

# Management Discussion and Analysis

## Industry Review

China is the largest textile producing country in the world. The cotton textile industry maintained its upward momentum to achieve unprecedented growth in 2003. The output of cotton yarn and cotton fabric in the PRC increased by 15.79% and 9.22% respectively in 2003 as compared to the output in 2002.

Leveraging on China's competitive advantages, including low labour costs, access to the world's largest source of cotton, favorable government policies and China's accession to the WTO, the total export value of cotton yarn and grey fabric in the PRC increased steadily. In the first half of 2003, domestic transportation and domestic sales of cotton textile products have been affected by the outbreak of the Severe Acute Respiratory Syndrome ("SARS"), but the export sales of cotton textile products in the PRC has not been affected.

In the 2003/2004 marketing year (from September 2003 to August 2004), the PRC's demand for cotton is expected to be an overwhelming 6.67 million tons while cotton production is only expected to be 4.93 million tons. Shortage in the supply of cotton led to a surge in domestic cotton price of about 55% in 2003. In the international market, the price of cotton increased by 32% in 2003. As a result, a number of domestic textile manufacturers with smaller operation scale and less financial strength were adversely affected, as evidenced

by the rising number of loss making textile factories from 23% in early 2003 to 47% in

October 2003. While such industry consolidation is inevitable, it will enable Weiqiao Textile, an industry leader with large economies of scale, solid customer base and unrivaled competitive edges, to enjoy tremendous growth and development potentials.

In 2003, there was an extensive electricity deficiency throughout PRC. The Group was not affected by such deficiency because it was able to obtain a stable supply of electricity at a rate that is lower than the market rate from Shandong Weiqiao Chuangye Group Company Limited (formerly known as Shandong Weiqiao Textile Group Company Limited, or "Holding Company").

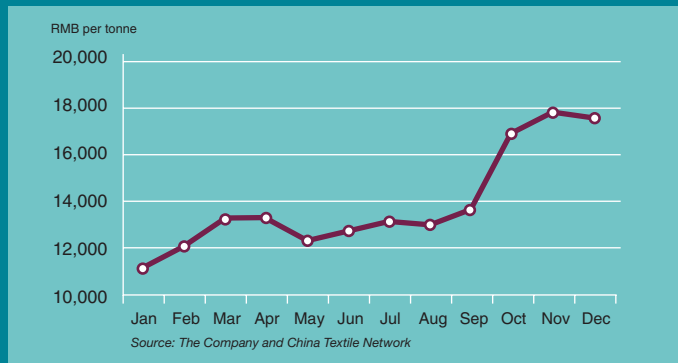
## Business Review

The Group is principally engaged in the production, sale and distribution of cotton yarn, grey fabric and denim. In 2002, it was ranked number one in terms of turnover in the cotton textile industry in the PRC and in terms of the aggregate export value of cotton yarn and grey fabric in the PRC. Growing along side with the country's booming economy and cotton textile industry, the Group continued to flourish and achieved new business heights in 2003. In 2003, the Group sustained its leading position in the PRC cotton textile market and succeeded in capturing a greater market share.

