Sustainable, Fast-Growing CHINA BUSINESS OPPORTUNITIES

- Extended our network into smaller cities and opened mega sports retail stores in Beijing
- Promoted our corporate identity across the China network
- Strengthened our IT infrastructure to enhance inventory control

40
20
MPH
km/h

宝元体育用品店
CONVERSE
IMPOSSIBLE IS NOTHING
SIEMENS
asics
TELEPHONE

Management Discussion and Analysis

REVIEW OF OPERATIONS

General Overview

For the year ended 30th September 2004, the Group achieved satisfactory growth. Turnover increased by 8.4% year-on-year to US$2,720 million. However, net profit declined by 1.6% year-on-year to US$303.3 million, while earnings per share declined 4.6% year-on-year to US$0.188. The increase in turnover was due to the solid contribution of the core footwear manufacturing operations and the surge in China retail operations. Meanwhile, the disposal of securities investments generated US$26.2 million in profit for the Group in fiscal year 2004. Gain from disposal of an associate and securities investments amounted to US$5.5 million in the previous year.

The operating environment in 2004 was generally challenging. The surge in crude oil and commodity prices exerted substantial pressure on the prices of petrochemical derivatives, the key components in the manufacture of the midsole and outsole of shoes. The volatility in the raw materials market last year was something that had not been seen for at least five years.

Fluctuations in raw material prices undermined the Group's gross profit margin, due to the time lag in reflecting new pricing and resistance levels in the market. The increase in average selling price (ASP) in the second half of fiscal year 2004 was not enough to prevent an overall reduction in margins for the full year. The jump in these material costs also affected the Group's upstream businesses, which, by their very nature, were more exposed to the volatility in the raw materials market.

Elsewhere, utility costs rose following the surge in crude oil prices, and direct labor costs climbed due to an overall increase in salary levels in the Pearl River Delta area. There have been no difficulties experienced in recruiting staff – despite a general labor shortage in the Pearl River Delta area – due to the good working environment and fringe benefits offered by the Group.

Production Review

The Group's major product, athletic shoes, accounted for 61.2% of total turnover, slightly lower than in the previous year. The casual/outdoor shoes and sports sandals categories saw rises in their contribution to revenue, of 16.3% and 32.5% year-on-year in 2004, respectively. The increase in ASP in the second half of fiscal 2004 reversed a five-year downtrend. As a result, there was a marginal year-on-year increase in ASP for athletic and casual/outdoor shoes for the full year. Soles and components, which includes the upstream businesses acquired in 2002, reported 7.1% year-on-year growth in turnover. China retail sales jumped to US$74.2 million in 2004, as a result of continued expansion of the Group's retail network and a more than 30% increase in year-on-year same store sales.

At the end of fiscal year 2004, the Group operated 309 production lines, up 19 compared with the previous year. The Group had 170 lines in China, 88 in Vietnam and 51 in Indonesia.

Total Turnover by Product Category (year ended 30th September)

	2004		2003		y-o-y
	US$ millions	%	US$ millions	%	% change
Athletic Shoes	1,665.1	61.2	1,630.4	65.0	2.1
Casual/Outdoor Shoes	502.3	18.5	431.9	17.2	16.3
Sports Sandals	38.6	1.4	29.1	1.2	32.5
Soles & Components	405.8	14.9	378.9	15.1	7.1
Retail Sales – Shoes & Apparel	74.2	2.7	25.7	1.0	188.1
Others	34.0	1.3	13.5	0.5	152.5
Total Turnover	2,720.0	100.0	2,509.5	100.0	8.4

The US continued to be the Group's biggest market in 2004, accounting for 41.2% of total turnover. Sales to the US grew 7.7% in 2004, but there was a decline in sales to Europe. Sales to Asia recorded encouraging growth, increasing 22.9% year-on-year to US$701.1 million.

