

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL PERFORMANCE

The Group's consolidated turnover for the period ending 30 September 2005 increased by 44% over the consolidated turnover recorded for the same period in the previous year, rising from HK\$817 million to HK\$1,175 million. This growth arose from a significant increase in sales volume of the Group in the period, as demand for MP3 players and related digital consumer electronics grew steadily across the board and the Group expanded its markets, particularly in Europe.

The rise in turnover was however accompanied by a slight fall in gross profit, from HK\$229 million in the corresponding period last year to HK\$219 million in the period under review. This reflected a decrease in the Group's gross profit margin from 28% last period to 19% this period, as its margins came under pressure from a more mature competition. Net profit however rose from HK\$131 million (restated) to HK\$152 million for the period, with net profit margin fell from 16% for the same period last year to 13% in the period under review. The Group achieved this through careful cost controls in administration, and by generally keeping tight control on overheads. There was no major capital expenditure in the period under review. Earnings per share amounted to HK22.67 cents, by comparison with HK25.81 cents (restated) for the same period last year.

BUSINESS REVIEW

Continued expansion of major foreign markets

The period under review was characterized by strong growth in the Group's international markets and overseas sales networks, leading to a significant rise in turnover and an increasingly high global profile for the Group's 'Matsunichi' brand name. The Group now enjoys a strong presence in Europe, in particular in the UK and Germany: in both countries, its customer base includes most major electronics retail chains. It has begun successfully promoting and selling its own brand products through these outlets. The Group's success in Europe is clear from the figures: in the relevant period last year, the Group's European sales represented just above 1% of its total turnover of ODM and OBM products, while in the period under review they rose to around 19%.

Over the past six months, the Group has worked hard to fuel this expansion and has consolidated its relationship with the UK's biggest electronics retail chain. The Group has acquired many new customers, both retail chains and distributors, in Germany and France. It is currently negotiating with distributors in Spain and Italy, and negotiations are also underway in Poland and Russia with an eye on the potential of the largely untapped eastern European market. The Group has also been transforming its German base from simple warehouse into an integrated logistics and customer service centre to cope with rising European demand.

In North America the Group has worked on expanding its channels, in preparation for the widespread launch of its OBM products scheduled for the second half of the year. It has managed to secure more channels in both the US and Canada in the period under review, so that currently most of the big retail channels in North America carry the Group's storage products, and own brand MP3 products will be launched through these outlets within the next six months. In Asia, China continues to be the cornerstone of the Group's own brand MP3 business, accounting for over 75% of OBM sales worldwide for these products. The Group has also expanded its wider Asia Pacific coverage, successfully broadening its markets in Thailand, Australia and New Zealand. The Group continued to consolidate its Taiwan market, with sales there representing around 3% of its total global turnover.

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A wide product range driving growth

In the period under review, the Group launched four series of new products across its range of MP3s, PMPs, and flash and hard disk memory products, continuing its drive towards adding multimedia functions to its products. For example, it has launched new high-capacity memory products specially designed for storing high quality digital images. While keeping average selling prices stable, the Group's products now offer on average twice the storage capacity that they were offering a year ago.

The Group's immediate target is to ship some 5 million pieces of MP3 players annually, making it one of the largest players in an industry in which global demand is estimated to be around 60 million pieces for 2005. In the period under review, MP3 players with flash memory accounted for the majority of the Group's total MP3 sales.

Global positioning through marketing

The signing of Michael Phelps, the famous US 6-time Olympic gold medalist as global spokesman and its associated marketing campaigns, has provided the Group with significant added leverage in its negotiations in the US and Europe. The Group has found that its association with Phelps has improved its ability to negotiate with major retail chains and distributors in these markets, and made it easier to introduce the Group's own brand product range. Matsunichi is now one of the few Asian brands in the industry to enjoy a major level of exposure in European markets.

Michael Phelps visited Hong Kong and China during the summer, creating good exposure for the Group in its key Asian markets and positioning Matsunichi as an international (and therefore more desirable) brand in China. Although Hong Kong does not represent a major market for the Group in terms of volume sales, its presence there is also important for generating respect and sales throughout Mainland China, where consumers look to Hong Kong as a trend-setting retail environment.

