Management Discussion and Analysis

SEWCO

Business review

Turnover and gross profit

During the year under review, rising raw material costs were still a major concern to the Group. To cope with the price hikes, the Group changed its strategy and focused on orders with relatively higher profit margin only. The Board considered this policy successful as the gross profit margin was maintained at 14.8% (2003: 14.6%) for the year ended 31 December 2004.

Sales of hard toys and stuffed toys for the year ended 31 December 2004 remained relatively stable as compared to those of the previous year. The sales of hard toys and stuffed toys contributed 87.0% (2003: 88.9%) and 13.0% (2003: 11.1%) respectively to the Group's turnover.

Geographically, USA and Canada remained the major market where 83.7% (2003: 82.2%) of the Group's turnover was generated. The balances of 12.7% (2003: 14.9%) and 3.6% (2003: 2.9%) were attributable to sales to Japan & others and Hong Kong & Mainland China. There was no material change in the rate of contribution to operating profit in terms of geographical segments.

Expenses

Selling and distribution costs amounted to HK$15,827,000 (2003: HK$19,506,000), representing 3.5% (2003: 4.1%) of the Group's turnover for the year ended 31 December 2004. The decrease in such costs was mainly due to the lower warehouse rental expenses during the year ended 31 December 2004 after the completion of a new factory complex in Gangkou Zhen, Zhongshan Shi, Mainland China.

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Administrative expenses of HK$35,884,000 (2003: HK$35,753,000) for the year ended 31 December 2004 were maintained at the same level with those of 2003.

Other operating expenses amounted to HK$262,000 and were attributable to the loss on the disposal of fixed assets. Other operating income of HK$60,000 recorded in the year 2003 was mainly the revaluation surplus of fixed assets. No revaluation surplus of fixed assets had been recorded for the year ended 31 December 2004.

Net profit from ordinary activities attributable to shareholders

Although profit from ordinary activities was maintained at HK$18,956,000 (2003: HK$19,185,000) for the year ended 31 December 2004, net profit from ordinary activities attributable to shareholders decreased by 37.1% from HK$19,557,000 in 2003 to HK$12,301,000 in 2004. The decrease in net profit in the current year was mainly attributable to the provision of tax in respect of a non-taxability claim made in prior years which is now under dispute with the Hong Kong Inland Revenue Department ("IRD") while last year's net profit included a reversal of tax overprovision in prior years as a result of the resolution of a tax dispute with the IRD in last year.

Liquidity and financial resources

As at 31 December 2004, the Group's net current assets amounted to HK$93,971,000 (2003: 97,137,000). The Group maintains a strong and healthy financial position by financing its operations with internally generated funds and banking facilities granted by its principal bankers. As at 31 December 2004, the Group had cash and bank balances, which were mainly in Hong Kong dollars, US dollars and Renminbi, of approximately HK$19,462,000 (2003: HK$56,349,000). The decrease in balances was mainly due to the payments for the construction of the new factory complex and the purchase of plant and machinery made during the year ended 31 December 2004. The Group's current ratio (current assets/current liabilities) and gearing ratio (total bank borrowings/total shareholders' equity) were 1.9 (2003: 2.4) and 6.0% (2003: 8.1%), respectively.

The Group has aggregate banking facilities of HK$116,030,000, comprising the term loan, revolving loan, import and export facilities and overdrafts. As at 31 December 2004, the Group had utilised its term loan facility of HK$15,530,000, of which HK$5,960,000 is repayable by four equal quarterly installments within one year, and the balance of HK$9,570,000 will be repayable by six quarterly installments with the final payment on 12 May 2007. This term loan facility is a clean loan without any charges or securities required and is subject to floating interest rates. It is one of the conditions of the term loan facilities that Mr. Cheung Po Lun, the Chairman of the Board and the controlling shareholder (as defined in the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited) of the Company, his family members, close relatives, related trusts or companies controlled by him, his family members, close relatives or related trusts must beneficially own not less than 51% of the issued voting share capital of the Company throughout the life of the term loan facilities. A breach of the aforesaid condition will constitute an event of default under the term loan facilities and all amounts outstanding under the term loan facilities will become due and payable immediately. As at 31 December 2004 and up to the date of the approval of the audited consolidated financial statements of the Group for the year ended 31 December 2004, Mr. Cheung Po Lun beneficially owns, through a company wholly-controlled by him, approximately 66.96% of the issued share capital of the Company.

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Liquidity and financial resources (continued)

Except for the contracted commitments of HK$4,380,000 for the purchase of plant and machinery, the Group did not expect to incur material capital expenditure in the coming year. Therefore the Board believes that the existing financial resources will be sufficient to satisfy the Group's future operation needs and capital commitments.

Contingent liabilities

The Group had a contingent liability in respect of possible future long service payments to employees under the Hong Kong Employment Ordinance, with a maximum possible amount of HK$613,000 (2003: HK$590,000) as at 31 December 2004. The contingent liability has risen at the balance sheet date as a number of current employees have achieved the required number of years of service to the Group, and will be eligible for long service payments under the Employment Ordinance if their employment is terminated under certain circumstances. A provision has not been recognised in respect of such possible payments, as it is not considered probable that the situation will result in a material future outflow of resources from the Group.

At the balance sheet date, the Group had provided corporate guarantees of HK$500,000 (2003: HK$500,000) to a bank in respect of banking facilities granted to one of its associates. As at 31 December 2004, such banking facilities were utilised up to an amount of HK$463,000 (2003: HK$500,000).

Charge on assets

The Group did not have any charge on assets as at 31 December 2004 and 31 December 2003.

Exchange risk

During the year under review, the Group was not subject to any significant exposure to foreign exchange rates risk as the majority of the Group's transactions were conducted in Hong Kong dollars, US dollars and Renminbi.

Employees

As at 31 December 2004, the Group had a total of approximately 8,970 (2003: 7,320) employees in Hong Kong and Mainland China. The Group provides remuneration packages to employees largely based on industry practice, individual performance, qualification and experience. In addition, discretionary bonuses and share options under the Company's share options scheme may be granted to eligible staff by reference to the Group's performance and individual performance. The Group also provides subsidies to staff for external training in order to enhance the Group's competitive edge.