

Management Discussion and Analysis

Liquidity and Financial Resources

The Group continues to enjoy financing for its operations by internally generated cash flows.

As at 31 December 2005, the Group had cash and bank balances of approximately HK\$77.7 million (2004 HK\$101.7 million). In addition, the Group has also maintained a portfolio of liquid investments of approximately HK\$67.7 million (2004: HK\$61.4 million) at the end of the year under review. The decrease in the balance of liquid funds was mainly attributable to the increase in balances of inventories and trade and other receivables as compared to 2004.

As at 31 December 2005, inventories of the Group had increased by HK\$35 million as compared to 2004. The increase was partly due to the additional inventories of HK\$14.7 million for the expansion of the Retail Business, the increase in raw materials of HK\$9 million as a result of the change in purchasing strategy as part of the cost control measures and also the increase in work in progress and finished goods of HK\$7.6 million of the Manufacturing Business, which reflected a higher level of order on hands as compared to 2004.

The balance of trade and other receivables increased by HK\$32 million as compared to 2004. The increase, while partly due to the Retail Business, mainly reflected the higher volume of turnover of Manufacturing and Trading Businesses in the last quarter of 2005 as compared to 2004. As at 31 December 2005, the turnover of trade receivables for Manufacturing and Trading Businesses was 66 days as compared to 65 days at 31 December 2004.

About 81% and 10% of these liquid funds were denominated in US dollars and HK dollars respectively and the remainder mainly in Renminbi, Pound Sterling and Japanese Yen.

As at 31 December 2005, the Group had banking facilities of HK\$95.3 million (2004: HK\$94.8 million), of which HK\$88.5 million (2004: HK\$93.1 million) was not utilised. Banking facility in the amount of HK\$27.1 million (2004: HK\$46.7 million), of which HK\$1.6 million (2004: HK\$1.2 million) was utilised, is secured by inventories, and trade and other receivables of a subsidiary amounting to HK\$36.8 million (2004: HK\$27 million) and HK\$71.9 million (2004: HK\$65.5 million) respectively as at 31 December 2005.

The Group continued to maintain its gearing ratio (being the Group's net borrowings over total equity) at zero. In view of the strong financial and liquidity position, it is evident that the Group will have sufficient financial resources to meet its commitments and working capital requirements.

Acquisition of Subsidiary

On 31 March 2005, the Group acquired a 51% interest, at a consideration of HK\$10 million together with a shareholder's loan of HK\$ 20 million, in a joint venture to operate an exclusive retail license to design, manufacture and sell "SANRIO" products in the PRC. Goodwill arising from the acquisition amounted to HK\$3.5 million.

Capital Expenditure

During the year, the Group spent approximately HK\$6.9 million (2004: HK\$28 million) on additions to plant and equipment to further upgrade its manufacturing capabilities. This compared to the original budget of HK\$21 million which included the construction of an additional factory building comprising a logistics centre. The construction project has been delayed and is expected to commence in second half of 2006. The Group had also spent HK\$7.3 million (2004: HK\$2.3 million) on building the retail platform and opening of new retail stores in 2005.



For the year 2006, the Group has budgeted approximately HK\$32 million for capital expenditure. About HK\$21.8 million of the budget will be for the upgrade of the manufacturing facilities including the additions of three production lines in 2006 and the construction of an additional factory building. This is expected to increase the production capacity by 20% by the end of 2006 and another 35% in 2007. The Group also plans to outsource some of the production process with an aim to further increase its production capacity in 2006. Another HK\$7 million of the budget is for the expansion of the retail operations under the Lids, Kangol and Sanrio licenses.

The above capital expenditure is expected to be financed by internal resources of the Group.

Contingent Liabilities

As at 31 December 2005, Drew Pearson Marketing, Inc. (“DPM”), a subsidiary of the Group in the US, was under investigation by the tax bureau of the United States in connection with DPM’s accounting records for the period from 1999 to 2003, in particular, a transaction in the amount of HK\$7.75 million between the Company and DPM during the financial year ended 31 December 2001. As at the date of the annual report, no litigation against the Group had been resulted from such investigation. Based on the opinion from DPM’s legal counsel, the result of the investigation and the total amount involved are unknown at this stage.

DPM was an associated company of the Group prior to 30 April 2002 when the Group increased its shareholding in DPM from 42.86% to 85.71%. On 31 December 2003, the Group acquired the remaining interest in DPM which then became a wholly owned subsidiary of the Group.

Exchange Risk

Most assets and liabilities of the Group are denominated either in HK dollars, US dollars or Renminbi. The Group estimates that any 2% appreciation of the Renminbi is expected to reduce the gross margin of the Manufacturing Business by about 0.6%. However, as the businesses in the PRC market grow, the expected positive contribution will provide a hedge against the adverse effect of any appreciation of Renminbi to the manufacturing costs.

Employees and Remuneration Policies

At 31 December 2005, the Group employed 104 (2004: 93) employees in Hong Kong, and 2,750 (2004: 2,520) employees in the PRC and a total of 96 (2004: 102) employees in the USA and UK. The expenditures for employees during the year were approximately HK\$124 million (2004: HK\$105 million). The Group ensures that the pay levels of its employees are competitive and employees were remunerated based on their position and performance. Key employees of the Group, including Directors, are also granted share options under the share option schemes operated by the Company.