Management Discussion and Analysis

BUSINESS REVIEW

The first half of 2005 continued to be a difficult period for handset players worldwide. Operating environment was particularly tough for domestic manufacturers in the PRC market. Despite increase in handset market demand in the PRC, majority of domestic players were not able to benefit from this market growth as they were mainly focusing on inventory clearance by means of price reduction.

According to CCID statistics for the first half of the year, three major global players took up a 36% share in the PRC total handset unit shipment. The competitiveness of domestic handset manufacturers was substantially weakened. At the same time, illegal handset players continuously expanded their market share which further intensified the market competition.

Competition was even more ferocious in the international market. Severe price reductions among global giants narrowed the survival rate of other players. A rising number of manufacturers switched to explore the potential of new markets, resulting in keen competition in emerging markets and other parts of the world.

Under these market challenges, the Group's performance in the first half of 2005 was unsatisfactory, posting a consolidated turnover of HK$2,971 million and posted a loss attributable to shareholders of HK$853 million during the period.

During the period under review, the Group implemented various measures to improve its operating performances and efficiencies. The appointment of Dr. LIU Fei as the Company's executive director and CEO further strengthened the management team. With extensive experience in working for international companies and in the wireless industry, Dr. Liu will lead the Company's business development with effective business strategies.

The Group also took initiatives to restructure the operations of its subsidiaries, TCL Mobile and T&A. With a common vision to speed up business integration, the Group and Alcatel entered into an agreement to restructure T&A into a wholly owned subsidiary of TCL Communication through a share swap. As a result, Alcatel became the Group's shareholder and strategic partner.

The Group will further evolve its business platform and undergo restructuring to redefine the roles of different operating bases. Following the restructure, it is believed that the Group will have full control and higher flexibility over the usage and allocation of its resources at reduced operating costs, therefore speeding up business integration and synergy realization. Business integration is expected to bear positive effects gradually in the coming quarters.

For the six months ended 30 June 2005, the Group's handset sales were 4.83 million units, a 10% increase as compared with the same period last year. The increase was attributable to the contribution from T&A, which offset the sales decrease from TCL Mobile.

	Unaudited Handset Unit Sales For the SIX months ended 30 June		
('000 units)	**1H 2005**	1H 2004	Change
TCL Mobile	**1,906**	4,401	–57%
— The PRC	**1,384**	4,090	–66%
— Overseas	**522**	311	+68%
T&A	**2,920**	n.a.	n.a.
Total	**4,826**	4,401	+10%

TCL Mobile

For the first half of 2005, handset unit sales of TCL Mobile dropped 57% year-on-year to 1.91 million units. The Group, as other players in the PRC market, deployed significant resources to clear inventories accumulated in the channels. New product launches and marketing activities slowed down with only 14 new models launched during the period, 5 of which were launched at the end of the period.

In line with market trends, new technologies including PDA and MP3 functions, touch screen capabilities, mega pixel embedded cameras, audio streamlining and video recording functions, were applied as value-added features. The limited number of new models launch inevitably led to a 30% drop in average selling price. Sales revenue from TCL Mobile decreased significantly, resulting in an operating loss of HK$500 million during the period under review.

Facing this highly competitive market, TCL Mobile strived to enhance its competitiveness by implementing cost control measures and strengthening its management team to formulate effective operating strategies. During the period, TCL Mobile adopted BOM cost analysis and new management system to control raw material and manufacturing costs.

Sales and marketing efforts were condensed to improve profit margin during the period. TCL Mobile continued to consolidate its sales network by reducing the number of distribution layers and to supply products directly to terminal distributors. Customer relationships were built directly with major retail electrical appliance chain stores in the PRC.

The Group is pleased to see that the overseas business achieved encouraging results with 68% unit sales increase as compared to the same period last year. Market developments in previous years have strengthened the Group's foothold and built a solid foundation in emerging markets. Presence in the South America market was gradually secured by stable cooperation with major operators in developing OEM business. Of the overseas shipment, 73% came from the OEM business.

T&A

T&A maintained stable sales during the first six months of 2005, with total unit sales amounting to 2.92 million. Sales revenue amounted to HK$1,920 million. Cost control measures implemented in the first quarter of 2005 gradually came into effect, resulting in a quarter-on-quarter reduction in operating costs of over 33% during the second quarter of the year. However, as the Group's new restructuring plan implemented in June 2005 will take time to take effect, the operating costs, therefore, remained high in the first half of 2005. An operating loss of HK$600 million was recorded.

During the period under review, operating costs of T&A were reduced through execution of a series of cost control measures and continual re-evaluation of the composition of various operating and administrative costs. In addition, a restructuring plan for further improving operating efficiency was formulated. Under the plan, T&A SAS, T&A's French subsidiary, will be transformed into a business development, advanced R&D, sales and marketing and product development support centre focusing on the European markets.

