MANAGEMENT DISCUSSION AND ANALYSIS

Review of results and operation

The first half of the year was a period of business repositioning for the Group facing a difficult operating environment. On the back of a challenging and fiercely competitive market for electronics products, the Group has continued to put every effort to reinforce its own Sunway brand name, invest in new manufacturing facilities, strengthen its core businesses and make strategic capital investments.

The Group is one of the leading manufacturers and suppliers of electronic components and parts in Hong Kong, and a leading supplier of electronic calculators, electronic clocks and watches, and other consumer electronic products, such as fax machines.

Major electronic components supplied by the Group include quartz crystals, liquid crystal displays ("LCDs") and watch movements. The Group is also a major trader in these and other components, namely integrated circuits ("ICs").

For the six months ended 31 March 2001, the Group recorded a consolidated turnover of HK$427,053,000. Profit before taxation for the Period and the corresponding period in 2000 was HK$44,849,000 and HK$120,069,000, respectively, with gross profit ratios standing at approximately 18% and 26%, respectively. Basic earnings per share was HK3.92 cents and diluted earnings per share was HK3.91 cents.

The Group felt acute price pressure across the electronics industry, and has responded to the market by implementing new pricing strategies and adjusting its product portfolio in order to maintain its leading market position and share in electronic components and parts such as quartz crystals and LCDs. While these strategies have helped to strengthen the Group's lead in the market, they inevitably led to a short-term decline in both turnover and gross profit. Sales drop was also recorded in electronic calculators due to intensified market competition. As noted by the Group in the annual report of the past year, market demand for traditional lower-end watch movements has continued to decline. To capture these new market trends, the Group has implemented a series of operational realignments to reengineer its product portfolio. As a result of such initiatives, the Group launched in the first half of this year new high-end product lines including personal data assistants ("PDAs") and high frequency quartz crystals.

The decrease in profit before taxation was due to the revenue decline as explained above and the share of the loss of an associated company for the Period. Finance costs rose by approximately 19.3% to HK$6,456,000, mainly attributed to the interest paid for the convertible bonds issued in May last year. Operating expenses stood at about the same level as in previous corresponding period.

The production of high frequency quartz crystals, which are used in telecommunications devices such as cellular phones, modems and fax machines, commenced successfully in September last year. Monthly production capacity has now topped approximately 3 million pieces which is half of the full design capacity. The Group aims to increase the monthly capacity to 5 million pieces in the second half of this financial year. The major markets for this new product line include Taiwan, the PRC and Hong Kong. The management is confident that this new business line will become a major contributor to the Group in the future.

The market for LCDs remained competitive but the Group was able to maintain a stable turnover from this business line. The Group earmarked investments to establish new production facilities with a view to expanding its capacity in tandem with growing global demand for this essential component for a wide range of electronic consumer products.

During the Period, the Group also paid up the remaining part of the capital contribution, amounting to US$1 million for its investment in Taiwan Communication (Fujian) Company Limited ("Taiwan Communication"). The joint venture had a total capital injection of US$2 million as at 31 March 2001, and is engaged in the manufacture and trading of telecommunications products including fax machines and IP telephony products.

Subsequently in April 2001, the Group paid up the remaining investment contribution in Angstrem Joint Stock Company ("Angstrem") for the acquisition of 35,256 equity shares of the company. Angstrem is a leading Russian producer of ICs. The Group considers the acquisition a long-term investment, as well as a means to enable it to secure a stable supply of integrated circuits and to reduce the lead-time in product delivery, helping the Group to strengthen its competitive position as a leading ICs trader.

Liquidity and financial resources

The Group generally finances its operations with internally generated cashflow and banking facilities provided by its principal bankers in both Hong Kong and the PRC. Such facilities were secured by fixed deposits amounted to approximately HK$10,218,000, certain properties and plant and machinery held by the Group and the corporate guarantees of certain related companies and the Company. The Group maintains a strong financial position. As at 31 March 2001, the total shareholders' equity of the Group was approximately HK$833.1 million, an increase of 5.4% over that as at 30 September 2000. The Group's cash and bank balances as at 31 March 2001 stood at HK$122.5 million. The bank borrowings and trust receipt loans of the Group amounted to HK$129.7 million, a decrement of 18.4% as compared to that as at 30 September 2000. The decrement was mainly due to the decrease in secured short term bank loans of HK$37.4 million. All the bank loans were denominated in Renminbi. The Group's gearing ratio, which was computed by dividing the current liabilities and long term debt by shareholders' equity, has lowered from 41.4% as at 30 September 2000 to 32.7% as at 31 March 2001. Borrowings are closely monitored by the Group to maintain gearing at a reasonable level.

