



Management Discussion and Analysis

In 2003, building on the strong foundation laid in 2002, Kelon experienced rapid development and recorded encouraging results. Turnover reached RMB6,168,110,000, representing a surge of approximately 26.44% as compared to 2002. Net profit attributable to shareholders amounted to RMB191,170,000, representing a substantial increase of approximately 125.99% over 2002. Basic earnings per share were RMB0.19. In order to prepare for the rapid development in the future, the Board of Directors does not recommend payment of a final dividend for 2003.



The encouraging results during the Reporting Period were mainly attributable to the propensity of the international home appliance corporations procuring in China. With its price competitiveness, product quality as well as technological advantages, Kelon's OEM export sales were able to grow rapidly.

In addition, the Group firmly believes that the provision of high technology and high value-added products is the key to win and consolidate market leadership in the highly competitive domestic appliances industry. The Group was hence committed to improving the technological level of its products, leading to the successful launch of various new products. Riding on this competitive advantage, the Group successfully captured the high-, mid- and low-end markets with the effective multi-branding marketing strategy. The Group's domestic distribution network was also extended into towns and villages through actively building sales channels in local markets, contributing to the steady growth of domestic sales.

Furthermore, the raw material costs of steel and plastics did not have significant impact on the Group's cost structure, attributable to the economies of scale which enable Kelon to enjoy a lower production cost than its peers in the industry. In 2002, the Group greatly reduced its costs through strengthened management and the implementation of an open tender procurement system. In 2003, Kelon further controlled its costs through enlarging the scale of production, lowering the management cost, as well as improving the bargaining power by coordinating joint procurement with Kelon's sister company, Hefei Meiling Co., Ltd. during the Reporting Period. Although intense market competition has put pressure on product prices, Kelon was able to achieve a gross profit margin of approximately 26.90% in 2003.

Turnover Structure Analysis

During the Reporting Period, the Group's sales revenues of refrigerators and air-conditioners accounted for 48.90% and 43.46% respectively of the Group's total income, while the remaining 7.64% of the total income came from the steadily growing freezers and small appliances business.

Domestic sales accounted for 70.32% of the Group's total turnover. For export sales, the Group's OEM business achieved excellent results as its revenue in 2003 surged 145.2% over 2002, which contributed 29.82% to the Group's total income and became one of the main growth drivers for the Group's income and profit.

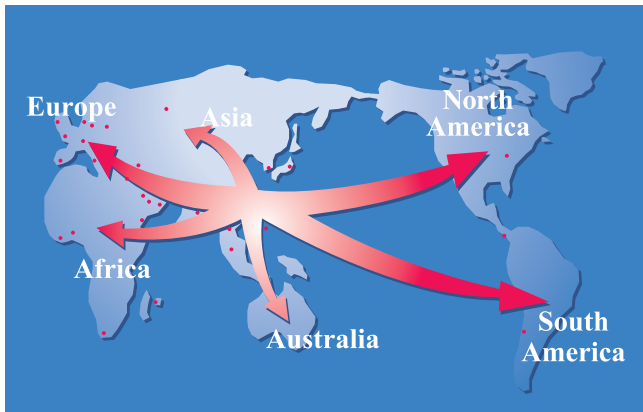
Healthy Financial Standing

During the Reporting Period, the Group continued to exercise stringent financial management. Riding on its strong foundation from the previous year, the Group was able to maintain its sound financial standing.

As at 31 December 2003, the Group's total assets reached RMB9,513,632,000, with net assets of RMB2,810,866,000. Bank balances and cash (including pledged bank deposits) amounted to RMB2,120,039,000. Current assets stood at RMB6,112,670,000.

Strong Surge in Export Sales

The Group manufactures air-conditioners and refrigerators for world renowned international home appliance corporations through its OEM services. During the Reporting Period, export sales maintained its excellent performance and continued to be one of the main contributors to the growth of the Group's revenue and profit.



The fierce competition in the OEM market has exerted pressure on the downward adjustment of product prices. With the cost, product quality and technological advantages of its OEM products, the Group experienced rapid growth in its sales orders both in terms of sales volume and sales revenues. At present, the Group's OEM products are sold to 75 countries and regions around the world, with sales from the Asia Pacific region and Europe contributing the most to the Group's turnover.

