4. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

4.1 Turnover

From financial year 2002 to financial year 2003, turnover increased by RMB114.9 million, or 24.46%, to RMB584.6 million. Turnover is comprised of three different segments: Retail, OEM and Other:

4.1.1 Retail

Retail turnover increased by RMB52.4 million, or 16.03%, to RMB379.3 million in financial year 2003. This increase was driven by an increase in unit volume sold and a modest increase in average unit selling price. The increase in unit volume sold reflected, among other factors, the expansion in the number of the Group's PORTS (including concessions and retail stores) and BMW Lifestyle retail outlets from 247 at the beginning of the year to 270 as of 31 December 2003. The Group's new store expansion program was disrupted by SARS. The increase in average unit selling price reflected, in part, the strength of the PORTS brand as the Group was able to achieve this increase in a PRC market that experienced deflation in the consumer goods market as well as the continued effectiveness of the Group's marketing program and brand-building activities. The Group believes the overall retail turnover increase was also a reflection of the continued growth in average annual household income in urbanised PRC cities where the Group principally locates its retail outlets, and the increased ability and willingness of these households to purchase fashion and luxury items.

Retail turnover was adversely affected by the SARS outbreak, as the new store expansion program was interrupted and traffic in shopping malls and departments stores was significantly reduced. The increase in retail turnover came mostly in the second half of the year.

In financial year 2003, turnover from concessions represented 73.21% of total retail turnover and turnover from retail stores represented 26.79% of total retail turnover. In the past, Chinese consumers have looked to department stores for their retail needs. The Group followed this trend when it entered the PRC market, selling its branded products primarily through an increasing number of concessions in department stores. As the PRC retail market has evolved, shopping malls with individual free-standing stores have been developed and Chinese consumers have begun to change their shopping patterns. In connection with this development, the Group has increased its focus on retailing through its own retail stores. The Group expects retail store turnover to increase further as shopping malls continue to be built in China and shopping patterns continue to shift toward a stronger consumer preference for shopping in malls.

4.1.2 OEM
OEM turnover increased by RMB51.5 million, or 44.08%, to RMB168.2 million in financial year 2003. OEM turnover benefited as North American retailers concerned about the war in Iraq and the increasing threat of terrorism in India and certain South East Asian countries shifted orders to the PRC. The OEM segment was able to take advantage of its strong reputation in the industry to win new contracts. As a percentage of total turnover, OEM turnover increased from 24.86% in 2002 to 28.78% in 2003.

4.1.3 Other
The Group's other turnover increased by RMB11.1 million, or 42.35%, to RMB37.2 million in financial year 2003. In 2003, Other turnover comprised mainly of wholesale sales to corporate customers and sales to retailers in smaller cities in China. It also includes export sales of BMW Lifestyle apparel as part of a new agreement signed between the Group and BMW, in which the Group was appointed by BMW to supply BMW Lifestyle apparel products worldwide. The growth in the BMW export sales business accounted for all the increase in this segment. As a percentage of total turnover, other turnover increased from 5.55% in 2002 to 6.35% in 2003.

4.2 Cost of sales

Cost of sales increased by RMB72.6 million, or 41.45%, to RMB247.9 million in financial year 2003. Most of this increase in cost of sales is directly related to the increase in turnover and sales volume in 2003.

4.3 Gross profit

As a result of the factors discussed above, the Group's gross profit increased 14.35% to RMB336.7 million in 2003, but gross profit margin decreased from 62.69% in 2002 to 57.59% in 2003. The decline in gross profit margin was particularly pronounced in the first half of the year reflecting the negative effects of the SARS outbreak. First half gross profit margin was 54.69%; while, second half gross profit margin improved to 59.81%, reflecting the diminished effects of SARS.

