# MANAGEMENT DISCUSSION AND ANALYSIS

Fiscal 2003/04 was an exceptional year for the VSC Group. Not only was it the 10th anniversary of VSC's listing on the Main Board of The Stock Exchange of Hong Kong Limited (the "Stock Exchange") since 1994, it was also a year when the VSC Group thrived, both operationally and financially, with the successful introduction of new businesses, operations, locations and capital to establish a solid foundation for further growth. Turnover increased by 29% to a record high of HK$3,549 million and profit attributable to shareholders improved by 34% to HK$81 million. Such development was achieved under a turbulent operating environment, particularly during the SARS outbreak in Hong Kong and Mainland China in the early 2003/04 and the global soaring steel price throughout the rest of the year. These encouraging results are driven by the VSC Group's focus and concerted efforts on the following key parameters in the execution of its corporate strategies:

1) **Tap the Strongest Growing Economy, China**
The VSC Group is committed to the China market, the world's fastest growing and emerging market. Turnover generated from its China operations amounted to HK$2,378 million in fiscal 2003/04, representing 67% of the total turnover as compared to 54% or HK$1,477 million in fiscal 2002/03. New businesses and operations were set up or acquired in Shanghai, Tianjin, Beijing, Shenzhen and Guangzhou to capture the booming business opportunities in these regions due to robust economic growth of China.

2) **Target the Strongest Growing Sectors**
The four target industries on which the VSC Group focuses to serve continue to fuel strong demand on its steel products. These four target sectors, namely information technology and telecommunications, home appliances, construction and automobile parts are all fast growing and consume high proportion of all kinds of steel in its finished products. We carefully select reputable and reliable high-volume users in each target industry as long-term key customers and provide them with the best services to meet their ever-rising demand.

3) **Select and Invest in Loyal Customers**
The China market is a very large market, but it can also be quite volatile. The VSC Group has taken a long-term view of its businesses in China. As such, the VSC Group's strategy is not to adopt any short-term approach to fast and significant growth, such as entering into a large market and to capture massive market share through aggressive means (e.g. price wars and undercutting other competitors). Instead, the VSC Group is willing to exercise discipline to "invest" in its customers, focus on individual market sectors both geographically and in terms of products offerings. The VSC Group will "prune" its customer base to a very selected few that will appreciate the VSC Group's value propositions. Securing business dealings with these customers often take time and effort but such investment is justified as these customers are more sizable, more professional, covering a more diversified global market, hence, will provide the VSC Group with a more stable business environment and room for sustainable growth.

4) **Offer High Value-added Processing Services**
The VSC Group strives to expand and enrich its product offering and value-added processing

services to offer a total solution for the customers. Our value proposition embraces processing services of cutting, slitting, punching, bending, stamping, coating, assembly, machining, technical advisory and quality control for both construction and industrial steel applications, offering through both internal production facilities and outsourcing to external parties to maximise the processing efficiency and capability for our customers.

5) **Enhance Distribution Network and Supply Chain**

The VSC Group has strategically developed services centres and sales outlets in a host of major cities throughout China to form a strong distribution network. A regional headquarters was set up in Shanghai during the year to oversee the China operation and further enhance our coverage in the northern and northeastern China. Global supply chain management remains our core competence, having developed excellent relationship with overseas and domestic steel mills, this enabled us to support the expanding distribution network with secured supply of quality steel even under a "supplier-centric" market, in which steel price soared during the year.

Along such theme, both the operational groups of the VSC Group, CAMP and CMG, with their respective focus on steel processing and steel distribution, have collaboratively developed and refined the businesses and contributed to the encouraging growth of the VSC Group as a whole for the financial year under review.

***China Advanced Materials Processing ("CAMP")***

The VSC Group's CAMP operations consist of three business units: 1) coil centre operations in Dongguan, Tianjin, Guangzhou and Nansha, which provide rolled steel processing services to OEM manufacturers of white goods, electrical appliances, computers and automobile parts in the respective regions; 2) manufacturing of customised enclosure systems in Shenzhen, which carries out a variety of precision metal processing and assembly services for telecommunication, automobile and other industries; 3) distribution of engineering plastic resins and injection moulding machines to industrial manufacturers of household appliances, audio/video equipments, telecommunication applications and computers located in China.

The CAMP division or "Service Centre" as it is known in the western industrial countries, is predominantly engaged in high value-added physical processing in factories that yields higher profit margin. China, at times referred to as the "factory of the world", continues to lead the world with the largest tonnages in steel production, consumption and import (industry reports have said that for 2003 the total consumption of steel in China was well in excess of 200 million metric tonnes which put the China market multipled in size as compared to other more developed western industrial countries). This translates into huge demand of high value processing services for flat steel products, especially from the VSC Group's four target

# CAMP Service Centres

# CAMP

Engages in high profit margin, value-added physical processing, serving information technology and telecommunications, home appliances and automobile parts industries in China


# CHINA ADVANCED MATERIALS PROCESSING

sectors. When comparing to western developed countries, the market for steel service centre in China is still at its infancy with a very low penetration rate. The VSC Group's knowledge base and early inroad into these sectors has given it an "early mover" advantage with relatively few competitions addressing a vast potential market. As a result, the CAMP operations have thus gradually become a more prominent profit engine of the VSC Group and will be the focus of the VSC Group's future business development. Turnover and segment results generated from the CAMP operations have increased by approximately 43% and 18%, respectively, over that in 2002/03 and accounted for approximately 19% and 51%, respectively, of the VSC Group's total turnover and segment results.

***Coil Centre Operations***

In a nutshell, a coil centre operation is an important step in the steel consumption value chain between steel makers (i.e. steel mills) and finished product producers (i.e. end product manufacturers or OEM manufacturers). A typical operation buys finished steel in the form of large steel coils, processes the coils (through slitting, cutting and leveling into smaller steel coils or flat sheets) to the exact shape, size and quantity as specified by the customers and delivers at the exact time the customers require. Traditionally, such operations constitute the front-end raw material processing for most steel consumption manufacturers, but as these manufacturers mature towards higher value production, they begin to sub-contract these operations to reliable local vendors. Such progression is a necessary step as these manufacturers mature, whether they are OEM or inhouse manufacturing, and can be seen as part of the manufacturing maturing process as experienced by most of the more developed industrial countries like the US or Europe. Value propositions to customers include, inter alia,

— less inventory through just-in-time (JIT) delivery with a 24 to 48 hours' order lead time;

— reliable supply chain management through working closely with the suppliers, logistics vendors and customers;

