REVIEW OF OPERATIONS

I. PERFORMANCE HIGHLIGHTS

Performance statistics for the six months ended 31st December 1999 and 2000 are set out below.

	2000 *HK$'000*	**1999** *HK$'000*	**% Increase/ (Decrease)**
Turnover	144,769	115,730	25%
Profit attributable to shareholders	24,025	23,606	2%
Net profit margin	17%	20%	(3%)
Basic earnings per share (cents)	2.54	2.71	(6%)
Cash and bank balances	27,808	19,054	46%
Gearing ratio	53%	33%	20%
Overheads	20,854	15,672	33%
Finance costs	3,577	819	337%

The period has seen the successful adoption of a business strategy more suited to the current market environment, where the number of exhibition channels and their revenue potential are increasing.

Overheads

Overheads rose by about 33% as a result of the increase in the Group's scale of operations. In general, the increase in overheads is attributable to higher depreciation charges relating to additional equipment and fixtures for the new office, and higher salaries as a result of staff expansion. In particular, about HK$2 million is a one-off charge relating to the setting up of the Group's web site u333.com.

Finance costs

Finance costs have tripled when compared with the same period last year, as a result of the expansion of the scale of operations and the increase in content investment.

II. TRADING RECORD ANALYSIS

Turnover highlights

Set out below is the turnover analysis by principal activities for the six months ended 31st December 1999 and 2000.

	2000 *HK$'000*	1999 *HK$'000*	% Increase/ (Decrease)
VCD	91,420	84,219	9%
DVD	13,982	8,403	66%
Sub-licensing and film exhibition	35,507	19,626	81%

Video Distribution

Video distribution, the Group's core business, increased by 14% compared with the same period last year. During the period, the Group has benefited from cost-savings through higher efficiency from better utilization of the Group's own replication equipment. Gross profit margin for video distribution has improved by 7% compared with the same period last year.

Capitalizing on increasing popularity of home video entertainment in Hong Kong and continuous upgrading of DVD players at affordable prices and better quality, sales of DVD was particularly strong and increased by 66% to HK$14 million. The Directors believe that the growth in DVD sales will continue to outperform other formats.

Despite a market slowdown after years of rapid expansion, the Group's VCD sales still rose by 9% to HK$91.4 million. During the period under review, the Group broadened the content library to cater to different consumer tastes and preferences. The Group distributed 288 new Titles, comprising local and foreign films, infotainment and educational programmes, animation programmes, documentaries, stage performances, karaoke, television series and adult features.

Sub-licensing and film exhibition

During the period under review, sales from sub-licensing and film exhibition increased by 81% to approximately HK$35.5 million, representing 25% of total turnover. The Group attributes such strong growth to the emergence of more media channels, further deregulation of the local broadcasting industry, and the gradual economic recovery in Southeast Asia, which have boosted demand for quality Titles, especially Chinese-language films, to a new high.

Operating margin, however, declined because costs relating to film exhibition have, as usual, been incurred up front while not all revenue and profit are fully realized and reflected in the current period. In particular, revenue from sales to other non-theatrical channels, including sales of video products and sub-licensing though contracted for, will only be recognized upon delivery in subsequent periods.

As a well-stocked content library should enhance the sub-licensing business, the Group has been broadening and diversifying its content library through investment and participation in film and video programmes production. The Group is also expanding its customer network in Hong Kong, China, Taiwan, Macau, Thailand, Malaysia, Singapore, Japan, Korea, Indonesia, Australia, New Zealand, Canada and the US.

III. CONTENT INVESTMENT

Business strategy

Before 2000, expansion of the Group's content library had been achieved mainly through acquisition of contents with limited rights. A small portion of contents with perpetual rights had been acquired through investment and participation in film production. Since 2000, an increasing proportion of the Group's content investment has been in the acquisition of Titles with perpetual rights and all rights and participation in film production.

