

MANAGEMENT DISCUSSION AND ANALYSIS



MARKET REVIEW

According to statistics published by the China Building Materials Industry Association ("CBMIA"), actual output of flat glass in the PRC in 2004 amounted to approximately 300 million weight cases, representing an increase of over 19% as compared with 2003. CBMIA's statistics also show that actual sales of flat glass in China in 2004 amounted to approximately 292 million weight cases, with a closing inventory of approximately 9 million weight cases at the end of December 2004. The average sales/production ratio of the flat glass industry in China was approximately 97% in 2004, as compared with 99% in 2003.

These figures illustrate that the austerity measures implemented by the PRC government did not affect the demand of flat glass during 2004. The market prices of flat glass remained stable and at high levels during the first half of 2004, and rose further by an average of approximately 5% during the second half of 2004. The Directors believe that the rise in flat glass prices was largely due to increased demand resulting from PRC's rapid economic development.

BUSINESS REVIEW

Capitalising on the solid foundation established in 2003, the Group continued to record satisfactory performance in 2004. Production volume and average selling price of the Group's flat glass products increased by 23% and 18% respectively as compared with 2003. In addition to the strong market demand for glass products, average selling price of the Group's flat glass was driven up due to successful strategy of product diversification continued to be implemented in 2004, namely, adding an increased portion of high value glass products to the product mix, which included the ultra-thin flat glass.

The Group's operating results in 2004 was not materially affected by the austerity measures implemented by the PRC government. The price of heavy oil, the major fuel for glass production, remained high during the year, while that of soda ash, the key raw material for manufacturing glass products, kept surging throughout 2004. These resulted in an increase of unit cost of sale for the Group by 16% in 2004. Although the increase of unit cost of sale has partly offset the rise in average selling price of the Group's flat glass, The Group's gross profit margin was improved from approximately 32% in 2003 to 35% in 2004, and the Group's overall profitability was further enhanced.

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Products

The Group's float glass for the construction and automotive markets are sold without further processing (i.e. as flat glass), or are processed into products with additional properties (i.e. as processed glass or special glass).

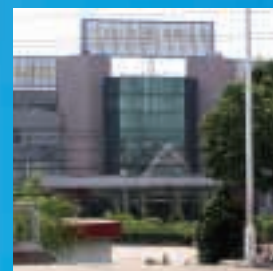
Flat Glass

All of the Group's five (2003: four) flat glass production lines were in full operation in 2004 at an aggregate daily melting capacity of 2,350 tonnes (2003: 2,050 tonnes). During the year, the Group produced 15.4 million weight cases (2003: 12.5 million weight cases), or approximately 770,000 tonnes (2003: 625,000 tonnes), of flat glass and achieved a sales/production ratio of over 95%. Sales of flat glass amounted to RMB1,119 million in 2004 (2003: RMB781 million) and accounted for 93.4% (2003: 96.5%) of the Group's total sales. Average selling price of the Group's flat glass in 2004 was RMB77 per weight case (2003: RMB65 per weight case). Improvement in average selling price was partly attributable to the growing contribution of more expensive ultra-thin glass in the product mix, since the ultra-thin glass production line was in full operation in 2004.

Among such, the Group won a RMB50 million automotive glass sales contract in July 2004 from a leading automotive glass processor in Eastern China. This single largest automotive glass sales contract, awarded since the Group's ultra-thin glass production line commenced operation in the fourth quarter of 2003, marks the full speed entry of the Group's ultra-thin glass business into the automotive industry.

In fact, the selling price of ultra-thin glass ranging from 2 mm to 3 mm in thickness is on average 20% higher than that of regular flat glass of 4 mm to 6 mm thick. The relatively stable price helps mitigate the effect of price fluctuation of regular flat glass for the construction market. Besides enjoying cost advantage over imported glass products, the Group is among a handful of domestic glass manufacturers in China capable of offering a stable supply of high quality ultra-thin glass products at a reasonable price.

During the year, approximately 88% and 12% of the Group's flat glass output were automotive grade glass (higher quality with higher average selling price) and construction grade glass (lower quality with lower average selling price), respectively.



