Management Discussion and Analysis

GROUP REORGANISATION

Huali Holdings (Group) Limited was established on 28 February 2005 as an exempted company under Chapter 22 of the Companies Law of the Cayman Islands and was registered in Hong Kong as an overseas company pursuant to Part XI of the Companies Ordinance on 27 April 2005.

In order to prepare for listing on the Main Board of the Stock Exchange, the Group underwent a reorganisation (the "Reorganisation"), pursuant to which the Company became the holding company of the Group. Details of the Group's Reorganisation and the public offering and placing totalling 50,000,000 shares of the Company are set out in the Company's prospectus dated 24 October 2005.

The Company's shares were listed on the Stock Exchange on 2 November 2005.

OPERATING RESULTS

As at 31 December 2005, the Group's total assets was RMB539 million. Total equity amounted to RMB317 million, representing an increase of 26.5% over 2004. The Group realised sales income of RMB662 million in 2005, representing an increase of 9.4% over 2004. Profits attributable to shareholders were RMB40.90 million, representing an increase of 42.8% over 2004. The basic earnings per share for the year were RMB0.26, as compared to RMB0.19 for 2004.

During the period under review, turnover increased by 9.4% over 2004. Gross profit margin was approximately 11.9% (2004: approximately 12.2%). Net profit margin attributable to shareholders was approximately 6.2% (2004: approximately 4.7%). Profits attributable to shareholders increased by 42.8% over 2004, which was mainly attributable to the increase in the Group's sales of paperboards and cartons as a result of the full year operation in 2005 of Zhongshan Huali Packaging Company Limited ("Zhongshan Huali") which commenced operation in April 2004. Shanghai Huali Packaging Co., Ltd. ("Shanghai Huali") became a wholly-owned subsidiary of the Group since October 2004 as a result of the Reorganisation and this greatly increased the Group's profits attributable to shareholders for 2005.

DISTRIBUTION COSTS AND ADMINISTRATIVE EXPENSES

Distribution costs for the year ended 31 December 2005 were approximately RMB30.34 million (2004: RMB31.98 million), represented a decrease of approximately 5.1% for the same period in 2004. This was mainly attributable to a reduction in transportation costs. After Zhongshan Huali had commenced business, it became another production base of the Group in the Pearl River Delta, which helped to shorten transportation distance between the Group and its customers and hence reduced transportation costs.

The Group's administrative expenses for the year ended 31 December 2005 were approximately RMB18.48 million (2004: approximately RMB14.61 million), represented an increase of approximately 26.5% for the same period in 2004. The rise in administrative expenses was due to the increase of manpower as a result of the Group's operation expansion during the year.

INTEREST EXPENSES

The interest expenses of the Group was RMB2.48 million for the year ended 31 December 2005 as compared to RMB3.63 million for the year ended 31 December 2004. The decrease was mainly due to the decrease in average amount of outstanding bank loans during the year.

DIVIDENDS

The Board recommended the payment of a final dividend of HK7.8 cents per share for the year ended 31 December 2005 to shareholders of the Company, totalling HK$15.60 million (approximately RMB16.22 million). Subject to the approval of the shareholders in the forthcoming annual general meeting of the Company, the Company plans to pay the dividend on 8 June 2006 to shareholders whose names appear on the Register of Members of the Company on 9 May 2006.

INVENTORIES, DEBTORS' AND CREDITORS' TURNOVER

The inventory turnover of the Group was 46 days for the year ended 31 December 2005 as compared to 47 days for the year ended 31 December 2004. The inventory turnover of 2005 was similar to that in 2004. The Group's debtors' turnover days were 77 days for the year ended 31 December 2005 as compared to 96 days for the year ended 31 December 2004. The above debtors' turnover days are substantially same as that normally granted by the Group to its customers. In 2005, the Group enhanced its risks control and the recoverability of its account receivables, resulting in a substantial decrease in debtor's turnover. The Group's creditors' turnover days were 90 days for the year ended 31 December 2005 as compared to 105 days for the year ended 31 December 2004. The Group settles much of its creditor balances with surplus cash.

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

The total equity of the Group as at 31 December 2005 were RMB317 million (31 December 2004: RMB251 million). As at 31 December 2005, the Group had current assets of RMB311 million (31 December 2004: RMB316 million) and current liabilities of RMB222 million (31 December 2004: RMB302 million). The liquidity ratio was 1.4 as at 31 December 2005 as compared to 1.0 as at 31 December 2004. The Group generally finances its operations with internally generated cash flow and credit facilities provided by bankers. As at 31 December 2005, the Group had outstanding bank loans of RMB38.47 million of which RMB36.30 million were fixed-rate loans (31 December 2004: outstanding bank loans of RMB52.12 million of which RMB51.64 million were fixed-rate loans). These bank loans were secured by corporate guarantees provided by certain subsidiaries of the Company. Following the initial public offering ("IPO") and listing of the shares of the Company on the Stock Exchange on 2 November 2005, the Group's gearing ratio (being the total borrowings including bills payable and bank loans divided by total assets) decreased from approximately 26.6% as at 31 December 2004 to approximately 23.0% as at 31 December 2005 as the financial position of the Group further enhanced.