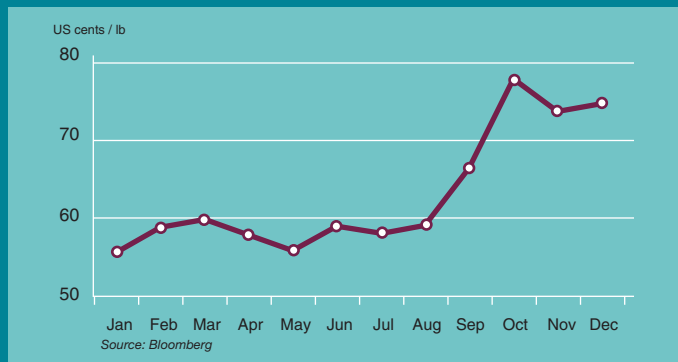







### China's Cotton Index (2003)



### Cotlook's Daily A Cotton Index Price (2003)

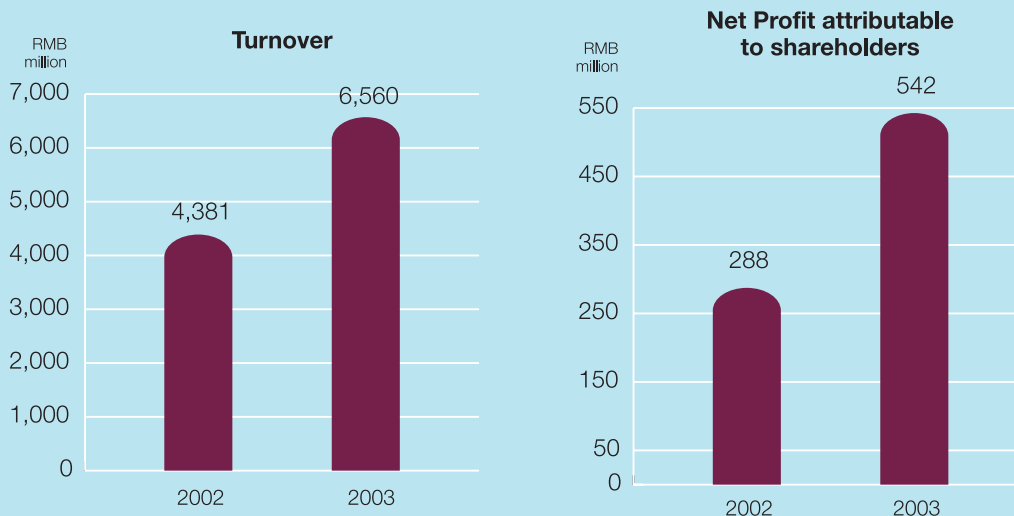


### Growing Production Volume

|   | Production Volume for 2002 | Production Volume for 2003 |
|---|----------------------------|----------------------------|
|  Cotton yarn | 161,800 tons               | 324,000 tons               |
|  Grey fabric | 264 million metres         | 585 million metres         |
|  Denim       | 91 million metres          | 105 million metres         |

# Management Discussion and Analysis

The Group recorded significant growth in both turnover and net profit attributable to shareholders for the year ended 31 December 2003. The bar charts below illustrate the turnover and net profit attributable to shareholders for the years ended 31 December 2002 and 31 December 2003:

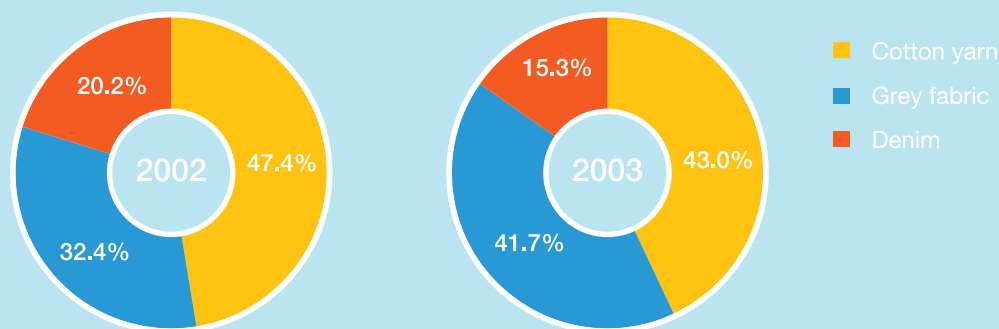


During the year ended 31 December 2003, the audited turnover of the Group was about RMB6,560 million, representing an increase of 49.8% over the comparable period in 2002, and net profit attributable to shareholders was about RMB542 million, representing an increase of 87.9% over the comparable period in 2002.

Such increases in turnover and net profit were mainly attributable to the commencement of the full operations of the Third Production Area and Binzhou Weiqiao Technology Industrial Park Co., Ltd. ("Binzhou Industrial Park") in the third quarter of 2003. This in turn enabled the Group to further enhance its economies of scale to reduce the unit fixed production costs and raw materials purchasing cost.

