神州数码
Digital China

神州數碼控股有限公司*
DIGITAL CHINA HOLDINGS LIMITED
*(Incorporated in Bermuda with limited liability)*

# THIRD QUARTERLY REPORT

# FOR THE NINE MONTHS ENDED 31 DECEMBER 2003

(* *For identification purpose only*)

The directors (the "Directors") of Digital China Holdings Limited (the "Company") would like to announce the unaudited consolidated results of the Company and its subsidiaries (collectively, the "Group") for the nine months ended 31 December 2003 together with the comparative figures for the corresponding period of last financial year.

## CONDENSED CONSOLIDATED INCOME STATEMENT

| | Notes | **Three months ended 31 December 2003 (Unaudited) HK$'000** | **Nine months ended 31 December 2003 (Unaudited) HK$'000** | Three months ended 31 December 2002 (Unaudited) (Restated) HK$'000 | Nine months ended 31 December 2002 (Unaudited) (Restated) HK$'000 |
|---|---|---|---|---|---|
| Turnover | 2 | **3,968,393** | **10,988,515** | 3,521,169 | 9,311,801 |
| Cost of inventories sold | | **(3,694,639)** | **(10,290,301)** | (3,244,905) | (8,569,623) |
| Selling expenses | | **(26,713)** | **(68,761)** | (19,670) | (59,926) |
| Promotion and advertising expenses | | **(22,154)** | **(64,800)** | (25,891) | (65,118) |
| Staff costs | | **(92,709)** | **(263,731)** | (75,646) | (205,113) |
| Other operating expenses, net | | **(39,421)** | **(256,877)** | (77,858) | (205,943) |
| Earnings before interest, tax and depreciation | | **92,757** | **44,045** | 77,199 | 206,078 |
| Depreciation | | **(13,605)** | **(39,331)** | (11,851) | (29,160) |
| Interest income | 2 | **532** | **1,910** | 853 | 2,579 |
| Profit from operating activities | 3 | **79,684** | **6,624** | 66,201 | 179,497 |
| Finance costs | | **(12,272)** | **(35,875)** | (7,872) | (25,292) |
| Share of losses of associates | | **(939)** | **(5,016)** | (682) | (5,444) |
| Profit/(Loss) before tax | | **66,473** | **(34,267)** | 57,647 | 148,761 |
| Tax | 4 | **(888)** | **6,886** | 1,250 | (1,054) |
| Profit/(Loss) before minority interests | | **65,585** | **(27,381)** | 58,897 | 147,707 |
| Minority interests | | **438** | **2,442** | (510) | (479) |
| Net profit/(loss) from ordinary activities attributable to shareholders | | **66,023** | **(24,939)** | 58,387 | 147,228 |
| Earnings/(Loss) per share | 5 | | | | |
| — Basic (HK cents) | | | **(2.90)** | | 17.15 |
| — Diluted (HK cents) | | | **N/A** | | 16.12 |

## CONDENSED CONSOLIDATED BALANCE SHEET

| | Notes | At 31 December 2003 (Unaudited) HK$'000 | At 31 March 2003 (Audited) (Restated) HK$'000 |
|---|---|---|---|
| **Non-current assets** | | | |
| Fixed assets | | **386,447** | 323,833 |
| Goodwill | | **19,457** | 21,113 |
| Intangible assets | | **15,494** | 6,044 |
| Deferred tax assets | | **19,867** | 8,606 |
| Interests in associates | | **26,718** | 25,948 |
| | | **467,983** | 385,544 |
| **Current assets** | | | |
| Inventories | | **1,031,874** | 1,020,503 |
| Trade and bills receivables | 6 | **1,691,701** | 1,512,181 |
| Prepayments, deposits and other receivables | | **274,861** | 334,335 |
| Cash and bank balances | | **874,633** | 667,097 |
| | | **3,873,069** | 3,534,116 |
| **Current liabilities** | | | |
| Trade and bills payables | 7 | **1,707,740** | 1,424,028 |
| Other payables and accruals | | **403,008** | 333,103 |
| Tax payable | | **2,085** | 1,464 |
| Interest-bearing bank borrowings, unsecured | | **364,851** | 448,986 |
| | | **2,477,684** | 2,207,581 |
| **Net current assets** | | **1,395,385** | 1,326,535 |
| **Total assets less current liabilities** | | **1,863,368** | 1,712,079 |
| **Non-current liabilities** | | | |
| Interest-bearing bank borrowings, unsecured | | **546,000** | 312,000 |
| **Minority interests** | | **11,669** | 7,091 |
| | | **1,305,699** | 1,392,988 |
| **Capital and reserves** | | | |
| Issued capital | | **85,922** | 85,870 |
| Reserves | | **1,219,777** | 1,243,746 |
| Proposed final dividend | | **—** | 63,372 |
| | | **1,305,699** | 1,392,988 |

## CONDENSED CONSOLIDATED CASH FLOW STATEMENT

| | Nine months ended 31 December 2003 (Unaudited) HK$'000 | 2002 (Unaudited) (Restated) HK$'000 |
|---|---|---|
| Net cash inflow from operating activities | **272,785** | 439,874 |
| Net cash outflow from investing activities | **(123,909)** | (231,334) |
| Net cash inflow from financing activities | **58,660** | 231,901 |
| Increase in cash and cash equivalents | **207,536** | 440,441 |
| Effect of foreign exchange rate changes, net | **—** | (2,784) |
| Cash and cash equivalents at the beginning of the period | **667,097** | 472,707 |
| Cash and cash equivalents at the end of the period | **874,633** | 910,364 |

## CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

| | Share capital (Unaudited) HK$'000 | Share premium account (Unaudited) HK$'000 | Capital reserve (Unaudited) HK$'000 | Reserve funds (Unaudited) HK$'000 | Exchange fluctuation reserve (Unaudited) HK$'000 | Retained profits (Unaudited) HK$'000 | Proposed final dividend (Unaudited) HK$'000 | Total (Unaudited) HK$'000 |
|---|---|---|---|---|---|---|---|---|
| At 1 April 2003 | | | | | | | | |
| — as previously reported | 85,870 | 289,895 | 623,689 | 27,874 | 1,003 | 292,679 | 63,372 | 1,384,382 |
| — adjustment on adoption of SSAP 12 (Revised) | — | — | — | — | — | 8,606 | — | 8,606 |
| — as restated | 85,870 | 289,895 | 623,689 | 27,874 | 1,003 | 301,285 | 63,372 | 1,392,988 |
| Exercise of share options | 52 | 970 | — | — | — | — | — | 1,022 |
| Net loss for the period | — | — | — | — | — | (24,939) | — | (24,939) |
| Transfer from retained profits | — | — | — | 731 | — | (731) | — | — |
| Payment of dividend | — | — | — | — | — | — | (63,372) | (63,372) |
| **At 31 December 2003** | **85,922** | **290,865** | **623,689** | **28,605** | **1,003** | **275,615** | **—** | **1,305,699** |
| At 1 April 2002 | | | | | | | | |
| — as previously reported | 85,868 | 289,850 | 623,689 | 14,259 | (669) | 188,504 | 59,936 | 1,261,437 |
| — adjustment on adoption of SSAP 12 (Revised) | — | — | — | — | — | 10,725 | — | 10,725 |
| — as restated | 85,868 | 289,850 | 623,689 | 14,259 | (669) | 199,229 | 59,936 | 1,272,162 |
| Exercise of share options | 2 | 45 | — | — | — | — | — | 47 |
| Exchange realignment | — | — | — | — | 1,672 | — | — | 1,672 |
| Net profit for the period (Restated) | — | — | — | — | — | 147,228 | — | 147,228 |
| Transfer from retained profits | — | — | — | 13,615 | — | (13,615) | — | — |
| Payment of dividend | — | — | — | — | — | — | (59,936) | (59,936) |
| At 31 December 2002 (Restated) | 85,870 | 289,895 | 623,689 | 27,874 | 1,003 | 332,842 | — | 1,361,173 |

## NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**1. Basis of presentation and principal accounting policies**

The unaudited condensed consolidated financial statements for the nine months ended 31 December 2003 are prepared in accordance with Hong Kong Statement of Standard Accounting Practice ("SSAP") No. 25 "Interim financial reporting" issued by the Hong Kong Society of Accountants. In preparing the unaudited condensed consolidated financial statements, the same basis of presentation, accounting policies and methods of computation as set out in the Group's annual accounts for the year ended 31 March 2003 had been consistently applied except for the adoption of the following new/revised SSAPs and the change of the accounting estimate:

**Adoption of new/revised SSAPs**

- SSAP 12 (Revised) : "Income taxes"
- SSAP 35 : "Accounting for government grants and disclosure of government assistance"

SSAP 12 (Revised) principally prescribes the accounting treatment and disclosures for deferred tax. In prior years, deferred tax is provided using the income statement liability method on all significant timing differences to the extent it is probable that the liability will crystalise in the foreseeable future, a deferred tax asset is not recognised until its realisation is assured beyond reasonable doubt. SSAP 12 (Revised) requires the adoption of the balance sheet liability method, whereby deferred tax is recognised in respect of all temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, with limited exceptions. In the absence of any specific transitional requirements in SSAP 12 (Revised), the new accounting policy has been applied retrospectively. The principal impacts of the revision of this SSAP are that opening retained profits at 1 April 2002 and 1 April 2003 have been increased by HK$10.7 million and HK$8.6 million respectively and the tax expense for the nine months ended 31 December 2002 decreased by HK$1.9 million and the tax benefit for the nine months ended 31 December 2003 increased by HK$11.3 million.

SSAP 35 prescribes the accounting treatment and disclosures for government grants and disclosures for other forms of government assistance. This SSAP has had no major impact on the unaudited condensed consolidated financial statements.

**Change of accounting estimate**

During the nine months ended 31 December 2003, the rates used to determine the general provision of the inventories of a business segment were revised. In the opinion of the Directors, the revised general provision rates would be more appropriate for the Group to determine the inventory value. The effect of change of accounting estimate was not material to the results for the nine months ended 31 December 2002 and 2003.

**2. Turnover, revenue and segment information**

The Group is principally engaged in the distribution of information technology ("IT") products, provision of systems integration services and development and distribution of networking products. Turnover represents invoiced value of goods sold and services rendered to customers, net of business tax, value-added tax and government surcharges, and after allowances for goods returned and trade discounts.

