

**MANAGEMENT
DISCUSSION
AND ANALYSIS**

Market

Review

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Market Review

China's Sustaining Economic Growth

In 2001, while the global economy slowed down, China's economy continued to grow rapidly. China's Gross National Product (GNP) recorded a 7.5% increase, reaching RMB9,593.3 billion. In addition, sales of consumer products in China's market grew 10.1% from 2000, amounting to RMB3,759.5 billion. With the continued expansion of the economy, the Chinese domestic appliances market remained a focus of the PRC's consumer products market.

Increased Competition in China's Domestic Appliances Market

In 2001, the domestic appliances market continued to experience intense competition. Both domestic and international household appliances companies strove their best to promote their products using various strategies: provision of quality after-sales services, comprehensive sales networks, strengthening of

brand reputation, as well as mergers and acquisitions between enterprises. Among these strategies, price reduction was the primary strategy used by competing enterprises. The price war has adversely affected the market share of the top five domestic refrigerator manufacturers, which saw a decrease from 72.48% in the previous year to 65.95% in 2001.

With China's entry into the WTO, more foreign household appliances companies, including multinational corporations, will enter into the Chinese market, leveraging their advanced production technology, creative marketing strategies and established brand names to gain their market share in the Chinese market. At the same time, they are progressively merging with China's domestic appliances companies and the stronger players will gradually eliminate the weaker players in the market.





Results

Review



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Results Review

In 2001, the Group recorded an annual turnover of RMB4.38 billion, representing an increase of 13.2% as compared with 2000. Loss attributable to shareholders was RMB1.57 billion while basic loss per share was RMB1.58.

The board of directors does not recommend the payment of a final dividend to shareholders. (2000: no final dividend)

Although the 2001 results still reported a loss, the Group's overall operating performance has significantly improved from the previous year.

The operational improvement was mainly attributable to the following four factors. Firstly, the total sales revenue of the Group recorded an increase of 13% as compared with the previous year, with the air-conditioner business experiencing a 38% growth. Secondly, domestic

and overseas sales of refrigerators grew by 20%, maintaining its leading position in the Chinese market. Thirdly, there was a strong growth in overseas sales, where exports grew by nearly 400%, with export revenue increased accordingly. Fourthly, there was reduction in costs as the average costs of sale of refrigerators and air-conditioners have, compared to the previous year, decreased by 9% and 7% respectively, contributing to a reduction in expenditure and an increase in profit.

Despite the improvement of its operations, the Group has yet to make a profit. This was due to the following reasons: firstly, despite an increase in sales revenue and a reduction in costs, the advertising expenditure was not shared with the Rongsheng Group, resulting in an increase in refrigerator and air-conditioner advertising expenditure of RMB280 million as compared with

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the previous year. Secondly, as a result of intense market competition and clearance of inventory at reduced prices, the average price of refrigerators recorded an 8% drop as compared with the corresponding period in the previous year, which caused downward pressure on the Group's profit. Thirdly, the existing sales channels are undergoing restructuring, shifting from a wholesale to a retail environment, which will take more time for its intended effect. Fourthly, the Group made provisions for the devaluation of its property in Japan and Hong Kong. Fifthly, the Group also made provisions for the devaluation of some of its investment projects, a one-off amortization of the balance of goodwill, and charging the excess loss to the minority interests in the consolidated financial statement. Finally, management costs remained high as in the previous year and did not help reduce the Group's expenditure.

Turnover Structure Analysis

Market leader in the domestic refrigerator market

Domestic sales of refrigerators maintained its leading position among the competitors. Sales volumes were at about the same level as compared with 2000. However, sales revenue dropped 9% owing to intense market competition and the clearance of inventory, therefore reducing the selling prices.

Strong growth in domestic air-conditioner sales

The Group recorded healthy growth in the domestic sales of air-conditioners. Sales volumes and sales revenue grew rapidly by 18% and 27% respectively as compared to 2000, despite the intense market competition.

Strong growth in exports

The Group recorded strong growth in exports as a result of its increasing efforts in developing the overseas markets. In 2001, export sales volumes and sales revenue for refrigerators amounted to 380,000 units and RMB250 million respectively, an increase of 6 times and 4 times respectively as compared to 2000. Furthermore, export sales volumes and sales revenue for air-conditioners reached 230,000 units and RMB380 million respectively, representing an increase of 3.9 times and 2.4 times respectively as compared to 2000.

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Healthy Financial Fundamentals


During the year under review, the Group continued to implement stringent financial management, building on its strong foundations and maintaining a healthy financial standing. This is mainly reflected in the following areas:

For the year ended 31 December 2001, the Group's total assets exceeded RMB6.6 billion, with net assets at RMB2.4 billion. Bank deposits and cash amounted to RMB778 million.

