DISCUSSION AND ANALYSIS OF THE GROUP'S PERFORMANCE

Financial review

For the six months ended 30 June 2003, an unprecedented combination of negative factors prevailed globally. The economy was hampered by the sudden threat and spread of the SARS virus and the US-led Iraqi war. Fortunately, these unfavorable factors had little impact on the Group's performance during the first half of the year. Making use of its overseas offices to maintain close contact with clients, the Group received ongoing orders from retail clients. Together with its solid foundation and established reputation, as well as its prudent cost management measures, the Group's turnover increased approximately 14.3%, from HK$340.0 million to HK$388.6 million during the period, while gross profit rose to HK$104.9 million (2002: HK$93.4 million) representing a growth of 12.3% on a consolidated basis.

The Group's consolidated profit attributable to shareholders reached HK$58.4 million (2002: HK$48.9 million) increasing 19.4% over the previous year on a consolidated basis. This positive performance was mainly attributable to the Group's well-established and long-term relationships with customers and mass retailers, cost effective vertically integrated systems and prudent financial management. The Group's cash and bank deposits as at 30 June 2003 amounted to HK$337.2 million (31 December 2002: HK$320.1 million).

Business review and prospects

For the six months ended 30 June 2003, plush stuffed toys remained the major business of the Group, accounting for 94% of the Group's total turnover as compared to 92% in the same period last year. During the period under review, the Original Equipment Manufacturing ("OEM") business accounted for 87% of the Group's total turnover. The Group's sizable vertical integration of its production process provides a major competitive edge over its competitors. This advantage is further emphasized during poor market economy as the Group is able to meet the requirements even of risk-averse clients.

Continuous orders have been received from the Group's preferred partners, many of which are international and extremely well-known retail brands as well as character licensors, such as Disney, the SEGA Corporation, Banpresto Co., Ltd., Warner Bros. and Bandai Co. The close relationship with the mass market retailers and distributors, including Costco Wholesale Corporation, Walmart and Target, have also provided strong support in the growth of the Group's business.

The Group's OEM business was further enhanced during the period under review when the Group entered into License Agreements with Warner Bros. Consumer Products ("WB"), a division of Time Warner Entertainment Company L.P. The agreements allow the Group to utilize WB's famous cartoon characters, as licensed products, in the manufacturing of beanbags and plush stuffed products. These licensed products will be sold to Warner Bros.' authorized parties worldwide excluding the United States, Puerto Rico, the US Virgin Islands and Canada on a non-exclusive basis. Continuous orders have been secured for the manufacturing of these new products, further broadening the revenue stream of the Group. The management believes that this enriched product mix with its strong market appeal, will escalate the Group's worldwide cartoon characters' manufacturing business and raise its OEM business to a new level.

Being a first mover in the industry, the Group has already established a foothold in the ODM market with its own brand, "Caltoy". During the period under review, the Group's ODM business accounted for 13% of its total turnover, as compared to only 6% in the corresponding period last year. The Group will aggressively capture the huge potential in the ODM market. To meet the demands of this market, the Group designs over 800 ODM items a year. Expecting to expand the ODM business contribution to the range of 30% to 35% of total turnover within the next 3 to 4 years, more resources will be allocated for the development of ODM business. With its previously acquired marketing company, Sung Won Industries, Inc, the Group expects to further expand its ODM market and is always on the lookout for suitable marketing companies to further boost sales in this business.

The Group's second major business, steel and plastic toys, accounted for 6% of total turnover. The sales of steel and plastic toys decreased 21% when compared to the same period last year. This was due to the continuous decrease in order size from US customer.

For the six months ended 30 June 2003, production at the Group's eight plants was running at over 95% of capacity. The new dyeing facility, now under full operation, has made a significant contribution to the efficiency of the Group's vertical integration. This has not only reduced production costs for the Group, but also guaranteed the quality of its products. To cater for the increasing orders, the Group maintained its subcontracting policy ensuring full flexibility for the Group. At the same time, a new manufacturing plant adjacent to the existing plant in Bao'an commenced operations in March. Not only has production capacity been boosted by 13% with total production growing to 9,000,000 pieces per year, the new facility has further strengthened the Group's leading position in the plush stuffed toy industry.

The North America and Japan are the Group's two major markets, contributing 33.6% and 51.3% respectively to the Group's total turnover. In the first six months of 2003, the US economy remained unfavorable due to the war in Iraq. However, the Group's export business to the USA remained unaffected due to the resilient nature of the toy industry. At the same time, sales to the Japanese market remained buoyant, increasing from 44.1% to 51.3% of total turnover. This was mainly attributable to the continuous patronage of our business partners like Sega and Bandai. Japan is viewed as a fast growing market in the industry and the Group expects the growth momentum in Japan to continue. More marketing activities are also expected in the US and Europe to boost sales in these markets. The Group believes that successful marketing strategies will further enhance the Group's performance in the future.

Over the years, the Group has maintained prudent cost control management. Its vertical integration allows the Group to flexibly allocate and commit resources among the various production bases, enabling the mass manufacturing of products to meet tight delivery schedules, shortening production lead times while also maximizing economies of scale. Given the scale and scope of the Group, the Group is able to enjoy competitive material costs, which improve the cost structure of the Group.

Complementing its the well-established track record, the Group has been undertaking numerous initiatives to enhance its business structure, building solid foundations for future growth and positioning itself as a leading toy manufacturer. At the same time, the Group will continue with its aggressive efforts to bring fruitful yields and a continuous stream of profit to shareholders.

Post-balance sheet event

On 4 September 2003, shareholders of the Group approved the acquisition of the entire issued share capital of Dream INKO Co., Ltd ("Dream Korea") through its wholly owned subsidiary, J.Y. International Company Limited. The acquisition will be settled by a cash consideration of US$17 million (translating into approximately HK$132.6 million), which will be satisfied in full out of Dream International's internal cash resources. The deal is expected to be completed by 30 September 2003.

The management believes that the completion of the acquisition will enhance capabilities in product design and development while further improving operational efficiencies with full control from design to marketing. In addition, it will eliminate on-going connected transactions, enabling the Group to maintain flexibility in its operations.

Number and remuneration of employees

As at 30 June 2003, the Group employed 25, 11,844 and 11 employees in Hong Kong, mainland China and USA respectively. The Group values its human resources and recognizes the importance of attracting and retaining quality staff for its continuing success. Staff bonuses and share options are awarded based on individual performance and job nature.

Liquidity and financial resources

As at 30 June 2003, the Group had net current assets of HK$403 million (2002: HK$393 million).

The Group continues to maintain a strong liquidity position with cash and bank balances at 30 June 2003 amounted to HK$337.2 million (31 December 2002: HK$320.1 million).

Treasury policies and gearing

The Group has consistently adhered to the prudent treasury policy. Most of the Group's liquid fund is placed in principal guaranteed short-term dual currencies deposits among various banks. The Group also made use of the financial tools of long-term structured deposits and structured foreign currency loan to reduce the Japanese Yen accounts receivable exposure and to enhance return from the liquid assets of the Group within the controllable risk level.

The Group's gearing ratio, calculated on the basis of total bank borrowings over the total shareholders' equity, decreased from 7.8% to 6.0% mainly due to the clearance of the current bank loans and overdrafts.