# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

## OVERALL PERFORMANCE

### Turnover

Turnover for the first half of 2004 was RMB291.6 million (US$35.2 million) compared to RMB253.4 million (US$30.6 million) for the same period in 2003, representing an increase of 15.07%. Turnover comprises of three different segments: Retail, OEM and Other.

#### Retail Turnover

Retail turnover for the first half of 2004 was RMB222.5 million (US$26.9 million) compared to RMB163.3 million (US$19.7 million) for the same period in 2003, representing an increase of 36.25%. This increase was driven by increases in same store sales, increases in unit volume sold as well as by unit price increases. The increase in unit volume sold reflected, in part, an increase in the number of the Company's retail outlets from 270 at the beginning of 2004 to 288 at the end of the first half of the year. This increase is in line with the company's internal store location management program's planning. The increase in average unit selling price reflected, in part, the strength of the PORTS brand in the Chinese market due to the continued effectiveness of the Company's marketing activities, as well as the continued improvement in the knowledge about the consumers' preferences in the Chinese market. It should be noted that the Company was able to achieve price increases in line with and greater than the rate of inflation. The sales increases for the months of January, February, March, and June were strong compared with the same months last year. These increases were further enhanced during April and May, due to the depressed sales levels due to SARS in 2003. As a percentage of total turnover, retail turnover increased from 64.44% in the first half of 2003 to 76.32% in the first half of 2004, representing the increasing importance of the retail division to the Company.

#### OEM Turnover

Turnover from the OEM division declined 26.51% from RMB84.5 million (US$10.2 million) in the first half of 2003 to RMB62.1 million (US$7.5 million) in the first half of 2004. This decline was driven primarily by a return in export trading patterns to normality. In the first half of 2003, export trading volumes in China benefited from the reticence of overseas buyers to travel to South Asia due to fears of terrorism related to the outbreak of the Iraq War. The first half of 2004 has seen a gradual reduction in these fears and has correspondingly affected export-trading volumes in China. As a percentage of total turnover, OEM turnover declined from 33.35% in the first half of 2003 to 21.30% in the first half of 2004.

#### Other Turnover

The Company's "Other" turnover was RMB6.9 million (US$0.8 million) in the first half of 2004 compared to RMB5.6 million (US$0.7 million) in the first half of 2003, representing an increase of 23.21%. Other turnover comprised mainly of the export of BMW Lifestyle apparel to the global BMW dealer network as well as to BMW

Lifestyle boutiques (outside of China). It also includes wholesale sales to corporate customers and sales to retailers in smaller cities in China. As a percentage of total turnover, other sales increased from 2.21% in the first half of 2003 to 2.38% in the first half of 2004. With the development of the BMW Lifestyle apparel export market, it is anticipated that this division's contribution to the Company's business will increase.

**Cost of sales**

Cost of sales in the first half of 2004 was RMB105.7 million (US$12.8 million) compared to RMB114.8 million (US$13.9 million) in the first half of 2003, representing a decline of 7.93%. This decline in cost of sales was driven by a shift in the mix of the business away from the OEM division, which has a higher "cost of goods sold" structure, to the retail division, which enjoys a lower "cost of goods sold" structure. The retail division has significantly higher gross profit margin.

**Gross profit**

As a result of the factors discussed above, the Company's gross profit increased 34.10% from the first half of 2003 to the first half of 2004, and the Company's gross profit margin increased from 54.69% in the first half of 2003 to 63.73% in the first half of 2004. The increase in gross margin was driven, in part, by the improvement in the gross profit margin in the retail division. The management's decision to raise the average unit retail selling price at the start of the 2004 Spring/Summer season was the primary reason for the improvement. Furthermore, the increase in gross margin was also driven by a shift in the mix of the business away from the OEM division, which has a higher "cost of goods sold" structure, to the retail division, which enjoys a lower "cost of goods sold" structure, and hence a higher gross profit margin.

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

**Retail Gross Profit**

Retail gross profit increased 40.17% from the first half of 2003 to the first half of 2004, while gross margin increased from 75.85% to 78.01% over the same period. The management team believes the Company's gross margin is within the range of such margins achieved by other international fashion and luxury brands. The increase in gross margin was driven, in part, by management's decision to raise prices at the start of the Spring/Summer 2004 season. The ability to do so reflects largely on the strength of the PORTS brand in the Chinese market, the pricing power enjoyed by the Company, as well as a return to a slightly more inflationary environment at the start of 2004 in the PRC consumer market.

Of the Company's gross profit, retail contributed 93.42% of the total in the first half of 2004, compared to 89.37% in the first half of 2003, reflecting the increasing importance of the retail business to the Company.

**OEM Gross Profit**

Gross profit from the OEM Division was RMB9.6 million (US$1.2 million) in the first half of 2004, compared to RMB10.9 million (US$1.3 million) in the first half of 2003, representing a decline of 11.93%. This decline occurred as a result of the reduction in volume handled by the OEM division. However, gross margin increased from 12.92% in the first half of 2003 to 15.44% in the first half of 2004. The increase in gross margin was driven by improved sourcing and a return to a more normal trading environment after the disruption caused by the outbreak of the Iraq War during the first half of 2003.