The pie charts below illustrate the sales analysis of the Group by product for the years ended 31 December 2002 and 31 December 2003:

### Turnover breakdown by products



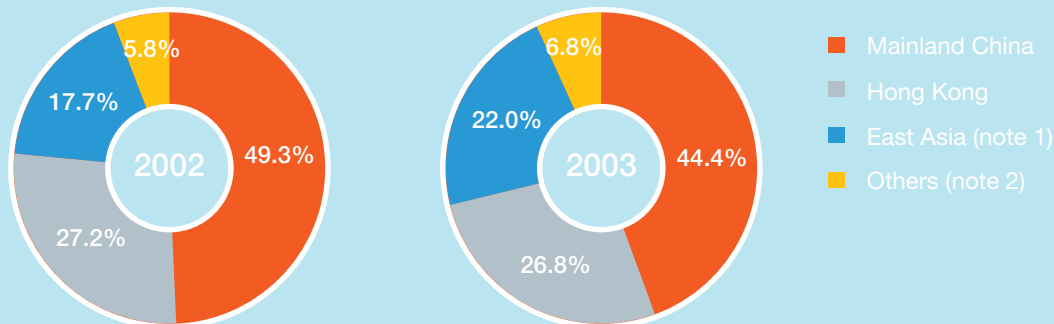
In terms of turnover, the largest proportion of turnover was attributable to cotton yarn among the three key product categories of the Group. The growth in sales of cotton yarn was mainly attributable to the further enhancement of the Group's production capacity as well as the robust market demand. Grey fabric was the second key source of the Group's turnover. Economies of scale were well achieved as a result of the rapid growth in the grey fabric market and the enhancement in the efficiency of the Group's equipment. Such factors contributed to the improvement in the performance of the grey fabric segment which recorded a greater percentage increase in sales than other products. As for denim, which is mainly for sale in the domestic market, the decline in sales in the first half of 2003 was due to the SARS outbreak in the PRC which adversely affected sales in the domestic retail sector. The outbreak also adversely affected the transportation of the Group's denim products whose key markets are in Guangdong and Fujian regions within the country. However, the sales of denim rebounded in the second half of 2003 and the overall sales in 2003 increased by 13.7% compared to 2002.

In 2003, the Group produced an aggregate of about 324,000 tons of cotton yarn, 585 million metres of grey fabric and 105 million metres of denim. Due to the commencement of full operations of the Third Production Area and Binzhou Industrial Park in the third quarter of 2003, the aggregate production volume of cotton yarn and grey fabric increased by 99.9% and 116.9%, respectively, compared to the corresponding period in 2002.

While the cotton price increase had an adverse impact on many players in the PRC cotton textile industry, the Group was able to minimize such impact by capitalizing on its advantages of access to imported cotton quota, good product quality and extensive and loyal customer base. During the year ended 31 December 2003, the ratio of imported and domestic lint cotton was 57.2% (2002: 27.8%), and 42.8% (2002: 72.2%), respectively. The Group was able to pass on the increase in raw material cost to its customers and succeeded in improving its gross profit margin.

The pie charts below illustrate the sales analysis of the Group by geographical segment for the years ended 31 December 2002 and 31 December 2003:

#### Turnover breakdown by geographical segments



Notes:

1. Principally comprising Japan and South Korea
2. Principally comprising Taiwan, Thailand, the US and certain European countries

# Management Discussion and Analysis

The Group has an extensive customer base with nearly 3,000 customers in more than 20 provinces and municipalities in the PRC and about 400 customers spanning across more than 20 countries and regions. Comparing to 2002, the number of the Group's domestic and overseas customers has increased by 50% and 33%,

respectively. The Group's customers include renowned market giants such as Fountain Set (Holdings) Limited and Texwinca Holdings Limited, as well as esteemed traders such as Itochu Corporation, Nichimen Corporation and Marubeni Corporation, who together contribute to the Group's stable revenue base, increasing orders and satisfactory business growth.

