

Management Discussion and Analysis

Results Review

The Group recorded substantial losses in its audited financial results for 2005. During the Reporting Period, the Group recorded a turnover of approximately RMB6,978,372,000, losses attributable to equity holders of approximately RMB3,702,172,000 (2004: approximately RMB226,294,000), and loss per share of approximately RMB3.73. The main reasons are:

- (1) Substantial bad debts, substantial accrued expenses, defective inventories, excessive non-performing investments, idle assets, economic disputes and other potential losses arising from previous management of the Company were realized concurrently during the current period;
- (2) The Group was subject to formal investigation by the CSRC in early April for alleged violation of PRC securities law and regulations as a result of Mr. Gu Chu Jun, the former Chairman of the Group, and his associates being suspected of having committed economic crimes. The above incident had adversely affected the confidence of financial institutions, suppliers and distributors in the Company, which led to great difficulties in our financing efforts. The tight cash flow situation also affected the Group's relationship with our suppliers and distributors, and resulted in the Group being unable to engage in normal operations and production activities during the Reporting Period. As a result, nearly all of the Group's production was suspended during the Reporting Period's peak season for the production and sales of refrigerators and air-conditioners from May to September, causing the sales amount to decrease substantially;
- (3) As a result of the suspension in production mentioned above, new models of products could not be manufactured in 2005, and as such popular products were unable to be supplied to the market in a timely manner and had to be substituted by older models, resulting in the reduction of the Group's gross profit margin during the Reporting Period;
- (4) From May to August during the Reporting Period, the Group has maintained a steady workforce and made regular payment of wages in the hope of resuming normal production as soon as possible, and at the same time, there was no reduction in other necessary operating costs and expenses. As such, the Group's operating costs during the Reporting Period has not been significantly reduced; and
- (5) The persistently increasing costs of the key raw materials resulted in a narrower profit margin for the Group's core products during the Reporting Period.

The Board does not recommend the payment of a final dividend for the year 2005 (2004: nil).

Guangdong Greencool Enterprise Development Company Limited ("Guangdong Greencool"), the Company's single largest shareholder, and Qingdao Hisense Air-Conditioner Company Limited ("Hisense Air-Conditioner") entered into the "Equity Transfer Agreement between Guangdong Greencool Enterprise Development Company Limited and Qingdao Hisense Air-Conditioner Company Limited in relation to the transfer of shares in Guangdong Kelon Electrical Holdings Company Limited" (the "Equity Transfer Agreement") on 9 September 2005, and Guangdong Greencool and Hisense Air-Conditioner further entered into the "Supplemental Agreement" and the "Second Supplemental Agreement" to the Equity Transfer Agreement on 28 September 2005 and 15 April 2006, respectively. To date, the equity transfer is still in process.

As an effort to overcome the difficulties of the Company and to resume normal operations, the Company entered into a sales agency agreement, a supplemental agreement and a second supplemental agreement with Qingdao Hisense Marketing Company Limited ("Hisense Agent"), a connected party of Hisense Air-Conditioner, on 16 September 2005, 26 September 2005 and 1 April 2006, respectively. Pursuant to these agreements, Hisense Agent will act as the Company's sales agent and distribute its domestic sales products in the PRC and assist the Company to explore the domestic market before 10 May 2006. On 16 September 2005, the fifth Board appointed Mr. Tang Ye Guo as president of the Company; and Mr. Xiao Jian Lin, Mr. Su Yu Tao, Mr. Shi Yong Chang and Mr. Luo Jun as vice presidents of the Company, who together with Mr. Lin Lan, a vice president, comprised the new management of the Company. The new management of the Company has, since its inauguration, been working towards the Group's future development, by

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realigning operation structure and internal control system, so as to resolve the remaining historical problems of the Company, and has taken advantage of the Hisense's capital and sales channels, suppliers and market management. The new management of the Company has also taken certain effective measures, which included adjusting the internal organisation, strengthening planning and management, improving cash flow, disposing of idle assets, cutting down cost and expenses, and exploring domestic and overseas markets, and has effectively restored the confidence of financial institutions, distributors and suppliers in the Group's prospects. Such measures have improved the Group's external operating environment, as a result of which the Group's production and operation have gradually normalised. Consequently, remarkable increase was recorded in both the Group's production and product sales in the fourth quarter of the Reporting Period. The Company began to show healthy development trends in respect of its business management and internal management.

