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# Annual Report PENWEST 1995

PENWEST develops, manufactures and markets specialty carbohydrate-based chemicals for the paper and textile industries. The Company also produces and markets pharmaceutical excipients (the inactive ingredients in tablets and capsules) and specialty potato starch and dextrose-based food ingredients. PENWEST'S core competence is carbohydrate chemistry.

Penford Products Co. is based in Cedar Rapids, Iowa, and serves the paper and textile industries.



Penford Products Co.

Penwest Pharmaceuticals Group, is based in Paterson, New York, and serves the pharmaceutical, vitamin and nutritional industries.



Pharmaceuticals Group

Penwest Foods Co. is based in Englewood, Colorado, and serves food producers throughout North America.



Penwest Foods Co.

1995 → PENWEST → Strong across-the-board improvement in operating earnings. → Increased earnings per share.

PENFORD PRODUCTS → Secured the largest customer in Penford history. → Double-digit volume growth. → Shifted sales mix to higher-margin products.

PENWEST PHARMACEUTICALS GROUP → Increased Cedar Rapids MCC volume by 71 percent.

→ TIMERx signed new licensee partnerships. PENWEST FOODS → Successfully

commercialized six new products in four markets. → Grew sales volume by 40 percent. → Completed construction on the newest food grade potato starch plant in North America.

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### Selected Financial Data

Thousands of dollars except per share data / Year ended August 31

#### Operating Data:

	1995	1994	1993	1992 <sup>(1)</sup>	1991 <sup>(2)</sup>
Net sales	\$ 174,200	\$ 158,787	\$ 135,517	\$ 125,952	\$ 110,910
Gross margin percentage	27.5%	25.9%	26.4%	26.8%	29.0%
Income from operations	14,973	10,894	9,110	10,466	12,515
Net income	7,217	6,120	6,315	7,505	8,813
Earnings per share	\$ 1.03	\$ 0.86	\$ 0.88	\$ 1.01	\$ 1.17
Dividend declared per share	\$ 0.20	\$ 0.20	\$ 0.20	\$ 0.15	
Average shares outstanding	7,018,970	7,110,953	7,175,855	7,461,439	7,558,910

#### Balance Sheet Data:

Property, plant and equipment (net)	\$ 111,440	\$ 99,973	\$ 96,250	\$ 73,742	\$ 61,223
Long-term debt	58,628	42,897	46,998	30,877	31,550
Shareholders' equity	71,982	67,165	62,490	61,447	60,081
Capital expenditures	23,019	13,259	31,266	19,450	14,006
Total assets	186,760	164,357	157,966	130,641	120,488

(1) During fiscal year 1992, the Company adopted FASB Statement No. 106 "Employer's Accounting for Post Retirement 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.

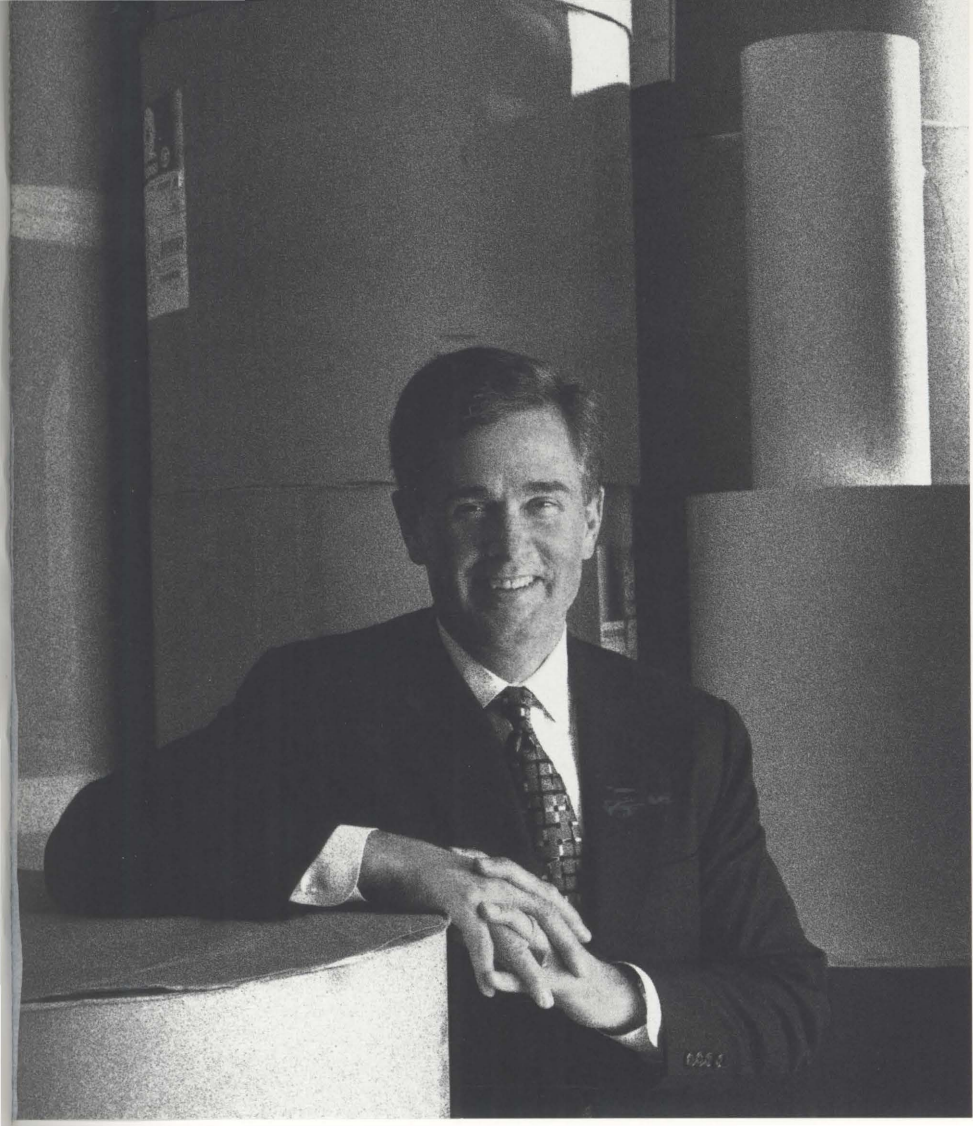


DEAR PENWEST SHAREHOLDERS

PENWEST's strategic focus produced measurable results in FY 1995. In each business, we were able to capitalize on our core competency in carbohydrate chemistry to produce products that add value for our customers, and thus generated significant sales and earnings increases for our shareholders – gratifying evidence that we are on the right track toward fulfilling our mission.

That mission has been the driving force behind our investments and redirection of the past few years: to become the preeminent marketer of carbohydrate-based ingredients through innovative technologies in attractive markets. This is the focus we believe will create value for our shareholders and opportunity for our employees.

The purpose of this year's Annual Report is to examine the link between our mission, our customers and our ability to service the interests of our shareholders. More specifically, we believe that it is important that our shareholders understand exactly how we use our strategic and operating strengths to create the value-added products our customers demand, and thus generate steady improvements in our financial performance. In the section following my report you will find three examples of customer partnering relationships in each of our business areas. These examples illustrate how our unique capabilities in research and development, manufacturing, and marketing of carbohydrate-based products make a difference to our customers and to the product's end-users, and how, ultimately that contributes to our success.



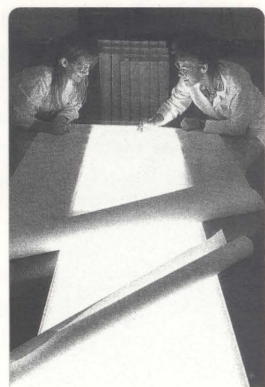


## Operating Highlights and Fundamentals

1995 results demonstrated the fundamental strengths of each business, although our fourth quarter results suffered from the impact of a heat wave in the Midwest which caused ten days of power interruptions at our Cedar Rapids facility. For the full fiscal year, earnings per share were up 20 percent to \$1.03 per share. Operating income was up 37 percent from the prior year. While we were disappointed with the fourth quarter disruptions, 1995 began to generate returns from the investments made the past few years.

Penford continues to grow faster than the paper industry, even while the paper industry is at or near the top of the cycle. That impressive growth rate is the result of Penford's focus on value-added rather than commodity products. During the year, Penford reached an agreement with Georgia-Pacific to supply Penford Gums for Georgia-Pacific's conversion to alkaline papermaking chemistry. This represents one of the single largest orders in Penford's history and will have a favorable impact on margins for the 1996 fiscal year commencing with actual shipments in December 1995.

We believe it is also an indicator of the industry's commitment to conversions, which ultimately benefits PENWEST. Penford also introduced a new corn-based cationic starch (Pencat®) in 1995 for the wet end of the papermaking process. Pencat competes effectively against waxy maize starches.



By focusing on quality and the specific needs of customers, Penford outpaced paper industry growth in 1995.

