

iMerchants Limited

Third Quarterly Report 2001-2002

CHARACTERISTICS OF THE GROWTH ENTERPRISE MARKET (“GEM”) OF THE STOCK EXCHANGE OF HONG KONG LIMITED (THE “STOCK EXCHANGE”)

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This report, for which the directors of iMerchants Limited collectively and individually accept responsibility, includes particulars given in compliance with the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange for the purpose of giving information with regard to iMerchants Limited. The directors, having made all reasonable enquiries, confirm that, to the best of their knowledge and belief:— (1) the information contained in this report is accurate and complete in all material respects and not misleading; (2) there are no other matters the omission of which would make any statement in this report misleading; and (3) all opinions expressed in this report have been arrived at after due and careful consideration and are founded on bases and assumptions that are fair and reasonable.

CHAIRMAN'S STATEMENT

This is proving to be a very difficult year for businesses in Hong Kong and the three months ended 31st December 2001 were particularly challenging. Recent statistical evidence showing that many economies around the globe have slipped into recession confirmed the anecdotal observations of numerous businesses and individuals, which have experienced falling salaries, revenues, and profits.

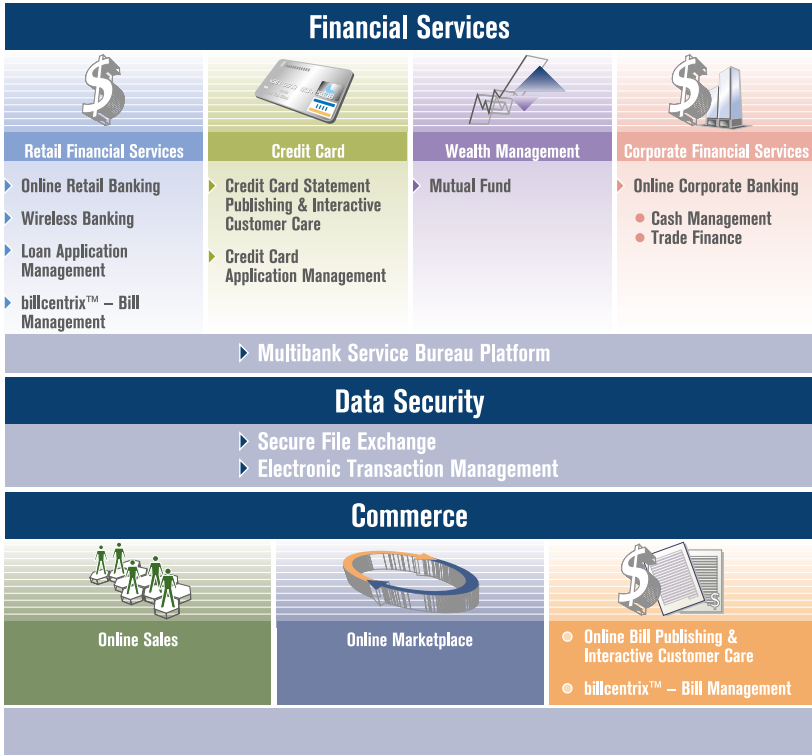
Despite this pessimistic environment, iMerchants' team has dedicated itself to building a stronger company and, to this end, has pursued three broad initiatives during the past calendar year:

- Perhaps most significantly, iMerchants has focused on building a solid base of application software products. The rationale for this strategy is to turn intellectual property into assets that the Company expects will enable it to deliver technology solutions more efficiently and earn higher margins. The Company's years of implementing technology projects gave it a rapid start in this effort, as iMerchants was able to turn the knowledge and software developed in those projects to build products. Also, the Company has devoted staff to research and development activities to further broaden its product range. The Company continues to refine its product mix and, during the three months ended 31st December 2001, was excited to begin aggressively promoting its data security products.
- The Company has also continued its product development and business development efforts on the banking and financial services industry, building on its five years of providing solutions to the industry. The Company adopted this industry focus to allow it to better understand the issues faced by its clients and, thus, to deliver competitive solutions that provide greater value to them.
- Finally, iMerchants has been actively enhancing its internal processes to enable the Company to operate more efficiently and effectively and has enhanced its service delivery methodologies.

