

MANAGEMENT DISCUSSION AND ANALYSIS

Financial results

For the six months ended 30 June 2003, the Group recorded a turnover of HK\$196,549,000, compared to HK\$196,113,000 in the corresponding period last year. During the period, turnover for rare earth products (including fluorescent materials) and refractory products was comparable, at HK\$97,365,000 and HK\$99,184,000 respectively. Nevertheless, because of the low price levels for rare earth products, the refractory materials business remained the major profit contributor, accounting for 66% of the overall results. The gross profit margin during the period fell from 29% in the corresponding period last year to 20% this year, while net profit margin was 11%. Profit attributable to shareholders amounted to HK\$21,823,000. Basic earnings per share were HK2.68 cents.

Interim dividend

The Board does not recommend the payment of an interim dividend for the six months ended 30 June 2003. It intends to defer the distribution until the final results announcement.

MANAGEMENT DISCUSSION AND ANALYSIS *(Continued)*

Business review

Rare earth business

In the first half of 2003, the global economy continued to be plagued by the economic downturn. As such, market demand did not reach expected growth. At the same time, restructurings and reforms in the PRC's rare earth industry were still on. As competition within the rare earth industry in the PRC market intensified, rare earth products prices still lingered at low level. The rare earth industry is experiencing resource restructuring and undergoing an evolutionary process to weed out underperforming players. However, riding the continuing advancement and application of rare earth technology, market demand for the downstream products of rare earth oxide will gradually accelerate.

During the period under review, capitalizing on its competitive edge in capital, its facilities, techniques and production skills, the Group has modernized the technology of some of its production lines to cater for ever-changing market demand, enhanced the structure for existing products and speeded up new product development. In the first half of 2003, though the market did not have a significant rebound, the Group sold approximately 1,800 tonnes of rare earth products, generally maintaining sales volume at a comparable level to the corresponding period last year. However, as sale of certain relatively high priced products such as mixture of Yttrium and Europium was greater than that in the corresponding period last year, the turnover of the rare earth business increased. The Group is committed to expanding the overseas market and leading to vigorous growth in export sales. During the period, export sales reached 62% of turnover and surpassed the previous year's entire share of 35%. Product prices, following the downward adjustment last year, remained stable in the first half of 2003. With the Group's efforts to strengthen its internal management, tighten its budget controls and reduce costs of production, the gross profit margin for the rare earth business in the first half of 2003 rose to 12%, compared to the previous year's margin of approximately 5%. The provision made in 2002 for the reduction in inventory value exerted a relatively greater impact on the changes in the gross profit.

After more than half a year's operation of the production lines for the rare earth trichromatic phosphor, the quality of these products is gradually improving. For the first half of 2003, sales of fluorescent materials recorded at approximately 52,000 kilograms with a gross profit margin achieved of over 20%. The development of overseas markets has also been progressing while trial products have passed related customers' quality tests. With its sophisticated technology and modern production skills, the production and sale of fluorescent materials will gradually be lifted.

MANAGEMENT DISCUSSION AND ANALYSIS *(Continued)*

Business review *(Continued)*

Refractory materials business

Refractory products are widely employed in the metallurgy, petroleum, chemical, construction and power industries. As the rare earth business has not significantly rebounded, the refractory materials business became the main source of profit for the Group. However, the sluggish worldwide economy and the spread of the Severe Acute Respiratory Syndrome (SARS) virus in April and May in particular, posed a negative impact on the refractory materials business. In May, transportations of raw materials and products as well as business meetings were severely affected. As most customers' production processes are labour-intensive, operations were basically suspended. As a result, production of refractory materials during the month was approximately 1,900 tonnes, which was 4,400 tonnes less than the 6,300 tonnes produced in the corresponding month last year, while sales of refractory materials were 1,440 tonnes, 5,060 tonnes less than the 6,500 tonnes sold in the corresponding month last year. In the first half of 2003, the Group's refractory materials business recorded total sales of about 20,000 tonnes, which was 6,000 tonnes less than the corresponding period last year. The SARS epidemic was the main factor behind the fall.

During the period, leveraging its competitive edge of long-term cooperation with its international partner in technological advancement and the continuous modernization of its skills to improve the quality and lift its production levels, while at the same time enriching the product mix and expanding its overseas market, export levels for the Group's refractory products reached 6,800 tonnes, with sales contributions from overseas market reaching 32%, surpassing last year's entire share of 18%. With regard to local sales, the Group's sales strategies are to raise the sales proportion of medium to high-end refractory products and offer high-quality after-sales services etc., which will effectively reduce the negative impact brought about by the intense competitions of low-end and under-priced products. The Group will therefore be able to successively maintain its market share among the steel-metallurgy corporations within the PRC. Additionally, while the production yield rate increased, the Group managed to maintain stable returns despite the reduction in total sales volume. In the first half of 2003, the gross profit margin for refractory materials business dropped from 32% in the corresponding period last year to 27% due to the reduction in overall production levels and therefore leading to an increase in average production costs.

MANAGEMENT DISCUSSION AND ANALYSIS *(Continued)*

Prospects

The development of a business is unavoidably susceptible to the unfavourable business environment. In the first half of the year, the Group experienced the most difficult challenges since its establishment. Owing to the dedication of the management and every staff member, the Group has overcome these challenges. This fully reflects the strategic capabilities of the Group in placing its firm foothold on this competitive global market, as it lays solid foundations for the Group's sustainable development into the future.

Rare earth business

Only by continuously enriching its product varieties can the Group consolidate its foothold in the market. Exploring new rare earth downstream products is the trend to maintain the sustainable growth of the rare earth business. The Group has been unrelenting in enhancing its research and development capabilities. It constantly provides training programs for research and development staff members, cooperates with large-scale research and development institutions and universities to jointly develop rare earth applied products and keeps abreast of the latest technological development in the rare earth world. In addition, the Group interacts closely with customers to stay alert to their needs and the development in the market to adjust its services with developments in the international market.

The Group will leverage its competitive edge in the separation of rare earth products, continue to strengthen its exploration and development of value-added products, enhance sales and reduce production costs, to achieve higher profits by turning 50% of the rare earth oxide produced by the Group to rare earth value-added downstream products.

MANAGEMENT DISCUSSION AND ANALYSIS *(Continued)*

Prospects *(Continued)*

Refractory business

Following the technological advancement and development of industries such as the metallurgy, construction, petrochemical industries, etc., demand for medium to high-end refractory products is increasing. Therefore, the Group plans to make use of its core competencies in equipment and technology to further enhance its existing production facilities, to continue increasing the proportion of medium to high-end refractory products produced as well as to enrich its new product and to substantiate the market competitiveness of the Group's refractory products. Additionally, the Group will strengthen its cooperation with raw materials suppliers and continue to expand its overseas markets, in the hope of raising the Group's market share while improving product quality and developing new products through advanced overseas technology, so as to maintain sustainable growth in its export sales.

Liquidity and financial resources

As at 30 June 2003, the Group had cash and bank balances of approximately HK\$393,903,000 with nil long-term liability. Net current assets increased to HK\$638,339,000 from HK\$600,568,000 as at the end of last year. Total liabilities to total assets ratio has been reduced to 6%.