

4. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

4.1 Turnover

Turnover increased from RMB584.6 million in FY2003 to RMB714.2 million in FY2004, an increase of 22.2%. Turnover comprises of three different segments: retail, OEM, and other turnover. In FY2004, the retail segment grew in importance in terms of overall turnover, increasing from 64.9% of total Group turnover in FY2003, to 68.8% of total turnover in FY2004.

4.1.1 Retail

Retail turnover increased from RMB379.3 million in FY2003 to RMB491.6 million in FY2004, an increase of 29.6%. The increase was driven by an increase in unit volume sold, growth in sales in existing stores and sales from new stores, and an increase in the average selling price. The increase in unit volume sold is due to, among other factors, the increase in the number of PORTS and BMW Lifestyle retail outlets from 270 as at 31 December 2003 to 299 as at 31 December 2004. The number of new stores opened during FY2004 was in line with the Group's ongoing plan to increase the size of its retail network by 10% each year. The increase in average selling price reflects, in part, the increasing strength of the PORTS and BMW Lifestyle brands, and the effectiveness of the Group's marketing program. The Directors believe that the increase in retail turnover is also partially attributable to the continued growth in average annual household income in urban cities in the PRC, where most of the Group's retail outlets are located. This increase in income enables an increasing number of PRC consumers to purchase the Group's products.

During FY2004, turnover from concessions represented 71.8% of total retail turnover and turnover from retail stores represented 28.2% of total retail turnover. Accordingly, sales from concessions in department stores still represented the majority of the Group's retail turnover. However, the Directors believe that retail stores located in upscale shopping malls will become of increasing importance to the positioning of the PORTS and BMW Lifestyle brands.

As at 31 December 2004, turnover from the retail segment represented a larger percentage of the overall turnover of the Group than in previous years, from 64.9% of total Group turnover in FY2003, to 68.8% of total Group turnover in FY2004.

4.1.2 OEM

Turnover from the OEM segment decreased from RMB 168.2 million in FY2003 to RMB157.2 million in FY2004, a decrease of 6.5%. As a percentage of total turnover, the OEM segment declined in importance for the Group in terms of overall turnover, declining from 28.8% of total turnover in FY2003 to 22.0% of total turnover in FY2004. This decline was driven primarily by a reduction in orders from certain key OEM customers in North America. The Directors anticipate that the contribution of OEM turnover to the Group's total turnover will continue to decline in 2005.

4.1.3 Other

Other turnover increased from RMB37.2 million in FY2003 to RMB65.3 million in FY2004, an increase of 75.7%. This increase was driven primarily by a significant increase in the export of BMW Lifestyle products to BMW dealers worldwide. The increase in the export of BMW Lifestyle products has more than offset the decline of the Group's wholesale business within this segment. On this basis, the Directors intend to focus on continuing to grow export sales of BMW Lifestyle products, whilst lessening the Group's focus on its wholesale business. The Directors anticipate that exports of BMW Lifestyle products will continue to grow, whilst the wholesale business will continue to decline in 2005.

4.2 Cost of sales

Cost of sales increased from RMB247.9 million in FY2003 to RMB278.0 million in FY2004, an increase of 12.1%. The increase in cost of sales was directly related to the increase in the Group's turnover during FY2004, although the percentage increase in cost of sales is significantly less than the percentage increase in total turnover and volume of sales.

4.3 Gross profit

Gross profit increased from RMB336.7 million in FY2003 to RMB436.1 million in FY2004, an increase of 29.5%. Gross profit margin also increased from 57.6% in FY2003 to 61.1% in FY2004. The improvement in gross profit margin was driven predominantly by the increasing contribution of gross profit generated by the retail segment.

4.3.1 Retail

Gross Profit for the retail segment increased from RMB290.1 million in FY2003 to RMB378.1 million in FY2004, an increase of 30.3%. Gross profit margin for the retail segment also improved from 76.5% in FY2003 to 76.9% in FY2004. The Directors believe that the gross profit margin enjoyed by the retail segment is in line with what is achieved by other international high end fashion and luxury brands. In FY2004, the retail segment accounted for 86.7% of the Group's total gross profit, up from 86.2% of the Group's total gross profit in FY2003. This increase, in part, reflects the growing importance of the retail segment to the Group.

