"Great Wall" is
one of the three major brands of
dry wine in China, where the Group
enjoys a 37% market share.

Management Discussion and Analysis

Mr. Yu Guangquan
Managing Director

During the year:

- The Group's consolidated turnover totalled HK$16,792,623,000, a substantial increase of 23% compared with the previous year;

- While profit attributable to shareholders amounted to HK$300,702,000, which was 27% less than that in the previous year, the Group's EBITDA was HK$744 millions, 2.6% less than that in the previous year;

- The basic earning per share was 17.1 HK cents, a 32% decrease compared to 25.3 HK cents per share (restated) during the previous year; and

- The dividend of 6.5 HK cents represented a payout ratio of 38.0%, compared to 9.5 HK cents per share (a payout ratio of 37.5%) during the previous year.

The Group has five food-related core businesses, namely, edible oils, soya bean meal and related products; wineries; confectionery; flour milling; and trading.

The performances of these businesses during the year are set out below, together with other information related to the Group.

Edible oils, soya bean meal and related products

The Group is now China's largest producer of edible oils and soya bean meal. It is mainly involved in the oil extraction and refined oil businesses, as well as in the sales of related products, such as the "四海" brand of soya bean meal (an important raw material used to feed animals and poultry), retail bulk edible oils, the "Fortune" brand of consumer-pack oils, and specialty oils in China.

A sharp increase in soya bean prices greatly affected this sector during the year. The price of imported soya bean rose to a historical high for a period of several months during the first half of the year. This, coupled with continuous increase in freight charges, resulted in high production costs. In addition, demand for soya bean meal decreased substantially, due to the outbreak of avian flu. The industry subsequently experienced a broad range of business hardships. Due to these factors, it was impossible to pass on the full increase in production costs to downstream products, and many oil extraction enterprises suffered difficulties due to their inability to absorb the shocks. Despite this harsh operating environment, the Group surmounted many difficulties and minimised its losses during the first half of the year. Indeed, it managed to outperform its competitors in the oil-extraction industry by using its own strength and applying effective solutions.

As soya bean prices declined to a more reasonable level, and other adverse factors decreased or disappeared altogether, the sector turned around during the second half of the year, and it even managed to return to profit in the fourth quarter. This profit not only covered the losses during the first half of the year, but also made a contribution to the Company. On the whole, the sector recorded a turnover of HK$11,657,102,000, an increase of 27% over the corresponding period of the previous year, and it accounted for 69.4% of the Group's total turnover. In 2004, the Group sold 3,151,428 tonnes of soya bean meal, a 12% increase over the previous year; whereas sales of retail bulk edible oils totalled 1,044,330 tonnes, an increase by 1.2%; and sales of consumer-pack oils amounted to 504,850 tonnes, an increase by 30%.

Management Discussion and Analysis

To improve the sector's overall gross profit margin, the Company supplemented its traditional consumer-pack oil products by proactively introducing new consumer packs of edible oils that have a higher gross profit margin than soya bean oil, such as sunflower seed oil and safflower seed oil. These products were marketed as high-end edible oils under the "Vitoil" brand; and they cater to the growing demand among Chinese consumers for more diversified, specialised and higher-quality edible oils. During the entire year, the percentage of sales of consumer-pack edible oils compared with bulk oils rose from the 35% and 65% of past years to 40% and 60% respectively. The changes in the Company's product mix further reinforced the Company's strength in this particular sector of the industry.

The year also saw a remarkable improvement in the Company's development of its edible-oil by-products. The Company began to produce lecithin as a by-product of the soya bean oil refinement process. Besides improving the functioning of the heart and brain, lecithin can also be used as an emulsifier in the food-processing industry. During the year, the sector sold 3,394 tonnes of lecithin. The gross profit margin of lecithin, which is higher than that of oil refinement, improved the profitability of the entire business.

In the face of fierce market competition, the Company will put greater efforts into adjusting its product mix and producing specialty oils, special oil types, and other related products that involve more-advanced technology and add greater value. These products are mostly special plant lipids that provide various nutritional elements that the human body cannot produce by itself. They can improve people's health by freeing them from various diseases caused by deficiencies of these lipids.

Edible vegetable oils are important products that influence the standards of living in China. The improvement of China's market system and the complete opening up of the edible oils market have resulted in growing consumption of edible oils. This has in turn created promising future prospects for the market. Although the price of imported soya bean may still fluctuate, the Company will leverage its long-established advantage of having a completely integrated business operation to lower its production costs. It will use the trading expertise it has acquired over the years to broaden its raw-material purchase channels and control its costs and risks. The Company will also continue to develop the "Fortune" and "Vitoil" brand names and expand its sales channels in order to capture greater market share. At the same time, the Company will increase its investment in technological development and research and proactively adjust its product mix in order to stimulate greater sales in this sector.

