

Management's Discussion and Analysis

Business Review

During 2004/05 fiscal year, Lenovo successfully strengthened its leadership position in the China PC market through implementing strategic initiatives set in the beginning of the year. Lenovo's market share for PC products reached as high as 28 percent during the quarter ended December 2004.

With a clear focus on the PC business, Lenovo pre-empted irrational competitive pricing tactics of second-tier domestic PC vendors and withstood intensified competition from foreign brands. During the year, Lenovo strategically modified its product line to capture opportunities in market segments with high-volume growth potential, leveraging its customer-oriented sales model and efficient operating platform. As a result of its divestiture of non-core businesses and its expansion into the emerging township market segment, the Group's consolidated turnover for the 2004/05 fiscal year recorded a slight decrease of 2.7 percent while its PC shipments grew in line with the market average. Excluding the impact of divestiture of non-core businesses, group turnover increased by 1.6 percent for the full year. The Group maintained its overall gross margin at approximately 14.8 percent and achieved a 6.4 percent increase in net profit on lower operating expenses.

Implementation of Strategic Initiatives

The rapid growth and structural changes in the Chinese economy, along with the proliferation of foreign competitors and increasing strength of domestic private enterprises, has led to changes in customer demands and the competitive landscape in China PC market. To address these changes, Lenovo implemented strategic initiatives at the beginning of the last fiscal year focused on strengthening the fundamentals of various business segments. The Group's goal is to provide customers with

high-quality products and world-class service by focusing on the core business, adopting a customer-oriented sales model and further improving operating efficiencies.

Business Focus

Lenovo set its priorities to ensure that resources and efforts were more effectively allocated to the core PC and related products business and, at the same time, strengthen the competitiveness of its mobile handset business. This helped Lenovo grow market share and strengthen its leading position. At the same time, Lenovo adopted an innovative approach towards its non-core businesses, namely contract manufacturing and IT service. In July 2004, the Group formed a strategic alliance with AsialInfo Holdings, Inc. to capture the growing IT service market in China by transferring its non-telecom related IT service business to AsialInfo in a stock transaction valued at RMB300 million. This focus on the core business has increased the Group's competitiveness and improved its operations during the year while building a strong foundation for its efforts to globalize the PC business.

Customer-Oriented Sales Model

Lenovo's efforts to build a customer-oriented sales model and organizational structure also met with success during the past year. Lenovo was able to meet customer needs better and improve the control of its customer information by building a network comprising 110 sales zones spanning 18 regions in China. The Group also expanded its coverage in the high-growth township market segment by expanding its retail network to include more than 4,400 outlets. Lenovo also achieved positive results from its emphasis on building a direct-to-customer model to serve large customer accounts. Sales to these types of customers increased steadily, accounting for approximately 7.1 percent of core business turnover. During the fiscal year, the Group also launched its telesales model, and achieved satisfactory results in a short time period.



Improved Efficiency

In addition to its ongoing efforts, the Group has also embarked on a series of projects to improve operational efficiencies. Among them, Lenovo's VMI (Vendor Managed Inventory) system helped reduce the costs of logistics while improving the Group's various operating quality indices. During the year, these efforts helped streamline and reduce the Group's cash cycle to 5.1 days.

Performance of Business Segments

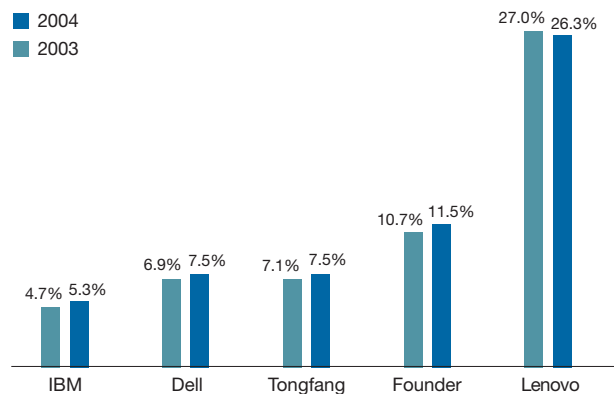
During the 2004/05 fiscal year, Lenovo's overall core business activity achieved a steady growth rate, due to the successful implementation of its strategic initiatives and favorable macroeconomic conditions in China. In 2004, the country's GDP grew by 9.5 percent year-on-year, as corporate profits in China rose sharply and disposable income steadily increased. Moreover, the government's macroeconomic control measures to cool the economy did not affect the growth of China's PC market, which achieved a 19 percent year-on-year increase in unit shipments during the year ending March 2005.

Corporate IT Business

Continued IT investments from the government and education sectors and the rapid growth of small- and medium-sized enterprises (SMEs) drove the growth of China's corporate PC market. At the same time, the notebook computer market enjoyed significant growth due to increasing demand for mobile computing. The overall average selling price (ASP) of desktop computers declined more rapidly, however, in the past year as competitive bidding became the predominant procurement practice in the government and education sectors.

