

Management Discussion and Analysis

OPERATIONS REVIEW

China remains the Group's largest market, where sales continued momentum in line with the country's economic growth. Telecom operators were under competitive pressure to invest in core network equipment to provide greater network capacity as well as to improve the quality of their networks, hence the demand for enhanced network monitoring, network security equipment and software continued. The success of China's aerospace projects has also accelerated investment in the telecoms and related sectors. The austerity measures taken by the Central Government to cool down overheated sectors of the economy did not impact critical infrastructure projects.

As an early entrant in the China market since the late eighties, we have amassed comprehensive knowledge of, and established trust with customers, in the world's biggest market in terms of demand for IT and telecoms services and solutions. Our track record of innovative communications solutions and unfailing systems deliveries has helped establish long and trusted relationships with our business partners. For the year ended 30 June 2005, China sales contributed HK\$711 million to the Group's turnover, a rise of 9 percent compared with HK\$652 million in the last corresponding year.

In Europe, the Group continued to build on its dominant position within the emergency services, exhibiting its next generation fire services communications solutions at the prestigious Interschutz fair in Hannover, Germany. Discussions on major fire projects continued between our European headquarters and interested parties in several European cities.

Healthcare continued to be a core sector of the Group's wireless IT solutions on a global basis. The year under review saw the installation of new applications to deliver clinical efficiencies and improve emergency response times for the National Health Service (NHS) using wireless technology, and our UK subsidiary Multitone was awarded key supplier status to the NHS as part of the latter's Purchase and Supply Agency (PASA) contracts. This has enabled the Group to secure new businesses for key health authorities from its competitors, and the Group's technologies are being adapted and introduced to key international markets. During the year, European sales accounted for HK\$309 million of the Group's turnover (2004: HK\$282 million).

In the US, the Group has continued to benefit from changes in the regulations with respect to new narrowband radio networks. The Federal Government has continued to upgrade the hospitals of the Veterans Administration throughout North America, of which the Group has secured a market share of approximately 70 percent in terms of installation works. This places the Group in a strong position to secure more business in the next phase of the band shift, which includes the Department of Defence.

The Group has also seen expansion of its activities in the Middle East with the installation of onsite communications systems at a number of prestigious hotel and hospital sites throughout the region during the year.

During the year, much of the European telecom equipment production has been transferred to the Group's manufacturing plant in Malacca, Malaysia, in order to fully utilise the existing production facility there. This enabled the UK facility to concentrate on high margin system integration solutions.

Kantone has continued to invest in new products and solutions, specialising in applications software suites for use in healthcare, hospitality, emergency and industrial markets. The Group has also overseen the introduction of new VoIP (Voice over Internet Protocol) applications including mobility integration for use with various systems and standards.

FINANCIAL REVIEW

During the year, the Group has achieved continued growth in turnover and net profit. Turnover increased to HK\$1,127 million, representing a rise of 11 percent as compared with HK\$1,015 million for the previous year. Net profit for the year was HK\$268 million, an increase of 73 percent as compared with HK\$155 million for the previous year. Basic earnings per share for the year was HK11.52 cents, an increase of 67 percent as compared with HK6.88 cents for the previous year. The increase in turnover was mainly attributable to increased sales of existing and new products to the established customer base as well as the expanding clientele covering new markets.

Gross profit for the year increased by 8.5 percent to HK\$476 million, and gross margin was stable at 42.2 percent. The Group continued to invest in product development and systems advancement, thereby enhancing the value-added features of its products and solutions, and in turn helping drive industry-leading productivity. Net profit benefited from the general reduction in operating expenses, as a result of the Group's increased outsourcing of product distribution and development work. General and administrative expenses decreased by HK\$8 million to HK\$68 million; depreciation and amortisation expenses decreased by HK\$30 million to HK\$72 million; while distribution costs increased slightly by HK\$5 million to HK\$58 million. The reduction in impairment losses recognised for investments also contributed to the improvement in net profit.

Despite the general increase in interest rates during the year, finance costs for the year at HK\$9.1 million were slightly less than last year's HK\$9.5 million, benefiting from the lower interest rate of convertible bonds.

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POST BALANCE SHEET EVENTS

Acquisition of e-Lottery Business in China

On 23 August 2005, Kantone announced its move into the PRC electronic lottery market by acquiring a 60 percent interest in an investor (the "Investor") of a pioneer systems developer and service provider in paperless betting systems in China, Shenzhen Helper Science Development Co. Ltd. ("Shenzhen Helper"), which is engaged in providing technological support to PRC governmental lottery administration authorities in return for recurring revenue sharing of betting turnover. Shenzhen Helper has developed the telephone betting operating systems for the welfare lottery market in Shenzhen and Shanghai, where the bulk of the e-lottery activities in China takes place, and has entered into a new agreement with Anhui Province Welfare Lottery Centre for the design, development and maintenance of the telephone betting operating system for the entire Anhui province, as well as to assist in the development of e-lottery business in Anhui.

The acquisition consideration is HK\$52 million, with an additional sum of HK\$18 million to be injected by Kantone to the Investor for its future development and expansion. In view of the rapid growth of China's lottery market, and the popularity of mobile phones and the Internet as communication medium, paperless lottery is expected to capture a significant share of the overall lottery growth in the years to come, thereby having the potential to make contribution to the Group's results in the forthcoming years.