Wineries

This business mainly consists of the production and sales of wines in China under the brand name of "Great Wall". During the year, the turnover of "Great Wall" branded wines was HK$1,164,246,000, a dramatic increase of 31% compared with the previous year and accounting for 6.9% of the Group's total turnover.

"Great Wall" is a major brand of dry wine in China, where the Group enjoys a 37% market share. The Group's current annual winemaking capacity is 77,000 tonnes; and the sales volume increased from 51,000 tonnes in 2003 to 57,000 tonnes in 2004. Sales of "Great Wall" branded wines have continued to grow rapidly, resulting from the synergistic initial effects of the integration of the Group's three wineries, increased production capacity, continuous enhancement of product quality, ongoing promotion of the brand, and better marketing strategies.

During the year, the Company proactively adjusted its product mix by entering the high-end wine market. It successfully launched the Huaxia Vineyards Cru A Dry Red Wine, which won immediate market recognition and acclaim. Thanks to its excellent quality and the renowned "Great Wall" brand, it has established a foothold in the southern China region which is the best market for red wines in China. At the same time, the excellent quality of Huaxia Vineyards Cru A Dry Red Wine has also been recognised by international wine connoisseurs, earning it the cachet of "The Best Red Wine in China", as well as winning the great gold medal by the jury of Fifth China Wine and Spirits Competition, which was co-organised by the International Wine Connoisseurs of Brussels (布魯塞爾國際評酒協會).

Management Discussion and Analysis

During the year, the "Great Wall" brand was also recognised by the Trademark Office of the State Administration for Industry and Commerce in China as a "Well-known Trademark in China", thus formally receiving well-known brand-name protection from China's trademark authorities. This has undoubtedly helped the Company to combat counterfeiters, as well as strengthen and further establish the brand names of "Great Wall" wines.

These satisfactory results have helped the Company define the directions for its future development in this sector. It will continue to adjust its product mix and develop the market for high-end wines, as well as protect and strengthen the promotion of the "Great Wall" brand. Besides adding two new pouring lines that can each produce 15,000 bottles of wine per hour at the Huaxia Winery Co., Ltd (華夏葡萄釀酒有限公司) and Yantai COFCO Winery Co., Ltd (煙台中糧葡萄釀酒有限公司), the Company also began building the Chateau Nava Valley (the "Chateau") in Yantai, Shandong Province, China. The Chateau will be developed into a comprehensive economic unit that encompasses vine development, grape growing, wine production and sales, technological development and research, vineyard tourism and promotion of oenology. Construction is scheduled for completion in 2007. The Chateau will be another milestone in the history of "Great Wall" wines, because it will symbolise their evolution from the middle to high-end market, where they will compete aggressively with western wines.

Since China further reduced the tariff on imported bottled wine to 14%, many leading foreign wineries have accelerated their entrance into the Chinese market. Chinese enterprises also took advantage of the continuing growth in demand for wine to establish more production bases and their own brands. To increase its market share further, the Company has been seeking opportunities to expand its business in China. It is also exploring possibilities for cooperation with foreign wineries to generate greater profit. The Company regards and accepts competition as a driving force, and it plans to develop the "Great Wall" wines business faster and on a larger scale by strengthening the integration of its three wineries, and investing more resources into building up the brand.

Confectionery

The Group produces and distributes "Le Conte" brand of chocolate and confectionery products in China. During the year, "Le Conte" branded products remained the Company's main products in this sector, and they enjoyed a market share of 12%, giving them the second place in the chocolate and confectionery market in China. In 2004, the sector's turnover totalled HK$343,725,000, an increase of 17% over the corresponding period of the previous year and accounting for 2.1% of the Group's total turnover. Since sales within the industry as a whole rose by around 8% to 10%, the Company's above-average growth was satisfactory.

Despite sharp increases in the prices of cocoa, nuts and packaging materials, which directly affected the gross profit margin of this sector, the Company still managed to achieve better turnover and profit than its competitors, thanks to effective cost controls, flexible purchase, production and sales policies, and strong internal management.

During the year, the Company added another production line and launched new products, such as chocolate thins and jelly products, successfully advancing towards its goals of business growth through diversification and securing a leadership position in new product development. The Company currently has 11 production lines, with an annual total production capacity of 10,000 tonnes of chocolate and 5,000 tonnes of confectionery goods. In 2004, the Company also manufactured nearly 100 individual products in five product series.

The Company will proactively use the resources of the research centre at its Shenzhen plant to strengthen its growth dynamic by researching and developing snack-food products, such as confectionery, and by diversifying its product mix. Meanwhile, it will seek opportunities for mergers and acquisitions in order to expand its market share.

