Management Discussion and Analysis of Results of Operations and Financial Position

INDUSTRY REVIEW

Heavy-duty vehicles industry

The development of road system, especially highway system, and the strong economic growth in the PRC have stimulated the sale of vehicles, especially heavy-duty vehicles in the PRC. Furthermore, highway transportation services, being more economical and efficient, sales of heavy-duty vehicles have been rising very rapidly in recent years, and the production of heavy-duty vehicles has surpassed that of medium-duty vehicles. A sizeable proportion of the unit sales of heavy-duty vehicles with a load capacity of 15 tonnes (and above) in the PRC is concentrated in a few manufacturers, which are the major customers of the Company such as: China Heavy Duty Truck Group Company Limited ("CHDTGL"), Chongqing Hongyan Heavy Duty Motor Company Limited ("Chongqing Hongyan"), Shaanxi Heavy-duty Company Limited ("Shaanxi Motor"), Beijing Futian Motor Company Limited ("Beijing Futian"), Baotou North-Benz Heavy-duty Truck Co., Ltd. ("North-Benz"), etc. Although during the Period, the PRC central government implemented a series of austerity measures, the sales of heavy-duty vehicles with a load capacity of 8 tonnes (and above) was not much affected. In the PRC, the total sales of heavy-duty vehicles with a load capacity of 8 tonnes (and above) during the Period rose by 45% as compared with that of the same period of 2003. Major truck manufacturers engaged in manufacturing heavy-duty vehicles with a load capacity of 15 tonnes (and above) also recorded very impressive growth rates at the range of approximately 80% to 150%.

It is estimated that approximately 80% of the medium to heavy-duty vehicles in the PRC are frequently overloaded in previous years. Lower toll charges for smaller trucks are the main cause for overloading. The PRC central government is cracking down hard on the widespread practice of truck overloading. Furthermore, toll charges for heavy-duty vehicles with a load capacity of 15 tonnes (and above) was reduced by approximately 30%. All these have stimulated the demand for heavy-duty vehicles with a load capacity of 15 tonnes (and above) and also accelerated the pace of truck-capacity upgrading in the PRC.

The said government crackdown on truck overloading also means that transportation companies that strive to remain in business and make a profit will be more inclined to upgrade their existing medium-duty vehicles to heavy-duty vehicles. The Directors believe that rising port container throughput, highway cargo shipment as well as the property and infrastructure development will remain the main drivers for the growth of 15 tonnes (and above) trucks in the years ahead.

Construction machines — wheel loaders

Wheel loaders with a load capacity of 5 tonnes (and above), being our second-most important market, is also showing strong growth during the Period.

In recent years, the wheel loader market grew by over 29% year-on-year. During the Period, the implementation of a series of austerity measures with credit-tightening policies by the PRC central government adversely affected the sales of some categories of the construction machines such as excavators to a certain extent. But there is no clear sign of over supply of construction machines, especially in wheel loaders with a load capacity of 5 tonnes (and above). The sales growth of wheel loaders only slowed down mildly since the implementation of the said austerity measures. A sizeable proportion of the sales of construction machines with a load capacity of 5 tonnes (and above) in the PRC is concentrated in a few manufacturers which are the major customers of the Company, such as: Guangxi Liugong Machinery Co., Ltd. ("Guangxi Liugong"), Shanghai Longgong Machinery Company Limited ("Shanghai Longgong"), Fujian Longyan Construction (Group) Company Limited ("Fujian Longyan"), Shandong Lingong Construction Machinery Co., Ltd. ("Shandong Lingong"), etc.

BUSINESS REVIEW

The Company is one of China's leading high-speed, heavy-duty diesel engine manufacturers, supplying mainly to certain major domestic truck and construction machine makers. The Company's core products are its six-cylinder, 110–266kW output, 9.7 litre displacement WD615 diesel engines. The Company also launched the WD618 series of diesel engines in 2000, which have a higher power output of 265–323kW. At the end of 2004, the Company invented the Euro III diesel engines with 10–12 litre displacement and higher horsepower up to 480 horsepower. The Euro III diesel engines will be required by China government to be adopted in all heavy-duty vehicles by 2008. The Company believes that the Euro III diesel engines can be manufactured by using the new production lines installed during the Period if such orders received by the Company in 2005.