Market Share of Top 5 PC Brands in China

Source: IDC



As a result of redesigning the Lenovo sales model and introducing tailor-made innovative products, Lenovo's commercial desktop market share has increased over the review period. During the fiscal year, the Group introduced the newly designed Qitian IV and Kaitian S desktop series targeting the government and education sectors and SMEs, respectively. Its ability to better serve corporate customers with the new customer-oriented sales model effectively put Lenovo ahead of its domestic and international competitors. To alleviate the impact on ASPs and gross margins from the increased competitive bidding, the Group also enhanced its marketing efforts to further penetrate the SME market.



Lenovo Kaitian commercial desktop



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In view of the growing importance of notebook computers in the China PC market, Lenovo streamlined its notebook product line. The Group's three distinctive notebook series – Soleil, Tianyi and Xuri – set trends in the market with innovative features such as nano-technology, 180-degree rotating screens and intelligent power management capabilities. Tianyi Y200, for example, is the world's first 13-inch wide screen notebook. The launch of the Xuri notebook series demonstrated Lenovo's ability to identify and fulfill customer needs for low-cost mobile solutions. The Group's outstanding R&D and marketing capabilities have strengthened its leadership position in China's notebook computer market.

Consumer IT Business

The consumer desktop market in China enjoyed better growth in the past year, bolstered by vendors' efforts to penetrate township markets and rising demand for large-screen LCD monitors, resulting from declining prices.

Since adopting the strategy of focusing on its PC business, the Group has strengthened its competitiveness in the consumer market through an effective customer segmentation strategy and by partnering with upstream suppliers. Lenovo understands customer needs in township markets and has captured its growth potential by launching Yuanmeng, a desktop computer series emphasizing performance at affordable prices.

Along with modifying product lines to meet the demands of newly emerging segments in township cities, Lenovo introduced new computer models targeting other segments. For the high-end consumer market, Lenovo introduced the Tianjiao Broadband Collaborative desktops, which allows for better utilization of broadband technology such as videophone modules. The Group also actively promoted its 17-inch LCD desktops, with the intent of raising ASPs.

Handheld Device Business

During the past year, the mobile handset market in China maintained a steady unit shipment growth of about 16 percent, benefiting mainly from the growing demand for color-screen and camera phone models. In the aggregate, domestic vendors lost market share due to disadvantages in research capabilities compared with their foreign competitors. The Group's ongoing persistence in developing proprietary products has placed it among the few domestic vendors that enjoyed market share gains during the year.





Lenovo Tianjiao Collaborative consumer PC

In the 2004/05 fiscal year, Lenovo emphasized the importance of maintaining healthy operations for its handset device business, given the competitive market environment. During the year under review, the Group began to reap the benefits of its efforts over the past two years of building its sales channels and enhancing its R&D capabilities. Lenovo's mobile handset unit shipment jumped 63 percent year-over-year, ranking as one of the top five domestic brand names in China. The Group also saw its gross profit margin for the handheld device business rise to 23.8 percent, leveraging its enhanced product development capability. During the year, Lenovo expanded its product line with a number of camera phone models, including one-mega-pixel camera phones. As for marketing and sales, the number of retail outlets for mobile handsets increased due to the successful launch of the "10,000-shop expansion project," allowing for more effective market coverage.



Lenovo Smartphone ET960



FINANCIAL REVIEW

Results Highlights

For the year ended March 31	2005 HK\$'000	2004 HK\$'000
Turnover	22,554,678	23,175,944
Earnings before interest, taxation, depreciation and amortization expenses	1,173,616	1,125,129
Profit attributable to shareholders	1,120,146	1,052,885
Dividends per ordinary share (HK cents)		
Interim dividend	2.4	2.0
Proposed final dividend	2.8	3.0
Earnings per share (HK cents)		
Basic	14.99	14.09
Fully diluted	14.97	13.99

Comparing with the last year's results, the Group's turnover slightly decreased by 2.7 percent to HK\$22,555 million in the 2004/05 fiscal year. However, EBITDA increased by 4.3 percent to HK\$1,174 million. Profit attributable to shareholders for the year increased by 6.4 percent to HK\$1,120 million. The basic earnings per share and fully diluted earnings per share were 14.99 HK cents and 14.97 HK cents, representing increases of 6.4 percent and 7.0 percent respectively.

Total turnover of the corporate IT business grew by 2.5 percent over the last year to HK\$12,226 million and segment operating profit decreased by 9.2 percent to HK\$658 million. The turnover of consumer IT business kept in line with last year and reached HK\$7,768 million, while the segment operating profit was HK\$463 million. Turnover of handheld device business increased by 7.5 percent to HK\$2,203 million for the year while the loss of the business was HK\$54 million. During the year, turnover of other business (IT service and contract manufacturing businesses) dropped by 75.2 percent to HK\$358 million and a loss of HK\$87 million for the year was recorded.