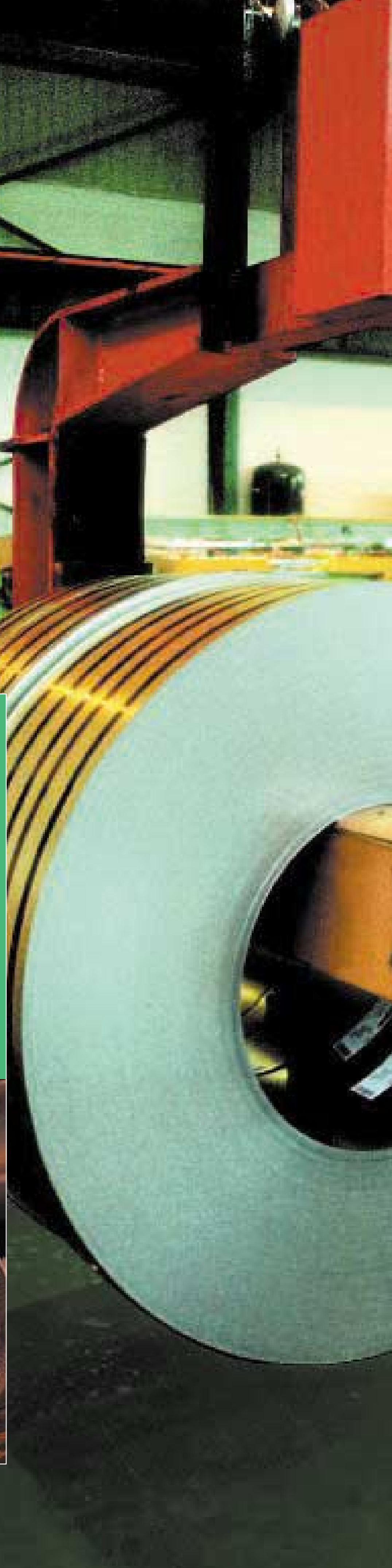
— lowering in production costs via reduction in raw material scrap and materials handling costs;

— savings in investment of machinery and factory space;

— ensured quality of steel in terms of surface treatment, thickness and other technical requirements; and

— flexible and reliable supply of product range from different sources/grades of steel mills.

The coil centre operations of the VSC Group currently consist of three main subsidiary factories in Dongguan, Tianjin and Guangzhou as well as its 14% investment in the joint venture company in Nansha. During the year, the VSC Group expanded the capacity of its Dongguan factory (completed in July 2003), built a



# COIL CENTRE

"greenfield" factory in Tianjin (commenced operation in July 2003) and acquired an existing factory in Guangzhou (completed by end of March 2004), resulting in close to tripling of its processing capacity as compared to last financial year.

With the addition of an automated slitting machine in the first quarter and the dedicated team's effort to develop high-volume key customers, the **Dongguan coil centre (DGCC)**, managed to achieve an increase in turnover of about 27% to a record high of approximately HK$353 million. As compared to last year, profitability was however adversely affected by the SARS epidemic in the early 2003/04 and the volatility in the steel price throughout the rest of the year. During the SARS outbreak, orders were delayed or cancelled since the overseas end customers of the OEM vendors or manufacturers of international brand names we served refrained from traveling to Mainland China. Throughout the year, the steel price was driven upwards by the rising raw material costs such as iron ore, coal, electricity and freight charges. Coupled with the blazing demand of steel underpinned by robust economic growth in Mainland China and the inability to produce adequate quantity of quality flat steel products domestically, the price for imported steel has seen an unprecedented sharp rise within a short period and remained buoyant for much of the period under review. Such persistent high costs placed an intense pressure on our profit margin as the VSC Group's core strategy is to be "customer centric" in the long run while leveraging on its relationship with steel mills to maintain its competitiveness in the current "supplier centric" market environment. As such, the VSC Group has decided to "invest" in its customers, and has not passed on the entire steel price rises to certain customers selectively which resulted in the gross margin being eroded to 18% from 25%. Nevertheless, such pricing strategy has enabled DGCC to pave the way for businesses with more high-volume reliable long-term customers. The key customers portfolio has healthily expanded with a wider dispersion of major customers as reflected by the sales contribution of the top 10 customers changing from over 50% to about 36%. Reflective of its continuous efforts to improve production capacity and efficiency, DGCC was awarded the status of New and High Technology Enterprise in June 2003 and Advanced Technology Enterprise in December 2003 as recognition of its high productivity and technical innovation. Monthly output tonnages are on the rising trend and reached new high of over 8,000 metric tonnes in March 2004. For the year under review, DGCC has against such difficult backdrop achieved segment results of approximately HK$52 million, a slight 11% drop from last year record high figure of HK$58 million. As mentioned above, the profit margin was adversely affected in the short term because the VSC Group has taken a more long-term strategy to absorb some of these sharp rises in steel prices to "invest" in the loyalty of its customers which the VSC Group believe will go along way to differentiate the VSC Group positively from the future more competitive landscape.

The "greenfield" **Tianjin coil centre (TJCC)** is the VSC Group's first inroad of steel service centre to the northern China market, strategically located to service the industrial manufacturers in Tianjin, Beijing, Shandong, Liaoning and Hebei which constitute a very different market demography. Since production commenced in July 2003, very encouraging progress in terms of customer development and production improvement has been made. Large customers such as Kelon, a domestic manufacturer with multiple factories in several provinces, and LG, a large Korean manufacturer have been secured. Unlike its Dongguan sister plant, whose clients are mainly OEM vendors with their end products exported to the US and European markets, TJCC's target customers are mostly manufacturers of household appliances, electronics equipments, transformer, lift and automobile parts having their finished goods distributed in the China market. Other than importing steel from overseas, toll processing and domestic sourcing of steel would also be required to serve some of these local customers. By transferring the knowledge base and several staff from Dongguan to fill key positions of this new facility, production run has been speedily set up and continuously improved to attain a current monthly output of about 40% of DGCC. It is also planned to further streamline the operation process and launch a series of training programmes to increase the production tonnage and obtain ISO accreditation within 2004. For its first 9-month operation in 2003/04, turnover generated from TJCC amounted to approximately HK$38 million. Although segment results made an operating loss of approximately HK$0.7 million after one-off absorption of the pre-commencement expenses of HK$0.5 million, TJCC has already attained operational breakeven and is expected to be a profit contributor to the VSC Group in coming years.

Consistent with its stated mission to establish a chain of professionally managed steel service centres in various strategic locations in China using an "enterprise" management approach, the VSC Group acquired a 70% stake in an existing plant located at Huangpu of Guangzhou in late March 2004. The **Guangzhou coil centre (GZCC)** is the third similar coil centre that the VSC Group is responsible for operations and managements. Our partner, Shinsho Corporation, is the trading arm of a large Japan steel manufacturer — Kobe Steel Group. Through such strategic alliance, the VSC Group expects to secure a new source of stable and high quality supply of steel for its entire coil centre operations. The VSC Group can also embark on the established Japanese clientele in both automobile and home appliance sectors of the existing GZCC. GZCC has been in operation since 1996. It is equipped with advanced Japanese machineries and the capacity is similar to DGCC of approximately 100,000 metric tonnes per annum, which at the time of VSC's acquisition was only operating at 20~30% capacity utilisation rate. Guangzhou is now developing into a major automobile and home appliance manufacturing hub in southern China with vast demand and business opportunities for the VSC Group to exploit. We are now rationalising the resources and undergoing necessary restructuring of sales, marketing and production functions of this acquired operation to increase its business and improve profitability.


