

# MANAGEMENT DISCUSSION AND ANALYSIS

## FINANCIAL RESULTS

The Group achieved a turnover of HK\$2,997 million for the year ended 30 June 2006 (the "Year"), an increase of 22 percent as compared with HK\$2,462 million for the previous year (the "Previous Year"). Profit attributable to equity holders of the Company for the Year was HK\$550 million, an increase of 20 percent as compared with HK\$459 million for the Previous Year. Earnings per share for the Year was HK43.08 cents (2005: HK37.94 cents), an increase of 14 percent. EBITDA (earnings before interest, taxation, depreciation and amortisation) rose by 40 percent to HK\$1,099 million. The increase is attributable mainly to the improvement in contribution from subsidiaries and from the provision of services and software licensing. Before taking into account of HK\$50.4 million of change in fair value of convertible bonds upon the adoption of new Hong Kong Accounting Standards (please refer to Note 2 to the consolidated financial statements for details), the Group's profit before taxation was HK\$755 million, an increase of 32 percent over the Previous Year.

The underlying strong recurrent demand for the Group's customised solutions in wireless technologies, communications software, and Internet-related products and services is a result of ongoing investments in systems and networks which have allowed us to significantly improve customer-service metrics while driving industry-leading productivity. The Group continued to maintain a clear competitive edge in providing customised communications solutions for niche markets.

Total operating expenses have gone up largely in line with the increase in turnover and as a result of a general increase in staff costs on the back of a strengthening economy. Distribution costs have come down to HK\$61 million (2005: HK\$74 million), after continued efforts in expanding clientele in previous years. General and administrative expenses were HK\$197 million, up 17 percent (2005: HK\$169 million). Depreciation and amortisation expenses went up 94 percent to HK\$384 million (2005: HK\$199 million), which was attributed to the roll-out of several new projects. Operating margin as a percentage of turnover remained stable at 24 percent. The Group's profit before minority interests was also helped by increased profit contribution from subsidiaries Kantone and Digital HK.

Finance costs for the Year were lower at HK\$10 million (2005: HK\$13 million), despite the general increase in interest rates during the Year, as the Group benefited from a relatively high level of liquidity, which had the effect of improving gearing and reducing its reliance on other means of debt financing.

## BUSINESS REVIEW

The global and regional operating conditions have been broadly favourable in spite of subdued sentiment as a result of increasing interest rates, political instability in the Middle East, and surging of energy prices. Continuing strong demand for high-performance and high-reliability communications products and security-related solutions, coupled with rising economic confidence, provided momentum to business growth. In Mainland China, the macro-economic tightening measures appeared to have only a slight dampening effect on an overheated economy, as such measures are specific to certain sectors, which do not include basic infrastructural projects such as the telecommunications and IT sector.

China market maintained its robust momentum in line with the country's thriving economy, generating an overall increase in capital expenditure by our customers to improve the quality of their networks in order to meet increasing demand. In particular, China's plans to develop the Northeastern and Northwestern provinces and cities have a positive impact on the demand for capital investment projects in telecoms infrastructure within the mainland. The success of China's aerospace projects has also accelerated investment in the telecoms and related sectors. Meanwhile, upcoming international events such as the Olympics to be held in Beijing and the Expo in Shanghai in 2010 have spurred demand for increased security and spending on anti-terrorist measures. For the Year under review, China sales accounted for HK\$2,257 million of the Group's turnover (2005: HK\$1,823 million), a rise of 24 percent compared with the Previous Year.

The Group also reported encouraging growth in its European business, where healthcare and fire services continued to be core sectors for the Group's wireless messaging solutions. During the Period, several new installations were implemented which were accompanied by enhanced applications to deliver clinical efficiency and improve emergency response times. A revamp of the fire services in the UK subsequent to the terrorist attacks on London in 2005 also contributed to the increased business activities. Turnover attributable to the operations in Europe was HK\$487 million (2005: HK\$409 million), a rise of 19 percent compared with the Previous Year.

