

# Management Discussion and Analysis



## Results Review

In 2004, Kelon further consolidated its leading market position and achieved a record high turnover of RMB8,436,404,000, representing a growth of 36.77% as compared with 2003. During the Reporting Period, the profit level of the Group was adversely affected by the following factors, thus the Group recorded a net loss of RMB44,658,000:

- (1) intense competition in both domestic and export markets squeezed the already narrow profit margins of products;
- (2) the price of raw materials, such as copper, aluminium and plastics, surged in the second half of 2004, and the Group was not able to offset the increased cost entirely by raising the market price of new products;
- (3) a decrease in VAT-rebate for exports of refrigerators and air-conditioners from 17% to 13% in 2004;
- (4) the sales revenue in the fourth quarter recorded a substantial drop as compared with the first three quarters, while the ratio of expenses to sales revenue weighted relatively higher, resulting in a decline of the operating results in the fourth quarter;
- (5) the Group wrote off approximately RMB71,400,000 in goodwill for its investment in Huayi Compressor Holdings Company Limited, an associated company of the Group which had reported operating losses in consecutive years;
- (6) the provision for inventories increased by approximately RMB41,412,000 due to the net realizable value of certain inventories dropped below their costs as a result of revaluation performed at the end of 2004;
- (7) bad debt provision increased by approximately RMB30,000,000 in the fourth quarter.

For the year 2004, basic loss per share were RMB0.05. The Board of Directors does not recommend the payment of a final dividend for 2004 (2003: Nil).

Despite the negative external factors, the Group has sustained its dominant position in the domestic refrigerator and air-conditioner markets and has become the OEM-supplier of choice for most of the world's leading multinationals in 2004 by leveraging the core technologies of its products, its brand advantage, its expanded economies of scale and the continuously improved product quality.

In November 2004, Kelon formed a joint venture company - Kelon Weili Electrical Appliances - making its first move into the manufacturing of washing machines and giving the Group a more complete product offering both in the domestic and overseas markets.

### TURNOVER ANALYSIS

During the Reporting Period, the sales revenues of refrigerators and air-conditioners accounted for 38.81% and 53.35% of the Group's total turnover respectively. The sales revenue of freezers represented 3.98% of the Group's total turnover, while the remaining 3.86% of income came from the sales of product components.

Domestic sales accounted for 60.4% of the Group's total turnover, whereas export sales recorded excellent results with a surge of 71.5% over that of 2003, contributing 39.6% to the Group's total turnover. The export business remained as one of the major growth drivers of the Group's turnover and profit.

### HEALTHY FINANCIAL STANDING

During the Reporting Period, the Group was prudent in its financial management. It strived for perfection in the management of its budget, resources and operating finance, ensuring the stability of the Group's financial position. As at 31 December 2004, the Group's total assets reached RMB11,832,017,000 while net asset amounted to RMB3,209,216,000. Bank balances and cash (including pledged bank deposits) amounted to RMB2,320,121,000. Net current liabilities amounted to RMB406,016,000.

## Operations Review

### ENCOURAGING EXPORT SALES GROWTH

Despite the intense competition in the international domestic appliances market during the Reporting Period, the Group continued to record strong growth in sales revenue and improved profit level for the air-conditioners and refrigerators manufactured under OEM arrangements for well renowned international home domestic appliance corporations, sizeable domestic appliances chain stores and supermarkets. This revealed the competitive advantages of the Group's products in terms of technology, cost and quality. During the Reporting Period, Kelon's export business achieved even better results, with revenue reaching RMB3,340,164,000, a 71.5% growth over 2003. Within the business segment, revenue from air-conditioners accounted for 46.5% of the total export sales, whilst that of refrigerators and freezers made up 25.0% and 5.6% of the total export sales respectively. Small home appliances, accessories and other income accounted for the remaining 22.9%.

Kelon continued to expand its international sales network rapidly in 2004. Currently, the Group's products are exported to over 100 countries and regions, and its customer base has doubled in size to over 600. Export turnover contribution from Europe and Africa as well as America made up the largest portions of 44.4% and 30.0% respectively. The rest of the export revenue came from the Asia Pacific region.