Over the past decade, emission and noise control regulations have become increasingly stringent, and against this background, the technologies for diesel engines in this respect have also been greatly improved.

China has implemented Euro II emission standards since September 2004. Demand for heavy-duty diesel engines from the heavy-duty vehicles and construction machines industries has also increased in the past few years due to the economic growth of, the improvement of road systems of, and increases in investment in heavy infrastructure in the PRC. The Directors believe that the development of environmental-friendly investment in heavy-duty diesel engines will be a major trend of the PRC's diesel engine industry.

The Company has a very stable customer base which includes certain well-known market leaders in their industries including: CHDTGL, Shaanxi Motor, Guangxi Liugong, Shanghai Longgong, Shandong Lingong, North-Benz, Chongqing Hongyan, etc. During the Period, sales to our top five customers accounted for approximately 62.2% of our total turnover and top ten customers represented approximately 76.0% of our total turnover.

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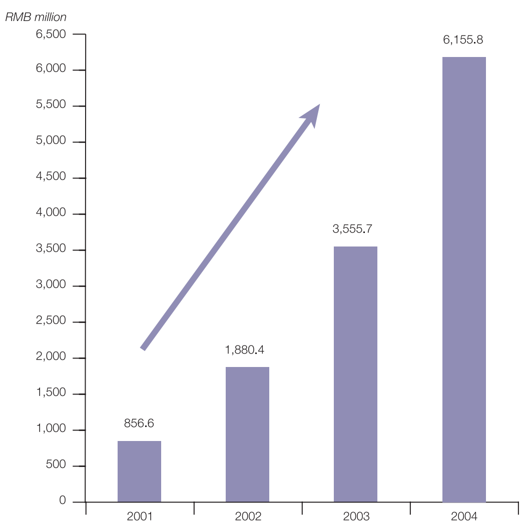
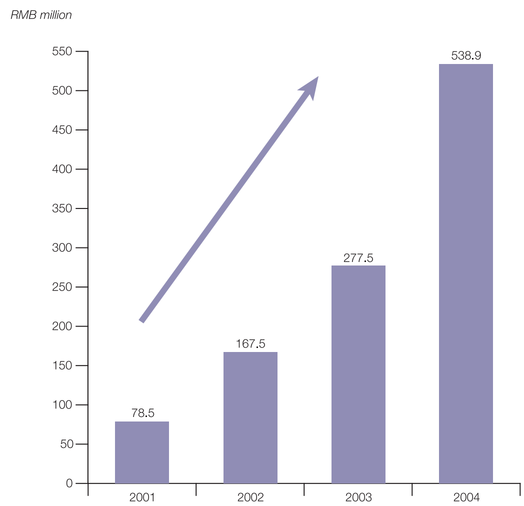
FINANCIAL REVIEW

During the Period, the Company recorded significant growth in both turnover and net profit attributable to shareholders.

Turnover



Net profit attributable to shareholders



The significant increase in turnover and net profit attributable to shareholders were attributable to the significant increase in the demand for our products together with the increasing production capacity of diesel engines as a result of the improvement in our existing production lines. In addition, the expansion in scale that we achieved have enabled us to absorb fixed production costs more effectively and to enjoy greater bargaining power in purchasing raw materials, in particular, the purchases of out-sourced parts for the manufacture of diesel engines. This in turn enabled us to adopt a more flexible pricing strategy.

