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Market Analysis

MANAGEMENT DISCUSSION AND ANALYSIS

Market Analysis

China Economic Growth

Throughout the year, the PRC economy progressed steadily as a whole, benefiting from the Government's continued efforts to implement the economic policies established in 1999. Consumption was stimulated to boost economic growth. In 2000, GDP rose by 8% to approximately RMB8,940 billion to break the USD1,000 billion mark.

Average per capita income in major cities was RMB6,280, representing a 6.4% real increase as compared with 1999. Due to the reduction in overall food production volume and prices of most agricultural products remained low, average per capita income in the agricultural sector continued to decrease to RMB2,253 in 2000.

With the faster pace of economic growth in the PRC, all the industrial, investment, import and export sectors outperformed their 1999 results. Personal income overall is also rising steadily. Consumer's confidence in the domestic market was largely improved due to the various Government measures to increase demand within the country. Sales of consumer products in the PRC market rose continuously with total retail value reaching RMB3,415 billion in 2000, representing a 9.7% increase as compared with 1999. Of this total, urban and rural areas accounted for RMB2,111 billion and RMB1,304 billion, respectively.



The headquarters of Guangdong Kelon Electrical Holdings Co., Ltd. at Shunde



MANAGEMENT DISCUSSION AND ANALYSIS

Intense Competition in the White Domestic Appliances Market

Starting from early 1990s, the white domestic appliances market shifted from a supplier market to a consumer market, prompting manufacturers to invest more in improving production techniques so as to attract more customers. New products were launched periodically; differences in quality and categories between brands were narrowed, and hence industry players were then forced to compete on the basis of price, service, sales network and brand name.

Year 2000 saw the continuation of the keen market competition in the domestic appliances market. Confusion in prices was seen in the marketplace and competition became more acute. Manufacturers were forced to lower prices to stimulate sales. Prices for refrigerators and air-conditioners dropped by an average of about 8.4% and 10% respectively, while profit margin for the entire industry was severely reduced.



Noise testing laboratory of refrigerator

MANAGEMENT DISCUSSION AND ANALYSIS



Quality control lines for refrigerator production

Oversupply of white domestic products was another reason for the price drop. During the year, manufacturers produced 20 million refrigerators while only about 9 million sets were sold. A total of 20 million air-conditioners was produced as compared with consumer demand of 11 million sets.

Not surprisingly, market share of leading brands of refrigerators declined in 2000. The top five brands accounted for less than 72% of the market as compared to 75% in 1999. At the same time, imported products, which target the medium- to-high markets, appears to be quite successful. Although market share of foreign brands such as Electrolux and Siemens is not overwhelming, sales growth was impressive during 2000. The same situation was also seen in the air-conditioner business with the market share of the top five local brands decreased from 65% in 1999 to below 62% in 2000.

Although the Group's efforts to clear up inventories and to provide substantial incentives to distributors have negatively affected results for 2000, management is convinced such measures will bring positive impact to results in year 2001.



Business Review

To
Today
Today's
Today's V
Average Volume
52-Week Range
EPS!



MANAGEMENT DISCUSSION AND ANALYSIS



Testing lines for air-conditioner production



Twenty-four-hour refrigeration testing lines for refrigerator production



Business Review

Results Performance

Facing intensified market competition, turnover of the Group for 2000 was RMB3,870 million, representing a decrease of 31% compared with 1999. Loss attributable to shareholders was RMB688 million while loss per share was RMB0.68. Due to deficit results recorded, the Board of Directors decided not to distribute any final dividend for the year ended 31 December 2000.

Loss recorded for 2000 was mainly attributable to decrease in turnover and gross margin, loss realised on sale of aged inventories and increase in distribution costs and administrative expenses due to incentives given to distributors.

The decrease in turnover was mainly attributable to five factors. First, intense market competition caused the product prices to fall. During the year, the Group cut its prices for the entire product range by an average of 11%. Second, there was an increase in the amount of sales rebates and discounts given to distributors, as part of the Group's efforts to further strengthen customer relationship. Third, the Group re-sold the outdated models returned from distributors at discounted prices. Fourth, the Group recognised the need to clear up outdated refrigerator models blocked within the distribution channels and thereby managed sales to its distributors. Fifth, sales mix of both air-conditioners and refrigerators for 2000 leaned towards products with lower unit prices.

MANAGEMENT DISCUSSION AND ANALYSIS

Gross margin dropped from 31% in 1999 to 16% mainly due to decrease in prices resulted from severe price wars, re-sale of returned goods from distributors at discounted prices and sales mix with increased products with lower unit prices.