In promising geographic markets, our Pacific Rim business has about doubled. We are evaluating a variety of options to cost-effectively serve this fast-growing region. Other regions are also under examination, particularly those where fiber is abundantly available and local demographics suggest long-term growth in paper consumption. All paper industry indicators suggest continuing tight supply, pressure to move toward recycled products, and increased demand — all of which bodes well for Penford.

Penwest Pharmaceuticals Group, comprised of Mendell and TIMERx Technologies, generated strong results, with all indicators pointing to continued growth. Mendell's strategic vision is to become the premier manufacturer and marketer of a full line of excipients to the pharmaceutical industry. That vision has Mendell squarely focused on a strategy of broadening the division's capabilities in and market penetration of an extensive line of microcrystalline cellulose (MCC) products which we market under the brand name Emcocel™. MCC is the preferred tableting agent in the pharmaceutical industry.

Through the third generation research and development process, Mendell has begun filling an Emcocel product pipeline that included launching three new products during fiscal 1995. A year and a half ago we began shipping Emcocel products from a new state-of-the-art facility in Cedar Rapids, Iowa. This second facility, complementing an existing facility in Finland, gives us enhanced capabilities to serve the large markets in North America and Europe.



It also gives Mendell the flexibility to aggressively penetrate those markets with a stream of new products designed to serve customer needs. This new Cedar Rapids facility achieved break-even for the year and is poised for growth in fiscal 1996 with several significant customer trials now underway. As of this writing, one of these trials has materialized into the largest contract ever awarded Mendell. A significant measure of Mendell's progress in 1995 is that its earnings were an all time record as its sales of Emcocel products continued to show double-digit growth rates.

With TIMERx, we now have five products licensed and this technology is gaining recognition among a large number of major pharmaceutical companies. Clinical trials of TIMERx in formulations continue to make excellent progress.

Volumes at Penwest Foods were up sharply for the year, a measurable sign that the group has now penetrated the food industry in meaningful ways. Lamb-Weston announced the national rollout of a product, developed jointly with Penwest Foods, that keeps french fries crisper longer under restaurant heat lamps. The food group also reported increasing sales of a specialty potato starch product to one of the nation's leading meat processing companies for use in low- and no-fat hot dogs.

Penwest Foods completed the expansion of its food grade potato starch facility during fiscal 1995. The division is on target to leverage this new capacity during fiscal year 1996 as the division's sales momentum accelerated during the latter half of the 1995 fiscal year.



With Emcocel volumes higher by over 60 percent, the Pharmaceuticals Group not only met the demand but maintained the most stringent quality standards in the industry, standards measured in parts per million over tons produced.

## Strategic Overview

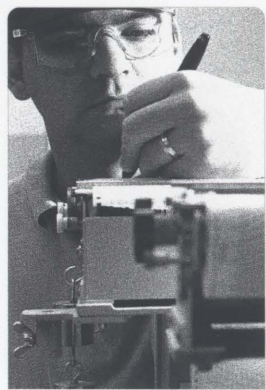
This year's achievements illustrate that each division is actively capitalizing on our core competency in carbohydrate chemistry through partnership with our customers. For PENWEST, this foundation has required developing the right operating and management structures to facilitate turning our unique knowledge and understanding of carbohydrates into marketable products.

PENWEST's products all have a common characteristic beyond their carbohydrate base. Our products enhance our customers' competitiveness by improving their own products. The end user, the consumer, isn't aware of our products, even though as a magazine reader, a headache sufferer or a hot dog lover, they may feel, taste or otherwise be affected by them. But our customers do know — they know that our products and expertise can help them attract more consumers — cost-effectively.

Our research and development is particularly vital because each of our businesses demand constant improvement. While differing in the speed of change, all demand leading edge technology to make their products more competitive. This means we deal with each customer base in different ways. We must work in close partnership with our customers to understand the business and industry and most particularly, their customers.

Our R&D function is organized in a way that reflects these differing dynamics. Each business conducts its own R&D function, according to the principles of our third generation R&D process which keeps them closely linked to their customers and PENWEST's overall strategic direction. At the same time, however, we have in place vital mechanisms that maximize the efficient exchange of basic ideas and know-how across business lines. Common principles that transcend these business boundaries are explored in teams that report to the corporate R&D planning committee.

This combination of bottom-up and top-down R&D means we are close to the marketplace while also optimizing our internal know-how — both fundamentally important to our long-term success. We are also making important advances in our marketing and manufacturing that will enhance our ability to serve our customers better. These include new account management and customer service programs and reorganizing of our sales and service organizations in an effort to improve the rapidity and quality of our customer service.



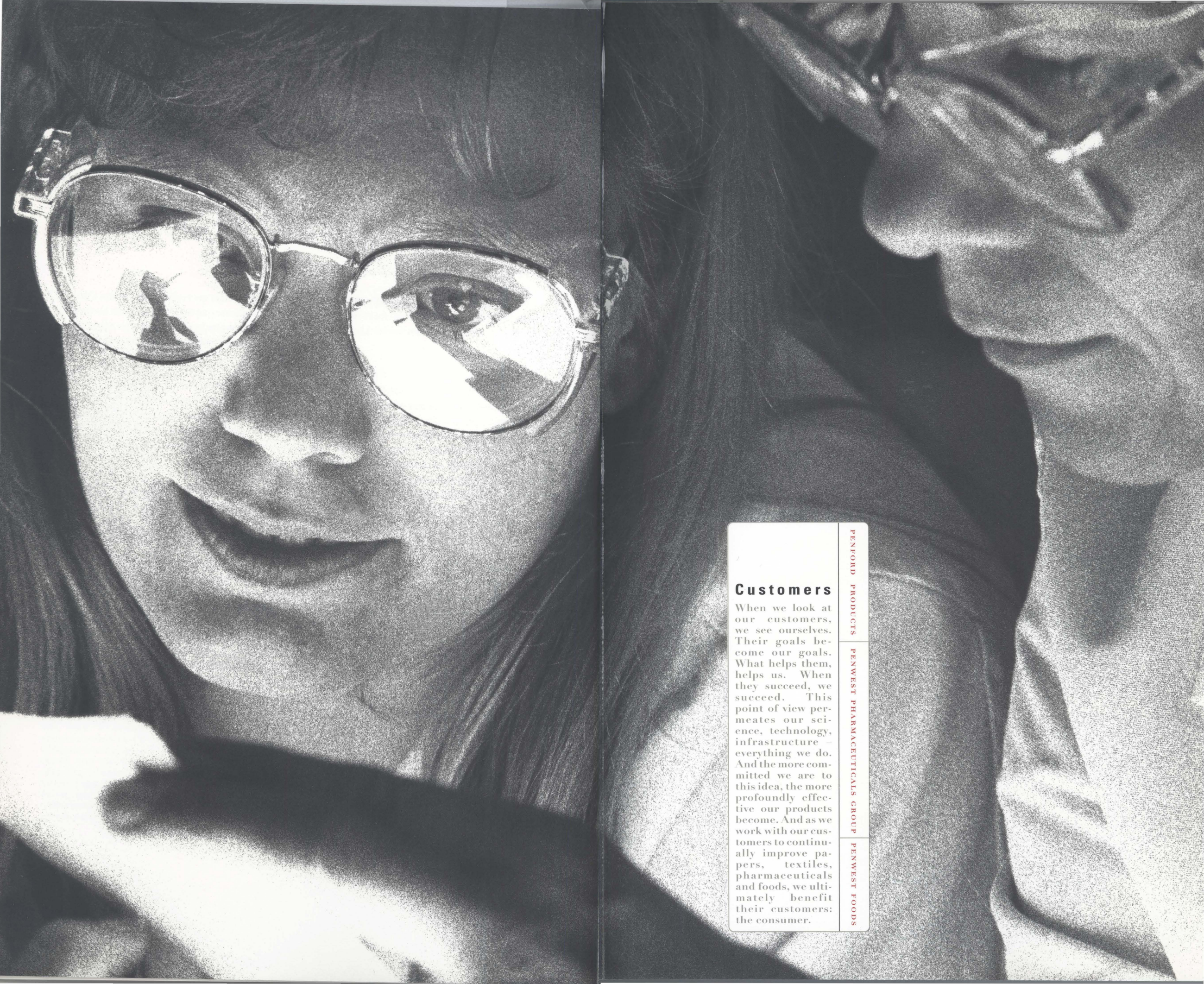
The year's end has brought two major retirements, Frank Olsen, Vice President, Employee Relations and Cal Knudsen, Director. Both gentlemen have been with PENWEST from the beginning, eleven and a half years ago, and have significantly contributed to the success and scope of PENWEST. We thank them for their dedicated service as well as their candid and sage advice and counsel. We wish them well in the years ahead.

In sum, PENWEST is focused on building value for you by developing, manufacturing and marketing products that enhance our customers' ability to serve their markets more efficiently and productively. Building on our core carbohydrate competency, we work closely with our customers at every stage of the process to ensure that the end result meets their business needs. The body of this report traces that effort from beginning to end. We hope it will illustrate exactly how PENWEST's strengths are working for you.

