

| Chairman's Statement

Dear Shareholders,

I shall present the annual report of China Water Affairs Group Limited (the "Company") and together with its subsidiaries (collectively, the "Group") for the year ended 31 March 2006.

INDUSTRY OVERVIEW

China's rapid economic growth has brought changes to the pattern of water consumption in the country. China's water resources per capita are only a quarter of the world's average. Nearly 80% of China's water resources are found in the Yangtze River and in the southern regions of China. Northern China, with 35% of the country's population, has only about 13% of the mainland's water resources. As water demand continues to rise, uneven water distribution, falling groundwater tables, poor efficiency of utilisation, as well as pollution are becoming the major contributing factors causing the decline and deterioration of water resources which further aggravates the already acute water scarcity in China. In the absence of effective pollution controls, China's surface and ground water quality has been seriously degraded. Many of the water resources are so polluted that they are no longer fit for human consumption even after treatment. Unless effective pollution measures are put in place, China's water quality will continue to worsen as a consequence of rapid urbanisation, industrial development and rising population.

In recognition of this acute water scarcity and continuing deterioration in water quality in China, the Chinese Government understands that deregulation is needed in order to improve efficiencies in previously inefficiently operated government owned water systems. Tariff hikes will also be used by the Chinese Government as a mean to reduce excess usage of water and to promote water conservation in the world's most populous country.

As water is a unique commodity with no substitute, water operators enjoy the benefit of regional monopolies. With water demand rising steadily, water tariff will inevitably be raised as clean and safe water resources declines. Deregulation and tariff hikes are likely to attract foreign investors to acquire or merge with water operations previously owned by governmental entities. The potential growth in utilisation through increases in rate of urbanisation, penetration and tariff hikes, provide foreign investors with opportunities to obtain continued long term profitability and providing fair returns on their investments.

Company's business

Since the Company changed its name to China Water Affairs Group Limited, it realigned its business focus to becoming a major player in the business of raw water and urban water supply as well as waste water services in China. The Company is now the holding company for regulated utility companies providing water and/or waste water services to more than 1.2 million people in Guangdong, Jiangxi, Henan and Hebei Provinces in the Peoples' Republic of China. In addition to the provision of urban water supply and sewage treatment, the Group is also providing value added services such as installing meters to industrial and residential users and undertaking water related construction projects to further strengthen the Group's financial position both in terms of revenue and net profit.

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Recent development

As an integral part of the company business strategies, the Company continues to expand through acquisition and merger activities. It has entered into 9 preliminary agreements recently with Municipal Government in Shandong, Shanghai, Xinhui, Lijiang, Zhoukou, Sanya, Fuyang and Baiyin cities for the investment or formation of sino-foreign joint venture companies to engage in the business of providing treated and untreated water as well as sewage treatment services to these cities. Since the date of this announcement, the Company has executed agreement with China Water Industry Investment Corporation for the acquisition of an 8% interest in Shandong Water Supply and entered into joint venture agreement with the Municipal Government of Zhoukou, Henan Province to engage in the business of water supply services in Zhoukou city. Providing that joint venture agreements with the remaining Municipal Government can be timely executed, the Company will increase its population coverage from about 1.2 million to 4 million people. The total daily water supply capacity will increase to about 2.4 million tons from the existing 0.5 million tons. At the same time, daily utilisation volume will be increased from the current 185,000 tons to over 1 million tons.

The Company has raised funding through issuing of new shares during the year to partly finance the business expansion. In the months of June and July 2006, the Company successfully issued convertible bonds for an aggregated value of HK\$300 million which has further strengthened the Company's financial position to fund its project expansion.

BUSINESS REVIEW

Results

The results following the shift and realignment of the Group's business focus is first witnessed in this year's financial report. The addition of 3 majority owned water supply companies in Jiangxi and the acquisition of a 50% interest in Conseco Seabuckthorn Company Limited ("Conseco"), a previously state-owned company, engaged in the Seabuckthorn related business and with the significant downsizing of the remaining electronic businesses at the end of 2005, the Group has completed its business transformation to an integrated water supplier and a provider of sewage treatment services.

