Management Discussion and Analysis

BACKGROUND

The Company was listed on the Main Board of the Stock Exchange since 17 November 2005 and became the first Chinese based non State-owned infrastructure machinery manufacturer listed in Hong Kong. The Company is currently one of the top three manufacturers in wheel loaders and a major manufacturer of infrastructure machinery in the PRC.

The consolidated turnover of the Company and its subsidiaries (together, the "Group") for the year ended 31 December 2005 was RMB2,678 million, representing an increase of approximately 27% as compared to RMB2,109 million in 2004. Gross profit from operations was RMB553 million, representing an increase of approximately 32% as compared to RMB420 million in 2004. Consolidated profit attributable to shareholders of the Company reached a high record to RMB236 million, representing an increase of approximately 79% as compared to the previous period.

OPERATION REVIEW

Core activities of the Company in 2005 include the design, manufacture and sale of wheel loaders, road rollers and other infrastructure machinery equipments and components. The results and performance of 2005 were encouraging and positive for the Group with continued strong customers demand in wheel loaders despite the implementation of the austerity measure in cooling down the overheated economy in the PRC in the first half of 2005. In terms of geographical distribution of the Group's turnover, northern region of PRC remained as our principal marketing region, representing approximately 38% of total turnover which amounted to RMB1,013 million. The eastern region of PRC recorded a decline of approximately 6% of total turnover as compared to 2004. The sales in south western region of PRC surged to RMB487 million, accounting for approximately 18% of total turnover, showing an increase of approximately 6% as compared to the same period in 2004. Wheel loaders were primarily applied in a variety of infrastructure activities, including construction of roads, railways, tunnels and bridges and mining activities. In 2005, approximately 42% of turnover was attributable to entities involved in the construction of roads, railways, tunnels and bridges, approximately 40% of turnover was attributable to mining and approximately 8% of turnover was attributable to water supply projects.

SEGMENT INFORMATION

Wheel loaders

Sales in wheel loaders was the major sales contributor for the Company which accounts for approximately 96% of the Group's consolidated turnover in 2005. The ZL50 series continued to be the major revenue driver and achieved a total turnover amounting to RMB2,179 million in 2005, showing an increase of approximately 25% as compared to RMB1,748 million in 2004. The ZL30 series was the second largest revenue generator and achieved a turnover amounting to RMB374 million in 2005, showing an increase of approximately 37% as compared to RMB273 million in 2004. The sales of ZL 40 series dropped by approximately 55% to RMB22 million as compared to RMB49 million last year. This reflected the decline in demand for 4 tons wheel loaders in the PRC.

Management Discussion and Analysis

Road rollers

The Group recorded an increase of approximately 2,800% in turnover for road rollers from RMB1 million in 2004 to RMB29 million in 2005. The growth was primarily due to higher price and increased sale efforts for road rollers in 2005 as compared to the associated trial run production which was taken place in Shanghai, resulting in higher cost and lower price in 2004.

Production capacity and capacity utilization rate

In 2005, the Group achieved production volume of 17,000 units for wheel loaders and 250 units for road rollers respectively. The average utilization rates of the production facilities were approximately 93% and 80% for wheel loaders and road rollers respectively.

Vertically integrated production model

The Company adopted a vertically integrated production model which offered better control in production costs and product quality. At present, the Company is able to produce approximately 50% of the components used in machinery, namely, axle and transmissions and hydraulic parts. The Company plans to further increase its capability in components and parts manufacturing in the future.

Use of net proceeds from the Initial Public Offering (the "IPO")

On 17 November 2005, the Company was listed on the Main Board of the Stock Exchange, which involves a global offering of new shares (further details of which were set out in the prospectus of the Company dated 8 November 2005) (the "Offering"). The net proceeds obtained from this Offering (the "IPO Proceeds") was approximately HK$443 million. As of 31 December 2005, approximately HK$170 million of the IPO proceeds has been earmarked for the purpose of expanding the Group's production capacity.

The Group plans to spend approximately RMB200-300 million in 2006 to expand production capacity, to purchase machinery and equipment and to enhance research and development facilities.

FINANCIAL REVIEW

Gross margin

The gross margin for the year ended 31 December 2005 increased from approximately 19.9% in 2004 to approximately 20.6%. This was due to the decline in steel price in the second half of the year and improved margin for road rollers.

The Group achieved a growth in profit during the past few years. The continued profit was mainly attributable to the following factors: product mix enhancement, effective cost control and improved economies of scale in both purchase and overhead.

