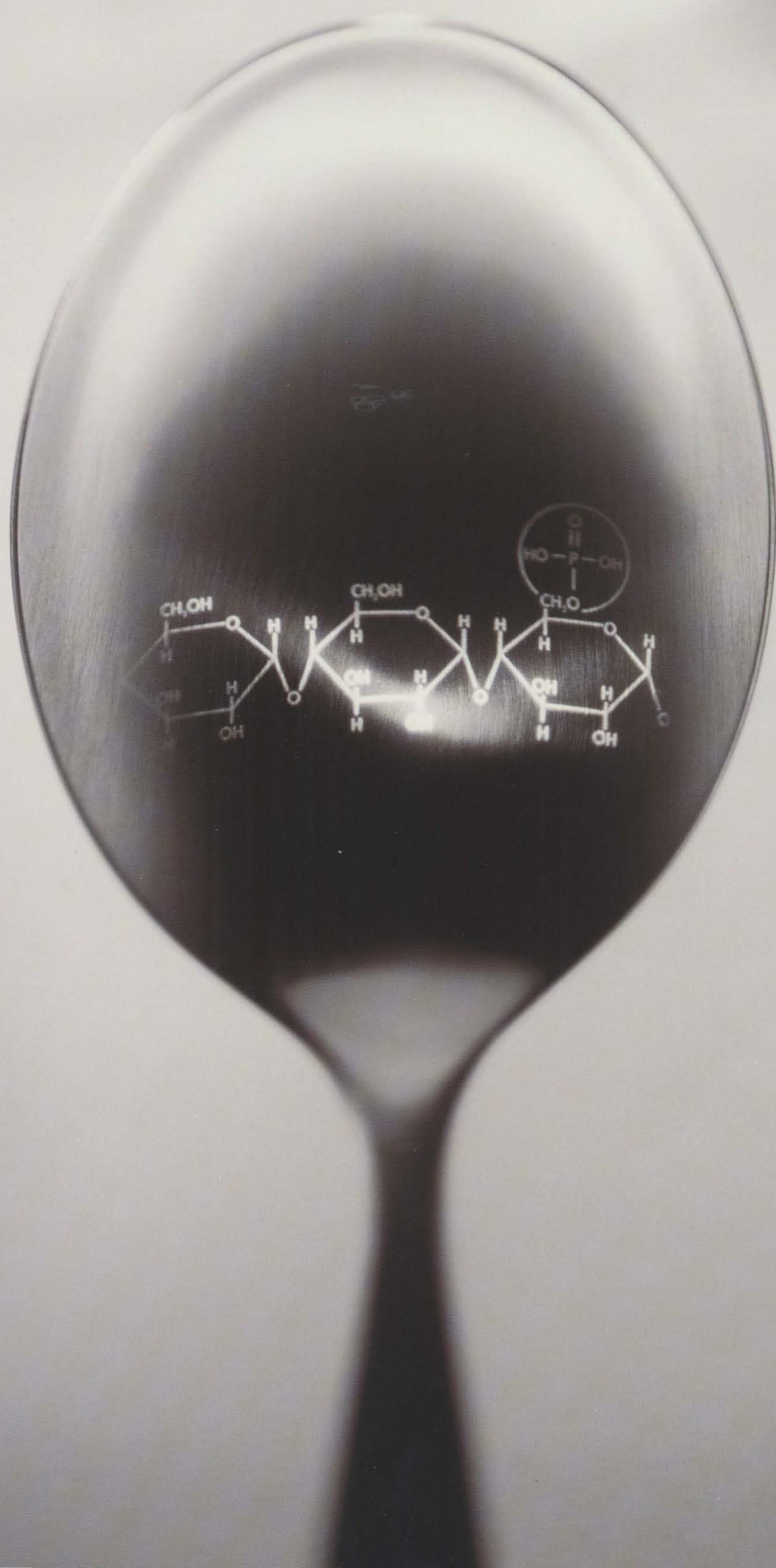
TIMER_x


**controlled release technology which appeals
directly to the competitive and cost requirements
of pharmaceutical manufacturers.**

Building on its strategic foundation
of complex carbohydrate chemistry, the latest weapon
in PENWEST's arsenal is food grade

POTATO STARCH

with product extensions developing quickly and finding
acceptance among major food producers.





O p e r a t i o n s
R e v i e w 1 9 9 4

Penford Products Co.

Penford Products Co. is the leading supplier of specialty chemical starches to the paper and textile industries. Penford's products help form a high-quality sheet at the wet end of paper production. The division's Penford Gums are used extensively in coatings and on the size press, in a process that determines how much ink a sheet of printing paper will accept. ♦ All Penford products add value to printing papers and textiles — they bring higher levels of quality to the finished product and manufacturing efficiencies to the production process. ♦ The products are found in three basic paper types: uncoated freesheet papers like those in fine books and high quality office paper, coated free sheet, like the full-color pages of this annual report, and coated groundwood of the type used in mail-order catalogues.

Penford Products Co. had a strong year, with record customer demand and double-digit growth in volume. The major capacity expansions brought on line in recent years brought returns in fiscal 1994 as we increased volume and market share in each of the three market segments we serve.

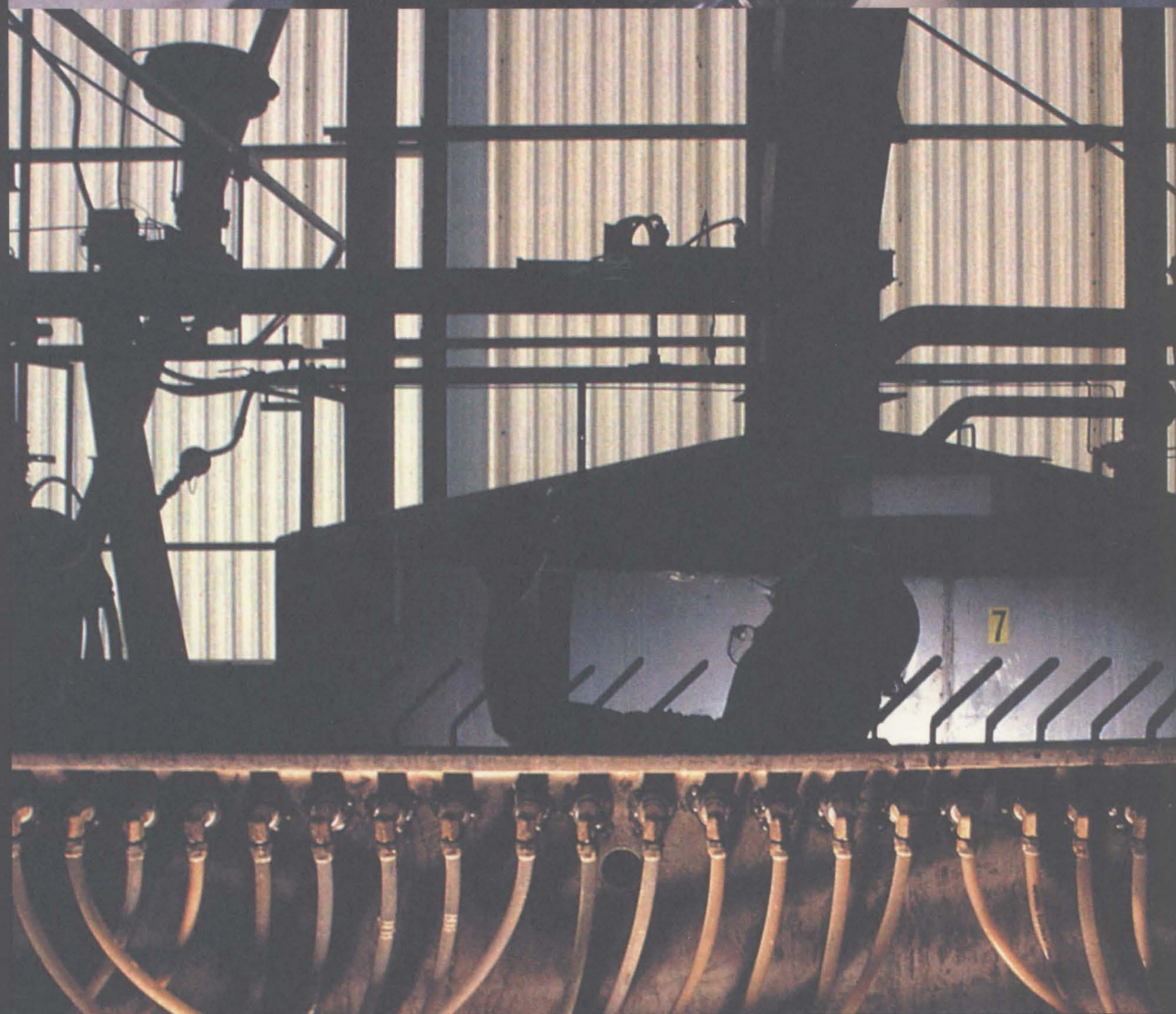
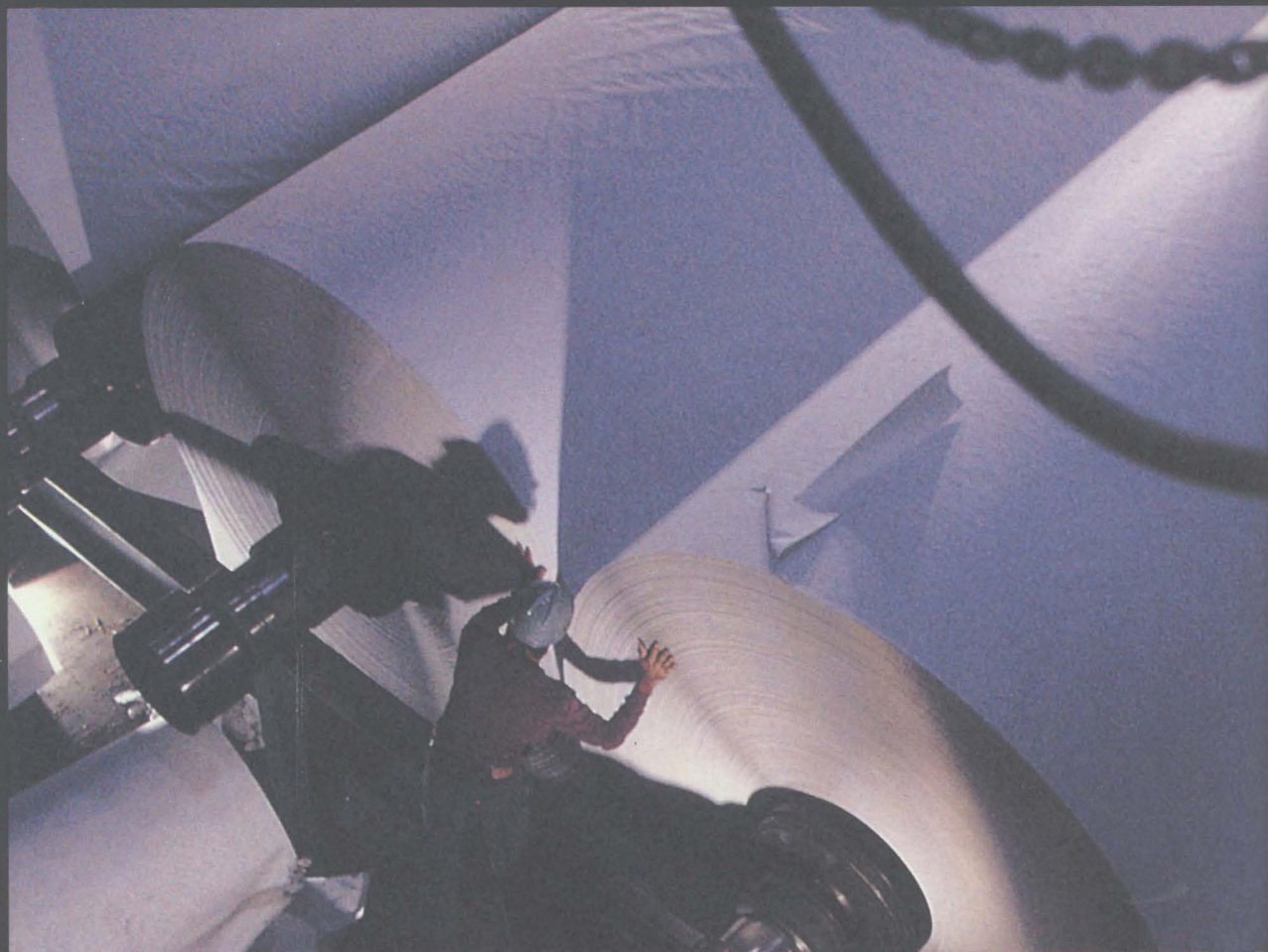
Penford's modified starch lines have grown at four to five times the growth rate of the paper industry generally. In the past decade we invested \$84 million, expanding and filling capacity three times.

