

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Business Review

After the adjustments in 2002, China's IT market entered into a new phase of growth in more confident strides in 2003. Although the economy suffered briefly at the outbreak of SARS, growth picked up again during the second half of the year, with GDP grew by 9.1% last year. Prompted by the favourable market environment, demand in the IT market rose. Total market value grew 11.1% year on year in 2003.

Lenovo achieved respectable results in the 2003/04 financial year. Its overall turnover rose by 14.5%. The value of China's PC market grew only 9.8% in 2003\* while the turnover of Lenovo's PC business increased 11.7%, surpassing market performance. Due to the losses incurred by the newly-developed businesses and contract manufacturing business and the increased operating

expenses as the result of continued investments in research and development, net profit of the Group recorded a slight increase of 3.5%.

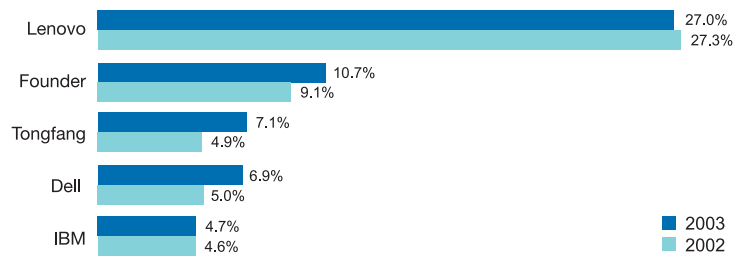
### Corporate IT Business

Competition was intense in China's corporate IT market in 2003. While demand shrunk in the government and education sectors as a result of the SARS outbreak, orders surged among SMEs and in local municipal markets. In 2003\*, unit shipments of commercial PC and servers rose 15.7% and 19.8% respectively, and the notebook computer market, benefiting from the widespread adoption of the "Centrino" chip and price reductions, expanded and recorded 77.6% growth in unit shipment.



\* 2003 refers to the period between April 2003 and March 2004

### Market Share of Top 5 PC Brands in China



Lenovo's corporate IT business recorded an increase of 10.4% in turnover over the previous year. Gross margin, however, saw a drop from the past year's 15.3% to 14.3% this year as a result of fierce competition in the market. The unit shipment of notebook computers stood out among other products boosting a 51.0% growth. With strengthened design capabilities for notebooks, the Group launched in November 2003 "Soleil E600", its first proprietary notebook computer embedded with Collaborating Applications. The product was well-received by the market.

As for desktop computer, Lenovo launched the "Kaitian II" last September, the first Collaborating PC with unmatched security, collaboration and manageability by other products in the market. Capitalising on the commercial buying season in the third quarter of the fiscal year and demands from growth enterprises, the Group mounted effective marketing activities for the product and achieved record sales.



### Consumer IT Business

The consumer IT market experienced steady growth with unit shipment of consumer PC in 2003\* grew by 6.7%. It was enhanced by increase of family income and continuous improvement in quality of living. The SARS outbreak also stimulated short-term sales as computer emerged as a major means for families to access information and leisure entertainment, and primary and secondary schools switched to "Lesson on Air" e-learning model.

Lenovo's consumer IT business performed well in the 2003/04 financial year, reporting an increase of 15.1% in unit shipment of consumer PCs, out-performing the market. The Group's consumer IT business recorded an increase of 13.8% in turnover over the previous year. Gross margin rose slightly from the previous year's 13.3% to 13.7% this year. Operating profit increased by 28.4%.



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The Group's effective customer segmentation strategy and customers' preference of using quicker and easier way to purchase computers during the SARS period were the reasons for the relatively outstanding performance of the business stream. In May last year, to meet the needs of different customers, the Group released three major product lines, namely "Tianjiao", "Fengxing" and "Jiayue" which reported impressive sales. "Tianjiao" emphasises digital applications meeting the needs of consumers who enjoy fashionable lifestyle; "Fengxing" boasts technological leadership and powerful functions catering to customers who value technological expertise; and

"Jiayue" designed for ordinary households and students features ease-of-use. The competitive edge of the "Lenovo 1+1 Home Specialty Shop" is evident especially during the SARS outbreak as they are conveniently located in different areas, allowing consumers to quickly and easily purchase the IT products they needed, hence reducing the risk of infection for consumers.