## Financial Review

### Gross profit and gross profit margin

The table below is an analysis of the Group's gross profit and gross profit margins attributable to its major product categories for the years ended 31 December 2002 and 31 December 2003:

| Product category | For the year ended 31 December |                             |                         |                             |
|------------------|--------------------------------|-----------------------------|-------------------------|-----------------------------|
|                  | 2002                           |                             | 2003                    |                             |
|                  | Gross Profit<br>RMB'000        | Gross Profit<br>Margin<br>% | Gross Profit<br>RMB'000 | Gross Profit<br>Margin<br>% |
| Cotton yarn      | 489,449                        | 23.6                        | 605,789                 | 21.5                        |
| Grey fabric      | 48,014                         | 3.4                         | 386,362                 | 14.1                        |
| Denim            | 114,193                        | 12.9                        | 218,162                 | 21.7                        |
| <b>Total</b>     | <b>651,656</b>                 | <b>14.9</b>                 | <b>1,210,313</b>        | <b>18.5</b>                 |

The gross profit margin of the Group increased to 18.5% for 2003 from 14.9% for 2002.

As a result of the increase in the market price of lint cotton, the principal raw material used by the Group and the reduction in sales of high-end cotton yarn (with the increase in share of high-end grey fabric, more high-end cotton yarn was used to produce high-end grey fabric) in 2003, the gross profit margin attributable to cotton yarn decreased to 21.5% for 2003 (2002: 23.6%).

As a result of the increase in average unit selling prices and production volume and the improvement in product mix, the gross profit margin attributable to grey fabric increased to 14.1% for 2003 (2002: 3.4%).

The gross profit margin for denim increased to 21.7% for 2003 (2002: 12.9%). This is mainly due to the reduction in the Group's production cost as a result of

increased recycling of waste materials and by-products produced during the production of cotton yarn and grey fabric, which are raw materials of denim.

### Selling and distribution costs

The Group's selling and distribution costs increased by 88.9% to RMB148 million for 2003 from RMB79 million for 2002. As a result of the increase in sales, in particular, export sales which increased by 64.2% to RMB3,646 million for 2003 from RMB2,221 million for 2002, transportation costs increased to RMB104 million (2002: RMB58 million), sales commission increased to RMB19 million (2002: RMB12 million), staff costs increased to RMB18 million (2002: RMB5 million), and other expenses increased to RMB7 million (2002: RMB4 million).

### **Administrative expenses**

Administrative expenses for 2003 amounted to RMB90 million, representing an increase of 123.2%, as compared to RMB40 million for 2002. Such increase was mainly due to the increase in the number of administrative staff as a result of (i) the injection of the operating assets of the Second Production Area and Third Production Area into the Company by Holding Company; (ii) the acquisition of the 91% equity interests in Binzhou Industrial Park from Holding Company and Binzhou Weiqiao Property Company Limited ("Binzhou Weiqiao") (formerly named Binzhou Weiqiao Textile Company Limited) by the Company; (iii) the establishment of Shandong Luteng Textile Co., Ltd. ("Luteng Textile") in the second half of 2002; and (iv) the establishment of Shandong Weiqiao Mianye Company Limited on 30 September 2003. Staff cost and other related expenses have increased as a result.

### **Finance costs**

Finance costs rose to RMB158 million for 2003, representing an increase of 55.5% as compared to RMB102 million for 2002. The increase in bank loans for 2003 as compared with 2002 was mainly due to (i) the injection of the operating assets and related liabilities of the Second Production Area and the Third Production Area into the Company by Holding Company in the second half of 2002; (ii) the acquisition of 91% equity interests in Binzhou Industrial Park in the second half of 2002 from Holding Company and Binzhou Weiqiao; (iii) the establishment of Shandong Weiqiao Mianye Company Limited on 30 September 2003; (iv) the production capacity expansion at the end of 2003; (v) the funding of the capital expenditures in 2003; and (vi) the general working capital requirements of the Group.

### **Liquidity and financial resources**

The cash and cash equivalents of the Group were RMB1,532 million as at 31 December 2003, representing an increase of 814% from cash and cash equivalents of RMB168 million as at 31 December 2002. During the

year ended 31 December 2003, the Group invested RMB2,788 million in capital expenditures, incurred a net cash outflow from operating activities of RMB731 million and incurred an exchange loss of RMB7 million. These cash outflows were largely offset by an increase in net bank loans of RMB2,119 million, a net IPO proceeds of about RMB2,511 million, a decrease of pledged deposit by RMB247 million and an interest income of RMB12 million. The net debt-to-equity ratio (total bank borrowings net of cash and cash equivalents over shareholders' equity) decreased to 0.64 as at 31 December 2003 from 1.42 as at 31 December 2002 as a result of the above.

