Raw Pork and Processed Meat Product Business

Benefiting from the ever-increasing demand, chilled pork was the biggest driver to the Group's growth in 2005. Processed meat products maintained favourable sales.

Financial Review

The shares of the Company were listed on the Main Board of The Stock Exchange of Hong Kong Limited ("Stock Exchange") on 3 October 2005 ("Global Offering"), achieving a remarkable milestone in the Group's development. The response to its Global Offering was encouraging. The Global Offering was significantly oversubscribed whilst the Hong Kong public offering was oversubscribed for more than a hundred times.

The Group reported impressive results for the 2005 financial year. Both turnover and net profit grew significantly. For the year ended 31 December 2005, the turnover of the Group reached RMB4.454 billion, an increase of 71.8%. Net profit increased remarkably by 112.3% to record RMB0.359 billion. Basic earnings per share was RMB0.344, an increase of 85.9% as compared with RMB0.185 in 2004.

These encouraging results in 2005 were mainly attributable to continued favourable sales of the Group's processing meat products amid the ever increasing demand for chilled and frozen pork products. Effective cost and operational expense control also contributed to the rise in profit.

Turnover

Chilled and frozen pork

In 2005, the Group intensively developed its chilled pork business, the biggest driver to the Group's growth. For the year ended 31 December 2005, sales of chilled pork totaled RMB2.016 billion, a substantial increase of 218.4% compared with RMB0.633 billion in 2004. This represents 42.2% (2004: 21.6%) of the Group's total sales (before inter-segment elimination) and 57.0% (2004: 34.7%) of total raw pork sales. Sales of frozen pork during the year were RMB1.519 billion, an increase of 27.7% compared with RMB1.190 billion recorded in the corresponding period of 2004. This represents 31.9% (2004: 40.6%) of the Group's total sales (before inter-segment elimination) and 43.0% (2004: 65.3%) of total raw pork sales. These satisfactory results in our chilled and frozen pork operations were mainly attributable to the fact that chilled pork is healthier and more hygienic than pork that is kept at room temperature. Chilled pork can satisfy the increasing demand from Chinese domestic consumers as living standards improve. Sales of raw pork also grew rapidly as the Group increased market penetration in its existing markets and further expanded sales channels as well as developed new markets in certain mid to small size cities during the year.

Processed Meat Products

The Group's processed meat products are classified into Low Temperature Meat Products ("LTMP") and High Temperature Meat Products ("HTMP") and focus primarily on pork. By the end of 2005, the Group offered a selection of over 500 types of LTMP including grilled sausage, Taiwan sausage, smoked ham, roast ham and Chinese bacon. The Group produces over 200 types of HTMP including various pork sausages. For the year ended 31 December 2005, sales of LTMP were RMB0.991 billion, an increase of 18.9% compared with RMB0.833 billion in 2004 and represented 20.8% (2004: 28.5%) of the Group's total sales (before inter-segment elimination) and 80.2% (2004: 75.5%) of the Group's turnover in processed meat products. The Group has already developed a strong "Yurun" brand in the LTMP industry. Purchases and sales of LTMP in 2005 recorded continuous growth as these products became trendier in the domestic consumer market. With the improvement in living standards and changing life styles, there is a growing demand for high-end gourmet food products that are nutritious, hygienic and convenient. The Group's various high quality packaged meat products are a perfect match for these diet trends. To further strengthen competitiveness and market share, the Group refined its product mix, increased its marketing efforts for high-end LTMP products, strengthened product promotion by working with large scale retail shops, and explored new marketing channels. Thanks to these efforts, sales of LTMP products recorded satisfactory growth.

Sales of HTMP decreased by 9.7%, from RMB0.271 billion in 2004 to RMB0.244 billion and represented 5.1% (2004: 9.3%) of the Group's total turnover before inter-segment elimination and 19.8% (2004: 24.5%) of the Group's total turnover in processed meat products. Although HTMP is not a strategic segment for the future, the Group proactively readjusted its product mix by retreating from low margin products and markets to focus on higher margin areas.

Cost of Sales

The Group's total cost of sales increased from RMB2.215 billion in 2004 to RMB3.815 billion in 2005. The increase was in line with the increase in sales revenue. Cost of sales represented 85.6% of the Group's total turnover in 2005, which was fairly stable compared to 85.4% in 2004.