Meanwhile, the Group's strategic investment in In-Car Telematics solutions and anti-radiation products to counteract radio emission from mobile phones continued to report steady progress. For the telematics project in particular, the Group actively positioned itself with the Chinese authorities as a key supplier in the run-up to the 2008 Olympics, which calls for heightened security and safe transportation. Type approvals for the drink driving prevention device have been obtained from the relevant authorities. In connection with an ID card project in China, the Group entered into an alliance with a PRC systems provider in digital image capturing to pursue identity card and IT security opportunities. The investment represents a great opportunity for the Group to build on its IT security and communications software expertise, with promising return from the rapidly-growing smart-card and online security business in China.

### Professional Consultants

During the year, the appointment of four professional consultants with broad international gaming experience has further boosted the Group's management expertise and operational skills in e-Gaming and Online Entertainment, and their collective experience would prove to be of immense value in the Group's pursuit of this exciting business on a global basis. The new appointments were:

- *John Schreck*, who has served as Chief Stipendiary Steward of the Hong Kong Jockey Club, Director of Racing in Macau, and Chief Stipendiary Steward of the Australian Jockey Club. His expertise lies in his great depth of knowledge of the global gaming operations and the various regulatory frameworks.
- *Michael Thornhill*, who has served as a steward of the Hong Kong Jockey Club and Senior Partner of Johnson Stokes and Master, with particular expertise in licensing arrangements and global strategy.
- *David Gairns*, who has served as a steward of the Hong Kong Jockey Club, Chairman of Hong Kong Lotteries Board, and Senior Partner of KPMG (Hong Kong). His expertise lies in financial planning and evaluation of business acquisitions.
- *Timothy McNally*, who has served as Director of Security and Corporate Legal Services of the Hong Kong Jockey Club, and Assistant Director-In-Charge of the Federal Bureau of Investigation (FBI), Los Angeles, California. His expertise lies in risk analyses and security management of global gaming operations.

### **KANTONE HOLDINGS LIMITED (“KANTONE”)**

Kantone's performance continued to improve. It recorded a turnover of HK\$1,347 million, an increase of 20 percent over the Previous Year. Profit attributable to equity holders of Kantone was HK\$333 million, representing an improvement of 24 percent compared with HK\$268 million of the Previous Year. Excluding a provision of HK\$51.3 million of change in fair value of convertible bonds, Kantone's profit before taxation was HK\$383 million, an increase of 43 percent. Its gross margin has improved to 39 percent of turnover from 37 percent of the Previous Year, due to continued investment and introduction of high value-add products. Kantone's profit margin (before taking into account of HK\$51.3 million of change in fair value of convertible bonds and impairment loss of HK\$6.8 million recognised for available-for-sale investments) also rose to 29 percent from 25 percent as a result of efficient outsourcing and cost control measures.

Sales in China was in line with the country's economic growth. With China's continued economic prosperity, Kantone's customised solutions and products have grown from strength to strength. A combination of factors such as natural economic growth, improved standards of living, and upcoming international events are growth drivers to sustain spending in the telecoms and IT sector.

Within Europe, UK sales registered steady growth. The award of key supplier status by the National Health Service (NHS) as part of the latter's Purchase and Supply Agency (PASA) has won Kantone a number of new contracts in the personal security arena.

In the US, Kantone continued to focus on projects arising from the Government's spectrum migration programme for public sector networks.

Meanwhile, Kantone continued to invest in research and development, and has a number of exciting new products in the development pipeline.

### **e-Gaming and Online Entertainment**

Building on its expertise in integrated IT solutions and telephone data management, Kantone continued to expand its portfolio of investments in betting software solutions and various gaming and entertainment websites. In October 2005, Kantone completed its acquisition of a controlling stake in a pioneer systems developer and service provider in paperless betting systems in China. The newly-acquired operation has a track record in providing software solutions and technological support to PRC governmental welfare lottery administrative authorities for establishing a comprehensive paperless betting platform with complete payment solutions in return for recurring revenue sharing based on betting turnover. Through the acquisition, Kantone now holds a leading position in the e-lottery market in China, with existing paperless betting platforms in Shenzhen and Shanghai, where long-term agreements have been signed with the regional Welfare Lottery Centres. Betting turnover via the Group's e-platform has steadily increased, and the use of SMS on mobile phone and websites for paperless betting is gaining popularity among young people and more well-off white collar workers who have a generally higher level of spending and are more receptive to modern technologies.

