Management Discussion and Analysis

MARKET OVERVIEW

The handset industry in the PRC has become increasingly mature after rapid growth in the past few years. According to China Center for Information Industry Development's ("CCID") statistics, total handset demand in the PRC amounted to 65 million units in 2004, representing a relatively flat growth compared to the growth of year 2003. This, together with the oversupply of thousands of handset models in the market, directed competition towards two extremes. High-end handsets with innovative features continued to emerge, leading to rapid price reduction in mid- to low-end products. On the other hand, overseas players increased their marketing efforts to recapture the market shares lost in previous years by offering a wide range of mid- to low-end products to tap the market. Competition among domestic and overseas players was keener than ever, leading to smaller players being phased out. It is believed that this trend will be beneficial for long-term market development.

Competition in the global handset market was equally intense, with the world's leading brands dominating the market. International handset giants gradually introduced high-end handsets with innovative features to penetrate the high-end market. Advancements in technology stimulated all players to speed up new product rollout in order to capture greater profit. At the same time, substantial price reductions were regularly offered to clear inventories. These led to a shortened product life cycle and thus a reduction in profit margin for handset manufacturers, therefore overall operating environment was difficult.

BUSINESS REVIEW

The Group understood that to stay competitive under tremendous market challenges, it had to extend its business coverage and broaden its revenue base so as to compete with international brands on the same platform. Moving along this direction, the Group and Alcatel joined hands to establish T&A, which officially commenced operations in September 2004. This extended the Group's network coverage to over 50 countries and initially formed an international operating platform.

The Group's business operations are conducted through its wholly owned subsidiary TCL Mobile and 55%-owned subsidiary T&A. TCL Mobile is principally engaged in the design and manufacture of TCL brand handsets for sale in the PRC, as its primary market, and for export to overseas markets as its secondary market. In addition, it also engages in OEM business that manufactures handsets for overseas brands. T&A, on the other hand, principally sells Alcatel brand handsets via its international business network.

For the year ended 31 December 2004, the Group sold over 10 million handsets, representing an increase of about 2% as compared to the previous year. The sales volume increase was mainly attributable to the sales from T&A since its operations commenced in early September which offset the sales decline from the PRC market. Currently, multimedia handsets are the mainstream product in the market. To keep up with the market pulse, the Group aggressively promoted high-end multimedia handsets in 2004. Sales of such multimedia handsets amounted to 2.15 million units, representing a significant increase of 3,196% over the last year and accounting for 22% of the Group's total unit sales.

T&A has been established for only a short period. Its initial operating costs had nevertheless exerted financial pressure on the Group and adversely affected the Group's business performance. Loss from T&A during the period under review amounted to approximately HK$258 million.

Sales Volume by Company

('000 units)	2004	2003	Change
TCL Mobile	7,512	9,817	-23%
- The PRC	6,664	9,541	-30%
- Overseas	848	276	+207%
T&A	2,503	n.a.	n.a.
Total	10,015	9,817	+2%

TCL Mobile

In 2004, TCL Mobile sold 7.5 million handsets, a decline of 23% as compared to the same period last year. PRC remained TCL Mobile's core market and accounted for 92% of TCL Mobile's total turnover. During the year under review, while the growth of the PRC handset market experienced a slowdown, intensifying competition was seen as foreign brands increased their marketing efforts, in addition to the Group's slow pace of product development resulted in a delay in new product launch and led to sales decrease. Despite this, the Group continued to maintain its position in the PRC market. According to statistics from MII, for the year ended December 2004, TCL brand handsets continued to be the top 5 handset brands in the PRC, taking up a 6% share of the market.

In the meantime, TCL Mobile actively promoted its TCL brand handsets to overseas markets. During the year under review, the Group promoted TCL brand handsets to overseas emerging markets, such as Vietnam, Thailand, Malaysia and Russia. Satisfactory sales performances were recorded in such markets.

In addition, the Group also leveraged on its competitive advantages of superior production technology, low cost structure and high quality products, to aggressively expand its OEM business to enhance profitability. For the year ended 31 December 2004, TCL Mobile recorded satisfactory growth in its overseas business, with sales volume and turnover posting encouraging growth of 207% and 70% respectively. TCL brand handsets and OEM businesses accounted for 61% and 39% of TCL Mobile's overseas turnover respectively. The results were highly encouraging.

TCL Mobile launched 26 new TCL brand models in 2004, including 23 GSM and 3 CDMA models. Among these, 3 were high-end smartphone handset models, 11 had multimedia functions, and 12 were colour-display models. TCL Mobile was committed to product R&D and achieved several functionality breakthroughs in the year. It is the first PRC handset manufacturer to launch smartphone equipped with 1.0 mega pixel camera and the first to apply Qualcom 6050 chips into its handsets.