The underlying forces behind Penford's growth remain essentially unchanged. Mills continue to convert from acid- to alkaline-based papers. In fact, during the fourth quarter one of those conversions was responsible for the largest single order in our Company's history.

The alkaline process, which requires more specialty starches, reduces the overall cost of papermaking while enhancing paper quality.

These conversions will continue. While the 4.0 million ton coated free sheet segment of the market is almost completely converted, there remains a 3.3 million ton conversion potential from the uncoated free sheet market. Coated groundwood, a 4.3 million ton market, has just begun to convert.

Another source of growth is the conversion by mills from commodity-type pearl starches to value-added modified starches. Commodity-type pearl starches have a 40 percent share of a 2.8 billion pound market. Penford expects, in time, to convert a significant portion of that market to Penford Gums. These conversions are driven by increasing standards of quality in the paper industry. Penford Gums — our top-of-the-line specialty starch products — offer papermakers performance characteristics that can



be quantified. They add strength to paper, reduce downtime for papermakers, improve print quality and reduce the need for other chemicals. They run cleaner on a size press and help distribute moisture uniformly on the sheet. They also help the drying process and can reduce the papermakers' use of expensive virgin fiber.

These conversions fueled a double-digit growth rate at Penford during the past five years as the paper industry struggled with recession, on the one hand, and growing overcapacity, on the other. In fiscal 1994, Penford Gum volumes were up 14 percent for the full year, while volume in the three paper segments served by Penford ranged from a slight decline to a 4.3 percent gain. Entering fiscal 1995, we see some signs of a recovery in paper industry operating rates, and volumes in some segments are up.

High-quality printing paper at a major Ohio mill is coated with Penford Gums after the papermaking process. Specialty chemical starch products from Penford, applied at three major stages of paper production, make paper stronger and better suited for printing with less fiber and more filler. Below, recent capacity expansion at Penford Products Co. included additional steep tanks, the first stage in starch production. Hoses in the foreground are sample lines for monitoring quality control.

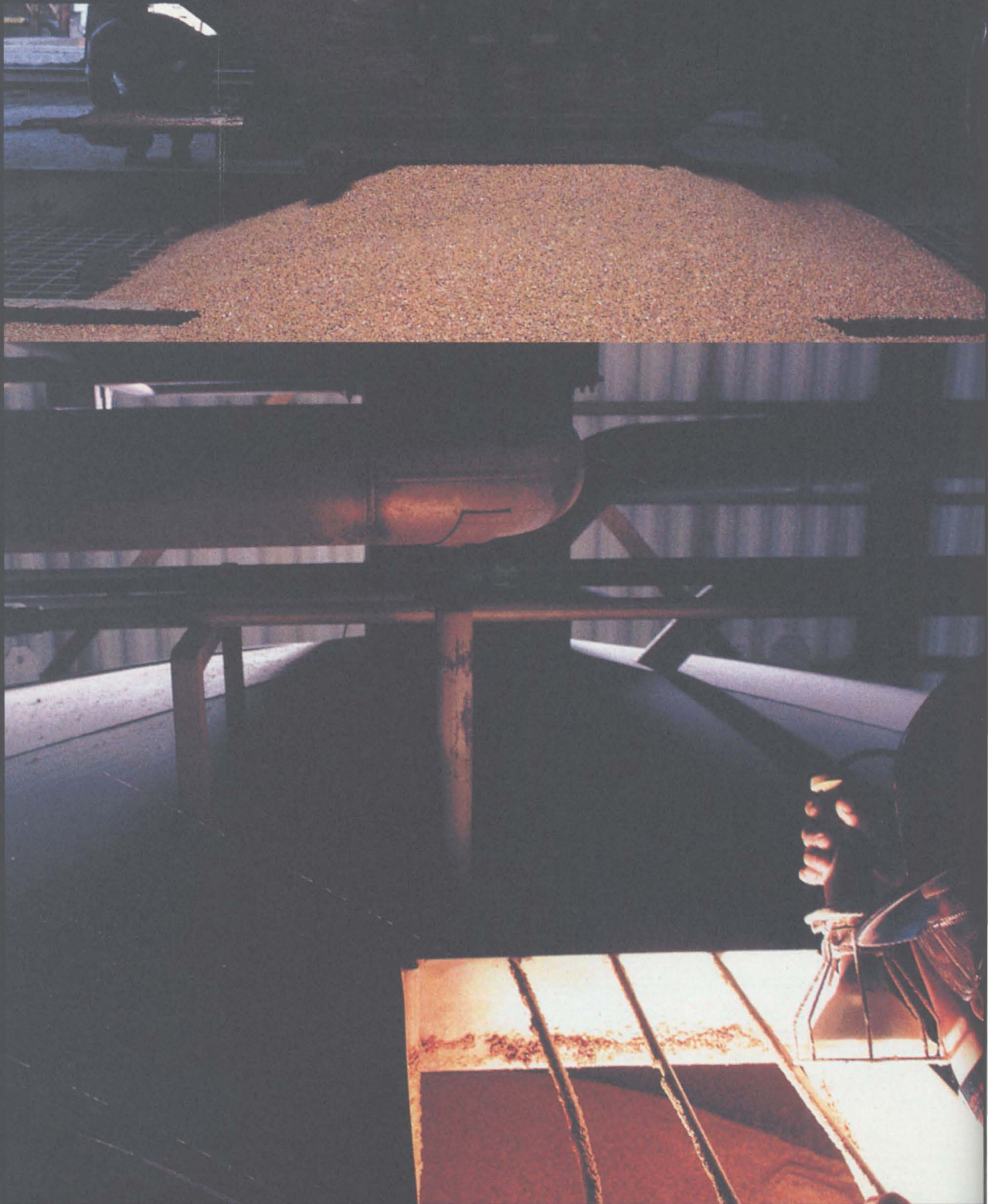
Building Partnerships and Market Share As the paper industry continues to focus on cost, productivity and quality, Penford will become a more important partner to its customers. New, world-class paper machines continue to come on stream, creating broader markets for sophisticated starches that create stronger film and higher surface quality. The proliferation of personal computers fuels rising demand for ink jet printing papers that absorb just the right amount of ink for a sharp, clear image. Penford, through its Penford Gums, has a strong leadership position in coating and sizing starches, with twice the share of its nearest competitor.

While the continuing sales success of Penford Gums for sizing and coating applications is the most important achievement, Penford is also scoring important share gains in the paper forming, or the wet end of paper production. Of the three starch types used in the wet end process, Penford makes two: cationic corn starches manufactured at our plant in Cedar Rapids, and cationic potato starches produced at our plant in Idaho Falls.

B

1656 CU FT

CLEAN INSIDE GROOVES AND TOP
OF SLIDES BEFORE CLOSING



By year's end we were operating at near capacity at the Idaho Falls plant. Despite brisk competition from domestic and European producers, Penford's share of the starch market in paper forming rose from 9 percent last year to 10.5 percent at the end of fiscal 1994.

Starch Copolymer Sales The starch copolymer family of products continues to find acceptance, not only in North America but, increasingly, in Europe. The starch copolymer Pensize is used with metering film applicators on high speed size presses for improving surface characteristics. European papermakers are experimenting with Pensize as a component in "triple coating," a process that improves the surface quality of coated paper.

About 21 million bushels of corn pass through Penford's Cedar Rapids plant each year. Much of it flows through this grate under a rail car with a 3,400-bushel payload. Penford is one of the major users of raw corn in eastern Iowa, with sharply higher production in each year of the past decade. Below, at the end of the steep cycle, water is drained from the now-malleable corn kernels. The corn is pumped through pipes to attrition mills where its basic components — corn oil, corn gluten feed, corn gluten meal and starch — are separated.

Penford also has commercial accounts for Penflex[®], which replaces polyvinyl alcohol in sizing textiles. Penflex offers performance advantages and is more cost effective than the chemicals it replaces.

Offshore Markets, Expanded R&D Penford's international business is thriving, with sales to customers in Asia and increasing orders from papermakers in Mexico and Europe. In recognition of increasing business opportunities offshore, Penford is creating a distinct marketing group for international sales.