# ENCLOSURE SYSTEMS MANUFACTURING

The VSC Group's 14% owned **Baosteel Jingchang joint venture** in Nansha continued to pose another strong year of growth in its fifth year of operation. 2003/04 turnover of the joint venture surged by 149% to over RMB495 million. Annual volume also exceeded 95,000 metric tonnes in tonnage for the year 2003. Benefiting from the substantial increase in output in absorbing the fixed costs, profitability also improved impressively. Net profit for the financial year under review amounted to approximately RMB13.3 million. Dividend received during the year was about RMB0.4 million and dividend declared after year end based on distributable profit amounted to about RMB1.3 million. The Nansha joint venture continued to grow and expand, leveraging on the strong support from its shareholders, Shanghai Baosteel Group and Japan Mitsui Group, in supplying of steel and working capital. Ongoing improvements were made in adapting the latest technology and modern management tools such as balance scorecard to set specific measurable targets on areas of financials, customers, internal operation and training and development. Phase 2 expansion was almost completed by year end of 2003 and in order to grasp the booming business of automobile parts in the region, a plan for Phase 3 expansion is also being considered to buy land for the new production facilities. As in Phase 2, the Nansha joint venture will use its own internal resources and own bank borrowing to finance the requisite capital expenditure for Phase 3.

***Enclosure Systems Manufacturing***

After 15 months of operation, the **VJY enclosure systems manufacturing (VJY)** is in its second full year of production and has accomplished encouraging performance by making 2003/04 its first profit-making year. Turnover surpassed the RMB100 million mark and has increased by 174% to about HK$109 million. Segment results achieved an operating profit in the amount of about HK$9 million, as compared to a loss of HK$6 million in the previous year. Such achievement testifies to the effectiveness in implementing the VSC Group's strategic decision in investing substantial resources and efforts to move downstream to provide precision metal processing services for fast growth industry of telecommunication and automobile.

Currently, VJY has secured its position as one of a selected few core vendors of customised enclosure systems to the two leading domestic PRC telecommunication equipment providers/manufacturers, Huawei and Zhongxing. Telecommunication industry in China thus far is characterised by its high-growth potential, with double-digit annual growth rate of telecommunication investment and Internet users. VJY's top customer, Huawei, enjoys a leading position in the 3G technology and is exporting extensively its products to markets outside of Mainland China, for example, to the Hong Kong mobile phone network provider — Sunday. Using key account management and closely monitoring the telecommunication market trend, VJY has maintained a strong foothold in the Mainland China telecommunication industry to well serve its key customers' needs in both domestic and overseas markets. Businesses with other major customers such as Emerson, the renowned U.S. power supply equipment


# PLASTICS & MACHINERY

provider and Japan Isuzu's Guangzhou plant for supply of passenger bus parts were also developed with encouraging progress.

VJY will continue to strengthen and develop its technical capability as a core competence to enhance competitiveness. Production flow and processes were redesigned and refined with an update of product mix through Total Cycle Time methodology and Oracle ERP application to raise output capacity and planning achievement rate while production lead time, work in progress and rework are to be optimised. Outsourcing of certain less stringent and demanding production processes was being implemented from time to time to provide production flexibility and to enhance capacity. VJY's profit margin was affected by the high raw material costs especially during the second half of financial year 2003/04 and in particular the metal costs such as steel and copper reached historic highs. However, capitalising on its excellent steel supply chain management and relationship with the major steel mills the VSC Group have lessened such impact to VJY's raw material costs. Special efforts will be placed to further focus on cost reduction measures and mechanism to lower materials costs and manufacturing expenses. The VSC Group reckons the need and is committed to build manufacturing excellence in VJY to turn it into an efficient and low cost operator to meet the tremendous sales growth opportunity in future.

***Plastics and Machinery Distribution***

For the year under review, the **plastics and machinery distribution** recorded a 11% increase in turnover to approximately HK$172 million and a 21% growth of segment results of approximately HK$10 million. For the plastics division, sales volume grew by 34%, representing the team's effort in promoting the engineering plastic resins of Samsung Atofina, Samsung Cheil, Mitsubishi and GE Plastics. The team rendered value-added technical advice to customers in their new products development and coordinate with the suppliers in testing the applications. In light of the rising living standards and higher product quality in Mainland China as well as the lowering of import duty on resins with Mainland China's concession into the WTO, demand for high quality imported resins by the domestic manufacturers has been increasing. During the year, the division formed a local sales team in Shenzhen to exploit the local market. A wholly owned trading company in Shenzhen will be set up in mid 2004 to target this market with full force. A sales team will also be established in Guangzhou with its office locating in GZCC to explore cross-selling opportunities to its existing customers and expand the coverage to Guangzhou, Shunde, Zhongshan and Zhuhai. On the other hand, the machinery division was affected by strong competition and poor sentiment for new capital investment, especially for the division's costly high-end Japanese injection moulding machinery. Commission from new machineries sold was much reduced. The division aims to improve its revenue by promoting more maintenance programmes and also developing the second hand machinery market.