4.3.2 OEM

Gross profit from the OEM segment increased from RMB24.3 million in FY2003 to RMB25.6 million in FY2004, an increase of 5.3%. Gross profit margin also improved, increasing from 14.4% in FY2003 to 16.3% in FY2004. The Group introduced controls on gross profit margin for the OEM segment in FY2004 by refusing orders with unacceptable gross profit margin. However, as OEM is a very competitive business, the Directors do not expect any significant improvement in the performance of the OEM segment going forward.

4.3.3 Other

Gross profit from the Other segment increased from RMB22.3 million in FY2003 to RMB32.4 million in FY2004, an increase of 45.3%. However, gross profit margin declined from 60.0% in FY2003 to 49.6% in FY2004. The mix of business within this segment changed in FY2004. Business has shifted away from the high margin, low volume wholesale of PORTS branded products, towards the lower

margin, high volume business generated by the export of BMW Lifestyle products. BMW Lifestyle products have been well received by BMW dealers throughout the world, and the Directors anticipate continued growth in the export of BMW Lifestyle products during 2005. The Directors anticipate that the overall gross profit contribution of the Other segment to the Group's gross profit will increase in 2005, but also anticipate a continued decrease in the gross profit margin of the Other segment due to the shifting mix of business. The Other segment now ranks second in terms of contribution to the Group's net profit in FY2004.

4.4 Other operating income

Other operating income decreased from RMB7.9 million in FY2003 to RMB4.8 million in FY2004, a decrease of 39.2%. This decline was mostly attributable to a decrease in store design and decoration service income, although the decrease was partially offset by an increase in royalty income from sales of PORTS branded eyewear, which almost doubled to RMB2 million in FY2004. The Directors anticipate that royalty income from sales of PORTS branded eyewear will continue to increase during FY2005.

4.5 Operating Expenses

Operating expenses increased from RMB225.5 million in FY2003 to RMB294.8 million in FY2004, an increase of 30.6%. Operating expenses have generally increased in accordance with the growth of the business. The Group experienced higher operating expenses during FY2004 compared to previous years due to the fact that FY2004 was the first full year that the Company operated as a publicly listed company. Operating Expenses consist of distribution expenses, administrative expenses and other operating expenses:

4.5.1 Distribution expenses

Distribution expenses increased from RMB185.1 million in FY2003 to RMB243.8 million in FY2004, an increase of 31.8%. The increase was principally due to an increase in sales commissions, rental payments, and depreciation charges. Depreciation charges increased by RMB4.4 million in FY2004 as a result of increased investments in manufacturing, distribution facilities and retail outlets. Advertising and promotional costs increased by approximately RMB2.8 million in FY2004, amounting to approximately 4.5% of retail turnover.

4.5.2 Administrative expenses

Administrative expenses increased from RMB18.6 million in FY2003 to RMB26.5 million in FY2004, an increase of 42.1%. The increase was principally due to an increase in salaries and benefits, insurance and office sundries mostly attributable to the fact that FY2004 was the first full year that the Company operated as a publicly listed company. The Directors anticipate that the rate of increase in administrative expenses will remain constant during FY2005.

4.5.2 Other operating expenses

Other operating expenses increased from RMB21.8 million in FY2003 to RMB24.5 million in the FY2004, an increase of 12.2%. The increase was due to a small increase in the provision for ageing inventory.

4.6 Profit from operations

As a result of the increase in turnover, and the increasing economies of scale derived from the growth of the Group's operations, the Group's profit from operations increased from RMB119.1 million in FY2003 to RMB146.1 million in FY2004, an increase of 22.7%. The Group's operating margin (profit from operations expressed as a percentage of turnover), increased from 20.4% in FY2003 to 20.5% in FY2004.

4.7 Income tax expense

The Group's effective income tax rate increased from 7.2% of profit before tax in FY2003 to 8.3% of profit before tax in FY2004. This increase was due to a decrease in the tax refund received by the Group from RMB6.6 million in FY2003 to RMB5.0 million in FY2004.

The majority of the Company's subsidiaries are located, for tax purposes, in the Xiamen special economic zone, and thus enjoy a favorable income tax rate of 15%. The effective tax rate of the Group is reduced by tax refunds received each year pursuant to certain PRC tax laws and regulations relating to the re-investment of net profits by foreign owned companies. The tax refund received by the Group, amounting to RMB6.6 million in FY2003, decreased to RMB5.0 million in FY2004. This decrease increased the effective tax rate of the Group. Further, one of the Company's subsidiaries, Ports International Marketing (Xiamen) Ltd., which operates the BMW lifestyle business in The PRC, has for the first time, turned a small profit, and hence triggered the tax holiday for this business in FY2004.