The restructuring plan also allows further consolidation of R&D and manufacturing operations. T&A's handset manufacturing and R&D have started to integrate into TCL Mobile's existing operations. As such, full synergies, including R&D, manufacturing and sourcing will be realized more effectively.

Product development strategies were re-established during the period to strengthen the competitiveness of Alcatel brand handsets. The groundwork for the rollout of a series of new products, with advanced technology, such as MP3 players, stereo speakers and video streamlining functions, for launch in the second half of 2005, was underway during the period under review. Furthermore, R&D efforts were placed on the development of EDGE and 3G technologies to enhance its competitiveness in the international marketplace in the near future.

During the period, T&A focused on securing the European market through tightening its relationships with operators and exploring further business opportunities in markets such as South America, Portugal, Holland and other emerging markets. In the future, further marketing efforts will be put into effect in South American markets, to strengthen its foothold in this growth driven region.

Outlook

It is anticipated that the global industry landscape of the handset industry will remain competitive in the second half of 2005. The Group will encounter tremendous challenges in implementing restructuring plans and restoring its profitability at the same time.

Despite the gloomy operating environment, the Group's performance is expected to gradually improve in the coming future. The Group is committed to speeding up its new product rollout so as to regain its market share and profitability. TCL Mobile has recently announced a series of near 30 new products that it expects to launch in the second half of 2005. T&A will also adopt an aggressive product launch plan to market over 10 multimedia products as well as other range of new handset models. Products include high-end models with digital technologies and MP3 functions, and are expected to increase the Group's margins and product ASP in the coming quarters.

Meanwhile, the Group will further enhance its R&D capabilities. Leveraging on its comparatively low manufacturing costs in the PRC, more resources will be dedicated to developing multimedia handsets and gradually increasing the Group's focus on developing EDGE and 3G technologies to meet the expected demand from the PRC and worldwide markets.

Looking forward, with overseas competitors capturing an even larger share of the market, together with the relaxation for the handset licensing policy, competition is expected to intensify in the PRC market. To accommodate the market challenges, the Group will make efforts in speeding up the product rollout and in reforming its distribution channels.

Furthermore, the Group will continue to expand its overseas business, including both branded and OEM businesses. For its branded business, the Group will strengthen its foothold in Southeast Asia, India and Russian markets. Also, the Group will target business opportunities with telecommunication operators in Europe and South America and expand its OEM business in South America and Southeast Asia markets.

Looking ahead, the Group will strive to optimize its operations and to realize the full synergies from TCL Mobile and T&A, now the wholly owned subsidiaries of the Group, in which R&D and manufacturing operations of both subsidiaries will be consolidated gradually in the future. As a result, more significant synergies from the procurement, manufacturing, R&D and economies of scale are expected to be realized, leading the Group to be in a better position to turnaround its business.

FINANCIAL REVIEW

Results

For the six months ended 30 June 2005, the Group's unaudited consolidated turnover amounted to HK$2,971 million (2004: HK$3,488 million), representing a year-on-year decrease of 15% as compared to the same period last year.

The Group's gross profit margin dropped to 2% from 23% in the same period last year which was attributable to severe drop in selling prices, mainly as a combined result of the continued keen competition in both the PRC and global markets, inventory clearance in PRC markets and less new products launched.

Loss attributable to shareholders widened to HK$853 million (2004: profit attributable to shareholders was HK$302 million). Basic loss per share was HK30.2 cents (2004: basic earnings per share were HK10.7 cents (RMB0.11)).

Inventory

The Group's inventory turnover period was 28 days. Excluding the effect of T&A, inventory turnover was 50 days (same period 2004: 14 days). Over 90% of the inventories have an aging period of less than 3 months.

Accounts Receivable

Credit period ranging from 31 days to 180 days and the accounts receivable turnover was 49 days (same period 2004: 3 days). Excluding the effect of T&A, accounts receivable turnover was 27 days.

Significant Acquisition

The Company entered into the Framework Agreement with Alcatel Participations on 11 May 2005. The Company strives to improve operating efficiencies and reduce operating cost. Towards this end, the Company intends to further evolve the business platform of T&A HK and transform T&A SAS, the direct wholly owned French subsidiary of T&A HK, into a business development, sales and marketing and product development support centre focusing on the European market. By entering into the Framework Agreement with Alcatel, adjustments to the corporate structure of T&A HK are planned to better reflect the outlook on operations of the Group.

