MANAGEMENT DISCUSSION AND ANALYSIS

Financial Review

The first half of 2005 was a difficult period for all plush stuffed toy manufacturers, including Dream International Limited (the "Company") and its subsidiaries (together the "Group"). Apart from the increase in average labour costs, the escalating oil price also imposed additional burden on material costs. Nevertheless, during the period, the Group maintained its leadership in the industry and has been endeavouring to keep down the adverse effects on its business.

Due to the tough business environment, the Group focused on reinforcing, reorganizing and restructuring its current business. For the six months ended 30 June 2005, the Group reported a turnover of HK$430.1 million (2004: 499.6 million) with gross profit of HK$83.5 million (2004: HK$142.8 million). Loss attributable to the equity holders of the Company amounted to HK$16.5 million (2004: Profit of HK$47.7 million).

During the review period, the Group maintained a healthy financial position. As at 30 June 2005, the Group had HK$187.6 million cash and bank deposits and the bad debts were controlled down to a low level of only about HK$1 million for the period.

Business Review and Prospects

Product Analysis

For the six months ended 30 June 2005, sales of plush stuffed toys amounted to HK$409.1 million, accounting for 95.1% of the Group's total turnover. With a solid client base comprising renowned international brand and character licensors, the Original Equipment Manufacturing ("OEM") business of the Group, which represented 88.0% of its total turnover, continued to enjoy higher margins than other manufacturers.

The contribution of the Original Design Manufacturing ("ODM") business to the Group's total turnover recorded HK$30.5 million during the review period. Despite the tough market situation, not only did the Group secure a new US customer, KOHL'S, but also extended its product range to cover infant products, such as rattle, plush, and bedding including pillows, throws and soft blanket, which were successfully launched in a retailing giant in the US. The Group is striving to source more economic new substitutable materials for the production of appealing designs to boost the ODM sales.

The Group's another business, steel and plastic toys, accounted for 4.9% of its total turnover. The Group's current production capacity for steel and plastic toys is fully used to serve its existing clients, IDES and Funrise. To facilitate the taking on of new customers, the Group intends to establish a new plant in Taicang, Jiangsu province of China and construction work will commence later this year.

Market Analysis

For the six months ended 30 June 2005, the North American market accounted for 40.3% of the Group's total turnover, followed by Japan at 39.9%. During the period under review, the proportion of turnover contribution of the European market jumped to 15.2% from 9.7% in the corresponding period in 2004, attributable to the increasing orders from the OEM customer, IKEA. In addition to the promising US and Japan markets, Europe became another major market contributing stable income to the Group.

Operation Analysis

During the review period, the Group operated 8 plants in China and Vietnam. The Group implemented prudent cost control measures to lessen the adverse effects of escalating raw material and labour costs in China. Seeing the trend of adopting polyester to replace acrylic knitted fabric, the Group has started to invest in a polyester line at its fabric production facilities, which will cost a total of US$1 million. The pressure from rising material costs is expected to subside to certain extent, and hence profit margins are to be enhanced from the current level. In addition to establishing plants in Vietnam, the Group's manufacturing base was also extended to inland China, such as Guangxi and Anhui provinces, to alleviate the labour shortage problem and take advantage of the lower wage rates in those areas.

The Group is committed to reinforcing its vertical integration to ensure steady supply of raw materials and better control of production costs for its core plush stuffed toy business.

Prospects

The labour shortage problem is likely to persist in coastal cities of China in the near future. To alleviate this pressure and the elevated wages, the Group will employ equipment-aided manufacturing processes to lessen its reliance on labour. The Group will also continue to establish its manufacturing facilities in inland China and scale up its Vietnam operation to minimize the unfavourable impacts of high labour costs.

A plant of the Group equipped with 330 sewing machines started operation in Vietnam in the fourth quarter last year, and another plant of a larger scale also commenced operation on 1 July 2005 ahead of schedule. Not only do the plants in Vietnam enable the Group to diversify the risk from putting all the facilities in one country, but also relieve some pressure from labour shortage and higher labour cost in the Group's China production facilities temporarily.

To improve the shrinking profit margin, in addition to the restructuring plan for Korea, China and Vietnam, a series of strategies will be implemented. For the short and medium term, the Group will reassess the customer mix by easing out customers with comparatively low margins. It will also provide polyester fabrics for its own demand through its vertical integrated operation. Moreover, the proportion of equipment-aided production will be raised to trim material and labour costs. Investing more resources on R&D to initiate new designs and to develop innovative products with higher margins will be crucial to the long-term development of the Group. At the same time, more efforts will be put in marketing to heighten our product exposure in the toy market and in better customizing customers' needs.

Apart from measures to overcome challenges in the market and operational environments, the Group has also mapped out plans to consolidate its business. Capital expenditure of nearly US$3.8 million has been set aside for the second half of 2005 for the expansion of its existing plant in Shuyang, Jiangsu province and other areas in Anhui province, as well as for setting up a tricycle plant in Jiangsu province. The expansion work will be finished in the first quarter of 2006 which will boost production capacity by 5 to 6%, while the tricycle plant will start operation in the second half of 2006 with an anticipated annual sales volume of over US$15 million. These new development plans together with the recent Vietnam plants help the Group to gain a foothold to encounter the threats and the opportunities ahead.

Number and remuneration of employees

As at 30 June 2005, the Group had 20, 11026, 183, 11, 6 and 810 employees in Hong Kong, mainland China, South Korea, US, Japan and Vietnam respectively. The Group values its human resources and recognizes the importance of attracting and retaining quality staff for its continuing success. Staff bonuses and share options are awarded based on individual performance and job nature.

Liquidity and financial resources

As at 30 June 2005, the Group had net current assets of HK$251.8 million (31 December 2004: HK$328.1 million).

The Group continued to maintain a healthy liquidity position. The Group's current and non-current cash and bank deposits as at 30 June 2005 amounted to HK$187.6 million (31 December 2004: HK$234.7 million). While the Group's current and non-current net cash and bank balance as at 30 June 2005 amounted to HK$72.5 million (31 December 2004: HK$181.1 million)

Long-term structured bank deposits

As at 30 June 2005, an aggregate amount of long-term bank deposits US$12,000,000 (equivalent to HK$93,264,000) (31 December 2004: HK$85,288,000) was placed with a major bank. Interest is payable quarterly in the first year ending 14 January 2006 fixed at a rate of 6.5% per annum and in subsequent years ending 14 January 2017 at the rates based on ten times of the differential of U.S. dollar swaps with maturity of 30 years and 10 years.

Treasury policies and gearing

The Group has consistently adhered to its prudent treasury policy. Most of the Group's liquid fund is placed in principal guaranteed short-term dual currencies deposits in various banks during the period. The Group also made use of the financial tools of currencies option to reduce the Japanese Yen accounts receivable exposure and to enhance return from the liquid assets of the Group within the controllable risk level.

The Group's gearing ratio, calculated on the basis of total bank borrowings over the total shareholders' equity, was increased to 17.50% (31 December 2004: 8.9%) to fund the expansion of the production plants in Vietnam.