



MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS REVIEW

During the year, the Company and its subsidiaries (the “Group”) recorded a turnover of HK\$6.6 million, decreasing from HK\$101 million last year. A loss of HK\$72.3 million was recorded for the year ended 31st March 2006, reducing from a loss of HK\$130.3 million last year. The decrease in turnover and the net loss reflects the development stage of the Group’s animated movies in the pipeline, contributions of which shall be recognised after their respective deliveries. The management is optimistic on the Group’s business development and operations and believes the Group’s results in subsequent periods will better reflect its business development and growth.

Loss for the year reflects:

- i) the lack of revenue being recognised for the animated film currently in production until they are released;
- ii) expense of HK\$19.6 million recognised due to the adoption of new accounting policies in relation to share options granted to employees by the Group as part of its incentive scheme; and
- iii) an impairment loss on CG animation pictures of HK\$19.4 million recognised in light of recent market conditions.

In the past year, the Group has gradually transformed its core operations from outsourced CG animation production services to the production of its own films. In order to facilitate this strategic transformation as well as the expansion into visual effects and game development areas, an acquisition of HK\$19.7 million of software and hardware was made. Management believes that the production of its own proprietary films and the diversification into businesses synergistic with the Group’s well-developed CG animation operations can best leverage on the Group’s resources and enhance returns.

During the year, the Company issued convertible notes to both (i) an independent third party; and (ii) Mr. Kao Cheung Chong, Michael (“Mr. Kao”), the Chairman, an Executive Director and major shareholder of the Group. The proceeds will be used to finance the expansion of the Group’s pre-production studios, recruitment of professional to strengthen the major operations in both Hong Kong and the USA, support pre-production of new projects, and the development of visual effects & game business. The gross proceeds from the issuance of the convertible notes, aggregated HK\$70 million. Details of the subscriptions are as follows:

a) *The Winnington Subscription Agreement*

The Company entered into the Winnington Subscription Agreement with Winnington Capital Limited on 8th November 2005 pursuant to which the Company agreed to issue and Winnington Capital Limited agreed to subscribe for, or procure the subscription of, the Winnington Convertible Note in an aggregate principal amount of HK\$50 million. The subscription was completed on 30th November 2005.



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b) *The Connected Subscription Agreement*

The Company also entered into the Connected Subscription Agreement with Mr. Kao, pursuant to which the Company agreed to issue and Mr. Kao agreed to subscribe for the connected convertible note in an aggregate principal amount of HK\$20 million. This constitutes a connected transaction of the Company under Chapter 14A of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") and was subject to approval from shareholders other than Mr. Kao and his associates by way of poll at the special general meeting convened on 20th December 2005 and the aforesaid resolution was duly passed by the independent shareholders on that date. The subscription was completed on 5th January 2006.

CG Animation Pictures

The Group is currently producing two animation pictures, namely *Highlander* and *TMNT*. *Highlander* is scheduled for completion in the fourth quarter of 2006 while *TMNT* is expected to hit cinema screens worldwide in 2007 under the distribution by Warner Bros. Pictures, Inc. and The Weinstein Company LLC. The corresponding revenue and cost for both animated films will be recognised commencing from their deliveries, which are expected to begin in the coming financial year.

On the financial side, in order to provide a steady source of fund for the production of *TMNT*, a US\$27.5 million film financing was secured from City National Bank of the USA on 30th November 2005 with a completion guarantee from cineFinance Insurance Services, LLC. Up to the balance sheet date, US\$12.1 million had been drawn.

Two new business streams, visual effects and game development were introduced during this financial year. The former involves the application of CG animation and visual effects into live-action movies while the latter involves the development of video game and arrangement of game publishing. The visual effects department began generating revenue for the Group during the year ended 31st March 2006. During the year, the game development division had been actively developing an original adventure video game demo for marketing purposes. Due to the similarity in certain applicable techniques and resource allocation, these two business streams can well leverage on the Group's robust resources in its core operation of CG animation production. The Group believes that both business ventures can create synergy within the Group and can provide a potential additional source of growth and income in the future.

Management Consultancy Services

Turnover generated from the provision of consultancy services by the Group in both Hong Kong and outside Hong Kong to its associate, Boto International Holdings Limited ("BIHL"), under a management consultancy agreement, reduced by HK\$4.3 million to HK\$6.1 million as compared to last year. The reduction was due to the retirement and resignation of certain senior executives previously providing consultancy services to BIHL.

Owing to the resignation & retirement of certain senior executives, the Board of Directors (the "Board") and BIHL mutually agreed to terminate the consultancy services provided by the Group to BIHL with effect from 1st April 2006.



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PROSPECTS

The Group's shift in focus from outsourced production services to production of its own projects is continuing satisfactorily. Production of *TMNT* and *Highlander* in the Group's Hong Kong and US studios and in Kabushiki Kaisha Mad House of Japan respectively are well into the core of their production cycles and have been progressing smoothly.

As *Highlander* completes in late 2006, the Group believes that this anime film, embodying a fusion of the East and West under the direction of acclaimed anime director Yoshiaki Kawajiri, will attract audiences into a brand new genre of animation film.