TCL Mobile actively promoted products which targeted high-end male customers. It launched the "神典" series of smartphone which offers camera, PDA and full-screen handwriting functions. In order to satisfy different customers' needs in the mid- to high-end markets, it subsequently launched 0.3 mega pixel and 1.3 mega pixel embedded camera models. In addition, during the fourth quarter of 2004, the Group launched the first smartphone with automobile-testing functions, extending the application of handsets to a new arena to capture more market opportunities. However, as that new handset model was only recently launched, the satisfactory sales have not been reflected in the results for the year under review.

With respect to handset design, TCL Mobile successfully developed the first ultra-thin clamshell handset. It also pioneered in applying animal fur to handset design, providing the world's first smartphone with elegant outlook, advanced digital camera and handwriting functions specifically for ladies.

During the year under review, TCL Mobile further improved its marketing and sales channels to maintain its competitiveness. Handsets were sold directly to network operators, chain outlets and retailers to reduce the layers of the distribution network, thereby reducing sales and distribution costs. Furthermore, the Group continually explored new channels for handset sales. Its smartphones with automobile-testing functions were promoted to the automobile industry and distributed via automobile-related channels.

T&A

T&A's handsets are mainly sold to handset users through major international telecommunication operators and distributors. During the year under review, T&A distributed handsets through Alcatel's extensive network that covers over 50 countries globally. At the same time, it also sold Alcatel brand handsets through TCL Mobile's network in the PRC. Nevertheless, as marketing and promotional activities started since the fourth quarter of 2004, T&A did not make significant contribution to the Group. For the four months ended 31 December 2004, the sale of handsets amounted to 2.5 million units.

On the R&D front, T&A leveraged on Alcatel's world class research platform to develop a new multimedia handset series with digital camera and broadcasting functions. During the year under review, T&A rolled out 3 new Alcatel brand handset models, with high resolution colour display, embedded camera, multimedia music and video recording and broadcasting functionality. All 3 handset models were well received in the market, with particularly encouraging response from network operators.

To increase its operating efficiencies, T&A implemented a series of cost control strategies and enhanced the economies of scale of its supply chain and manufacturing operations. Dedicated to realizing synergetic effects with TCL Mobile, T&A transferred its PRC's after-sales services and a portion of its manufacture to TCL Mobile during the year, effectively reducing its operating costs.

Outlook

Going forward, the Board expects continually intense competition in both the PRC and the global handset market. Substantial price reductions will continue to be a major means of promotion in 2005. Fortunately, after going through a consolidation phase, it is anticipated that the market will move towards healthier development, creating a favourable environment for competent handset manufacturers.

In 2005, TCL Mobile will continue to consolidate its PRC business and develop overseas emerging market with increasing efforts. It is also committed to developing its OEM business to establish a more diversified revenue base with stable revenue streams. TCL Mobile will implement a series of measures for internal adjustment, including:

— Strengthening inventory structure to reduce cost;
— Simplifying its distribution model to sell directly to retail chain stores and large-scale outlets;
— Increasing its R&D efforts to launch new products in a timely manner.

In the future, the Group will foster closer cooperation between TCL Mobile and T&A in terms of sales and marketing. At the same time, the Group will gradually switch to centralized procurement to lower costs. The Board believes that after incorporating T&A's high standard of R&D, the Group's product quality will be lifted in all aspects.

Meanwhile, T&A will step up the promotion of Alcatel brand handsets worldwide, particularly redeveloping their presence in the Western European market where handset sales are strong.

To improve operating efficiencies and to realize synergies with TCL Mobile, T&A started to relocate its manufacturing activities in 2004 to TCL Mobile which is headquartered in the PRC. The relocation is expected to complete in 2005. By leveraging on TCL Mobile's highly efficient and low cost manufacturing platform to increase the production volume, Alcatel brand handsets will strengthen their competitiveness in the international marketplace.

The Group is well positioned to make every effort to enhance it product R&D and achieve network expansion. The Group will integrate TCL Mobile's highly efficient manufacturing base and the nationwide distribution network in the PRC, together with Alcatel's R&D strengths and worldwide network coverage to increase the Group's operating efficiencies, resources and cost advantages, and gradually realize the synergies in procurement, R&D and manufacturing attributable to economies of scale. The Group believes future outlook will be improved along with the realization of synergies.

FINANCIAL REVIEW

Turnover by Company

(HK$ million)	2004		2003	
TCL Mobile	5,580	76%	9,020	100%
- The PRC	5,144	70%	8,764	97%
- Overseas	436	6%	256	3%
T&A	1,730	24%	n.a.	n.a.
Total	7,310	100%	9,020	100%

Turnover

During the year under review, the Group sold TCL brand and Alcatel brand handsets in the PRC market through TCL Mobile and T&A. Turnover generated from the PRC market dropped 40% to HK$5.31 billion from HK$8.76 billion in the corresponding period of the previous year, representing 73% of the total turnover. The Group, through TCL Mobile, also sold TCL brand handsets overseas and established the OEM business. Turnover generated from TCL Mobile's overseas sales and OEM business amounted to HK$436 million, accounting for 6% of the Group's total turnover and representing a significant increase of 70% as compared with the same period of the previous year. Meanwhile, the Group sold Alcatel brand handsets through the extensive sales network of T&A to over 50 countries worldwide, generating a turnover of HK$1.73 billion, representing 24% of the total turnover.