### LARGER MARKET SHARE FOR REFRIGERATOR BUSINESS

With the refrigerator market in China plagued by severe price wars during the Reporting Period, the industry saw an overall plunge in profit. The market prices of major raw materials for refrigerators was rising sharply, creating unprecedented cost pressure on the entire refrigerator industry. Nevertheless, with its newly



established production bases in Hangzhou, Nanjing, Shangqiu, Xian and Nanchang swung into operation during the Reporting Period, the Group's production capacity reached a new high and the enhanced economies of scale buffered part of the cost pressure. The Group thus had the leverage to more effectively influence the market price trend.

In addition, capitalizing its comprehensive multi-branding strategy, the Group was able to consolidate the position of its "Kelon" brand in the high-end market, and continued to gain grounds in the mid- to high-end markets with its "Ronshen" brand and the low-end market with its "Combine" brand. In 2004, the Group regained its top seller position for refrigerators in China.

The Group's continuous endeavor to advance technology underlines the success of its refrigerator business. The Group's Ronshen BCD-209S refrigerator, which received the "United Nations Energy Saving Grand Prix", was launched in the end of 2003. After five months' promotion, it became the top seller on the list of energy saving refrigerators in China surveyed jointly by the Research Institute of Market Economy of the State Council Development Research Center and the Beijing GuNeng Market Research Center. On the same technology foundation, the Group launched two more new models in the same series, which helped boost sales volume.

During the Reporting Period, Kelon augmented promotion through its sales channels. The Group also obtained fruitful results from participating in the joint promotion campaigns in China. Through expanding its refrigerator business geographically, Kelon was able to broaden its network coverage to rural areas and thus elevated its sales network to a new scale, achieving fruitful results in 2004.

## SATISFACTORY GROWTH FOR AIR-CONDITIONER BUSINESS



During the Reporting Period, the Group fully applied its multi-branding strategy. The Group achieved better defined positioning for its three brands, namely “Kelon”, “Huabao” and “Combine”, and developed respective sales network for each of them. With the different sales networks operating in complement, the air-conditioner business recorded satisfactory overall growth, with a 67.9% increase in turnover over 2003.

The Group’s air-conditioners are produced with market leading, state-of-the-art technologies. With the government advocating the usage of efficient and energy saving air-conditioners to help ease power shortage, Kelon “Shuang Xiao Wang” series, which boasts enhanced cooling and heating efficiencies, was popular in the market. With the help of effective sales and distribution strategy encompassing attractive sales offers, distributors’ profitability was enhanced as the sales of Kelon “Shuang Xiao Wang” shot up, creating a win-win scenario. The products topped the market of energy saving air-conditioners and also the market of highly efficient and energy saving air-conditioners with coefficient of performance over 3.0.

## STEADY GROWTH FOR SMALL HOME APPLIANCES BUSINESS

With the refrigerator and air-conditioner businesses progressing steadily and strongly and enjoying consolidated market leadership, Kelon stepped up development of its small home appliance business during the Reporting



Period. Apart from the OEM business mode, at full steam, Kelon also established its own production base for the manufacture of small home appliances and developed its own products. Its goal is to achieve large-scale production and product differentiation, ensuring that its products stand out among the competitors.

The Group’s newly built production base in Shunde has commenced operation. With gross area of 22,000 sq.m., the production base manufactures six categories of products, namely electric fans, rice cookers, electromagnetic heaters, water dispensers, gas stoves and exhaust fans, at 5 million units a year. The construction of the Group’s new production base in Zhuhai with gross area of 200,000 sq.m. was also completed. It is expected to commence operation in 2005 and will mainly be responsible for the manufacture of small refrigerators, electric fans and water dispensers, etc. When the two new production bases commence operation, Kelon will be among players who lead the industry in small home appliances output.

## Operations Review

### VENTURING INTO WASHING MACHINE MARKET

In November 2004, Kelon and Zhongshan Shuncang Industrial Company Limited formed the joint venture, Kelon Weili Electrical Appliances, in which the Group owns 80% interest, to focus on manufacturing and selling washing machines. Leveraging Kelon's management expertise and many advantages, and through streamlining operation, increasing production efficiency, enhancing product quality and utilizing the Group's established sales and distribution channels to expand market share, the Group believes its washing machine business will deliver satisfying results in the near future.



### HIGH TECHNOLOGY PRODUCTS BRING FAME AND PROFIT

With "Technologically Led" as its guiding principle for development, the Group established the Kelon Research and Development Center in late 2003. The center is responsible for conducting different technological research and development projects and technological exchange and collaboration activities, with the aim of boosting the Group's core competitiveness. In December 2004, the Group's R&D team had 700 members.