The division expanded its research and development portfolio from 14 to 28 projects, using the PENWEST third generation R&D discipline — which links research projects to real-world customer needs and the division's strategic plan.

For fiscal 1995, Penford is focused on increasing sales and market share of Penford Gums, increasing market penetration of its family of starch copolymers, developing international business and becoming more productive at home.

Penwest
Pharmaceuticals Group

The Penwest Pharmaceuticals Group joins the resources of Mendell, one of the world's leading producers and distributors of pharmaceutical excipients, and TIMERx Technologies, a developer of controlled release systems for orally administered prescription and over-the-counter drugs.

◇ Mendell offers the industry's widest array of excipient products — the inactive ingredients in tablet and capsule formulations, over-the-counter drugs, and vitamins. Mendell does business worldwide but its primary markets are in North America and Europe. ◇ TIMERx Technologies pioneered TIMERx, a patented, innovative controlled release technology. This business unit has the research and development capability to formulate and test its products in combination with active pharmaceutical substances. Controlled release technology is of special interest to manufacturers of new drugs as well as to those whose products will lose patent protection within the next few years or are already generically available.

In the first quarter of the new fiscal year, the Company formed the Penwest Pharmaceuticals Group. This restructured organization recognizes that the pharmaceutical industry is in a state of transition worldwide. Major consolidations and restructurings are changing the shape and direction of many industry leaders. These changes, in turn, will lead to opportunities for the Penwest Pharmaceuticals Group.

The Penwest Pharmaceuticals Group establishes the infrastructure for the long-term addition of other value-creating companies through merger, alliance or acquisition. Through such partnerships, the group intends to develop a formulation service capability to help customers optimally blend active ingredients with excipients.

A Good Year for Mendell Mendell recorded a good, profitable year at a time when the pharmaceutical industry it serves was in transition and turmoil. The gains at Mendell were led by a 25 percent volume increase in Emcocel, the microcrystalline cellulose product now manufactured at the new plant in Cedar Rapids as well as at the existing facility in Nastola, Finland. Volume overall was up 10 percent, about twice the growth rate of the pharmaceutical industry as a whole.

The new plant, which operated for most of the fiscal year, now supplies all North American customers. Volume growth from the Cedar Rapids facility has been consistent with internal projections.

The plant and its product have been very well received by domestic and international customers, many of whom have visited the site and conducted quality control audits. The plant passed all customer audits. In addition to

a very good sales year for Emcocel, Mendell recorded strong continuing demand for other key product lines.

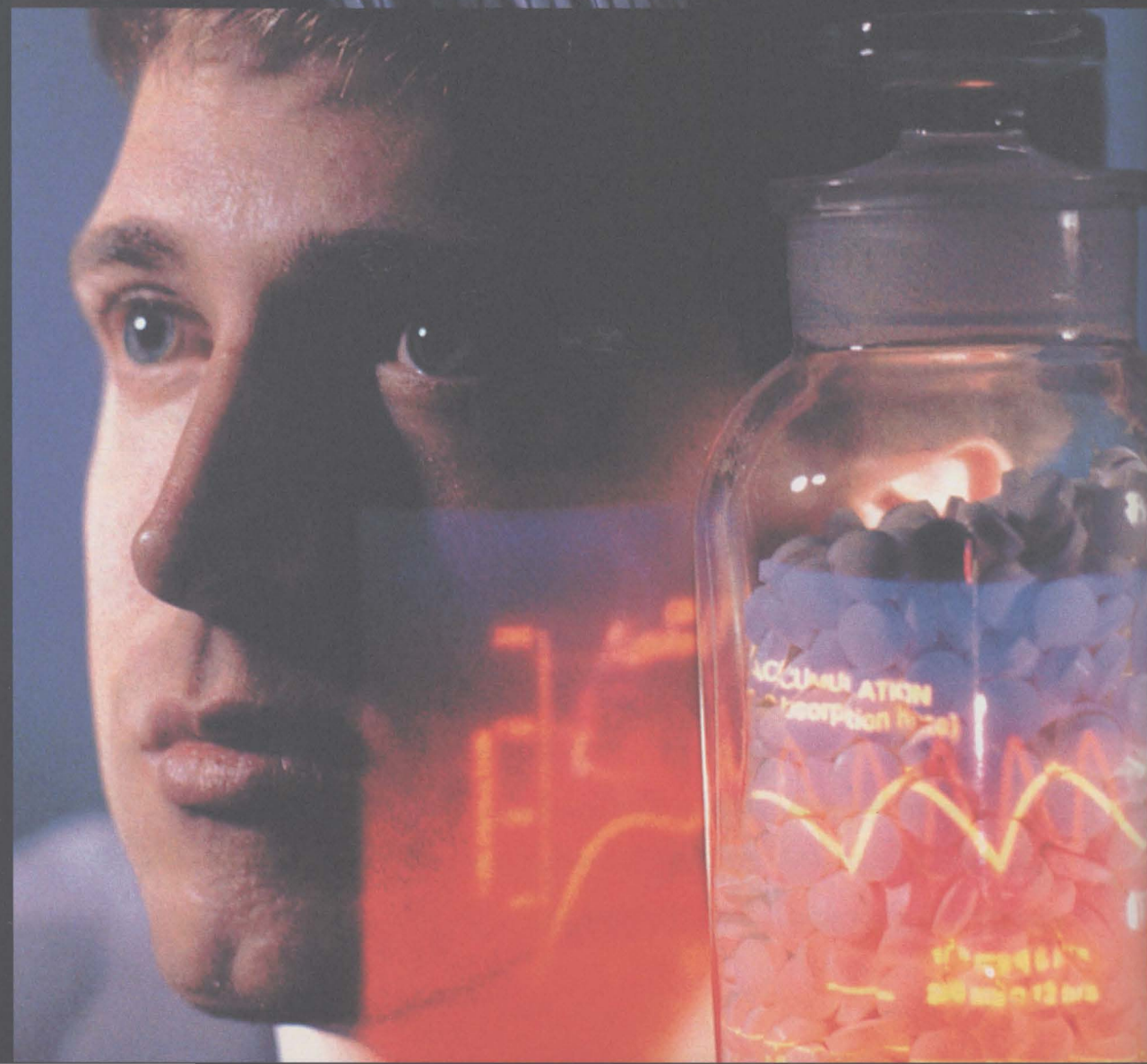
Turning Up the Heat on R&D The fiscal year marked the first full year that Mendell's R&D capability was managed under the PENWEST third generation model. One result of that customer-focused process is a new, patentable excipient with very broad application in a major segment of the pharmaceutical industry.

The new product was one of a number of R&D projects underway during the year. All these projects are excipient-related. They include new products and variations of existing products along with process improvements. Mendell's greater emphasis on research and development comes at a time when industry consolidation and restructuring is placing increased pressure on the internal R&D programs of Mendell's customers.

Industry Challenges In addition to massive mergers and acquisitions, the industry faces external pressure from regulators about how it prices, distributes and promotes products. Large managed care providers are presenting new competitive challenges. These industry-wide changes affect pharmaceutical companies and their suppliers.

Mendell recognizes the challenges presented by changes in the industry, but also sees opportunities. As the organization adds to its knowledge base about excipients and how they interface with active ingredients, Mendell becomes a more valuable resource to its customers. With its broad and expanding array of products, and a worldwide distribution capability, Mendell is well positioned to offer worldwide contracts that assure product consistency and on-time delivery. And with a strong and improving service capability, Mendell can continue to add value to its business relationships.

Three Objectives Mendell identifies three objectives that will govern its near-term planning. First, the division will grow sales, and especially



Emcocel sales, at a rate sufficient to generate a forecasted level of operating income to PENWEST. Second, Mendell will remain dedicated to developing innovative new product and process improvements. Finally, Mendell will reexamine its approach to customer service, challenging all employees at every level to contribute positively to unsurpassed customer relations.

TIMERx Technologies TIMERx Technologies added depth to its organization, broadened its vision and completed an important new development contract with a major ethical pharmaceutical manufacturer.

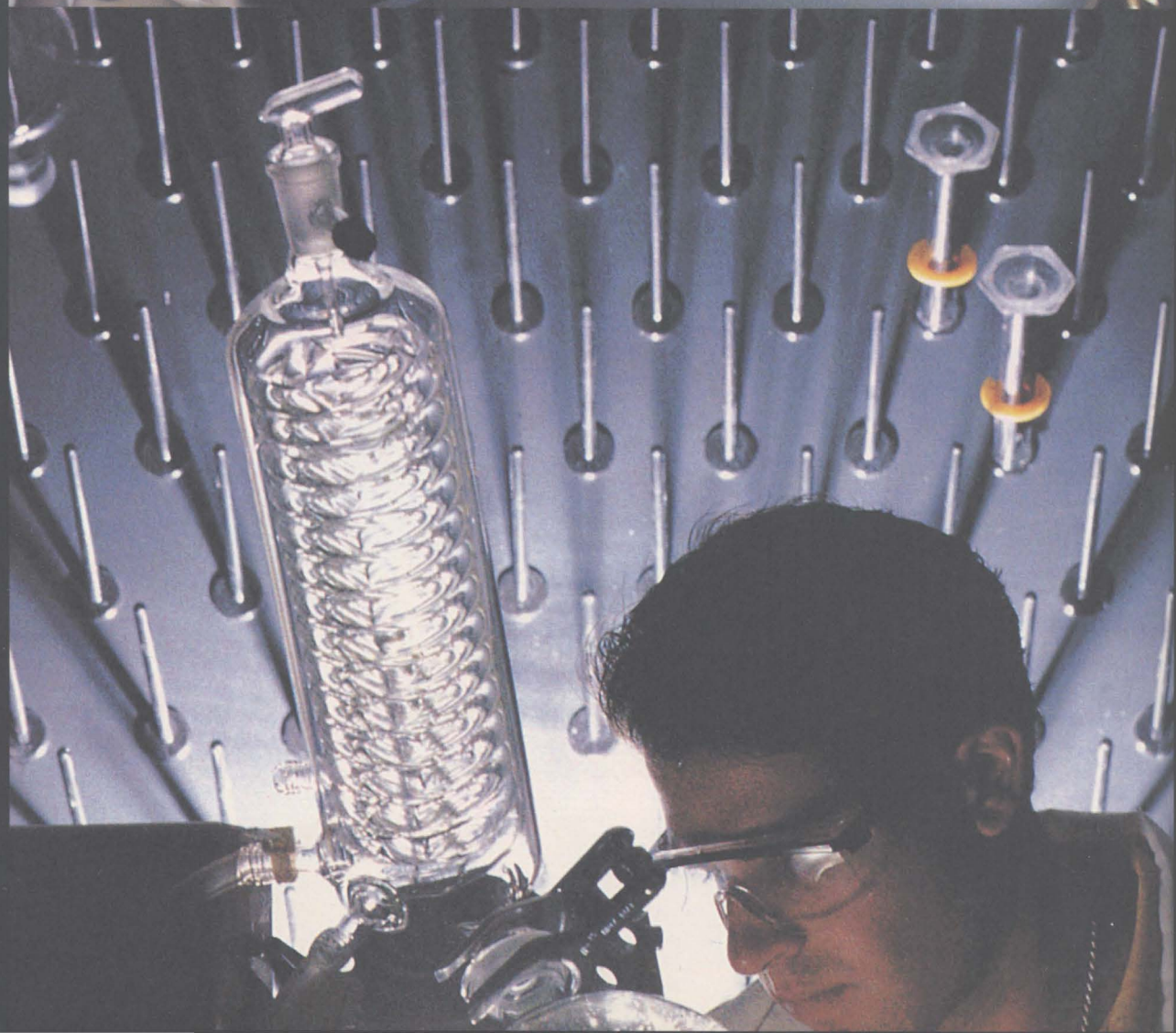
Clinical trials continue with two other customers who are testing TIMERx controlled release technology in combination with their active drugs.