Distribution costs increased from RMB760 million in 1999 to RMB920 million in year 2000, or an increase of 21%. Administrative expenses also increased from RMB410 million in 1999 to RMB640 million in year 2000, representing an increase of 56%. Increase in distribution cost was mainly attributable to increase in provision for warranty expenses in relation to the after-sales services provided to customers. The Group also incurred substantial promotional expenses to participate in distributors' promotional activities.

Increase in administrative expenses was mainly attributable to increase in provision for inventory obsolescence and doubtful debts. Management reviewed inventories held as of 31 December 2000, took a prudent and responsible approach towards obsolete and slow-moving items, and concluded an additional provision for inventory obsolescence of RMB160 million was necessary. This brought the total provision for inventory obsolescence as of 31 December 2000 to approximately RMB200 million, which represented 10% of the total inventory, as compared to 5% for 1999. During 2000, the



*The brandnew "Total Carefree" service
trademark of Kelon*

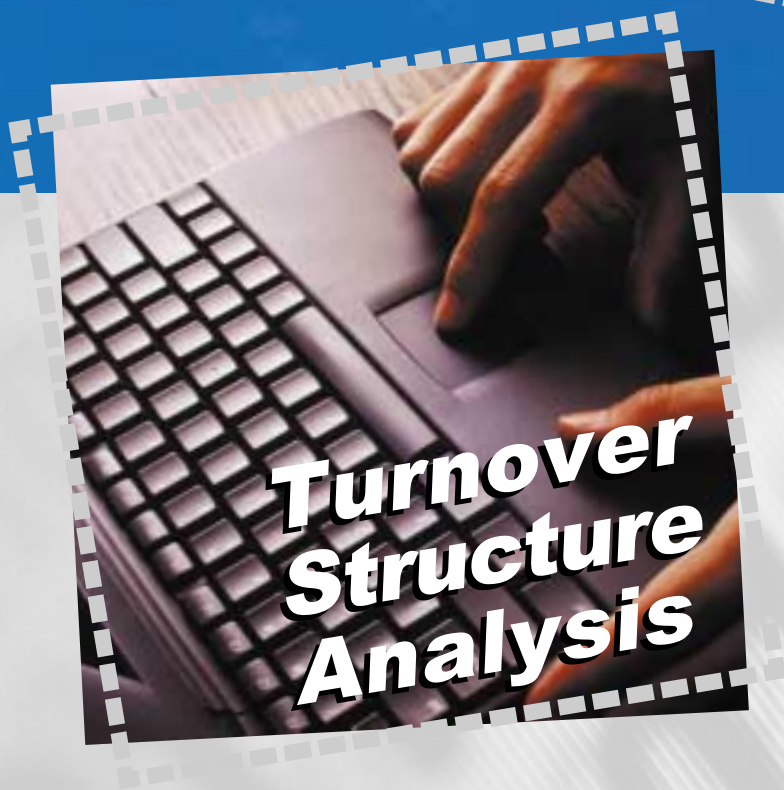
MANAGEMENT DISCUSSION AND ANALYSIS

Group implemented strict credit control over its accounts receivable and at present, substantially all of the Group's business is conducted without granting any credit to distributors. As to accounts receivable aged over one year or in dispute, the Group adopted a conservative accounting approach and increased provision for doubtful debt by RMB59 million to a total of RMB159 million by end of year 2000. This represents 53% of outstanding accounts receivable, which is a substantial increase over the 15% for 1999. Management is confident such provisions for inventory obsolescence and doubtful debts are non-recurring.

Although the Group's efforts to clear up inventories and to provide substantial incentives to distributors have negatively affected results for 2000, management is convinced such measures will bring positive impact to results in year 2001.



The Group's refrigerator business was mainly conducted under the "Kelon" and "Rongsheng" brands. The Group's air-conditioner business was mainly conducted under the "Kelon" and "Huabao" brands.