With the electronic business substantially reduced at the end of December 2005, the Group has recorded a turnover of HK\$52.9 million representing an increase of 9% from HK\$48.5 million recorded last year. The Group has recorded a gross profit of HK\$21.7 million from HK\$ 3.7 million last year representing an increase of 486%. In addition to the gross profit earned, the Group recognised gain of HK\$20.5 million arising on the initial recognition of biological assets at fair value less estimated point-of-sale costs under HKAS 41, which was fully realised through sales during the year.

For the year under review, the Group recorded a loss before taxation of HK\$20.3 million representing a reduction of HK\$9.5 million (2005: loss before taxation of HK\$29.8 million). Although the Group has recorded a segment profit from operation of HK\$11.1 million from our city water supply and sewage treatment segments, the first time adoption of the HKFRS 2 on share-based payment in respect of the share options granted to directors, staff and other parties during the year have been valued at HK\$30.5 million. After excluding these share options expenses under the new HKFRS 2, the Group would have made a pre-tax profit of HK\$10.2 million.

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Future plans and prospects

China is one of the most populated countries in the world with 1.3 billion people, however, only less than 300 million people in the country have access to drinkable tap water. Accelerated by the severe water resources shortage in China, particularly in North China, the water crisis will worsen progressively if governmental controls were not put in place. In light of this severe water shortage, Chinese Government has reacted with determination to increase utilisation efficiency and by raising water tariff to instill a concept of water conservation. Deregulation and tariff hikes in the water sector are means to which the Government has taken to achieve efficiency in water operations previously owned by the state or local governmental authorities and to discourage excessive usage of this precious resource.

Deregulation and tariff hikes in China's water sector created unlimited business opportunities for water operators as well as investors locally and abroad to enjoy a steady and fair return on their investments. The most important factors in China's deregulation of its water systems are the benefits derived from the control of pipeline networks and the concessions to operate water systems in a regional monopolistic environment. With the control of pipeline networks, water operators will have direct access to end-users and can benefit the entire future tariff hikes. Regional monopolistic concessions to operate water systems for a maximum of 30 years also guarantee water suppliers with an uninterrupted return on their investment over the concession period.

Given the phenomenal size of China's water market, it is expected competition will not be so intense in the near term. However, fierce competition is unavoidable in the long run when more and more operators and investors are entering into the market. We believe that companies with access to capital markets will benefit this deregulation the most as they are able to access foreign capital markets to finance merger and acquisitions of water systems in China. Therefore, first mover advantage is an important success factor in capturing a fair share of the water market in China.

China Water Affairs being a first mover in this industry and with access to foreign capital markets will greatly benefit from the lucrative returns provided by the deregulation of China's water sector. Strong governmental influence and in depth knowledge of the water operation culture in China possessed by our senior management will accelerate merger and acquisitions process. We are also able to capitalise on our professional knowledge and expertise in the mainland's water industry to form strong alliances with local municipalities in providing clean and safe water to cities within China. We will continue our corporate objective to "growth through merger and acquisitions" and to accomplish our mission to provide safe and clean water to the Chinese public. We are confident that we will be able to deliver a steady and reasonable return to our shareholders by adhering to our goals and to actively exploring other opportunities to expand our water and waste water operations. We are striving to increase both our revenue and earnings by providing value added services such as meter installation and water related constructions to achieve even higher returns for our shareholders.

The formation of a joint venture last year with Xinyu Municipal Government to operate the water supply in Xinyu city has been a success and its operating results so far is in line with our business model. Our first water supply project, Guangdong Renhau Water Supply, fits perfectly into our business model and has turned around to produce positive contributions this year. We expect other projects to follow the example of Xinyu and Renhau and to provide reasonable returns to the Company in the future. Substantial contribution has also been made by the newly acquired Consec with total revenue and income recorded at HK\$26.7 million and with segment result of HK\$16.9 million. We expect contribution from Consec to increase substantially in the next financial year when full year result will be consolidated.

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We will continue our strategy to meet challenges faced by the industry such as strict environmental, health and safety standards; economic regulations by state and/or local government and impact of weather and drought conditions on water sales demand. We will strive to improve our ability to deliver quality customer service and to supply water in sufficient quantities for future demand. At the same time, the Company will adhere to the "growth through acquisition strategy" to allow us to operate in existing neighboring service areas and in new service areas within China to further strengthen our operational capabilities and to establish a solid base for our assets.