The Framework Agreement requires the Company to acquire from Alcatel Participations the Alcatel Shares by way of Share Swap. The Alcatel Shares represent the shares allotted by T&A HK to Alcatel at the time of the establishment of T&A HK for its contribution in cash of €45 million (about

HK$448.9 million) and its mobile handset business amounting to a total value of €45 million (about HK$448.9 million) pursuant to the JV Subscription Agreement. Furthermore, the Shares to be acquired by Alcatel pursuant to the Share Swap will not be subject to any lock-up period.

The number of Shares to be issued pursuant to the Share Swap is 141,375,000 Shares, being equivalent to 5% of the issued Shares on the last trading day before the Share Swap Completion Date, or about 4.76% of the enlarged issued share capital of the Company immediately after completion of the Share Swap. Based on the average closing price of HK$0.448 per Share for the 5 trading days prior to the Announcement Date, 141,375,000 Shares represent a market value of about HK$63 million. The Share Swap was duly completed on 18 July 2005. The then share price was HK$0.435 and the Shares represented a market value of about HK$61 million.

The acquisition is subject to the payment by Alcatel to T&A HK of a sum of €1.28 million (about HK$12.8 million at time of entering into the agreement) in cash for the Post-closing Adjustment pursuant to the JV Subscription Agreement. Furthermore, Alcatel shall pay €20 million (about HK$199 million at time of entering into the agreement) in cash to T&A HK on or before 1 October 2005, subject to the completion of the Company's acquisition of the Alcatel Shares. Upon payment, Alcatel will be fully released from its obligation in respect of the patent cross licenses or third party licenses under section 4 of the Pre-closing IP Agreement. The Board expects that the future operation of the Group may not require such cross licences and accordingly does not expect the intended release of Alcatel from the said obligations will have any material adverse impact on the Group.

Liquidity and Financial Resources

The Group maintained a healthy liquidity position throughout the period. The cash and cash equivalents balances as at 30 June 2005 amounted to HK$918 million, of which 18% in Renminbi, 22% in US dollars, 59% in Euro and 1% in Hong Kong dollars & others for the operations. The Group's financial position remains healthy, with total assets of HK$3,768 million and a gearing ratio of 0% 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$11,270,000 (31 December 2004: HK$107,568,000), were secured by the pledge of deposits amounted to HK$1,124,000 (31 December 2004: HK$11,373,000).

Fund Raising

On 11 May 2005, the Company entered into the Subscription Agreement with its ultimate controlling shareholder, TCL Corporation, pursuant to which the Company has agreed to issue at par and TCL Corporation has agreed to subscribe for an aggregate of €20 million principal amount issue (about HK$199 million at time of entering into the agreement) of 3% Convertible Notes, with a term of 3 years and during which a right by the Subscriber to convert the Convertible Notes in whole or in part in the principal amount into shares at the Conversion Price of HK$0.58175, representing a premium of approximately 30% over the average closing price HK$0.4475 of the Shares on the Stock Exchange for the last 10 trading days immediately before the date of the Subscription Agreement. Such shares issued by the Company upon the conversion will rank pari passu in all respects with the Shares in issue as at the relevant conversion date.

The Company has option to redeem, in whole or any part, the Convertible Notes at 100% of their principal amount plus interest accrued to but excluding the date of redemption after 24 months from the Issue Date.

The Notes Issue will increase the Group's working capital and can be used by the Group to finance its operation and is therefore beneficial for the Company. The issue and subscription of the Convertible Notes of €20 million were completed on 29 July 2005.

Capital Commitment and Contingent Liabilities

As at 30 June 2005, the Group had capital commitments of approximately HK$14 million (31 December 2004: HK$24 million) contracted, but not provided for. The Group had the following contingent liabilities:

(i) As at 30 June 2005, contingent liabilities in respect of discounted notes and endorsed notes with recourse not provided for in the financial statements were HK$362 million (31 December 2004: HK$49 million).

(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 utilises 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 6,140 employees as at 30 June 2005. Total staff costs for the period were approximately HK$404 million. The remuneration policy was reviewed, in line with current legislation, market conditions and both individual and company performance.

Stock Option Granted

The Company granted Share Options totaling 130,450,000 shares to the option participants permitted under the Share Option Scheme adopted by the Company by way of a shareholders' resolution dated 13 September 2004 (representing 4.61% of the total Shares in issue as at the date of adoption). The subscription price will be HK$0.415, which was the average price for the five trading days immediately preceding the date of grant. The exercise periods will start from 28 February 2006 for one-third of the option granted, 30 November 2006 for another one-third and 31 August 2007 for the last one-third and in no event be exercised after 30 November 2008.

In order to prepare the financial reports to account for the option expenses required by the Hong Kong Financial Reporting Standard 2 — Share Based Payments, a financial consultant is appointed to perform, by adopting the binomial model, the valuation of the options granted. The option expenses related to the period under review was HK$909,000.