**Primary reporting format — business segments**

| | **Three months ended 31 December 2003 (Unaudited) HK$'000** | **Nine months ended 31 December 2003 (Unaudited) HK$'000** | Three months ended 31 December 2002 (Unaudited) (Restated) HK$'000 | Nine months ended 31 December 2002 (Unaudited) (Restated) HK$'000 |
|---|---|---|---|---|
| **Segment turnover** | | | | |
| Distribution of IT products | **3,354,201** | **9,317,312** | 3,154,311 | 8,016,895 |
| Provision of systems integration services (including hardware and software sale and services revenue) | **546,917** | **1,491,145** | 323,172 | 1,141,151 |
| Distribution of networking products | **67,275** | **180,058** | 43,686 | 153,755 |
| | **3,968,393** | **10,988,515** | 3,521,169 | 9,311,801 |
| Other revenue | | | | |
| Interest income | **532** | **1,910** | 853 | 2,579 |
| | **3,968,925** | **10,990,425** | 3,522,022 | 9,314,380 |
| **Segment results** | | | | |
| Distribution of IT products | **188,212** | **459,625** | 224,111 | 561,009 |
| Provision of systems integration services (including hardware and software sale and services revenue) | **68,418** | **191,626** | 41,615 | 151,296 |
| Distribution of networking products | **17,124** | **46,963** | 10,538 | 29,873 |
| | **273,754** | **698,214** | 276,264 | 742,178 |
| Unallocated items | **(194,070)** | **(691,590)** | (210,063) | (562,681) |
| Profit from operating activities | **79,684** | **6,624** | 66,201 | 179,497 |
| Finance costs | **(12,272)** | **(35,875)** | (7,872) | (25,292) |
| Share of losses of associates | **(939)** | **(5,016)** | (682) | (5,444) |
| Profit/(Loss) before tax | **66,473** | **(34,267)** | 57,647 | 148,761 |
| Tax | **(888)** | **6,886** | 1,250 | (1,054) |
| Profit/(Loss) before minority interests | **65,585** | **(27,381)** | 58,897 | 147,707 |
| Minority interests | **438** | **2,442** | (510) | (479) |
| Net profit/(loss) from ordinary activities attributable to shareholders | **66,023** | **(24,939)** | 58,387 | 147,228 |

**Secondary reporting format — geographical segments**

Over 90% of the Group's operations are located in The People's Republic of China ("PRC"), which is considered as one geographical location in an economic environment with similar risks and returns. Consequently, no geographical segment analysis is presented.

**3. Profit from operating activities**

The Group's profit from operating activities is arrived at after charging/(crediting):

| | Nine months ended 31 December | |
|---|---|---|
| | **2003** | 2002 |
| | **(Unaudited)** | (Unaudited) |
| | **HK$'000** | HK$'000 |
| Exchange losses/(gains), net | **(10)** | 1,504 |
| Operating lease rentals in respect of land and buildings | **23,263** | 28,514 |
| Loss on disposal of fixed assets | **959** | 558 |
| Amortisation of intangible assets | **460** | — |
| Amortisation of goodwill | **1,656** | 400 |
| Provisions and write-off of obsolete inventories | **10,156** | 25,450 |
| Provisions and write-off of doubtful trade receivables | **91,666** | 15,459 |

**4. Tax**

| | Nine months ended 31 December | |
|---|---|---|
| | **2003** | 2002 |
| | **(Unaudited)** | (Unaudited) |
| | | (Restated) |
| | **HK$'000** | HK$'000 |
| Group | | |
| Current tax: | | |
| PRC corporate income tax | **(4,375)** | (2,934) |
| Deferred tax | **11,261** | 1,880 |
| | **6,886** | (1,054) |

(a) PRC corporate income tax represents tax charges on the estimated assessable profits of the PRC subsidiaries of the Group. In general, the PRC subsidiaries of the Group are subject to the PRC corporate income tax rate of 33% except for certain subsidiaries which are entitled to tax holidays and preferential tax rates.

(b) No provision for Hong Kong profits tax has been made as the Group has no estimated assessable profits arising in Hong Kong for the nine months ended 31 December 2002 and 2003.

(c) No provision for Hong Kong profits tax and PRC corporate income tax have been made for the associates as the associates have no estimated assessable profits for the nine months ended 31 December 2002 and 2003.

**5. Earnings/(Loss) per share**

The calculation of basic loss per share was based on the net loss attributable to shareholders for the nine months ended 31 December 2003 of approximately HK$24,939,000 (For the nine months ended 31 December 2002: restated net profit of approximately HK$147,228,000), and the weighted average of 858,785,135 (For the nine months ended 31 December 2002: 858,682,215) ordinary shares in issue during the nine months ended 31 December 2003.

Diluted loss per share for the nine months ended 31 December 2003 has not been calculated as the impact of the outstanding share options was anti-dilutive.

The calculation of diluted earnings per share for the nine months ended 31 December 2002 was based on the net profit attributable to shareholders for the nine months ended 31 December 2002 of approximately HK$147,228,000 (restated) and 913,404,235 ordinary shares, which was the weighted average of 858,682,215 ordinary shares in issue during the nine months ended 31 December 2002 and the weighted average of 54,722,020 ordinary shares deemed to have been issued at no consideration on the deemed exercise of all the outstanding share options during the nine months ended 31 December 2002.