Tod R. Hamachek  
President and  
Chief Executive Officer  
November 6, 1995

The same principles that have helped create dramatic improvement for Penford and the Pharmaceuticals Group have contributed to our foods division's growth, showing a 40 percent increase in sales while commercializing six new products.





## Customers

When we look at our customers, we see ourselves. Their goals become our goals. What helps them, helps us. When they succeed, we succeed. This point of view permeates our science, technology, infrastructure — everything we do. And the more committed we are to this idea, the more profoundly effective our products become. And as we work with our customers to continually improve papers, textiles, pharmaceuticals and foods, we ultimately benefit their customers: the consumer.

PENFORD PRODUCTS

PENWEST PHARMACEUTICALS GROUP

PENWEST FOODS



Penford Products and Georgia-Pacific





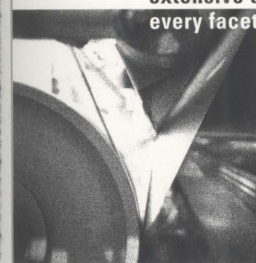
The ability to custom tailor our products to specific applications and manufacturing needs gives Penford customers a resource, and an edge, in real-world problem solving.

R E S P O N D I N G



To do more than simply survive in changing markets means redefining your business and your products to thrive in new conditions. Do things differently. Do things better. For Georgia-Pacific's Ashdown, Arkansas mill – one of the largest uncoated freesheet mills in the world – it meant engineering a more efficiently produced paper utilizing less fiber. It meant changing their papermaking machines from an acid- to an alkaline-base. It meant increasing productivity, improving quality and enhancing operational safety while simultaneously controlling and reducing costs.

For Penford, it meant much more than simply supplying a product. What began as a consulting assignment quickly grew in scope. With an understanding developed over a span of 20 years of working with Georgia-Pacific, Penford applied extensive technical expertise to every facet of the project.

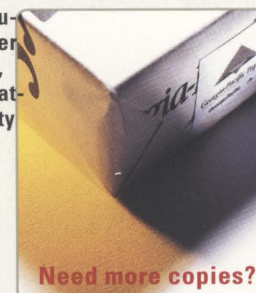


We share the goals and objectives of Georgia-Pacific, and participate in extensive quarterly reviews to ensure performance remains on target and productivity remains high.

E V A L U A T I N G

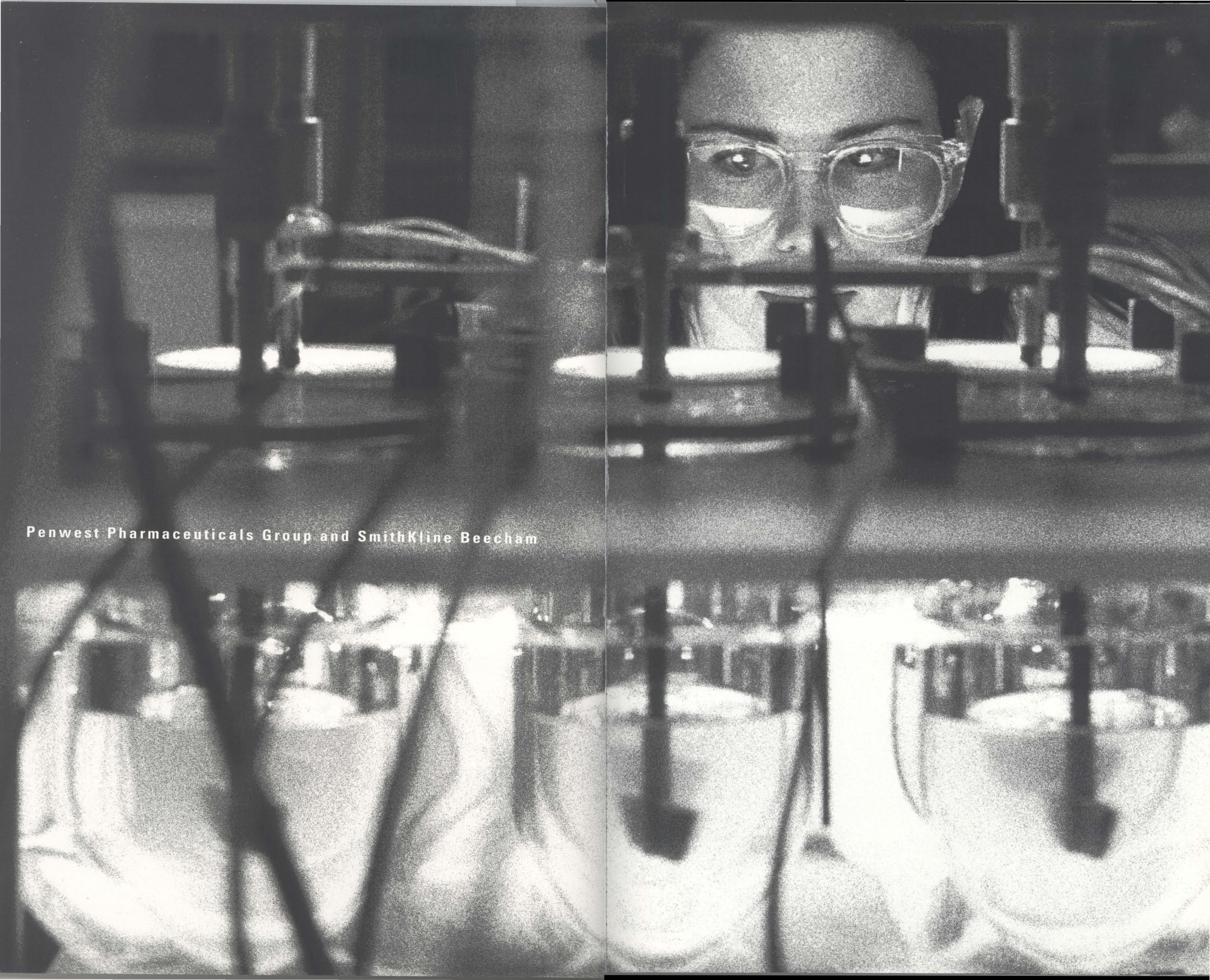
It's the best example of what can be accomplished by defining goals, setting benchmarks, measuring results and working in partnership to continually improve. Together with Georgia-Pacific, we succeeded in creating higher productivity and a better product.

Together with Georgia-Pacific, the measures and targets necessary to achieve product and performance goals were defined. Our value-added approach addressed all the parameters, and rather than rely on a standard product, we created a custom tailored product profile to exactly match the characteristics Georgia-Pacific sought. Alkaline-based paper production allows papermakers to reduce the fiber content while increasing the filler content. While this is more cost-effective, it decreases paper strength. With our specialized hydroxyethylated starches, Georgia-Pacific was able to optimize the fiber / filler balance without sacrificing strength. The result combined lower fiber content, higher filler content, archival quality and lower production costs while meeting or exceeding the stringent specifications set for copier and laser bond papers.



Need more copies?





Penwest Pharmaceuticals Group and SmithKline Beecham



In 1995, volume for Explotab®, the excipient used in SmithKline Beecham's Tagamet HB, increased significantly, meeting the rush to market as Tagamet became an OTC product.

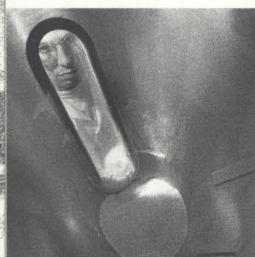
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There is a profound change taking shape in the pharmaceuticals industry. Drugs that were once available by prescription only are now being marketed over-the-counter. And along with growing use among consumers, comes an intense competition for market share.

SmithKline Beecham has been a customer for more than ten years. Our Explotab excipient, a vital ingredient in Tagamet HB, has characteristics which ensure consistent and proper release time once the medication is in the body. The introduction of Tagamet HB to the over-the-counter market increased volume significantly, while demanding that the strict FDA tolerances were still met.

Tagamet was already one of the largest selling medications in the world – meeting the new demand for increased volume was crucial in two ways. First, the quality and consistency of our excipient needed to remain extremely high, offering strictly repeatable results. Second, there was an imperative to reach market quickly and capitalize on the product's introduction to the over-the-counter market.



Quality control reaches new degrees of accuracy. For millions of doses of Tagamet HB, we are providing excipients that meet tolerances measured in parts per million.