Gains on Disposal of Investments

The Group recorded net gains of HK\$157 million on disposal of investments during the year ended March 31, 2005. The gains were mainly from the disposal of

subsidiaries and associated companies in relation to IT service business and printed circuit board business.

Amortization of Marketing Rights

Marketing rights for the Olympic Partner Program are amortized on a straight-line basis from January 1, 2005 to December 31, 2008. During the year ended March 31, 2005, amortization of HK\$32 million was charged to the consolidated profit and loss account.

Impairment of Assets

During the year, impairment losses of approximately HK\$20 million and HK\$31 million for investment securities and goodwill arising from business combination were charged to the consolidated profit and loss account respectively.

Capital Expenditure

The Group incurred capital expenditures of HK\$177 million during the year ended March 31, 2005, mainly for acquisition of fixed assets, injection into construction-in-progress and optimization of the Group's information technology systems.

Liquidity and Financial Resources

As at March 31, 2005, total assets of the Group amounted to HK\$9,032 million, which were financed by



Turnover and Segment Results

For the year ended March 31	2005		2004	
	Turnover HK\$'000	Segment operating results HK\$'000	Turnover HK\$'000	Segment operating results HK\$'000
Corporate IT	12,225,923	658,034	11,925,240	724,886
Consumer IT	7,768,024	463,459	7,760,668	432,225
Handheld device	2,202,929	(54,462)	2,050,164	(76,910)
Other business	357,802	(87,378)	1,439,872	(153,958)
Amortization of goodwill and marketing rights		(48,605)		(25,274)
Impairment of assets		(51,364)		–
Gains on disposal of investments		156,958		47,558
Others		–		(22,000)
Finance income		105,677		93,368
Finance costs		(6,667)		(2,881)
Total	22,554,678	1,135,652	23,175,944	1,017,014

shareholders' fund of HK\$5,204 million, minority interests of HK\$24 million, long-term and current liabilities of HK\$3,804 million. The current ratio of the Group was 1.9.

The Group had a solid financial position and maintained a strong and steady cash inflow from its operation activities. As at March 31, 2005, cash and cash equivalents of the Group totaled HK\$3,019 million. The balance consisted of about 0.8 percent in Hong Kong dollars, 43.6 percent in US dollars and 55.6 percent in Renminbi.

Although the Group has consistently been in a very liquid position, credit facilities have nevertheless been put in place for contingency purposes. As at March 31, 2005, the Group's total available credit facilities amounted to HK\$3,275 million, of which HK\$1,473 million was in trade line, HK\$740 million in short-term and revolving money market facilities and HK\$1,062 million in currency forward contract and derivatives. As at March 31, 2005, the facility drawn down was HK\$342 million in trade line and HK\$94 million for the currency options was utilized.

There were no outstanding bank loans as at March 31, 2005.

There were no assets held under finance lease during the year and as at the year end.

The Group consistently adopted a hedging policy for business transactions to minimize the risk of fluctuations from exchange rates on daily operations. As at March 31, 2005, the Group had outstanding currency options amounting to HK\$94 million.

Contingent Liabilities

The Group had no material contingent liabilities as at March 31, 2005.

Employees

As at March 31, 2005, the Group had a total of 9,682 employees, 9,625 of whom were employed in Chinese mainland and 57 in Hong Kong and overseas.

The Group implements remuneration policy, bonus and share options schemes with reference to the performance of the Group and individual employees. The Group also provides benefits such as insurance, medical and retirement funds to employees to sustain competitiveness of the Group.



Management's Discussion and Analysis



The new Lenovo management team

Future Prospects

As the Group became more focused on the PC business, management saw a clear opportunity for Lenovo to accelerate its growth and improve its competitive position by expanding into the global market. Globalization of operations will allow Lenovo to drive costs down and maximize efficiencies. Lenovo will also maximize the benefits of its innovative technologies, which help differentiate its products from competitors, and enhance its premium brand status.

Acquisition of IBM's Personal Computer Business

Lenovo has always aspired to become a global company. Since 2003, Lenovo started laying the groundwork for its globalization. First, it adopted a new logo and English brand name that could be used without restriction around the world. It proudly announced in 2004 its decision to become a worldwide partner of the International Olympic Committee, becoming the first Chinese enterprise to join The Olympic Partner Program. Lenovo is the exclusive computer equipment provider for the 2006 Turin Olympic Winter Games, 2008 Beijing Olympic Games and for more than 200 national Olympic committees worldwide. These achievements have accelerated Lenovo's journey into the international marketplace.

