

Management Discussion and Analysis



Market Review

The flat glass industry in the People's Republic of China (the "PRC") experienced a difficult year in 2002. According to the statistics published by the State Economic & Trade Commission ("SETC"), which was recently reorganised to be a part of the Ministry of Commerce, eight new flat glass production lines commenced operation during the year, making a total of 92 flat glass production lines in the PRC as at the end of 2002. Total production volume of flat glass in the PRC reached 228 million weight cases or 11.4 million tonnes in 2002, representing an increase of 11.5% over that of 2001. According to the China Construction Glass and Industrial Glass Association, 12 flat glass production lines are planned or currently under construction in the PRC.

During the first 8 months of 2002, the average selling price of flat glass in the PRC continued its downward trend which had started in late 2001. In late August 2002, some major flat glass manufacturers in the northeast part of the PRC decided to strengthen the enforcement of the official regulation prohibiting selling flat glass products below the industry average production costs. This initiative was supported by other glass manufacturers in the PRC. As a result, the selling price of flat glass gradually rebounded to RMB60 per weight case in December 2002. However, the overall average selling price of flat glass in 2002 stood at approximately RMB55 per weight case, which was 13% lower than that of 2001.

Business Review

Operational Performance

The Company's aggregate production capacity has increased to a daily melting capacity of 1,650 tonnes, consisting of the first production line with its melting capacity increased from 400 tonnes per day to 450 tonnes per day after an overhaul, the second production line with a melting capacity of 600 tonnes per day, and the addition of the third production line with a daily melting capacity of 600 tonnes, which commenced operation in September 2002.

In 2002, the Company's total flat glass output was approximately 9.35 million weight cases or 467,500 tonnes, representing an increase of 13% over that of last year. Approximately 79%, 14% and 7% of the Company's total output in 2002 were automotive grade glass, construction grade glass and mirror grade glass, respectively. Due to the oversupply of flat glass in the PRC market, the average selling price of the Company's flat glass fell by 35% to approximately RMB55 per weight case in 2002. Another factor leading to the decrease in the average selling

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price of the Company's products was a change of its product mix. To fulfil customers' demand, the total sales of thin flat glass of 4mm to 6mm in thickness, which were usually sold at lower selling prices, accounted for 66% of the total turnover in 2002, as compared with only 45% in 2001.

The Company maintained an output efficiency ratio of 1.38 tonnes/day per employee in 2002, compared with 1.59 tonnes/day per employee for the year of 2001. The decrease in the output efficiency ratio was a result of the employment of new staff in the second half of 2002 to prepare for the commercial operation of the processed glass production lines in 2003.

The overhaul of the first production line took place from June to August in 2002. The product quality of the first production line has been substantially improved after the overhaul.

The Company's inventory has been consistently kept at a low level. The average inventory turnover for the year ended 31 December 2002 was 21 days, compared with 25 days for the first half of 2002 and 20 days for the year of 2001.

Financial Performance

In 2002, the Company sold approximately 9.35 million weight case or nearly 100% of its total output. Although the sales volume increased by 13%, as compared with 8.3 million weight cases in 2001, the Company's turnover fell by 27% to RMB506.4 million in 2002, as compared with RMB696.1 million in 2001. The disproportional decline in the turnover was mainly due to the decrease in the Company's average selling price by 35% from RMB84 per weight case in 2001 to RMB55 per weight case in 2002, as affected by the oversupply of flat glass in the market. There was no material fluctuation in the unit cost of sales of the Company in 2002 as compared with that in 2001. The gross profit margin of the Company declined to 25% in 2002, compared with 26% for the first half of 2002 and 52% in 2001. The net profit for the year ended 31 December 2002 was RMB86.3 million, in contrast to RMB212 million for the year ended 31 December 2001. The net profit margin for the full year of 2002 and the full year of 2001 were 17% and 30%, respectively.

The Company received a subsidy income of RMB19.3 million from the Ministry of Finance of Yangxunqiao Township, Shaoxing County for the staff costs and manufacturing overheads incurred in 2002. There was no such income last year. Since this subsidy income was designated to finance the Company's expenses incurred for the current year, the directors believe that this kind of income may not recur in the future.

The Company's general, administrative and other operating expenses decreased as a result of the write back of RMB8.1 million for staff discretionary bonuses, staff costs and welfare expenses for 2001. As stated in the meeting of the Board of Directors, the amount was payable only if the Company's performance was satisfactory in 2002. In view of the declining operating results of the Company in 2002 and in anticipation of a difficult market environment in 2003, the directors resolved not to pay the bonus and to write back the provision made last year and not to make a similar provision for the year ended 31 December 2002.

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Products

In 2002, the Company successfully increased its product range by producing small quantities of premium quality mirror grade flat glass, tinted flat glass and ultra-thick flat glass. Approximately 79% of the Company's total turnover was derived from automotive grade glass while 14% was from construction grade glass. Mirror grade glass accounted for the remaining 7%. In term of glass type, 96% of the Company's flat glass products was clear glass while 4% was tinted glass. In terms of thickness, 4mm to 6mm thin flat glass contributed to 66% of the Company's total turnover while 32% was from 8mm to 12mm thick flat glass. 15mm ultra-thick glass accounted for the remaining 2% of the total turnover.

Sales and Marketing

Approximately 81% of the Company's turnover was made in Zhejiang Province and 9% in aggregate for the provinces of Jiangsu, Guangdong and Fujian, as compared to 65% and 30% respectively in 2001. The Company shifted its focus to the local market of Zhejiang Province to minimise transportation cost and to avoid intense market competition in the nearby provinces.

