

" *H*engan is
committed to extend its
reach to personal and
family hygiene product
related businesses so as to
fortify the Group's leading
position in the industry."



“Growing with you for a better life”

OVERALL PERFORMANCE

The Chinese economy experienced strong and sustainable growth, recorded an economic growth of 9.1% in 2003. While foreseeing inflation and individual economic sectors require restraint, it is believed that the implementation of some austerity policies will not materially affect the overall economy. Though the economic growth in 2004 will be retarded, is expected to be over 8%. The growth in domestic demand remained strong that benefits sales of the Group's products.

The Chinese personal hygiene product industry maintained its eminent growth trend in 2003. The SARS outbreak did not affect the operation and sales of the Group but arouse public awareness of personal hygiene, which motivated sales of most products of the Group. Amidst the backdrop of a highly competitive consumer goods market, the Group continued to enhance product quality. Through adopting flexible sales strategies in different regions and markets, the Group successfully maintained its leading market position.

After rapid development of sanitary napkins, the major products of the Group, over the past decade, the market had entered into a stage of oversupply. Keen market competition affected the business growth of the Group. Given the fact that implementation of new management processes in the past has effectively propelled the morale and operation efficiency of the staff, to accelerate the Group's business development and capture the immense market potential of household and personal hygiene products in the PRC, the management believes to grow the Group by acquisition of other products or brands will become the Group's future development strategy. The Group has, therefore, successfully acquired during the year approximately 68.9% equity interest in Changde Hengan Paper Products Co., Ltd. and secured the control in the manufacture and sales of tissue paper products under the brand “Heartex” (心相印). With the remarkable growth in the sales of tissue paper products during the year, the Group's reliance on traditional core products started to lessen. It is expected that sales of tissue paper products will become a new growth engine of the Group.

During the year under review, the Group's turnover amounted to HK\$1,688,512,000 and profit attributable to shareholders was HK\$254,988,000, representing a year-on-year increase of 51.4% and 27.7% respectively. The improvement in sales revenue was attributable to the revenue contribution from the tissue paper business acquired during the year and improvements in sales of paper diapers, as well as the additional revenue from the sales of “MissMay” skin cleansing and care products. Notwithstanding there was a growing trend of price reduction, the stable raw materials prices during the year coupled with the efficiency improvement in the production and purchasing processes contributed to a reduction in production cost, the average gross profit margin stayed in line with that of the previous year, amounted to 42.3%. During the year, due to the exquisite market competition, the Group had to adjust the spending in marketing and sales promotion and as such, sales and distribution costs still accounted for 18.9% of the turnover in 2003 (2002: 18.5%).



BUSINESS REVIEW

Sanitary napkins

The market penetration of sanitary napkins in the PRC has exceeded 50%, with an annual market demand of approximately 33 billion pieces. The market of sanitary napkins has entered into a mature stage with lingered growth. Low entry barrier of the industry and excess market supply imposed certain pricing pressure on most products.

To maintain its market share, the Group not only implemented brand promotion on a nationwide basis, but also adopting flexible strategies on marketing and product sales in different regions. Together with new sales management measures, overall sales of sanitary napkin products remained flat. Sales of the "Anle" winged sanitary napkins and health care series increased significantly that offsetted the decrease in the sales volume of overall "Anle" products. Complemented by a number of measures, such as proactive marketing promotion and effective shelf management etc., the sales volume of "Anerle" sanitary napkins recorded impressive growth of 26.4% in 2003. As the overall selling prices gradually shifted towards the mid-end price level, overall sales revenue of Anerle series only increased by 3.3%. While the "Anerle" sanitary napkins target mid to high-end markets, the Group launched during the year a product series under "嬌適安心" that targets the mid-end market and received encouraging market response.



During the year, Hengan upheld its stringent control in production cost through various measures. Coupled with the stable price level of major raw materials like fluff pulp, the Group's production cost was effectively improved and the gross profit margin was maintained.

With increasing market demand, sales of pantliners during the year achieved a remarkable growth. To satisfy different consumers' needs and increase the overall market share of pantliners, the Group launched during the year "Anle" branded pantliners. Revenue from pantliner sales reached approximately HK\$153,007,000, representing a growth of 15%.

Disposable diapers

As Mainland consumers becoming more familiar with the use of disposable diapers and the increasing disposable income per capita, the market for baby diapers flourishes. Meanwhile, product qualities varied and product price difference was notable.

After the business rehabilitation in 2002, the Group has ameliorated the quality of baby diapers products for establishing a solid brand foundation. During the year, the Group launched the new "slim and comfort" series and new dry and breathable products to complement the nationwide promotion activities with the flexible pricing strategy of the Group, sales reached HK\$319,401,000, representing a substantial year-on-year increase of 25.6%. As the demand for high quality products is expected to remain strong, the Group has planned to import a new production line to expand its capacity to meet the market demand.

The sales of adult diapers or incontinence products recorded impressive growth and the sales reached HK\$13,789,000, representing an increase of 50.5%, of which export accounted for 56.6%. The Group will further strengthen its export business and it is expected that the sales of adult diapers in 2004 will stride towards new height.