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Processed glass

In 2004, all of the Group's six (2003: six) processed glass production lines were in commercial production – manufacturing mirror glass, tempered glass, insulating glass and laminated glass. During the year, approximately 2.8 million sq.m. (2003: 1.0 million sq.m.) of processed glass products were sold at an average selling price of RMB28 per sq.m. (2003: RMB27 per sq.m.), achieving a turnover of RMB79 million (2003: 28 million). Sales of processed glass accounted for 6.6% (2003: 3.5%) of the Group's total sales in 2004.

In line with the Group's development strategy of product diversification, the Group established Zhejiang Engineering Glass Company Limited in 2003. Approximately RMB350 million was invested in building a new processed glass production line – vacuum magnetically-enhanced cathodic sputtering coating glass production line – for manufacturing energy efficient glass, including low-E glass and heat reflecting coating glass (also known as solar control film glass). This production line, which commenced production around the end of 2004, has an annual capacity of 2 million sq.m.

Sales and marketing

With rapid economic growth in the Yangtze River Delta, the Group continued to focus its sales and marketing efforts in its local Zhejiang market during the year, and penetrated further into the markets of Shanghai and Jiangsu Province. Sales to the Yangtze River Delta accounted for 93% of the Group's total sales in 2004 (2003: 91%). The Group also supplied glass products to Guangdong, Fujian and other provinces.

Supply of fuel and raw materials

In 2004, the price of heavy oil remained high and the Group expended 12% more on average for heavy oil, at approximately RMB1,880 per tonne.

Market price of soda ash continued its rising trend in 2004, with an increase of over RMB100 per tonne every month since August 2004, and peaked at RMB1,850 per tonne by December 2004. The Group expended 49% more on average for soda ash at an average price of approximately RMB1,480 per tonne during the year. There were no material fluctuations in the costs of other major raw materials.

Supply of electricity

The Group's business relies to a significant extent on the smooth and non-stop operation of its float glass production lines. In this regard, there arose no event which affected its production.

Zhejiang Province has been suffering from severe power shortages in recent years. To help ease the electricity shortage, the provincial government demanded manufacturing companies in Zhejiang to take turns, during the peak electricity consumption seasons, to shut down production. The Group however was not affected as the local government has committed to providing adequate electricity supply to the Group's float glass production, which guarantees non-stop electricity supply.

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FINANCIAL REVIEW

In 2004, the gross profit margin of the Group was 35%, as compared with 32% in 2003. Average selling price of the Group's flat glass increased by 18% to RMB77 per weight case, which offset the higher unit cost of sale which rose by 16% from RMB43 per weight case in 2003 to RMB50 per weight case in 2004.

The Group achieved a net profit of RMB205 million and a net profit margin of 17%, compared with the net profit of RMB182 million and net profit margin of 23% in 2003. The significant increase in bank borrowings, from approximately RMB689 as at 31 December 2003 to approximately RMB1,648 million as at 31 December 2004, for financing of the Group's capital expenditures in 2004, coupled with the increase in interest rate for bank borrowings during the second half of 2004, have partially led to the decline in the Group's net profit margin. In addition, the Group made profit tax provision of approximately RMB15 million in 2004 for the subsidy income received for the financial years 2002 and 2003 as a result of changes in circumstances, which further decreased the Group's net profit margin.

The Group's average inventory turnover in 2004 was 30 days, compared with 25 days in 2003. The increase was mainly due to the purchase of more fuel and raw materials to support the increase in production volume of flat glass in 2004.

OUTLOOK

Product diversification

The Group has established its growth strategy of product diversification in recent years, in addition to the expansion of production capacity. Through diversifying the product mix, the Group is set to enhance the value of its flat glass products and develop downstream by producing a higher proportion of processed glass products. This will help secure higher and more stable selling prices of all the Group's glass products.

Ultra-thin Glass

The Group successfully developed ultra-thin glass of 1.1 mm in thickness for the electronics industry in July/August 2004, and further realised the development of ultra-thin glass of as thin as 0.6 mm in January 2005. To the best knowledge and belief of the Directors, only a few glass manufacturers in China are presently capable of producing similar products. Current market price of the ultra-thin glass for the electronics industry is on average over four times the selling price of ultra-thin glass for the automotive industry. However, due to capacity constraints, the Group's commercial production of these ultra-thin glass has not been commenced yet.