To explore the huge potential of China's snack-food market, which is based on the expectation of higher consumer demand, the Company will build on its existing network of more than 200 distributors by developing the high-end confectionery, chocolate and snack-food market through a

Management Discussion and Analysis

strategy of creating multiple brands and increasing marketing promotion, while further expanding sales channels in second- and third-tier cities and controlling costs. In addition, it will strive to develop sales channels in areas outside mainland China, such as Hong Kong and Macau, and explore opportunities for further business growth through ambitious strategic deployment. The Company expects these measures to result in satisfactory growth for the confectionery and chocolate sector, and make positive contributions to its overall business.

Flour milling

During the year, the turnover of the Group's flour milling business totalled HK$589,255,000, up 41% over the preceding year and accounting for 3.5% of its total turnover.

As spending power has been growing in China, the Company has continuously adjusted its product portfolio by increasing the proportion of its production and sales of high-end flour and specialty flour. High-end and specialty flour now accounts for approximately 50% of its turnover. Besides continuously adjusting its product portfolio, the Company will speed up its launch of new products and the development of downstream products, such as vermicelli.

The Company has placed emphasis on this sector's management, and it has now developed management systems of proven effectiveness that have continuously improved profitability. The enhanced turnover and profitability both indicate a promising future for the flour milling business.

Meanwhile, the Company has been focusing on establishing a sales network and the development of product brands. During the year, its "神象" flour brand received recognition for the first time as a renowned PRC brand in an appraisal of renowned brands in China.

Trading

The Company engages in domestic trade and the import and export of foodstuffs, grains and animal feedstock. In 2004, it was mainly involved in bulk commodity back-to-back trading of sugar, maize, fishmeal, cotton meal, vegetable meal, rice, soya beans and red beans. The Company also processed raw materials for export. In addition, it provided foodstuffs trade agency services on a commission basis. During the year, its trading business recorded HK$3,038,295,000 in turnover, an increase of 4% compared with the corresponding period of the previous year and accounting for 18.1% of the Group's total turnover. The trading business was made up of approximately 75% export business, 20% import business, and the remaining 5% domestic trade.

In response to the ever-changing market, the Company adjusted its trading strategies to increase exports of food and cereal products with higher profit margin, thus contributing significantly to its turnover. The Company will continue to explore new trading channels and introduce new commodities. The management believes that the trading business can still contribute healthy and stable operating profit by capitalising on the Company's diversified trading business model, its more than 50 years of experience in the foodstuffs industry, its established international network and its vigorous risk management system in trading.

As the Company continues to focus on developing an effective strategy to promote its brand name products, the business of these products has accounted for an increasing proportion of the overall business; accordingly the proportion of the trading sector's contribution will decrease. The Company's ultimate goal is to make its brand name products the core business, and this trend will remain unchanged in the future.

Liquidity and financial resources

The Company's financial position was sound with a stable cash flow. As of the end of December 2004, the Company's total shareholders' equity amounted to HK$4,312,985,000, representing an increase of 4.3% compared with the previous year (as restated). As of 31 December 2004, the Company's cash and bank deposits totalled HK$1,144,448,000 (31 December 2003: HK$1,113,800,000). The Company's net current assets were approximately HK$1,125,159,000 (31 December 2003: HK$1,098,178,000).

Taking into consideration all the above, as well as bank loans and other loans and facilities available, the management believes that the Company will have adequate financial resources to settle debts and provide funding to meet its daily operational and capital expenditure.

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The Company's monetary assets, liabilities and transactions are principally denominated in Hong Kong dollars, Renminbi and US dollars. The Company believes that, the pegged exchange rate between Hong Kong dollar and US dollar, together with minimal fluctuation in the exchange rate between Hong Kong dollar and Renminbi, means that its recent exposure to exchange-rate movements is limited. However, the Company will closely monitor the fluctuation in the exchange rate among Hong Kong dollar, Renminbi and US dollar and will adopt appropriate measures to reduce the exchange risk, if any.

Capital structure

During the year, a total of 10,011,000 shares of HK$0.1 per share were issued as a result of the exercise of share options by certain executive directors of the Company and employees of the Group. Accordingly, the amount of the issued share capital of the Company has increased by HK$1,001,100. Details on the movements of the share capital of the Company are set out in note 27 headed "Share Capital" to the financial statements.

As of 31 December 2004, the Company had no significant borrowings except for certain bank loans, loans from minority shareholders of the Company's subsidiaries, loans from the Company's ultimate holding company, China National Cereals, Oils & Foodstuffs Corporation ("COFCO"), and loans from a wholly owned subsidiary of COFCO, all of which totalled HK$2,671,948,000 (31 December 2003: HK$2,979,514,000). During the year, all the Company's bank borrowings bore fixed annual interest rates of between 2.57% and 6.34% (31 December 2003: between 1.38% and 5.84%). Other borrowings were interest-free or bore fixed annual interest rates ranging from 2.31% to 5.58% (31 December 2003: from 2.38% to 5.31%).