Capital structure

As at 31 March 2001, the number of share options outstanding remained the same as that as at 30 September 2000.

During the Period, one of the convertible bondholders, Credit Suisse First Boston (Hong Kong) Limited ("CSFB"), converted twice in the total sum of US$300,000 bonds into ordinary shares of the Company. The Company has also redeemed a total of US$200,000 bonds from CSFB during the Period. Accordingly, the issued share capital of the Company has been increased to HK$100,866,031 as at 31 March 2001. Subsequent to the balance sheet date and up to the date of this report, the Company has also made further redemption on a total sum of US$1 million bonds from CSFB which resulted in the balance of the convertible bonds being reduced to US$8,100,000 at the date of this report. The issued share capital of the Company remained the same as that at 31 March 2001.

Pledge of assets

Certain leasehold land and buildings, plant and machinery and certain time deposits of the Group, together with the corporate guarantees of certain related companies and the Company, are used to secure banking facilities of the Group. As at 31 March 2001, such facilities were utilised to the extent of approximately HK$129,716,000.

Application of proceeds of share offer

During the Period and up to the date of this report, out of the net proceeds of about HK$270 million raised from the share offer in September 1999, HK$50 million and HK$40 million have been applied respectively to the purchase of additional machinery, equipment and other facilities and for the construction of factory plant to expand and upgrade LCDs production capacity and quartz crystal production capacity, respectively. Approximately HK$22.7 million was used to invest in the joint venture, Taiwan Communication and the total amount of approximately HK$12 million was fully paid as the acquisition of the 5.4% equity interest in Angstrem.

The Group has spent about HK$2.9 million for the expansion in the market research and product development division. The remaining balance of about HK$142.4 million of the net proceeds is intended to be applied for the following main purposes:

- investment in Taiwan Communication — HK$137.3 million

- expansion of the Group's market research and product development division — HK$0.1 million

The actual and intended applications of the net proceeds of the share offer are in line with the plans set out in the prospectus of the Company dated 25 August 1999. In particular, the plans to expand and upgrade the LCDs and quartz crystal production capacity as well as the acquisition of Angstrem have been completed as planned.

Employees and remuneration policies

As at 31 March 2001, the Group has approximately 18,000 full time management, administrative and production staff in the PRC and Hong Kong. The Group has a share option scheme and offers rent-free quarters to its employees in the PRC. The employees are remunerated based on their work performance, work and professional experiences and prevailing industry practices. Following the adoption of the Mandatory Provident Fund ("MPF") Scheme in December 2000, the Group's directors and employees in Hong Kong joined the MPF Scheme.

Prospects

Management views the second half of the year and beyond with optimism. It looks forward to benefiting from the opening up of untapped markets on the mainland following China's imminent accession to the WTO and the improvements of living standards in the western and northern provinces resulting from the state's "Go West" policy.

The Group will continue to pursue active developments in its core businesses lines, including the design, manufacture and sale of a wide range of electronic and related components and parts (comprising quartz crystals, LCDs and watch movements) and consumer electronic products (comprising electronic calculators and electronic clocks and watches). To expand its lead in the industry, the Group has committed continued expansion of its production lines to meet the anticipated growth in the demand for components used in telecommunications products.

As part of its product reengineering initiatives, the Group has also earmarked investments in the development and production of new PDAs lines in the year ahead. The new product line, branded and registered as “Supermate”, is designed to capture the upper-end market for business executives and professionals in the PRC. The new PDAs incorporate such special functions as electric light support and PC connectivity, as well as a database of healthcare, postal code and other useful information. This new business line is expected to command a higher profit margin, and will help the Group further diversify its product and revenue base.

The investment in Angstrem has been fully completed. The acquisition will help cement the Group’s relationship with this major ICs producer, ensuring a stable supply of ICs for the Group’s trading operations. The investment in Taiwan Communication will be carried out as planned.

The Group also anticipates favourable market response to its newly established line of high-frequency quartz crystals, due to the wide application of this component in different kinds of telecommunications devices. The management expects the profit margin for this business line to further improve as production capacity increases towards an optimal scale.

All in all, the Group is optimistic about business prospects. Management’s dedicated efforts to adjust the Group’s business focus, streamline operations in non-performing areas, and establish new growth engines has helped it stabilize its performance amidst surmounting difficulties in the electronics industry. Management is confident that these new business strategies will drive the Group into sustainable long-term profitability and growth. In the second half of this financial year, the Group will focus in developing new markets and further strengthening its competitiveness. The Group will also actively look out for new business opportunities to maximize return for its shareholders.