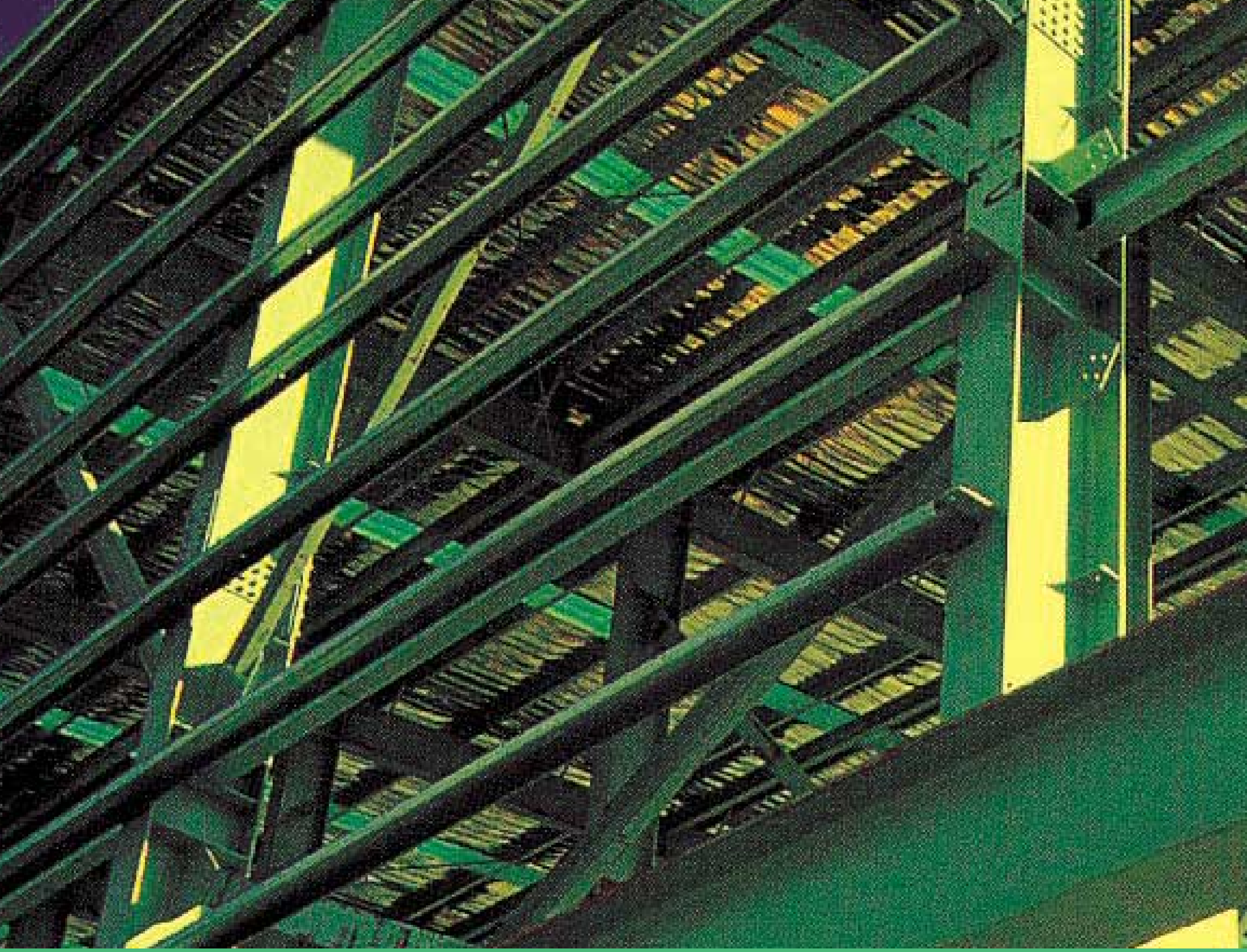
# PRODUCTION PROCESS

## Coil

We provide high value-added services to and work closely with home appliance, telecommunication, information technology and automobile parts manufacturers

Metal Parts

End Products



# CMG

Dominating a niche part of the market, namely the distribution of selected construction steel and building products to reputable dealers and end users in affluent cities including Shanghai and Shenzhen

# CONSTRUCTION MATERIALS GROUP

## *CONSTRUCTION MATERIALS GROUP ("CMG")*

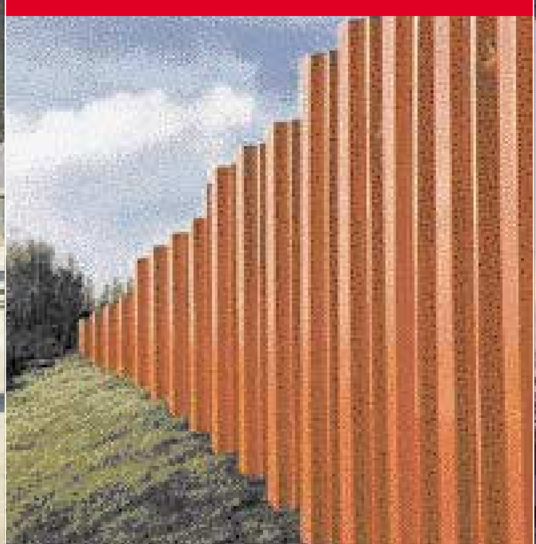
As stated in last year's annual report, the VSC Group has expanded its CMG coverage from Hong Kong to a few selected major cities in Mainland China (e.g. Shenzhen and Shanghai) to capture the booming market potential for construction materials in those regions. In China, unlike most more industrialised western countries, the PRC construction industry is the top steel-consuming sector, accounting for about 54% of total annual steel consumption in the country. It was estimated by PRC's domestic experts that steel consumption by construction industry in 2005 would amount to 139 million metric tonnes per annum, which is larger than most industrial nations' total annual consumptions. Such demand is driven by flourishing construction activities in relation to modernisation in major cities and towns, urbanisation of rural areas as well as infrastructure development of highways, railways and utilities facilities. Capitalising on its global supply chain management capability and well established distribution networks in various parts of China, CMG is able to identify a niche part of the market, namely the distribution of selected construction steel and building products to reputable dealers and end users in certain major cities including Shanghai and Shenzhen. Consisting of a team of highly seasoned and experienced steel professionals who are well versed in the price trend and demand and supply of steel, CMG has successfully developed new businesses of imported structural steel, sheet piling, plate, rebars and galvanised steel (GI) in those major cities, which to a large extent accounted for the increase in turnover of CMG during the year. Turnover and segment results of CMG in 2003/04 have increased by 26% and 3% to approximately HK$2,873 million and HK$68 million, respectively, and accounted for approximately 81% and 49% of the total turnover and segment results, respectively, of the VSC Group.

### *Steel Distribution*

Predominantly the revenue model of VSC Group's CMG operation is steel distribution, which embody stockholding business of construction steel in Hong Kong, steel distribution in Mainland China together with its 18.9% investment in the iSteelAsia Group, distribution of mainly domestic steel products in eastern China by its 66.7% owned joint venture, Shanghai Bao Shun Chang ("BSC"), and supply of GI to and distribution of pre-painted galvanised steel (PPGI) for its 10% owned joint venture with the Beijing Shougang Group. With the added emphasis in the Mainland China market, sales revenue from distribution of steel in Mainland China increased from 47% in 2002/03 to 61% of the total steel distribution turnover in 2003/04.

Steel distribution in Hong Kong was subject to a very challenging operating environment for the year 2003/04. The continuous setback in the property market spread to the construction and building products industries and reduced number of construction contracts, notably in the private sector. While outbreak of SARS further hit the economy of Hong Kong to the bottom, in the second half of financial year 2003/04,

# STEEL



the market sentiment improved dramatically after the PRC central government rolled out a series of measures including Closer Economic Partnership Arrangement (CEPA) and relaxation of individual travel visa to Mainland Chinese of a number of cities to bolster and revitalise Hong Kong economy. During the second half of the year under review, Hong Kong staged a strong recovery in the tourism and retail sectors. The real estate market also started to turn more positive and active with the resumption of land auctions by the Hong Kong government announced by late 2003. These are good signs for the Hong Kong construction industry and hence the demand for steel, leading to the anticipation that recovery was on the verge which if sustainable will be beneficial to the VSC Group in the coming years.