The tightly-knitted cooperation between Hollywood creative talents via the Group's creative studio in Los Angeles and the CG talents of the Group's Hong Kong production studio continues to fare well in the production of *TMNT*. As will be seen upon its debut, *TMNT* incorporates many new techniques and technologies developed by the Group that will certainly give viewers a lasting impression. The Group believes that the movie, which will be distributed by Warner Bros. Pictures, Inc. and The Weinstein Company LLC internationally in 2007, will represent quality that is rarely seen from the works of studios in the region and its exciting action and great humor will surely provide audiences worldwide with a wonderful cinematic experience.

While the Group steadily establishes its foothold in the echelon of world-class studios via the production of *TMNT*, it continues to seek to expand its portfolio and refine its capabilities. In June 2006, the Group obtained the license option from Tatsunoko Production of Japan to produce a new CG animation feature length motion picture based on the long-running anime franchise *Gatchaman*, which was one of the pioneering Japanese anime TV programs to gain general international popularity. With over 205 TV episodes, one feature film, three direct to video films and its various releases and renditions under other titles internationally over a thirty-year span, *Gatchaman* is also one of the longest running anime franchises and, as a result, has accumulated a substantial "Gatchamaniac" fan base all over the world. The Group believes that this franchise has the right combination of well-established fan base and an action element that best highlights the Group's strength in producing CG animation with thrilling action. Mr. Kevin Munroe, scriptwriter and director of *TMNT* shall script and direct this coming film. Consistent with the Group's strategy to mitigate investment risk via the securing of distribution arrangements, the Group is now producing a teaser and pre-marketing materials for presentation to potential international distributors.

To further enhance the Group's production capabilities and capacity, the Group continues to expand its operations both in Hong Kong and in the USA. A new studio facility of approximately 16,000 square feet in Los Angeles, USA is being furnished and shall become the home of the Group's US studio in the third quarter of 2006. The new facility offers a better-equipped and logistically laid out environment for the Group's Hollywood artists to apply their talents. In Hong Kong, the Group's production studio shall also expand from approximately 56,000 square feet to approximately 70,000 square feet, which shall be used to accommodate the additional workforce required for the various upcoming projects undertaken by the Group. The enhanced facilities of the Group, together with further increase in talent pool, shall provide the Group with yet higher capacity and capabilities to handle the various exciting projects coming through the pipeline.



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Leveraging the artistic and technical strengths of the Group, the Group's video game development is steadily progressing. The Group is currently working with an experienced game industry consultant in the USA on developing game concepts and business opportunities.

iDream Production Limited, the Group's visual effects division, continues to deliver quality work in special effects production for live-action movies. Several visual effects productions for local movies and various commercials have been delivered at quality that was well received by clients. A number of new projects are currently under development or negotiations with various moviemakers and production companies. With the renowned quality of the Group's productions in both animation and visual effects, the Group is confident that this division can continue to grow with success.

The Group's CG animation operations has evolved and matured tremendously since the days of its first project *Zentrix*TM, courtesy of the non-stop quest for progress of the Group's energetic and loyal team of CG talents. With the debut of *TMNT* underway and many more exciting movies to come, the Group is stepping progressively closer to its goal of becoming a comprehensive world-class animation studio.

LIQUIDITY AND FINANCIAL RESOURCES

The Group generally finances its operations with internally generated cash flows and banking facilities. At 31st March 2006, the Group had available aggregate banking facilities of HK\$82.7 million of which approximately HK\$50.1 million had been utilized. The Group's cash deposits and bank balances as at that date amounted to approximately HK\$105.2 million. The Board believes that the Group has sufficient financial resources to discharge its debts and finance its operations and capital expenditures.

Furthermore, the Group has maintained a sound capital structure with a current ratio of 1.7 and a gearing ratio of 36.74% (being total borrowings to total assets) at year end date.

FOREIGN EXCHANGE EXPOSURE

Transactions of the Group are predominately denominated in Hong Kong dollars, US dollars, Euro and Japanese Yen, no hedging or other instruments to reduce the currency risks have been implemented during the year. However, review of the Group's exposure to foreign exchange risk is conducted periodically and derivative financial instruments may be used to hedge against such risks when necessary.



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PLEDGE OF ASSETS

At 31st March 2006, a CG animation picture and all rights therein and thereto, and all properties and things of value pertaining thereto, and all products and proceeds thereof, whether now in existence or hereafter made, acquired or produced with a carrying value of HK\$147,710,000 was pledged as securities to a bank (the "Bank") for the credit facilities granted to the Group, to an insurance company for the guarantee granted to the Bank and to two independent third parties for the distribution and exploitation in and to the CG animation picture.

CONTINGENT LIABILITIES

At 31st March 2006, the Group had no significant contingent liabilities.

HUMAN RESOURCES

At 31st March 2006, the Group employed about 400 full-time staff worldwide. Remuneration policies are reviewed regularly to ensure that compensation and benefit packages are in line with the market in respective countries where the Group has operations. Remuneration packages of Directors and senior management are reviewed and approved by the Remuneration Committee formed by two Independent Non-executive Directors and one Executive Director of the Company. In addition to basic salary, incentives in the form of bonuses and share options may also be offered to eligible employees on the basis of individual performance and at the discretion of the Board.

The Group is committed to continually developing the potential of its staff to the fullest and updating them with the latest in technological and technical developments. The Group's studio has in-house training facilities where structured training programs are given to staff in both technical and managerial disciplines. Besides internal training programs, the Group also provides customised training courses in collaboration with external training consultants and educational institutions.