4.8 Profit attributable to shareholders

As a result of the factors discussed above, the Company's profit attributable to shareholders increased from 107.5 million in FY2003 to RMB137.1 million in FY2004, an increase of 27.5%. The Company's net profit margin also improved from 18.4% in FY2003 to 19.2% in FY2004.

4.9 Financial Position & Liquidity

The Group continues to enjoy a strong financial position, with significant cash reserves generated from normal business operations. Cash inflow from operating activities increased from RMB82.7 million in FY2003 to RMB150.3 million in FY2004, an increase of 81.7%. Investment in fixed assets increased from RMB26.2 million in FY2003 to RMB41.0 million in FY2004, an increase of 56.5%. As at 31 December 2004, the Group had approximately RMB375.1 million in cash, cash equivalents and time deposits, as compared to RMB315.1 million as at 31 December 2003. The Group also had access to significant bank loans and overdraft facilities, although these were not utilized. The Group currently has no interest bearing loans with any commercial banks. As at 31 December 2004, the Group's gearing ratio was zero. The Group's current ratio is 4.9, based on current assets of RMB718.4 million and current liabilities of RMB146.0 million.

4.10 Acquisitions & Disposals of Subsidiaries & Associated Companies

The Group did not engage in any acquisitions or disposals of any subsidiaries or associated companies during FY2004.

4.11 Currency Risk Management

The Group's cash balances from normal business operations are mainly deposited in Renminbi ("RMB"), United States dollars ("US\$"), Hong Kong dollars ("HK\$") and the European Union common currency ("Euros"), with major banks in Hong Kong and the PRC. The Group is engaged in very limited currency hedging and considers its risk exposure to currency fluctuations to be minimal.

4.12 Capital Commitments & Contingent Liabilities

As at 31 December 2004, the Group had capital commitments of RMB109.9 million (compared to RMB120.0 million as at 31 December 2003) based on RMB98.0 million of authorized but not contracted for capital commitments (compared to RMB120.0 million as at 31 December 2003), and RMB11.9 million authorized and already contracted for capital commitments (compared to RMBNil million as at 31 December 2003). These capital commitments were primarily attributable to planned budgeted activities such as the opening of superstores, the expansion and renovation of retail outlets and the expansion of manufacturing and distribution facilities. As at 31 December 2004, the Group had no material contingent liabilities.

4.13 Capital Structure of the Group

The Group requires working capital to support its manufacturing, retail, OEM and other operations. As at 31 December 2003, the Group had cash, cash equivalents and time deposits of approximately RMB315.1 million, denominated principally in HK\$, US\$ and RMB. As at 31 December 2004, cash, cash equivalents and time deposits held by the Group increased to approximately RMB375.1 million, denominated principally in RMB, US\$, HK\$ and Euros. Cash balances and net cash inflow from operating activities are sufficient to support the operating activities of the Group.

The Company exercised a four-for-one share subdivision in November 2004, although this did not affect the capital structure of the Company.

4.14 Major Customers & Suppliers

During FY2004, the Group purchased approximately 12% and 32% of its goods and services from its largest supplier and five largest suppliers, respectively. The percentage of turnover attributable to the Group's largest customer and five largest customers combined was roughly 11% and 26%, respectively. None of the Directors, their associates or shareholders (to the best knowledge of the Directors that own more than 5% of the Company's share capital) were interested at any time in the year in the above suppliers or customers.

4.15 Charges on Assets

As at 31 December 2004, the Group had not charged any of its assets.

4.16 Human Resources

As at 31 December 2004, the Group had approximately 3,850 employees. Total personnel expenses, comprised of wages, salaries, and benefits, amounted to RMB95.9 million in FY2004, compared with RMB68.3 million in FY2003.

The Group is committed to fostering a safe and comfortable workplace and a corporate culture that emphasizes training, career development opportunities and rewards employees for performance. A competitive remuneration scheme, a safe and comfortable work environment, and a merit-based advancement program provide incentives for employees to excel in their areas of responsibility. In addition, share options were granted to Directors and eligible employees pursuant to the terms and conditions of the share option scheme adopted by the Company on 14 October 2003. No new share options were granted in FY2004.

4.17 Post-Balance Sheet Date Developments

After the balance sheet date, the Directors proposed a final dividend on 23 March 2005. Further details are disclosed in note 10 to the financial statements.