ODM/OBM business streams

In the period under review, the Group maintained a roughly 60/40 split in terms of sales between ODM and OBM business respectively. Its ODM business remained robust, and a number of Matsunichi products are sold in the US and Europe under the brand-names of the Group's overseas ODM customers. USB storage devices make up around 86% of the Group's total ODM business, with MP3 players making up the other approximately 14%. The Group is also currently negotiating with Japanese companies with the aim of expanding its ODM business in the Japanese market. Given the lower profit margins involved in ODM sales, however, the Group is aiming to shift its ODM/OBM mix by the end of the year, with the goal of building OBM sales to make up 55% of overall sales revenue. Currently, over 80% of the Group's MP3 players are OBM models, and following further marketing in Europe and the US, this percentage is expected to rise still further.

Trends in improving manufacturing efficiency

The Group's manufacturing facilities have been working within capacity in the period under review, with an average of 70% capacity being utilized. To maximize utilization during the period, the Group also carried out a small amount of SMT and PCB subcontracting works for a few international electronic goods manufacturers. Currently, the Group's manufacturing capabilities have the capacity to expand production as orders grow, a situation that means it will not be placed under pressure as new customers are added. At the same time, the Group has been working to ensure its logistics, production systems and processes are ready to cope with an influx of new orders as markets grow. Special areas of focus here have included improving process management systems, enhancing factory efficiency, developing strong and reliable relations with suppliers and ensuring delivery schedules meet customers' demands. As tough new European deadlines for restrictions on hazardous substances approach, the Group has also worked solidly to implement the appropriate standards, and is confident that it will meet all the new regulations.

PROSPECTS

Projected worldwide growth in demand

Industry analysts International Data Corporation have estimated that between 2003 and 2008, global shipments of MP3 players will rise from 33 million units to approximately 116 million units, at a CAGR rate of 28.8%. In Europe demand is particularly strong, with some estimates putting growth in demand for MP3 players there at 200% over the next few years, while global demand is expected to rise a further 60%. With these figures in mind, the Group plans to launch new series of MP3 players regularly, made up of a mixture of players utilizing flash memory and high capacity micro hard disks. The Group's future development is not, as with some competitors, largely staked on a single model or design template. Its strength rather lies in the fact that it is geared to a wide design range, appealing to many different customers with specific needs and diverse tastes. For example, it is shortly launching new MP3 series focused on particular interest groups. Its new 'fashion accessory' design series builds synergies with the fashion world, while the first in its sports series will integrate MP3 functionality with sports-related functions, including built-in pedometer, step counter, stopwatch, and related features.

In the longer term, the Group is looking to its high cost, high profit PMPs and other multi-media electronic projects as growth drivers. It intends to launch more PMP models in the coming months, which will boast improved picture quality and memory capabilities. Although PMP is yet to become a major electronics product category, the Group is an early mover in this rapidly growing field and will enjoy a strong position once the technology is more widely adopted.

Further down the track, the Group is exploring products that will expand its product range more dramatically still, such as integrating MP3 players with portable DAB (digital audio broadcasting) and satellite radio.

As one of the first developers and manufacturers of high capacity micro hard disk memory storage products, the Group holds a strong advantage in a field that still has relatively few competitors. Consumer demand continues to grow however for these high capacity products, and the Group is currently developing software to further enhance the product's functionality, along with encryption and other data protection features. These improved models should be available around the end of the year.

Breaking ground for OBM sales in the US

In terms of market expansion, the Group intends to focus on further penetrating the US market in the coming six months, with a particular emphasis on building up sales of its OBM products. Analysts predict that there is room for further substantial growth in the US market, and the Group is aiming both to expand its market share there and to improve its gross margins, specifically by promoting its OBM products. Initially, this goal will require a commitment to relatively high marketing expenditure: the Group expects that marketing costs will initially balance the higher OBM margins gained, so that its gross profit margin should remain stable at around the current rate of 19%.