Employing a differentiation strategy, Lenovo commits itself to technological innovation and launching products of the most advanced designs. The strategy is vital to the continuous improvement of the gross margins for its consumer IT business. In November 2003, the Group introduced the first home PC, "Tianjiao Avantia", embedded with Collaborating Applications technology. The new product realises discretionary combination of functions among computers, home appliances and other terminal devices, with automatic wireless collaborating features. The market returned positive response.

Recognising the growing need for mobile computing among consumers, Lenovo led the market in developing the "Tianyi" notebook computer. The unique design and multimedia capabilities of "Tianyi" have created a superior image for Lenovo in the market. The Group's share of this particular market segment increased to more than 30%.





## Handheld Device Business

China's mobile handset market saw steady growth in 2003, recording 9.3% increase in unit shipment. It was the result of massive launch of new generation handsets and aggressive marketing of value added digital services by telecommunications providers. The overall profit level was, however, lowered as some manufacturers sought to reduce the inventory of monochrome handsets.

During the year, unit shipment of Lenovo handsets grew more than 90% and the turnover of the handheld device business increased by 42.3% over the previous year. However, profit was affected by the inventory of monochrome handsets and excess supply of OEM handsets in the market. As a result of the Group's dedicated efforts in the research and development of proprietary handset products, self-developed products are contributing a growing share to its total sales. They accounted for a remarkable 64.2% of total handset shipment this year, testifying to the successful transition of the Group from a primarily OEM model to a self-developed model. Helping to maintain gross margin at 16.0%, the new focus enabled the handheld device business to gradually reduce loss in the second half of the year.



Lenovo launched 16 new handset models during the year, including two smart phone models featuring integrated communication and data processing. The "ET180" handset, which was launched in April last year by the Group, was the first high-end computerised handset introduced by a Chinese manufacturer. It possesses the functions of a pocket PC and marries commercial and leisure applications. In January, the Group launched the "ET560", the first handset with Collaborating Applications capabilities that can communicate with different home appliances and other terminal devices through infrared, blue tooth and GPRS technologies.

## IT Service Business

With China's IT service market promising long-term growth potential, the turnover of Lenovo's IT service business recorded an impressive growth of 198% over the previous year. Its gross margin rose to 38.9% this year from 28.7% of the past year. The Group reported breakthroughs in vertical markets including the e-government sector, sales of network security products and solutions, and the financial service sector.

## Contract Manufacturing Business

As severe competition in the European motherboard market continued in 2003, gross margin of the business was affected and loss was incurred. To focus on its computer and handset businesses, Lenovo sold 50% of its motherboard business to Ramaxel Technology Limited by the end of 2003. The Group believes this would benefit the future development of the business.

# Effective Market Segmentation

## Meeting Customer Needs





Detailed customer segmentation strategy promises consumers popular IT products to fulfill their diverse needs.



## Financial Review

### Summarised Financial Results

	2004 <i>HK\$'000</i>	2003 <i>HK\$'000</i>
Turnover	<b>23,175,944</b>	20,233,290
Earnings before interest, taxation, depreciation and amortisation expenses	<b>1,125,129</b>	1,174,720
Profit attributable to shareholders	<b>1,052,885</b>	1,017,152
Dividends per share (HK cents)		
Interim dividend	<b>2.0</b>	1.8
Proposed final dividend	<b>3.0</b>	3.0
Special dividend	–	5.2
Earnings per share (HK cents)		
Basic	<b>14.09</b>	13.55
Diluted	<b>13.99</b>	13.54

Comparing with last year's results, the Group's turnover increased by 14.5% to HK\$23,176 million in the current fiscal year. EBITDA reached HK\$1,125 million. Profit attributable to shareholders for the year

increased by 3.5% to HK\$1,053 million. The basic earnings per share and fully diluted earnings per share were 14.09 HK cents and 13.99 HK cents representing increases of 4.0% and 3.3% respectively.