The Group's total borrowings, consisting of bank loans and long term debts payable to Holding Company, as at 31 December 2003 were RMB4,653 million in total, compared with RMB2,534 million in total as at 31 December 2002. The maturity profile spread over a period of five years with RMB1,991 million repayable within one year or on demand, RMB997 million in the second year and RMB1,665 million in the third to fifth years, inclusive. Day-to-day funding requirements and capital expenditure of the Group are expected to be met by its IPO proceeds and internal cash flow. The Group also has access to significant uncommitted short-term borrowing facilities provided by its principal banks.

The Group's accounts receivable turnover days were about 28 days for the year ended 31 December 2003, increasing from 21 days for the year ended 31 December 2002. The increase in accounts receivable turnover days was attributable to the Group's increased ratio of export sales from 50.7% for 2002 to 55.6% for 2003. The accounts receivable turnover days for export sales are longer than that for domestic sales.

For the year ended 31 December 2003, the Group's inventory turnover days increased to 142 days from 73 days for the year ended 31 December 2002. The inventory turnover days increased mainly because the price of lint cotton in the second half of 2003 was unstable and the Group purchased an increased volume of imported lint cotton for use in early 2004.

# Management Discussion and Analysis

During the year ended 31 December 2003, the Group did not use any financial instrument for hedging purposes and the Group did not have any hedging instrument outstanding as at 31 December 2003.

## **Profit attributable to shareholders and earnings per share**

The Group's profit attributable to shareholders for 2003 was about RMB542 million, representing an increase of 87.9%, as compared to about RMB288 million in 2002, which is higher than the profit forecast as stated in the Prospectus.

During the year ended 31 December 2003, the amount of basic earnings per share of the Company was RMB0.89. No diluted earnings per share amount has been presented as the Company did not have any dilutive potential ordinary shares during the year.

## **Capital structure**

As at 31 December 2003, the Group's borrowings were

primarily denominated in RMB and US dollars while its cash and cash equivalents were mainly held in RMB and US dollars.

It is the intention of the Group to maintain an appropriate mix of equity and debt to ensure an efficient capital structure from time to time. As at 31 December 2003, the Group had a total indebtedness of about RMB4,653 million (consisting of bank loans and long term debts payable to Holding Company) and cash and cash equivalents of about RMB1,532 million. The gearing ratio was 41% (total indebtedness (consisting of bank loans and long term debts payable to Holding Company)/total assets).

Details of the bank loans outstanding as at 31 December 2003 are described in Note 29 to the financial statements. As at 31 December 2003, 97.9% of the Group's bank loans was at fixed interest rates and 2.1% was at floating interest rates. The Group did not have any seasonal variance of borrowing requirements.

## **Use of IPO proceeds**

Weiqiao Textile conducted an IPO in September 2003. The H shares of the Company were listed on the Main Board of The Stock Exchange of Hong Kong Limited on 24 September 2003. The IPO was well received by institutional investors and the public. The international placing was significantly over-subscribed and the Hong Kong public offer recorded an impressive subscription rate of 118.6 times. The over-allotment option was fully exercised on 25 September 2003. Net proceeds of about RMB2,511 million were raised from the IPO. During the year ended 31 December 2003, the Company applied the proceeds from its IPO in September 2003 for the purposes set out in the Prospectus as follows:

|   | <i>HKD million</i> |                   |
|---|--------------------|-------------------|
|   | Planned            | Actual allocation |
| Expansion of product portfolio to include more high value-added cotton textile products | 406                | 339               |
| Upgrading the existing production technology  | 94                 | 94                |
| Establishment of a technology development center  | 47                 | —                 |
| Upgrading the information systems   | 34                 | —                 |
| Repayment of bank loans   | 566                | 566               |
| Acquisition relating to the Group's cotton textile manufacturing business               | 100                | —                 |
| General working capital   | 1,124              | 1,124             |



### Details of the Group's asset pledged

Details are set out in Note 29 to the financial statements.