Gross profit margin profitability varied significantly between Retail, OEM and Other reflecting the different business dynamics faced by each segment:

4.3.1 Retail
For the retail business, gross profit increased 12.87% to RMB290.1 million in financial year 2003, while gross profit margin declined from 78.63% in 2002 to 76.50% in 2003. The management team believes the Group's gross profit margin is within the range of such margins achieved by other international fashion and luxury brands. The decrease in gross profit margin in 2003 was due to the impact of SARS. Because overall consumer traffic was down due to the reticence of ordinary citizens to venture into public places due to SARS, a larger share of our turnover, particularly in the first half of financial year 2003, were made to our VIP customers (through a "shop-at-home" program available only to members of our VIP program). PORTS has developed several important customer relationship management initiatives to cater to these high-volume affluent shoppers. One important component of these loyalty programs is that our

VIP customers are entitled to a modest discount when shopping at PORTS. Gross profit margin was thus negatively impacted, particularly in the first half of financial year 2003, as a larger proportion of our turnover was transacted with our VIP customers. First half gross profit margin was, thus, 75.85%. Second half gross profit margin increased to 76.99%, reflecting the diminished effect of SARS.

Of the Group's total gross profit, retail accounted for approximately 86% in financial year 2003. This reflects the importance of the retail business towards the overall operation of the Group.

4.3.2 OEM
For the OEM business, gross profit declined 1.33% to RMB24.3 million in financial year 2003. However, gross profit margin declined from 21.08% in 2002 to 14.44% in 2003. SARS-related travel restrictions prevented the Group's quality control staff to inspect OEM merchandise in a timely manner. As a result shipments were delayed to certain OEM customers. The Group offered discounts to affected customers as inducement and also picked up the cost of air freighting the merchandise to some North American customers. The Group also had difficulty in securing new sources for outsourcing. . The negative effect of SARS was particularly pronounced during the first half of 2003 when gross profit margin declined to 12.92%. In the second half of 2003, the OEM business' gross profit margin increased to 15.97% reflecting diminished impact of SARS and improved global political situation.

4.3.3 Other
Gross profit from other businesses increased by RMB9.5 million, or 74.07%, to RMB22.3 million in financial year 2003. Gross profit margin increased from 49.08% in 2002 to 60.02% in 2003. The increase in gross profit reflects the Group's improved bargaining position with corporate and wholesale customers as well as the additional business from the shipment of BMW Lifestyle products to BMW dealers worldwide. The management team believes that the additional business reflects, in part, the confidence of BMW in the quality and reliability of the PORTS team.

4.4 Other operating income

Other operating income decreased by RMB1.0 million, or 10.91%, to RMB7.9 million in financial year 2003. In financial year 2003, other operating income consisted principally of income from store design and decoration services provided to third parties, including department stores that contain new ***PORTS INTERNATIONAL*** concessions. Design and decoration income decreased by 16.64% to RMB4.9 million in 2003. This decrease was primarily due to the interruption in the new store expansion program caused by the SARS outbreak. In addition, royalty income from the sale of ***PORTS INTERNATIONAL*** branded eyewear increased RMB0.3 million, or 37.93%, to RMB1.2 million in financial year 2003. This increase reflects, in part, the growing brand recognition and acceptance of ***PORTS INTERNATIONAL*** branded eyewear in the market.

4.5 Distribution expenses

Distribution expenses increased by RMB24.3 million, or 15.13%, to RMB185.1 million in financial year 2003. The increase was principally due to increases in rent and depreciation. Rent expenses for retail outlets increased by RMB15.5 million, or 18.63%, to RMB98.7 million in financial year 2003. This increase was mainly due to an increase in the number of retail outlets. In particular, because the occupancy cost of a concession is equal to a percentage of the monthly turnover made through that concession, increases in the Group's retail turnover led to increases in the Group's rent expenses. Depreciation expenses increased by 56.55% to RMB9.4 million in financial year 2003. The increase was principally driven by greater renovation and fixtures costs related to an increase in the number of Group-owned stores. Other major components of distribution cost only increased modestly. Salaries and benefits increased by RMB1.4 million, or 4.46%, to RMB32.2 million in financial year 2003. This small increase was mainly due to the fact that there was little inflationary pressure on retail wages and benefits in the PRC. Advertising, the other key driver of distribution expenses, increased by RMB0.7 million, or 3.71%, to RMB19.2 million in financial year 2003. This increase in advertising was modest because of the cancellation of most large-scale cultural and social events (such as high-profile fashion shows) due to SARS.