**6. Trade and bills receivables**

An ageing analysis of the trade and bills receivables at balance sheet dates, net of provisions, is as follows:

| | **At 31 December 2003 (Unaudited) HK$'000** | At 31 March 2003 (Audited) HK$'000 |
|---|---|---|
| Within 30 days | **954,738** | 800,880 |
| 31 to 60 days | **215,762** | 225,131 |
| 61 to 90 days | **111,288** | 134,537 |
| 91 to 180 days | **243,176** | 161,376 |
| Over 180 days | **166,737** | 190,257 |
| | **1,691,701** | 1,512,181 |

The Group's trading terms with its customers are mainly on credit, except for new customers, where payment in advance is normally required. The credit period is generally for a period of 30 days, extending up to 60 days, 90 days and 180 days for distribution business, networking products business and systems integration business respectively for major customers.

**7. Trade and bills payables**

An ageing analysis of the trade and bills payables at balance sheet dates is as follows:

| | **At 31 December 2003 (Unaudited) HK$'000** | At 31 March 2003 (Audited) HK$'000 |
|---|---|---|
| Within 30 days | **1,122,575** | 711,060 |
| 31 to 60 days | **479,673** | 446,339 |
| 61 to 90 days | **53,267** | 140,647 |
| Over 90 days | **52,225** | 125,982 |
| | **1,707,740** | 1,424,028 |

**8. Contingent liabilities**

At 31 December 2003, the Group had discounted bills with recourse to banks amounting to approximately HK$366 million (31 March 2003: HK$372 million).

## QUARTERLY DIVIDEND

The Directors do not recommend a dividend payment for the third quarter ended 31 December 2003 (For the third quarter ended 31 December 2002: nil).

## MANAGEMENT DISCUSSION AND ANALYSIS

### Business Review

For the third financial quarter ended 31 December 2003, the Group's turnover amounted to HK$3,968 million with profit attributable to shareholders totalling HK$66 million, an increase of 12.7% and 13.1% compared with the respective figures of HK$3,521 million and HK$58 million for the same period last year. Turnover for the first three financial quarters increased by 18% year-on-year to HK$10,989 million. While a net loss of HK$25 million was incurred for the 9-month period, the amount reflected a narrowing in process as the Group made a turnaround to profit in the second and third financial quarters.

The third financial quarter saw the Group fostering a healthy growth while maintaining its top priority to strictly control the risk benchmarks concerning trade receivables and inventory. Following their return to growth in the second financial quarter, the Group's businesses continued the way forward in a healthy and persistent manner. At the same time, the Group also managed to further improve its cash flow and reduce its total debts. All these laid a strong foundation for the Group to sustain a healthy and solid growth in the future.

## MANAGEMENT DISCUSSION AND ANALYSIS (continued)

### Distribution Business

The Group's IT products distribution business recorded a turnover of HK$3,354 million during the third financial quarter, a growth of 6.3% over the same period last year. Its gross profit margin was 5.61% compared with 7.10% recorded in the same period last year. The decline in gross profit margin was mainly due to lower than expected margins derived from the distribution of notebook computers and desktop personal computers. However, the set back in margins encountered by these products is considered to be temporary. For the first three financial quarters, the distribution businesses recorded a turnover of HK$9,317 million, an increase of 16.2% compared to the same period last year. In order to improve its cash flow and obtain a healthier development, the distribution business has tightened its control on trade receivables and inventory since the second financial quarter. This policy has been more stringently applied during the third financial quarter with favourable results achieved in the first and second quarters. Apart from the continued growth in turnover, the distribution business enhanced its risk control and improved its cash flow. On the marketing side, the Group has put more emphasis on the distribution of high-end products that command stronger growth momentums and higher gross profit margins. As a result, strong growth continued in the sales of high-end products including storage products, software items, and network application products such as Internet video systems and network security products. The digital consumer products introduced less than two years ago also maintained rapid growth after SARS has subsided, and enjoyed the highest growth among the Group's distribution products.

Distribution has always been a sector where the Group commands a leading edge position, and the Group's strategic transformation into an IT services provider is safeguarded by the strong and sustained profits generated by its distribution business. Servicing the product suppliers and providing them with supply-chain management expertise have always been the core principles held by the Group's distribution business. In the face of the ever-changing market environment, the Group will adopt a more proactive approach in product distribution to accommodate the suppliers' change in marketing strategy. Moreover, the Group will explore the possibility of forming closer relationships and strategic alliances with the suppliers.

### Systems Integration

The Group's systems integration business recorded a turnover of HK$547 million in the third financial quarter, a significant gain of 69.2% compared to the same period last year. Its gross profit margin was 12.51%, levelling the 12.88% recorded in the corresponding period last year. This was the fourth consecutive financial quarter since the end of 2002 that the systems integration business reported a turnover growth on a year-on-year comparison — and the best financial quarter in two years as represented by its highest growth in turnover. The strong performance of the third financial quarter was mainly driven by a substantial amount of new contracts secured from the two telecommunications operators, China Telecom and China Unicom. Indeed, the strong inflow of contracts from the telecommunications sector was the major driving force behind the significant amount of turnover recorded by the systems integration business during the first three financial quarters, which, compared with the same period last year, increased by 30.7% to HK$1,491 million with gross profit margin decreasing slightly from 13.26% to 12.85%. The telecommunications sector has been a major source of revenue for the Group's systems integration business. Unlike last year when the telecommunications sector substantially reduced its IT spending, this year major sectors such as the telecommunications sector and the financial sector are expected to maintain relatively stable IT spending.