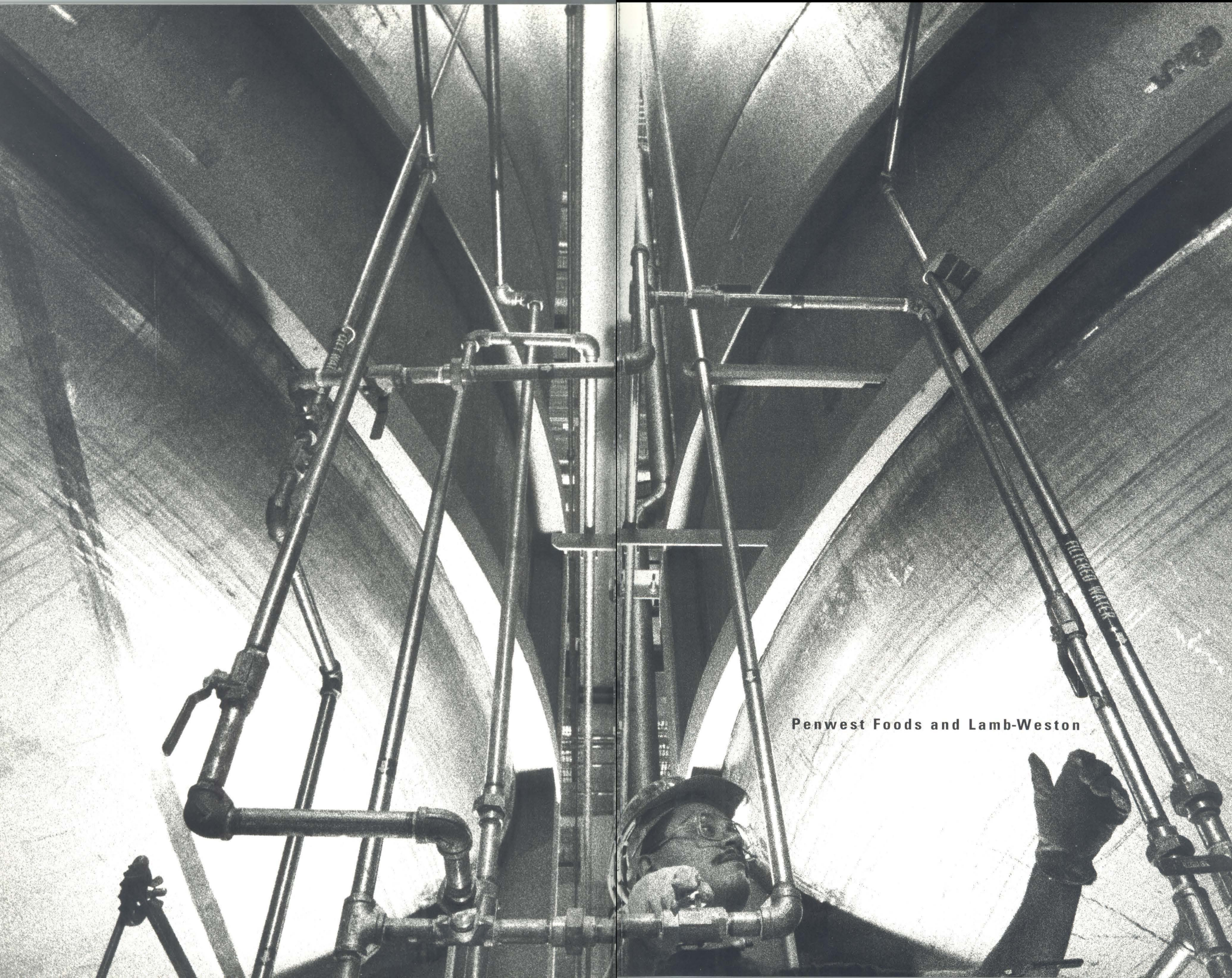
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The standards we apply to our products actually exceed the tolerances our clients specify. It's just one way we can assure them of consistently reproducible results, optimal production runs and overall dependability. Testing is constant throughout every phase of production. Success requires an unflagging commitment to make certain that our products meet the exact specifications required. The fact that SmithKline Beecham has consistently turned to us to meet those criteria may be the most meaningful measure of all.

Feeling better?







Penwest Foods and Lamb-Weston



Our research is tied to market needs and to the realities of large-scale production. We have the infrastructure in place to meet the demand for greater volume and higher quality.

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Proprietary ideas and processes. Confidentiality. Focused expertise. A commitment to work in unison. These elements are as vital as any other component necessary in successfully developing starch ingredients and dextrose for the food industry.



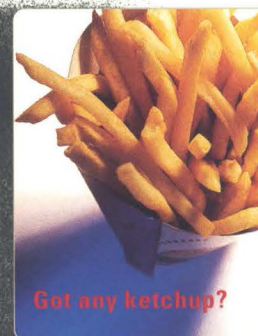
At the beginning, Lamb-Weston wouldn't tell us exactly what they were looking for. But by outlining specific characteristics and working together, sharing information between our R&D department and their own, we began to make progress.

State-of-the-art products require state-of-the-art facilities supported by a commitment to keep quality standards high in every phase of operations.

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What began as a blind test on small, individual prototypes was scaled up to full production. With our leading competency in carbohydrate chemistry, we have the distinct ability to apply our skills to specific, highly quantifiable goals and contribute the experience necessary to make those goals work outside the lab – in the plants and on the production lines of our customers. As we worked with Lamb-Weston, the goal became clear – to develop a new french fry coating that would improve flavor, maintain freshness and add crispness.

With Lamb-Weston, we did just that. We reduced the number of ingredients and helped speedup production lines. We made the fries crisper, we extended shelf-life. We even made them taste better.



Got any ketchup?



**Penford Products Co.**

Product	Chemistry	Applications	Characteristics	End Products
<b>Apollo® 500, 600, 700</b>	cationic corn	wet end	increases retention and strength	coated and uncoated papers, carbonless paper
<b>Apollo 4240, 4270, 4280</b>	cationic hydroxyethylated corn	sizing	superior surface sizing	art paper, cotton content writing paper
<b>Astrocote™ 75</b>	anionic potato	coating and sizing	high solids, low viscosity	parchment, erasable bond papers
<b>Astro® Gum 21</b>	anionic corn	coating and sizing	increases strength, opacity, porosity	board, polycoated papers, greeting cards
<b>Astro Gum 3010, 3020</b>	carboxymethylated corn	coating and sizing	increases strength, opacity, porosity	board, polycoated papers, greeting cards
<b>Astro® X-100, X-101, X-150, X-200</b>	cationic potato	wet end	increases retention and strength, stabilizes alkaline size emulsion	coated board, uncoated freesheet, coated offset paper
<b>Douglas Clearsol® 7, 8, 9, 10</b>	oxidized corn	coating and sizing	clear, strong and flexible films	uncoated freesheet printing papers
<b>Douglas® 3006, 3012, 3018, 3040</b>	oxidized corn	sizing	strong films, stable viscosity	uncoated offset, book, text and forms papers
<b>Fibre cote™ 80P</b>	cationic hydroxyethylated potato	coating and sizing	added strength, enhanced clarity	art paper, cotton content writing paper
<b>Pencat® 500, 550, 600</b>	cationic corn	wet end	improves dry strength properties	coated freesheet printing papers, paperboard
<b>Penford® Gum 200, 220, 230, 240, 250, 260, 270, 280, 290, 295, 300, 330, 360, 370, 380, Pen-cote®, Pen-sprae® 3800</b>	hydroxyethylated corn	coating and sizing	clear, strong waterholding films, high gloss and ink holdout	printing and writing papers, coated board
<b>PENGLOSS® 115</b>	starch copolymer	coating	high porosity, opacity, runnability	gloss offset and rotogravure papers
<b>Pensize® 630, 640</b>	starch copolymer	size press coating	improves stiffness and porosity	high quality textbook and offset papers
<b>Polaris™ Gum LV, MV</b>	hydroxyethylated potato	coating and sizing	excellent gloss and ink holdout	high quality printing and writing papers

Penwest Pharmaceuticals Group				
Product	Chemistry	Applications	Characteristics	End Products
EMCOCEL® Microcrystalline Cellulose	cellulosics (wood pulp)	tableting	binder / compaction	OTC / prescription drugs, nutritionals
EMCOSOY® Soy Polysaccharides	soy polysaccharides	tableting	disintegration	OTC / prescription drugs, nutritionals
EMDEX® Dextrates	corn (sugars)	tableting	compaction / sweetness	OTC / prescription drugs, nutritionals
EXPLOTAB® Sodium Starch Glycolate	potato (starch)	tableting	disintegration	OTC / prescription drugs
NONPAREILS Sugar Spheres	sugar and sugar / starch spheres	tablets / capsules	drug carrier	OTC / prescription drugs, nutritionals
TIMERx™	polysaccharide gums (hydrocolloids)	controlled drug delivery	diffusion controlled gels	pharmaceutical solid dosage forms

Penwest Foods Co.

Product	Chemistry	Applications	Characteristics	End Products
<b>Cantab®</b>	dextrose	tableting	degree of hardness	candies
<b>Cantab+™</b>	dextrose	fruit coatings	flow, non-dusting	raisins, dates
<b>Carridex™</b>	dextrose	carrier	flavor absorption	artificial sweeteners
<b>Cryodex™</b>	glucose solids	cryoprotectant	gel strength	surimi, processed meats
<b>PenBind™ 100</b>	potato	binder	water holding	processed meats
<b>PenBind™ 190</b>	potato	coating batter	film former	fried snacks
<b>PenCling 200</b>	potato	binder	protein adhesion	low-fat cheese
<b>PenCling 580</b>	potato	wafer coating	moisture barrier	cream-filled cookies
<b>PenPlus® MG</b>	potato	thin dough systems	water binding	low-fat tortillas
<b>PenPlus® 40</b>	potato	extrusion	lubricity	extruded cereals
<b>PenPlus® 300</b>	potato	bakery dough	viscosity control	cookies, cakes
<b>PenPlus® 2700</b>	potato	bakery systems	freeze/thaw stable	frozen waffles



## Operational and Financial Review

1995-1996

1995-1996

The Board of Directors has reviewed the Operational and Financial Review for the year ended 31 March 1996. The Board has approved the Review for publication.