### Exposure to foreign exchange risk

Income and most of the expenditure of the Group are denominated in RMB and US dollars. 55.6% of the Group's income and 57.2% of the Group's purchase cost of lint cotton were dominated in US dollars in 2003. The Group has not experienced any material difficulties or effects on its operations or liquidity as a result of fluctuations in currency exchange rates during the year ended 31 December 2003. The Board believes that the Group will have sufficient foreign exchange to meet its foreign exchange requirements.

### Contingent liabilities

Details are set out in Note 34 to the financial statements.

### Employment, training and development

As at 31 December 2003, the Group had a total of over 69,000 employees. Total staff costs amounted to 9.5% of its total turnover for the year ended 31 December 2003. Employees were remunerated based on their performance, experience and prevailing industry practices. The Group's remuneration policies and packages were reviewed on a regular basis. Bonuses and commissions may also be awarded to employees based on performance evaluation. These provide drives and incentives to encourage better staff performance and motivation.

### Taxation

Tax payable by the Group grew from RMB170 million for 2002 to RMB306 million for 2003, representing an increase of 80.2%. This increase was primarily due to the increase in profit before tax by 85.1% to RMB853 million for 2003 from RMB461 million for 2002. Details of the reconciliation of the Group's effective tax rate to the applicable rate are set out in Note 11 to the financial statements.

### Outlook

Due to the enormous international demand for cotton textile products, the Group expects that the PRC cotton textile market will continue to exhibit growth, prosperity and a smooth development. The Group is confident that it will achieve greater business heights and corporate development in the coming future.

By the end of 2003, the domestic cotton price was about RMB17,300 per ton (including tax) while the Cotlook's Daily A cotton price was about US\$0.75 per pound. The PRC government recently increased the import quota by another 500,000 tons of cotton in addition to the 894,000 tons for 2004 in an effort to relieve the pressure of the high domestic cotton prices. However, domestic cotton prices are expected to remain at a high level for 2004. The gap between the average domestic cotton price and average international cotton price will narrow in 2004. Market consolidation is expected to continue in the industry. The smaller and less efficient operators will be driven out of the market, leaving behind leading cotton textile manufacturers with sufficient production facilities and capabilities and industry recognized product quality. Weiqiao Textile, the largest cotton textile manufacturer in the PRC, has the opportunity of acquiring a greater market share as a result of such consolidation.

As China joins the WTO, the global textile trade business will become further integrated and liberalized, which will help to boost the market potential of the textile industry in China. The Agreement on Textiles and Clothing provides that all the quotas on textile products will be removed by the end of 2004. The relaxation of the quota restrictions on imported cotton will directly lower our cotton costs and give us an advantage over international competitors. It will enhance the export to European and American markets and extend our market coverage. The rapid economic growth of China and the consolidation of the textile industry in China will also present the Group with more business opportunities.



# Management Discussion and Analysis

With a view of achieving further historic highs in performance and unrivaled operation success, the Group will ride on its robust growth momentum by introducing more advanced equipments, further increasing its production capacity and expanding the range of its high value-added products. The Group plans to increase its capital investment to expand its cotton yarn and grey fabric production capacity by about 50% and 70% respectively by the end of 2004 to meet the growing market demand. From time to time, the Directors will assess the supply of raw materials and other resources and if necessary implement appropriate measures to ensure that a steady supply can be maintained to support the Group's continuous expansion. The Group plans to introduce more advanced production equipment to expand its product portfolio to include more high value-added cotton textile products. The Group will also improve its existing information system and employ more high caliber employees to sustain its competitive advantages in the market. Last but not least, in addition to the enormous PRC market, the Group will further explore the markets in Asia, Europe and US, so as to strengthen its leading position in the domestic cotton textile market as well as to solidify its presence in the global cotton textile industry.

Weiqiao Textile will not rest on its laurels by its encouraging performance, but instead it will become even more motivated to achieve astounding success to reward its supportive shareholders and enhance value for its loyal customers.