Under such a difficult business environment, the **Hong Kong steel stockholding department** (which consists of rebars, structural steel, soil nails and couplers) finished the year 2003/04 with a slight increase in turnover of 2% and a 5% decrease in gross profit. In terms of tonnage, this department turned about 444,000 metric tonnes of steel, which is a decrease of 24% from the same period last year. Performance of the major unit, rebars stockholding business, is satisfactory. Sales improved by 7% to about HK$950 million and gross profit mildly dropped 2% to HK$52 million. As for the structural steel businesses, turnover decreased by 19% to about HK$188 million but gross margin has been slightly improved to 7.3% as compared with 6.8% over the same period last year. The engineering products business, coupler and soil nail, continued to grow steadily by 17% to about HK$15 million. As the first player engaged in the rebars stockholding business in Hong Kong since 1961, the department has built a very solid foundation and loyal relationship with many major property developers and contractors. The department continued to utilise key account management and centralised project database in its sales and marketing endeavours. Diligent efforts were also applied to rationalise resources, e.g. controlling operating costs, streamlining operation efficiency and strengthening supply chain management. Currently, the department's contracts-on-hand total about HK$760 million extending to year 2006. Highlight of some major projects included International Exhibition Centre at Chek Lap Kok, Phase 7 Development for The Hong Kong Polytechnic University, Superstructure Works at Phase 6 at Planning Area 19 in Tung Chung, Student Hostels Phase 3 Development at City University, Sands Macau Hotel and Wynn Resorts Macau. Although it is believed that the worst is over for Hong Kong economy and local construction sector, the department remains cautious in adjusting its business strategy. With the recovery of rebar price driven up by the supply and demand of the world and the shortage of iron ore, the department aims to maintain a sustainable profit contribution to the VSC Group.

As mentioned before, keenly aware of the strong demand underpinned by the booming construction industry in Mainland China, the VSC Group is able to develop a niche market of distributing selected high quality steel products in several major cities where a lot of building and infrastructure projects are carried out by foreign investors. The most significant progress made by CMG during the year was to develop the business of imported structural steel, mainly H-beams and sheet piles, into Shanghai. Taking advantage of import relaxation and reduced custom duty for H-beams due to China's accession into WTO, the VSC Group grasped the opportunity to successfully introduce high quality imported structural steel to Shanghai. As compared to the traditional approach of foundation work using rebars and concrete, use of H-beams saves construction time, offers flexibility in structural design and increases saleable area with less columns, which are all very well received by developers in the booming Shanghai property market. The VSC Group further enhanced the application and popularity of sheet piles by introducing the "Silent Piling" technology to the Shanghai market. This advanced method highlights the product's strength in environmental friendliness (less dust and noise), which is especially important in densely populated cities like Shanghai. With the operation headquarters opened in Shanghai in May 2003, the VSC Group is strongly positioned in promoting this new imported H-beams and sheet piles business which unlike rebars, the PRC is still a net importer of these H-beams and sheet piles. Turnover arising from such distribution for 2003/04 exceeded HK$330 million as compared to zero in the last financial year. Coupled with other steel products distribution to distributors and end users in southern China, CMG achieved an aggregate turnover of about HK$654 million for steel distribution in Mainland China, a 2-fold increase from last financial year. The ongoing purchasing arrangement with the iSteelAsia Group also gave rise to sales of steel products of approximately HK$156 million. Given such sizeable volume of steel distribution, the VSC Group has benefited much in its supply chain management to obtain bulk purchase discount and flexible shipment delivery from the major international steel mills, which helps both CMG and CAMP to raise its competitiveness over other players.

**BSC** is a 66.7% joint venture company formed in 1993 with the Shanghai Baosteel Group. Leveraging on the strong support and connection with the Baosteel Group, this first venture of the VSC Group to steel distribution in Mainland China has persistently delivered good performance and yield to the VSC Group in the past decade. For 2003/04, turnover further jumped 55% to approximately HK$772 million and net profit contribution before minority interests rose 27% to about HK$13 million. Another high growth potential business for the VSC Group on steel distribution in China would stem from its investment of 10% in the Beijing Shougang Group's manufacturing of pre-painted colour-coated steel sheets or PPGI. By its 10% investment of US$4 million, with the principal recoverable by a put option to the Shougang Group in Hong Kong, the VSC Group is entitled to supplying the raw materials, GI to and exclusively distributing at least 50% of finished goods, PPGI at a pre-determined discounted cost from this new factory. The factory had commenced production since late 2003 and the VSC Group had already provided it with the