Bob E. Sherwood, Ph.D., vice president of research and development at Mendell stands beside a pilot scale spray dryer at the Company's Patterson, New York headquarters. The dryer helps identify new excipients that improve upon the performance of products now in the market. Below, Troy W. McCall, Ph.D., is manager of pharmaceutical development at TIMERx Technologies. A specialist in pharmacokinetics — the branch of pharmacology that deals with the absorption, distribution and elimination of drugs from the body — Dr. McCall formulates drugs using the TIMERx patented controlled release system.

Good News from Research Continuing research reveals that TIMERx technology is applicable across a wide base of pharmaceuticals. The organization will, independently, test a number of products through initial biostudies. In effect, TIMERx will be doing the initial formulation research and will be in a position to negotiate partnerships with licensees.

While the controlled release market is very large, it is served by relatively few technologies. TIMERx is based on a patented hydrophilic matrix system which allows for a slowly eroding core. Competitive systems include coated beads (which have been on the market for decades) and an "osmotic pump tablet" that releases active ingredients through laser-drilled holes.

TIMERx, in its simplicity, efficacy and ease of manufacture, offers pharmaceutical companies a cost-effective system at a time when health care providers worldwide are focusing on cost controls. Controlled release systems are easier to administer, offering more effective medication and potentially fewer side effects.



Penwest Foods Co. (PFC) develops, manufactures and markets specialty food ingredients for three distinct industries. It serves North America's leading food processing companies.

◇ This division of PENWEST is the only North American producer of value-added food-grade potato starches. Specialty starches marketed under the PenPlus trademark are used by food processors in a wide variety of consumer products ranging from gravies to snack foods.

◇ PFC is also a leading producer and marketer of agricultural nutrients. Fast Break® and Fast Break Plus® are high-performance, corn-based protein supplements that accelerate the growth cycle of commercial mushrooms. ◇ The division has assembled some of the industry's leading carbohydrate chemists and applications expertise.

The division's investment in people, research and development facilities, product development and customer support produced sharply higher sales volumes and new growth opportunities. New products strengthened the division's position in both the food and agricultural markets.

Potato Starch Sales Up Fourfold Volume in the potato starch lines quadrupled on an annualized basis. The plant in Richland, Washington, reached near capacity during the year. A threefold increase in capacity will come on line in January, enabling Penwest Foods to accommodate demand from existing customers

and open the possibility of incremental business from new customers.

Volume increases reflect new business agreements with several major North American food processing companies who converted from other starch products to specialty potato starches marketed under the PenPlus brand. In converting to PFC products, customers gain manufacturing efficiencies and enhanced flavor and texture in consumer products.

Penwest Foods Co. chemist Todd Strahm works with a differential scanning calorimeter, equipment designed to tell researchers at precisely what temperature food starch gelatinizes, or melts. This enables scientists to predict how a particular starch will behave in a specific food application. Below, Strahm operates a rotary evaporator, a device for analyzing solids dissolved in water. R&D projects are focused on process improvements as well as new product development.

Potato starches are growing in popularity among food processors because they have unique functional characteristics as ingredients, such as viscosity and flavor blandness. They are also more user-friendly on consumer labels than the substances they replace.

New Capacity for Growing Demand The new \$9.1 million plant expansion in Richland, Washington will serve as the foundation for a growing food-



grade potato starch business. The state-of-the-art facility will increase PFC's ability to develop and manufacture a broad line of food-grade products including PFC's first entry into "cook-up" starches, the largest and fastest growing segment of the market. Due to come on line in January 1995, the expansion will greatly increase PFC's flexibility in serving its customers.

Opportunities from Change The potato starch market is a high-growth market in North America, with volume increasing at a 20 percent annual compounded rate for the last five years. It is a small segment of a huge and dynamic food industry which changes constantly, offering new and exciting opportunities. The industry introduces thousands of new products each year, while hundreds of other products are reformulated. There is an increasing globalization of the industry, presenting greater opportunities for leverage from major accounts.

A \$9.1 million capacity expansion at Penwest Food's Richland plant includes new reaction tanks, among other capital improvements. The plant chemically converts raw potato starch into value-added food ingredients. New storage tanks at the Penwest Foods plant hold potato starch cyclene. A threefold increase in capacity at the plant will come on line in January 1995, expanding the company's production volume and increasing the mix of products.

Penwest Foods' customers are changing with the markets. Internal R&D staffs are leaner. They increasingly rely on the technical expertise of suppliers for ingredients and solutions to technical problems. New product development cycles have shrunk from many years to several months, creating a favorable downstream effect on suppliers with technical proficiency, manufacturing flexibility and quick reaction time.

Penwest Foods Co. is in an excellent position to benefit from changes in the food industry by focusing on its core technical strengths and matching those strengths to marketplace needs.

Agricultural Products to Expand Lineup Penwest Foods' agricultural products group set the stage for further domestic and international growth by offering three new products in early fiscal 1995.

Historically, the group had a single product, Fast Break, a growth supplement for mushrooms. It serves a large and expanding commercial

mushroom industry in the U.S., capturing 30 percent of the market. The new products will be commercialized first in the United States and then internationally. Each will be a branded product sold on its value to the end user and its competitive advantage over other products.

COMPEAT™, a 100 percent reprocessed fiber by-product, is an ideal medium for mushroom growers and commercial plant, shrub and flower growers. The Fast Break line will be expanded with Prozyme™, a product for a broader range of growing conditions. The division also introduced EXPRESS™, which converts plants and straw to compost through enzymatic action.

Through these new offerings, the agricultural products group will grow from a single product entity into a leading supplier of specialized high performance and technically innovative products to the commercial agriculture market.

Market-Centered R&D Penwest Foods' strategic direction is driven by the marriage of technical innovation to marketing expertise.

During the year, R&D was reorganized into two groups: one to support unique customer requests and another to develop a broad range of products for multiple category applications.

The division continued its focus on the traditional baking, sauces, gravies and puddings segments while entering new categories with products for nutrition, snack foods and meats.

Penwest Foods' research and development team is among the finest in the food industry, with broad-ranging expertise in starch, cereal, synthetic and organic chemistry and molecular biology.



F i n a n c i a l
R e v i e w I 9 9 4

Management's Discussion and Analysis
of Financial Condition and Results of Operations

PENWEST

Comparison of Fiscal 1994 to 1993 Results of Operations

Sales increased \$23.3 million, or 17.2%, during fiscal 1994. The increase was generated from additional volumes due to the specialty ethylated starch capacity expansion in late fiscal 1993 at Penford's Cedar Rapids plant, as well as greater utilization of existing oxidized starch capacity. Penford also had increased sales of its potato starch and corn cationic products. Mendell sales of microcrystalline cellulose (MCC) increased due to additional capacity that was brought on line in August 1993. Sales at Penwest Foods Co. (PFC) increased significantly during the year; however, PFC continued to record losses.

Gross margins were 25.9% for fiscal 1994 compared to 26.4% for fiscal 1993. The gross margins in fiscal 1994 were affected by a change in the volume mix with an increase in the sales of oxidized starches, which yield lower margins. Margins at Penford in the prior year were negatively affected by approximately \$425,000 of expenses related to flooding in the Midwest. Margins at Mendell declined during the year primarily due to increased expenses at the new MCC plant in Cedar Rapids.

Operating expenses increased \$3,537,000, or 13.3%, due to increased research and development, an increase in operating expenses at PFC, and higher expenses associated with a stock appreciation rights program. This increase at PFC was due to its growth and a continued investment in its business.

Research and development expenses increased \$684,000, or 12.1% in fiscal 1994 due to an increase at both Mendell and TIMERx Technologies. This level of growth is expected to continue in the coming year with a targeted spending of research and development between 3.5% to 4.0% of sales.

Net interest expense increased \$1.3 million in fiscal 1994 due to lower capitalized interest in the current year, higher interest rates, and a lower investment portfolio.

The effective tax rate was 24.3% in fiscal 1994 compared to 17.3% in fiscal 1993. The effective rate in 1994 is lower than the statutory rate primarily due to a federal tax benefit recorded during the first quarter related to research and development expenditures. The effective tax rate for 1993 was less than the statutory rate due to certain tax refunds and credits received by the Company.

PENWEST's core business was strong in fiscal 1994. The specialty paper chemical products continued to grow at double-digit rates. Although there was some improvement in the Company's largest customer base, the paper industry, many of the large paper companies are still in the early stages of recovery which makes the environment difficult to increase sales and prices. Paper industry analysts are forecasting a turnaround in the industry in 1995. Currently there are signs of this, but the overall industry is still not healthy. The starch copolymer family of products continued to make progress during fiscal 1994 and operated at break-even. The Company is continuing its efforts to grow sales in this area. Mendell anticipates higher sales volumes in 1995 as it continues to qualify ethical pharmaceutical companies for its MCC at the new Cedar Rapids plant. Penwest Foods Co. anticipates increased potato starch sales and manufacturing efficiencies as its new capacity comes on line with the expansion due to be completed in January 1995. PFC also expects to continue to grow the agricultural nutrients business with several new innovative products.