Despite the poor economic environment, I am excited about the progress that iMerchants has made over the past years and look forward to seeing these initiatives yielding benefits in the future.

BUSINESS OUTLOOK

iMerchants offers a range of application software products, with a particular focus on the financial services industry and on data security.



In the three months ended 31st December 2001, iMerchants began promoting its data security solutions. This is a service area that builds on iMerchants' experience as one of the leading companies in Hong Kong in implementing security solutions for electronic transactions and, in particular, launching applications that use Public Key Infrastructure ("PKI") and digital certificates for authentication, encryption, and digital signing of documents. With the enactment of the Hong Kong's Electronic Transactions Ordinance (Chapter 553 of The Laws of Hong Kong), which gives legal recognition to electronic signatures made using a digital certificate issued by a recognized Certificate Authority ("CA"), and the ability of PKI to address security concerns, these technologies will be very important to help move high-value transactions online.

iMerchants is offering its Electronic Transaction Management Solution (“ETM”) to help organizations to make use of PKI in conducting electronic transactions. ETM integrates into client’s existing online applications and enables them to:

- authenticate users using digital certificates — ensure that they are who they claim to be, by validating their digital certificates when they sign in and perform transactions;
- ensure confidentiality and data integrity using digital certificates to decrypt information transmitted; and
- ensure non-repudiation of transactions by capturing an electronic record to prove that transactions occurred

In January 2002, iMerchants further enhanced its data security services by becoming one of the first solution providers to incorporate Diversinet Corporation’s (“Diversinet”) mobile-commerce security technology into its solutions. Diversinet is a leading provider of mobile commerce security solutions and Hongkong Post’s technology partner in offering digital certificates for mobile devices (“Mobile e-Certs”), such as personal digital assistants (“PDAs”) and mobile telephones. iMerchants is using Diversinet’s technology to develop applications that enable the use of the Mobile e-Cert to verify and authenticate the identity of each party involved in a wireless electronic transaction and to encrypt the data being transmitted between the parties, thus giving participants in mobile commerce the confidence of high security.

iMerchants has integrated Diversinet’s technology into its wireless banking solution for PDA, which can be used to perform wireless banking transactions on the PDA and secured using the Mobile e-Cert. This application makes use of other cutting-edge technologies such as Bluetooth and GPRS, or 2.5G wireless connectivity. iMerchants is currently promoting this solution to financial institutions seeking to lead the market in their provision of convenient access channels to their customers.

Between Mobile e-Cert technology, the provision of wireless connectivity, and the activities of solution providers like iMerchants, the infrastructure and applications needed to make wireless applications take off in Hong Kong are all in place. Looking ahead, iMerchants expects that these technologies will quickly become widely adopted and the Company will then be in a good position to help our clients to make use of them in their business applications.

iMerchants is also building its ability to provide data-warehouse and data-mart solutions to financial institutions. Data-warehouses and data-marts are centralized repositories of information that capture data from diverse systems, so that it can be usefully analysed. This service area builds on iMerchants’ experience of integrating systems operating on many different platforms and on its business knowledge of financial institutions. During the three months ended 31st December 2001, iMerchants was engaged to perform a data-mart project for an international financial institution.

iMerchants expects that an increasing number of financial institutions will implement data-warehouses and data-marts to combine and analyse the data necessary to understand the behaviour of their customers, their level of risk exposure and concentration, and the profitability of providing various products and servicing individual customers.