# BUILDING PRODUCTS

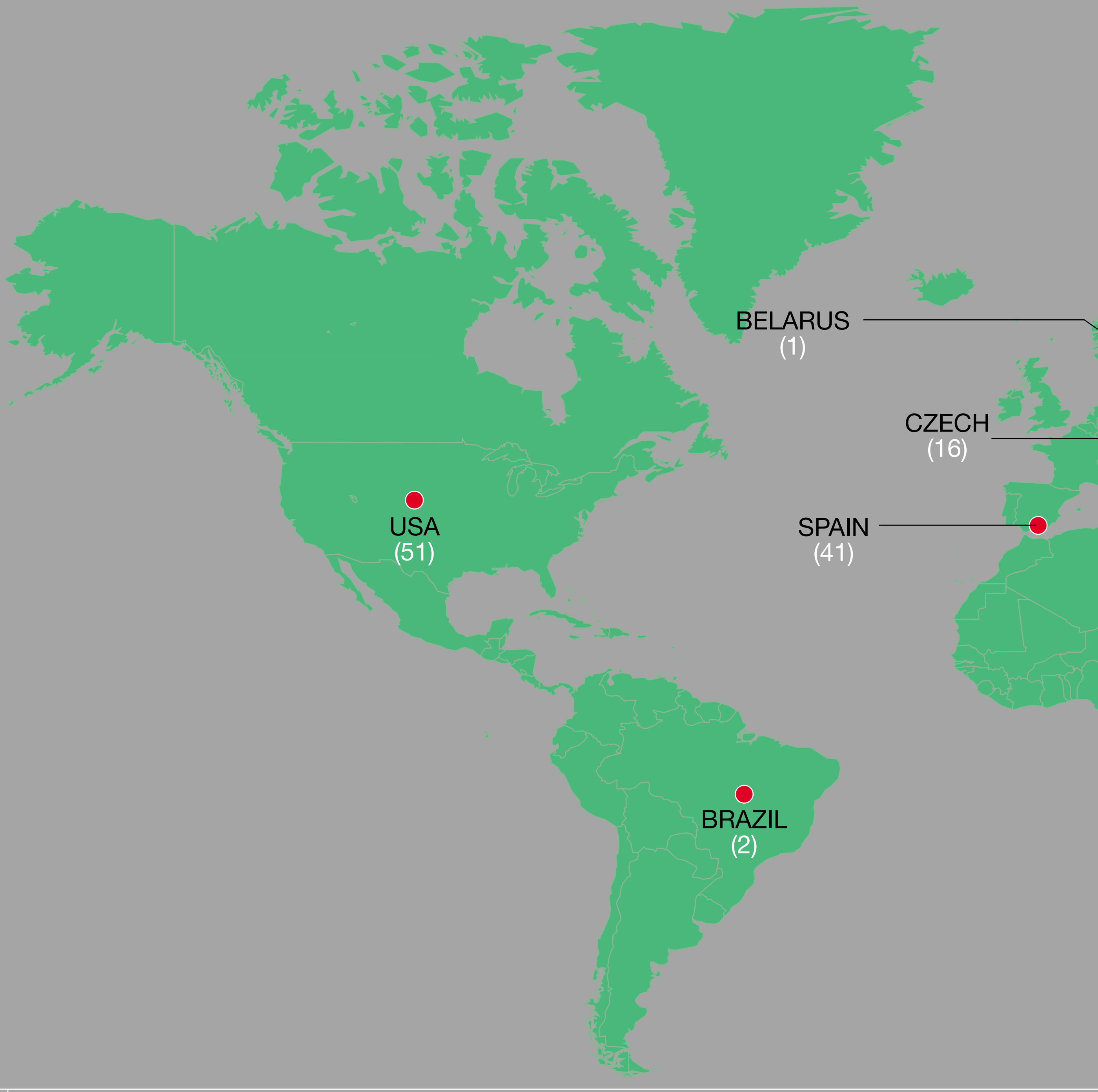
requisite GI and assisted in distributing some of its first few test-run batches of PPGI. The VSC Group has installed the distribution network infrastructure in preparation for the full scale production, including establishment of sales office and trading company in Beijing and Tianjin as well as comprehensive marketing plan to capture the booming demand arising from construction of infrastructures, stadiums, exhibition centres and hotels for the upcoming 2008 Beijing Olympic Games and large automobile manufacturing facilities in Beijing, Shanghai and Tianjin.

***Building Products***

**Building products department** achieved turnaround for its operation and improved its performance by having an operating profit as segment results of HK$5 million in the year, as compared to the operating loss of HK$2 million in last year. Although the overall turnover remained at similar level as in the prior year at HK$139 million, the contribution by various product lines and business units to turnover has been materially changed. As stated in our previous announcement, the kitchen cabinets division has been restructured to abolish large long-term projects in view of the inherent high risks and low return. Thus, turnover from the kitchen installation business has been dropped substantially as the division is now focusing on small but high end individual projects, which yield much higher profit margin and demand less human resources. Shrinkage of business in kitchen cabinets was however compensated by increase of turnover in project sales of sanitary wares, Rover tiles and the retail business, Leisure Plus as well as the new distribution of TOTO sanitary wares in Shanghai, which all recorded encouraging progress in business development. The department currently has contracts-on-hand worth around HK$33 million. Major outstanding projects include the supply of bathroom sanitary wares and tiles for Bellagio Sham Tseng, Ma Wan Island Phase 3 Oceanfront, Disney's Hollywood Hotel, Hong Kong Disneyland Hotel, Island Shangri-la Hotel renovation and Cityplaza renovation.

The project sales division has managed to raise sales revenue of its sanitary wares, TOTO, Laufen, Hansgrohe and Rover tiles, by an increase of 40% under the weak construction market. Such achievement marked the hard work and effort made by the sales team as motivated by an effective sales commission scheme as well as the extensive marketing effort in promoting our product brands to target customers. The division also successfully diversified its distribution network to Macau to secure more businesses. **Leisure Plus**, the retail outlet and showroom in Wanchai continued to attract more shoppers after extension to ground floor of the same building and opening on Sunday. As SARS has raised in the community a consciousness of higher quality sanitary products for hygiene, the high end image built by Leisure Plus in these products offering has been very well received, resulting in more than 2-fold increase in turnover and positive profit contribution from the previous loss making position.

# Our Sourcing Network




**STEEL MILL**

1. Republican Unitary Enterprise
2. Gerdau S.A.
3. Beijing Shougang Flourish Coil Coating Ltd
4. Benxi Iron & Steel (Group) Co. Ltd
5. Guangzhou Iron & Steel Co. Ltd
6. Guangzhou Shuangling Iron & Steel United Co. Ltd
7. Jinan Iron & Steel Co. Ltd
8. Laiwu Steel Corporation
9. Lian Yuan Iron & Steel Group Co. Ltd
10. Maanshan Iron & Steel Co. Ltd
11. Pingxiang Iron & Steel Co. Ltd
12. Shanghai Baosteel Corporation
13. Shuicheng Iron and Steel (Group) Co. Ltd
14. Sichuang Desheng Group Chuxiong Steel Co. Ltd
15. Wuhan Iron & Steel (Group) Co. Ltd
16. Trinecke Zelezamy, A.S.
17. Jindal Stainless Ltd
18. Shah Alloys Ltd
19. Pt the Master Steel Mfg Co.
20. JFE Steel Corporation
21. Kobe Steel Ltd
22. Koyei Steel Ltd
23. Nippon Metal Industry Co. Ltd
24. Nisshin Steel Co. Ltd
25. NKK Bars and Shapes Co. Ltd
26. Sumitomo Metal Industries, Ltd


27. Dongbu Steel Co. Ltd
28. Donghsin Special Steel Co. Ltd
29. Dongkuk Steel Mill Co. Ltd
30. Doowon Steel, Korea
31. Hyundai Hysco
32. INI Steel Co. Ltd
33. Pohang Coated Steel Co. Ltd
34. Pohang Iron & Steel Co. Ltd
35. Union Steel Mfg Co. Ltd
36. Liepajas Metalurgs
37. West Siberian Steel Works
38. Natsteel Ltd
39. Columbus Stainless (Pty) Ltd
40. Scaw Metals
41. Acerinox S.A.
42. China Steel Corporation
43. Great Fortune Steel Co. Ltd
44. Hai Kwang Enterprise Corporation
45. Tung Ho Enterprise Corporation
46. Yieh Phui Enterprises Co. Ltd
47. Thai Coated Steel Sheet Co. Ltd
48. Thai Cold Rolled Steel Sheet Public Co. Ltd
49. ICDAS Celik Enerji Tersance Ve Ulasim Sanayi A.S.
50. Krivorozhstal
51. North American Stainless

During the reporting year, the VSC Group has obtained distribution right of TOTO sanitary wares in Shanghai. A wholly owned trading company, **Leisure Plus Shanghai**, has been set up to handle wholesale and project sales of TOTO in Shanghai. In the year under review, Leisure Plus Shanghai generated a total turnover of approximately HK$31 million, an amount of similar magnitude to the annual turnover achieved in the Hong Kong market. Although the new operation was still not mature enough to absorb its pre-operating expenses and fixed overhead for a profitable situation, with the booming property market in Shanghai and expected rising demand as stimulated by the 2010 World Expo in Shanghai, the VSC Group is optimistic with the Shanghai market potential for the building products department to thrive.