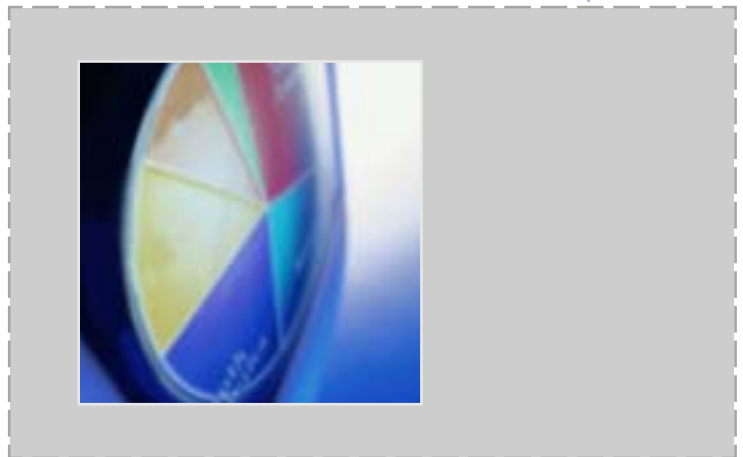


MANAGEMENT DISCUSSION AND ANALYSIS

Turnover Structure Analysis

The Group's turnover recorded for 2000 was RMB3,870 million, of which RMB2,149 million relates to sales of refrigerators and RMB1,600 million relates to air-conditioners, representing decrease of 37% and 27%, respectively, when compared to 1999.

The Group's refrigerator business was mainly conducted under the "Kelon" and "Rongsheng" brands. During the year ended 31 December 2000, the Group strived to clear up inventories blocked within the distribution channels. Measures taken included accepting more than 210,000 units of out-of-date models returned from and managing sales to distributors during 2000. These all helped bring inventory at distributors back to healthy levels. These measures however, coupled with the intensified market competition, caused the net sales volume of refrigerators to drop during 2000. On the other hand, average selling price also decreased, mainly attributable to the re-sale of out-dated models at discounted prices and the intense market competition.



The Group's air-conditioner business was mainly conducted under the "Kelon" and "Huabao" brands. Despite the increase in sales volume during the year under review, the substantial decrease in average selling price resulted in a decrease in turnover. The substantial price drop was mainly caused by the cut-throat price war prevailed throughout the market and a sales mix leaned towards products with lower unit prices. In addition, the Group granted higher sales discounts to its customer in 2000 for the purpose of strengthen customer relationship, which also contributed to the decrease in turnover for the year ended 31 December 2000.

During the year under review, the Group's financial management showed continuous improvements. In year 2000, funds tied up in working capital was reduced by RMB1,071 million



**Stable
and Healthy
Financial
Condition**

MANAGEMENT DISCUSSION AND ANALYSIS

Stable and Healthy Financial Condition

During the year under review, the Group's financial management showed continuous improvements. In year 2000, funds tied up in working capital was reduced by RMB1,071 million, mainly attributable to two factors. First, accounts receivable and notes receivable was reduced significantly by RMB1,069 million, achieved by the Group's strict credit control over its distributors as well as the discounting and use of notes receivable to settle payments. After netting off the increase in inventory due to goods returned from distributors and the increase in tax recoverable, funds tied up under current assets was successfully reduced by RMB254 million. Second, incentives offered to distributors and market popularity of new products enabled the Group to successfully attract RMB531 million deposits from distributors. Further, the Group's perceived strong cash flow position to honor payments enticed suppliers to offer better, deferred payment terms. These enabled the Group to increase sources of funds by RMB817 million through an increase in current liabilities.

As of 31 December 2000, the Group's net assets amounted to RMB4.148 billion while the debt-to-equity ratio was 16.7%, significantly lower than the 22.1% in 1999. Cash on hand was RMB839 million, representing an 11% increase over 1999. The Group secured approximately RMB1.1 billion in available banking facilities, of which RMB480 million was still unused. The

Group's overall debt level fluctuates within the year in line with the seasonality of our products. Nonetheless, the Group managed funds generated from and required for the sales and procurement cycles well, and always maintained a healthy level of cash on hand. The Group's debt repayment record was excellent on a consistent basis. As of 31 December 2000, the Group's outstanding capital commitment for purchasing machinery and equipment amounted to RMB13 million. In addition, the Group had commitments in respect of purchase of advertisements amounting to approximately RMB21 million.

Net cash inflow from operating activities was approximately RMB1,109,437,000 (1999: outflow of approximately RMB433,616,000) for the year ended 31 December 2000.

As of 31 December 2000, the Group had cash and bank deposits amounting to approximately RMB838,710,000 (1999: RMB753,140,000), of which approximately RMB192,314,000 (1999: RMB66,543,000) was denominated in foreign currencies, and bank loans amounting to approximately RMB694,783,000 (1999: RMB1,118,263,000), of which approximately RMB57,083,000 (1999: RMB108,063,000) was denominated in foreign currencies. As of 31 December 2000, the Group's bank loans bore interests at prevailing market rates with maturity dates ranging from 2001 to 2008.