In addition to these new initiatives, iMerchants continued to market its existing solutions to prospective customers. In the three months ended 31st December 2001, the Company was particularly focused on promoting its:

- *Mutual Fund Solution:* A growing number of banks, insurers and stock-brokers are seeking to offer consumers wealth management services and are including the sale of mutual funds as a key component of their wealth management service offerings. iMerchants' mutual fund solution supports the operation of retail financial institutions' mutual fund distribution efforts by providing sales support functions, order entry, client portfolio administration and tools to support back end settlement and reconciliation processes. The solution provides cost saving through more efficient back-office operations and more accurate order entry, and sales support tools to help the institution generate more revenue from its mutual fund business.
- *Online Corporate Banking Solution:* Incorporating cash management and trade finance modules, iMerchants' solution enables a bank to allow its corporate customers to access banking services via the Internet. The solution includes a customer-configurable maker-checker approval process and productivity enhancement tools.
- *Secure File Exchange (SFX):* The Company has used its SFX product to implement a PKI-enabled secure document transfer system to enable the transmission of settlement files between the members of a banking consortium. This product also has application in other industries needing to control the distribution and transmission of highly sensitive information.
- *Online Bill Publishing and Interactive Customer Care Solution:* iMerchants' electronic bill and statement publishing solution use the Internet as a medium to enhance customer service and contribute to customer retention. By providing a mechanism for publishing bills and statement online, clients' customers have better access to information and are then able to perform numerous self-service functions so as to improve customer convenience and reduce customer service costs. In addition, by distributing bills using electronic means, billers can significantly reduce the cost of billing.

Finally, the development of iMerchants' operations in the PRC continues apace. The Company has recruited the Vice-President, China Operations and is proceeding with the registration of a subsidiary in the PRC.

FINANCIAL RESULTS

In these difficult economic times, customers have cut back on discretionary expenditure and, consequently, reduced their budgets for information technology-related expenditure, meaning that many projects have been scaled back or even aborted. This has been a trend in the market throughout the nine months ended 31st December 2001, which has become more pronounced in recent months and has had a negative effect on iMerchants' financial results. For the nine months ended 31st December 2001, the Company generated a loss from operations of approximately HK\$22,701,000 and a loss for the period of approximately HK\$28,440,000. Included in the Company's loss for the period is the HK\$3,695,000 provision for its investment in a jointly controlled entity, which had been pursuing the development of an Internet platform for enabling sophisticated financial transactions. The provision results from the business not gathering sufficient support from potential users, as a result of changes in the business environment.

The difficult times being faced by the Company's clients and prospective clients is not expected to go on forever and iMerchants continues to work aggressively to strengthen ties with its existing clients and to build business relationships with new accounts in order to be well positioned as the economy improves. As a part of this strategy, the Company has priced its services aggressively and bundled software solutions with related computer hardware, which has resulted in a fall in the Company's gross margin. This strategy is paying off and during the three months ended 31st December 2001, iMerchants won several significant contracts from existing clients and was engaged to serve a number of new clients.

The Company is also promoting its software products, which are expected to enable it to deliver solutions more cost effectively and to result in higher gross margins in the future.

The Company continues to be in a strong financial position, with current assets, plus investments in liquid securities totaling HK\$281,084,000 without bank borrowings.

RESULTS

The board of Directors (the “Board”) of the Company presents the unaudited consolidated results of the Company and its subsidiaries (the “Group”) for the three months and the nine months ended 31st December, 2001 together with the comparative unaudited figures for the corresponding periods in 2000 as follows:

	Notes	Three months ended 31st December		Nine months ended 31st December	
		2001 HK\$'000	2000 HK\$'000	2001 HK\$'000	2000 HK\$'000
Turnover	2	3,168	14,017	16,445	35,594
Direct costs		(3,151)	(7,536)	(16,198)	(18,406)
Gross profit		17	6,481	247	17,188
Other revenue	3	1,673	4,845	7,999	15,786
Administrative expenses		(9,673)	(9,451)	(30,947)	(29,578)
(Loss) profit from operations		(7,983)	1,875	(22,701)	3,396
Finance costs		(1)	—	(8)	(1)
Provision for investment in a jointly controlled entity		(3,695)	—	(3,695)	—
Share of results of associates		(111)	(1,344)	(2,036)	(1,344)
(Loss) profit for the period		<u>(11,790)</u>	<u>531</u>	<u>(28,440)</u>	<u>2,051</u>
(Loss) earnings per share — basic	5	(1.015) cent	0.046 cent	(2.445) cent	0.176 cent

