Growing
› OUR MARKET

China business opportunities

- Expanded the distribution network in the Greater China region
- Strengthened operating efficiency and inventory control system

A balanced distribution network spanning five regions

Management Discussion and Analysis

Review of Operations

General Overview

The Group achieved satisfactory growth in the year ended 30th September 2005. Turnover rose 16% year-on-year to US$3,155 million. Net profit grew by 2.2% year-on-year to US$310.1 million, while earnings per share increased 2% year-on-year to US$0.191. The jump in turnover was due to sustained growth in the core footwear manufacturing operation and an increase in the contribution from Mainland China retail operations. The Group's net profit would have increased 11.9% year-on-year if the US$26.2 million profit from disposal of securities investments in fiscal 2004 had not been taken into account.

The operating environment in 2005 remained challenging. Crude oil and material prices stayed at high levels throughout 2005, and fluctuations in material prices affected the Group's gross profit margin. The upstream businesses posted a year-on-year improvement, but still faced a tough operating environment. Further rationalization will take place to improve the overall performance of these businesses.

Moreover, utility costs rose following the hike in crude oil prices, while direct labor costs climbed due to an overall increase in wage levels in the Pearl River Delta area. Over the past few years, the Group has taken the initiative to improve the general working conditions and benefits of staff, and this has helped to retain employees. Thus, the Group's factories in China have been minimally affected by the general labor shortage in the region.

There was an increase in the contribution from associates and jointly controlled entities in 2005. The Group raised its stake in Eagle Nice to 45%, leading to a higher contribution from this company. San Fang Chemical Industry Co. Ltd. was also a major contributor to the bottom-line among associates. Well Success Investments Limited and Hua Jian were the two major contributors among jointly controlled entities.

Production Review

The Group's major product, athletic shoes, accounted for 60.2% of total turnover, one percentage point lower than in fiscal 2004. The percentage of turnover accounted for by casual/outdoor shoes and sports sandals was similar to that of the previous year. In 2005, the Group manufactured a total of 185.9 million pairs of shoes, up 11.2% year-on-year, and there was a positive increase in the average selling price (ASP). Annual growth in the athletic shoe, casual/outdoor shoe and sports sandal categories was higher than the average market growth rate, demonstrating the Group's ability to increase global market share.

Retail sales in the Greater China region surged to US$169 million in 2005 due to ongoing development of the retail network and the expansion of the wholesale operation into Taiwan and Hong Kong. There was a positive increase in same-store sales, but more effort will be put into enhancing the efficiency of the Southern China operation, as competition there was particularly keen. The sports apparel and accessories manufacturing operation posted a healthy 35% annual growth in sales in 2005 due to the sustained flow of orders from customers.

At the end of fiscal 2005, the Group operated about 342 production lines, 33 more than in the previous year. The Group had 182 lines in China, 104 in Vietnam and 56 in Indonesia.

Total Turnover by Product Category

	2005		2004		y-o-y
	US$ millions	**%**	US$ millions	%	% change
Athletic Shoes	**1,899.0**	**60.2**	1,665.1	61.2	14.0
Casual/Outdoor Shoes	**581.8**	**18.4**	502.3	18.5	15.8
Sports Sandals	**43.9**	**1.4**	38.6	1.4	13.8
Soles & Components	**415.0**	**13.1**	405.8	14.9	2.3
Retail Sales - Shoes & Apparel	**169.1**	**5.4**	74.2	2.7	127.9
Others	**46.0**	**1.5**	34.0	1.3	35.2
Total Turnover	**3,154.8**	**100.0**	**2,720.0**	**100.0**	

The geographical distribution of the Group's products in 2005 was fairly well balanced. The US remained the Group's biggest market, accounting for 39.8% of total turnover, which compares with 41.2% in the previous year. There was double-digit sales growth in all major areas in 2005. Sales to Europe amounted to 26.4% of total turnover.