In December 1994, the power contract at the Company's cogeneration facility in Vancouver, Washington expires. The Company expects to sell the turbine and the boilers constituting the assets of the facility upon expiration of the power contract. A gain, which will be recognized in the second fiscal quarter of 1995, of approximately \$0.08 to \$0.10 per share will be recorded on the sale of these assets. This one-time gain will substantially offset the loss of operating income from the cogeneration facility, upon shutdown, during fiscal

1995. In connection with the sale, PENWEST has also entered into energy agreements at its Cedar Rapids manufacturing facilities which should take effect during the fourth quarter of fiscal 1995 and are expected to provide similar annual benefits as the expiring cogeneration contracts.

PENWEST

Comparison of Fiscal 1993 to 1992 Results of Operations

Sales increased \$9.6 million, or 7.6%, during fiscal 1993 as a result of volume increases made possible by additional capacity and increased demand for specialty ethylated starches. Production of ethylated starches was at capacity through the end of the third quarter of fiscal 1993 until new capacity came on line early in the fourth quarter. Starch copolymers accounted for less than 2% of sales in fiscal 1993 and were selling at a break-even level during the last two months of fiscal 1993. Sales increased for Penwest Foods Co. (PFC), however PFC continued to record net losses in fiscal 1993, in part due to investment in infrastructure for future growth. Mendell sales improved during the year due to higher sales volumes across all product lines.

Gross margins were 26.4% for fiscal 1993 compared to 26.8% in fiscal 1992. Gross margins were primarily impacted by the flooding in the Midwest, during the third and fourth quarters of fiscal 1993. The floods and related weather caused direct damage to the Company's facility in Cedar Rapids as well as extensive disruption of operations and transportation.

Operating expenses increased \$3,283,000 or 14.1% during fiscal 1993, primarily due to increased research and development expenditures, non-recurring costs of relocating PFC to Englewood, Colorado, and additional operating costs associated with establishing PFC as a separate operating entity.

Research and development expenses increased \$2.0 million, or 54% in fiscal 1993 due to a planned effort to increase investment in research and development throughout the Company.

The effective tax rate was 17.3% in fiscal 1993 compared to 25.9% in fiscal 1992. The effective tax rate for 1993 was less than the statutory rate due to certain tax refunds and credits received by the Company.

PENWEST

Liquidity and Capital Resources

PENWEST used its cash and short-term investments during fiscal 1994 to finance its capital expenditures and working capital additions. The Company, however, has a highly liquid position with working capital of approximately \$21 million and a three-year, \$15 million revolving credit agreement. During the fiscal year there were no outstanding borrowings under this agreement. The Company also has several uncommitted lines with various banks that are used for overnight borrowings. During the second half of the year these lines were used, however there were no outstanding balances at year end. Also, the Company is currently in the process of completing a \$20 million private placement of debt which is expected to be funded in December 1994.

Operating cash flow was \$12.4 million, \$17.5 million, and \$16.7 million in fiscal 1994, 1993, and 1992, respectively. The decrease in fiscal 1994 was primarily due to working capital increases.

Capital expenditures decreased to \$13.3 million in fiscal 1994 from \$31.3 million in fiscal 1993 and \$19.5 million in fiscal 1992. Expenditures have been funded from operations, cash, the private placement of debt, and borrowings under uncommitted lines. The only significant capital expenditures during fiscal 1994 were for the expansion of the Penwest Foods facility in Richland, Washington. The remainder of the expenditures was for various manufacturing facilities and research and development laboratories.

Capital expenditures in fiscal 1995 should be consistent with 1994. The only two significant planned projects are the completion of the expansion in Richland and laboratory and office expansions for TIMERx. The Company expects to fund these capital expenditures from operations and its new \$20 million private placement of debt.

The Company commenced paying a quarterly cash dividend of \$0.05 per share with the quarter ended February 28, 1992, and has paid such dividend each quarter thereafter. The Board of Directors reviews the dividend policy on a periodic basis.

In April 1994, the Board of Directors authorized a stock repurchase program for the purchase of up to 500,000 shares of the outstanding common stock of the Company. No shares have been purchased under this program to date.

In the third quarter of fiscal 1992, the Company adopted FASB Statement No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," changing to the accrual method of accounting for postretirement health care and life insurance benefits. Prior to September 1, 1991, postretirement benefits expense was recognized when claims were paid. The impact of adopting FAS No. 106 was to increase the postretirement benefits liability by \$9,010,000 and establish a corresponding deferred tax asset of \$3,063,000 (net of \$0.80 per share) at September 1, 1991. During the second quarter of fiscal 1994, the Company curtailed postretirement health benefits for salaried employees that had been previously accrued. The Company paid a portion of the health insurance premiums for salaried retirees but no longer does so for eligible salaried employees retiring after May 15, 1994. As a result, in the second quarter, there was a \$900,000 reduction of operating expenses recorded.

Consolidated Balance Sheets		PENWEST
THOUSANDS OF DOLLARS / AUGUST 31	1 9 9 4	1 9 9 3
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents		\$ 5,477
Short-term investments		6,458
Trade accounts receivable	\$ 20,748	16,005
Inventories	16,734	10,214
Prepaid expenses and other	4,593	3,389
Total current assets	42,075	41,543
PROPERTY, PLANT AND EQUIPMENT:		
Land	3,089	2,430
Plant and equipment	162,570	153,939
Construction in progress	6,611	2,642
Less accumulated depreciation	(72,297)	(62,761)
Net property, plant and equipment	99,973	96,250
Deferred income taxes	9,545	7,594
Other assets	12,764	12,579
	<u>\$164,357</u>	<u>\$157,966</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Bank overdraft, net	\$ 635	
Accounts payable	8,131	\$ 9,469
Current portion of long-term debt	4,100	3,880
Accrued liabilities	7,847	6,733
Total current liabilities	20,713	20,082
Long-term debt	42,897	46,998
Other postretirement benefits	10,102	10,305
Deferred income taxes and other	23,480	18,091
SHAREHOLDERS' EQUITY:		
Common stock, par value \$1.00 per share, authorized 29,000,000 shares, issued 8,577,427 shares in 1994 and 8,563,477 in 1993, including treasury shares	8,577	8,563
Additional paid-in capital	12,489	12,403
Retained earnings	79,128	74,375
Treasury stock, at cost, 1,766,752 shares in 1994 and 1,702,552 shares in 1993	(29,327)	(28,050)
Note receivable from PENWEST Savings and Stock Ownership Plan	(3,340)	(4,305)
Cumulative translation adjustment	(362)	(496)
Total shareholders' equity	67,165	62,490
	<u>\$164,357</u>	<u>\$157,966</u>

The accompanying notes are an integral part of these statements.

Consolidated Statements of Income		PENWEST		
THOUSANDS OF DOLLARS, EXCEPT PER SHARE DATA / YEAR ENDED AUGUST 31		1 9 9 4	1 9 9 3	1 9 9 2
Sales		\$158,787	\$135,517	\$125,952
Cost of sales		117,734	99,785	92,147
Gross margin		41,053	35,732	33,805
Operating expenses		30,159	26,622	23,339
Income from operations		10,894	9,110	10,466
Investment income		636	1,016	1,915
Interest expense		(3,444)	(2,489)	(2,252)
Income before income taxes and cumulative accounting changes		8,086	7,637	10,129
Income taxes		1,966	1,322	2,624
Cumulative accounting changes, net of income taxes				(4,387)
Net income		\$ 6,120	\$ 6,315	\$ 3,118
Weighted average common shares and equivalents outstanding		7,110,953	7,175,855	7,461,439
EARNINGS PER SHARE:				
Operations		\$ 0.86	\$ 0.88	\$ 1.01
Cumulative accounting changes				(0.59)
		\$ 0.86	\$ 0.88	\$ 0.42
Dividends declared per share		\$ 0.20	\$ 0.20	\$ 0.15

The accompanying notes are an integral part of these statements.

Consolidated Statements of Cash Flows		PENWEST	
THOUSANDS OF DOLLARS / YEAR ENDED AUGUST 31	1 9 9 4	1 9 9 3	1 9 9 2
OPERATING ACTIVITIES:			
Net income	\$ 6,120	\$ 6,315	\$ 3,118
Adjustments to reconcile net income to net cash from operating activities			
Depreciation and amortization	10,343	9,414	8,013
Deferred income taxes	2,676	2,891	682
Foreign currency translation	134	(361)	(96)
Change in operating assets and liabilities			
Receivables	(4,743)	(2,941)	(1,243)
Inventories	(6,520)	(367)	(2,539)
Accounts payable and other	4,349	2,523	4,404
Cumulative accounting changes			4,387
Net cash from operating activities	12,359	17,474	16,726
INVESTING ACTIVITIES:			
Additions to property, plant and equipment	(13,259)	(31,266)	(19,450)
Other	1,594	(815)	(161)
Net cash used by investing activities	(11,665)	(32,081)	(19,611)
FINANCING ACTIVITIES:			
Proceeds from uncommitted lines of credit	30,605		325
Payments on uncommitted lines of credit	(30,605)		(325)
Proceeds from long-term debt		20,000	
Payments on long-term debt	(3,880)	(673)	(300)
Purchase of treasury stock	(1,277)	(5,085)	(1,245)
Purchase of life insurance for officers' benefit plans	(1,343)	(1,343)	(1,343)
Payment of dividends	(1,371)	(1,394)	(708)
Other	1,065	850	305
Net cash from (used by) financing activities	(6,806)	12,355	(3,291)
Net decrease in cash	(6,112)	(2,252)	(6,176)
Cash and cash equivalents at beginning of year	5,477	7,729	13,905
Cash (bank overdrafts) and cash equivalents at end of year	\$ (635)	\$ 5,477	\$ 7,729
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Interest	\$ 3,478	\$ 2,341	\$ 2,080
Income taxes	\$ 2,909	\$ 3,005	\$ 2,345

The accompanying notes are an integral part of these statements.