Transforming into an IT services provider has been the Group's publicly stated strategy ever since it was listed in 2001. Following more than two years of hard work, the Group has made significant progress towards this target, as reflected by the wide recognition of the Group's reputation, software sophistication and professionalism in the telecommunications, financial and government sectors where the Group focuses on. In order to speed up the transformation, the Group is making further efforts to streamline and consolidate its resources to establish a new, vertically integrated and client-oriented operating structure. This new structure will adopt an account manager system to provide sector customers with a full range of services — including software solutions, systems integration, operational and maintenance support, systems outsourcing etc. — in a more intimate and professional manner. It is encouraging that customers in the telecommunications and financial sectors are gradually becoming more sophisticated about the essential value of software solutions and related services, which has reinforced the Group's resolution to transform into an IT services provider. The Group is confident that through the new operating structure it will be well prepared to greet the dawn of a service-driven IT market.

## Networking Products

For the third financial quarter, the Group's networking products business recorded a 54% increase in turnover as compared to the same period last year. This was the highest turnover growth recorded by the networking products business in the past two years, and came on the heels of the strong year-on-year turnover growth of 27.1% recorded in the second financial quarter. The gross profit margin increased to 25.45% during the third financial quarter, compared with 24.12% recorded in the corresponding period last year. These remarkable improvements can be primarily attributed to the Group's development and launch of new networking products and its successful strategy in focusing on the education and government sectors. The management firmly believes that with the restructuring of the business completed and its management strengthened, Digital China networking products will capture a stronger position in the market with higher endorsement from more users.

## Financial Management

In the second financial quarter, the Group successfully achieved growth in the Group's business, improved its cash flow from operating activities and reduced its debts by adopting stringent risk-control measures on trade receivables and inventory. Such measures yielded greater success during the third financial quarter. As at 31 December 2003, the Group's trade receivables amounted to HK$1,692 million. While this represented a slight increase compared with HK$1,602 million at the end of the second financial quarter, trade receivables turnover in the third financial quarter was reduced to 37.35 days, compared with 40.74 days in the second financial quarter and 38.83 days in the same period last year. As for the Group's inventory, it amounted to HK$1,032 million at the end of the third financial quarter, levelling the HK$1,026 million figure at the end of the second financial quarter. However, inventory turnover fell to 25.06 days during the third financial quarter, compared with 29.63 days in the second financial quarter and 28.50 days in the same period last year. Because of these satisfactory improvements in trade receivables and inventory level, the Group was able to record HK$326 million in net cash inflow from operating activities during the third financial quarter. The Group's risk control measures include stringent control on the amounts of trade receivables and inventory, as well as improvements on the ages of trade receivables and inventory, with the paramount objective of minimising the overall proportions of overdue trade receivables and slow-moving inventory. Such works form an integral part of the Group's ongoing efforts for continuous improvement and will continue in the remainder of this financial year and beyond.

## Further Business Information

As the Group's businesses have been realigning their operating models to cope with the changing marketplace and demands of customers, the management decided to offer a new perspective in this report on the analysis of the businesses, with more details that enable readers to gain a better picture of the Group's business development.

Having gone through over 10 years of development, the distribution business has fostered two different operating models. The first model focuses on the distribution of mass volume products with relatively uncomplicated features — such as desktop personal computers, notebook computers, printers, etc. — which essentially involves supply-chain management services provided for manufacturers as well as down stream sub-distributors and retailers. These services include sales and marketing, order processing, distribution management, warehousing management, credit management, and logistics. Hence, this business has its core values built on the provision of supply-chain services. The second model is related to the distribution of IT systems products targetting at corporate clients — including servers, software package and networking products — which see rising and compounding applications amidst growing demands from corporate clients for new products with sophisticated features. Given this trend, it is paramount that on top of providing supply-chain management services, the Group is also required to offer high-end services that range from technical design and support to integrated solutions of consultancy, training and system maintenance. Due to their more sophisticated nature, these services usually command higher profit margins. Another major difference between the two models is customer profile. The first model mainly targets sub-distributors and retailers, whereas the second model focuses on systems integrators. The following table shows the turnovers and gross profit margins of three categories of business derived from these two models. The first business is ***Distribution***, which emphasises the creation of value through providing supply-chain management. The second is ***Systems***, which comprises the distribution of enterprise application products and the Group's proprietary networking products, and a small part of the systems integration business. The third is ***Services***, which incorporates the bulk of the systems integration business, and segments of the distribution business that provide direct services for major clients in various industries.

## MANAGEMENT DISCUSSION AND ANALYSIS (continued)

The table is based on the Group's information for the three financial quarters up to 31 December 2003, and is expressed in million of Hong Kong dollar:

| | Distribution | | Systems | | Services | | Accumulated Figures | |
|---|---|---|---|---|---|---|---|---|
| | 3rd Quarter | 1st to 3rd Quarters | 3rd Quarter | 1st to 3rd Quarters | 3rd Quarter | 1st to 3rd Quarters | 3rd Quarter | 1st to 3rd Quarters |
| Turnover | 2,239 | 6,252 | 1,177 | 3,329 | 552 | 1,408 | 3,968 | 10,989 |
| Gross Margin | 3.86% | 2.99% | 10.24% | 9.79% | 12.09% | 13.16% | 6.90% | 6.35% |

**Prospects**

In the remainder of the financial year, the Group will carry on its primary mission to enhance cash inflow and obtain solid returns. On this basis, the Group will strive to grow its existing businesses and to develop new ventures. Such principle represents an overall guideline for the long-term development of the Group's operations.

