Management Discussion and Analysis

• OPERATING ENVIRONMENT

In 2002, the national economy continued to grow at a rapid pace as the government continued to implement pro-active fiscal policies and prudent monetary policies. Investments in infrastructure projects and the development of West China resulted in stronger demand for iron and steel products, underpinned by rising consumption of steel in terms of both monetary value and volume. The nation's gross production of iron and steel products also increased significantly. On the international front, the U.S. economy had yet to show a meaningful recovery and the global economy continued to be weak. This has led to an unexciting overseas steel market and consequently a lack of export growth for China's steel products. The volume of steel import remained high but, as the domestic steel market fared well, Chinese steel manufacturers enjoyed overall growth in 2002.

• FUNDAMENTAL STRATEGIES

On the production front, efficiency enhancement continued and output was increased to achieve economies of scale, which in turn resulted in stable and large-scale production. In terms of sales, efforts were made to reinforce existing markets and to explore new ones. Through flexible pricing, effective distribution and promotion strategies and innovative marketing measures, sales of "double high" (high technological level and high added value) products were strengthened and sales volume grew in tandem with expansion in production volume. Financially speaking, a strong cash inflow was maintained with faster turnover of cash income, thanks to enhanced controls over revenue collection and expenses.

• TECHNOLOGY UPGRADES AND PRODUCTION ASSET ARRANGEMENT

In accordance with the Company's development plans formulated for the 10-5 Plan period, the Company increased its restructuring efforts in the past two years. Major technology upgrades were launched in respect of existing equipment, while new projects were being constructed. In 2002, net loss on fixed assets phased out or made obsolete as a result of the implementation of this plan amounted to approximately RMB222 million. Meanwhile, provisions for asset impairment were made in respect of certain fixed assets and spare parts that were not functioning to their fullest extent.

• FINANCIAL STATUS AND EXCHANGE RISKS

The Group's capital structure comprised mainly shareholders' equity and bank loans. As at 31 December 2002, the total amount of bank loans borrowed by the Group was RMB1,904 million, including loans for working capital amounting to RMB919 million and project loans amounting to RMB985 million. Included in the above were two foreign currency loans in the amount of US$47.02 million and 54.76 million Euros, respectively. The rest were denominated in RMB. Movements of the Group's bank loans were based on developments in our production and construction projects. The Group had been able to repay all loans on or ahead of due dates, following consultation with relevant bankers. No overdue payments had been recorded.

As at 31 December 2002, in accordance with PRC accounting standards, the Group's total liabilities amounted to RMB5,276 million, including bank loans of RMB1,904 million and owners' equity of RMB11,863 million, with a gearing ratio (debt/ total assets) of 30.78%. Under the Hong Kong accounting standards, the Group's total liabilities amounted to RMB4,920 million, including bank loans of RMB1,904 million and owners' equity of RMB12,290 million, with a gearing ratio (debt/total assets) of 28.59%. The Group did not have any significant contingent liabilities. Other than internal resources, all capital requirements for the Group's projects during the 10-5 Plan period were financed through bank loans. Banks have promised to lend certain amounts for the following projects: RMB3,000 million for the thin plate project; RMB112 million for the dry-quenched coking project; RMB290 million for the train wheel rolling system; RMB84 million for the high furnace gas integration project; RMB12 million for the second phase of the management information system project; RMB110 million for the resource integration project; and RMB57 million for the converter furnace gas recovery project.

As at 31 December 2002, the Group's cash and balances with financial institutions amounted to RMB1,074 million. Bank remittance notes among bills receivable due within three months amounted to RMB564 million.

In 2003, the Group will continue to implement its development plans in accordance with the nation's 10-5 Plan – Magang's structural adjustment scheme in relation to the 10-5 Plan focusing on the Company's main business, ensuring that every project will be carried out in accordance with the Company's plans.

All loans of the Group were subject to fixed interest rates designated by the State except for the loans for the export of H-shape steel products amounting to US$35.88 million, which were subject to floating interest rates of LIBOR plus 0.5%.

The Company imported US$127.07 million worth of raw materials and spare parts required for production operations, while foreign exchange income generated from exports amounted to US$56.12 million in 2002. Both the Company's import and export operations were settled in US dollars, and the amount falling short in US dollar payment was made up by the purchase of additional US dollar with Renminbi. Given that the exchange rate between US dollar and Renminbi was relatively unchanged, changes in foreign exchange rates did not have any significant impact on the Company's profitability for the period.