Turnover analysis

During the Reporting Period, the sales revenue of refrigerators and air-conditioners accounted for 36.44% and 51.59% of the Group's total revenues, respectively, and that of freezers represented 3.74% of the Group's total revenue, while the remaining 8.23% came from other businesses.

Domestic sales accounted for 59.54% of the Group's total turnover, whereas export sales accounted for 40.46% of the Group's total turnover.

Refrigerator Business

During the Reporting Period, continuously keen competition in the refrigerator market, higher prices of raw materials for refrigerators without a notable increase in sales prices for refrigerators all contributed to a plunge in the profit margin of this industry. Affected by the event that Mr. Gu Chu Jun (former Chairman of the Board) was suspected of having committed economic crimes, the production of the Company for the second and third quarters was severely hit. The suspension in production during the peak season, i.e. between May and August, resulted in a decrease in the production of refrigerators in the first nine months of the year. After the new management of the Company took office, production of the Company has gradually resumed. The volume of refrigerators produced in the fourth quarter was close to the level of the corresponding period in last year. During the Reporting Period, the sales revenue of our refrigerators business was RMB2,542,839,000, representing a decrease of 20.87% as compared with the 2004.

During the Reporting Period, despite the difficult situation that was faced by the production and operation of the Group, we continued to adhere to our "Technologically Led" business guidelines and strive for strengthening the core competitiveness of Group's refrigerators. With the introduction of a series of energy-saving refrigerators, including 215YM (which can keep the food fresh even during power outage), at a time when power supply was generally insufficient throughout the country, the Group secured its leadership in the development of energy-saving refrigerators.

Air-conditioner Business

During the Reporting Period, the Company continued its devotion in developing its world-leading products with advanced technology products and paid great attention to scientific research and technological development. However, starting from May 2005, our air-conditioner business also came under significant pressure of insufficient capital, mainly because Mr. Gu Chu Jun (former Chairman of the Board) was suspected of having committed economic crimes. Since May to August were the peak season for sales of air-conditioners, insufficient supply of raw materials resulted in the suspension of production of air-conditioners, and sales revenue from the air-conditioner business during the Reporting Period dropped by approximately 11.08% as compared with the year 2004.

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Export sales

Although the Company achieved excellent results for export sales in the first quarter during the Reporting Period, we had difficulties in obtaining banking facilities since May (mainly because Mr. Gu Chu Jun (former Chairman of the Board) was suspected of having committed economic crimes). This has resulted in output decline for the Group. Accordingly, we had to turn down a considerable amount of orders, which inevitably affected the growth of our export sales. After the new management of the Company took office, every possible measure was taken to restore the lost orders, leveraging on the long-term cooperative relationship with our customers as well as their confidence in the quality of our products. Nevertheless, the Group's revenue from export sales during the Reporting Period dropped by approximately 18.37% as compared with that of the year 2004.

OUTLOOK

In 2006, competition in the global electrical appliance market will further intensify. The electrical appliance manufacturers are under unprecedented pressure arising from the soaring price of basic raw materials. The export business of electrical appliance enterprises is also subject to significant risks due to the appreciation of RMB and the ever-increasing trade barriers and non-tariff barriers established by some countries and economic regions.

In the domestic market, with the introduction of the compulsory energy-efficiency mark system by the PRC government, it is expected that energy-saving technology will be the arena for severe competition amongst air-conditioners and refrigerators. In addition, excessive production capacity and significant accumulation of stocks means that price war will be rigorous, competition to attract end-users will be severe and the costs of sales will surge.

As for the Company, as a result of Mr. Gu Chu Jun, the former chairman of the Board, being suspected of having committed economic crimes, the Company faces the following uncertainties:

1. As Mr. Gu Chu Jun, the former chairman of the Company, was suspected of having committed economic crime, the society became suspicious about the prospect of the Company during the Reporting Period. The Company was plunged into crisis with stagnant production and sales. Despite that if the Company has resumed its normal production and sales with the help of Hisense Group since September 2005, the incident has caused uncertain effects on the brand name and marketing channels of the Company.
2. As at the date of this announcement, the Group has taken legal actions against Guangdong Greencool and its related companies (the "Greencool Companies") for damaging the interests of the Group, and has claimed compensation for the losses. However, as the Group is not completely aware of the assets and liabilities situation of the Greencool Companies, there are risks that such claims, even if awarded, may be unable to enforce. Therefore, the outcome of such claims may have a material impact on the assets of the Company.