As of 31 December 2004, the Company's total assets were approximately HK$9,115,556,000 (31 December 2003: HK$9,676,789,000, as restated), and the aggregate debts (excluding loans from minority shareholders of subsidiaries that were of a capital nature) were HK$2,610,323,000 (31 December 2003: HK$2,865,148,000). Based on the above, the Company's gearing ratio was approximately 28.6% (31 December 2003: 29.6%).

Contingent liabilities and assets pledged

As of 31 December 2004, the Company had no material contingent liabilities.

As of 31 December 2004, certain of the Company's bank loans were secured by charges over its fixed assets and investment properties with a net carrying value of approximately HK$151,131,000 (31 December 2003: HK$176,657,000).

Employment and remuneration policy

As of 31 December 2004, the Company employed approximately 6,507 employees in China and Hong Kong (31 December 2003: 5,117 employees). All employees are remunerated according to their performance, experience and prevailing trade practices. Both on-the-job training and professional training were provided to them. The Company also provides retirement benefits, either in the form of the Mandatory Provident Fund Exempted ORSO or Mandatory Provident Fund entitlements, to employees in Hong Kong. A similar scheme is also provided for employees in China. Details concerning employee benefit schemes are set out in note 3 headed "Summary of Significant Accounting Policies" under sub-heading "Employee Benefits" to the financial statements.

The Company has implemented a share option scheme (the "Scheme") to reward eligible participants (including executive directors of the Company) according to their individual merits. During the year, 34,720,000 shares options were granted by the Company to executive directors, eligible employees of the Group and an eligible participant. A total of 10,011,000 shares were issued to certain executive directors and employees of the Group as a result of the exercise of their share options. In addition, share options in respect of a total of 720,000 shares lapsed during the year.

Taking into consideration the above and other relevant movements, a total of 67,574,000 share options of the Company were outstanding at the end of December 2004. The share options granted can be exercised at any time within four years after the expiration of a period of 12 months from the date when the options were granted.

Management Discussion and Analysis

Details of the Scheme are set out in note 28 headed "Share Option Scheme" to the financial statements.

Changes in the Company's structure

On 24 March 2004, pursuant to an equity transfer agreement, a wholly-owned subsidiary of the Company and a connected party became the investors in a wholly-foreign owned company ("JV Co") registered in China, in which the Company held 70% equity interests. The registered capital of the JV Co was US$12,800,000 (equivalent to approximately HK$99,840,000). On 28 February 2005, the registered capital of the JV Co was increased by US$9,600,000 (equivalent to approximately HK$74,880,000). Details of the JV Co and the Company's commitment are set out on page 27 of this annual report.

Apart from the above, there were no material changes in the structure of the Company during the year.

Prospects

With its strong foundations and capacity, the Company has maintained a leading position in the market after weathering a year of difficulties and challenges. The valuable experience gained in these adversities has made the Company become more mature and confident, more enlightened about its ongoing development in the future, as well as made the Company underpin its business.

The Company adheres to a strategy of focusing on the development of consumer food brands. It will continue to review its operations and market conditions using new ideas, and it will aim to advance towards a higher market position by adopting clearer strategic objectives and more-effective measures. Furthermore, the Company will be geared to and dominant in the market, with a view to steadily progressing towards market leadership for its brands.

In line with the development of its brands, the Company will invest considerable resources in research and development ("R&D") efforts. Its R&D centre has effectively pushed the development of new wines and confectionery products. As the Company continues to increase and improve its R&D functions, its edible oils R&D centre has undertaken to develop new and high value-added processed products to enhance its competitiveness. With R&D support and a market-led strategy, all sectors of the Company will further adjust and improve their respective product portfolios to provide consumers with their preferred products and services. The Company will strive to enhance and strengthen its sales performance in order to gain greater market share, and will continue to strive for internal integration to lower costs while increasing efficiency. At the same time, the Company will identify growth opportunities in external markets in order to increase the value of the Company. Effective implementation of these strategies for the healthy long-term development of the Company will substantially strengthen its competitiveness and stimulate its ongoing development.

The Chinese economy's robust growth and the incessant increase of its consumers' spending power have created a platform and a promising future for the Company's business development which gives it full confidence and optimism about its future prospects. With its ambition and using effective methods, the Company will certainly deliver faster growth and greater returns for its shareholders.

Yu Guangquan
Managing Director

"Le Conte" chocolate and confectionery products secured the second place in the market with a 12% share. During the year, the Company launched chocolate thins and jelly products, gaining a leadership position in terms of new product development.