MANAGEMENT DISCUSSION AND ANALYSIS

Financial Review

The Group's consolidated turnover reached HK$817 million for the interim period ended 30th September, 2004, representing a remarkable growth of approximately 268% as compared with the same period last year. The growth was attributed to a 222% increase in the Group's ODM business from the US market, as well as its expanded range of digital electronics products which attracted increased orders.

Compared with the last corresponding period, gross profit grew by 218% from HK$72 million to HK$229 million, translating into a gross profit margin of 28% while that of last year's was 32%. The relatively lower gross profit margin was mainly attributable to the reduction of the average selling prices of our digital electronic products and the discontinuation of the apparel trading business. The net profit margin, however, increased from 12% to 16% as a result of the drastic growth in turnover compared to a mild increase in operating expenses and hence economies of scale was achieved. Therefore, the Group's net profit increased tremendously by 420% to HK$134 million in the period with review. Earnings per share amounted to HK26.42 cents, representing an enormous growth of 72%.

Business Review

Satisfactory growth across various markets

At the continuous efforts to expand into overseas markets particularly the US, the Group successfully broadened its customer base during the interim period to include a few customers. The strong economic growth in the US accelerated the demand for digital consumer electronics products and boosted the Group's business substantially. Revenue contribution from the US increased by 760% amounting to HK$706 million, which represented 86% of the Group's total turnover for the first half of FY05. The US market not only provides a core revenue stream for the Group, but also a strong potential customer base for the Group's OBM business which it plans to extend to the continent.

The Group was also able to have achieved some breakthrough in Europe, recording revenue of HK$8.4 million from it in the interim period. Facilitated by the subsidiary it set up in Dusseldorf last year, the Group has rapidly extended the sales network for its OBM products in Europe. The Group believes there is much room for business growth in this market and plans to step up its marketing efforts there.

Back in Hong Kong, the Group recorded a 127% growth in revenue from its OBM business, thanks to its effective branding strategies, which created strong brand recognition of "Matsunichi" in the market.

With increased contribution from the overseas markets, the percentage of revenue contribution from the Greater China market lowered to 12% of the Group's total turnover for the interim period. This signifies the Group's access to a truly global market and the great variety of business opportunities for its digital consumer electronics products in the global market place.

Synergistic combination of ODM and OBM businesses

The Group's new production plant in Longgang, Shenzhen, has greatly expanded its production capacities for MP3 and USB drives. The vertically integrated operations in the Longgang plant and the Dalian plant have enabled the Group to shorten its product lead time, guarantee product quality and enhance cost efficiency. These have facilitated the development of both the ODM and OBM businesses of the Group. The Group thus enjoys the competitive advantages of innovative product design, premium product quality and competitive pricing.

The revenue contribution ratio from the ODM and OBM businesses was approximately one to three in the period under review. However, as OBM business enjoys a slightly higher profit margin, the Group will seek to more actively expand its OBM business, particularly for higher storage products, while maintaining a sizable ODM business.

Prospects

Ample opportunities arising in worldwide market

The global digital consumer electronics products market is expected to experience very promising growth in future. According to the International Data Corporation ("IDC"), the total worldwide shipment of flash MP3 players will reach 36.6 million units in 2007, representing a CAGR of 26% from 2002 to 2007. IDC also projects that the worldwide portable flash player market will attain a CAGR of over 24% from 2002 to 2007. The Group will seize these opportunities to capture a prominent share of the global market.

Defined product roadmap in place

To stay ahead of the market trends of greater miniaturization, higher storage and more features in the digital consumer electronics products, the Group has a well-defined product roadmap in place. The most imminent pursuit is the "Matsunichi" hard disk MP3 player to be launched by the end of year 2004. This new product is expected to become a major revenue growth driver for the Group in the next financial year. Given the very limited number of hard disk suppliers in the global market, and the fact that the Group has secured a substantial portion of the hard disks supplied by a long-time partner, the Group does not expect competition in the hard disk MP3 player market to intensify at the entrance of new market players, not to mention that the entry barrier of the industry is exceptionally high. With a highly effective cost structure, the Group has the capability to adopt a competitive pricing strategy to capture the hard disk MP3 market.

Moreover, foreseeing the gradual emergence of portable multimedia players ("PMPs"), the Group plans to launch its first PMP by mid-2005 when the market will be ready for the new product. Featuring functions of movie playback and photo image browsing, PMPs will command even higher profit margins, and will be the Group's growth driver in the longer term.

Elevated branding strategies

To complement the gradual extension of its OBM business to overseas markets and further strengthen the "Matsunichi" brand name in the Greater China market, the Group will launch a new marketing campaign by the end of 2004 or early 2005. One of the highlights of the campaign will be the appointment of an internationally recognized celebrity as an endorser to support the Group's international branding strategies.

Another important move of the Group was the acquisition of the related trademarks of "Matsunichi" from Matsunichi International Holdings Limited, Guangdong Matsunichi Electronics Limited and Guangdong Matsunichi Communications Technology Company Limited (collectively referred to as the "Sellers") for a total consideration of HK$210 million which will be satisfied as to HK$20 million by cash and as to HK$190 million by the issue of new shares at HK$2.0 per share. Mr. Pan Su Tong, Chairman of the Group, has beneficial interests in the Sellers and therefore the above acquisition constitute connected transactions under the Listing Rules, details of which were announced on 9th November, 2004. As the trademarks are crucial to the business of the Group, the Board considers that it is in the long term interest of the Group to acquire the full ownership and exclusive use in view of the new products which will be launched into the market. Subsequent to this acquisition, the Group will be able to fully capitalize on the brand equity of "Matsunichi".

To attain a more balanced business mix

As the active development of its ODM business continues, the Group expects the percentage of revenue contribution from the business to increase in the years to come, and eventually at the ratio of one to one with the OBM business. At the same time, the Group will continue to penetrate the ODM markets by leveraging its lower cost production base as well as its recognized technology and product quality. Moreover, the Group will strive to further expand its customer base and sales network across its markets worldwide.

In conclusion, all the above initiatives will be implemented with the full commitment of the management team and staff. With a vision to become a leading global player in the age of digital convergence, the Group will strive to capture a lion's share in the digital consumer electronics products market, to enhance profitability and long-term growth, and in turn bring to the shareholders fruitful results of its business growth.

Financial Position

As at 30th September, 2004, the Group had approximately HK$276 million of cash on hand compared to approximately HK$192 million as at 31st March, 2004. The strong cash position has paved the way to finance the working capital requirements of the Group. On the other hand, the Group had neither committed any substantial capital expenditure nor borrowed long-term loan. This further consolidated our liquidity position in the longer run.

However, the total short-term bank debts had increased vigorously from HK$81 million as at 31st March, 2004 to HK$325 million as at 30th September, 2004. The substantial increase in bank borrowings was inevitable as the increase in the volume of business during the six months' period has fostered the need for bank financing in the procurement of raw materials. As a result, the gearing ratio (defined as total bank borrowings on shareholders' equity) increased from 0.2 as at 31st March, 2004 to 0.51 as at 30th September, 2004 and on the other hand, the current ratio decreased from 3 times as at 31st March, 2004 to lower level of 1.8 times in 30th September, 2004.

The Group's sales and purchase transactions are primarily denominated in either Hong Kong Dollars or US Dollars. The Group did not face significant risk from exposure to foreign exchange fluctuations.