## Turnover and Contribution

	2004		2003	
	Turnover <i>HK\$'000</i>	Contribution to operating profit <i>HK\$'000</i>	Turnover <i>HK\$'000</i>	Contribution to operating profit <i>HK\$'000</i>
Corporate IT	11,925,240	777,698	10,803,311	744,153
Consumer IT	7,760,668	466,814	6,822,633	363,527
Handheld device	2,050,164	(74,565)	1,440,328	29,017
IT service	547,780	(58,009)	183,800	(61,405)
Contract manufacturing	892,092	(95,208)	983,218	8,554
Gains/(losses) on disposal of investment	-	47,558	-	(26,802)
Amortisation of goodwill	-	(25,274)	-	(7,463)
Others	-	(22,000)	-	-
<b>Total</b>	<b>23,175,944</b>	<b>1,017,014</b>	<b>20,233,290</b>	<b>1,049,581</b>

Total turnover of the corporate IT business grew 10.4% over the previous year to HK\$11,925 million and contribution to operating profit increased 4.5% to HK\$778 million.

The Group's consumer IT business recorded growth in turnover and contribution to operating profit of 13.8% and 28.4%, reaching HK\$7,761 million and HK\$467 million, respectively.

Sales of handheld device business increased 42.3% to HK\$2,050 million for the year while the loss of the business was HK\$75 million.

During the year, turnover of the IT service business rose by 198.0% to HK\$548 million, and loss reduced to HK\$58 million.

Turnover of contract manufacturing business dropped by 9.3% to HK\$892 million and loss of HK\$95 million for the year was recorded.



# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Significant Investments and Capital Expenditure

In line with the Group's overall business and resources allocation strategies, the Group sold 50% stake of its motherboard business during the year. The deal brought in profit amounted to HK\$12 million. The Group also recorded a net profit of HK\$35 million from the sales of securities investment. The cooperation with AOL on developing Internet business ended last year, shares of the jointly controlled entity previously owned by AOL were repurchased and the jointly controlled entity subsequently became a wholly owned subsidiary of the Group.

During the year, capital expenditure of HK\$466 million were incurred. Of this amount, HK\$58 million was used for investment in a subsidiary that develops and manufactures networking hardware products for the corporate IT business. The remaining HK\$408 million was used primarily for acquisition of fixed assets, injection into construction-in-progress and optimisation of the Group's information technology systems.

During the year, HK\$561 million was recorded as addition of intangible assets which was mainly attributable to the sponsorship of The Olympic Partner programme and recognition of goodwill arising from acquisition of subsidiaries.

## Liquidity and Financial Resources

As at 31st March 2004, total assets of the Group amounted to HK\$8,342 million which was financed by shareholders' fund of HK\$4,489 million, minority interests of HK\$29 million, long-term and current liabilities of HK\$3,824 million. The current ratio of the Group was 1.85.

The Group had a solid financial position and maintained a strong and steady cash inflow from its operating activities. As at 31st March 2004, cash and cash equivalents of the Group totalled HK\$2,650 million. The balances consisted of about 26.9% in Hong Kong dollars, 22.7% in US dollars and 50.4% in Renminbi.

Although the Group has consistently been in a very liquid position, credit facilities have nevertheless been put in place for contingency purposes. As at 31st March 2004, the Group's total available credit facilities amounted to HK\$3,783 million, of which HK\$1,609 million was in trade line, HK\$1,103 million in short term and revolving money market facilities and HK\$1,071 million in foreign exchange contract. As at 31st March 2004, the facility drawn down was HK\$671 million and HK\$468 million for the foreign currency forward contracts and options was utilised.

As at 31st March 2004, the Group had long-term loan amounted to HK\$75 million, comparing with the shareholders' fund of HK\$4,489 million, the Group's gearing ratio at the year end was 0.017. The Group will continue its prudent borrowing policy so as to maintain its gearing ratio at an acceptable level.

There were no assets held under finance lease during the year and as at the year end.

The Group consistently adopted a hedging policy for business transactions to minimise the risk of fluctuations from exchange rates on daily operations. As at 31st March 2004, the Group had outstanding foreign currency forward contracts and options amounting to HK\$468 million.