To minimise the negative impact from any deterioration of demand for float flat glass in the construction and automotive sectors, the Group intends to set up a new ultra-thin glass production line (the sixth flat glass production line) with a daily melting capacity of 150 tonnes and an annual production capacity of 10.12 million sq.m.. Located at the existing factory area of the Company, this production line will be able to manufacture ultra-thin glass of 0.5 mm to 1.3 mm in thickness for use in electronic products such as personal computers and scanners. The commercial production of these ultra-thin glass is scheduled to commence in the fourth quarter of 2005 (please refer to "Proposed A share issue" section).

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Low-E Glass

The production of low-E glass only commenced around the end of 2004, and the first sales contract worth over a million (RMB) was won by Zhejiang Engineering Glass Company Limited, a subsidiary which operates the low-E production line, at the same time. With higher market price and profit margin than those of regular flat glass, the Directors believe that the commercial production of low-E glass will not only broaden the Group's income stream, but also minimise the risk associated with heavy reliance on the regular float flat glass products.

Low-E glass is characterised by its ability to insulate heat and to reduce noise penetration and is thus widely used as glass panels on the outer wall of buildings. Certain cities like Beijing and Shanghai have already seen the increasing use of low-E glass for new buildings. Given the growth in demand for energy and rising power tariff in China, the Directors believe that the PRC government will urge the construction sector to adopt energy-saving low-E glass for new commercial and residential buildings in the future. It is hence expected that the demand for low-E glass and other processed glass such as laminated glass and insulating glass will further increase, and the production of such processed glass will generate substantial revenue for the Group.

Depending on the utilisation performance of the current low-E glass production line, the Group will consider constructing a second production line for low-E glass as well as tempered glass, laminated glass and insulating glass (please refer to "Proposed A share issue" section).

Capacity expansion

Apart from the ultra-thin glass production line (the sixth flat glass production line) currently under construction, the Group plans to further expand its flat glass business and relieve the capacity constraints by constructing two new float flat glass production lines (the seventh and eighth flat glass production lines) in Tao Yan, Shaoxing County, Zhejiang Province, each having a daily melting capacity of 600 tonnes. The commercial production of these two production lines is expected to commence in the fourth quarter of 2005. The Group will then have a total of eight flat glass production lines, reaching an aggregate daily melting capacity of 3,700 tonnes by the end of 2005.

Through better logistics and production arrangements of all the flat glass production lines, the Group targets to optimise its production efficiency and thus increase its production volume to over 16 million weight cases in 2005.

Soda ash project and soda ash market price

The Group's soda ash project in Qinghai has been progressing well in achieving integration for the Group's upstream operation. In August 2004, The National Development & Reform Commission ("NDRC") granted formal approval for the Group to construct a soda ash production line with an annual production capacity of 900,000 tonnes. The commercial production of the first phase of the project is scheduled to commence at the end of June 2005.

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Having secured a stable supply of soda ash – a major raw material used internally for flat glass production, the Group intends to sell any soda ash produced in excess of the quantity required for its float flat glass production. In view of the wide application of soda ash in glass, chemicals, metals and electronics industries, the Group has started to contact potential customers in these sectors to prepare for rolling out its soda ash business. The Directors believe that the project can help lower the Group's average unit cost of sale significantly, while offering new income stream for the Group.

In Eastern China, where the Group currently sources its soda ash, manufacturers have been experiencing high costs of production. Coupled with the strong demand for soda ash as a result of more flat glass production lines coming into operation in China, market price of soda ash has surged from RMB1,250 per tonne in early 2004 to RMB1,850 per tonne by the end of the year. The Directors, however, expect that the soaring soda ash price will come to a halt in the near future and local soda ash price will come down slightly to stay clear of competition of imported soda ash products from the US.