As a result of implementing the structural adjustment scheme in accordance with the 10-5 Plan, the Company incurred increased capital expenditure during the year. According to contracts signed, most imported equipment was purchased from Europe and Japan to be settled in Euro and Yen. In view of lower interest rates for Euro loans, the Company borrowed 52.65 million Euros in banks loans for the payment of imported equipment. By the time of the completion of the imported equipment contract, it is expected that foreign exchange in the amounts of 143 million Euros and 5,931 million Yen will have been required for the payment of the imported equipment. As the exchange rates for Euro and Yen are quite volatile, the Company is subject to exchange risks in respect of the above loans. The Company shall continue to negotiate with banks and relevant institutions to identify different means of reducing foreign exchange risks as permissible under State policies. Meanwhile, the Company shall also study and implement measures to reduce project costs so that total expenditure will always be contained within budget limits.

- **RECENT ECONOMIC DEVELOPMENTS**

In 2003, the Company is expected to face an operating environment characterised by the following:

1. China will continue to adopt pro-active fiscal policies and prudent monetary policies with increased investments in infrastructure projects to boost domestic demand. This is expected to stimulate consumption of steel products and to maintain robust demand in the market.

2. Rising fuel costs and power tariffs are expected in 2003, as well as upward adjustments in imported iron ore prices. Pressures on operating costs are anticipated as prices of coal, scrap steel and coke are expected to rise by significant margins.

3. Rising demand of steel products in the domestic market will stimulate capital investment in the steel industry, which will in turn lead to a rapid increase of iron and steel production capacity and production volume in the short term.

4. An oversupply of steel products in the international market means that other countries will intensify their export towards China. Prices in China's domestic steel market will, therefore, be pressured by the presence of increased imports.

5. On 21 May 2002, the Ministry of Foreign Trade and Economic Cooperation of The People's Republic of China ("MOFTEC") announced that starting from 24 May 2002, import tariff quotas would apply to nine categories of iron and steel products, namely, ordinary medium / thick plates, ordinary thin plates, silicon electroplates, stainless steel plates, ordinary steel coil, ordinary steel bar, ordinary steel section, seamless pipes and steel billets, whereby imported products within the respective quotas would be subject to existing tariff rates while imports exceeding the quotas would be subject to a surcharge in the range of 7% – 26% on top of existing rates. Such tariff quota system will be implemented on a global basis for 180 days effective 24 May 2002.

On 19 November 2002, MOFTEC decided to implement final protective measures in respect of five categories of imported steel products, namely, hot-rolled ordinary thin plates, cold-rolled ordinary thin plates (belts), color coated plates, non-oriented silicon electroplates and cold-rolled stainless thin plates (belts). These final protective measures were to be implemented for a term of 30 months in three stages, with differentiated quotas and tariff surcharges applied in each stage. Specifically, the quotas would be increased with the relevant special tariff surcharges reduced year-on-year. The products affected by the protective measures do not include the products manufactured by the Company.

All in all, more intense competition is expected in China's steel market in 2003. In response to the challenge, the Group shall continue to enhance the competitiveness of its products. We will step up our efforts in technology upgrades and business restructuring, so as to drive forward technological innovations, to improve our labour productivity and to further reduce production costs.

- **STRATEGIES IN THE LONGER TERM**

In June 2001, the Company formulated its development plans in accordance with the nation's 10-5 Plan – Magang's structural adjustment scheme in relation to the 10-5 Plan focusing on the Company's main business. Approximately RMB11,720 million will be invested according to such plans. A number of projects were already completed in 2002: the structure of furnace materials in iron production was improved; the output and quality of major products were enhanced, resulting in a lower iron to steel ratio. Full-scale continuous casting was achieved. Consolidated energy consumption for each tonne of steel produced was significantly lower.

Based on latest developments in the steel market and requirements relating to the Company's production technologies, the Board of Directors recently deliberated and approved the Company's structural adjustment scheme in relation to the 10-5 Plan. The Company committed an additional RMB2.16 billion, mainly for investment in 12 projects including the second zinc coating line, the second H-shaped steel production line and the new 2# coking furnace. The revised plans will be submitted to the shareholders' general meeting for approval. Given the technological progress in the steel industry and markedly shortened replacement cycles for production processes and equipment, the Board of Directors resolved to adjust upward the consolidated depreciation rate for the Company's fixed assets to 6.5%, as compared to 5.6% previously. The new depreciation rate became effective on 1 January 2003 and the adjustment in fixed asset depreciation is expected to increase the Company's depreciation charge in 2003 by RMB130 million.