Consolidated Statements of Shareholders' Equity

PENWEST

THOUSANDS OF DOLLARS / AUGUST 31

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	TREASURY STOCK	NOTE RECEIVABLE FROM PENWEST SAVINGS & STOCK OWNER- SHIP PLAN	CUMULATIVE TRANSLATION ADJUSTMENT	TOTAL SHARE- HOLDERS' EQUITY
Balances, September 1, 1991	\$8,501	\$12,055	\$67,109	\$(21,720)	\$(5,825)	\$ (39)	\$60,081
Net income			3,118				3,118
Exercise of stock options	39	277					316
Purchase of treasury stock				(1,245)			(1,245)
Savings and Stock Ownership Plan activity					506		506
Pension plan minimum liability			(171)				(171)
Translation loss						(96)	(96)
Dividends declared			(1,062)				(1,062)
Balances, August 31, 1992	8,540	12,332	68,994	(22,965)	(5,319)	(135)	61,447
Net income			6,315				6,315
Exercise of stock options	23	71					94
Purchase of treasury stock				(5,085)			(5,085)
Savings and Stock Ownership Plan activity					1,014		1,014
Pension plan minimum liability			450				450
Translation loss						(361)	(361)
Dividends declared			(1,384)				(1,384)
Balances, August 31, 1993	8,563	12,403	74,375	(28,050)	(4,305)	(496)	62,490
Net income			6,120				6,120
Exercise of stock options	14	86					100
Purchase of treasury stock				(1,277)			(1,277)
Savings and Stock Ownership Plan activity					965		965
Translation gain						134	134
Dividends declared			(1,367)				(1,367)
Balances, August 31, 1994	<u>\$8,577</u>	<u>\$12,489</u>	<u>\$79,128</u>	<u>\$(29,327)</u>	<u>\$(3,340)</u>	<u>\$(362)</u>	<u>\$67,165</u>

The accompanying notes are an integral part of these statements.

Notes to Consolidated Financial Statements

Note A.	PENWEST
	Summary of Significant Accounting Policies

BUSINESS

PENWEST's business is developing, manufacturing and marketing chemically modified carbohydrate-based specialty chemicals. No single customer accounts for more than 10% of sales. The consolidated financial statements include PENWEST and its wholly-owned subsidiaries. Material intercompany balances and transactions have been eliminated.

CASH AND CASH EQUIVALENTS

Cash equivalents consist of money market funds, short-term deposits and commercial paper.

PENWEST's cash management system includes a cash overdraft feature for uncleared checks in the disbursing accounts. Cash in the accompanying balance sheets represents the net amounts available to the disbursing accounts. Uncleared checks in excess of cash balances of \$927,000 are netted against cash at August 31, 1994.

INVESTMENTS

Investments are carried at cost and consist of preferred stock mutual funds. The market value of the portfolio approximates cost.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are recorded at cost. Expenditures for maintenance and repairs are expensed as incurred. The Company uses the straight-line method to compute depreciation assuming average useful lives of three to forty years for financial reporting purposes. For income tax purposes, the Company generally uses accelerated depreciation methods.

Interest is capitalized on major construction projects while in progress. Interest of \$51,000, \$985,000, and \$446,000 was capitalized in 1994, 1993, and 1992, respectively.

INCOME TAXES

Deferred income taxes are provided on temporary differences between financial and income tax reporting methods. In the third quarter 1992, the Company adopted FASB Statement No. 109, "Accounting for Income Taxes," changing to the liability method of accounting for deferred income taxes effective September 1, 1991.

REVENUE RECOGNITION

Sales revenue is recorded upon shipment of product.

EARNINGS PER SHARE

Earnings per common share were computed by dividing net income by the weighted average number of common shares and dilutive common share equivalents outstanding during the fiscal year. Outstanding stock options are considered to be common share equivalents.

RESEARCH AND DEVELOPMENT

Research and development costs of \$6,346,000, \$5,662,000, and \$3,672,000 in 1994, 1993, and 1992, respectively, were charged to expense as incurred.

RECLASSIFICATIONS

Certain prior year amounts have been reclassified to conform with current year presentation.

Note B.	PENWEST
	Inventories

Inventories are stated at the lower of cost or market. Cost, which includes material, labor and manufacturing overhead costs, is determined by the first-in, first-out (FIFO) method.

The Company generally follows a policy of hedging corn purchases related to fixed price sales contracts and certain anticipated corn purchases to minimize price risk due to market fluctuations and risk of crop failure. Gains and losses from these hedging transactions are deferred and included in inventory until such time as the corn is converted to finished goods and sold.

THOUSANDS OF DOLLARS / AUGUST 31	1 9 9 4	1 9 9 3
Raw materials, supplies and other	\$ 6,074	\$ 3,980
Work in progress	622	450
Finished goods	10,038	5,784
Total inventories	<u>\$16,734</u>	<u>\$10,214</u>

Note C.	PENWEST
	Debt

THOUSANDS OF DOLLARS / AUGUST 31	1 9 9 4	1 9 9 3
Unsecured term agreement, quarterly principal payments with final maturity in 2000	\$19,000	\$22,000
Private placement, 7.93% interest rate, semi-annual interest-only payments with principal payments beginning in 1996, final maturity in 2005	20,000	20,000
Unsecured note, 9.4% interest rate, due in quarterly installments through 2000	4,450	4,900
Note payable, 8.49% interest rate, quarterly principal and interest payments through October 1997	3,547	3,978
	46,997	50,878
Less current portion	4,100	3,880
Net long-term debt	<u>\$42,897</u>	<u>\$46,998</u>

Maturities of long-term debt for the fiscal years ending August 31, 1995 through 1999 are as follows (thousands of dollars):

1995	\$4,100
1996	7,127
1997	7,127
1998	8,955
1999	6,697

The Company has an unsecured term agreement of \$19 million with four banks which expires on November 30, 2000. Borrowing rates available to the Company under the term agreement are at prime rate or less depending on the selection of borrowing options. PENWEST can elect to borrow under several options, including prime, certificate of deposit, Eurodollar and bank offered rates. At August 31, 1994 the interest rate was approximately 5.43%.

To offset the effect of future interest rate fluctuations on borrowings under the unsecured term agreement, the Company has entered into interest rate swap agreements with financial institutions. The agreements covering \$15 million currently, fix interest rates at approximately 9%.

The Company has an unsecured revolving line of credit of \$15 million with four banks which expires on April 15, 1997. Borrowing rates available to the Company under the revolver are at prime rate or less depending on the selection of borrowing options. PENWEST can elect to borrow under several options, including prime, certificate of deposit, Eurodollar and bankers' acceptance rates. Borrowings under the revolver can be converted, at the option of PENWEST, to term notes due on the expiration date of the revolving line of credit. At year-end, there were no outstanding borrowings under this agreement.

The unsecured term agreement, the private placement, and the unsecured revolving line of credit include, among other terms, various limitations on long-term indebtedness, minimum net worth and working capital ratios, and restrictions on PENWEST's ability to purchase or redeem its own stock.

The Company has uncommitted lines of credit which provide for financing at various floating rates.

The Company has hedged the interest rate risk on \$8.9 million of its long-term debt using Treasury note futures. The cost of the hedge has been deferred and will be recognized as a component of interest expense over the life of the debt. The hedge will result in effective interest rate on the hedged portion of long-term debt of approximately 9.5%.

Note D.	PENWEST
	Leases

Certain of the Company's property, plant and equipment is leased under operating leases ranging from one to five years with renewal options.

Rental expense under operating leases was \$2,787,000, \$2,066,000, and \$2,092,000 for fiscal years ended August 31, 1994, 1993, and 1992, respectively.

Future lease payments as of August 31, 1994 for noncancellable operating leases having initial lease terms of more than one year are as follows:

THOUSANDS OF DOLLARS / YEARS ENDING AUGUST 31		OPERATING LEASES
1995		\$ 3,472
1996		2,558
1997		1,868
1998		1,296
1999		862
Thereafter		553
Total minimum lease payments		<u>\$10,609</u>

Note E.	PENWEST
	Stock Options

Under stock option plans, options have been granted to certain officers and key employees to purchase PENWEST common stock. Changes in stock options for the three years ended August 31 are as follows:

	1994	1993	1992	1994 OPTION PRICE RANGE
Outstanding at beginning of year	590,809	596,762	707,007	\$ 3.380 - 27.500
Granted	14,000	27,000	67,500	20.125 - 22.750
Exercised	(13,950)	(23,003)	(39,147)	3.310 - 16.587
Cancelled	(20,000)	(9,950)	(138,598)	3.380 - 24.750
Outstanding at end of year	570,859	590,809	596,762	\$ 3.313 - 27.500
Exercisable at end of year	299,109	184,259	94,762	\$ 3.313 - 27.500

At August 31, 1994, 62,232 stock appreciation rights (SARs) were outstanding to certain officers under related stock option grants. The SARs were granted in December 1986 at the market price of PENWEST stock and are fully vested as of August 31, 1994. As a result of appreciation (depreciation) of PENWEST stock and vesting of the SARs, expense was charged (credited) for \$342,000, (\$303,000), and (\$90,000) in 1994, 1993, and 1992 respectively.

Note F.	PENWEST
	Income Taxes

Income tax expense consists of the following:

THOUSANDS OF DOLLARS / YEAR ENDED AUGUST 31	1994	1993	1992
Current			
Federal	\$ (904)	\$(1,731)	\$1,953
Foreign	138	213	(196)
State	56	(51)	185
	(710)	(1,569)	1,942
Deferred			
Federal	2,253	2,808	618
State	423	83	64
	2,676	2,891	682
Total provision	\$1,966	\$ 1,322	\$2,624

A reconciliation of the statutory federal tax to the actual provision is as follows:

THOUSANDS OF DOLLARS / YEAR ENDED AUGUST 31	1 9 9 4	1 9 9 3	1 9 9 2
Statutory tax rate	34%	34%	34%
Statutory tax	\$ 2,749	\$ 2,597	\$3,444
State taxes, net of federal benefit	164	77	122
Tax refunds and credits, including research and development credits	(1,095)	(1,503)	
Tax advantaged investment income			(401)
Other	148	151	(541)
Total provision	\$ 1,966	\$ 1,322	\$2,624

The significant components of deferred tax assets and liabilities are as follows:

THOUSANDS OF DOLLARS / AUGUST 31	1 9 9 4	1 9 9 3
Deferred tax assets:		
Alternative minimum tax credit	\$3,269	\$1,770
Research and development credit	300	359
Postretirement benefits	3,671	3,674
Provision for accrued expenses	1,963	1,544
Other	342	246
Total deferred tax assets	9,545	7,594
Deferred tax liabilities:		
Depreciation	16,826	12,347
Other	926	1,413
Total deferred tax liabilities	17,752	13,760
Net deferred tax liabilities	\$ 8,207	\$ 6,166

The Company has approximately \$3.3 million of alternative minimum tax credit carryforwards, which do not expire, available to offset future income tax payable.

Note G.	PENWEST
	Pension and Other Employee Benefits

PENWEST maintains two noncontributory defined benefit pension plans that cover substantially all employees.

Benefits under the plan for hourly employees are primarily related to years of service. Benefits for salaried employees are primarily related to years of credited service and final average five-year earnings. Employees generally become eligible to participate in the plans after attaining age 21, and benefits normally become vested after five years of credited service.