Satisfactory Growth in Refrigerator and Freezer Business

In 2003, Kelon's refrigerator business saw encouraging results, which was attributable to the strong R&D capabilities and hence the industry-leading product features and technologies. During the Reporting Period, the Group further expanded the application of its Independent Multi-cycling Refrigeration (IMCR) technology, and successfully launched the industry-leading "Kelon", "Ronshen" refrigerators with triple and quadruple cycling technologies after conducting detailed market research and product planning.

In addition, Kelon launched its "Combine" refrigerator series in January 2003, which enabled the Group to achieve comprehensive market segmentation. With the "European Style at Affordable Prices" marketing strategy, coupled with an excellent channel promotion, the "Combine" refrigerators received overwhelming responses at its launch, bringing favourable profits to Kelon.



Riding on its well-established advantage on economies of scale, the Group was able to maintain its costs at competitive levels effectively during the Reporting Period, which was positive in maintaining an excellent level of gross profit.

Sustained Competition Faced by Air-Conditioner Business



Despite the impact of the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003, the Group's air-conditioner business grew steadily during the Reporting Period.

However, competition in the air-conditioner market remained extremely intense. The market price of the products has been decreasing at a faster rate than the decrease in the Group's production costs. Many manufacturers have been forced to sell their products at prices that are lower than their costs, exerting strong pressure on the Group's product prices and affecting the contribution of the air-conditioner business in the year to the Group's overall profit.

With its multi-branding marketing strategy, and the technological advantage of Kelon's air-conditioners, the Group was able to uphold its competitive advantages under the highly competitive market environment.

Good Performance of Small Home Appliances Business

The small home appliances market also saw a year of intense competition. However, by integrating its marketing and sales operations, establishing a dedicated sales department, and sharing the sales channels with the air-conditioner and refrigerator operations, Kelon greatly enhanced the distribution network coverage for the small home appliances. Adding to the launch of the "Combine" small home appliance series to capture the low-end market, these measures benefited the significant growth of the small home appliances business.



High Technology Products

Kelon believes that “leading technology” is the key to sustainable and healthy corporate development. During the Reporting Period, Kelon launched a number of industry-leading products:

Kelon “Digital Shuang Xiao Wang” Cooling and Heating Air-Conditioner



Riding on the patented technology of the Kelon “Shuang Xiao Wang” cooling and heating air-conditioners launched in 2002, the Group launched the “Digital Shuang Xiao Wang” cooling and heating air-conditioners during the Reporting Period, breaking a new record in terms of energy efficiencies.

Compared with the proprietary technology of the “Shuang Xiao Wang” cooling and heating air-conditioners launched in 2002, the cooling efficiency of Kelon “Digital Shuang Xiao Wang” cooling and heating air-conditioners rose from 3.8 to 6.0, while the heating efficiency also increased from 4.2 to 6.0, which is 160% higher than the national standard of 2.3 and 120% higher than the national energy-saving standard of 2.7. This is the highest level attained among international peers.

Kelon Refrigerators with Triple and Quadruple Cycling Technologies

Further to the launch of its IMCR technology in 2002, the Group extended the application and developed refrigerators with triple and quadruple cycling technologies during the Reporting Period. Surpassing the competitors again, these new products met the needs of high-end consumers for free selection of temperatures in multiple compartments, precise control of temperature, and the need for environmentally friendly and energy saving features, offering Kelon room to strive for higher profits.



Kelon IMCR
“Quadruple Cycling”
refrigerator

Energy-Saving Refrigerators Receiving International Recognition

Over the past 20 years, Kelon has been fully committed to improving the energy-saving levels of its products. With Greencool Enterprise Development Company Limited (“Greencool”) becoming Kelon’s single largest shareholder, the refrigerators’ energy-savings levels have been raised further through the synergy effect of Kelon’s strong technological background and Greencool’s world-leading refrigeration technology.