**Gross Profit of Other Turnover**

Gross profit from other turnover remained flat from the first half of 2003 to the first half of 2004. Gross margin, however, declined from 68.02% in the first half of 2003 to 38.12% in the first half of 2004. This decline in gross margin reflects an intentional shift in managerial focus from the domestic Chinese wholesale market (mainly in the form of corporate gifts) to the export wholesale market (mainly in the form of the export of BMW Lifestyle apparel products to BMW dealers and BMW Lifestyle boutiques worldwide). While the domestic wholesale market currently enjoys higher gross margin, the potential for volume growth is limited. The management team feels that the export market for BMW Lifestyle apparel products offers significantly greater growth opportunities and has, therefore, focused its attention on the development of this business.

**Other operating income**

Other operating income declined 52.17% from RMB4.6 million (US$0.6 million) in the first half of 2003 to RMB2.2 million (US$0.3 million) in the first half of 2004. Other operating income consists mainly of income from store design and decoration services provided to third parties, including department stores that contain new PORTS INTERNATIONAL concessions. Design and decoration income decreased by 89.40% to RMB0.4 million (US$0.05 million) in the first half of 2004. This decrease was a result of management's decision to reduce this activity and focus on the Retail business.

**Profit from operations**

As a result of the factors discussed above, the Company's profit from operations increased by 34.60% from RMB38.1 million (US$4.6 million) in the first half of 2003 to RMB51.3 million (US$6.2 million) in the first half of 2004. The Company's operating margin (profit from operations expressed as a percentage of turnover) increased from 15.03% to 17.60% over the same period. The increase in profitability is largely due to improved economies of scale with increased sales in the retail division as well as a shift in the mix of the business away from the OEM division, which has a higher "cost of goods sold" structure, to the retail division, which enjoys a lower "cost of goods sold" structure, and hence a higher gross profit margin.

## Profit attributable to shareholders

As a result of the factors discussed above, the Company's profit attributable to shareholders increased 26.26% from RMB35.8 million (US$4.3 million) in the first half of 2003 to RMB45.2 million (US$5.5 million) in the first half of 2004. The Company's net profit margin increased from 14.15% in the first half of 2003 to 15.52% in the first half of 2004. The increase in profitability is largely due to improved economies of scale related to increased sales in the retail division as well as a shift in the mix of the business away from the OEM division, which has a higher "cost of goods sold" structure, to the retail division, which enjoys a lower "cost of goods sold" structure, and hence a higher gross profit margin.

## OPERATING EXPENSES

Operating expenses increased to RMB136.7 million (US$16.5 million) in the first half of 2004 from RMB105.0 million (US$12.7 million) for the same period last year, an increase of 30.07%. Operating Expenses consists of distribution expenses, administrative expenses and other operating expenses. The changes in various components are summarized in the following paragraphs.

### Distribution expenses

Distribution expenses increased 29.43% from RMB86.3 million (US$10.4 million) in the first half of 2003 to RMB111.7 million (US$13.5 million) in the first half of 2004. This increase was principally due to increases in rent and salaries and benefits. Rent expense for retail outlets increased 32.55% from RMB42.7 million (US$5.2 million) in the first half of 2003 to RMB56.6 million (US$6.8 million) in the first half of 2004. This increase was mainly due to an increase in the number of retail outlets and the increased sales volume in concession stores. In particular, the occupancy cost of a concession store is equal to a percentage of the monthly sales made through that concession. Accordingly, the Company's rental expenses increase as its retail turnover increases. Salaries and benefit expenses increased 42.86% from RMB15.4 million (US$1.8 million) in the first half of 2003 to RMB22.0 million (US$2.7 million) in the first half of 2004. This increase reflects investments made by the Company in human capital, specifically in design talent and the corresponding support staff.

Other major components of selling expenses only increased modestly. Depreciation expenses increased 25.53% from RMB4.7 million (US$0.6 million) in the first half of 2003 to RMB5.9 million (US$0.7 million) in the first half of 2004. The increase was principally driven by greater renovation and fixturing costs related to an increase in the number of Company-owned stores. Advertising expenses increased 5.43% from RMB9.1 million (US$1.1 million) in the first half of 2003 to RMB9.7 million (US$1.2 million) in the first half of 2004. This modest increase reflects the increasingly effective and efficient use of the advertising budget by the Company.