Total Turnover by Geographical Market

	2005		2004		y-o-y
	US$ millions	**%**	US$ millions	%	% change
U.S.A.	**1,255.2**	**39.8**	1,121.3	41.2	11.9
Canada	**58.7**	**1.9**	45.3	1.7	29.5
Europe	**834.6**	**26.4**	734.3	27.0	13.7
South America	**65.0**	**2.1**	56.0	2.0	16.0
Asia	**862.4**	**27.3**	701.1	25.8	23.0
Other Areas	**78.9**	**2.5**	62.0	2.3	27.4
Total Turnover	**3,154.8**	**100.0**	**2,720.0**	**100.0**	

Cost Review

Total operating costs increased 15.9% year-on-year to US$2,964.2 million, while cost of sales rose 17.2% to US$2,427.7 million for the year ended 30th September 2005. The percentage of materials to sales increased due to higher oil prices. Also, the percentage of direct labor costs increased due to higher wages. Administrative expenses were kept well under control due to the implementation of effective cost control measures. The rise in selling and distribution expenses was mainly related to higher turnover from China retail sales operations. The increase in other operating expenses was largely due to higher energy costs and R&D expenses. In fiscal 2005, there was no booking of profit from the disposal of investment securities, and therefore the amount under other operating income was lower.

Research and Development

The Group is committed to investing in research and development (R&D) in order to provide customers with advanced technical support from the mold shops and custom R&D centers. R&D efforts focused on the development of raw materials and the streamlining of production processes, with the aim of developing advanced footwear and shortening product cycles. In 2005, the Group invested US$94 million in R&D, a 5% increase over 2004.

Financial Review

Liquidity

The Group maintains a strong financial position. As at 30th September 2005, the Group had cash on hand of US$405 million (2004: US$466 million) and total borrowings of US$756 million (2004: US$777 million). The gearing ratio (total borrowings to shareholders' equity) was 39% (2004: 44%) and the net debt to equity ratio (total borrowings net of cash on hand to shareholders' equity) was 18% (2004: 18%).

Capital expenditure

Capital expenditure jumped to US$224.9 million (2004: US$155.4 million), mainly due to the acquisition of land for plant development and purchase of machinery. The Group spent approximately US$61.5 million on constructing new factory buildings and ancillary facilities, mainly in Vietnam and China. Meanwhile, US$110.5 million went into plant and equipment and leasehold improvements for production facility expansion, and US$33.6 million was spent on acquiring new land and buildings.

Dividends

A final dividend of HK$0.48 per share (2004: HK$0.46) has been recommended, making the full-year dividend per share HK$0.75 (2004: HK$0.71).

The Group's operating cash flow remains strong, and a suitable level of cash holding will be maintained. The policy of upholding steady growth in the normal dividend payment each year remains intact. The dividend payout ratio for 2005 is 50.4%, which compares with 48.7% in 2004.

Employees

As at 30th September 2005, the Group employed 265,000 staff, up from 252,000 in 2004. The Group adopts a remuneration system based on an employee's performance throughout the year, and offers equal opportunities to all staff. There are incentives in the form of discretionary performance bonuses to those who make creative suggestions that improve productivity.

Subsequent Events

Yue Yuen Industrial (Holdings) Limited issued a total of US$317,000,000 zero coupon convertible bonds due in 2008 (the "CB2008") that gave the holders the right to require Yue Yuen to redeem the bond on 23rd December 2005. The put option was exercised in respect of US$308,755,000.

On 14th December 2005, Yue Yuen signed a Put Release Agreement with Morgan Stanley & Co. International Limited ("Morgan Stanley") pursuant to which Morgan Stanley would solicit purchases of bonds in respect of which the put option had been exercised from the holders of such bonds. Yue Yuen will make an additional payment to or to the order of Morgan Stanley on maturity of exercised bonds, which are so purchased to increase the redemption amount.

As a result, the Put Option in respect of US$223,225,000 in the principal amount of the CB2008 has been revoked and US$231,470,000 principal amount of the CB2008 remains outstanding. The Company has paid US$85,102,350 to redeem US$85,530,000 principal amount of the CB2008.