Sales of WD615 and WD618 series engines

Turnover of the Company for the Period amounted to approximately RMB6,155.8 million, representing an increase of approximately RMB2,600.1 million or approximately 73.1% over the same period in 2003. Turnover was derived mainly from the sales of diesel engines used in heavy-duty trucks and construction machines, which accounted for approximately 60.7% and 27.7% of the total turnover, respectively. The significant increase in turnover was mainly attributable to the robust market demand for our WD615 engines. To meet increasing demand, the Company has further expanded its production capacity and improved its operational efficiency during the Period. The expansion in scale also enabled the Company to achieve economies of scale and adopt a more flexible and competitive pricing strategy for our products. As a result of the above factors, the Company's net profit attributable to shareholders for the Period increased to approximately RMB538.9 million, representing a approximately 94.2% increase as compared to that for the same period in 2003.

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Sales of engine parts

In addition to the production and sale of engines, the Company also engages in the production and sales of engine parts. During the Period, the Company recorded an approximately 413.4% increase in sales of engine parts from approximately RMB100.0 million in 2003 to approximately RMB513.5 million. The surge was mainly attributable to the increase in sale volume of diesel engines from approximately 80,480 units in 2003 to approximately 134,460 units in 2004 as a result of the continuing strong growth in heavy-duty vehicles and construction machines markets in the PRC. The sales of diesel engine parts represented approximately 8.3% (2003: 2.8%) of the Company's turnover during the Period.

Gross profit and gross profit margin

During the Period, the Company's gross profit increased by approximately 74.9% to RMB1,504.7 million (2003: RMB860.3 million) as a result of increase in the sales volume from approximately 80,480 units in 2003 to approximately 134,460 units of diesel engines in 2004 and the gross profit margin of the Company remained relatively the same as of previous year.

Finance costs

Finance costs represent the interest expenses paid on bank borrowings wholly repayable within five years during the Period.

The Company maintained very low level of bank borrowings. Total bank loans decreased from approximately RMB151.7 million in 2003 to only RMB20 million in 2004 due to sufficient cash being generated from the operating business during the Period. The increase in finance costs was mainly due to the fact that certain bills receivables were discounted to banks without recourse and this led to the increase in finance costs from approximately RMB30.4 million in 2003 to approximately RMB53.2 million for the Period.

Taxation

PRC Enterprise income tax for the Company was calculated at statutory income tax rate of 33% (2003: 33%) of the assessable profit except that the Company's Chongqing branch is taxed at a preferential rate of 15% (2003: 15%) pursuant to the relevant laws and regulations in the PRC. The tax charges during the Period were approximately RMB205.5 million in aggregate, representing an effective tax rate of approximately 27.6% (2003: 39.1%). The difference in the effective tax rate of 27.6% compared to the statutory rate of 33% was due to the fact that the Company was granted a tax credit of approximately RMB63.6 million relating to its acquisition of certain PRC made machinery and equipment. The amount of tax credit is calculated as 40% of the current year's additions of PRC made machinery and equipment for production use.

According to the Notice of the Ministry of Finance and the State Administration of Taxation concerning certain preferential policies on enterprise income tax (財政部、國家稅務總局《關於企業所得稅若干優惠政策的通知》) and the Notice of the State Administration of Taxation concerning the proper implementation of the continuing administrative work after the cancellation and delegation of the examination and approval procedure for enterprise income tax (國家稅務總局《關於做好已取消和下放管理的企業所得稅審批項目後續管理工作的通知》), as the Company is a high technology enterprise and its new production facilities and registered address are situated in the industrial park administered by the State (the "State Industrial Park"), and the production at the State Industrial Park has already commenced in April 2005, the Company is now entitled to enjoy preferential enterprise income tax treatment at a reduced tax rate of 15% in respect of the taxable profit generated from the new production facilities at the State Industrial Park starting from the tax assessable year of 2005 without the need to obtain any prior approval from PRC authorities (as compared to the 33% taxation rate charged on the Company's taxable profit made at its existing production facilities at its previous registered address). For details, please refer to the announcement of the Company dated 17th March, 2005.