During the year under review, the Group continued to exercise stringent control over credit risks. Accounts receivables turnover rate was 29 days, leading in the domestic appliances industry in China.

During the year under review, inventory management was substantially improved. Inventory turnover rate increased from 1.7 times in the previous year to 2.4 times. The ending inventory was reduced by about RMB400 million as compared to the corresponding period in the previous year.

The new management has thoroughly reviewed the Group's long-term investment projects. For the non-profit making or less profitable investments, the management has strategically drawn back and wound down these investments, as well as made provisions for their devaluation. This would further improve the Group's asset operations and increase the return on assets.



Operation Strategies

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Operation Strategies Implemented in 2001

Sales and Marketing Revolution

After a year of reforming and strengthening of the domestic and overseas networks, Kelon has established a stable and comprehensive sales network in 2001.

With regard to the management of sales network, the Group has established sales branches in 28 provinces in the country which are in full operation in 2001. The refrigerator business and the air-conditioner business launched their "500-5000 Project" and "Hundred-store Project" respectively. These fostered our working relationships with the PRC's hundreds of leading shopping malls, supermarkets, and chain stores located in cities having the strongest purchasing power. This increased the proportion of sales from end retailers and their sales efficiency, offering premier service network to meet customer needs. The Group also upgraded its overseas sales team of over 10 persons to an international sales department of close to 80 persons. Overseas sales branches were established or upgraded in the U.S.A., Europe, Japan and Hong Kong to effectively expand our sales network. The Group's products are now exported and distributed to 74 countries and regions around the world.

In 2001, the Group reaped fruitful results in establishing its sales network under the sales and marketing revolution. The number of contracted distributors increased substantially by 67% from 3,000 to 5,000, while the number of wholesalers increased 25% from 320 to 400. In the air-conditioner business, the Group successfully signed on 450 major retailers as direct distributors, a growth of 160% as compared to the previous year. The Group also signed wholesale cooperative agreements with more than 300 air-conditioner distributors. In addition, with the support of the wholesalers from the respective regions, the Group signed agreements with thousands of second-tier retailers, thereby ensuring that the Group's sales network covers the entire country's core distributors.

The expansion of overseas sales network brought about a significant growth in export volumes. In particular, the sales volumes for refrigerators and freezers reached 530,000 units, an increase of 67% in comparison with the corresponding period in the previous year. This represented 16.6% of the total export volumes of the industry.

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The Group expects that through its established sales network, it will maintain its leading position in 2002, further expanding its wholesale and retail coverage. The Group will put more emphasis on the quality of the sales network, enhancing customer relationships from having existing trade relations to having mutually beneficial partnerships. The Group will further consolidate its sales network through timely communications of market information and strengthening of sales and marketing efforts.

Enhancement of Brand Value

In early 2001, Kelon officially launched its new corporate identity (CI), bringing a totally new corporate image to the customers. This new CI was also awarded the "Ten Best Corporate Logos in China" in China's first corporate logo contest.

During the reporting period, the Group not only attained rejuvenated growth in its business results, it also increased its brand value. The "Kelon" and "Rongsheng" brands used by the Group were evaluated by an authoritative organization with significant growth in their values in 2001. In May 2001, according to the "PRC Urban Household Appliances Market Survey 2000" jointly released by the Institute of Market Economy under the Development Research Center of the State Council, the Department of Economic Operation of the Ministry of Information Industry, the Research and Development Department of the Information Center of the State and the PRC Home Appliances Trade Association, the Group's "Rongsheng (Kelon)" refrigerators came first in four areas — "Most Frequently Mentioned Products", "Most Recognized Brand", "Market Share" and "Expected Purchase Rate". This helps maintain the Group's leading position in the market.

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Product Technology Innovation

The Group has strong research capabilities, and leads the market with its innovative product designs. With respect to refrigerators, Kelon possesses ten cutting-edge technologies: super energy-saving, automatic temperature sensor, automatic door-opening, four-level temperature adjustment and soft-cooling, network refrigerator, automatic ice-making, power voltage adjustment, super fresh-retaining, super quiet, as well as computer-assisted intelligence control. Five of these technologies lead the world standards. In air-conditioners, the Group has undergone technological transformation including generalization, standardization and minimization to optimize the product series.

In 2001, Kelon successfully registered 173 product patents, a growth of 40% compared to the previous year. Among these product patents, 20% was invention patents, which is higher than the average industry standard. During the course of the year, the Group developed 149 types of new refrigerators, of which 58 types were for domestic sales and 91 types were for overseas sales and OEM products. For air-conditioners, newly developed products amounted to 156 types, of which 78 types were for domestic sales and another 78 types were for overseas sales and OEM products.