During the Reporting Period, the Group further improved the technological levels of its refrigerators and air-conditioners and maintained its leading market position. The Group's important technological achievements in 2004 included:

### High efficiency "Digital Shuang Xiao Wang" Air-Conditioner Series Broke World Record Twice

The Group launched the first generation of Kelon "Shuang Xiao Wang" air-conditioner in early 2002 which set and subsequently broke time and again the coefficient of performance (COP) record in China. In June 2004, the Group successfully developed the fourth generation of Kelon "Digital Shuang Xiao Wang" with COP reaching 6.65, breaking for the first time the world record long held by Japanese manufacturers. While the industry was still applauding this achievement, Kelon broke its own record in October 2004 by launching the Kelon "Shuang Xiao Wang" KFR-22GW air-conditioner with a COP of 7.0. This not only proved the world leading status of Kelon's energy efficient air-conditioners, but also attained for the air-conditioner industry of China its first world championship in the energy saving aspect. It also marked the achievement by Kelon of its goal to leap from being a leader in China's air-conditioning industry to a leader in the global air-conditioning industry.

Kelon constantly strives to advance and improve its core energy saving technology and the quality of its air-conditioners. In a survey targeting air-conditioner users conducted by the Research Institute of Market Economy of the State Council Development Research Center, Kelon's air-conditioners came first among all domestic brands in "Recognition on quality", "Leading in technology" and "Brand loyalty".



### World's Best Energy Saving Refrigerator and Environmentally Friendly Refrigerant



Encouraged by Ronshen BCD-209S refrigerator winning the “Energy Saving Grand Prix” title thus earning high industry and market recognition, the Group continued to invest resources in research and development, leading to the successful launch of the BCD-209S/ET series with two new models in October 2004. The series boasts power consumption as low as 0.33 kwh per day, 0.22 kwh lower than the first generation of BCD-209S refrigerator and exceeding by far the highest A++ energy saving grading in Europe. Kelon broke yet again another world record.

In addition, in June 2004, HFC-245fa, the third generation foaming agent which the Group pioneered in developing and putting to use, received professional accreditation from an expert committee comprising representatives of the State Administration of Environmental Protection, the China Household Electrical Appliance Association, China Association of Refrigeration and other professional parties. The third generation foaming agent has good heat insulating capability, hence can substantially reduce the energy consumption of a refrigerator. More importantly, this foaming agent does not damage the ozone layer, thus environmentally safe. This achievement exemplified Kelon’s leadership in energy saving and environmental protection technology.

### EXPANDED PRODUCTION SCALE FORTIFYING EFFECTIVE COST STRUCTURE

During the Reporting Period, Kelon continued to optimize the resources allocation and management workflow of its sales and distribution network. The Group in association with the subsidiary of its single largest shareholder, Guangdong Greencool Enterprise Development Company Limited, adopted an open and transparent bidding system in procurement. It also enhanced its design techniques. Through acquiring under-utilized production lines, the Group expanded its production scale. In addition, Kelon’s international management skills translated into added productivity and economies of scale. A series of cost control measures were implemented to ensure Kelon’s overall production costs were at the lower level in both the global and domestic markets. Thus, the Group was able to sustain its cost advantage in the vigorously competitive market.

### PREVAILING BRAND POSITIONS

In 2004, Kelon ranked 12th among “China’s 500 Most Valuable Brands” and led in the category of domestic appliance jointly issued by World Brand Laboratory and the World Economic Forum. Its brand equity was worth approximately RMB34.7 billion.

## Operations Review

### **BASIC MEDICAL INSURANCE SCHEME FOR EMPLOYEES**

In accordance with the Provisional Rules of Basic Medical Insurance in Shunde City issued by the People's Government of Shunde City on 2 December 2000, and other relevant accounting requirements of the PRC, the Group has implemented a set of basic medical insurance policy for its employees since 1 January 2002. The amount involved is stated as the Group's welfare expenditure.

### **SIGNIFICANT EVENTS**

On 14 October 2004, the transfer of 57,436,439 Legal Person Shares, representing 5.79% of the total issued share capital of the Company, from Foshan Shunde Xinhong Enterprise Company Limited to Guangdong Greencool Enterprise Development Company Limited ("Greencool Enterprise"), the single largest shareholder of the Company, was completed. The shares held by Greencool Enterprise were increased from 204,775,755 to 262,212,194 Legal Person Shares, with shareholding rising from 20.64% to 26.43%.