Proposed A share issue

In January 2005, the Company announced its plan to apply to the China Securities Regulatory Commission ("CSRC") for the allotment and issuance of not more than 280 million A shares to institutional and public investors in China and to propose to list such shares on the Shanghai Stock Exchange. The proposed A share issue represents approximately 48.38% of the Company's existing issued share capital and approximately 32.61% of the enlarged issued share capital. The A shares shall rank pari passu with the existing H shares and domestic shares in all material respects. The proposed A share issue has been approved by shareholders at class meetings for holders of domestic shares and H shares respectively and at an Extraordinary General Meeting held on 12 March 2005, and is subject to approval from the relevant PRC authorities, including CSRC.

It is intended that the net proceeds from the proposed share issue would not exceed RMB1,500 million, which will be used in the following projects:

- approximately RMB530 million to fund the construction of a production line for soda ash with annual production capacity of approximately 900,000 tonnes;
- approximately RMB140 million to fund the construction of a production line for ultra-thin glass (0.55 mm to 1.3 mm in thickness) applicable to the electronics industry with annual production capacity of approximately 10.12 million sq.m.;
- approximately RMB650 million to fund the construction of a production line for quality ultra-thick glass (8 mm to 25 mm in thickness and 4,500 mm x 6,000 mm in width) with daily melting capacity of approximately 1,000 tonnes; and
- approximately RMB180 million to fund the construction of a production line for low-E glass with annual production capacity of approximately 2.6 million sq.m.

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The Directors believe the proposed A share issue will provide financial resources to fund the Group's upstream and downstream expansion projects with high growth potential, which in turn will help sustain the Group's rapid growth and market leadership. In addition, it will minimise the Group's financial risks for obtaining bank loans, lower its gearing and broaden its equity base.

Conclusion

With more flat glass production lines coming into operation in the PRC, the Directors remain prudent in assessing how the austerity measures will affect the glass industry, and accordingly the average selling price of the flat glass. However, with robust economic growth and improvement of living standards, the Directors are confident that the demand for high quality flat glass and processed glass will continue to surge.

CAPITAL EXPENDITURES AND COMMITMENTS

Total capital expenditures of the Group in 2004 amounted to RMB1,231 million, of which RMB147 million was spent on the construction of the low-E glass production line, RMB729 million on the construction of the soda ash plant in Qinghai, and RMB355 million on the acquisition of land use rights and other relevant fixed assets.

As at 31 December 2004, the Group's total contracted capital commitments in respect of plant and machinery, land use rights, other fixed assets and investment in subsidiaries amounted to RMB8,138 million. The amount was not recorded as a liability of the Group.

In 2003, the Company entered into cooperation agreements with three local government authorities in Zhejiang Province for the construction of a number of glass products production lines. As such, the Company established several subsidiaries in Zhejiang Province in 2004 (details as in Note 16 to the Accounts). With the rights to adjust the time schedule as well as the amounts of these proposed investment projects, the Directors will assess the level of expenditure to be incurred in 2005 according to the Group's cash flows and financing conditions.

LIQUIDITY AND FINANCIAL RESOURCES

As at 31 December 2004, the Group's cash and cash equivalents balance amounted to RMB707 million, compared with RMB380 million as at 31 December 2003. As at 31 December 2004, the shareholders' funds of the Group amounted to RMB1,359 million, representing an increase of RMB118 million from RMB1,241 million as at 31 December 2003.

As at 31 December 2004, the Group had outstanding bank loans amounting to RMB1,648 million, representing an increase of RMB959 million from RMB689 million as at 31 December 2003. Out of the outstanding bank loans, RMB1,348 million was repayable within one year and RMB300 million was repayable beyond one year.

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As most of the bank financing was in the form of short-term bank loans, the Group recorded a net current liabilities position as at 31 December 2004. Nevertheless, the Group did not experience any major problem in renewing its short-term bank loans upon their expiry.

Further to the official approval from NDRC in August 2004, each of the State Development Bank and the Agricultural Bank of China have granted long-term loan facilities to the Group amounting to RMB600 million (RMB1.2 billion in aggregate), of which RMB300 million had been drawn as at 31 December 2004 and the remaining portion can be utilised to finance its soda ash project in Qinghai.

The Group's debt ratio as at 31 December 2004 was 43%, compared with 30% as at 31 December 2003. The calculation of debt ratio is based on total debts of RMB1,650 million (2003: RMB691 million) over total assets of RMB3,880 million (2003: RMB2,312 million).