The Company's funding policy is to contribute amounts to the plans sufficient to meet or exceed the minimum requirements of the Employee Retirement Income Security Act of 1974.

Assumptions used in the measurement of the projected benefit obligation in 1994 and 1993 included a discount rate of 8.0% and 7.5%, respectively, and a rate of increase in compensation levels of 6.0% for the salaried employees. The change in the discount rate had the impact of reducing the projected benefit obligation by approximately \$1 million. The expected long-term rate of return on plan assets is assumed to be 8.0%.

Net periodic pension expense consisted of the following:

THOUSANDS OF DOLLARS / YEAR ENDED AUGUST 31	1 9 9 4	1 9 9 3	1 9 9 2
Service cost of benefits earned during the year	\$ 591	\$ 545	\$ 436
Interest cost on projected benefit obligation	1,256	1,245	1,189
Actual return on plan assets	(842)	(2,449)	(987)
Net amortization and deferral	(253)	1,676	197
Net pension expense	\$ 752	\$ 1,017	\$ 835

The following table sets forth the funded status of both pension plans as of August 31, 1994 and 1993:

THOUSANDS OF DOLLARS / AUGUST 31	1 9 9 4	1 9 9 3
Actuarial present value of projected obligation, based on service to date and current salary levels:		
Vested	\$15,521	\$15,384
Nonvested	387	396
Accumulated benefit obligation	15,908	15,780
Effect of projected salary increases	1,663	1,919
Projected benefit obligation	17,571	17,699
Plan assets at fair market value	15,977	15,922
Projected benefit obligation greater than plan assets	(1,594)	(1,777)
Unrecognized actuarial net loss	1,264	1,391
Balance of unrecognized net obligation at transition being amortized over 15 years	577	920
Unrecognized prior service cost	472	621
Adjustment to record minimum liability	(1,987)	(1,860)
Net pension liability	\$ (1,268)	\$ (705)

Assets of the pension plans are invested in units of common trust funds managed by Frank Russell Trust Company. The common trust funds own stocks, bonds and real estate.

PENWEST SAVINGS AND STOCK OWNERSHIP AND PROFIT SHARING PLAN

The Company has a savings investment plan. The savings component, available to all employees, matches 75% of the employee's contribution up to 6% of the employee's pay, in the form of PENWEST common stock. The plan held 165,903 unallocated shares of PENWEST common stock as of August 31, 1994, including shares earned but not yet allocated. During 1994, approximately 50,010 shares of stock were earned by plan participants. The savings component expense of the plan was \$599,900, \$519,000, and \$318,000 for fiscal years 1994, 1993, and 1992, respectively.

The plan also includes an annual profit-sharing component that is awarded by the Board of Directors based on achievement of predetermined corporate goals. This feature of the plan is available to all employees who meet

the eligibility requirements of the plan. The profit sharing expense, which reflects the cost basis of stock released by the plan to participants, was \$285,000, \$420,000, and \$424,000 for the fiscal years 1994, 1993, and 1992, respectively.

The plan acquired the PENWEST common stock by issuing a note to the Company. The note is reflected as a reduction of shareholders' equity and is amortized ratably as stock is released to participants in the plan.

SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN

The Company established a Supplemental Executive Retirement Plan (SERP) which covers certain employees. The plan is nonqualified and is subject to the provisions of Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions." For 1994, 1993, and 1992, the net pension expense accrued for the SERP was \$347,000, \$283,000, and \$348,000, respectively.

HEALTH CARE AND LIFE INSURANCE BENEFITS

The Company offers health care and life insurance benefits to most active employees. Costs incurred to provide these benefits are charged to expense when paid. Health care and life insurance expense was \$2,649,000, \$2,297,000, and \$1,469,000 in 1994, 1993, and 1992, respectively.

Note H.	PENWEST
	Other Postretirement Benefits

PENWEST maintains two postretirement benefit plans that cover substantially all salaried and hourly retirees.

Benefits under the plan for hourly employees include medical coverage, prescription drug coverage and, to a certain grandfathered group, life insurance. Hourly participants contribute to the cost of the benefits based on a pension credit formula.

Benefits under the plan for salaried employees includes medical coverage and vision coverage. Salaried participants contribute, for the most part, 100% of the premiums.

Presently, the Company funds the current benefits on a cash basis.

In the third quarter 1992, the Company adopted FASB Statement No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," changing to the accrual method of accounting for these benefits effective September 1, 1991. Prior to 1991, postretirement benefit expense was recognized when claims were paid.

Postretirement benefit expense was \$834,000, \$1,088,000, and \$1,100,000 for the twelve months ended August 31, 1994, 1993, and 1992, respectively.

The following table sets forth the plan's funded status:

THOUSANDS OF DOLLARS / AUGUST 31	1994	1993
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION		
Retirees	\$ 5,020	\$ 5,160
Fully eligible active plan participants	297	502
Other active plan participants	2,365	2,810
	7,682	8,472
Plan assets at fair value	0	0
Accumulated postretirement benefit obligation in excess of plan assets	7,682	8,472
Unrecognized actuarial net gain	2,420	1,833
Accrued postretirement benefit obligation	\$10,102	\$10,305

Net periodic postretirement benefit costs include the following components:

THOUSANDS OF DOLLARS / YEAR ENDED AUGUST 31	1 9 9 4	1 9 9 3
Service cost – benefits earned during the period	\$295	\$ 288
Interest cost on accumulated postretirement benefit obligations	604	800
Net amortization and deferral	(65)	
	<u>\$834</u>	<u>\$1,088</u>

Future benefit costs were estimated assuming medical costs would increase at a 14.0% annual rate for fiscal 1995, then beginning in fiscal 1996, decreasing ratably over the next seven years to an annual rate of 6.0% and then remaining at a 5.5% annual rate thereafter. A 1.0% increase in this annual trend rate would have increased the accumulated postretirement benefit obligation at August 31, 1994, by \$962,000, with an increase of \$163,000 in the annual 1994 postretirement benefit expense. The weighted average discount rate used to estimate the accumulated postretirement obligation was 8.0%.

During the second quarter of fiscal 1994, the Company curtailed postretirement health benefits for salaried employees that had been previously accrued. The Company currently pays a portion of the health insurance premiums for salaried retirees but will no longer do so for eligible salaried employees retiring after May 15. As a result, in the second quarter, there was a \$900,000 reduction of operating expenses recorded.

Note 1.	PENWEST
	Shareholders' Equity: Unissued Preferred Stock and Common Stock Purchase Rights

There are 1,000,000 shares of \$1.00 par value preferred stock authorized for issue; however, none are outstanding.

COMMON STOCK PURCHASE RIGHTS

On June 16, 1988, PENWEST distributed a dividend of one right (Right) for each outstanding share of PENWEST common stock. In addition, previously outstanding Rights were redeemed for \$0.025 each. When exercisable, each Right will entitle its holder to buy one share of PENWEST's common stock at \$44.00 per share. The Rights will become exercisable if a purchaser acquires 20% of PENWEST's common stock or makes an offer to acquire common stock. In the event that a purchaser acquires 20% of the common stock of PENWEST, each Right shall entitle the holder, other than the acquirer, to purchase one share of common stock of PENWEST for one half of the market price of the common stock. In the event that PENWEST is acquired in a merger or transfers 50% or more of its assets or earnings to any one entity, each Right entitles the holder to purchase common stock of the surviving or purchasing company having a market value of twice the exercise price of the Right. The Rights may be redeemed by PENWEST at a price of \$0.01 per Right, and they expire in June 1998.

Note J.	PENWEST
	Quarterly Financial Data (Unaudited)

THOUSANDS OF DOLLARS EXCEPT EARNINGS PER SHARE DATA 1993/94	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	TOTAL
Sales	\$37,817	\$35,837	\$41,347	\$43,786	\$158,787
Gross margin	9,987	8,724	11,050	11,292	41,053
Income from operations	2,599	1,678	3,267	3,350	10,894
Net income	1,761	863	1,774	1,722	6,120
Earnings per common share	\$ 0.25	\$ 0.12	\$ 0.25	\$ 0.24	\$ 0.86
Dividends declared	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.20
1992/93					
Sales	\$33,512	\$31,821	\$34,501	\$35,683	\$135,517
Gross margin	9,527	8,603	9,285	8,317	35,732
Income from operations	2,932	2,624	2,320	1,234	9,110
Net income	1,872	1,647	1,385	1,411	6,315
Earnings per common share	\$ 0.26	\$ 0.23	\$ 0.20	\$ 0.20	\$ 0.88
Dividends declared	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.20

Report of Ernst & Young LLP, Independent Auditors

Board of Directors and Shareholders
Penwest, Ltd.

We have audited the accompanying consolidated balance sheets of PENWEST, LTD. as of August 31, 1994 and 1993, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended August 31, 1994. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of PENWEST, LTD. at August 31, 1994 and 1993, and the consolidated results of its operations and its cash flows for each of the three years in the period ended August 31, 1994 in conformity with generally accepted accounting principles.

Ernst & Young LLP

Seattle, Washington
October 18, 1994

PENWEST

Report of Management

The management of PENWEST, LTD. has prepared and is responsible for the integrity and fairness of the financial statements and other financial information presented in this annual report. The statements have been prepared in accordance with generally accepted accounting principles and, to the extent appropriate, include amounts based on management's judgment and/or estimates. In order to fulfill its responsibilities for these financial statements and information, management maintains accounting systems and related internal controls. These controls are designed to provide reasonable assurance that transactions are properly authorized and recorded, that assets are safeguarded, and that financial records are reliably maintained. The concept of reasonable assurance, however, incorporates an acknowledgment that the cost of a control system must be related to the benefits derived.

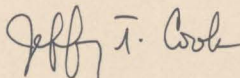
Ernst & Young LLP independent auditors, is retained to audit the Company's consolidated financial statements. Their accompanying report is based on an audit conducted in accordance with generally accepted auditing standards, including a review of internal accounting controls and tests of accounting procedures and records to the extent necessary to support their audit.

The Audit and Environmental, Health and Safety Committee of the Board of Directors, which is composed solely of outside directors, meets periodically with management and with the independent auditors to review the quality of financial reporting, the operation and development of the internal control systems, and the results of independent audits.

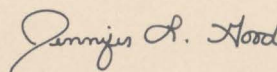
The independent auditors regularly meet with the Audit Committee without the presence of any other parties.