Operating costs and other operating expenses

The Group's operating costs and other operating expenses (including administrative expenses, selling and distribution costs and other operating expenses) was RMB273 million, representing an increase of RMB70 million or approximately 35% as compared to 2004. Administrative expenses increased from RMB41 million in 2004 to RMB70 million in 2005. This was due to the acquisition of the three connected companies in 2005 which were responsible for the supplying of parts and components to the Group as well as the listing expenses incurred for the Company's listing on the Stock Exchange and the Offering. In addition, selling and distribution costs have increased to RMB197 million, representing an increase of approximately 23%. The increase was in line with the expansion of our business.

Interest on bank borrowings wholly repayable within one year

The interest on bank borrowings wholly repayable within one year of the Group in 2005 was RMB31 million, representing an increase of approximately 47%. This was mainly due to the increase in the average bank borrowing interest rate of more than 1% in 2005 over 2004.

LIQUIDITY AND FINANCING

Cash and bank balance

The Group generally finances its operations with internally generated cash flow as well as banking facilities provided by its principal bankers. As at 31 December 2005, the Group's cash and bank balances was RMB408 million, representing an increase of approximately 157% as compared to the amount of RMB159 million in 2004. The increase was primarily due to the receipt of the IPO proceeds. In 2005, bank borrowings were RMB455 million, which was a slight decline of approximately 3.5% from 2004.

Cash flow from operating activities

The Group's net cash flow from operating activities in 2005 was RMB105 million, which was approximately equivalent to 2004's figure.

Cash flow used in investing activities

The Group's net cash flow spent in investing activities in 2005 was RMB200 million, representing an increase of RMB84 million over 2004, which was mainly due to the construction of a new office building, the acquisition of three connected companies and the construction of new production plant of Fujian Longyan Construction Machinery (Group) Limited.

Cash flow from financing activities

The Group's net cash flow from financing activities in 2005 increased by approximately 147% from RMB139 million in 2004 to RMB344 million. This was mainly attributable to the IPO proceeds.

Net operating working capital

As at 31 December 2005, the current assets of the Group amounted to RMB1,541 million, which mainly comprised inventories of RMB704 million, trade and bills receivables amounted to RMB350 million, bank balances and cash amounted to RMB408 million. The Company's current assets had increased by RMB315 million, which was in line with our business expansion. The reason was mainly due to the net proceeds acquired from the Offering. As at 31 December 2005, the current liabilities of the Company was RMB920 million, which comprised trade and bills payables amounted to RMB291 million and bank borrowings due within one year amounted to RMB455 million. The current liabilities had been decreased by RMB128 million in view of the decrease in tax payables as well as trade and bills payable.

Capital commitment

As at 31 December 2005, in respect of capital expenditures, the Group had contracted but not provided in the financial statements in respect of acquisition of property, plant and equipment amounted to approximately RMB41 million and RMB66 million respectively in 2004.

PROSPECT

In the economic forecast in the 11th Five-Year Plan (2006-2010) recently announced by the PRC Government, the annual Gross Domestic Product (GDP) growth of the PRC is expected to grow at the level of at least 7.5% each year in the next 5 years. In addition to that, according to the latest figures published by the Economist Intelligence Unit in early March, 8.6% GDP growth in the PRC is expected in 2006. The resilient economic growth and steady increase of average income per capita support the stable growth of infrastructure projects.

Increasing fixed asset investments in PRC leading to strong infrastructure machinery demands

Entering the 21st century, a number of mega construction projects are in progress which the directors believe will fuel the market demand for infrastructure machinery. As industrialization and urbanization continue to accelerate, the demand for urban development including roads, bridges and highways will increase further. Against this background, the directors expect that the infrastructure machinery industry in the PRC will continue to grow with immense potentials alongside with economic development. The Company is in the best position to take advantage of this market trend, given the Company's unrivalled competitive edges and in-depth understanding of market trends, China Infrastructure will further enhance its product portfolio. The Company believes that the year of 2006 will be another year of strong business growth.

Overseas markets

With a view to increasing sales and broadening customer base through better network coverage, the Company will further expand its nationwide distribution system and service network, in particular the sales force in north western and north eastern China. At the same time, the Company will explore overseas market. With the improved quality and excellent value for money products, the Company will develop customized products in synchronization with the overseas customers' needs. The Company will adopt proactive promotion strategy to raise profile and brand awareness of the China Infrastructure's brand name. It is expected that there will be at least 20% of the total turnover contributed from overseas markets in the next three to five years.