Service Quality Improvements

In June 2001, Kelon announced the setting up of the "Total Carefree" service brand name and the registration of the "Total Carefree" service trademark, being among one of the first batch of applicants registering for domestic appliances service brand names. In order to seek for joint development with partners, on one hand, Kelon's customer service system provides technical, components, and billing support to service partners, and carry out promotions for core service partners. On the other hand, Kelon actively establishes the "Total Carefree" service chain stores to foster closer relationships with its service partners.

Currently, there are more than 3,000 service partners and 20,000 staff working directly for Kelon's after-sales services. In 2001, according to researches conducted with service partners and distributors, satisfaction levels of Kelon's after-sales services increased by 5.3% and 20% respectively, reaching good or excellent standards. Both "Kelon" and "Rongsheng" brands were elected amongst the top 25 "Best After-Sales Service of Domestic Appliance Brands Ranked by Consumers across the Country", and the "Rongsheng" brand was elected amongst the top 10.

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Resource Management System Improvements

In 2001, to establish an Enterprise Resource Planning (ERP) system, Kelon and a well-known consulting company joined hands to structure and design a new business flow and information system to provide the Group with effective management methods and enhanced operating efficiencies. The first phase of the project is expected to be completed by 2002, with the second phase commencing in 2003.

Employee Relations and Benefits

During the year under review, Kelon had a total of 7,400 staff, with 2,240 middle and senior technicians, representing 30% of the total staff. The Group acknowledges that professional talent is the key to a company's development. The Group has therefore developed diversified remuneration packages to reward its staff

according to their achievements and performance. With respect to staff training, in order to meet the challenges brought about by China's entry into the WTO, the Group appointed a well-known training company in the U.S.A. from the second half of the year to provide managerial level training to its branch managers, aiming at raising their competitiveness. The Group will continue to recruit new talent into the company to create greater value for the Group.

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Appointment of New Directors

On 29 October 2001, Mr. Gu Chu Jun, through a sale and purchase agreement between Greencool Enterprise Development Company Limited and Guangdong Kelon (Rongsheng) Group Company Limited, acquired the control of a 20.64% equity interest in the form of legal person shares at a final consideration of RMB348 million. The transfer procedures were completed on 18 April 2002, and Greencool Enterprise Development Company Limited, 90% owned by Mr. Gu Chu Jun, becomes the single largest shareholder of the Group.

During the Extraordinary General Meeting held on 23 December 2001, Mr. Gu Chu Jun, Mr. Liu Cong Meng, Mr. Yan You Song, Mr. Zhang Hong, Mr. Fang Zhi Guo were appointed as executive directors, and Mr. Chan Pei Cheong, Andy, Ms. Yu Xiaoyang and Mr. Chen Man Fai were appointed as non-executive directors. Mr. Gu Chu Jun was elected by the Board of Directors in the Board Meeting as Chairman on the same day.

Mr. Xu Tie Feng, Mr. Qu Yunbo, Ms. Yu Chor Woon Carol, Mr. Cai Shi Er, Mr. Li Bao Guo, Dr. Philip Yu Hong Wong, Mr. Li Kwok Wing, Meocre and Mr. Zhang Xusheng resigned as directors on 23 December 2001.



Future

Prospects

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Future Prospects

Looking ahead, in light of the PRC's booming economy, as well as the increasing domestic salaries and rising purchasing power, the domestic household appliances market will have tremendous room for expansion.

Technologically Led and Profitability Driven

In the coming year, Kelon is reviewing and devising a five-year development strategy, with the operating concept "Technologically Led and Profitability Driven". The Group is refocusing on realizing profits as the priority for its operations to sustain the momentum for corporate development. The Group is looking forward to consolidating and strengthening the financial fundamentals to sustain the Group's success, bringing favorable returns to shareholders.

As such, the Group will focus on developing its core businesses — refrigerators and air-conditioners. The Group will leverage its strong technological fundamentals to create value-added features for its products, instead of adopting unhealthy price-cutting trends. The Group will innovate and launch new hi-tech, high value-added and high profit margin products. The Group will use its product attributes such as value-added high energy-saving features as the weapon for competition, and at the same time command a premium for the Group's product prices. The Group will also focus on satisfying consumer demand for product quality and efficiency, which will help maintain the sales volumes and profitability.

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Innovative Products

In early 2002, the Group launched the industry's revolutionary products: refrigerators with "Independent Multi Cycling Refrigeration" (IMCR) technology and the "Shuang Xiao Wang" cooling and heating air-conditioners.