Facing unfavourable market conditions in 2000 and the urgent need of internal reformations, the new leadership has already initiated a series of revolutionary changes for the Company, which can be classified into four main areas. These changes comprise sales and marketing transformation, technological improvement, cost control and effective use of information technology



Revolution and Renovation



MANAGEMENT DISCUSSION AND ANALYSIS

Revolution and Renovation

Facing unfavourable market conditions in 2000 and the urgent need of internal reformations, the new leadership has already initiated a series of revolutionary changes for the Company, which can be classified into four main areas. These changes comprise sales and marketing transformation, technological improvement, cost control and effective use of information technology, which indicated positive results following their implementation a few months ago. The management team is confident that the Company will be able to bring the business back to profitability in 2001.

Sales and Marketing Re-engineering

Sales and marketing re-engineering reforms initiated in 2000 comprised product planning, promotional tools integration, sales force restructuring and sales network enforcement.

On product planning front, the Group established its specialized Product Planning Division during

the third quarter of 2000. The Division aimed to launch new products for 2001 that hit the market with success by designing such products based on consumer needs and market research reports. With the total number of products reduced by 60%, the overall product costs was significantly reduced while development, production, and marketing resources could be focused on the fewer products launched.

On promotional efforts front, during the fourth new quarter of 2000, the Group embarked on a program to re-design its corporate image and executed its branding strategy. A brand new Corporate Image was launched in early 2001. The Group's investment in Qin Jia Yuan Shares Company Limited ("QJY") rendered the advertising dollars spent on a more cost effective basis, and thereby cutting the total advertising costs. QJY also helped monitor the effectiveness of the Group's advertisements.



Evolution of the trademarks of Kelon and Rongsheng

MANAGEMENT DISCUSSION AND ANALYSIS

Regarding the Group's sales teams, with two major restructurings in year 2000 the headcount of salespersons was reduced from 3,500 to 2,000. The entire marketing organization was restructured to enable the refrigerator and air-conditioner businesses to share common resources. The Group delegates certain power and authority to the branches set up in 28 provinces. This adds energy and flexibility to the front-line sales units and enables the marketing organization to act and react on market trends and to respond swiftly to challenges posted by competition.

Regarding sales network, the Group focused to align and strengthen its wholesale, distribution and retail network. Number of wholesalers was increased from 320 to 400, while indirect retailers rose from 3,000 to 5,000 and direct distributors were increased from 300 to 800. The Group also entered into co-operative agreements with distributors to foster a closer relationship with them. In year 2000, the Group did not only put significant focus in expanding its retail sales network, it also upgraded its after-sales network and marketing and promotional campaigns.

Improving Technology

During the year under review, the Group pursued product development and research of technologies aggressively. One year after the establishment of Kelon Technology Research Center, the Group now grasped 10 cutting-edge refrigerator technologies: super energy-saving, automatic temperature sensor, automatic door-



Kelon Brand refrigerator sales counter



Kelon Brand air-conditioner sales counter

MANAGEMENT DISCUSSION AND ANALYSIS



opening, super fresh-retaining, four-level temperature adjustment and soft-cooling, network refrigerator, automatic ice-making, power voltage adjustment, super quiet and computer-assistance intelligence control. The first five technologies reach world's leading standards and are invaluable assets to the Group's future business development.

Besides, the Group had developed 55 air-conditioner models (including export products), of which 17 new models were granted the "Energy Saving Certificate". In addition, technology improvements included personal split-type air-conditioner, VFD box-set and voice-control air-conditioner.

The Group believes that breakthroughs in refrigerator and air-conditioner technology were achieved and new products of advanced technologies will be launched in 2001.

Stringent Cost Control

Facing keen competition and severe price cut in the household appliances market, the Group recognised cost reduction as one of its major task to bring the business back to profitability.

Cost control measures included cost analysis of components, public bidding procedures for procurement, logistic management and downsizing workforce. The Group believes that such measures implemented exercised during the year will reduce the overall operating costs.

Integrating Information Technology

At the end of March 2000, the parent company Kelon Group together with the Chinese Academy of Science and a renowned US research institution established "Sino-American Kelon Smart Technology Control Research Center" in Beijing. The establishment marked the Group's accomplishment in advanced research and provided a strong back up of information technology to the Group. By the end of 2000, the "Modern Household Information Services and Artificial Intelligence Distribution Control System" developed by the Beijing research center has obtained experts' approval.

In April 2000, the Group set up the first vertical procurement platform for household appliance in the PRC. The Group also formed a partnership with the PRC's largest washing-machine producer, Wuxi Little Swan Company Limited, providing a one-stop-shop for e-business services. The on-line procurement process helps to reduce operating costs and create another channel to generate income for the Group. At present, there are already over 200 members on the procurement platform.