The Group's liquidity position remains stable and the Group possesses sufficient cash and available banking facilities to meet its commitments, working capital requirements and future investments for expansion. The Group's transactions and monetary assets are principally denominated in Renminbi, Hong Kong dollars or United States dollars. The Group has not experienced any material difficulties or effects on its operations or liquidity as a result of fluctuations in currency exchange rates during the year ended 31 December 2005. During the year ended 31 December 2005, the Group did not employ any financial instrument for hedging purposes.

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USE OF PROCEEDS FROM THE INITIAL PUBLIC OFFERING

The net proceeds from IPO which was completed in November 2005, of approximately HK$48 million, was earmarked as to approximately HK$45 million for the acquisition of a piece of land for the construction of a new factory. As at 31 December 2005, since the Group had not yet located a suitable land for acquisition purpose, the above net proceeds were placed as bank deposits for future acquisition of land.

EMPLOYEES AND REMUNERATION POLICY

As at 31 December 2005, the Group employed nearly 1,500 full-time staff members. The basic remunerations of the employees are determined with reference to the remuneration benchmark, the employees' experience and their performance. Salaries of employees are maintained at a competitive level and are reviewed annually, with close reference to the relevant labour market and economic situation. Directors' remuneration is determined based on a variety of factors such as market conditions and responsibilities assumed by each director. Apart from the basic remuneration and statutory benefits required by laws, the Group also provides discretionary bonuses based upon the Group's results and the individual performance of the staff.

The Group has not experienced any significant problems with its employees or disruption to its operations due to labour disputes nor has it experienced any difficulty in the recruitment and retention of experienced staff. The Group maintains a good relationship with its employees. Most members of senior management have been working for the Group for more than 10 years.

The Group adopts a share option scheme at around the time of IPO. As at 31 December 2005, the Group had not granted any options under the scheme.

As at the date of this report, the Company granted a total of 19,300,000 options under the scheme, details of which are set out on pages 30 to 32.

The Group also provides internal training to its employees.

CONTINGENT LIABILITIES

The Group has no contingent liabilities as at 31 December 2005.

MATERIAL ACQUISITION

Save and except the Reorganisation, there was no material acquisition by the Group in 2005.

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BUSINESS REVIEW

With return of an improved global economy in 2005, purchasing power in Mainland China rose, yet raw material prices rose substantially or remained at high levels, the Company faced both opportunities and challenges at the same time. Satisfactory results were achieved by the Group under the joint efforts of the entire management and staff of the Group.

The Company has focused on producing medium to high grade cartons and other packaging materials, with the target clientele being medium and large sized enterprises. In the previous year, the Company's clientele have increased both in quantity and quality. Due to a rise in demand for consumer goods, the Company's sales income had realized a growth of 9.4% in 2005. Thanks to the management, which had captured the relevant market trends in time, the Company managed to capitalize on opportunities afforded by rising market demand for paper packaging containers and materials. Since 2003, the Group has been actively involved in expanding its scale, including building new factories and expanding production facilities in order to push up production capacity and volume. At the same time, the Company purchased sizable colour printing facilities to raise production standards and offered customers a comprehensive range of higher quality products and services. As at 31 December 2005, the Group's production capacity reached approximately 210,000 tonnes which helped to maintain its comparable advantage position in the industry. In light of the inflating prices of raw materials, the Group strictly controls its various costs by tendering part of its product transportation services and strengthening the management of account receivables and inventory. At the same time, the Group has enhanced its negotiations with suppliers to lower the raw material costs in order to maintain its cost stability.

PROSPECTS

With a steady growth in the global economy and increasing consumption power in China, the demand for corrugated paper packaging is expected to increase, which will create great potential for the development of the Group. Meanwhile, high raw material prices and the intensive market competition have also presented challenges to the Group. The management believes that, given the Group's experience accumulated over the years and its position in the industry, its quality products and services as well as its expanding customer base, the Group will be in a favorable competitive position.

The Group will, as usual, treads its stated strategy unswervingly by capitalizing on the national strategic development roadmap in order to expand its production capacity, absorb high-quality clientele and enhance development of new products to raise profitability. The Group will gradually centralize the procurement of its major equipments and raw materials and finalize a new location in Shenzhen for the construction of a new manufacturing base.