Refrigerators with IMCR technology broke traditional concepts for refrigerators with individual cooling and freezing compartments. In this refrigerator, the functions of cooling and freezing are operated independently. Temperature controls in cooling and freezing can then be precisely achieved, bringing the refrigerator's energy-saving level to new heights and perfecting the precise temperature control capability. This emergence of technology from Kelon will strengthen the competitiveness of the "Kelon" and "Rongsheng" brands in the domestic and overseas markets, raising the technological added value and establishing the foundation for the Group to achieve profits this year.

The "Shuang Xiao Wang" cooling and heating air-conditioner is a new product adopting and optimizing with the highly efficient, energy-saving, and environmentally friendly "Greencool Refrigerant," which enables high and sustained cooling and heating efficiencies. Apart from its high cooling and heating efficiencies, its most significant characteristic is its energy-savings. The

current cooling efficiency of domestic air-conditioners is between 2.4-3.2, while the heating efficiency is between 2.5-3.3. "Shuang Xiao Wang" cooling and heating air-conditioners have now attained a cooling efficiency of 3.8 and a heating efficiency at a world record breaking level of 4.2.

Exports and OEM Business Development

To keep in closer contact with overseas markets and customers, the Group plans to set up two more offices (or branches) in the U.S.A. and Europe in 2002. In addition, the Group will look into establishing close partnerships with the world's famous electrical appliances manufacturers and distributors to form a strong network base to facilitate the Group's future development.

In 2002, the Group targets to meet the market demands of developed countries such as the U.S.A. and Europe for a wider range of air-conditioners, small refrigerators and medium-sized two-door refrigerators. For dehumidifiers with its key market in North America, the Group will not only offer strong support to the product technology development, it will also aggressively expand market coverage of dehumidifiers into the emerging markets.

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With regard to overseas marketing communications, the Group will actively participate in and capitalize on professional household appliances exhibitions to strengthen its presence in professional household appliances magazines and websites, and to enhance the promotion of the “Kelon” brand in countries and regions with high market potential. The Group also has initial plans to penetrate Europe, the U.S.A. and Asia Pacific regions through the acquisition of controlling stakes in enterprises with overseas distribution networks, paving the way for Kelon to enter international markets and to raise sales performance.

Stringent Cost Controls

The Group will continue to adopt the open tender procurement system which was commenced in 2001, perfecting the pricing information system, adjusting the procurement process, and introducing higher quality, low-price, strong and reliable suppliers. This will improve procurement quality and efficiency, and thus reduce cost margins. In addition, the Group will try to save costs by strengthening its budget control and management plan, and ensuring the implementation of cost-savings in phases.

The Group will further adjust its investment strategies by winding down short-term non-profit making investments. The Group will also streamline the management team by changing the organizational structure.

Brand Promotion

The Group will launch a series of consecutive promotional activities to market its innovative products and enhance its brand image. In particular, the Group has purchased prime time on CCTV to air its TV commercials at a low price for advertising during the peak seasons from March to June 2002 and from November to December 2002.

Human Resources Motivation

In 2002, the Group will further strengthen its human resources reform by boosting, nurturing and retaining talent as its mission.

Firstly, the salary incentive system will be further rationalized to boost staff enthusiasm. Secondly, more internal and external specialists will be brought in to provide training to all staff to enhance their competitive advantages. In addition, the Group will recruit more qualified and experienced talent, especially in sales and marketing, to train and transform the conventional sales team into contemporary sales and marketing professionals, conversant with multi-knowledge and skills in logistics, branding and distribution, to enhance their value.

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Future Prospects

Following the shareholding and management changes, new atmosphere and dynamics have been injected into the Group. The corporate development direction is also clearly set. The new management's experience and professional expertise in the refrigeration industry, together with their vision and insight, will effectively open a new chapter in the development of Kelon's business.

Kelon is set to meet market challenges and opportunities with its advanced technologies, innovative products, excellent after-sales services, effective domestic and international sales and marketing practices, as well as talented professionals. Kelon will be heading to a new milestone in its history, reinstating its advantages to become a stronger and successful presence in the domestic appliances market.



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The Company's Response to the Auditors' Report

Regarding the financial statement audited by Arthur Andersen Hua Qiang ("Andersen"), the following are the Company's explanation to the opinion of Andersen:

1. Although the present directors of the Company have already adopted the following policies in early 2002:
 - (a) modify the structure of the Company to enhance its efficiency;
 - (b) develop and manufacture products with high added value;
 - (c) introduce new mechanism to reduce costs;
 - (d) request Greencool Enterprise Development Company Limited to pay the Company RMB 198 million, being the amount due under the share transfer and the transfer of debts arrangements as soon as possible so as to increase the cash flow of the Company.