Gross Margin

The Group's gross profit margin dropped to 14% from 21% in the same period of the previous year, mainly as a result of the continual decrease of product selling prices in response to keen competition in both the PRC and global handset markets. The selling price of handsets declined more rapidly in 2004 than the cost of mobile phone spare parts. As a result, the Group's gross profit margin was squeezed.

Expenses

The commencement of T&A's operations in September 2004 has contributed to the increase in selling and distribution costs and administrative expenses during the year under review. Selling and distribution costs and administration expenses accounted for 11% and 6% of the total turnover respectively (2003: 9% and 2% respectively).

The Group was listed on the HKSE in September 2004. The finance costs for the listing amounted to HK$59 million.

Tax

During the year under review, the Group recorded a negative tax provision of HK$3 million due mainly to the over provision made last year.

Significant Investments and Acquisitions

On 31 August 2004, the Company established a joint venture with Alcatel pursuant to the subscription agreement entered into between the Company and Alcatel on 18 June 2004 (the "Subscription Agreement"), whereby the Company contributed Euro 55 million (approximately HK$537 million) in cash for a 55% equity stake in T&A, and Alcatel contributed cash and its mobile handset business ("Alcatel mPD") for the remaining 45% stake in T&A, which amounted to a value of Euro 45 million (approximately HK$439 million). The aforesaid subscription ratio was determined assuming the consolidated net asset value (the "NAV") of T&A, excluding certain specified items and the cash payment by the Company and Alcatel for the subscription (which in essence represents the NAV of Alcatel mPD), was not less than zero as at 31 August 2004, the closing date of the Subscription Agreement (the "Joint Venture Closing Date"). Accordingly, the

Subscription Agreement has provided for a post-closing adjustment mechanism such that if the NAV as at T&A Closing Date as estimated by Alcatel for the purpose of closing (the "Estimated NAV") is less than that as reflected in the final audited consolidated balance sheet of T&A (the "Audited NAV"), Alcatel shall pay the difference in cash to T&A. If however the Audited NAV exceeds the Estimated NAV, T&A shall pay the difference in cash to Alcatel.

Inventory

The Group's inventory turnover period was 20 days. Excluding the effect of T&A, inventory turnover was 17 days (2003: 16 days). Over 99% of the inventories have an aging period of less than six months. Credit period ranged from 31 days to 180 days and the accounts receivable turnover was 60 days. Excluding the effect of T&A, account receivable turnover was 20 days (2003: 16 days).

Liquidity and Financial Resources

The Group consistently maintained a healthy liquidity position throughout the year. The cash and cash equivalents balances as at 31 December 2004 amounted to HK$2 billion, of which 5% was maintained in Hong Kong dollars, 22% in US dollars, 33% in Renminbi and 40% in Euro for the operations. The Group's financial position remains strong, with net current assets of HK$1.46 billion as at 31 December 2004 and a gearing ratio of 12% at the end of the period under review. The gearing ratio is calculated based on the Group's total interest-bearing borrowings and shareholders' funds.

Pledge of Deposits

Notes payables of HK$107,568,000 (2003: HK$353,268,000), were secured by the pledge of deposits amounted to HK$11,373,000 (2003: 161,354,000).

Capital Commitments and Contingent Liabilities

As at 31 December 2004, the Group had capital commitments of approximately HK$23,845,000 contracted, but not provided for. The Group had the following contingent liabilities:

(i) As at 31 December 2004, contingent liabilities in respect of discounted notes and endorsed notes with recourse not provided for in the financial statements were as follows:

(HK$'000)	2004	2003
Notes discounted or endorsed with recourse	48,657	599,155

(ii) One of the Group's subsidiary, ASTEC was involved in a patent infringement litigation brought by Hubin, Huxuanhua and Dalian Hanpu Applied Technology Co., Ltd. (the "plaintiff") in March 2001. In May 2002, the PRC trial court rendered civil judgment in favor of ASTEC with no damages or expenses to be borne by them. In the same month, the plaintiff appealed to the High Court and up to date, the appellate proceeding is still in progress.

According to the legal letter and the opinion from the engaged lawyer, it is very likely for the appellate court to render judgment in favor of Astec again. Accordingly, no provision was made for such litigation in the financial statements.

Foreign Exchange Exposure

It is the Group's policy not to engage in speculative transactions. Foreign currency transaction exposure is managed in accordance with treasury guidelines and utilizes forward contracts. Most of the Group's transactions are either hedged or denominated in Hong Kong dollars, US dollars or Renminbi.

Employees and Remuneration Policy

The Group had 8,072 employees as at 31 December 2004. Total staff costs for the period were approximately HK$362,646,000. The remuneration policy was reviewed, in line with current legislation, market conditions and both individual and company performance.

"The Group believes future outlook will be improved along with the realization of synergies."

A STRONG PRESENCE

BLOSSOMING SYNERGIES THROUGH INTERNATIONAL PARTNERSHIP