On December 8, 2004, Lenovo announced that it would acquire IBM's global PC business for US\$1.25 billion. The acquisition included IBM's desktop and notebook computer businesses, as well as its PC-related R&D centers, manufacturing plants, global marketing networks, and

service centers. Under the terms of the agreement, Lenovo also has the right to use the IBM brand for a period of five years and permanent ownership of the renowned "Think" trademark. As part of the transaction, Lenovo and IBM entered a broad-based, strategic alliance in which IBM became the preferred supplier of warranty and maintenance services and preferred supplier of customer leasing and channel financing services to Lenovo. In addition, Lenovo will be the preferred supplier of PCs to IBM, enabling IBM to offer a full range of personal computing solutions to its enterprise and small and medium business clients.

Lenovo completed the landmark acquisition on April 30, 2005, marking an historic event for Lenovo and a new era for the global PC industry. The new Lenovo is a leader in the global PC market, with approximately 8 percent of the worldwide PC market by shipments.

In association with the acquisition, Lenovo received a US\$350 million strategic investment in May 2005 by three of the world's leading private equity firms: Texas Pacific Group, General Atlantic LLC and Newbridge Capital LLC. Lenovo issued to the strategic investors unlisted Series A cumulative convertible preferred shares and unlisted warrants. This investment represented a strong vote of confidence in Lenovo's future.

Personal Computer Business

In 2005 and 2006, demand for notebook computers as well as strength in emerging PC markets is expected to drive growth in the worldwide PC market. Increased adoption in



emerging markets for both desktop and notebook computers will present significant growth opportunities as will the trend toward increased notebook adoption in more developed PC markets. These trends, supported by replacement cycles for older systems, are expected to drive worldwide PC growth through the next five years.

In the PC business, the new Lenovo is well situated in terms of product lines and geographic presence to take advantage of the growth opportunities presented in both emerging markets as well as by the ongoing shift in demand to notebook computers.

Globally, the Group's ThinkPad line of notebook computers provides a strong offering to meet the growing demand for mobile computing. In China, Lenovo's notebook offerings also include the Soleil, Tianyi and Xuri. Together, the company has a powerful product line for consumers as well as enterprises, with a range of price points and features.

Lenovo's family of desktops – led by brands such as the Tianjiao, Fengxing, Kaitian, Yangtian – provides a strong competitive base in China and potentially globally, especially when combined with the ThinkCentre line of desktops.

Lenovo has particular strength in emerging markets, and exceptional strength in the largest and fastest-growing emerging market, China, where it is the market leader. The China PC market is growing seven times faster than the US market. Lenovo has been the number-one PC vendor in China for eight consecutive years and commands about one-third of the market in 2004.

Lenovo has strong products and favorable geographic positioning. Lenovo's business model addresses the future of the PC business: a company that best balances leading-edge technology and efficiency, offering PC users innovative products and a choice in how they purchase computers.

What will set Lenovo apart from the competition is its belief in innovation to meet customers' needs. With users spending up to eight hours a day or more on their PCs, there is clear demand for innovation and Lenovo plans to lead in design, performance, productivity, and cost-competitiveness.

Lenovo's sales model is also driven by customer needs. Customers can buy from Lenovo through multiple direct and indirect routes: the Web, telesales, business partners, retail stores, and the IBM sales force, whichever meets their needs.

In addition to being well-positioned to take advantage of key market trends and to sell through multiple worldwide channels, Lenovo will continue to successfully integrate the IBM Personal Computing Division, in order to gain the benefits of near-term cost-savings as well as lay the foundation for longer-term synergies.

Lenovo can now compete in more segments of all markets – notably consumer outside of China and enterprise within China – which brings added scale and operating efficiencies to help drive growth and profitability. True global scale means Lenovo has the ability to leverage fixed costs more effectively. For instance, entering new markets worldwide to take advantage of new opportunities should require minimal incremental investments. It also means the ability to leverage procurement capabilities, optimize supply relationships, and streamline end-to-end processes from order taking through fulfillment, all in order to become more efficient.

Mobile Handset Business

The mobile handset market in China is expected to continue its steady growth in 2005 and 2006. Lenovo anticipates that competition will remain intense due to the large number of domestic and international brands in the market.

Lenovo believes the way to compete and further advance its position in the China mobile handset market is to focus on improving the value chain as well as to respond promptly to market needs. In the coming year, the Group will enhance its capability to develop and introduce proprietary products, emphasizing faster time-to-market and closer ties with suppliers. Lenovo will also further develop its chain-store distribution channel and implement aggressive marketing strategies.

In addition, Lenovo will increase its expense controls and continue streamlining internal operations to improve efficiencies of its mobile handset business. With increasing strengths in product innovation and operational efficiencies, Lenovo anticipates that its mobile handset products will become even more competitive in the market.





**TOGETHER
WE DRIVE INNOVATION**

ThinkPad X41 Tablet