A third project to install a paperless betting operating system for the entire province of Anhui has been completed during the period, and is currently under trial run. Kantone now owns the IP (intellectual property) rights of a robust e-lottery platform complete with secure micropayment systems linked to banks which facilitated one-stop-shop automatic betting transactions for multiple lottery games.

The paperless lottery project in China represents a significant addition to Kantone's e-Gaming and Online Entertainment business with its growing portfolio of assets, complementing its mainstream Telecoms and IT business. At this early stage of investment, Kantone's primary focus is on laying a solid foundation for future growth and expansion, which includes ongoing technology enhancement of the betting platform, development of more user-friendly applications such as Java for use on new generations of mobile phone and other solutions, together with preparatory work on a comprehensive marketing programme aimed at building awareness of such an alternative and emerging mode of betting, and capturing a larger share of the market. e-Lottery in China is still at its developing stage, but if it were to follow the trend of the high adoption rate of other technologies such as mobile phones and Internet usage, e-lottery will have a significant impact on China's overall lottery market, and in turn, will impact positively on Kantone's results in the future.

### **DIGITALHONGKONG.COM ("DIGITAL HK")**

The profit contribution of Digital HK was HK\$1,362,000, compared with HK\$1,240,000 for the Previous Year. Digital HK has adapted well in the highly competitive marketplace amidst the rapid technological changes in the IT industry. It continued to maintain momentum in its pursuit of business in relation to e-commerce solutions, and had benefited from a steadily growing customer base resulting from increased awareness of its products and services.

In order to expand its revenue sources other than the provision of electronic payment services and IT consultancy, Digital HK had identified healthcare and related IT services as opportunity for future growth. It intends to participate more actively in the marketing and promotion of information medicine and online healthcare services through new investments and partnerships in order to achieve enhanced return. Digital HK had made a strategic investment in a bioinformatics project which focused on developing customised database design tools targeted at empowering the process of drug discovery. The project has reported steady progress, and is expected to contribute to the Digital HK's results in the coming years.

## **LIQUIDITY AND FINANCIAL RESOURCES**

The Group's financial position remained strong with a low gearing and a net cash position. As at 30 June 2006, the Group had HK\$921 million made up of deposits, bank balances and cash. Current assets were approximately HK\$1,845 million (2005: HK\$1,637 million) and current liabilities amounted to approximately HK\$268 million (2005 (restated): HK\$304 million). With net current assets of HK\$1,577 million, the Group had maintained a high level of financial liquidity. The gearing ratio at the end of the Year, which calculation was based on the Group's total borrowings of HK\$178 million (2005 (restated): HK\$191 million) and equity attributable to equity holder of the Company of HK\$5,259 million (2005 (restated): HK\$4,705 million), was 0.03 (2005: 0.04).

Total borrowings comprised bank borrowings of HK\$155 million (2005: HK\$59 million); other borrowings, which represented block discounting loans, of HK\$5 million (2005: HK\$9 million); and convertible bonds of HK\$18 million (2005 (restated): HK\$123 million). Finance costs for the Year have come down to HK\$10 million (2005: HK\$13 million) as a result of a higher level of liquidity.

Included in the bank borrowings of HK\$155 million were bank loans and overdrafts of HK\$1.8 million (2005: HK\$2.9 million) being secured by the Group's land and buildings with a net book value of HK\$11.9 million (HK\$10.3 million). These borrowings comprised debts of HK\$0.7 million, HK\$0.8 million and HK\$0.3 million repayable within one year, in the second year and the third year respectively. The unsecured bank borrowings of HK\$153 million were repayable on demand.

The other borrowings of HK\$5 million were unsecured, with HK\$2.7 million repayable within one year, HK\$1.7 million repayable in the second year and the remaining in the third and fourth year.

As at 30 June 2006, Kantone had outstanding convertible bonds with face value of USD0.1 million which will mature on 1 April 2008.

Except for the USD convertible bonds, all other borrowings were used by the subsidiaries of the Group, bearing interest at floating rates, and were denominated in local currencies. The currency risk exposure associated with the Group's borrowings was insignificant.

## CAPITAL COMMITMENTS

As at 30 June 2006, the Group's capital commitments contracted for but not provided in was HK\$32,000 (2005: HK\$69,000) and the Group's capital commitments authorised but not contracted for was HK\$489 million (2005: HK\$388 million). These commitments were set aside for the acquisition of property, plant and equipment, and development of systems and networks.