The Review is a summary of the Operational and Financial Review for the year ended 31 March 1996. It is intended to provide a summary of the Review for the Board of Directors and the Shareholders.

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# Financial Review

PENWEST 1995

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## Operational and Financial Review

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 the paper machine. 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 by bringing a higher level of quality to the finished product and manufacturing efficiencies to the production process.

### Industry Briefs

The paper industry staged a strong recovery from a five-year recession, and shows all the signs of sustainable growth for some years to come. Paper companies' profits are up sharply, reflecting strong across-the-board price increases of as much as 30–40%. Industry operating rates are expected to be at 95% of capacity in 1996, up from strong levels in 1995. Fiber (pulp) prices hit new highs, more than double last year, making starch and coatings more attractive as a lower cost alternative, and creating opportunities for Penford.

The prolonged recession has changed some of the dynamics of the industry. Most paper companies have downsized significantly. New faces bring a renewed effort on Penford's part to educate customers about the product and process benefits of Penford's specialty products. Customers today are seeking greater levels of service, cost containment and suppliers with environmentally sound production facilities. Many customers also are looking for longer and stronger relationships with their suppliers.

### Penford Highlights

Penford completed a stronger performance year reflecting higher sales and market share of Penford Gums, Penford's flagship product. Penford Gums grew at a 12% rate and are expected to continue double-digit growth in 1996. Higher-margin Penford Gums now account for 82% of total production at Penford, up from 71% earlier in the year. The driver behind this strong demand continues to be the conversion of paper mills from acid- to alkaline-based production processes. The largest customer in Penford history came aboard in 1995 as the result of such a conversion. Even with a 33% production expansion in recent years — and additional grind capacity that will come on line in March 1996 — Penford is pressed to keep up with demand. The division did reach capacity on industrial potato starch, with a volume gain of 72%, almost doubling the output of the year-earlier period.

The starch copolymer business operated at break-even on the strength of existing commercial accounts and new opportunities in textiles.

The division's export business continues to grow, especially Penford Gum sales to customers in South America and Asia.

Penford realigned its manufacturing operations to improve quality and productivity while reducing costs. Sales and technical service were restructured to bring them closer to customers and better able to understand customers needs. The division's R&D portfolio is focused on new products for papermakers and process improvements for manufacturing.

Major personnel initiatives included the appointment of Frank C. Rydzewski as executive vice president of operations and Richard L. Lynch as executive vice president of North American operations.

An otherwise strong year for Penford was marred by ten power interruptions — with the loss of 50 hours of production — as a result of record heat and humidity in Iowa. Penford's contract with its electric utility allows interruption of service under certain circumstances. In addition to disrupting production, the outages cost PENWEST nearly \$1 million in pre-tax profit and about ten cents per share in lost earnings. Penford and the utility are working on alternative strategies for future peak loads.



Penwest Pharmaceuticals Group

The Penwest Pharmaceuticals Group combines the resources of Mendell, one of the world's leading producers and distributors of pharmaceutical excipients, with TIMERx Technologies, a developer of controlled release systems for orally administered prescriptions 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 with primary markets in North America and Europe. TIMERx Technologies pioneered TIMERx, a patented, innovative controlled release technology.

Industry Briefs

Mendell benefits from a strong pharmaceutical industry, with growing volume and generally stable long-term business relationships. An accelerating rate of new drug approvals — as prescription medicines lose patent protection and reappear as generics — offers new business opportunities.

TIMERx Technologies is focused on the multi-billion dollar controlled release market in North America and Europe, a market with a high rate of consistent growth. Controlled release offers extended patent protection for pharmaceuticals and improved safety, convenience and effectiveness to consumers.

Mendell Highlights

Mendell completed the year with sales up, expenses flat and profit tripled.

The division's major investment in a new microcrystalline cellulose (MCC) plant in Cedar Rapids began returning significant increases in volume and profit. Cedar Rapids-produced Emcocel™ has found excellent acceptance in a competitive North American marketplace. Volume was up 71% at the plant, reflecting strong demand for Emcocel in both North America and Europe where overall sales grew 15%. Several major new customer trials were underway as the fiscal year closed.

Mendell committed significant R&D expense to develop a new generation of MCC products for introduction in FY 1996. The division's overall focus is on being the quality manufacturer and supplier of innovative MCC products.

Other excipients in Mendell's lineup generally did well, with good volume and share gains.

TIMERx Technologies Highlights

TIMERx technologies targets therapeutic categories where extended duration of drug action is especially beneficial: cardiovascular, central nervous system, analgesics and antibiotics.

TIMERx, along with several drug company partners in North America and Europe, is developing four drug formulations with TIMERx as the controlled release agent. The four drugs are in various stages of regulatory development with the earliest possible commercial sales beginning late in calendar 1996.

During fiscal 1995, TIMERx completed construction of new laboratory, office and Good Manufacturing Practices facilities in Patterson, New York. These facilities are designed to support an expanded drug development effort.

Operational and Financial Review	
	Penwest Foods Co.

Penwest Foods Co. develops, manufactures and markets specialty food ingredients for many of 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. The division also manufactures and markets specialty corn dextrose products for selected applications.

Industry Briefs

While the food processing industry grows only modestly overall, Penwest Foods has targeted high-growth niche markets for development: coatings for crisper snack foods, starch-based fat substitutes for applications in meat products, and specialty potato starches for low-fat and no-fat baked products like tortillas. People are eating more snack foods and buying more restaurant take-out. At the same time, a very high percentage of food industry R&D funds are earmarked for developing low- and no-fat alternatives, as consumers increasingly seek healthier diets. As the food processing industry continues its consolidation, many in-house R&D departments are getting smaller, creating opportunities for suppliers like Penwest Foods.

Penwest Foods Highlights

Penwest Foods grew sales by 40%, cut operating expenses and significantly reduced its net operating loss. By year-end the division was operating at near break-even.

The division broadened its customer base to include eight of the largest food processing companies in the world and completed a major plant expansion that tripled capacity.

The strongest growth came from the division's three potato starch market segments, as the division gained a 50% share of the 20 million pound specialty modified potato starch market. A Penwest Foods-developed starch is used in a coating that keeps french fries crisper longer for three national food service chains. This innovative value-added product was developed in partnership with a major U.S. french fry producer.

Specialty potato starch products from Penwest Foods now are used in four major hot dog brands in the low- and no-fat categories. The starch binds moisture while replacing fat, keeping the product juicy. The low- and no-fat segment of the hot dog market is the only growth area of that market.

Another specialty potato starch was successfully developed for low- and no-fat tortillas, a fast-growing segment of the baking category. The starch replaces shortening for a healthier alternative. Tortillas have captured an increasing share of traditional bread products markets in recent years.

In other developments, Penwest Foods accelerated its commercialization process, compressing the time between the lab and the marketplace. More emphasis was placed on field sales and technical service to customers at a time when customers are cutting back on their own technical staffs. R&D has a greater customer focus, with 25% of its professional time devoted directly to customers, aligning the organization more closely with customer needs.



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

### Comparison of Fiscal 1995 to 1994 Results of Operations

Sales increased \$15.4 million, or 9.7%, during fiscal 1995. The increase reflects higher demand for hydroxyethylated (HES) corn starches from paper industry customers as new customers converted to Penford Gums. During the year, Penford converted the single largest customer in its history. As a result, Penford is near production capacity. The improvement in the paper industry has also benefited Penford.

Also contributing to the increase were higher sales of industrial potato starches to the paper industry. The Company's Idaho Falls potato starch plant's capacity was essentially sold out by year-end. Sales of microcrystalline cellulose (MCC) to pharmaceutical industry customers were up sharply as PENWEST's Cedar Rapids MCC plant gained new customers and its operating results reached break-even. Specialty food-grade potato starches sold by Penwest Foods Co. (PFC) gained 107%, reflecting new product activity and the addition of major new customers. However, PFC was not profitable in 1995.

Gross margins were 27.5% in 1995 compared with 25.9% in 1994. Higher gross margins reflected renegotiated sales contracts with key customers, a shift at Penford to higher margin products, the achievement of break-even at Mendell's Cedar Rapids MCC plant and reduced losses at Penwest Foods. Operating margins grew from 6.9% to 8.6%, a gain of 24.6%. The 1995 margins were depressed by power interruptions and higher corn costs at Penford Product Co.'s Cedar Rapids plant. High heat and humidity in Iowa placed exceptional demand on the local electrical utility, which interrupted service to some of its industrial customers, including Penford. The plant experienced ten blackouts during the fourth quarter. This resulted in fewer units being produced and therefore a higher per unit cost. Since Penford does not maintain much inventory, most of the impact was recorded during the fourth quarter.