Andersen was unable to form an opinion on the Group's ability to continue as a going concern because the Company recorded losses in the two consecutive years ended 31 December 2001 and had a net current debt of RMB 180 million.

Such opinion does not have any impact on the Company's financial condition and results of operation.

2. As most of the directors and senior management responsible for the Company's operation in 2001 resigned, Andersen was not able to obtain representations and assurances from the previous management to confirm that all material transactions in 2001 were accurately recorded and fully disclosed. Although the present management endeavoured to ensure that all material transactions were recorded and fully disclosed and was willing to make such representations and assurances, Andersen was unable to form an opinion because the

present management was not responsible for the operations in 2001 and hence could not accept such representations and assurances. Unless such liabilities become known, such opinion does not have any impact on the Company's financial condition and results of operation.

3. In 2001, the company seal of one of the Company's subsidiaries was mistakenly used, and as a result the Company had to repay a debt of RMB 210 million for and on behalf of Guangdong Kelon (Rongsheng) Group Company Limited. Based on this incident, the auditors indicated that they could not ascertain the contingent or real liabilities caused by this incident. The present management has increased its control and management over the use of the company seal of all companies and has also implemented various policies including:
 - (a) the present management has conducted a financial audit of all existing guarantees made by the Group;
 - (b) the present management has demanded the officers at the financial management department to review all guarantees and loans made with external parties to ensure that the records are complete;
 - (c) the present management has confirmed with Shunde local banks and financial institutions, China Merchant Bank, Shenzhen Development Bank and Pudong Development Bank that the Group has not incurred any contingent or actual liabilities as a result of any guarantees provided by the Group.

So far, no further contingent liability has been discovered. But the Group cannot refute the possibility of the existence of contingent or actual liabilities. Unless these liabilities become known, such opinion does not have any impact on the Company's financial condition and results of operation.

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4. Fixed assets are stated in the accounts at actual cost or estimated value less accumulated depreciation. The management has used an estimate as a basis to forecast the discounted cash flow of these assets. Although the discounted cash flow is positive, that is, no provision has to be made, having considered the results of operation in the past 2 years and the fact that the market condition is changing rapidly, Andersen was unable to determine whether the discounted cash flow forecast is appropriate. Based on the evaluation of the present management, the value attached to such assets is reasonable.

Such opinion does not have any impact on the Company's financial condition and results of operation.

5. The present management team noted that a contract was signed at the end of 2000 with advertising agents relating to the advertisements which they would handle for and on behalf of the Company with an aggregate value of RMB 160 million. After consulting the previous management team and on the basis of the terms of the contract, and a representation made by the previous management team and in accordance with the conservative policy in accounting standards, the advertising fees were included in the accrual and other payable balance. Andersen is of the opinion that there is insufficient evidence to support that the advertising services had been performed in 2001. The present management team is now gathering more information on this matter.

Such opinion does not have any impact on the Company's financial condition and results of operation.

6. By the end of 2001, accounts receivable from Guangdong Kelon (Rongsheng) Group Company Limited amounted to RMB 862 million. The present management believes that the chance of recovery of such amount is very high. Nevertheless, the management has, in accordance with the conservative policy in accounting

standards, made a 20% provision amounting to RMB 172 million. The management team is now in negotiation with Guangdong Kelon (Rongsheng) Group Company Limited to collect the money. Since there is no agreement reached as to the timing and method of repayment of the money, Andersen was unable to assess whether the provision is adequate and whether any reclassification may be required to reflect the timing of the ultimate settlement.

If the total amount can be collected, the net asset value and total asset value of the Group will increase by RMB 172 million while its loss will be reduced by RMB 172 million for 2001. If the amount cannot be collected, the liabilities of the Group will increase by RMB 690 million while the total asset value will decrease by RMB 690 million and the increase in loss will be RMB 690 million for 2001.

7. Long term receivables for 2001 include the RMB 58 million to be collected from the Employee Union of the Company. No provision has been made on this amount as the present management believes that the total amount can be collected. RMB 6 million has already been collected at the end of March 2002.

As Andersen is unable to assess the collectibility of the above amount, it has reserved its opinion in respect of this matter.

If the collectibility of this amount can be ascertained, such opinion does not have any impact on the Company's financial condition and results of operation. If the remaining balance of the money cannot be collected, the long term receivables of the Group in 2001 and the value of the total assets will reduce by RMB 52 million while its loss will increase by RMB 52 million.