

# *Management Discussion and Analysis*

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The first half of 2003 provided an extremely unfavourable environment for the financial industry. The outbreak of SARS and high unemployment rate had resulted in a loss of loan demand and continuing bankruptcies. Although signs of recovery emerged in the second half of the year, the continued deflation and unemployment still deterred the lending environment and customers' spending. Under such operating environment, the Company slowed down its member-recruitment activities and underwriting of new receivables in the first half. With the implementation of positive credit data sharing in August 2003, it provides the Company with a comprehensive picture of an individual's total credit exposure and thereby enhances credit risk management. As a result, the Company launched a series of affinity cards and utilised its expanded merchant network to recruit new members. Together with the launch of various spending campaigns and the use of tele-marketing to cross-sell loan products to customers, the Company recorded an increase in the overall sales volume by 18.0% when compared with last year. However, with the unemployment rate still at a high level, the overall charge-off rate remained at double digit. In view of the slow recovery in the economic situation, the Company continued to exercise tight control on operating expenses, especially on advertising and branch-related expenses.

## **KEY FINANCIAL HIGHLIGHTS**

The Company achieved a slight profit growth, with net profit increased by 1.8% to HK\$119.4 million from HK\$117.3 million in 2002/03. Earnings per share increased by 1.8% from 28.01 HK cents to 28.50 HK cents in 2003/04.

Operating income was HK\$723.4 million, a decrease of HK\$92.4 million when compared with HK\$815.8 million in 2002/03. Operating expenses decreased by 14.7% from HK\$274.1 million to HK\$233.8 million, with cost-to-income ratio dropped to 32.3% from 33.6% in the previous year.

The Company's charge for bad and doubtful debts decreased by 14.7% or HK\$59.5 million to HK\$343.9 million from HK\$403.4 million in the previous year.

Despite the transfer of additional amount of credit card receivables to the special purpose vehicle under the enlarged securitisation programme, total debtor balance still recorded an increase of HK\$58.8 million, from HK\$1,876.7 million as at 20th February 2003 to HK\$1,935.5 million as at 20th February 2004.

The Board recommended the payment of a final dividend of 9.0 HK cents per share. Together with the interim dividend of 5.0 HK cents per share already paid, the total dividend for the year increased to 14.0 HK cents per share from 13.0 HK cents per share in 2002/03, with the dividend payout ratio increased to 49.1% from 46.4%.

# *Management Discussion and Analysis*

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## **INCOME STATEMENT ANALYSIS**

### **Operating Income**

With the record of gains on sales of credit card receivables at the time of securitisation and gain on disposal of investment securities and other investments in the previous year, operating income before interest expense recorded a drop of HK\$119.3 million, from HK\$959.6 million in 2002/03 to HK\$840.3 million in 2003/04. Under the securitisation programme backed by credit card receivables, the Company is required to sell from time to time certain designated credit card receivables to a special purpose entity. Interest income and fees and commissions of these credit card receivables are distributed back to the Company in the form of investment income from the seller and subordinated interests in the securitisation trust. As a result, interest income decreased by 27.2% to HK\$479.8 million from HK\$659.0 million in 2002/03.

With HIBOR continued to remain at a low level and with the renewal of HK\$540.0 million long-term bank borrowings at a lower interest rate, average funding cost moved down from 5.5% in the first half to 4.2% in the second half of this year, and ended up at 4.8% for the whole year. Average funding cost in the fourth quarter even reached 3.9%. Interest expense amounted to HK\$117.0 million, representing a decrease of 18.7% when compared with HK\$143.9 million in the previous year. The Company's net interest income recorded a drop of 29.6% to HK\$362.9 million from HK\$515.2 million in 2002/03.

The Company recorded securitisation income of HK\$252.2 million in 2003/04, as compared with HK\$192.2 million in 2002/03, representing the gains on sales of credit card receivables, investment income from the seller and subordinated interests and unrealised gains on interest-only strips and cash reserve account. The Company recorded an increase in both handling, late and storage charges and servicer fee on credit card securitisation, however, without another gain on disposal of investment securities, other operating income decreased by 0.9% to HK\$108.9 million from HK\$109.9 million in 2002/03.

### **Operating Expenses**

In view of the sluggish economy, the Company continued to exercise tight control on operating expenses, especially on advertising and branch-related expenses. Operating expenses for the year amounted to HK\$233.8 million, a drop of 14.7% or HK\$40.3 million when compared with HK\$274.1 million in 2002/03, with cost-to-income ratio at 32.3%. Staff costs and operating lease rentals represented 79.6% and 80.9% respectively when compared with last year, which was attributable to the branch restructuring and the cut down on promoter costs. Advertising expenses represented 74.4% when compared with last year, which was in line with the decline in promotion activities in the first half of the year.