In December 1994 the Company sold the assets of its cogeneration facility, recording a pre-tax gain of \$899,000 (8 cents per share after tax) in the second quarter. The gain effectively offset earnings the facility would have provided in fiscal 1995. The turbine from the facility was sold to IES Utilities, Inc. and in the fourth quarter of fiscal 1996, the Company expects to begin receiving a portion of its thermal needs in Cedar Rapids from that turbine under a thermal supply agreement with IES Utilities, Inc. This agreement should generate a savings that will approximate the earnings from the Company's cogeneration facility prior to the sale.

Operating expenses increased \$2.7 million, or 9.0%. Operating expenses in 1994 were reduced by \$900,000 as the result of the curtailment of postretirement health benefits previously accrued. Research and development expenses increased \$427,000, or 6.7%, as a result of greater development spending at Penwest Pharmaceuticals Group. The Company expects to continue R&D investments at approximately 3.5 to 4% of sales.

Net interest expense increased \$2.0 million reflecting a greater debt level, higher interest rates and a lower investment portfolio.

The effective tax rate was 35% in fiscal 1995 compared with 24.3% in the prior year when PENWEST recorded a federal tax benefit relating to research and development expenditures.

### Comparison of Fiscal 1994 to 1993 Results of Operations

Sales increased \$23.3 million, or 17.2%, during fiscal 1994. The gain 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. increased significantly during the year; however, PFC continued to record operating 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.

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 were still in the early stages of recovery which made the environment difficult to increase sales and prices. The starch copolymer family of products continued to make progress during fiscal 1994 and operated at break-even.

Liquidity and Capital Resources
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PENWEST has strong liquidity and capital resources. The Company had \$5.3 million in cash and cash equivalents at year-end and working capital of \$29.2 million. The Company has a \$15 million revolving credit agreement. There were no borrowings under this agreement during the fiscal year. The Company also has several uncommitted lines with various banks that are used for overnight borrowings. These lines were used throughout the year, however, there were no outstanding balances at year-end.

Operating cash flow was \$16.3 million, \$12.2 million, and \$17.8 million in fiscal 1995, 1994, and 1993, respectively. The improvement in fiscal 1995 was primarily due to an improvement in operating income and by changes in working capital components.

Capital expenditures increased to \$23.0 million in fiscal 1995 compared to \$13.3 million in fiscal 1994 and were \$31.3 million in fiscal 1993. Expenditures have been funded from operations, cash, a private placement of debt, and borrowings under uncommitted lines. The significant capital expenditures during fiscal 1995 were for the completion of expansion of the Penwest Foods facility in Richland, Washington, the completion of new laboratory facilities for Penwest Pharmaceuticals Group, and some capacity expansion at Penford Products. The remainder of the expenditures were for various improvements to manufacturing facilities.

Capital expenditures in fiscal 1996 should be lower than fiscal 1995. The only significant planned project is a \$6 million capacity expansion project at Penford Products. The Company expects to fund these capital expenditures from operations and cash.

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. The Company repurchased 66,000 shares of its stock during fiscal 1995 for \$1,310,000.



# Consolidated Balance Sheets

Thousands of dollars / August 31

1995

1994

## Assets

### Current assets:

Cash and cash equivalents	\$ 5,334	
Trade accounts receivable	23,943	\$ 20,748
Inventories	14,209	16,734
Prepaid expenses and other	5,447	4,593
Total current assets	48,933	42,075

### Property, plant and equipment:

Land	3,359	3,089
Plant and equipment	175,533	162,570
Construction in progress	3,371	6,611
Less accumulated depreciation	(70,823)	(72,297)
Net property, plant and equipment	111,440	99,973
Deferred income taxes	9,927	9,545
Other assets	16,460	12,764
	\$186,760	\$164,357

## Liabilities and shareholders' equity

### Current liabilities:

Bank overdraft, net		\$ 635
Accounts payable	\$ 8,749	8,131
Accrued liabilities	6,728	7,847
Current portion of long-term debt	4,270	4,100
Total current liabilities	19,747	20,713
Long-term debt	58,628	42,897
Other postretirement benefits	10,155	10,102
Deferred income taxes and other	26,248	23,480

### Shareholders' equity:

Common stock, par value \$1.00 per share, authorized 29,000,000 shares, issued 8,591,027 shares in 1995 and 8,577,427 in 1994, including treasury shares	8,591	8,577
Additional paid-in capital	12,550	12,489
Retained earnings	84,949	79,128
Treasury stock, at cost, 1,832,752 shares in 1995 and 1,766,752 shares in 1994	(30,637)	(29,327)
Note receivable from PENWEST Savings and Stock Ownership Plan	(2,978)	(3,340)
Cumulative translation adjustment	(493)	(362)
Total shareholders' equity	71,982	67,165
	\$186,760	\$164,357

The accompanying notes are an integral part of these statements.



# Consolidated Statements of Income

Thousands of dollars except per share data / Year ended August 31

1995

1994

1993

Sales	\$174,200	\$158,787	\$135,517
Cost of sales	126,341	117,734	99,785
Gross margin	47,859	41,053	35,732
Operating expenses	32,886	30,159	26,622
Income from operations	14,973	10,894	9,110
Other income	899		
Investment income	418	636	1,016
Interest expense	(5,183)	(3,444)	(2,489)
Income before income taxes	11,107	8,086	7,637
Income taxes	3,890	1,966	1,322
Net income	\$ 7,217	\$ 6,120	\$ 6,315
Weighted average common shares and equivalents outstanding	7,018,970	7,110,953	7,175,855
Earnings per share	\$ 1.03	\$ 0.86	\$ 0.88
Dividends declared per share	\$ 0.20	\$ 0.20	\$ 0.20

The accompanying notes are an integral part of these statements.

# Consolidated Statements of Cash Flows

Thousands of dollars / Year ended August 31

1995

1994

1993

## Operating activities:

Net income	\$ 7,217	\$ 6,120	\$ 6,315
Adjustments to reconcile net income to net cash from operating activities			
Depreciation and amortization	10,375	10,343	9,414
Deferred income taxes	1,504	2,676	2,891
Gain on sale of assets	(899)		
Change in operating assets and liabilities			
Receivables	(3,195)	(4,743)	(2,941)
Inventories	2,525	(6,520)	(367)
Accounts payable and other	(1,181)	4,349	2,523
Net cash from operating activities	16,346	12,225	17,835

## Investing activities:

Additions to property, plant and equipment	(23,019)	(13,259)	(31,266)
Proceeds from sale of assets	2,500		
Other	(530)	1,594	(815)
Net cash used by investing activities	(21,049)	(11,665)	(32,081)

## Financing activities:

Proceeds from unsecured line of credit	41,305	30,605	
Payments on unsecured line of credit	(41,305)	(30,605)	
Proceeds from long-term debt	20,000		20,000
Payments on long-term debt	(4,100)	(3,880)	(673)
Purchase of treasury stock	(1,310)	(1,277)	(5,085)
Purchase of life insurance for officers' benefit plans	(2,501)	(1,343)	(1,343)
Payment of dividends	(1,360)	(1,371)	(1,394)
Other	(57)	1,199	489
Net cash from (used by) financing activities	10,672	(6,672)	11,994
Net increase (decrease) in cash	5,969	(6,112)	(2,252)
Cash (bank overdrafts) and cash equivalents at beginning of year	(635)	5,477	7,729
Cash (bank overdrafts) and cash equivalents at end of year	\$ 5,334	\$ (635)	\$ 5,477

## Supplemental disclosure of cash flow information

Cash paid during the year for:			
Interest	\$ 4,976	\$ 3,478	\$ 2,341
Income taxes	\$ 2,052	\$ 2,909	\$ 3,005

The accompanying notes are an integral part of these statements.

# Consolidated Statements of Shareholders' Equity

Thousands of dollars	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Note Receivable from PENWEST Savings & Stock Ownership Plan	Cumulative Translation Adjustment	Total Shareholders' Equity
Balances, September 1, 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	8,577	12,489	79,128	(29,327)	(3,340)	(362)	67,165
Net income			7,217				7,217
Exercise of stock options	14	61					75
Purchase of treasury stock				(1,310)			(1,310)
Savings and Stock Ownership Plan activity					362		362
Translation loss						(131)	(131)
Dividends declared			(1,396)				(1,396)
Balances, August 31, 1995	\$8,591	\$12,550	\$84,949	\$(30,637)	\$(2,978)	\$(493)	\$71,982

The accompanying notes are an integral part of these statements.



## Notes to Consolidated Financial Statements

### 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

The Company considers all highly liquid investments with a maturity of less than three months when purchased to be cash equivalents.

Cash equivalents consist of money market funds, short-term deposits, and commercial paper. Amounts reported in the balance sheet represent cost which approximates market value.

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 \$1,581,000 are netted against cash at August 31, 1995.

#### 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 \$209,000, \$51,000 and \$985,000 was capitalized in 1995, 1994, and 1993, respectively.