Titles with all rights enable the Group to distribute and sub-license them in multiple geographical locations and in multiple formats for unlimited time period.

Increase in content investment

Given the strategy of investing in perpetual rights, financed by proceeds from US$7 million convertible notes issued to Multimedia Group Limited (a company wholly-owned by a fund under the management of HSBC Private Equity (Asia) Limited) and cash flow from operations, the Group has increased its content investment significantly compared with the same period last year.

Characteristic of content investment and its impact on financial results

A key characteristic of investment in film production and acquisition of Titles with perpetual rights is that the resulting contribution to sales and profit in the first year of theatrical release is typically understated and does not reflect the full commercial return from such investment. This is because promotion and other costs relating to a theatrical release are incurred up front while revenue as well as profit from subsequent distribution and sub-licensing will only be fully realized over a period of time. Such financial impact is reflected, for instance, in the lower operating margin achieved in sales from sub-licensing and film exhibition as described above.

Investment return

In assessing the profitability of investment in film production and acquisition of Titles with perpetual rights, the Group usually sets a target to recoup the full cost of investment, including marketing costs, within one and a half to three years. Thereafter, any further revenue will add directly to the Group's profit.

Based on signed commitments for sub-licensing of the Group's perpetual Titles and estimates of VCD and DVD sales, the Directors are confident that investment in new Titles released during the period will meet the above return criteria.

IV. PROSPECTS

Strategy

The Group will continue with the strategy to expand its content library through investment in film production and acquisition of mainly Titles with perpetual rights and all rights.

Video distribution

In Hong Kong, the Group plans to expand its video distribution business by acquiring and producing quality Titles. Apart from the United States and Europe, the Group plans to acquire Titles from Japan, Korea and Southeast Asia which have been gaining popularity in Hong Kong. Coupled with a competitive pricing strategy, the broadening of the content library should drive the growth of DVD and VCD sales in Hong Kong and Macau.

Film production

After several years' decline in box office revenue, the local film industry has shown signs of recovery. A greater variety of quality films has been released and audience have returned to cinemas, particularly during holidays, with several films having generated gross box office revenue in excess of HK$10 million. The Group expects that its film production operation will benefit from the industry's recovery.

Sub-licensing

The Group also expects increasing prospects for the sub-licensing business following the granting of more pay television licenses in Hong Kong, as this should boost the demand for content. The Group anticipates its sub-licensing operation to be one of the key drivers of revenue growth in the near future.

Apart from local market, the Group continues with its strategy of geographical diversification by exploring new overseas markets. Given the emergence of new media channels, the gradual economic recovery in Southeast Asia and the increasing popularity of Chinese-language films in the US and Europe, the Group will be able to expand its overseas sub-licensing network further.

Opportunities in China

In China over 90% of households own televisions, and there are three times more households with televisions than in the United States. China is the largest cable television market in the world with 70 million viewers, and it is the world's largest VCD market with an estimated 50 million households that own video players in 1998.*

The Group expects that upon entering the World Trade Organization, the Chinese government will open up and liberalize the entertainment industry. The Group is negotiating with mainland counterparts in respect of joint film production and strategic alliance. The Group has established a network of contacts in China while filming Shaolin Soccer, giving it an advantage in future developments on the mainland.

Internationalization

The Group will continue to internationalize its content library by acquiring more foreign films with international distribution rights. In addition, film production will give the Group direct control over distribution and sub-licensing of contents in overseas markets. The Group expanded to Eastern Europe in 2001 by selling Titles to customers in Russia and Ukraine.

Conclusion

Overall, the Directors are confident that the Group's strategy of investing in film production and acquisition of Titles with perpetual rights should produce satisfactory results. The Group will continue to strengthen its core businesses and increase its share of the entertainment market in Greater China.

**Source:* *Data quoted is extracted from "China: The Next Entertainment Frontier" published by Booz-Allen & Hamilton*