# Management Discussion and Analysis

## Charge for Bad and Doubtful Debts

The Company's charge for bad and doubtful debts decreased by 14.7% or HK\$59.5 million to HK\$343.9 million from HK\$403.4 million in the previous year. This was attributed to the tightened credit control, prompt collection efforts and improved credit quality as a result of lower personal bankruptcies. In view of the slow economic recovery and high unemployment rate, the Company still adopted a conservative and prudent provisioning policy.

## BALANCE SHEET ANALYSIS

The Company's shareholders' funds as at 20th February 2004 were HK\$1,183.6 million, representing a growth of 5.8%, or HK\$64.9 million, when compared with the balance as at 20th February 2003. The net asset value (before final dividend) per share as at 20th February 2004 was HK\$2.83, compared with HK\$2.67 per share as at 20th February 2003.

## Debtor Balance

With the transfer of additional credit card receivables to the special purpose entity under the enlarged securitisation programme, credit card receivables as at 20th February 2004 was HK\$1,080.3 million, as compared to HK\$1,275.9 million as at 20th February 2003. With the launching of new purpose loan products and the change of borrowing behaviour from cash advance to personal loan, instalment loans receivable reached HK\$676.1 million as at 20th February 2004, an increase of 79.9% when compared with HK\$375.8 million as at 20th February 2003. Total debtor balance as at 20th February 2004 was HK\$1,935.5 million.

Considering the drop in overdue debtor balance for 3 months or above, the Company reduced the amount of allowance for bad and doubtful debts. Allowance for bad and doubtful debts amounted to HK\$190.4 million as at 20th February 2004, a decrease of HK\$45.5 million when compared with the previous year and representing 9.8% of total debtor balance.

Set out below is an analysis of debtor balance of hire purchase debtors, instalment loans receivable and credit card receivables which was overdue for more than 1 month:

	20th February 2004		20th February 2003	
	HK\$'000	%*	HK\$'000	%*
Over 1 month but less than 2 months	135,315	7.0	176,250	9.4
Over 2 months but less than 3 months	23,609	1.2	34,420	1.8
Over 3 months	95,470	4.9	129,332	6.9
	<u>254,394</u>	<u>13.1</u>	<u>340,002</u>	<u>18.1</u>

\* Percentage of total debtor balance

# *Management Discussion and Analysis*

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## **Retained Interests in Securitisation Trust**

The Company raised a total of HK\$850 million through the realisation of credit card receivables originated and selected by the Company to a special purpose entity, which issued trust certificates backed by such receivables.

Under the securitisation programme, the entitlements to interest-only strips and cash reserve account are stated at fair values whereas seller and subordinated interests are stated at their allocated amounts and subject to amortisation. The interest-only strips, which are retained by the Company, represent the present value of expected cash flows generated from the securitised credit card receivables during their estimated lives.

As at 20th February 2004, the Company had retained interests in the securitisation trust in the forms of seller interest, subordinated interest, interest-only strips and cash reserve account amounting to HK\$913.5 million, as compared with HK\$732.6 million as at 20th February 2003.

## **Bank Borrowings and Capital Financing**

The Company relied principally on its internally generated capital, bank borrowings and structured finance to fund its business. The principal source of internally generated capital is from retained earnings.

With the full repayment of the HK\$540 million issued debt securities in last October, and the diversification of funding sources through structured finance to cater for the growth in receivables, the Company has utilised the platform of the off-balance asset securitisation entered in 2002 to obtain an additional funding of HK\$250 million in January this year. As a result, the Company managed to reduce its interest-bearing liabilities by a total of HK\$850 million.

As at 20th February 2004, the Company had bank borrowings amounted to HK\$1,644.9 million. Out of these borrowings, 49.3% will mature within one year, 9.4% between one and two years, 16.1% between two and three years and 25.2% over three years. The Company had further strengthened its financial position as compared with 2002/03. As at 20th February 2004, total debt-to-equity ratio was 1.52, as compared with 1.63 in 2002/03. All the Company's borrowings were denominated in Hong Kong dollars.

The net asset value of the Company as at 20th February 2004 was HK\$1,183.6 million, or HK\$2.83 per share, as compared with HK\$2.67 per share as at 20th February 2003. With the full repayment of the issued debt securities, the corresponding charges were released and no assets were pledged as at 20th February 2004.

# *Management Discussion and Analysis*

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The Company's principal operations were transacted and recorded in Hong Kong dollars and thereby did not subject to any exposure on exchange rate fluctuation. During the year, the Company engaged in derivative financial instruments mainly to hedge its exposure on interest rate fluctuations.

Capital expenditure for the year amounted to HK\$15.2 million as compared to HK\$31.8 million in the previous year. This was mainly related to the system development on different operating systems, including the modification of auto-judgment system and the implementation of alarm system for credit card fraud effectuation. As at 20th February 2004, capital commitments entered were mainly related to the purchase of property, plant and equipment.

Taking into account the financial resources available to the Company, including internally generated funds and available banking facilities, the Company has sufficient working capital to meet its present requirements.