Tissue paper

Sales of the prominent “Hearttex” branded tissue paper, which the Group acquired during the year, amounted to HK\$634,432,000, with an increase of 61% when compared with the previous year. With only seven and a half months period following completion of the acquisition on 16th May 2003, the tissue paper business contributed HK\$409,846,000 and HK\$37,515,000 to the Group’s sales revenue and profit respectively.

“Hearttex” products belong to the high-end tissue product category in the PRC. The products include facial tissues, pocket handkerchiefs, bathroom tissues and wet tissues. Leveraged on the increasing consumer demand for high-end tissues as well as the outstanding quality and brand reputation of “Hearttex” products, the sales continued to surge and the tissue raw material supply of the Group was inadequate to satisfy the overwhelming demand. The Group has planned to build two tissue paper raw material production base in Fujian and Shandong province and the total capital expenditure requirement for the next three years amounting to approximately HK\$800 million. It is expected that production will be taking place by phases from 2005 onwards. Following the SARS outbreak last year, the market of wet tissues swiftly expanded that the Group has recently launched to the market wet tissue series comprising cleansing, antiseptic and baby wipes with a view to cater to market demand. We believe the sales of these new products will attain encouraging results in 2004.

Skin cleansing and care products

During the year under review, the Group was dedicated in promoting the previously regional “MissMay” branded products to a national level. The Group also trimmed certain existing products so as to focus on promoting the more popular ones. Certain of the Group’s products are slowly being accepted by the market, witnessing a sales for the year of HK\$73,946,000. In view of the keen market competition, the Group is still cautiously optimistic towards the development of “MissMay” products.

Distribution and marketing strategies

The Group has a distribution network spanning nationwide. During the year, the Group continued enhancing the existing traditional distribution channels and proactively establishing sample stores in small towns throughout the country, so as to promote the innovative corporate image of the Group and further increase sales volume, as well as reinforce consumers’ confidence.

In addition, the Group continued building its modern distribution channels and at the same time consolidating the sales strategy for key accounts in the PRC. The Group will, in addition to focusing on managing the few existing national chainstores, establish business cooperation with selected influential regional supermarkets in order to increase the sales through modern distribution channels.



Employees

At 31st December 2003, the Group employed approximately 12,000 full-time and temporary staff and a majority of the temporary staff are sales promoters and production workers. The Group's human resources policies and procedures are based on performance and merit and remuneration package is determined with reference to the experience and qualification of individual staff and general market conditions. Bonus is linked to the financial results of the Group as well as performance and contribution of the individual. The Group also ensures that staff are provided adequate training and continued professional development opportunity according to their needs.

The Group has also a share option scheme available for directors and employees.

Liquidity, financial resources and bank loans

The Group's financial position remained healthy. As at 31st December 2003, the Group's bank balances and cash amounted to HK\$643,771,000, with short-term bank loans of approximately HK\$304,840,000 and trust receipt bank loans of approximately HK\$43,610,000. The decrease in bank balances and cash was mainly due to the payment of HK\$262,500,000 for the acquisition of the tissue business. During the year under review, capital expenditure of the Group in terms of installation and improvement of production facilities was approximately HK\$75,000,000.

The Group's short-term bank loans are in Renminbi. The annual interest rate ranged from 2.875% to 4.536%. Approximately HK\$18,767,000 of the loans was secured by certain production facilities and raw materials of the Group. As at 31st December 2003, the gearing ratio of the Group was 19.0% (2002: nil). The ratio is calculated on the basis of the percentage of bank loans (including trust receipt bank loans) to the total shareholders' equity.

Foreign currency risks

Approximately 99% of the Group's income is in Renminbi while certain of its raw materials and equipment purchases are required to be settled in US dollar, Japanese Yen or Euro dollar. The Group has never any difficulties in getting sufficient foreign currencies for settlement of the purchases or repatriation of profits declared by the subsidiaries to the holding company in Hong Kong. As at 31st December 2003, the Group had not issued any financial instruments or entered into any contracts for foreign currency hedging purposes.

Future prospects

The Group believes the Chinese economy will continue to grow, different cities will experience various level of development and the market demand for consumer goods will increase. To satisfy different consumers' needs, the Group will carry out adjustments in various operation processes, from product design to final products to consumers, with an aim to meeting consumers' demand, enhancing product reputation and increasing sales and market share.



Apart from the organic growth of the Group's existing business and products, the Group will continue to seek suitable products or brands and utilise the extensive sales network to propel future business development. On the other hand, the Group will further develop overseas markets to extend its reach to the global market. In view of this, the Group acquired in January 2004 70% interests in a Hong Kong base personal care and first-aid products distribution company, at a consideration of HK\$14,000,000. The acquisition has not only enriched the product portfolio of the Group, it will also help establish a solid foundation for the Group's export business.

The consumption pattern in the PRC market has entered into a new stage, the selection of product quality, price and brand image has become a complicated decision of the consumers. Our management is confident of the Group's distinguished product quality, renowned brand and appropriate selling prices in surpassing the many international and local brands. We are committed to creating a prosperous, flourishing and successful future for Hengan and bringing fruitful returns to our supportive shareholders.

Hui Chi Lin
Chief Executive Officer

Hong Kong, 23rd March 2004