DISCUSSION AND ANALYSIS OF THE GROUP'S PERFORMANCE

Financial Review

Although during the period under review, material costs kept on rising, Dream International Limited (the "Company") and its subsidiaries (together the "Group") was able to maintain its growth leveraging on the increased production capacity of its new plants, its solid foundation and prudent cost management measures. Also with the well-planned strategy, the Group has stocked up raw material inventory to tackle the high material cost. During the period, the Group's turnover increased approximately 28.5%, from HK$388.6 million to HK$499.6 million, while gross profit rose to HK$142.8 million (2003: HK$104.9 million) representing a growth of 36.2% on a consolidated basis.

The Group's consolidated profit attributable to shareholders was HK$49.6 million (2003: HK$58.4 million). The reduction in profit was due to the increase of manufacturing costs. The shortage of labour has had an adverse impact on the utilization of the production facilities of the Group, especially in the Suzhou and Shanghai factories. Together with the increase in raw material prices during the period, these factors contributed to the decline in the net profit compared to the prior period.

Dream INKO Co., Ltd. ("Dream INKO") was acquired in September 2003 and the results of the Group for the prior period did not include any contribution from Dream INKO. With the consolidation of Dream INKO during the current period, its contribution to gross profit was sufficient to offset the increase in the Group's manufacturing costs. Accordingly, the overall gross margin of the Group increased from 27.0% in the first half of 2003 to 28.6% in the first half of 2004. On the other hand, administrative expenses were increased significantly compared to the prior period as they include HK$35.5 million which relate to Dream INKO. The net contribution of Dream INKO to the Group for the six months ended 30 June 2004 was HK$5.1 million after deducting the amortization of goodwill arising from the acquisition of HK$3.6 million.

Business Review and Prospects

Product analysis

For the six months ended 30 June 2004, plush stuffed toys remained as the major business of the Group, with sales reaching HK$480.7 million, accounting for 96.2% of the Group's total turnover as compared with 94.4% in the same period last year. During the period under review, the Original Equipment Manufacturing ("OEM") business accounted for about 86.8% of the Group's total turnover. The scalable operation of the Group managed the difficult high material cost period. Taking advantage of its better bargaining power, the Group was able to get better prices than small manufacturers who were more strongly hit by high material costs and some of whom were eventually ousted from the market.

Different from general manufacturing firms, the Group's OEM business enjoys higher margin. It received continuous orders from long-standing customers including international and well-known retail brands and character licensors, such as Disney, the SEGA Corporation, Banpresto Co., Ltd., Warner Bros. and Bandai Co.. Although, like other manufacturers, it faced the same price pressure from retailers and distributors, with strong purchasing power and sales capability, the Group maintained its selling price during the period.

During the period, the Group's Original Design Manufacturer ("ODM") business accounted for 9.4% of the Group's total turnover. The production of its own "Caltoy" brand products continued to provide a competitive edge for the Group. Although the margin of the ODM business is relatively low compared to OEM business, the Group will continue to allocate resources on this business to maintain its expansion mode. The management believes that the ODM business will remain as the Group's future growth driver, and is on track to achieve the 30% to 35% contribution target.

Steel and plastic toys business, another business of the Group, accounted for 3.8% of its total turnover. The Group recently entered into a joint venture agreement with Ides Co., Ltd. ("Ides"), a Japanese client of the Group for many years, to set up a manufacturing factory in Taicang, Jiangsu province, the PRC. The new factory will specialize in producing toy parts, toys, stationeries, children's ride-on toys, bicycles and infant products mainly for the markets of Japan, South Korea and the US. The collaboration with Ides allows the Group to take advantages of Ides' strong distribution network. With our seasoned manufacturing expertise, the Group sees the strengthening of its steel and plastic toy business and expansion of market share in the near future.

The construction of the plant will be started in 2004 and will be completed before the first half of 2005. The new plant will be built on a site of total area 45,000 square metres, with the plant building occupying 25,000 square metres. It will be equipped with steel and pipe processing, painting processing, injection processing and product assembly lines. The plant is expected to start operation by the second half of 2005 and attain annual production worth up to US$20 million by the end of 2008.

Market analysis

Japan remained as the major market of the Group, accounting for 44.5% of its turnover while the US came second at 41.5%. Thanks to the continuous efforts of the marketing team in the US, the gap between contributions from the two markets had been narrowed. The difference in OEM and ODM product shipments to Japan and the US also accounted for the different contributions from the two markets. The management believes the Group stands to benefit quickly with the improvement in the US market sentiment. Apart from that, the Group is continuously pursuing a greater presence in Europe by increasing sales to this market.

To maximize shareholders' value, the Group has been realigning the management and operation of its New York office. Through streamlining and restructuring the office's operation, the Group's overall performance will be enhanced. Expecting consolidation in segments of the retail industry, the Group will continue to carefully assess the mass market in the US so as to capture any potential business opportunities. In addition, the Group will improve its customer service and buyer relationships with existing accounts to generate more orders.

Operation analysis

The Group is expecting more business developments in the future, one of which is the plan to set up a plant in Vietnam. The trial run of the Vietnam plant was satisfactory, however, more analytical data have to be collected for further consideration. Also, we have an additional facility in Jiangsu province with full work forces which should be available by next year to cater for the increasing orders. The main reason for the drop of utilization rate of Shanghai facilities is due to shortage of manpower.

During the period, electrical power shortage also covered the area where the Group's facilities located. However, since the Group has its own generator the impact is not significant and yet the extra cost to run electricity is not significant enough to have any impact on the overall cost of production.

Number and remuneration of employees

At 30 June 2004, the Group had 23, 12,172, 197 and 11 employees in Hong Kong, Mainland China, South Korea and the US respectively. The Group values its human resources and recognizes the importance of attracting and retaining quality staff for its continuing success. Staff bonuses and share options are awarded based on individual performance and job nature.

Liquidity and financial resources

As at 30 June 2004, the Group had net current assets of HK$324.8 million (30 June 2003: HK$403.2 million).

The Group continued to maintain a strong liquidity position with cash and bank balances at 30 June 2004 amounted to HK$268.8 million (30 June 2003: HK$337.3 million).

Pledged bank deposits

As at 30 June 2004, the Group's long-term bank deposits of HK$78.0 million (30 June 2003: HK$84.8 million) were pledged to the extent of 141% (30 June 2003: 141%) of the outstanding bank loans, which amounted to HK$36.1 million at that date (30 June 2003: HK$32.8 million).

Treasury policies and gearing

The Group has consistently adhered to its prudent treasury policy. Most of the Group's liquid fund is placed in principal guaranteed short-term dual currencies deposits in various banks. The Group also made use of the financial tools of long-term multi-currencies structured deposits and structured foreign currency loan to reduce the Japanese Yen accounts receivable exposure and to enhance return from the liquid assets of the Group within the controllable risk level.

The Group's gearing ratio, calculated on the basis of total bank borrowings over the total shareholders' equity, was increased from 6.0% to 11.5%.