In determining the dividend payment, the objective is to reward shareholders with dividend income while retaining funds for future business development and expansion. As the economic situation is expected to continue to recover in the coming year, demand for consumer finance loans will increase. Moreover, shareholders generally expect a reasonable return on their investments and would expect a higher dividend amount when the share price goes up. In order to meet shareholders' expectation, the Board decided to increase the absolute dividend amount by 1.0 HK cents. For the year ended 20th February 2004, the Board recommended the payment of a final dividend of 9.0 HK cents per share, which together with an interim dividend of 5.0 HK cents per share, making a total dividend of 14.0 HK cents per share and a payout ratio of 49.1%.

## **SEGMENT INFORMATION**

The Company's business comprised mainly three operating divisions, namely credit card, hire purchase and instalment loan. In 2003/04, credit card operation accounted for 79.5% of the Company's turnover, as compared to 84.9% in 2002/03. For operating income after deducting charge for bad and doubtful debts, credit card operation accounted for 85.8% in 2003/04, as compared to 94.1% in 2002/03.

With the record of gains on sales of credit card receivables at the time of securitisation in the previous year, net interest income and credit card securitisation income for credit card operation recorded a drop of HK\$130.7 million, from HK\$653.7 million in 2002/03 to HK\$523.0 million in 2003/04. The Company recorded an increase in both handling, late and storage charges and servicer fee on credit card securitisation, resulting in other operating income for credit card operation to increase by 67.0% from HK\$52.6 million in 2002/03 to HK\$87.7 million in 2003/04. Operating profit before charge for bad and doubtful debts decreased by HK\$95.5 million to HK\$610.7 million in 2003/04. Although there was a drop in charge for bad and doubtful debts by 10.5% from HK\$318.4 million in 2002/03 to HK\$285.2 million in 2003/04, operating income after charge for bad and doubtful debts for credit card operation still recorded a drop by 16.1% from HK\$387.8 million in 2002/03 to HK\$325.6 million in 2003/04.

# *Management Discussion and Analysis*

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There was a drop in net interest income and other operating income by HK\$10.9 million for hire purchase operation due to keen competition in the market. With a significant decrease in charge for bad and doubtful debts by HK\$10.3 million, operating income after deducting charge for bad and doubtful debts for hire purchase operation was only marginally decreased from HK\$4.6 million in 2002/03 to HK\$4.0 million in 2003/04.

To meet the structural change of borrowing behaviour in the market, the Company launched different purpose loans such as beauty loan, decoration loan and study loan. This had boosted up the instalment loan business significantly, with net interest income and other operating income recorded an increase of 73.2% from HK\$66.5 million in 2002/03 to HK\$115.2 million in 2003/04. Together with a drop in charge for bad and doubtful debts by 21.9% from HK\$72.6 million in 2002/03 to HK\$56.8 million in 2003/04, operating income after charge for bad and doubtful debts for instalment loan operation was HK\$58.5 million in 2003/04 as compared with operating loss of HK\$6.1 million in 2002/03.

## **COMPETITIVE ADVANTAGES**

### **Synergy**

The Company continued to benefit from the launching of various well-accepted affinity cards and purpose loan products in the market resulting in the continuous growth in the number of cardholders and personal loan customers.

### **Know-how and Expertise**

AEON Credit Service Co., Ltd. has extensive know-how and expertise in the consumer finance industry and has assisted the Company in tackling the changing market environment, in particular the funding structure and credit risk and in bringing in innovative ideas on the marketing and recruitment programmes.

### **Customer Base**

The customer base of the Company is widely diversified. Using merchant network as the recruitment base, the Company had launched several new affinity cards to capture new customer sector. The new cardholders recruited in this financial year were mainly through the newly launched IDD 007 AEON Visa Card and Japan Home Visa Card, and also the AEON Jusco Visa Card. Around 70% of the customers is in the age range of 28 to 45, out of which 40% is young generation. With the launch of more affinity cards with department stores, the percentage of female cardholders has reached 65%.

# *Management Discussion and Analysis*

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## **Convenient Service**

In providing consumer credit services to customers, the Company emphasises on convenience. On the provision of payment service, besides the convenience store payment network, the Company has signed up with a bank to offer payment service to customers through phone banking, internet banking and ATM network. With the Company's extensive cash dispensing machine network coupled with its branch network and the call centres in Hong Kong and Shenzhen, customers can enjoy cash advance and personal loan services at a speedy and convenient way. As for credit purchase, the extensive discount merchant network continues to provide convenience and wide-ranging choices to cardholders.

## **GROWTH PHILOSOPHY**

The four key elements of the Company's growth philosophy are (1) ongoing product and service innovation; (2) total consumer credit services; (3) operational cost effectiveness; and (4) a strong network of affiliated companies. Consumers in Hong Kong have widely accepted and appreciated the innovative consumer credit finance services provided at low costs by the Company.