Gross profit and gross profit margin

The Group's gross profit increased by 69.1% from RMB0.378 billion in 2004 to RMB0.639 billion in 2005 as a result of the substantial increase in sales during the year.

The Group's overall gross profit margin decreased slightly by only 0.2 percentage point from 14.6% in 2004 to 14.4% in 2005. This was mainly due to the reason that the proportion of sales of chilled pork, which carry a relatively lower gross profit margin than processed meat products, increased from 21.6% to the Group's total sales (before inter-segment elimination) in 2004 to 42.2% in 2005. However, increases in the gross profit margin of chilled pork and LTMP during the year partly offset the decrease in the overall margin.

In the raw pork segment, the gross profit margin of chilled pork was 12.4%, exceeding the margin in 2004 by 1.4 percentage points, while the margin of frozen pork was 7.8%, which was an increase of 0.8 percentage point compared with 2004. Both increases were mainly attributable to the decrease in the procurement cost of live pigs by cash. Fixed costs were also lower as a result of economies of scale.

In the segment of processed meat products, the gross profit margin for LTMP was 23.4%, an increase of 2.3 percentage points compared with 2004. The main reason for the increase were the strategic adjustment to product structure that was implemented by the Group during the year to promote the sales of high gross margin products, as well as a decrease in the procurement cost of live pigs. The gross profit margin of HTMP was 17.6%, a decrease of 0.5 percentage point compared with 2004. However, since the gross profit of HTMP only accounted for about 6.7% of the Group's total profit, the impact on the Group's overall gross profit and gross profit margin was negligible.

Operating Expenses

Operating expenses include distribution expenses, administrative expenses and other operating expenses. For the year ended 31 December 2005, the Group's operating expenses were RMB0.264 billion, an increase of 33.3%, compared to RMB0.198 billion in 2004. The increase was mainly attributable to the growth in production volumes, the administrative costs associated with the maintenance cost of listing status, and an increase in professional costs. Operating expenses accounted for 5.9% of the Group's turnover for the year, down 1.7 percentage points as compared with 7.6% in 2004. The change was mainly due to the greater economies of scale.

Operating Profit

For the year ended 31 December 2005, the Group's operating profit was RMB0.398 billion, an increase of 50.2% from RMB0.265 billion in 2004.

Disciplined Cost Control amid Fast Growth

The Group's operating expenses as a percentage of turnover has reduced from 7.6% for the year ended 31 December 2004 to 5.9% for the year ended 31 December 2005. This was mainly attributable to the Group's success in controlling costs and operating expenses.

Net Financing Cost

For the year ended 31 December 2005, the Group's net financing cost was RMB31.001 million, a decrease of 29.2% compared with RMB43.756 million in 2004, which was mainly attributable to the reduction of interest expense as a result of repayment of most of the bank loans during the year and higher interest income from bank deposits as a result of the proceeds from the Global Offering.

Net Profit

For the year ended 31 December 2005, the Group's net profit was RMB0.359 billion, an increase of 112.3% compared with RMB0.169 billion in 2004. The increase was mainly attributable to the substantial increase in sales and the Group's success in controlling costs and operating expenses. The net profit margin was 8.1%, an increase of 1.6 percentage points compared with 6.5% in 2004.

Financial Resources and Liquidity

The shares of the Company were listed on the Stock Exchange on 3 October 2005. A total of 402,639,800 shares of nominal value of HK$0.1 each were issued at a price of HK$3.70. The net proceeds from the Global Offering were HK$1.380 billion.

The Group's major liquidity and capital resources are the cash inflow from operating activities and the proceeds from the Global Offering. Net cash from operating activities during the year was RMB0.273 billion, a decrease of RMB0.067 billion compared to RMB0.340 billion in 2004. Cash balances as of 31 December 2005 were RMB1.356 billion.

Assets and Liabilities

As of 31 December 2005, the Group's total assets were RMB2.857 billion, a decrease of RMB0.996 billion compared with RMB3.853 billion as of 31 December 2004. The main reasons are (1) non-trade receivables from related companies in the amount of RMB1.257 billion at the end of 2004 were collected during 2005; (2) land use rights of RMB0.196 billion were leased to the Group under operating leases subsequent to the reorganisation in 2005, and were not accounted for as assets; (3) bills receivable of RMB0.67 billion at the end of 2004 were collected during 2005; and (4) the net proceeds from the Global Offering of RMB1.437 billion.