Supply of Fuel and Raw Materials

The Company uses heavy oil as a fuel for the furnaces of its production lines. The consumption of heavy oil historically accounted for more than 30% of the Company's total cost of sales. Due to the unstable situation in Iraq, the global heavy oil price fluctuated in a wider range in 2002. In China, the market price of heavy oil increased from RMB1,150 per tonne in early 2002 to over RMB1,800 per tonne at the end of 2002. In order to minimise its heavy oil cost, the Company bypassed the local heavy oil distributors and purchased the heavy oil directly from importers. During the year, the Company's cost of heavy oil, on average, was only RMB1,365 per tonne, compared to that of RMB1,359 per tonne in 2001. The Company's average costs of other major raw materials in 2002 remained at the similar level as in 2001.

Outlook

The economic outlook in the PRC remains promising and the GDP growth in 2003 is forecasted at 7% by the PRC government. However, the oversupply situation in the construction materials industry is unlikely to improve significantly. SETC forecasts that the total production volume of flat glass in the PRC in 2003 will be approximately 220 million weight cases or 11 million tonnes in 2003, which is at a similar level as in 2002. On the other hand, to the knowledge of the directors, more than 10 flat glass production lines will cease production or be overhauled in 2003.

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In the first quarter of 2003, the average market price of flat glass has continued its upward trend which had started in the last quarter of 2002. Major flat glass manufacturers continue to raise their respective selling price of flat glass to offset the increase in the price of heavy oil. However, it is unlikely that the average price of flat glass would return to its peak level in 2000 and 2001. The directors expect that the heavy oil price would continue to fluctuate until the situation in Iraq becomes stable. The directors expect there will be no material fluctuation in the prices of other major raw materials.

During the year, the Company successfully diversified its product range to include mirror grade flat glass, tinted flat glass and ultra-thick flat glass. Since the competition in the tinted flat glass market is also intense, the Company plans to produce tinted flat glass as an auxiliary product upon the request of customers. The mirror grade flat glass can be further processed into mirror glass by the Company's new processed glass lines. As the market acceptance of the Company's ultra-thick flat glass was quite promising and the product was sold at a much higher price than that of thinner flat glass, the Company plans to increase the production volume of ultra-thick flat glass in 2003. At present, the ultra-thick flat glass market is dominated by expensive imported products. The Company endeavours to produce high quality ultra-thick flat glass products which can compete, not only on the price but also on the quality, with the imported products. In addition, the Company will further strengthen the market position of its existing products by improving the quality to match those of imported products.

The Company's processed glass production for tempered glass, laminated glass, insulating glass and mirror glass started trial production in early 2003. The commercial operation of these lines will start in the second quarter of 2003. Currently, most processed glass manufacturers in the PRC are only capable of manufacturing low grade processed glass while the high grade processed glass market is dominated by imported glass products. The Company intends to target its processed glass products at the PRC's medium to high grade processed glass market and will explore any export opportunities. The directors are confident that the Company is able to capture a fair market share in the medium to high grade processed glass market with a more competitive pricing over the imported products.

The directors noticed that the demand for special glass products is increasing globally as well as in the PRC. The Company established Zhejiang Engineering Glass Company Limited (浙江工程玻璃有限公司) in March 2003 to engage in the production and sales of Low-E coated glass (低輻射鍍膜玻璃), ITO glass (導電玻璃) and curved toughened glass (彎鋼化玻璃) with a proposed investment of RMB235 million. Low-E coated glass, which has energy-saving quality, is used in the construction of glass clad buildings. ITO glass is a major component of LCD panels. Curved toughened glass is a popular material in the furniture and the construction industries. Trial production of the special glass products is expected to commence in the first quarter of 2004. The directors expect that the special glass products will generate new source of revenue and reduce the risks of over-dependence on the flat glass products.

The Company is also considering expanding into the production of soda ash, an essential material for flat glass production. For this purpose, the Company entered into a memorandum of understanding ("MOU") with an independent third party ("Other Party") to set up a limited liability company ("New Venture") to manufacture

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soda ash in Qinghai Province. The registered capital of the New Venture is proposed to be RMB250 million. Under the MOU, the Company will provide the entire proposed registered capital while the Other Party will coordinate and assist in the procurement of the supply of the relevant raw materials. A formal investment agreement and the establishment of the New Venture is conditional upon the obtaining of all the necessary approvals and licences (including mining licences) from the relevant authorities in the PRC.

From geographical perspective, the Company will primarily focus on the flat glass market of Zhejiang Province where the Company's favourably located production facilities enjoy a cost advantage in transportation.

Underpinned by the strength in cost advantage, efficient operations and prudent financial management, the Company has overcome the unfavourable market conditions reasonably well. The directors believe the Company's management flexibility and strategic location will enable itself to become one of the leading enterprises in the PRC's flat glass industry.

Capital Expenditure

Total capital expenditure in 2002 amounted to RMB400.6 million, of which RMB345 million was spent on the construction of plant and buildings and production machinery and equipment and the deposits of RMB55.6 million paid to the vendors for the construction projects of production lines, the purchases of other fixed assets and the land use rights.

Liquidity And Capital Resources

As at 31 December 2002, the Company's cash and cash equivalents balance amounted to RMB423.8 million, compared with RMB593.5 million as at the end of last year. The Company's debt ratio as at 31 December 2002 was 12%, compared to 4% as at 31 December 2001. The calculation of the debt ratio is based on total debts of RMB185.2 million (2001 – RMB47.2 million) over total assets of RMB1,547.9 million (2001 – RMB1,240.4 million).