### Contingent Liabilities

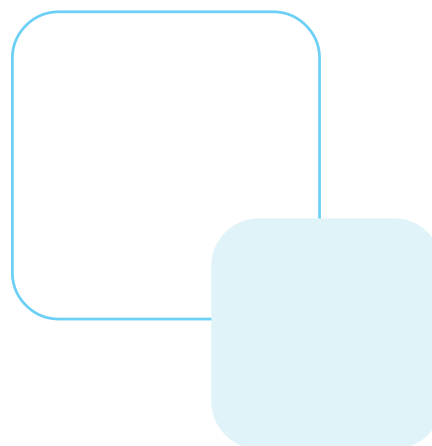
The Group had no material contingent liabilities as at 31st March 2004.

### Employees

As at 31st March 2004, the Group had a total of 11,408 employees, 11,311 of whom were employed in Chinese mainland and 97 were employed in Hong Kong and overseas.

Through reallocation of resources, the Group reinforced its focus on the development of its core business. It also undertook strategic personnel restructuring involving a total expense of about HK\$22 million for the year.

The Group implements remuneration policy, bonus and share option schemes subject to the performance of the Group and individual employees. It also provides training and benefits such as insurance, medical and retirement funds to its staff to sustain the competitiveness of the Group.



## Future Prospects

China's economy has seen rapid growth in the past few years. With the macroeconomic control measures of the Chinese government, the economy is expected to enter into a new phase of robust growth. Privately-run and foreign-invested enterprises are emerging as new drivers of economic growth in the country. And their demands for IT products and services are among the largest in the market, hence presenting the Group with immense business opportunities.

As for the demand for IT products, steady growth is expected in 2004. Unit shipment of notebook computers will see significant surge, making the limelight in the market. As for desktop PCs, sales are going to peak as customers seek to replace equipment bought between 1999 and 2000 for Internet capabilities and the "Y2K" transition. This growth trend in the IT market will be further fueled by the expanding applications and coverage of the broadband network. The continuous evolution of the different sectors, such as the government, education and manufacturing will also enhance the stable advancement of the corporate IT market.

To effectively cope with the changing market, Lenovo implemented the following new initiatives since the fourth quarter of 2003/04:

### Focus on developing PC and related products in the near term

To effectively capture opportunities during the next "golden age" of the China PC market, the Group recently set priorities to focus resources and attention into developing its core business – PCs and related products (including consumer and commercial desktop computers, notebook computers, servers and peripherals, etc.). The move will help to ensure the continuous improvement of the competitiveness of the business and returns from the promising market.

Furthermore, to strengthen Lenovo's competitiveness in the China mobile communications market – the fastest growing market in the world, the Group has identified mobile communications devices (including handsets, and handheld devices with communication functions) as another priority.





### **Establish a customer-oriented sales model and organisational structure**

To respond to the changes in the China IT market, the Group is committed to building a more customer-oriented sales model and organisational structure with the aim of providing products and services to meet the requirements of different customers more effectively.

Catering for customers' different needs in product application, buying patterns, preferred ways of delivery and service requirement, the Group will adopt a combined model. Through optimising existing distribution model, enhancing the capabilities of channel partners to win and serve customers, and establishing direct-to-customer model, the Group will build the optimal sales models for its different customer groups.

On the organisational structure front, to assist further penetration into regional markets in China, the Group has divided the original seven major regions in the country into 18 regions. The new structure significantly narrowed the gap between regional sales personnel and the customers, hence enabling faster response to customers' needs.

### **Improve overall operational efficiency**

In addition to the new initiatives in sales model, the Group will also improve its profitability through enhancing overall operational efficiency and reducing operating expenses.

Adjustments of business focus and market regions will enable the Group to allocate its resources more effectively. At the same time, the Group will further strengthen its supply chain management to enhance operational efficiencies. The application of Lenovo's Vendor Managed Inventory (VMI) system has been on track, helping to lower the risks and costs of the Group's logistic operations.

Currently, these initiatives have been implemented step by step in different departments and regional offices, achieving the structural adjustments intended. After trying it out for some time, these initiatives have been proven effective in meeting China's changing market environment. These initiatives will enable the Group to grow in steady strides, consolidating its leadership in the China PC market. It will also provide the Group with abundant resources for developing new businesses and entering the international markets while safeguarding returns to shareholders.

# Innovative Designs

Striving for Excellence





Launching novel notebook products with innovative technologies and designs, allowing customers to enjoy the benefits of mobile computing.