Although the Group is facing the foregoing uncertainties, the single largest shareholder of the Group will change soon. As such, it is expected that the credit risk arising from the current largest shareholder of the Company and chairman's alleged unlawful acts and embezzlement of the Group's interests should reduce substantially. The Group, as one of the leading enterprises in the domestic household electrical appliance industry, has an excellent technological development team with leading technological level in the industry, which will ensure the continued strong competitiveness of the Group's technology and products in the industry. The completion of the restructuring of the assets with Hisense will enable the Group to forge an alliance between two leading enterprises and swiftly improve the financial position of the Company to significantly enhance the scale of its business and its market competitiveness. The consolidated strength of the Group's principal business will leap to the forefront in the domestic industry and the Group still enjoys the great advantages of other enterprises in relevant industry, which will enable the Group to become a world-class manufacturer of household electrical appliances in the future.

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Looking into 2006, the Group will adhere to its operation policy which is characterised by following mottoes: “optimising internal systems, improving cash flow, continuing high-end innovation and maintaining operational efficiency”, and it will also strive to i) strengthen fundamental management construction; ii) streamline operational process and improve internal management mechanism; iii) cut product cost significantly; iv) improve sales structure; v) dispose of idle fixed assets; vi) speed up turnover of capital; vii) widen financing channels to increase capital; viii) lower financing costs; ix) reduce operational burden; and x) break the development bottleneck in respect of our products.

(1) Optimise internal systems

In 2006, the Group will bring into practice a management system characterised by a well-balanced combination of powers between central management and divisions with focus on the latter. The Group’s functions will be gradually adjusted to an investor-oriented managing function and a public platform constructing function, whereunder, the Group delegates its operational powers to subordinates by clearly designating responsibilities and operational targets. All of the subsidiaries of the Company will implement the market mechanism under the uniform platform constructed by the Group, including settlement on prices calculation and independent accounting, and that all of the subsidiaries will be responsible for their own profits or losses. At the same time, the Group will carry out strict reward and punishment system by linking annual salary of its management teams to operative responsibility indicators and linking the responsibility indicators of the subsidiaries to their respective responsibilities and benefits according to different natures and scales of the businesses. Meanwhile, the Group will establish operational planning system, internal settlement system, annual salary system and appraisal system in respect of each of the operating entities, with a view to motivate all of the operating entities through adjustments of internal mechanism, and ensure the Group will step into a path of healthy and rapid development.

(2) Speed up turnover of capital and obtain the required capital

The Group considers that the use of capital, liquidity and cash flow are problems that the Company needs to resolve. In 2006, the Group will adopt the following procedures to improve its financial position continuously in a short period, so as to guarantee a solid source of funding for the Group’s production and operations.

1. To speed up the restructuring of the assets of the Company and to improve the Company’s financial position so as to create a suitable environment for external financing.

Immediately after the change of its single largest shareholder, the Group will commence negotiation with its new shareholder, Hisense Air-Conditioner, to formulate and implement a plan of assets and business restructuring with Hisense. If the restructuring is implemented with the quality assets and business injected by Hisense, the assets and financial position of the Group will be improved significantly, and the scale of its business and its competitiveness will also be significantly enhanced. This will in turn improve the reputation of the Group and create a suitable environment for financing.

2. To accelerate clearance of the Group’s stored up capital.

The Group considers that the stored up capital is a critical resource to the Group. In 2006, the Group will completely dispose of the Company’s idle assets, and resolve the liquidity and subsistent operational problems by improving the efficiency in using the stored up capital.

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3. To concentrate on core businesses and dispose of non-performing subsidiaries as well as non-principal businesses.

Judging from our current status, the Group has run into a situation of over-investments. Many subsidiaries of the Company occupy large amount of capital but have been unable to operate and generate profits. This has placed the Group under heavy financial burden. In 2006, the Company will take strict measures to dispose of the subsidiaries that contribute little to our core development and generate little return. Meanwhile, in order to assure the healthy development of its core businesses including refrigerators, air-conditioners and freezers, the Company will, with a view to protect the interest of its shareholders, restructure or dispose of the non-principal businesses and will concentrate all of its resources to ensure the return of its core business to normal and further development.

4. To formulate scientifically and strictly implement business plans to improve turnover of capital.

The Group will establish a scientific, accurate and strict system for the formulation and implementation of plans to establish and optimize its business processes and to prevent and eliminate the recurrence of any idle assets, while the accountability system for any idle assets shall be defined and responsibility of such occurrence shall be solemnly tracked down. The Group will strictly eliminate slow-moving and inefficient cash flows at the management level. In respect of any project with an unreasonable allocation of funds, serious measures will be implemented promptly and legal measures will be considered for settlement when necessary.