In 2002, the Group launched the first IMCR refrigerator in the PRC, which consumed only 0.38 watt of electricity per day and brought about lower electricity usage, more energy savings and more convenience. In 2003, the Group broke the record of energy consumption again by developing the BCD-209 model refrigerator with 0.35 watt of electricity consumption per unit per day and energy savings of 0.94 watt of electricity consumption per unit per day. Reaching the A++ grade in European energy efficiency levels, this BCD-209 model refrigerator has broken the world record with the lowest energy consumption level per litre per day. Furthermore, it has received the only “Energy Saving Grand Prix” as well as the “Energy Saving Improvement Award” under the refrigerator manufacturer incentive program in China’s Energy Saving and CFC-Substitute Refrigerator Project. The project was initiated by the United Nations Development Programme, the Global Environmental Facility, the State Administration of Environmental Protection and the China Household Electrical Appliances Association.



Enhancing Product Competitiveness through “Project of Perfection”

During the Reporting Period, Kelon continued to implement the “Project of Perfection”, aiming at meticulous design, delicate manufacturing techniques, elegant products and attentive customer services. The initiative establishes the Group’s vision to enhance the competitiveness of Kelon’s products and to achieve leading international standards. Through the “Project of Perfection”, not only are quality controls and product designs enhanced, wastage in each production process is minimized and the corporate management process is optimized, largely offsetting the pressure on production costs caused by the increased cost of raw materials.

Well-Defined Positioning through Multi-Branding Strategy

Kelon’s products have been sold under the “Kelon”, “Ronshen” and “Huabao” brands for many years. The “Kelon” and “Ronshen” brands are well-known PRC trademarks, targeting at the high- to mid-end markets. These brands have been widely applied to a range of product series for air-conditioners, refrigerators, freezers and small home appliances well-received by users.

To capture the low-end market and to enlarge market share, Kelon launched the “Combine” brand in 2003, earning overwhelming market responses right from the start.

The success of the “Combine” brand facilitates Kelon’s all-embracing coverage in the high-, mid-, and low-end markets, contributing positively to the Group’s turnover and profit.



Cost Controls

Kelon accomplished significant results in cost controls during the Reporting Period. In addition to cutting down the procurement costs of raw materials and components through the analysis of market trends and the employment of flexible purchasing rules, the Group also lowered the design cost of products by optimizing the designs of the products and the refrigerating systems. This partially offset the pressure on production costs caused by the increased cost of raw materials.

Economies of Scale Realized by Kelon-Meiling Cooperation

Kelon's single largest shareholder, Greencool, acquired a 20.03% equity interest in Hefei Meiling Co. Ltd. ("Meiling"), an A- and B-share listed large-scale domestic refrigeration appliance manufacturer in China, and has become Meiling's single largest shareholder. The combined refrigerator capacity of Kelon and Meiling places both parties in a highly influential position in the industry in Asia.

To leverage the advantage of economies of scale, Kelon and Meiling cooperated in every aspect from procurement, R&D, sales and marketing, to servicing network. Through mutually complementing their competitive advantages and sharing of resources, significant results were achieved in enhancing the competitiveness of both enterprises. In terms of procurement cooperation, Kelon and Meiling jointly procured through a global open tendering exercise for over 500 categories in August 2003 to enhance bargaining power. Over 1,300 suppliers from the domestic and overseas markets participated in the tender. For sales channel cooperation, Kelon and Meiling organized the "2004 Kelon-Meiling Distributors Annual Meeting" in Hefei in December 2003 attended by close to 1,500 dealers, during which nearly 200 categories of products under the "Kelon", "Ronshen", "Meiling" and "Combine" brands were exhibited. These initiatives laid a solid foundation for cooperations of the two enterprises in the coming year.

Record Breaking Production Efficiency

In 2003, under the management's internationalized production management model, Kelon's production efficiencies were greatly enhanced and production cycles shortened, strengthening its market responsiveness. For example, production cycle of air-conditioners was shortened from 15 days to 9 days, with the daily productivity of indoor and outdoor products rising 22% and 21% respectively. Its highest productivity in a single month also broke the record by achieving a 52.2% growth as compared with 2002.