Notes:

1. Basis of preparation of the financial statements

The Company was incorporated in Hong Kong with limited liability on 25th October, 1999 under the Companies Ordinance. Its ultimate holding company is Galaface Limited, a company incorporated in the British Virgin Islands. The Company is an investment holding company. The principal activities of its subsidiaries are the provision of internet-based services.

Pursuant to a series of group reorganization steps (the “Group Reorganization”) to rationalize the Group structure in preparation for the listing of the Company’s shares on the GEM of the Stock Exchange, the Company became the holding company of the Group on 10th March, 2000.

The Group Reorganization principally involved the exchange of fully-paid shares of the Company with the entire issued shares of iMerchants Asia Limited (the “Share Exchange”).

A strategic investor, Pacific Century CyberWorks Limited (“PCCW”) has, through its indirect wholly-owned subsidiary Network Initiatives Limited, invested into the Group prior to the Share Exchange.

The shares of the Company were listed on the GEM of the Stock Exchange on 31st March, 2000.

The Group resulting from the Group Reorganization is regarded as a continuing entity. Accordingly, these financial statements of the Group have been prepared on the merger accounting basis as if the Company had always been the holding company of the Group.

In addition, the Group acquired a wholly-owned subsidiary in May 2000 from its immediate holding company. The acquisition of this subsidiary had been accounted for using the acquisition accounting basis.

2. Turnover

Turnover represents revenue generated from contracts for consultancy and software development, including the sale of the related equipment and the amounts received and receivable for other related services rendered.

3. Other revenue

Other revenue for the period comprised, among others, interest income of approximately HK\$7,461,000 (2000: HK\$14,558,000).

4. Taxation

No provision for Hong Kong Profits Tax has been made as the Group incurred tax losses for the period.

5. (Loss) earnings per share

The calculation of the loss per share for the three months and the nine months ended 31st December, 2001 is based on the loss of the Group of approximately HK\$11,790,000 (2000: profit of approximately HK\$531,000) and approximately HK\$28,440,000 (2000: profit of approximately HK\$2,051,000), respectively, and on the weighted average number of ordinary shares of 1,163,264,531 (2000: 1,165,476,000).

No diluted loss per share has been presented for the three months and nine months ended 31st December, 2001 as the exercise of the Company's outstanding share options would result in a decrease in loss per share.

No diluted earnings per share has been presented for the corresponding periods in 2000 as the exercise price of the Company's outstanding share options was higher than the average market price for those periods.

6. Dividend

The Directors do not recommend the payment of an interim dividend for the nine months ended 31st December, 2001 (2000: Nil).

7. Movements of reserves

	Share premium reserve HK\$'000	Merger reserve HK\$'000	Capital redemption reserve HK\$'000	Goodwill HK\$'000	Accumulated losses HK\$'000	Total HK\$'000
At 1st April, 2001	207,130	46,715	—	(3,016)	(27,360)	223,469
Reserve arising on repurchase of own shares	—	—	409	—	(796)	(387)
Loss for the period	—	—	—	—	(28,440)	(28,440)
At 31st December, 2001	<u>207,130</u>	<u>46,715</u>	<u>409</u>	<u>(3,016)</u>	<u>(56,596)</u>	<u>194,642</u>

PURCHASE, SALE OR REDEMPTION OF SHARES

During the nine months ended 31st December, 2001, the Company repurchased on the Stock Exchange a total of 4,094,000 ordinary shares of HK\$0.10 each in the share capital of the Company at an aggregate price of HK\$794,440.00 and the details are as follows:

Month of repurchase	Price per share		Number of Shares Repurchased	Aggregate Price Paid
	Lowest	Highest		
	HK\$	HK\$	HK\$	HK\$
April, 2001	0.20	0.20	1,284,000	256,800.00
August, 2001	0.215	0.219	400,000	86,440.00
September, 2001	0.18	0.20	1,626,000	310,080.00
November, 2001	0.18	0.18	784,000	141,120.00
			<u>4,094,000</u>	<u>794,440.00</u>

The Directors of the Company considered that the above repurchases were made with a view to enhancing the net asset per share of the Company. These shares were cancelled upon repurchase and the issued share capital of the Company was reduced correspondingly.