Tod R. Hamachek
President and
Chief Executive Officer



Jeffrey T. Cook
Vice President,
Finance and Chief Financial Officer



Jennifer L. Good
Corporate Controller

Directors

Richard E. Engebrecht

Engebrecht brings more than 40 years experience in the distribution business with the family of Univar companies to PENWEST's board of directors. Most recently, Engebrecht served as chairman of Momentum Corporation. Previously, Engebrecht served as president and chief executive officer of Momentum and VWR Corporation and president and chief operating officer of Univar Corporation. He began his career with Univar after earning a B.S. from Fresno State University. He also serves as chairman of the board of PrimeSource Corporation, and a director of Univar Corporation and VWR Corporation.

Tod R. Hamachek

Hamachek became PENWEST's president, chief operating officer and a director following the Company's 1984 spin-off from Univar Corporation. He was elected chief executive officer in 1985. Hamachek is a director of Northwest National Gas Company, DEKALB Genetics Corporation and The Blethen Corporation. He is a trustee of Virginia Mason Hospital, the Seattle Foundation, The Washington Roundtable, Lakeside School and Pacific Science Center. He also chairs the advisory board of the University of Washington Graduate School of Business. Hamachek holds an M.B.A. from the Harvard Business School and a B.A. from Williams College.

Paul H. Hatfield

Since 1959, Hatfield has worked for the Ralston Purina Company. He currently is a vice president of Ralston as well as the president and chief executive officer of Protein Technologies International, a wholly-owned subsidiary of Ralston Purina Company. A graduate of Kansas State, Hatfield has a B.S. in Agricultural Economics, and a Masters of Science in Economics and Marketing. Hatfield is currently a director of Petrolite Corporation, DeKalb Genetics Corporation, Stout Industries, the U.S. Chamber of Commerce, the Japan American Society, and is a member of the Advisory Board of International Business for St. Louis University.

C. Calvert Knudsen

Joining MacMillan Bloedel in 1976, Knudsen served as president, chief executive officer, chairman, and vice chairman of the board, prior to retiring in 1990. Knudsen is a director of Cascade Corporation, SAFECO Corporation, MacMillan Bloedel Limited, MacDonald Dettwiler & Associates, West Fraser Timber Co. Ltd., and a director emeritus of the Canadian Imperial Bank of Commerce.

Harry Mullikin

Mullikin's position as chairman emeritus and senior advisor for Westin Hotels & Resorts follows a long career with Westin that saw the company grow to 64 hotels worldwide. Mullikin is a director of Seattle-First National Bank, and Seafirst Corporation. A Washington State University graduate, he heads the Washington State University Foundation. He also chairs the board of directors of Virginia Mason Medical Center.

Sally G. Narodick

Narodick is chairman and chief executive officer of Edmark Corporation. Before joining Edmark in 1989, she was a partner of Narodick, Ross & Associates, a financial and marketing consulting firm. Previously, Narodick spent 15 years in various executive management positions with Seafirst Corporation. A graduate of Boston University, Narodick earned a Master of Arts in Teaching from Columbia University and an M.B.A. from New York University. She is a founder and director of Pacific Northwest Bank and also is a director of Washington Energy Corporation. She is a director of Lakeside School and serves on The Washington Roundtable.

William G. Parzybok

Parzybok is chairman of the board and chief executive officer of Fluke Corporation. He joined Fluke in early 1991 and was elected chairman of the board of directors later in the year. He began his career with Hewlett-Packard in 1968, spending 16 years in various executive management positions. Parzybok received a B.S. in electrical engineering and an M.S. in business management from Colorado State University. He currently serves on the University of Colorado's Engineering Development Council and the University of Washington's College of Engineering Visiting Committee. A trustee of The Washington Roundtable, Parzybok also is active in the Pacific Science Center as a foundation associate and as a member of its Science Council.

N. Stewart Rogers

Chairman of the board of PENWEST, Rogers served as senior vice president of Univar Corporation until retiring in 1991. Rogers is a director of Univar Corporation, Fluke Corporation, VWR Corporation, U.S. Bancorp, Olympic Steamship Company and The Port Blakely Company. He also serves as a trustee of the Seattle Opera Association, the National Institute for Music Theater and United Way of King County. He is a graduate of Stanford University, with a B.A. in history.

William K. Street

Since 1965, Street has directed The Ostrom Company as president and general manager. Earlier in his career, he was vice president and general manager of Physio-Control Corporation and general manager of Elkhorn Ranch, Ltd. Street is a director of Univar Corporation. He also is a director of the American Mushroom Institute and serves as president of the Tacoma Art Museum. A University of Washington graduate, Street is a member of the advisory committee for the university's Tacoma branch campus.

James H. Wiborg

Wiborg is chairman of Univar Corporation and of VWR Corporation. Wiborg holds a B.A. in industrial management from the University of Washington. He is a director of VWR Corporation, PACCAR Inc., PrimeSource Corporation and Univar Corporation. Additionally, he serves on the boards of directors of Matthew G. Norton Company, Firs Management Corporation, Northwest Building Corporation, Brandrud Furniture Corporation, Gensco, Inc. and as a trustee of the University of Puget Sound.

Director Emeritus: Curtis P. Lindley

Corporate Information

Officers

Tod R. Hamachek
President and
Chief Executive Officer

Jeffrey T. Cook
Vice President, Finance
and Chief Financial Officer

Franklin E. Olsen, Jr.
Vice President,
Employee Relations
and Corporate Secretary

Robert G. Widmaier
Vice President and
Chief Innovation Officer

Jennifer L. Good
Corporate Controller

H. Thomas Reed
Vice President, PENWEST
President and General Manager
Penford Products Co.

John V. Talley, Jr.
Vice President, PENWEST
President and General Manager
Penwest Pharmaceuticals Group

Gregory C. Horn
President and General Manager
Penwest Foods Co.

Board Committees

Executive Committee
James H. Wiborg, Chairman
Tod R. Hamachek
C. Calvert Knudsen
N. Stewart Rogers

Audit and Environmental,
Health and Safety Committee
Richard E. Engebrecht, Chairman
Sally G. Narodick
William K. Street
James H. Wiborg

Compensation Committee
Harry Mullikin, Chairman
William G. Parzybok
N. Stewart Rogers
James H. Wiborg

Pension and Benefits Committee
C. Calvert Knudsen, Chairman
Richard E. Engebrecht
Harry Mullikin
William G. Parzybok

Nominating Committee
William K. Street, Chairman
Sally G. Narodick
N. Stewart Rogers

Headquarters and General Information

PENWEST Corporate Headquarters
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P.O. Box 1688
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(206) 462-6000

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Idaho Falls, ID 83402

Penwest Pharmaceuticals
Group Headquarters
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1001 First Street S.W.
Cedar Rapids, IA 52404

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Finland

Postfach 1207
25430 Uetersen
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Penwest Foods Co. Headquarters
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Cedar Rapids, IA 52404

216 First Street
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Pacific Cogeneration, Inc.
777-108th Avenue N.E.
Suite 2390
Bellevue, WA 98004-5193

P.O. Box 1688
Bellevue, WA 98009-1688

Annual Meeting
10:30 a.m., January 24, 1995
Seattle Art Museum
100 University Street
Seattle, WA 98101

Form 10-K

The Company files an annual report with the SEC on Form 10-K, pursuant to the Securities Exchange Act of 1934. Shareholders may obtain a copy of this report without charge by written request to our headquarters' post office box address.

Legal Counsel
Bogle & Gates
Two Union Square
601 Union Street
Seattle, WA 98101-2346

Auditors
Ernst & Young LLP
999 Third Avenue, Suite 3500
Seattle, WA 98104

Investor Relations Counsel
Corporate Communications, Inc.
2125 Fifth Avenue
Seattle, WA 98121
(206) 728-1778

Kekst & Co., Incorporated
437 Madison Avenue
New York, NY 10022
(212) 593-2655

Transfer Agent and Registrar
First Interstate of Bank of WA, N.A.
c/o First Interstate Bank
26610 West Agoura Road
Calabasas, CA 91302

Shareholder Information
First Interstate Bank
Shareholder Services
(800) 522-6645

Stock Price Data

The common stock of PENWEST trades in the over-the-counter market under the Nasdaq symbol PENW. Presented below are quarterly closing stock price ranges for PENWEST.

Market Price

1993/1994 Quarter	High	Low
Ended 11/30	\$22.50	\$19.75
Ended 2/28	23.50	19.50
Ended 5/31	23.25	17.75
Ended 8/31	25.75	18.25

1992/1993 Quarter

Ended 11/30	\$22.25	\$16.75
Ended 2/28	23.25	17.75
Ended 5/31	20.25	17.88
Ended 8/31	20.00	17.25

Colophon

The 1994 PENWEST Annual Report uses a variety of papers featuring both recycled and virgin fiber. Printing techniques include foil stamping, transparent and opaque inks and both inline and offline matte and gloss varnishes. The report was electronically assembled in PostScript and translated to a DDES Crosfield environment for scanning, pre-press, proofing and film output, then was printed on modified 40 – inch Heidelberg six color Speedmaster CD presses and bound using the OTA Bind system.

Cover. Images were reproduced in four color process on an opaque white foil stamp. Images were derived from location photography taken with Polachrome film.

Letter. The portrait was reproduced in four color process from black and white Polapan film. An offline matte varnish was applied. Letter text was reproduced in matte inks.

Strategies. This section of the report incorporates coated and uncoated papers. Images reproduced on the coated papers were scanned from 4x5 transparencies, printed in four process colors with an offline gloss varnish. These pages were then dusted to polish the sheet. Uncoated pages were printed with double opaque black, double opaque white and an inline spot matte varnish.

Operations. Images were scanned from 35mm Polachrome film for reproduction on uncoated papers. These images were reproduced in four color process on an uncoated 100# stock with an offline matte varnish. Text was reproduced with custom color matte inks.

Financials. Pages were reproduced on smooth finish 100# uncoated stock in five custom color matte inks and finished with matte varnish.

Page composition. Pages were produced electronically and transmitted to printer via syquest. Software included Aldus PageMaker 5.0 and Freehand. Scans were placed as low resolution files and merged with high resolution files for final output. Color and composing were proofed using a waterproof system.

Typography. Futura Heavy is the only font used in the 1994 report. This extremely versatile and legible sans serif type was designed in 1928 by Paul Renner.

Credits. Designed and produced by Leimer Cross Design, Seattle. Studio photography by Tyler Boley Photography, Seattle. Location photography by Jeff Corwin, Seattle. Printed by H. MacDonald Printing, Vancouver, B.C.



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