## EXPOSURE TO EXCHANGE RATE FLUCTUATIONS

The Group does not engage in interest rate or foreign exchange speculative activities. It is the Group's policy to manage foreign exchange risk through matching foreign exchange income with expense, and where exposure to foreign exchange is anticipated, appropriate hedging instrument will be used.

## ACQUISITION

In October 2005, Kantone completed the acquisition of 60 percent interest in an investor of a paperless betting systems developer and service provider in China for a consideration of HK\$52 million. Through this acquisition, Kantone commands a leading position in the e-lottery market in China, with existing paperless betting platforms in Shenzhen and Shanghai.

## FINAL DIVIDEND AND SCRIP DIVIDEND SCHEME

Subject to the approval of shareholders at the forthcoming annual general meeting, the directors have proposed a final dividend of HK3.3 cents per share for the year ended 30 June 2006 (2005: HK3.1 cents per share) to shareholders whose names appear on the register of members of the Company on 22 November 2006. Taking into account the interim dividend of HK2.2 cents per share paid on 14 June 2006, total annual dividend per share would be HK5.5 cents, an increase of 15 percent over last year; and total dividend payment for the year would be HK\$73 million, an increase of 22% as compared with HK\$60 million of last year.

The final dividend will be satisfied by allotment of new shares of the Company, credited as fully paid, by way of scrip dividend, with an alternative to the shareholders to elect to receive such dividend (or part thereof) in cash in lieu of such allotment (the "scrip dividend scheme").

The scrip dividend scheme is subject to the granting by the Listing Committee of The Stock Exchange of Hong Kong Limited (the "Exchange") of a listing of and permission to deal in the shares to be issued pursuant thereto. A circular setting out the details of the scrip dividend scheme together with the form of election will be sent to the shareholders of the Company as soon as practicable.

It is expected that certificates for shares to be issued under the scrip dividend scheme and dividend warrants will be despatched to those entitled thereto on or before 26 January 2007.

## BONUS ISSUE OF WARRANTS

The directors of the Company have proposed a bonus issue of new warrants to subscribe for shares of the Company ("New Warrants") equal to 20% of the number of shares of the Company in issue on 27 February 2007 to the shareholders of the Company whose names appear on the register of members on 22 November 2006 in proportion as nearly as may be to their then shareholdings in the Company (subject as mentioned below) (the "Bonus Issue").

As at 23 October 2006, the Company had 1,314,223,009 issued shares of HK\$0.10 each ("Shares") and had outstanding 256,085,581 units of existing warrants of the Company (Stock Code: 564) which subscription period will expire on 26 February 2007 ("Existing Warrants").

The New Warrants will be issued in registered form in units of HK\$1.38 of subscription rights entitling their holders to subscribe for shares of the Company at a price of HK\$1.38 per Share (subject to adjustments) during a period of one year from the date of issue thereof (which is expected to be 8 March 2007, after the expiry of the Existing Warrants on 26 February 2007).

The Bonus Issue is conditional upon the approval of shareholders at the annual general meeting of the Company for the year ended 30 June 2006 and the Listing Committee of the Exchange granting listings of and permission to deal in the New Warrants and the Shares that fall to be issued on the exercise of the subscription rights thereunder. Application will be made to the Listing Committee of the Exchange for such listings.

A circular setting out the details of the Bonus Issue will be sent to the shareholders and, for information only, holders of Existing Warrants as soon as practicable. Further announcement will be made by the Company on the timetable for the Bonus Issue in due course.

## CLOSURE OF REGISTER OF MEMBERS

The register of members of the Company will be closed from 15 November 2006 to 22 November 2006, both days inclusive, during which period no transfer of shares will be effected. In order to qualify for the final dividend, the scrip dividend scheme and the Bonus Issue, all transfers of shares accompanied by the relevant share certificates and, in the case of warrant holders, all duly completed subscription forms accompanied by the relevant warrant certificates and the appropriate subscription moneys, must be lodged with the Company's Branch Share Registrars in Hong Kong, Secretaries Limited at 26th Floor, Tesbury Centre, 28 Queen's Road East, Wanchai, Hong Kong no later than 4:00 p.m. on 14 November 2006.