LIQUIDITY AND FINANCIAL RESOURCES

The Group continued to maintain a strong financial position throughout the year. The Group financed its operation and business development with internally generated resources, capital markets instruments, and banking facilities provided by its principal bankers. In April 2005, the Company entered into a subscription agreement with Credit Suisse First Boston (Hong Kong) Limited for the issue of up to US\$24 million 1 percent unlisted and unsecured convertible bonds due 2008. At the same time, Tranche 1 of convertible bonds in the aggregate amount of US\$8 million (equivalent to approximately HK\$62.4 million) was issued, raising net proceeds of HK\$60.1 million.

Subsequent to the balance sheet date, on 23 September 2005, Kantone announced a top-up placing of 240 million Kantone shares at HK\$0.73 per share to institutional investors (the "Placing"). Upon completion of the Placing, Kantone will be able to raise net proceeds of about HK\$168 million, such amount to be applied to the investment in and future development of the e-lottery business including the above-mentioned acquisition, and the general working capital of Kantone Group. As a result of the Placing, the Group's shareholder base will be enlarged and its liquidity position will be further enhanced.

As at 30 June 2005, the Group had HK\$139 million (2004: HK\$78 million) liquid assets made up of deposits, bank balances and cash. Shareholders' funds stood at HK\$1,081 million (2004: HK\$827 million). With net current assets of HK\$260 million, the Group maintained a comfortable level of liquidity. The gearing ratio of the Group as at 30 June 2005, defined as the Group's total borrowings to shareholders' funds, was 0.12 (2004: 0.10). The change in gearing ratio was mainly attributable to the issue of convertible bonds as described above.

Total borrowings comprise bank borrowings of HK\$59 million (2004: HK\$65 million); other borrowings, which represent block discounting loans, of HK\$9 million (2004: HK\$17 million); obligations under finance lease of less than HK\$1 million (2004: less than HK\$1 million); and convertible bonds of HK\$62 million (2004: Nil). Finance costs for the year amounted to HK\$9.1 million (2004: HK\$9.5 million).

Included in the bank borrowings of HK\$58,920,000 were bank loans and overdrafts of HK\$2,866,000 (2004: HK\$3,020,000) being secured by the Group's land and buildings with a net book value of HK\$10,277,000 (HK\$10,467,000). These borrowings comprised debts of HK\$1,148,000, HK\$672,000 and HK\$1,046,000 repayable within one year, the second year and in the third to fifth year respectively. The unsecured bank borrowings of HK\$56,054,000 were repayable on demand.

The other borrowings of HK\$9,202,000 are unsecured, with HK\$4,309,000 repayable within one year, HK\$2,594,000 repayable in the second year and the remaining repayable in the third to fifth year.

As at 30 June 2005, the aggregate outstanding principal amount of USD 8 million 1 percent unsecured convertible bonds will be due on 1 April 2008.

Except for the USD convertible bonds, all other borrowings were used by the subsidiaries of Group, bearing interest at floating rates, and were denominated in local currencies and the currency risk exposure associated with the Group's borrowings was insignificant.

CAPITAL COMMITMENTS

As at 30 June 2005, the Group's capital commitments authorised but not contracted for was HK\$112 million (2004: HK\$98 million). These commitments were set aside for the acquisition of property, plant and equipment, and systems and networks.

EXPOSURE TO EXCHANGE RATE FLUCTUATION

The Group does not engage in interest rate or foreign exchange speculative activities. It is the Group's policy to manage foreign exchange risk through matching foreign exchange income with expense, and where exposure to foreign exchange is anticipated, appropriate hedging instrument will be used.

In the normal course of business, the Group has entered into a forward contract with creditworthy financial institution in order to limit its exposure to adverse fluctuations in foreign currency exchange rates. Gains and losses on these contracts serve as hedges in that they offset fluctuations that would otherwise impact the Group's financial results. Costs associated with entering into such contract are not material to the Group's financial results.

FINAL DIVIDEND AND SCRIP DIVIDEND SCHEME

Subject to the approval of shareholders at the forthcoming Annual General Meeting, the directors have proposed a final dividend of HK1.1 cents per share for the year ended 30 June 2005 (2004: HK0.65 cents per share) to shareholders whose names appear on the register of members of the Company on 25 November 2005. Taking into account the interim dividend of HK1 cents per share paid on 8 June 2005, total dividends for the year would amount to HK\$49.8 million, an increase of 73.5 percent over HK\$28.7 million of last year.

The final dividend will be satisfied by allotment of new shares of the Company, credited as fully paid, by way of scrip dividend, with an alternative to the shareholders to elect to receive such dividend (or part thereof) in cash in lieu of such allotment (the "scrip dividend scheme").

The scrip dividend scheme is subject to the granting by the Listing Committee of The Stock Exchange of Hong Kong Limited of a listing of and permission to deal in the shares to be issued pursuant thereto. A circular setting out the details of the scrip dividend scheme together with the form of election will be sent to the shareholders of the Company as soon as practicable.

It is expected that certificates for shares to be issued under the scrip dividend scheme and dividend warrants will be despatched to those entitled thereto on or before 25 January 2006.

CLOSURE OF REGISTER OF MEMBERS

The register of members of the Company will be closed from 21 November 2005 to 25 November 2005, both days inclusive, during which period no transfer of shares will be effected. In order to qualify for the final dividend and the scrip dividend scheme, all transfers of shares accompanied by the relevant share certificates, must be lodged with the Company's Branch Share Registrars in Hong Kong, Secretaries Limited at Ground Floor, Bank of East Asia Harbour View Centre, 56 Gloucester Road, Wanchai, Hong Kong by no later than 4:00 p.m. on 18 November 2005.