Looking ahead, the Group strongly believes that IT service is the future that the Group should pursue. While striving to maintain a rapid and healthy development for its distribution business, the Group will move forward with firm steps to transforming into an IT services provider.

**Liquidity and Financial Resources**

At 31 December 2003, the Group had total assets of HK$4,341 million which were financed by total liabilities of HK$3,023 million, minority interests of HK$12 million and shareholders' funds of HK$1,306 million. The Group had a current ratio of approximately 1.56 as compared to that of approximately 1.6 at 31 March 2003, approximately 1.52 at 30 June 2003 and approximately 1.56 at 30 September 2003.

At 31 December 2003, the Group had cash and bank balances and unsecured short-term bank borrowings of HK$875 million and HK$365 million respectively.

With regard to the aggregate interest-bearing debts as a ratio of shareholders' funds, it once reached 1.03 at 30 June 2003 as compared to 0.55 at 31 March 2003. However, owing to the management's devoted efforts in enforcing prudent financial management, the ratio had already restored back to 0.74 at 30 September 2003 and it was further improved to 0.70 at 31 December 2003.

The computation of the above ratio was based on the total interest-bearing borrowings of HK$911 million (31 March 2003: HK$761 million, 30 June 2003: HK$1,281 million and 30 September 2003: HK$912 million) and shareholders' funds of HK$1,306 million (31 March 2003: HK$1,393 million as restated, 30 June 2003: HK$1,244 million and 30 September 2003: HK$1,239 million).

At 31 December 2003, all the interest-bearing borrowings of the Group were denominated in United States Dollar. Part of the United States Dollar borrowings amounting to HK$365 million were short-term bank borrowings repayable within one year and guaranteed by the Company. The rest of United States Dollar borrowings amounting to HK$546 million represented the syndicated loan (the "Loan") repayable within four years counting from the date of the first drawdown.

Owing to the unexpected loss of the Group in the first financial quarter, certain debt related ratios as the Company would otherwise be required to maintain under the Loan were adversely affected but the Company has already obtained the written consent from the syndicate of banks on a temporary arrangement in relation to those affected ratios.

Apart from the Loan, the Group has sufficient other financial resources, unutilised credit facilities and reserves to meet the funding requirements for its business operations.

## MANAGEMENT DISCUSSION AND ANALYSIS (continued)

At 31 December 2003, the Group's total available credit facilities amounted to HK$4,097 million of which HK$2,745 million was in trade lines, HK$806 million was in short-term and revolving money market facilities and HK$546 million was in transferable loan facility. At 31 December 2003, the facility drawn down was HK$1,340 million in trade lines, HK$23 million in short-term and revolving money market facilities and HK$546 million in transferable loan facility respectively.

Under the normal course of business, the Group has issued performance bonds to some customers for potential claims of non-performance in order to satisfy the specific requirements of these customers. As no material claims had been made by the customers under such performance bonds in the past, the management considers that the possibility of realisation of any actual material liabilities arising from such performance bonds is remote.

During the nine months ended 31 December 2003, capital expenditure of HK$72 million was incurred in the construction of integrated and centralised research and development and management centre in Beijing and an automated warehouse in Shanghai to accommodate the Group's future growth. Apart from the above, capital expenditure spent on the regular acquisition of fixed assets was HK$33 million.

### Human Resources

At 31 December 2003, the Group had approximately 4,100 (31 December 2002: approximately 3,700) full-time employees. The majority of those employees work in the PRC. The Group offers remuneration packages in line with industry practice. Remuneration of the Group's employees includes basic salaries and bonuses. The Group incurred total staff cost of approximately HK$264 million for the nine months ended 31 December 2003 (For the nine months ended 31 December 2002: HK$205 million). In order to attract and retain a high calibre of capable and motivated workforce, the Company offers share options to staff based on individual performance and the achievement of the Company's targets. The Group is committed to providing its staff with various in-house and external training and development programs.

## DIRECTORS' INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES

At 31 December 2003, the interests and short positions of the directors of the Company and their associates in the shares and underlying shares of the Company which were required to be notified to the Company and The Stock Exchange of Hong Kong Limited (the "Stock Exchange") pursuant to Divisions 7 and 8 of Part XV of the Securities and Futures Ordinance (the "SFO") (including interests and short positions which they were taken or deemed to have under such provisions of the SFO), or which were required to be recorded in the register kept by the Company pursuant to Section 352 of the SFO, or which were required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies (the "Model Code") contained in the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules"), were as follows:

### Shares of HK$0.10 each of the Company

| Name of director | Capacity | Interests in shares (Note 1) | Interests in underlying shares (Note 1) | Aggregate percentage of holding (%) (Note 3) |
|---|---|---|---|---|
| LI Qin | Beneficial owner | 1,016,000 | — | 0.12 |
| GUO Wei | Beneficial owner | 904,000 | 10,600,000 | 1.34 |
| ZENG Maochao | Beneficial owner | 808,000 | — | 0.09 |
| | Interest of spouse | 60,000 (Note 2) | — | 0.01 |
| LIN Yang | Beneficial owner | 220,000 | 5,500,000 | 0.67 |
| HUA Zhinian | Beneficial owner | 80,000 | 4,200,000 | 0.50 |

## DIRECTORS' INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES (continued)

**Notes:**

1. All the above interests in the shares and underlying shares of the Company were long positions. None of the directors of the Company or their associates held any short positions in the shares or underlying shares of the Company at 31 December 2003. Interests in underlying shares of the Company represented share options granted to such directors, further details of which are set out in the section headed "Share Options" below.