Sales Channel Expansion through “龍霸行動”

In 2003, the Group launched the “龍霸行動” throughout the PRC to actively expand its sales channels. Professionals were assigned to the second-, third- and fourth-tier markets in the PRC for the development and planning of sales channel and network expansion. As of December 2003, the number of the Group's air-conditioner wholesalers, direct retailers and franchised retailers largely increased by 28%, 46% and 102% respectively as compared with the same period in 2002. The point of sale for refrigerators also grew by 109% as compared to the same period in 2002, bringing the Group's point of sale coverage for refrigerators in the PRC to approximately 76% and achieving the target as set in early 2003.

Optimization of Management and R&D Teams

During the Reporting Period, Kelon was dedicated to the internationalization of the management team. The newly recruited senior management, instrumental in Kelon's future development, are familiarizing themselves with the culture of Kelon, and they are building a strong foundation for Kelon to compete in the international marketplace.

The Group's international sales department recruited talents throughout the world during the Reporting Period, doubling its overseas sales team members. To uplift the quality of its middle to senior management team, Kelon established a post-graduate human resources recruitment team in 2003, facilitating the number of master and doctorate staff members to increase in folds. At present, 50% of the Group's senior management members obtained post-graduate degrees. In addition, the Group organized a "Chairman's MBA Training Class" to optimize its human resources in terms of management, technology, as well as sales and marketing. After introducing 400 university graduates to the Group in 2002, Kelon recruited another 1,500 university graduates and 500 fellows during the Reporting Period.

For the R&D talents, Kelon's R&D team had 700 members as of December 2003, whom have demonstrated economies of scale and contributed much to the Group's R&D achievements.

Basic Medical Insurance Scheme for Employees

Since 1 January 2002, according to the Provisional Rules of Basic Medical Insurance in Shunde City (順德市基本醫療保險暫行規定) issued by the People's Government of Shunde City on 2 December 2000, and the relevant accounting requirements of the PRC, the Group has implemented the basic medical insurance policy for its employees. Such amount involved has already been stated as the Group's welfare expenditure.

Significant Events

On 18 May 2003, the resignation of Ms. Yu Xiaoyang as an independent non-executive director of the Company and the appointment of Mr. Xu Xiaolu as an independent non-executive director of the Company were approved at the Annual General Meeting.

On 18 May 2003, the resolution to utilize the Company's statutory common reserve and capital reserve to make up for the Company's accumulated losses was approved at the Annual General Meeting.

On 4 June 2003, the Shenzhen Stock Exchange cancelled the special treatment on the Company's A shares. The stock name abbreviation of the Company on Shenzhen Stock Exchange has been reinstated as "科龍電器".

With the dedicated effort of the entire Group, Kelon's special treatment ("ST") status has been ultimately removed, and the Group is posed on the brink of a bright future. Looking forward, the Group will strive to maintain its competitiveness in possessing leading technologies as well as strengthen its leading position in the domestic refrigeration appliances industry in the PRC.

The Group will also actively promote its proprietary "Shuang Xiao Wang" and IMCR technologies, and further expand the application of these advanced technologies to more product lines to enhance the overall technological benefits of its products. This will lead to new driving forces for growth and bring greater competitive edge in the highly competitive market.

In addition, the Group will continue to implement its comprehensive multi-branding strategies to strengthen the market coverage and to gain a larger market share. The Group will also strictly control product quality and production costs to increase the market competitiveness and the profitability of its products.

Over the past two years, despite the impact of price increase in raw materials, the Group's cost controls achievements were at the highest level amongst industry peers, which contributed significantly to the Group's profitability. In the future, the Group will be dedicated to lowering the costs incurred throughout every process, from finished products getting off the production line to their delivery to the consumers. The Group will also lift its profitability to a higher level through optimizing the organizational structure and enhancing efficiency.

Competition in the PRC's domestic refrigeration appliances industry will remain intense, while market competition in the air-conditioner industry in 2004 will be even more severe. The Group hence is unable to make a projection on the future profitability of its air-conditioner business. On the other hand, competition in the refrigerator industry is comparatively under control, making the Group confident in the future development of its refrigerator business. Strong growth in the export business is expected to be one of the main growth drivers in the Group's future development.

Looking forward, by strengthening its internationalization strategy in addition to maintaining its leading position in the PRC market, the Group is set to work towards its goal of becoming a leading international domestic appliances manufacturer.