Net profit margin

The net profit margin increased substantially from approximately 7.8% in 2003 to approximately 8.8% for the Period, which was primarily due to the improvement in operational efficiency, benefit from the economy of scale enjoyed by the Company and the tax credit granted to the Company as mentioned above.

Liquidity and financial resources

The Company had a very solid financial position and maintained a strong and steady cash inflow from its operating activities. As at 31st December, 2004, the net cash and cash equivalents of the Company amounted to approximately RMB1,774.2 million, representing an increase of approximately 424.6% from approximately RMB338.2 million as at 31st December, 2003. Such increase was primarily due to the cash inflow from operations and the net IPO proceeds of approximately RMB1,226.9 million received by the Company in March 2004.

The Company has sufficient financial resources to fund its operations, as well as its current investment needs and development plans disclosed in the prospectus of the Company dated 26th February, 2004.

Earnings per share — basic

The calculation of basic earnings per share is based on the net profit attributable to shareholders for the Period of approximately RMB538.9 million (2003: RMB277.5 million) and on the weighted averaged number of approximately 308,005,000 (2003: 215,000,000) shares in issue during the Period. The basic earnings per share for the Period was approximately RMB1.75, which represented an increase of approximately 35.7% compared with the same period in 2003. The significant increase in earnings per share was due to the increase in net profit attributable to shareholders for the Period by approximately 94.2% compared to that of the same period in 2003.

Capital structure

During the Period, the Company's bank borrowings were primarily denominated in RMB while its cash and cash equivalents were held in RMB and Hong Kong dollars.

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It is the intention of the Company to maintain an appropriate mix of equity and debt to ensure an efficient capital structure from time to time. As at 31st December, 2004, the Company had debts of approximately RMB20 million and the gearing ratio was only a mere approximately 0.4% (2003: 6.4%) (total debt/total asset).

Segment information

The Company is principally engaged in the manufacture and sale of WD615 and WD618 diesel engines and its related parts. As substantially all of the Company's turnover and operating results during the Period were derived from the PRC, no analysis of business and geographical segment is prepared for the Period.

Pledge of assets

As at 31st December, 2004, bank deposits and bills receivables of approximately RMB334.4 million (2003: RMB391.6 million) and RMB119.9 million (2003: RMB77.1 million) were pledged to secure banking facilities granted to the Company respectively.

Foreign exchange risk exposure

As almost all of the operations of the Company are located in the PRC. Its operating expenses as well as most of capital expenditure of the Company were denominated in RMB for the Period. Therefore, the Company did not experience any material difficulties or effects on its operations or liquidity as a result of fluctuations in currency exchange during the Period. The Directors believe that the Company will have sufficient foreign exchange currency to meet its foreign exchange requirements.

Contingent liabilities

The Company had no material contingent liabilities as at 31st December, 2004.

Capital commitments

As at 31st December, 2004, the Company had approximately RMB423.6 million (2003: RMB322.7 million) capital commitments, principally for the capital expenditure in respect of purchase of property, plant and equipment.

Capital expenditure

During the Period, the Company's capital expenditure of property, plant and equipment and intangible assets amounted to approximately RMB774.9 million. This was mainly attributable to the installation of new production lines, modification of existing production lines, research and development of Euro III diesel engines and acquisition of intangible assets related to trademarks.

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Human resources practice

As at 31st December, 2004, the Company had a total of over 5,200 employees. As the Company believes people are the cornerstone of its success, the Company has long been concerned with its employees' development by organizing various training courses to broaden their horizon. During the Period, some of the senior management of the Company attended training courses organised by reputational domestic and overseas universities such as 北京清華大學 (Peking Tsinghua University) and National University of Singapore (新加坡國立大學). Employees are remunerated based on their performance, experience and the prevailing industry practices, with compensation policies and packages being reviewed on a yearly basis. Bonus and commission may also be awarded to employees based on internal performance evaluation.

The Company has established an incentive scheme for its senior management. Under this scheme, up to 5% of the audited annual profit after tax of the Company will be paid as bonus to the Directors and other senior management staff each year.