#### Foreign Currencies

Monetary assets and liabilities of the Company's foreign operations are translated into U.S. dollars at year-end exchange rates and revenue and expenses are translated at average exchange rates. Non-monetary assets and liabilities are converted at historical rates. In each instance, the functional currency is the U.S. dollar. Realized gains and losses from foreign currency transactions are reflected in the income statements.

#### Income Taxes

Deferred income taxes are provided on temporary differences between financial and income tax reporting methods.

#### 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 and stock appreciation rights are considered to be common share equivalents.

Research and Development

Research and development costs of \$6,773,000, \$6,346,000 and \$5,662,000 in 1995, 1994, and 1993, respectively, were charged to expense as incurred.

Reclassifications

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

B

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. The instruments used are principally readily marketable exchange traded futures contracts which are designated as hedges. The changes in market value of such contracts have a high correlation to the price changes of the hedged commodity. Also, the underlying commodity can be delivered against such contracts. To obtain a proper matching of revenue and expense, gains or losses arising from open and closed hedging transactions are included in inventory as a cost of the commodities and reflected in the income statement when the product is sold.

Thousands of dollars / August 31

	1995	1994
Raw materials, supplies and other	\$ 3,828	\$ 6,074
Work in progress	483	622
Finished goods	9,898	10,038
Total inventories	\$14,209	\$16,734

## C

## Debt

Thousands of dollars / August 31

	1995	1994
Unsecured term agreement, quarterly principal payments, final maturity in 2000, 6.50% interest rate at year-end	\$16,000	\$19,000
Private placement, 7.93% interest rate, semiannual interest-only payments with principal payments beginning in 1996, final maturity in 2005	20,000	20,000
Private placement, 7.97% interest rate, semiannual interest-only payments with two equal principal payments, one in 1998 and one in 2006	20,000	
Unsecured note, 9.4% interest rate, due in quarterly installments through 2000	3,780	4,450
Note payable, 8.49% interest rate, quarterly principal and interest payments through October 1997	3,118	3,547
	62,898	46,997
Less current portion	4,270	4,100
Net long-term debt	\$58,628	\$42,897

Maturities of long-term debt for the fiscal years ending August 31, 1996 through 2000 are as follows (thousands of dollars):

1996	\$ 4,270
1997	7,127
1998	8,955
1999	16,697
2000	6,277

The Company has an unsecured term agreement of \$16 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.

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. 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 placements, 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 aggregating \$15 million which provide for financing at various floating rates.

The Company enters into interest rate swap agreements to modify the interest characteristics of its outstanding debt. These agreements involve the exchange of interest payment streams without an exchange of underlying principal amount. Net amounts paid or received are reflected as adjustments to interest expense. The fair values of the swap agreements are not recognized in the financial statements. In the event of default by a counterparty, the risk in these transactions is the cost of replacing the interest rate contract at current market rates. The Company continually monitors the credit ratings of its counterparties. Management believes the risk of incurring losses is remote, and that if incurred, such losses would be immaterial. At August 31, 1995, approximately \$25 million of the Company's outstanding debt was subject to interest rate swap agreements. Of this amount, \$15 million involves floating rate to fixed rate swaps which effectively fix rates at approximately 9% and \$10 million involves fixed rate to floating rate swaps, with the floating rate approximately 6% at August 31, 1995.

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 an effective interest rate on the hedged portion of long-term debt of approximately 9.5%.

## D

### Leases

Certain of the Company's property, plant, and equipment is leased under operating leases ranging from one to 15 years with renewal options.

Rental expense under operating leases was \$3,202,000, \$2,787,000 and \$2,066,000 for fiscal years ended August 31, 1995, 1994, and 1993, respectively.

Future lease payments as of August 31, 1995 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
1996	\$ 4,098
1997	2,814
1998	2,312
1999	1,951
2000	608
Thereafter	1,898
Total minimum lease payments	\$13,681

# E

## 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:

	1995	1994	1993	1995 Option Price Range
Outstanding at beginning of year	615,859	590,809	596,762	\$ 3.31 - 27.50
Granted	271,000	59,000	27,000	20.75 - 22.75
Exercised	(13,600)	(13,950)	(23,003)	3.31 - 22.63
Cancelled	(25,800)	(20,000)	(9,950)	19.13
Outstanding at end of year	847,459	615,859	590,809	\$ 3.31 - 27.50
Exercisable at end of year	401,159	299,109	184,259	\$ 3.31 - 27.50

At August 31, 1995, 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, 1995. As a result of appreciation (depreciation) of PENWEST stock and vesting of the SARs, expense was charged (credited) for \$78,000, \$342,000 and (\$303,000) in 1995, 1994, and 1993, respectively.

# F

## Income Taxes

Income tax expense consists of the following:

Thousands of dollars / August 31	1995	1994	1993
Current			
Federal	\$2,102	\$ (904)	\$(1,731)
Foreign	4	138	213
State	232	56	(51)
	2,338	(710)	(1,569)
Deferred			
Federal	1,459	2,253	2,808
State	93	423	83
	1,552	2,676	2,891
Total provision	\$3,890	\$1,966	\$ 1,322



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

Thousands of dollars / August 31	1 9 9 5	1 9 9 4	1 9 9 3
Statutory tax rate	34%	34%	34%
Statutory tax	\$3,776	\$ 2,749	\$ 2,597
State taxes, net of federal benefit	215	164	77
Tax refunds and credits, including research and development credits	(313)	(1,095)	(1,503)
Tax advantaged investment income	(47)		
Other	259	148	151
Total provision	\$3,890	\$1,966	\$ 1,322

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

Thousands of dollars / August 31	1 9 9 5	1 9 9 4
Deferred tax assets:		
Alternative minimum tax credit	\$ 2,725	\$ 3,269
Research and development credit	622	300
Postretirement benefits	3,691	3,671
Provisions for accrued expenses	2,366	1,963
Other	523	246
Total deferred tax assets	9,927	9,545
Deferred tax liabilities:		
Depreciation	17,650	16,826
Other	2,143	926
Total deferred tax liabilities	19,793	17,752
Net deferred tax liabilities	\$ 9,866	\$ 8,207

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 1995 and 1994 included a discount rate of 7.5% and 8.0%, 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 increasing the projected benefit obligation by approximately \$1.4 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 (in thousands):

Year ended August 31	1995	1994	1993
Service cost of benefits earned during the year	\$ 603	\$ 591	\$ 545
Interest cost on projected benefit obligation	1,363	1,256	1,245
Actual return on plan assets	(2,599)	(842)	(2,449)
Net amortization and deferral	1,480	(253)	1,676
Net pension expense	\$ 847	\$ 752	\$ 1,017

The following table sets forth the funded status of both pension plans as of August 31, 1995 and 1994 (in thousands):

August 31	1995	1994
Actuarial present value of projected obligation, based on service to date and current salary levels:		
Vested	\$17,081	\$15,521
Nonvested	430	387
Accumulated benefit obligation	17,511	15,908
Effect of projected salary increases	2,052	1,663
Projected benefit obligation	19,563	17,571
Plan assets at fair market value	18,910	15,977
Projected benefit obligation greater than plan assets	(653)	(1,594)
Unrecognized actuarial net loss	254	1,264
Balance of unrecognized net obligation at transition being amortized over 15 years	1,137	577
Unrecognized prior service cost	534	472
Adjustment to record minimum liability		(1,987)
Net pension asset (liability)	\$ 1,272	\$ (1,268)



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 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 113,271 unallocated shares of PENWEST common stock as of August 31, 1995, including shares earned but not yet allocated. During 1995, approximately 52,630 shares of stock were earned by plan participants. The savings component expense of the plan was \$520,000, \$599,900 and \$519,000 for fiscal years 1995, 1994, and 1993, respectively. Compensation expense is recorded by the Company at the market value of shares released.

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 \$402,000, \$285,000 and \$420,000 for the fiscal years 1995, 1994 and 1993, 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. The shares held by the plan are considered outstanding for the earnings per share calculation.

#### 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 1995, 1994, and 1993, the net pension expense accrued for the SERP was \$856,000, \$347,000 and \$283,000, 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 \$2,501,000, \$2,649,000 and \$2,297,000 in 1995, 1994, and 1993, respectively.



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 include 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.

Postretirement benefit expense was \$359,000, \$834,000 and \$1,088,000 for the years ended August 31, 1995, 1994, and 1993, respectively. Presently the Company funds the current benefits on a cash basis and therefore there are no plan assets.