**Other Investment**

During the year, the VSC Group's equity interest in **iSteelAsia Holdings Limited ("iSteelAsia")** was diluted from 19.2% to 18.9%, as caused by a subscription of 31.2 million new shares of iSteelAsia by the McKinsey group in settlement of an outstanding consulting fee of US$400,000. **iSteelAsia and its subsidiaries (together the "iSteelAsia Group")** continues to harvest from its investment into the development of sales infrastructure with deep market coverage in exploiting the huge potential of the China steel market. For the nine-month period ended 31st December 2003, the iSteelAsia Group's turnover soared 117% to approximately HK$1,123 million and in fact its first 6-month turnover had already exceeded the total annual turnover of about HK$811 million last year, reflecting its impressive business growth. Profitability of the iSteelAsia Group has however been severely affected by the unexpected epidemics of SARS. Gross margin was eroded as extra delivery costs and inventory stock-up costs were incurred to maintain the inventory turnover rate and liquidity. Additional initial set up cost has also been expensed to diversify the existing customer bases to second tier cities such as Wuxi and Shunde (Le Chong) to enhance the ability to grow market shares. As such, a net loss of approximately HK$6.4 million for the nine-month period ended 31st December 2003 has been recorded.

The VSC Group is mindful about the iSteelAsia Group's ability to tap the massive businesses as generated by the robust economic growth of China and to restore profitability with iSteelAsia's focusing its effort in certain cities and certain products with the goal to optimise its resources from economy of scale to achieve business growth. The VSC Group will, as previously agreed, continue to source and supply steel to the iSteelAsia Group to facilitate its expansion of steel trading operations and obtain bulk purchase benefit by aggregating demand of the two groups. The VSC Group will continue to monitor this investment proactively for better business synergy to both groups to solicit business, share resources and enhance business efficiency.

## KEY ELEMENTS OF GROWTH

The VSC Group has undergone substantial transformation and achieved tremendous growth in the past decade. Initially as a Hong Kong based trader of

HK$0.4 billion sales to a China focused processor and distributor achieving HK$3.5 billion turnover, the VSC Group has flourished upon two pivotal elements — human and capital resources.

1) **Human resources**

On human resources (HR) side, the VSC Group has always advocated the principle that its staffs are its most valuable capital. Our value propositions for total solution services could only be delivered with the presence of outstanding employees who are of high caliber and committed to meet the challenges and accomplish the goals. Our transformation from a trading business to a niche processing operation with geographically extended coverage of Mainland China demands dramatic cultural and mentality changes of our people. This requires them to adapt flexibly and loyally to the new requirements and environment. Ongoing business reengineering with widespread application of Total Cycle Time methodology has been instrumental in helping our staff changing from flexible opportunist traders to disciplined manufacturer focusing on details for continuous improvements. With the development of new businesses and expansion through mergers and acquisitions, our HR system and corporate structure have been constantly modified and evolved to accommodate staff with diverse background and to help them to become coherent members of the VSC team. The VSC Group's HR strategy for its approach into the China market is to encourage every employee to explore his/her career development together with the corporate business growth in China. Various job rotation or relocation opportunities are provided to several senior managers in some of the business units or branch companies located in different areas of China. Meanwhile the VSC Group is striving hard to adopt a high degree of localisation. Most of the senior executives including head of the CAMP operations, HR director and general managers of various business units are professionals recruited locally with western education and/or multi-national corporation working background who possess thorough understanding of business practices in Mainland China as well as the professionalism of modern management mindset and experiences. With the operation headquarters set up in Shanghai, the VSC Group is determined to recruit the best local talents and build a strong local management team rooted in China.

Under the above-mentioned directives, the VSC Group continued to grow rapidly in headcounts. As of May 2004, the VSC Group employed a total of 1,241 staff, a 41% increase over last year. The increase in number of employees is mainly due to the expansion of VJY, the new GZCC and the new Shanghai operations of steel and building products.

| Department | Headcount May 2004 | Headcount June 2003 |
|---|---|---|
| CAMP | | |
| — Coil Centres | 303 | 142 |
| — Enclosure Systems | 731 | 580 |
| — Plastics & Machinery | 21 | 14 |
| CMG | | |
| — Steel | 44 | 43 |
| — Building Products | 25 | 27 |
| — Shanghai Offices | 59 | 22 |
| Corporate Support | 58 | 51 |
| Total: | 1,241 | 879 |

The VSC Group recognises the importance of aligning individual staff's interest to the corporate goal. Based on core competence and achievement assessment related performance management system, tailor-made incentive schemes for bonuses and commission with measurable targets in achieving key success factors are designed with bottom-up approach for respective business units and corporate support functions. The VSC Group also believes in investing in its own people to provide the best human capital for supporting its high growth and improving profitability. The HR department launches many on-the-job trainings plus training subsidy to employees to enhance their knowledge and skills. It is planned to run a one-year comprehensive training programme jointly held by a renowned business school in China for some high-potential managers to develop them for further progression. The VSC Group also stresses the need to foster good and timely communication with staff. Annual mission day is held to communicate the corporate mission and goals with all staff. Periodical staff forums are organised to collect staff opinion and feedback on company policy. Regular newsletters in electronic format are published to provide staff with report of the latest corporate development and recreational activities. Total staff costs including contribution to retirement benefit schemes incurred during 2003/04 amounted to approximately HK$69 million. During the year under review, options to subscribe 20,045,000 shares have been offered and granted to participants under the new share option scheme adopted since 12th November 2001.

2) **Capital resources**

On financing side, the VSC Group has continuously refined its capital structure with the objective to secure the necessary funding at optimal cost of capital to finance its pursuit of business development.

