THE OPERATING ENVIRONMENT

The year 2001 marked the first year of China's Tenth Five-Year Plan. The nation continued to implement a pro-active fiscal policy and a prudent monetary policy. Treasury bonds amounting to RMB150 billion were issued to raise funds for investments in infrastructure projects and the development of western China, with an aim to maintain the swift pace of the nation's economic growth. This had both direct and indirect effects of stimulating the demand for steel products, as consumption of steel products saw substantial growth in 2001, both in terms of the size of individual orders and the overall volume. With growing demands in the market, there was a marked increase in domestic steel production. Internationally, the steel market remained in a doldrums as a result of the US economic recession and a weak global economy, making it increasingly difficult for China to export its steel products. Meanwhile, immense pressure was felt in the domestic market as the volume of steel imports registered a year-on-year increase. Overall, the China steel market remained over-supplied in 2001.

FUNDAMENTAL STRATEGIES

The cope with market changes, the Company adopted the following strategies:

(1) **Maximising production capacities to leverage economies of scale**: Specific targets throughout the production process were identified for increasing production capacity. The entire production process was optimised with a net effect of faster process flow. Pig iron production reported a net increase of 16.85% or 670,000 tonnes compared to 2000. Steel production increased by 21.71% or a net of 850,000 tonnes, while the output of steel products increased by 24.54% or 870,000 tonnes, net. The realisation of the Company's full production capacity resulted in improved economies of scale on the basis of its existing facilities.

(2) **Increased investment in technological upgrades and structural realignment**: The Company invested RMB691.98 million in technological upgrade projects in 2001 to adjust its processes and product mix. Through the upgrade of the sintering system, the structure of pre-iron furnace materials was improved to facilitate a marked increase in the volume of pig iron produced. In terms of steel processing, steel products were made in better quality and increased volumes after the continuous casting system was introduced to replace the open-hearth furnace as a move towards optimisation. The cast ratio increased to 88.2% from 87.0% in 2000. The iron and steel ratio was 0.97:1 in 2001. The process flow from the billet plant to the rolling plant was also realigned. The rolling system was focused on new product development. As a result of increased investment in technological upgrade programmes, our overall efficiency was enhanced. Major economic and technological indicators showed improvements. On a consolidated basis, an average unit coal consumption rate of 890 kilograms of standard coal for each tonne of steel produced was recorded, a reduction of 96 kilograms compared to 2000.

FUNDAMENTAL STRATEGIES (continued)

(3) **Focusing on market development**: Strengthened efforts were made in the marketing and development of new products to complement our traditional market share. A total of 504,000 tonnes of new products were produced in 2001, an increase of 284,000 tonnes compared to the previous year, all of which were hi-tech items with impending demands. The H-shaped beams of the Group, officially categorised as an import substitute, enjoyed enormous market potential. The Group produced 510,000 tonnes of H-shaped beams in 2001, an increase of 67% compared to 2000, among which 360,000 tonnes were sold domestically to be applied in key large-scale infrastructure projects that required elevated structures, such as bridges, highways, power stations and off-shore platforms for oil exploration, etc. A total of 150,000 tonnes were exported.

(4) **Enhanced use of capital**: The turnover of cashflow was expedited. Controls were exercised throughout the entire logistical process from purchase of materials to marketing of finished products. The leadtime of current fund was shortened by 31 days as a result. Efforts were also made to reduce the total amount of borrowings and to improve the loan structure. Due repayments or early repayments were made for certain bank loans to further improve its gearing ratio. Through rearrangements in the loan structure, finance costs were reduced. In terms of sales and marketing, we continued to adhere to the practice of "cash-before-delivery" with a view to controlling operating risks. Additional efforts were made to collect historical debts, resulting in a reduction of RMB148 million in accounts receivable compared to 2000. At the end of 2001, the gearing ratio of the Group prepared under PRC accounting standards and regulations was 29.58%, or 28% under Hong Kong accounting standards. None of the Group's assets were pledged or mortgaged to any creditors. The Group had no material contingent liability. The Group's deposits were primarily denominated in Renminbi. The Group estimates that the impact of foreign exchange risks will be relatively minor for the Company for year 2002.

(5) **Effective mechanisms for staff incentives and disciplines**: Our staff remuneration policy was mainly based on the principle of linking income to performance. A multi-level assessment system was set up to appraise staff performance and determine their remunerations. The management staff of the Company were paid on an annual basis. Salaries for middle-level management staff were linked to their duties and performance standards and determined at the end of the year. This system proved very effective in motivating our employees for better performance.

SITUATIONS IN THE WAKE OF WTO ENTRY AND RECENT ECONOMIC DEVELOPMENTS

In 2002, the iron and steel industry is entering a new phase of competition as China embraces the first year of WTO membership. China's steel producers will face more difficulties as the nation is required to abolish import quotas in tandem with its WTO commitments. Imports will increase at a faster pace, while prices in the domestic market will slide further as a result of reductions in import tariffs. The Group will also be negatively affected by increasing cost pressure as a result of price hikes in fuel and electricity that are needed in the course of its production.

The U.S. government has imposed a quota system or provisional protective tariff of 8 to 30%, effective 20 March 2002 for a period of three years, on a number of imported iron and steel products such as billets and still plates. This policy will apply to over 40 countries and regions, including China. The policy is regarded by China as an act of trade protectionism contravening the principles of WTO, and both sides are currently under negotiations. The European Union imposed an import quota system or additional tariffs of 14.9 to 26% for a period of 6 months, effective 29 March 2002 for a period of 6 months, on 15 imported steel products, thereby affecting the export of certain iron and steel products of the Company and China in general. In 2001, the sales mix of steel product exports of the Company by regional market was as follows: 92% for Asia; 1.2% for Europe; 5.9% for the U.S.; and 0.9% for other countries and regions. With the occurrence of the aforementioned international trade disputes, the Company will thus monitor closely the forthcoming developments and changes in prices, and hence make timely adjustments to the Company's sales strategies.

In 2002, the demand in the domestic steel market will continue to thrive as steel product consumption will be stimulated by fixed asset investment by the government which will continue to implement pro-active fiscal policies and prudent monetary policies so as to expand domestic demands and increase the construction of infrastructure. However, with the ever increasing domestic output of steel products, the Group expects increasing competition in China's steel market in 2002. The basic strategies of the Group would then be: focusing on improving product competitiveness; enhancing its efforts in technological upgrading and structural realignment; encouraging technological innovations; increasing labour productivity to lower production costs; and developing a series of effective and proactive measures including a modern enterprise system to cope with varied challenges. The Company has formulated a structural realignment programme for its main iron and steel business to be implemented in the Tenth Five-Year Plan period. Meanwhile, other reforms and management efforts are underway. In short, the Company is confident that in responding to the challenges, it will achieve greater progress.