4.6 Administrative expenses

Administrative expenses increased by RMB2.0 million, or 12.17%, to RMB18.6 million in financial year 2003 as a result of the increase in mainly rental expenses of RMB0.8 million. Rental expenses increased from RMB0.45 million in 2002 to RMB1.24 million in 2003. Administrative salaries and benefits, which is the largest category of administrative expense, increased by 3.3% to RMB12.1 million in financial year 2003.Other administrative expenses, such as, insurance, travel and general office expenses, increased by 19.09% reflecting the increased size of the administrative function, as noted above, increased travel to Munich, Germany, in support of the BMW Lifestyle initiative and the continued expansion of the Group's operations.

4.7 Other operating expenses

Other operating expenses consist principally of a stock provision that is taken against ageing inventory. In financial year 2003, inventory increased 15.31% to RMB184.8 million. In financial year 2003, the stock provision increased by RMB4.8 million, or 29.45%, to RMB21.2 million in 2003.

4.8 Profit from operations

As a result of the factors discussed above, the Group's profit from operations increased by 9.3% to RMB119.1 million in 2003 and the Group's operating margin (profit from operations expressed as a percentage of turnover) decreased from 23.20% in financial year 2002 to 20.37% in financial year 2003. The decline in profitability is largely the result of the disruption in normal business operations caused by the SARS outbreak and was particularly pronounced during the first half of 2003. First half operating margin was 15.03%; while, second half operating margin improved to 24.46%, reflecting the diminished effects of SARS.

4.9 Income tax expense

The Group's effective income tax rate decreased from 10.87% of profit before tax in 2002 to 7.21% of profit before tax in 2003. The decrease in the Group's effective income tax rate in 2003 reflects the fact that the Group received RMB6.6 million in tax refunds during 2003 pursuant to certain PRC tax laws and regulations relating to the re-investment of net profits by foreign invested companies. Under the PRC Income Tax Law, all production foreign investment enterprises established in the PRC with an operational period of over 10 years are allowed a tax holiday during their first two years of profit making operations. Such companies are then taxed for the next three years at half their income tax rate, and taxed thereafter at their full income tax rate. The full income tax rate currently applicable to the Group's subsidiaries located for tax purposes in the Xiamen special economic zone is 15%. Most subsidiaries have fully utilised their tax holiday. Ports International Marketing (Xiamen) Ltd., which operates the BMW Lifestyle business in China, has not had a profitable financial year since its incorporation and the tax holiday has not yet been triggered. Ports International (Beijing) Co. Ltd and Xiamen Xiangyu Ports Trading Co., Ltd. are not entitled to any tax holiday. Most of the Group's subsidiaries are located for tax purposes in the Xiamen special economic zone.

4.10 Profit attributable to shareholders

As a result of the factors discussed above, the Group's profit attributable to shareholders increased by 15.70% to RMB107.5 million in financial year 2003. The Group's net profit margin decreased from 19.78% in financial year 2002 to 18.39% in financial year 2003. The decline in net profit margin was largely due to the disruption in normal business operations caused by the SARS outbreak and was particularly pronounced in the first half of the year. First half net profit margin was 14.15%. In the second half, net profit margin rebounded to 21.63% reflecting an increase in profitability, due to the decline of SARS and changes in product mix related to seasonality.