Total Turnover by Geographical Market (year ended 30th September)

	2004		2003		y-o-y
	US$ millions	%	US$ millions	%	% change
US	1,121.3	41.2	1,041.5	41.5	7.7
Canada	45.3	1.7	43.5	1.7	4.2
Europe	734.3	27.0	753.9	30.0	(2.6)
South America	56.0	2.0	51.1	2.0	9.5
Asia	701.1	25.8	570.7	22.8	22.9
Other Areas	62.0	2.3	48.8	2.0	27.1
Total Turnover	2,720.0	100.0	2,509.5	100.0	8.4

Cost Review

Total operating costs increased by 10.7% year-on-year to US$2,556.6 million, while cost of sales rose by 11.6% to US$2,070.7 million for the year ended 30th September 2004. Raw materials accounted for a larger share of the cost of sales due to higher prices. A surge in revenue from China retail sales operations also led to an increase in related sales and administrative costs. Increases in other operating expenses were in line with the rise in other operating revenue, with the major components including expenses for utility generation, sales of samples and expenses from upstream businesses. Also, the Group incurred a loss of about US$9 million from the disposal of fixed assets.

Research and Development

The Group is committed to investing in research and development (R&D) in order to provide customers with advanced technical support from the mold shops and tailor-made R&D centers. The Group's R&D efforts focused on raw materials development and the streamlining of production processes so as to develop advanced footwear and shorten product cycles. In 2004, the Group invested US$89.3 million in R&D, a 6.1% increase over 2003.

FINANCIAL REVIEW

Liquidity

The Group maintains a strong financial position. As at 30th September 2004, the Group had cash on hand of US$466 million (2003: US$383 million) and total borrowings of US$777 million (2003: US$640 million). The gearing ratio (total borrowings to shareholders' equity) was 44% (2003: 40%) and the net debt to equity ratio (total borrowings net of cash on hand to shareholders' equity) was 18% (2003: 16%). The increase in the gearing ratio was due to investments made in various strategic projects, such as sports apparel and accessories manufacturing, during the year.

Capital expenditure

Capital expenditure for property, plant and equipment declined to US$150 million (2003: US$170 million). The Group spent approximately US$26.3 million on constructing new factory buildings and ancillary facilities, mainly in China and Vietnam. The Group also spent US$99.6 million on plant and equipment for production facility expansion, and US$7.3 million to acquire new land and buildings. In addition, the Group invested about US$100 million to form new joint ventures and associates during the period under review.

Dividends

A final dividend of HK$0.46 per share (2003: HK$0.46) has been recommended, making the full-year dividend per share HK$0.71 (2003: HK$0.69 plus a special dividend of HK$0.37).

The register of members of Yue Yuen will be closed from 8th February, 2005 to 18th February, 2005, both days inclusive, during which period no transfer of shares will be effected. The final dividend is payable on or before 8th March, 2005, to be approved at the annual general meeting.

The Group's operating cash flow remains strong, and a sufficient level of cash holdings will continue to be maintained. The policy of upholding steady growth in the normal dividend payment each year remains intact. The dividend payout ratio was 48.7% in 2004, compared with 46.4% in 2003.

Employees

As at 30th September 2004, the Group employed about 252,000 staff, up from 242,000 in 2003. The Group adopts a remuneration system based on an employee's performance throughout the year, and offers equal opportunities for all staff. There are incentives in the form of discretionary performance bonuses to reward staff who make creative suggestions that improve productivity.

Subsequent Events

On 28th December, 2004, the Group entered into an amendment agreement with, among other parties, Eagle Nice to amend the terms of the convertible note. Subject to, among other conditions, approval by independent shareholders of Eagle Nice at its extraordinary general meeting, the convertible note will be fully converted into 87,000,000 shares of Eagle Nice. The Group's interest in Eagle Nice will then be increased from 30.88% to 44.96%. Details of the agreement were set out in a joint announcement of the Company and Eagle Nice dated 29th December, 2004.