Business performance for the first quarter of 2001 endorsed the Group's re-engineering efforts and hard work for 2000. With the clearing up of inventories blocked within distribution channels, the 39 new refrigerator models launched in early 2001 incorporating 10 breakthrough technologies received wide market acceptance. Sales volume for domestic market reached 378,000 units, represented an increase of 23% over the corresponding period for 2000.



Prospects



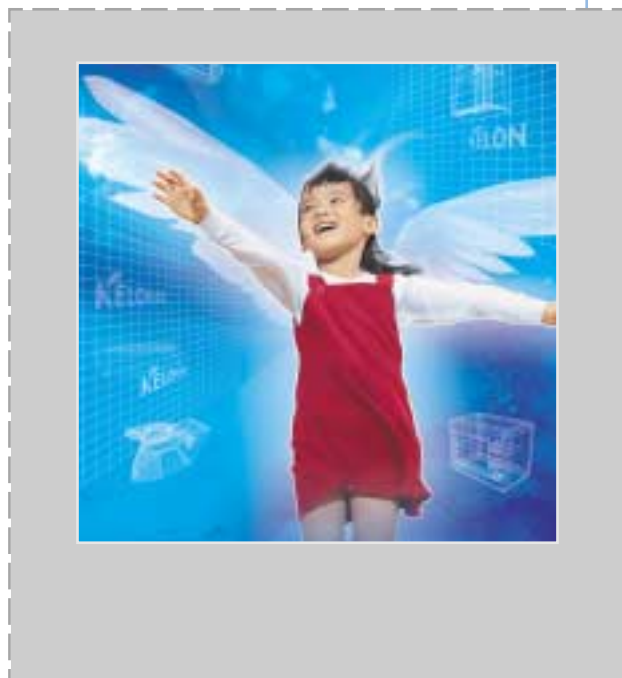
MANAGEMENT DISCUSSION AND ANALYSIS

Prospects

Business growth for first quarter of 2001

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The Group's air-conditioner business also demonstrated impressive growth. Sales volume for the combined domestic and export markets reached 216,000 units, or an 77% over the corresponding period for 2000, with unit cost of production reduced by 6%.



Jump in export sales

Export sales is the Group's key profit growth area for 2001. During the first quarter of 2001, the Group recorded encouraging growth for its export sales. This was achieved by (1) the introduction of new technologies rendered our products to be very popular among overseas consumers; and (2) the Group's increased efforts and resources in strengthening the export sales teams and in expanding overseas markets. Sales amount increased by over two times as compared to the corresponding period for 2000, with a turnover of over exceeding US\$30 million.

MANAGEMENT DISCUSSION AND ANALYSIS

Achievements in sales and marketing

In 2001, the Group continues with its re-engineering efforts in sales and marketing. The Group has committed to invest RMB200 million to systematically upgrade our retail network for both refrigerator and air-conditioner businesses. As a result, in early 2001, the Group was able to secure agreements with 800 dominant, reputable department stores, as well as 5,000 small to medium retail outlets throughout the country, to have them placed particular emphasis in marketing our refrigerators and air-conditioners. With the success of this critical strategy, share of Rongsheng and Kelon refrigerators distributed through direct retailers is now increased to 40% and 95% respectively. This enables the Group to be close to the end-consumer market, and hence improve our capability to react swiftly to changes in market environment. In exploring new marketing methodologies, the Group pioneered in setting up joint ventures with distributors and in developing products jointly with major retail chain stores such as Carrefour, Metro, Guomei and Suning to capture a higher market share.

Reduction of operating costs by factory merging and relocation

The Group will continue its stringent cost controls in the coming year. By combining Factory No. 1 and Factory No. 2, the production lines can cover products with capacity from 88 litres to 348 litres, thus enhance centralize logistic management. In addition, the metal-processing factory will be relocated and rebuilt. The Group believes that these moves will integrate resources, reduce management costs and enhance productivity.

Continual Development and Success

Kelon will continue to concentrate on manufacturing refrigerators and air conditioners as our core business while gradually diversifying into the related home-appliance business and high-tech industry. The Company will keep refining its reform measures. At the same time, Kelon will work hard to market new products of advanced technologies, with sophisticated sales and marketing strategies for both the local and overseas consumers. While business performance is expected to improve, we will also focus on further reducing costs in order to increase profit for our shareholders and to bring a bright future for Kelon.