Save as disclosed above, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities during the nine months ended 31st December, 2001.

COMPETING INTERESTS

During the period under review, none of the directors or the management shareholders (as defined in the GEM Listing Rules) of the Company had an interest in a business that competed with the Group or might compete with the business of the Group.

DIRECTORS' INTERESTS IN SECURITIES

At 31st December, 2001, the interests of the directors of the Company and their associates in the securities of the Company as recorded in the register maintained by the Company pursuant to Section 29 of the Securities (Disclosure of Interests) Ordinance (the "SDI Ordinance") were as follows:

Name of director	Number of ordinary shares held as		Number of shares entitled under the share option schemes held as
	personal interests	corporate interests	personal interests
Mr Leroy Kung Lin Yuen ("Mr Kung")	—	720,745,000 (Note i)	—
Mr Matthew P Johnston ("Mr Johnston")	100,000	—	23,340,000 (Note ii)

Notes:

- (i) The registered shareholder of 720,745,000 shares is iMerchants Group Limited ("iMerchants Group"). iMerchants Group is wholly-owned by Asian Gold Associates Limited ("Asian Gold"), in which 76% of the issued share capital of Asian Gold is owned by Galaface Limited ("Galaface"). Mr Kung is deemed to have interests in the 720,745,000 shares owned by iMerchants Group under the SDI Ordinance as he owns the entire interest in Galaface and is entitled to exercise more than one-third of the voting power at general meetings of both Asian Gold and Galaface.
- (ii) Among the balance, 11,670,000 share options were granted on 15th March, 2000 under a pre-IPO share option plan, which was approved by the written resolution of the shareholders of the Company dated 15th March, 2000. These share options entitle Mr Johnston to subscribe for 11,670,000 shares of HK\$0.10 each in the Company at HK\$1.48 each in various stages from 31st March, 2001 to 14th March, 2010.

The remaining 11,670,000 share options were granted on 23rd August, 2000 under a share option scheme, which was approved by the written resolution of the shareholders of the Company dated 15th March, 2000. These share options entitle Mr Johnston to subscribe for 11,670,000 shares of HK\$0.10 each in the Company at HK\$0.53 each during the various periods from 31st March, 2001 to 23rd August, 2010.

Save as disclosed above, at 31st December, 2001, none of the directors or any of their associates had any interests in any securities of the Company or any of its associated corporations as defined in the SDI Ordinance.

OUTSTANDING SHARE OPTIONS

Pursuant to the Pre-IPO Share Option Plan and Share Option Scheme, the principal terms of which were set out in the Prospectus, there were 37,000,000 and 40,300,000 share options, respectively, granted to and held by the grantees (which include the options granted to a director of the Company, as disclosed above) as at 31st December, 2001. Details of which are as follows:

	No of share options	Exercise price per Share	Exercise period
Pre-IPO Share Option Plan (Note 1)	37,000,000	HK\$1.48	31st March, 2001 to 14th March, 2010
Share Option Scheme (Note 2)	40,300,000	HK\$0.53	31st March, 2001 to 14th March, 2010

Notes:

1. An aggregate of 46,500,000 options were granted on 15th March, 2000 under the Pre-IPO Share Option Plan. Up to 31st December, 2001, 9,500,000 share options have lapsed. Options pursuant to the Pre-IPO Share Option Plan may be exercised in accordance with the terms of the relevant scheme as to:
 - a. one quarter of the options (rounded down to the nearest board lot) will be exercisable from 1 April, 2001 ("First Exercise Date");

- b. an additional one eighth of the options (rounded down to the nearest board lot) will be exercisable after the expiry of each successive six month period from the First Exercise Date; and
- c. the balance of the options exercisable after the expiry of a period of 48 months from 1 April, 2001.