4.11 Financial Position & Liquidity

The Group continues to be in a very strong financial position, with significant cash generated from normal business operations and from the proceeds of the IPO in 2003. As of 31 December 2003, the Group has roughly RMB315 million in cash and cash equivalents and time deposits with major banks compared with RMB45 million in 2002. The Group also possessed available bank loans and overdraft facilities of roughly RMB101 million, which have not been utilized, and which remain unchanged from 2002. During 2003, the Group paid off all its interest-bearing loans and borrowings, of RMB61 million, and currently has no such liabilities outstanding. As of 31 December 2003, the Group's gearing ratio was zero, based on no debt outstanding and total assets of roughly RMB692 million. The Group's gearing ratio was 17.1% in 2002. The current ratio was 6.1, based on current assets of RMB607 million and current liabilities of RMB100 million.

4.12 Acquisitions & Disposals of Subsidiaries & Associated Companies

The Group did not engage in any material acquisitions or disposals of any subsidiaries or associated companies in 2003.

4.13 Currency Risk Management

The Group's cash balances, from normal business operations and the proceeds from the IPO, are mainly deposited in Hong Kong dollars ("HK$"), United States dollars ("US$") and RMB with major international banks in Hong Kong and China.

The Group does not engage in any currency hedging, but considers its risk exposure to currency fluctuations to be minimal. Given the mix of currencies that the Group's revenue and cost base are denominated in, we feel that a natural hedge exists which limits the Group's foreign exchange risk. The Group's cost base is mainly denominated in RMB with limited Euro (Euro is the European common currency, adopted by 12 of the 15 members of the European Union, as part of the European Monetary Union) exposure. Revenue from operations is denominated mainly in RMB with limited Euro and US$ exposure.

4.14 Capital Commitments & Contingent Liabilities

As of 31 December 2003, the Group had capital commitments of RMB120 million based on authorized but not contracted for expenses, compared with RMB47 million in 2002. These expenses are related to planned initiatives such as the opening of superstores, expansion and renovation of retail operations and new product development. As of 31 December 2003, the Group has no contingent liabilities.

4.15 Capital Structure of the Group

The Group requires working capital to support its manufacturing, Retail, OEM and Other operations. In the past, the Group has financed its working capital needs principally through net cash inflows from operating activities and from short-term interest-bearing loans. As of 31 December 2003, the Group had cash and cash equivalents of RMB315 million, denominated principally in HK$, US$ and RMB, an increase of 604% from 31 December 2002, reflecting the Group's listing in Hong Kong as well as net cash inflows from operating activities before working capital changes. Net cash inflows from operating activities before working capital changes increased 11% to RMB132 million in 2003 from RMB119 million in 2002. The Group currently has no outstanding interest-bearing debt obligations.

4.16 Major Customers & Suppliers

During 2003, the Group purchased approximately 10% and 27% of its goods and services from its largest supplier and five largest suppliers, respectively. The percentage of turnover attributable to the Group's largest customer and five largest customers combined were roughly 19% and 31%, respectively. None of the Directors, their associates or shareholders (to the best knowledge of the Directors that own more than 5% of the Company's share capital) were interested at any time in the year in the above suppliers or customers.

4.17 Charges on Assets

As of 31 December 2003, the Group had not charged any of its assets.

4.18 Human Resources

As of 31 December 2003, the Group had in total approximately 2,950 employees. Total personnel expenses, comprised of wages, salaries and benefits, was RMB68 million in 2003, compared to RMB65 million in 2002.

PORTS is committed to fostering a safe workplace and a culture that prizes learning and merit-based advancement. Due emphasis is placed on training and developing our team, as PORTS' success is contingent on the efforts of a skilled and motivated work force. The Group engages in job-related training programs to help in the professional development of its employees.

PORTS strives to offer its staff competitive remuneration schemes. In addition, share options are given to eligible employees based on individual and Group performance. Share options may be granted to, among others, employees of the Group to subscribe for shares of the Company pursuant to the terms and conditions of the share option scheme adopted by the Company on 14 October 2003.

4.19 Post-Balance Sheet Date Developments

After the balance sheet date, the directors proposed a final dividend on 15 March 2004. Further details are disclosed in note 12 to the Financial Statements.