CAPITAL RAISING

On 4 April 2005, a shareholder of the Company, Asset Full Resources Limited ("AFRL") entered into a placing agreement with a placing agent for the placement of 57,600,000 ordinary shares of the Company owned by AFRL at a price of HK\$0.50 per share. Pursuant to a subscription agreement on the same date, AFRL subscribed for 57,600,000 new ordinary shares of the Company at a price of HK\$0.50 per share. The subscription of new shares raised total consideration of approximately HK\$28,100,000 (after expenses). The net proceeds intended to be used as to approximately HK\$25.1 million to finance existing city water projects in the PRC and the remaining balance of approximately HK\$3.0 million as general working capital. As of the balance sheet date, the net proceed has been used as intended purpose.

On 19 January 2006, AFRL entered into a placing agreement with a placing agent for the placement of 107,700,000 ordinary shares of the Company owned by the AFRL at a price of HK\$0.42 per share. Pursuant to a subscription agreement on the same date, AFRL subscribed for 107,700,000 new ordinary shares of the Company at a price of HK\$0.42 per share. The subscription of new shares raised total consideration of approximately HK\$43,900,000 (after expenses). The net proceeds intended to be used as to approximately HK\$35.9 million to finance existing projects and the remaining balance of approximately HK\$8.0 million as general working capital. As of the balance sheet date, approximately HK\$18 million was used to fund existing projects and approximately HK\$8 million used as general working capital with the remaining balance of HK\$17.9 million being placed in bank balances.

On 16 March 2006, AFRL entered into a placing agreement with a placing agent for the placement of 137,600,000 ordinary shares of the Company owned by AFRL at a price of HK\$0.96 per share. Pursuant to a subscription agreement on the same date, AFRL subscribed for 137,600,000 new ordinary shares of the Company at a price of HK\$0.96 per share. The subscription of new shares raised total consideration of approximately HK\$129.1 million (after expenses). The net proceeds intended to be used as the Group's general working capital. As of the balance sheet date, the unused balance of HK\$129.1 million was placed in bank balances.

During the year ended 31 March 2006, the subscription rights attaching to 45,640,000 share options issued pursuant to the share option scheme of the Company were exercised at the subscription price of HK\$0.41 per share, resulting in the issue of 45,640,000 shares of HK\$0.01 each for a total cash consideration of approximately HK\$18,712,000 (before expenses).

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LIQUIDITY AND FINANCIAL RESOURCES

As at 31 March 2006, the Group has total cash and bank balances of approximately HK\$235 million (2005: HK\$20.2 million). The gearing ratio, calculated as a percentage of total liabilities to total assets, is 36.1% (2005: 61.9%) as at 31 March 2006. The current ratio has been improved from approximately 0.8 times as at 31 March 2005 to approximately 2.27 times as at 31 March 2006.

In the opinion of the directors, the Group will have sufficient working capital to meet its financial obligations in full as they fall due in the foreseeable future.

HUMAN RESOURCES

As at 31 March 2006, the Group has employed approximately 620 staff, principally work in Hong Kong and the PRC. The remuneration package of the employees is determined by various factors including their experience and performance, the market condition, industry practice and applicable employment law.

FOREIGN EXCHANGE RISK MANAGEMENT

During the year, the Group's trading activities were principally denominated in Hong Kong dollars and China Renminbi. As the exchange rate of Renminbi against Hong Kong dollar was relatively stable during the year, the management considers the fluctuations among these currencies as minimal and the Group do not expose to excessive currency fluctuation risk.

PLEGGED OF ASSETS

The Group's bank loans at 31 March 2006 were secured by:

- (a) pledge of water revenue of a subsidiary; and
- (b) guarantees by 江西長林機械（集團）有限公司, 江西新余紡織廠, 仁化縣自來水公司 and 江西省水利水電開發總公司. 仁化縣自來水公司 and 江西省水利水電開發總公司 are minority equity holders of the Company's subsidiaries.

CONTINGENT LIABILITIES

As at 31 March 2006, the Group did not have any material contingent liabilities.

ACKNOWLEDGEMENTS

On behalf of the Directors, I wish to express my gratitude to all staff and business associates of the Group for their continued support.

Duan Chuan Liang

Chairman

Hong Kong, 28 July 2006