### Administrative expenses

Administrative expenses increased 33.70% from RMB9.2 million (US$1.1 million) in the first half of 2003 to RMB12.3 million (US$1.5 million) in the first half of 2004. This increase was due mainly by an increase in official sundries, which comprises mainly the increase in auditor's expenses, rental, annual listing fees, and Director's limited liability insurance. Official sundries expense increased 162.50% from RMB0.8 million (US$0.1 million) in the first half of 2003 to RMB2.1 million (US$0.3 million) in the first half of 2004. Administrative salaries and benefits, which is the largest category of administrative expense, increased by 8.06% to RMB6.7 million (US$0.8 million) in the first half of 2004, as a result of salary increases, and an increase in the number of middle management personnel to support the continued expansion of the Company's operations. Other administrative expenses (except for salary and sundry expenses), such as travel and general office expenses, increased by 59.09% reflecting the increased size of the administrative function, as noted above. For instance, increased travel to Munich, Germany, in support of the BMW Lifestyle initiative and the continued expansion of the Company's operations.

**Other operating expenses**

Other operating expenses increased modestly from RMB9.6 million (US$1.2 million) in the first half of 2003 to RMB12.7 million (US$1.5 million) in the first half of 2004. Other operating expenses consist principally of a stock provision that is taken against aging inventory. The slight increase in operating expenses was driven by a slight increase in aging inventory.

**Income Tax**

The Company's effective income tax rate increased from 0.5% of profit before tax in the first half of 2003 to 13.55% of profit before tax in the first half of 2004.This increase is the result of a tax refund of RMB4.6 million (US$0.6 million) received during the first half of 2003.

**Financial Position, Liquidity and Gearing Ratio**

The Group continues to be in a very strong financial position, with significant cash generated from normal business operations and from the proceeds of the IPO in 2003. As of 30 June 2004, the Group had roughly RMB308.5 million (US$37.3 million) in cash and cash equivalents and time deposits with major banks compared with RMB315.1 million (US$38.1 million) as of 31 December 2003. The Group also possessed available bank loans and overdraft facilities of roughly RMB101.0 million (US$12.2 million), which have not been utilized. The Group currently has no outstanding bank borrowing. As of 30 June 2004, the Group's gearing ratio was zero, based on no bank debt outstanding and total assets of roughly RMB691.7 million (US$83.6 million). The Group's gearing ratio was 0% as of 31 December 2003 based on no bank debt outstanding. As of 30 June 2004, the current ratio was 7.08, based on current assets of RMB602.0 million (US$72.7 million) and current liabilities of RMB85.1 million (US$10.3 million).

**Acquisitions & Disposals of Subsidiaries & Associated Companies**

The Group did not engage in any material acquisitions or disposals of any subsidiaries or associated companies in the six months ended 30 June 2004.

**Currency Risk Management**

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

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

**Capital Commitments & Contingent Liabilities**

The Group has capital commitments of RMB1.9 million (US$0.2 million) which have been contracted for, and capital commitments of RMB120.0 million (US$14.5 million), which are authorized but not contracted for as at 30 June 2004, and no contingent liabilities as at 30 June 2004.

**Capital Structure of the Group**

The Group requires working capital to support manufacturing, Retail, OEM and Other operations. In the past, the Group financed its working capital needs principally through net cash inflows from operating activities and from short-term interest-bearing loans. The IPO of the Company's shares on 31 October 2003 has provided an additional source of working capital. As of 30 June 2004, the Group had cash and cash equivalents and time deposits of RMB308.5 million (US$37.3 million), denominated principally in HK$, US$ and RMB, a decrease of 2.09% from 31 December 2003. Net cash inflows from operating activities increased 130.95% to RMB38.8 million (US$4.7 million) in the first half of 2004, as compared to RMB16.8 million (US$2.0 million) for the same period in 2003. The Group currently has no outstanding interest-bearing debt obligations.

**Major Customers & Suppliers**

During the first half of 2004, the Group purchased approximately 11% and 30% of its goods from its largest supplier and five largest suppliers, respectively. The percentage of turnover attributable to the Group's largest customer and five largest customers combined were approximately 11% and 22%, respectively. None of the Directors, their associates or shareholders (to the best knowledge of the Directors that own more than 5% of the Company's share capital) were interested at any time during this period in the above suppliers or customers.

**Charges on Assets**

As of 30 June 2004, the Group had not charged any of its assets.

**Human Resources**

As of 30 June 2004, the Group had approximately 3400 employees. Total personnel expenses, comprised of wages, salaries and benefits, was RMB45.3million (US$5.5million) in first half of 2004, compared to RMB36.5million (US$4.4million) for the same period in 2003.

### Post-Balance Sheet Date Developments

After the balance sheet date, the Directors proposed an interim dividend of RMB0.16 per share, totaling RMB21.73 million (US$2.62 million) on 25 August 2004, payable to shareholders of record on 30 September 2004. Further details are disclosed in the ”OTHER INFORMATION” section on page 33.

## Significant Events

The Board of Directors intend to put forward a proposal to shareholders that, subject to the approval of shareholders and the Listing Committee of the Stock Exchange of Hong Kong, each of the existing issued and unissued shares in the Company be subdivided into four shares. A circular containing details of the proposed subdivision of shares, with a notice to convene a special general meeting, will be issued to the shareholders as soon as practicable.