As of 31st December, 2001, no options under the Pre-IPO Share Option Plan have been exercised.

- 2. An aggregate of 47,240,000 options were granted on 23rd August, 2000 under the Share Option Scheme. Up to 31st December, 2001, 6,940,000 share options have lapsed. Options pursuant to the Share Option Scheme may be exercised in accordance with the terms of the relevant scheme which are the same as those of the Pre-IPO Share Option Plan set out in paragraph 1 above.

As of 31st December, 2001, no options under the Share Option Scheme have been exercised.

Save as disclosed above, during the nine months ended 31st December, 2001, none of the directors and employees of the Company or its subsidiaries was granted options to subscribe for shares in the Company.

DIRECTORS' RIGHTS TO ACQUIRE SHARES OR DEBENTURES

Other than the share option schemes as described in the section headed "OUTSTANDING SHARE OPTIONS" above, at no time during the period was the Company, any of its holding companies, fellow subsidiaries or subsidiaries a party to any arrangement to enable the directors of the Company to acquire benefits by means of the acquisition of shares in, or debentures of, the Company or any other body corporate and none of the directors, or their spouses or children under the age of 18, had any right to subscribe for the securities of the Company, or had exercised any such rights.

SUBSTANTIAL SHAREHOLDERS

At 31st December, 2001, other than the interests disclosed in the section headed "DIRECTORS' INTERESTS IN SECURITIES" above, the Company has not been notified of any other interests at 31st December, 2001 representing 10% or more of the issued share capital of the Company.

SPONSOR'S INTERESTS

As updated and notified by the Company's sponsor BNP Paribas Peregrine Capital Limited (the "Sponsor"), at 31st December, 2001, neither the Sponsor nor its directors or employees or associates (as referred to in Note 3 to rule 6.35 of the GEM Listing Rules) had any interests in the securities of the Company or any member of the Group or any rights to subscribe for or to nominate persons to subscribe for the securities of the Company or any member of the Group.

Pursuant to the agreement dated 30th March, 2000 entered into between the Company and the Sponsor, the Sponsor will receive usual sponsorship fees for acting as the Company's retained sponsor for the period from 31st March, 2000 to 31st March, 2002.

OTHER DIRECTORS' INTERESTS

Mr Alex Ko Po Ming, an independent non-executive director, is the chairman of BNP Paribas Peregrine Capital Limited (formerly known as BNP Prime Peregrine Capital Limited). Mr Alex Ko Po Ming is interested in BNP Paribas Peregrine Capital Limited, which entered into a sponsorship agreement with the Company on 30th March, 2000 pursuant to which BNP Paribas Peregrine Capital Limited would act as sponsor to the Company, and will receive usual the sponsorship fees in connection therewith, up to 31st March, 2002.

Mr Ronny Chow Fan Chim, an independent non-executive director, is a partner of Deacons (formerly known as Deacons Graham & James), legal advisers to the Company. Deacons will receive usual professional fees in connection with the legal services it provides to the Company from time to time.

AUDIT COMMITTEE

The Company's audit committee was formed on 15th March, 2000, comprising all the independent non-executive directors, namely, Dr Alice Piera Lam Lee Kiu Yue and Messrs Alex Ko Po Ming and Ronny Chow Fan Chim. The terms of reference of the audit committee have been established with regard to "A Guide for the Formation of an Audit Committee" issued by the Hong Kong Society of Accountants in December 1997. The primary duties of the audit committee are to review and supervise the financial reporting process and internal control procedures of the Group.

By order of the Board
Leroy Kung Lin Yuen
Chairman

Hong Kong, 8th February, 2002