The Group's total liabilities as of 31 December 2005 were RMB0.615 billion, a decrease of RMB2.582 billion compared to that as of 31 December 2004, of which RMB0.02 billion was outstanding bank loan (outstanding loans at the end of 2004 was RMB1.806 billion). Details of the Group's bank and other loans are set out in note 23 to the financial statements. The main reasons for the decrease in total liabilities are (1) loans of RMB0.904 billion were not transferred to the Group subsequent to the reorganisation in 2005; (2) bills payable of RMB0.387 billion at the end of 2004 were repaid during 2005; (3) non-trade payables to related companies in the amount of RMB0.412 billion were repaid during 2005; and (4) the liability component of the convertible instruments of RMB0.118 billion was converted into equity during 2005.

As of 31 December 2005, the Group's outstanding bank loans amounted to RMB0.02 billion, a substantial decrease of RMB1.648 billion compared with RMB1.668 billion as of 31 December 2004. Such outstanding bank loan carries a fixed interest rate and is repayable within one year.

As of 31 December 2005, the Group's cash and cash equivalents amounted to RMB1.356 billion, an increase of RMB1.105 billion compared with RMB0.251 billion as of 31 December 2004. The increase mainly represents the proceeds from the Global Offering and the cash generated from operations during the year.

As of 31 December 2005, the Group's total equity was RMB2.242 billion, an increase of RMB1.587 billion compared with RMB0.655 billion as 31 December 2004. The increase was mainly due to the proceeds from the Global Offering and the net profit for the year. Details of the Group's total equity are set out in Consolidated Statement of Changes in Equity on page 55 of this annual report.

The Group's total debt to total capitalisation ratio (calculated as total debt including bank and other loans, finance lease liabilities and liability component of convertible instruments, divided by the sum of total debt and shareholders' equity) decreased substantially to 12% as of 31 December 2005 compared with 75% as of 31 December 2004 as a result of the decrease in total borrowings and the increase in capital after the Global Offering.

Further Enhancement on Productivity and Profitability

The Group plans to further optimise the product mix, streamline production processes and expand its sales networks in order to further enhance productivity and profitability.

Pledge of Assets

Details of the Group's pledge of assets as of 31 December 2005 are set out in notes 15, 23 and 26 to the financial statements.

Capital Commitments

Details of the Group's capital commitments as of 31 December 2005 are set out in note 31 to the financial statements.

Contingent Liabilities

Details of the Group's contingent liabilities as of 31 December 2005 are set out in note 32 to the financial statements.

Taxation

The income tax expense of the Group for the year ended 31 December 2005 were RMB7.685 million. The effective tax rate was 2.1%, which was substantially lower than the 23.7% in 2004 due to the preferential tax treatment that was enjoyed by most of the Group's subsidiaries after the reorganisation.

Foreign Exchange Risk

Most of the Group's income and expenses are denominated in Renminbi. For the year ended 31 December 2005, the Group did not experience any material difficulties or negative effects on its operations or liquidity due to currency exchange rate fluctuations.

Human Resources

As of 31 December 2005, the Group employed 9,286 (2004: 8,850) employees in the PRC and Hong Kong. Total staff costs for the year were RMB0.112 billion, accounting for 2.5% of the Group's turnover (2004: RMB0.100 billion, accounting for 3.9% of turnover). The Group offered competitive remuneration as incentive to staff for innovation and improvements, which was in line with industry practice. We offered performance-based bonuses to staff. The Group provided other employee benefits including contributions to social security scheme such as retirement benefit schemes. In addition, the Group invested in continuing education and training for management and employees to help continuously improve their skills and knowledge.

Business Review

Production Facilities and Production Capacity

In 2005, the Group's upstream capacity expansion progressed smoothly: Annual slaughtering capacity reached 7.85 million heads, an increase of 54.8% compared with the 5.07 million heads at the end of 2004. The capacity of the Group's four main slaughtering facilities in Lianyungang, Fuyang, Neijiang and Suzhou exceeded one million heads in each location.

The Group achieved noticeable results in its chilled pork segment as it continued to increase its marketing efforts in line with its business plans. Based on average production capacity, the utilization rate in the upstream business substantially increased to 72% in 2005 from the 43% in 2004, which was mainly driven by chilled pork.

In 2005, the Group continued to develop the market for LTMP in its downstream business. Based on the figures recorded at the end of the year, the utilization rate in the downstream business increased from 53% in 2004 to 55% in 2005, with LTMP enjoying relatively faster growth.