2. 60,000 shares were owned by the wife of Mr. ZENG Maochao.

3. The aggregate percentages of holding were calculated on the basis of 859,221,331 shares of the Company in issue at 31 December 2003.

Save as disclosed above, at 31 December 2003, none of the directors and chief executives of the Company or their associates had any interests or short positions in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of the SFO) which were required to be recorded in the register kept by the Company pursuant to Section 352 of the SFO or which were required to be notified to the Company and the Stock Exchange pursuant to the Model Code.

## SHARE OPTIONS

The old share option scheme of the Company was adopted on 14 May 2001 (the "2001 Share Option Scheme") and terminated on 18 July 2002. Upon termination, no further options shall be granted under the 2001 Share Option Scheme but the provisions of the 2001 Share Option Scheme shall remain in full force and effect in all other respects to govern all outstanding options granted thereunder prior to termination. The new share option scheme of the Company was adopted on 18 July 2002 (the "2002 Share Option Scheme").

### (i) 2001 Share Option Scheme

The following table shows the movements in the Company's share options under the 2001 Share Option Scheme during the nine months ended 31 December 2003 and options outstanding at the beginning and end of the period:

| Grantee | Outstanding at 1 April 2003 | Granted during the period | Exercised during the period | Lapsed during the period | Outstanding at 31 December 2003 | Subscrip-tion price HK$ (Note 2) | Date of grant | Exercisable period (Note 1) |
|---|---|---|---|---|---|---|---|---|
| **Directors** | | | | | | | | |
| GUO Wei | 2,800,000 | — | — | — | 2,800,000 | 3.180 | 12/07/01 | 12/07/02–11/07/09 |
| | 2,800,000 | — | — | — | 2,800,000 | 1.976 | 31/08/01 | 31/08/02–30/08/09 |
| LIN Yang | 1,500,000 | — | — | — | 1,500,000 | 3.180 | 12/07/01 | 12/07/02–11/07/09 |
| | 1,500,000 | — | — | — | 1,500,000 | 1.976 | 31/08/01 | 31/08/02–30/08/09 |
| HUA Zhinian | 1,100,000 | — | — | — | 1,100,000 | 3.180 | 12/07/01 | 12/07/02–11/07/09 |
| | 1,100,000 | — | — | — | 1,100,000 | 1.976 | 31/08/01 | 31/08/02–30/08/09 |
| **Other Employees** | 34,784,000 | — | — | 1,779,000 | 33,005,000 | 3.604 | 08/06/01 | 08/06/02–19/06/09 |
| (Note 3) | 1,100,000 | — | — | — | 1,100,000 | 3.180 | 12/07/01 | 12/07/02–11/07/09 |
| | 21,074,000 | — | 517,000 | 239,000 | 20,318,000 | 1.976 | 31/08/01 | 31/08/02–30/08/09 |

**Notes:**

1. All options granted are subject to a vesting period of 4 years with 25% becoming exercisable on the first anniversary, 25% on the second anniversary, 25% on the third anniversary and 25% on the fourth anniversary of the respective date of grant.

## SHARE OPTIONS (continued)

2. The subscription price of the options is subject to adjustment in the case of rights or bonus issues, or other similar changes in the Company's share capital.

3. Options in respect of 1,100,000 shares exercisable at HK$3.180 per share and another 1,100,000 shares exercisable at HK$1.976 per share, which were previously disclosed as options held by a director of the Company, were grouped under the category of "Other Employees" following the retirement of such director at the annual general meeting of the Company held on 8 August 2003.

### (ii) 2002 Share Option Scheme

The following table shows the movements in the Company's share options under the 2002 Share Option Scheme during the nine months ended 31 December 2003 and options outstanding at the beginning and end of the period:

| Grantee | Outstanding at 1 April 2003 | Granted during the period | Exercised during the period | Lapsed during the period | Outstanding at 31 December 2003 | Subscrip-tion price HK$ (Note 2) | Date of grant | Exercisable period (Note 1) |
|---|---|---|---|---|---|---|---|---|
| **Directors** | | | | | | | | |
| GUO Wei | — | 5,000,000 | — | — | 5,000,000 | 2.750 | 13/10/03 | 13/10/04–12/10/11 |
| LIN Yang | — | 2,500,000 | — | — | 2,500,000 | 2.750 | 13/10/03 | 13/10/04–12/10/11 |
| HUA Zhinian | — | 2,000,000 | — | — | 2,000,000 | 2.750 | 13/10/03 | 13/10/04–12/10/11 |
| **Other Employees** | — | 50,420,000 | — | — | 50,420,000 | 2.750 | 13/10/03 | 13/10/04–12/10/11 |

**Notes:**

1. All options granted are subject to a vesting period of 4 years with 25% becoming exercisable on the first anniversary, 25% on the second anniversary, 25% on the third anniversary and 25% on the fourth anniversary of the respective date of grant.