5. To reduce the use of funds significantly in all aspects.

In 2006, the Group will establish a series of scientifically reasonable internal control systems in various aspects which may affect the liquidity of capital, including the product distribution aspect, the accounts receivable collection aspect, the procurement aspect and the production aspect, so as to ensure a significant reduction in the use of funds in all aspects. The Group will establish guidelines with respect to the use of funds by every production, operations and management sections, and also establish a corresponding assessment mechanism and management system. For the marketing network in particular, such guidelines will be established for every subsidiary and office, while for the manufacturing network, such guidelines will be established for every production process and every category of products. The formulated management measures and policies will be strictly followed to ensure a high turnover of capital. The Group will also establish a system of analysis to examine areas including the source of funding, structure of funding, use of funds, turnover of capital and cash liquidity, with a view to formulate suitable measures to improve its financial position. All subsidiaries of the Company shall solve their respective financial problems and be responsible for improving their respective situations.

6. In 2006, the Group will strengthen cooperation with banks and other financial institutions. It is expected to enter into memoranda of understanding with major creditor banks for the purpose of improving the financing conditions, exploring more financing channels, maintaining and endeavouring to expand financing scales so as to cater for the Group's additional funding requirements.

7. The Group will further regulate the products planning of the Group in 2006, streamline the types of products, underscore high-end strategy, reduce product costs, and further enhance the competitiveness of its products.

8. Continue to strengthen the settlement of embezzlement by Greencool and its related parties or third parties and solicit the support of the governments of all levels and regulatory bodies to recover any embezzled funds of the Company as far as possible, and supplement the liquidity of production.

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In 2006, the Group will concentrate on disposing of excessive investments made in previous years, and also emphasise on the allocation of its resources on the core businesses of the Group in accordance with the strategic development of the Group. It will minimise the outflow of funds, reduce capital occupation by all means, raise the turnover of capital and ensure that the capital requirement for normal production of the Group's core businesses will be met.

(3) Continuing the pursuit of high-end innovation

The Group will continue to aim towards high-end innovation in its product research and development, manufacturing and brand marketing. This strategy is vital in terms of the Group's existence and growth, and it also sets the foundation and direction for the Group's future expansion. In 2006, the concept of "high-end innovation" will be applied to all aspects of the Group's operations. The Group will also assist all members of staff to develop this mind-set of high-end innovation. The Group hopes to become an "enterprise of high-end innovation" with high standards of management, producing high quality products and achieving high profit margins. Accordingly, the Group will focus on developing the following areas in the year 2006:

1. Continuing to be a world leader in terms of technological innovation and research;
2. In terms of production planning, the Group's main objective is to use its technology to produce high-end consumer oriented products. This will be achieved by making comprehensive production plans, upgrading and transforming the Group's products, improving product quality, reducing production costs, and making better allocation of resources to manufacture products that will rapidly penetrate the market;
3. The Group aims to achieve world class standards in the management of its manufacturing process, including areas such as quality control, design specifications and efficiency in the production process to improve the details of the products, the standards of quality and to allow for increased market responsiveness;
4. The objectives of the Group's sales division is to raise the competitiveness of the products by increasing sales and by achieving a greater market share for the products. The sales division must also assist all aspects of the Group's operation to make a transition towards the strategy of high-end innovation, including areas such as resource allocation, the formulation of policies, promotion of the Group's image, methods of marketing, the transportation of the products, promotion activities and establishing the sales network. To maintain the strategy of high-end innovation, the sales division will also continuously strive to improve its promotion efforts to enhance the image and reputation of the "Kelon" and "Rongsheng" brand names.

(4) Ensuring operational efficiency

In 2006, the primary objectives of the Group's Operational Management is to build a solid foundation and to achieve the targeted profit levels. The Operational Management will work towards achieving a healthy and fast-paced development for the Group as well as increase profit levels. It has always been the Group's ultimate goal to achieve efficiency in its operations, and this will primarily be accomplished by improvements in production efficiency. In order to increase the efficiency of the Group's operations in 2006, concepts of product efficiency and measures to improve product efficiency will be applied to every aspect of the Group's operations.

Looking back, the Group has undergone a very critical stage. However, in the future, the Group sees both opportunities and challenges. The Group's management strongly believes that possessing a clear vision and using united effort, with the support and supervision of its shareholders and the combined efforts of all its staff, it will overcome its difficulties and strive towards new innovations. In the year 2006, the Group will build a solid foundation for its future development and strive towards becoming a world class manufacturer of electrical appliances.