Quality Control

The Group entered into China's meat processing sector with high-end LTMP products. Product quality has always been the most important objective for the Group since its establishment. The Group implemented strict quality controls throughout the entire processes of procurement, production, sales and logistics. The majority of the Group's operating subsidiaries have obtained ISO9001 and/or HACCP certifications.

Thanks to stringent and comprehensive quality control management, production facilities and products were not affected by the outbreak of streptococcus suis in pigs in certain areas of the Sichuan province of the PRC from June to August 2005 and of avian influenza at the end of 2005. These outbreaks did not have any adverse impact on the ability of the Group to execute its slaughtering plans in 2005.

Brands and Market Promotions

During the year, the Group conducted promotional activities in different regions across the PRC. Television and mobile media were used to effectively raise public awareness of the Group's products. The Group's strategic planning team developed new attractive packaging that further differentiated the Group's products from those of its competitors.

Sales and Distribution

As of 31 December 2005, the Group had a sales team of 1,630 staff. The Group sells chilled and frozen pork directly to customers in large cities. These customers are mainly third-party distributors and accounted for approximately 55% (2004: 53%) of the Group's total turnover of raw pork. The Group's processed meat products were distributed to different areas across the country through a sales network spanning 30 provinces and autonomous regions. The Group's processed meat products are sold mainly through modern sales channels, primarily international hypermarkets, local supermarket chains, convenience stores in prime locations and third-party distributors. In 2005, processed meat products were mainly sold through modern sales channels, accounting for approximately 59% (2004: 62%) of total turnover of processed meat products.

During 2005, the Group explored the richer and faster growing markets in the lower to mid streams of the Yangtze River such as Jiangxi Jiujiang, Jiangsu Jinjiang, Zhejiang Xiqing regions. The Group's strategy for the upcoming year will focus on selling primarily chilled pork and LTMP in these regions of the Yangtze River and other relatively affluent regions in China. The North Eastern and Northern regions are important pork-consuming areas in China. Rich in natural resources, these regions enjoy higher living standards which, coupled with preferential government policies, will facilitate the Group's efforts to develop its market.

Prospects

2006 is the first year of the implementation of the Eleventh Five-Year Plan of the PRC. The Chinese economy will be gradually transformed from an investment driven model to a consumption driven model, helping the PRC to become the world's consumption giant. The urbanization and modernization will further promote the integration of the live pig slaughtering and processing meat industry, which will be beneficial to the Group's development.

2006 is also the first year following the listing of Yurun Food's shares on the Stock Exchange. The Group plans to further improve its product structure, streamline production processes and sales networks, and develop a corporate governance model that best suits Yurun Food's unique management culture. With an aim to achieving high growth while maintaining stable profitability, the Group is committed to delivering on the promises made at the time of the Global Offering in order to express its gratitude for the support of its investors.

The Group shall further expand its chilled and frozen pork businesses and increase its emphasis on the upstream businesses. The procurement network will also be strengthened, especially to enhance disease prevention.

With respect to processed meat products, the Group will optimize product structure, focusing on product innovation and sales of high-margin products to maximize economies of scale and lower production cost in order to further raise overall profitability.

In view of promising sales prospects and growing market demand, Yurun Food plans to rapidly expand its production capacity, especially upstream, by a variety of flexible measures, including green-field projects, expansion of existing facilities, leasing and joint ventures to satisfy the market demands.

Yurun Food will further strengthen its brands with highly effective advertising campaigns through television channels and mobile media. This will help the Group not only increase awareness and its reputation among the general public, but also enhance its market influence in the mid to high-end markets. The Group intends to consolidate our chilled pork products under our flagship "Yurun" brand to boost our chilled pork business.

Attracting and retaining top management and executive talent is the key for sustaining Yurun Food's core competencies. The Group plans to implement a performance based incentive scheme for the Group's core management team and staff in 2006. It will also improve overall management quality and business professionalism through on-the-job training and formal training programs. This will help develop team spirit and reinforce a sense of unity and belonging for both management and staff.

Yurun Food will continue to pursue its long-term operating goals of expanding business scale and increasing market share through highly selective acquisitions in 2006. We will carefully look for value-accretive acquisition opportunities as we seek to maintain our leadership in the industry and maximise returns to shareholders.