On 27 October 2004, Kelon and Zhongshan Shunchang Industrial Company Limited entered into a joint venture agreement to form Guangdong Kelon Weili Electrical Appliances Company Limited. The total investment amounted to US\$24,160,000. The Group has 80% share of the joint venture.

On 26 November 2004, the proposal to re-elect namely Mr. Gu Chu Jun, Mr. Liu Cong Meng, Mr. Li Zhen Hua, Mr. Yan You Song, Mr. Zhang Hong and Mr. Fang Zhi Guo as executive directors of the fifth session of the Board were endorsed by the Board of the Company, and so were the proposed re-election of independent non-executive directors, namely Mr. Chan Pei Cheong, Mr. Li Kung Man and Mr. Xu Xiao Lu. On 15 January 2005, all the above-mentioned proposals were passed at the Extraordinary General Meeting of the Company.

On 26 November 2004, the re-election of Mr. Bai Yun Feng and election of Mr. Zeng Jun Hong as shareholder representative supervisors of the fifth session of Supervisory Committee were proposed, whereas Ms. He Si was resolved to be the staff representative supervisor and form the Supervisory Committee together with the shareholder representative supervisors. On 15 January 2005, the re-election of Mr. Bai Yun Feng and election of Mr. Zeng Jun Hong as shareholder representative supervisors of the fifth session of the Supervisory Committee were approved.

On 26 November 2004, the Board of the Company proposed the resolution to use the Group's internal resources to repurchase not more than 10% of the issued H shares (namely 45.96 million H shares) of the Company. This resolution was approved by the Extraordinary General Meeting on 15 January 2005.

## Outlook

Entering 2005, Kelon sees its magnificent business development blueprint taking shape. Firmly founded on the advantages of its traditional refrigerator and air-conditioner products, the Group is taking its small home appliances and washing machine products into a new stage. Kelon is emerging as a leading enterprise in the global domestic appliances industry.

In the past year, “survival of the fittest” ruled the domestic appliances industry. Through consolidating its air-conditioner and refrigerator businesses, Kelon has not only ridden out the extremely difficult operating environment, but has also attained controlling influence among domestic market players. The selling prices of refrigerators and air-conditioners in China and overseas have started to rebound since the end of 2004. The rising product prices coupled with the advantage of economies of scale which the Group enjoys, the management believes Kelon is able to ensure a more brilliant future for its refrigerator and air-conditioner businesses.

Boosting its technological edges remains at the core of Kelon’s development strategy. Capitalizing the success of its “Digital Shuang Xiao Wang” air-conditioners and Ronshen energy saving refrigerators, the Group is committed to developing more trend-setting energy saving products. Kelon is going to tap the opportunities arising from the energy saving concept, which is taking roots among consumers in China, to achieve rapid growth.

The multi-branding strategy of the Group is bearing fruit. The Group is enjoying optimum benefits from its extensive market coverage, while at the same time, will strive for larger and more stable market share. To further expand its sales channels, Kelon’s regional sales centers will continue to move downstream to penetrate the third- and fourth-tier markets such as the rural areas.

The Group does not rule out the possibility of raw material price rising in 2005, but given its superb quality products and stringent cost control, the Group will be able to stay at the head of the industry in competitiveness and profitability.



In the aspect of export sales, Kelon has become the major supplier for many major global domestic appliances manufacturers. Leveraging its product quality, economies of scale and leading cost advantage, complemented by effective export sales strategy and management, the Group will be able to sustain its rapid growth of export business, thus laying the foundation for it to excel in the global market.

The small home appliances market in China is growing at high speed. Despite the intense competition, it has a rosy prospect. Kelon’s small home appliances will also be sold under its “Kelon” and “Combine” brands to capture the mid- to high-end and mid- to low-end markets respectively. The Group will also inject additional resources into research and development to facilitate the introduction of more energy saving small home appliances. The newly established Kelon Weili Electrical Appliances will focus on refining its production process and product designs in 2005. Supported by Kelon’s extensive sales channels, Kelon Weili Electrical Appliances will be able to further expand its market.

The Group has built solid position in the China air-conditioner and refrigeration markets. Looking ahead, the Group will strive to explore and capture the small home appliance and washing machine markets, and step up its internationalization efforts. Kelon will forge ahead towards its goal of becoming a leading international domestic appliances manufacturer.