The following table sets forth the plan's funded status (in thousands of dollars):

Accumulated postretirement benefit obligation:

Year ended August 31	1995	1994
Retirees	\$ 4,119	\$ 5,020
Fully eligible active plan participants	311	297
Other active plan participants	2,190	2,365
Accumulated postretirement benefit obligation	6,620	7,682
Unrecognized actuarial net gain	3,535	2,420
Accrued postretirement benefit obligation	\$10,155	\$10,102



Net periodic postretirement benefit costs include the following components:

Year ended August 31	1 9 9 5	1 9 9 4	1 9 9 3
Service cost — benefits earned during the period	\$186	\$295	\$ 288
Interest cost on accumulated postretirement benefit obligations	402	604	800
Net amortization and deferral	(229)	(65)	
	\$359	\$834	\$1,088

Future benefit costs were estimated assuming medical costs would increase at a 10% annual rate for fiscal 1996, then beginning in fiscal 1997, decreasing by one half of a percent ratably over the next nine years to a rate of 5.5%. A 1% increase in this annual trend rate would have increased the accumulated postretirement benefit obligation at August 31, 1995 by \$954,000, with an increase of \$105,000 in the annual 1995 postretirement benefit expense. The weighted average discount rate used to estimate the accumulated postretirement obligation was 7.5% in 1995 and 8.0% in 1994. The change in discount rate had the impact of increasing the accumulated postretirement benefit obligation by \$1,100,000.

During the second quarter of fiscal 1994, the Company curtailed postretirement health benefits for salaried employees that had been previously accrued. The Company formerly 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 of 1994, there was a \$900,000 reduction of operating expenses recorded.



**Shareholders' Equity: Unissued Preferred Stock**

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 \$.01 per Right, and they expire in June 1998.

**Pacific Cogeneration, Inc.**

In December of 1994, the Company sold the assets of its subsidiary Pacific Cogeneration, Inc. to third parties. The Company recognized a gain on the sale of \$899,000 which is reflected as other income in 1995.





Quarterly Financial Data (Unaudited)

Fiscal 1995

Thousands of dollars except  
earnings per share data

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Sales	\$42,771	\$42,429	\$43,618	\$45,382	\$174,200
Gross margin	11,244	11,912	12,465	12,238	47,859
Income from operations	3,716	3,504	4,225	3,528	14,973
Net income	1,757	2,153	2,000	1,307	7,217
Earnings per common share	\$ 0.25	\$ 0.31	\$ 0.29	\$ 0.19	\$ 1.03
Dividends declared	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.20

Fiscal 1994

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

## Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Shareholders  
PENWEST, Ltd.

We have audited the accompanying consolidated balance sheets of PENWEST, LTD. as of August 31, 1995 and 1994, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended August 31, 1995. 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, 1995 and 1994, and the consolidated results of its operations and its cash flows for each of the three years in the period ended August 31, 1995, in conformity with generally accepted accounting principles.

*Ernst & Young LLP*

Seattle, Washington

October 13, 1995



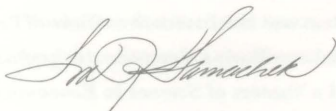
## Report of Management

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.

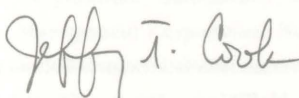
Ernst & Young LLP, independent auditors, is retained to audit the Company's consolidated financial statements. Their accompanying report is based on an audit conducted in accordance with generally accepted auditing standards, including a review of internal accounting controls and tests of accounting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

The Audit 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.

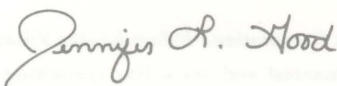
The independent auditors regularly meet with the Audit Committee without the presence of any other parties.



Tod R. Hamachek  
President and  
Chief Executive Officer



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



Jennifer L. Good  
Corporate Controller and  
Corporate Secretary

## Directors

### Richard E. Engebrecht

Mr. 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

Mr. 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 Seattle Times Co. He is a trustee of Virginia Mason Medical Center, the Seattle Foundation, The Washington Roundtable and Lakeside School. Hamachek holds an M.B.A. from the Harvard Business School and a B.A. from Williams College.

### Paul H. Hatfield

Mr. Hatfield worked for the Ralston Purina Company from 1959 until his retirement in 1995. Most recently, Hatfield served as a vice president of Ralston as well as the president and chief executive officer of Protein Technologies International, a wholly-owned subsidiary of the 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 vice-chairman of Petrolite Corporation, and a director of DEKALB Genetics Corporation, Stout Industries, the U.S. Chamber of Commerce, and the Japan American Society. Hatfield is also a member of the Advisory Board of International Business for St. Louis University.

### Harry Mullikin

Mr. 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

Ms. 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**

Mr. 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, Mr. 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 is a graduate of Stanford University, with a B.A. in history.

**William K. Street**

Since 1965, Mr. 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**

Mr. 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 also a director of PACCAR Inc. and PrimeSource 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.

**Curtis P. Lindley**

**Director Emeritus**

## 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  
(Retired August 31, 1995)

Robert G. Schmelzer  
Vice President,  
Human Resources

Robert G. Widmaier  
Vice President and  
Chief Innovation Officer

Jennifer L. Good  
Corporate Controller  
and Corporate Secretary

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  
Vice President, PENWEST  
President and General Manager  
Penwest Foods Co.

### Board Committees

**Executive Committee**  
James H. Wiborg, Chairperson  
Richard E. Engebrecht  
Tod R. Hamachek  
N. Stewart Rogers

**Audit and Environmental,  
Health and Safety Committee**  
Richard E. Engebrecht, Chairperson  
Paul H. Hatfield  
Sally G. Narodick  
William K. Street

**Compensation and Benefits Committee**  
Harry Mullikin, Chairperson  
William G. Parzybok  
Paul H. Hatfield  
James H. Wiborg

**Pension Committee**  
Sally G. Narodick, Chairperson  
Harry Mullikin  
N. Stewart Rogers  
William K. Street

**Nominating Committee**  
Paul H. Hatfield, Chairperson  
Sally G. Narodick  
William G. Parzybok

### Headquarters and General Information

PENWEST Corporate Headquarters  
777-108th Avenue N.E.  
Suite 2390  
Bellevue, WA 98004-5193

P.O. Box 1688  
Bellevue, WA 98009-1688  
(206) 462-6000

Penford Products Co. Headquarters  
1001 First Street S.W.  
Cedar Rapids, IA 52404

1088 West Sunnyside Road  
Idaho Falls, ID 83402

Penwest Pharmaceuticals  
Group Headquarters  
2981 Route 22  
Patterson, NY 12563

1001 First Street S.W.  
Cedar Rapids, IA 52404

Church House  
48, Church Street  
Reigate, Surrey RH2 0SN, UK

Maitotic 4, 15560 Nastola  
Finland

Postfach 1207  
25430 Uetersen  
Germany

Penwest Foods Co. Headquarters  
11011 East Peakview Avenue  
Englewood, CO 80111

1001 First Street S.W.  
Cedar Rapids, IA 52404

216 First Street  
Richland, WA 99352

### Annual Meeting

10:30 a.m., January 23, 1996  
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 P.L.L.C.  
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 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

PENWEST common stock, \$1.00 par value, is traded on the Nasdaq Stock Market under the symbol "PENW." On October 25, 1995, there were 1,415 shareholders of record. The high and low closing bid prices of the Company's common shares during the last two fiscal years are set forth below. The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

Market Price		
1994/1995 Quarter	High	Low
Ended 11/30	\$25.50	\$21.00
Ended 2/28	23.00	17.50
Ended 5/31	23.25	20.50
Ended 8/31	26.25	21.25
1993/1994 Quarter		
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

During each quarter in fiscal years 1995 and 1994, a \$0.05 per share cash dividend was declared and paid. The Company anticipates that it will continue to pay such quarterly dividends in the foreseeable future.



cataphon. The 1995 PENWEST Annual Report uses a variety of papers, all manufactured using Penford products. Printing techniques include embossing, debossing, transparent and opaque inks and both inline and offline matte varnishes. The report was electronically assembled in PostScript and translated to a Sciex Prisma environment for scanning, pre-press, proofing and film output. The report was printed on 40-inch Heidelberg six-color Speedmaster and 40-inch Mitsubishi eight-color presses and bound using the OTA Bind system.

Outside	<p><b>Jacket.</b> The jacket vellum is printed two sides using match and process inks with a sculptured blind emboss. <b>Cover.</b> The cover features a blind deboss.</p>
Inside	<p><b>Letter.</b> The portrait was reproduced as a high-key duotone from a black and white print. An offline matte varnish was applied. Letter text was reproduced in matte inks. <b>Customers.</b> This section of the report utilizes a 100# dull coated book. Images were reproduced as duotones from black and white prints, scanned with an unsharp mask to enhance film grain. Eight inks were used and an offline, dot-for-dot matte varnish was applied to the images. <b>Financials.</b> Pages were reproduced on felt finish 80# uncoated stock in four custom color matte inks. <b>Page composition.</b> Pages were produced electronically and transferred to printer via Syquest. Software included Adobe Page-Maker 6.0 and Adobe PhotoShop 3.0. Images were placed as low resolution files and merged with high resolution files for final output. Color and composing were proofed using a waterproof system. <b>Typography.</b> Univers 67, a sans serif, and Didot Bold Extended, both created by Adrian Frutiger in 1957 and 1991 respectively, are used in the 1995 report.</p>
Credits	<p><b>Seattle.</b> Designed and produced by Leimer Cross Design. Photography by Jeff Corwin. <b>Los Angeles.</b> Cover illustration by Paul Bice, Jr. Printed by Lithographix.</p>