2. The subscription price of the options is subject to adjustment in the case of rights or bonus issues, or other similar changes in the Company's share capital.

## SUBSTANTIAL SHAREHOLDERS' INTERESTS

At 31 December 2003, the following persons, not being a director or chief executive of the Company, had the following interests and short positions in the shares and underlying shares of the Company as recorded in the register required to be kept by the Company under Section 336 of the SFO:

| Name | Notes | Long position held in shares | Short position held in shares | Percentage of holding of long/short position in shares (%) (Note 6) |
|---|---|---|---|---|
| Legend Holdings Limited | 1,2 | 426,785,314 | 11,920,200 | 49.67/1.39 |
| Employees' Shareholding Society of Legend Holdings Limited | 1,3 | 426,785,314 | 11,920,200 | 49.67/1.39 |
| GAP Coinvestment Partners II, L.P. | 4 | 111,774,000 | — | 13.01/— |
| GAP (Bermuda) Limited | 4 | 111,774,000 | — | 13.01/— |
| General Atlantic Partners (Bermuda), L.P. | 4 | 111,774,000 | — | 13.01/— |
| General Atlantic Partners, LLC | 4 | 111,774,000 | — | 13.01/— |
| GapStar, LLC | 4 | 111,774,000 | — | 13.01/— |
| J.P. Morgan Chase & Co. | 5 | 95,987,700 | — | 11.17/— |

## SUBSTANTIAL SHAREHOLDERS' INTERESTS (continued)

**Notes:**

1. The English names "Legend Holdings Limited" and "Employees' Shareholding Society of Legend Holdings Limited" are direct transliterations of their Chinese registered names "聯想控股有限公司" and "聯想控股有限公司職工持股會" respectively.

2. 140,232,042 shares were held by Right Lane Limited, a wholly owned subsidiary of Legend Holdings Limited, and Legend Holdings Limited was deemed to be interested in such shares by virtue of the SFO. Therefore, the 426,785,314 shares in which Legend Holdings Limited was interested as disclosed above also included the 140,232,042 shares held by Right Lane Limited.

3. Employees' Shareholding Society of Legend Holdings Limited was the controlling shareholder of Legend Holdings Limited and therefore, by virtue of the SFO, was deemed to be interested in the 426,785,314 shares in which Legend Holdings Limited was interested.

4. GAP Coinvestment Partners II, L.P., GAP (Bermuda) Limited, General Atlantic Partners (Bermuda), L.P., General Atlantic Partners, LLC and GapStar, LLC have entered into an agreement pursuant to which each of the aforesaid parties was deemed to be interested in the aggregate of 111,774,000 shares.

5. J.P. Morgan Chase & Co. was deemed to be interested in an aggregate of 95,987,700 shares by virtue of the SFO. Those interests comprised direct interests in 81,870,200 shares and 1,704,000 shares held by JF Asset Management Limited and JF International Management Inc. respectively, both of which were subsidiaries and controlled corporations of J.P. Morgan Fleming Asset Management (Asia) Inc. which itself was a subsidiary and a controlled corporation of J.P. Morgan Fleming Asset Management Holdings Inc.. J.P. Morgan Fleming Asset Management Holdings Inc. was then a subsidiary and a controlled corporation of J.P. Morgan Chase & Co.. Also, direct interest in 15,600 shares was held by J.P. Morgan Whitefriars Inc., which was a subsidiary controlled in turn by J.P. Morgan Overseas Capital Corporation, J.P. Morgan International Finance Limited, J.P. Morgan International Inc. and JPMorgan Chase Bank, all of which were subsidiaries and controlled corporations of J.P. Morgan Chase & Co. In addition, JPMorgan Chase Bank also had a direct interest in 12,397,900 shares of the Company.

6. The percentages of holding of long/short positions in shares were calculated on the basis of 859,221,331 shares of the Company in issue at 31 December 2003.

## PURCHASE, SALE OR REDEMPTION OF THE COMPANY'S LISTED SECURITIES

During the nine months ended 31 December 2003, neither the Company nor any of its subsidiaries had purchased, sold or redeemed any of the Company's listed securities.

## AUDIT COMMITTEE

The Company has established an audit committee comprising members of the two independent non-executive directors of the Company, namely Mr. LEUNG Pak To, Francis (chairman of the audit committee) and Professor WU Jinglian. The audit committee has reviewed with the management the accounting principles and practices adopted by the Group and discussed auditing, internal control and financial reporting matters including the review of the unaudited condensed consolidated financial statements and the third quarterly report for the nine months ended 31 December 2003 of the Group.

## CODE OF BEST PRACTICE

None of the directors of the Company is aware of any information that would reasonably indicate that the Company is not, or was not for any part during the nine months ended 31 December 2003, in compliance with the Code of Best Practice set out in Appendix 14 of the Listing Rules except that the non-executive director and independent non-executive directors of the Company are not appointed for a specific term but are subject to retirement by rotation and re-election in accordance with the Bye-Laws of the Company.

By Order of the Board
**LI Qin**
*Chairman*

Hong Kong, 19 February 2004

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