In terms of equity, number of issued shares increased from 247 million in 1994 to 368 million in 2004. Shareholders' equity stood at about HK$661 million as at 31st March 2004. During the past 10 years, the VSC Group has from the capital market received equity money of over HK$570 million through different exercises including initial public offer, spin-off listing, share placements, bonus warrants and stock options. As stated in the Company's announcement dated 18th November 2003, the most recent share placement was done on 17th November 2003 by exercising the general mandate as authorised to the Board of the Company in the 2002/03 Annual General Meeting for 33 million new ordinary shares at HK$1.8 per share, representing a discount of 6.25% to the closing price of the Company's shares on 14th November 2003 (being the last trading date of the shares on the Stock Exchange prior to the date of the placing agreement) at HK$1.92 per share, bringing in net proceeds of about HK$54.7 million for financing the continuous development of the VSC Group's CAMP operations in the PRC. The said placement was done through Celestial Capital Limited to independent third parties and represented approximately 9.36% of the Company's total issued share capital on a fully diluted basis. During the period under review, approximately

HK$30.5 million was utilised to acquire the 70% stake in GZCC. The balance of the proceeds was used as working capital of the VSC Group. Another share placement involving placement of 31.2 million existing old shares at HK$1.25 per share to institutional investors was also completed in July 2003. These exercises could not only inject the required capital but also improve our shareholders' base with reputable institutional investors and funds, who should in turn help to enhance shareholders' value by improving market awareness of the Company with a strong shareholder base.

In terms of bank borrowings, the VSC Group as a steel distributor and processor requires significant short-term banking lines to finance its working capital need for inventory and accounts receivable. Throughout the years, the VSC Group has developed excellent relationships with a number of local and international banks in Hong Kong and continues to expand its banking profile. Aggregate banking facilities in short-term trade lines surge from HK$0.8 billion in 1994 to over HK$1.4 billion in 2004 with number of principal banks increasing from five to fifteen, including local, Chinese, Japanese and European banks. Such trade lines offered consist of letter of credit and trust receipt loans. Interest costs are levied on inter-banks borrowing rates plus very competitive margin. As the VSC Group establishes more presence and operations in China, the need for RMB financing also emerges to satisfy payments of local operating expenses and domestic purchases. RMB revolving loans and bill exchange facilities have been obtained from domestic and foreign banks in the amount of RMB110 million. With the VSC Group's adding investment in service centres, longer-term borrowings for better cash flow management are preferred in funding capital expenditures of land, plant and machinery. In October 2003, the VSC Group successfully secured a HK$250 million three-year revolving credit and term loan facility from a syndicate of nine of its existing bankers, reflecting a vote of confidence and support from the banking sector. The facility together with its other short-term trade lines could further strengthen the financial position and enable the VSC Group to gain more flexibility in capturing market opportunities and pursue business growth in China.

## CORPORATE GOVERNANCE

The VSC Group is committed to ensuring high standards of corporate governance in the interests of its shareholders. As a company celebrating its 10-year anniversary of listing in the Stock Exchange, the VSC Group has continued to evolve and reform its corporate practices and structure in response to the increasing demand and expectation for better corporate governance to enhance shareholders' value. The Listing Rules in Hong Kong have recently been amended with major changes and new rules relating to corporate governance issue. The VSC Group will comply with all these new mandatory requirements and minimum standards. It will also closely keep abreast of the progress of the drafting of new code in this area and strive to adopt the recommended best practices upon its finalisation. Efforts and principles adopted by the VSC Group in promoting its corporate governance are as follows:

1) **The Board and senior management** — Currently, the Board consists of four executive directors and four non-executive directors (of whom three are independent). The executive directors are responsible for managing the overall business and implementing corporate strategies. The non-executive directors are all well experienced senior business executives who advise the executive directors and management on business strategies and development. The executive directors have regular meetings with the head of CAMP or CMG, general managers of respective business units and key staff of support units to discuss major business plans and review operation and financial performance. Special review meeting or brainstorming sessions are also held from time to time. Seasoned independent advisers with diversified industry expertise and experience are invited to join these meetings whenever necessary. All executive directors and senior management are required to declare in an annual management compliance statement his/her full compliance in conducting the business activities in a legal and ethical manner.

2) **Audit committee and internal control** — The audit committee has been set up since December 1998 and consists of three non-executive directors with Mr. Ting Woo Shou, Kenneth as Chairman and Dr. Chow Yei Ching and Dr. Shao You Bao as members (of whom two, including the chairman of the audit committee, are independent non-executive directors). Following the amendment of the Listing Rules, the VSC Group will aim to ensure at least one of the members of the audit committee is an independent non-executive director with appropriate professional qualifications or accounting or related financial management expertise as required. The Chief Financial Officer was appointed as the qualified accountant of the Company on 31st March 2004 in compliance with the Listing Rules. The audit committee meets formally twice a year to review and discuss the various internal control and audit issues as reported by the external auditors and internal audit team. It also reviews the interim and final financials and recommends to the Board for approval. During the year, various internal audit review and investigation have been conducted in respect of payroll, payment approval, sales and purchase cycle for different business units. Through this mechanism, the

VSC Group aims to maintain a proper internal control environment and accounting system, which can safeguard the company assets and provide reliable financial reports. These audited consolidated accounts for the year ended 31st March 2004 of VSC now reported on have been reviewed by the audit committee.

3) **Code of best practice** — The Company has complied with the Code of Best Practice (the "Code") as set out in Appendix 14 of the Listing Rules throughout the accounting year covered by the annual report, except that the non-executive directors are not appointed for specific terms. However, the non-executive directors are subject to retirement by rotation and re-election at annual general meeting in accordance with the Company's Bye-laws. In the opinion of the Directors, this meets the objective of the Code. A draft to revise the Code (which has been renamed the Code on Corporate Governance Practices) has been issued by the Stock Exchange for public consultation. The draft contains 2 tiers of recommended board practices — minimum standards and recommended best practices. As stated before, the VSC Group will ensure full compliance on the minimum requirements and endeavour to adopt the recommended best practices.

4) **Directors' securities transactions** — The Company adopted on 31st March 2004 "Appendix 10 — Model Code for Securities Transactions by Directors of Listed Issuers" as the required standard against which Directors must measure their conduct regarding transactions in securities of the Company according to Appendix 10.1 of the Listing Rules.

5) **Investor relationship and communication** — The VSC Group is committed to promote transparency and maintain effective communication with investors, analysts and the public press. The management periodically meets with existing and potential investors to make corporate presentations. Regular plant visits to our various manufacturing facilities are arranged for various interested fund managers, research analysts and bankers. The investors section and highlight of most updated news on home page of our website provides the investor community and the public with easy access of the VSC Group's corporate information, financial information, announcements and interim/annual reports. The VSC Group continues to maintain high level of transparency in information disclosures. Again as in prior two years, its 2003 annual report has been mentioned several times by the Judges' Report of the HKMA Best Annual Report Awards and was referred to as one of the five companies, which deserved special mention in the provision of understandable annual reports.

Amid the increased complexity and operational scale, the VSC Group also continues to improve the timeliness and promptness of the dissemination of its financial information such as the timing of results announcement to let its shareholders and public investors be aware of the most updated status at the earliest time.