Management Discussion and Analysis of Results of Operations and Financial Position

The Company is one of the China's leading high-speed, heavy-duty diesel engine manufacturers, supplying mainly to certain major domestic truck and construction machinery manufacturers. The Company's core products are six-cylinder, 110–266kw output, 9.7 litre displacement WD615 diesel engines and WD618 diesel engines with an output of 265–323kw. During the year under review, the Company started a trial production of its newly invented Euro III diesel engines, with a 10–12 litre displacement and higher power up to 480 horsepower, on a market testing basis by using the new production lines.

INDUSTRY REVIEW

Heavy-duty trucks industry

During the year under review, the PRC central government implemented a series of austerity measures to cool down investments in infrastructures. With effect from 1st April, 2005, the central government has implemented a new policy of 《道路車輛外廓尺寸、軸荷及質量限值》 (Vehicles' Maximum Measurement On Size, Weight and Loading Capacity), which required all truck manufacturers to re-design their trucks so as to meet certain design standards with specific length, height and chassis structure standards. As a result, the nationwide crackdown on truck overloading has been easing off since the second quarter of 2005. The implementation of the above-mentioned measures had certain negative impacts on the heavy-duty trucks industry, which in turn substantially slowed down the sales of the Company's diesel engines which were used in heavy-duty trucks as compared to the previous year. In China, during the year, the total sales of heavy-duty trucks decreased by approximately 36% as compared with the same period in 2004. A sizable proportion of the unit sales of heavy-duty trucks with a load capacity of 15 tonnes (and above) in China was concentrated in few manufacturers, which also included the major customers of the Company, such as: 中國重型汽車集團有限公司 (China Heavy Duty Truck Group Co., Ltd) ("CHDTGL"), 重慶紅岩重型汽車有限公司 (Chongqing Hongyan Heavy Duty Motor Company Limited) ("Chongqing Hongyan"), 陜西重型汽車有限公司 (Shaanxi Heavy-duty Company Limited) ("Shaanxi Motor"), 北京福田汽車有限公司 (Beijing Futian Motor Company Limited) ("Beijing Futian"), 包頭北方奔馳重型汽車有限責任公司 (Baotou North-Benz Heavy-duty Truck Co., Ltd) ("North-Benz"), etc.

Construction machinery — Wheel loaders industry

During the year under review, the sale of the wheel loaders with a load capacity of 5 tonnes (and above), being the second-most important market of the Company, slowed down as a result of the implementation of series of austerity measures with credit-tightening policies by the PRC central government. A sizeable proportion of the sales of construction machinery with a load capacity of 5 tonnes (and above) in the PRC was concentrated in a few manufacturers, which also included the major customers of the Company, such as: 廣西柳工機械股份有限公司 (Guangxi Liugong Machinery Co., Ltd) ("Guangxi Liugong"), 上海龍工機械有限公司 (Shanghai Longgong Machinery Company Limited) ("Shanghai Longgong"), 福建龍岩工程機械(集團)有限公司 (Fujian Longyan Construction (Group) Company Limited) ("Fujian Longyan"), 山東臨工工程機械股份有限公司 (Shandong Lingong Construction Machinery Co., Ltd) ("Shandong Lingong"), etc.

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SALES OF WD615 AND WD618 SERIES ENGINES

During the year under review, the Group's turnover decreased by approximately 14.7% from RMB6,155.8 million in 2004 to approximately RMB5,250.7 million in 2005. The turnover of the Group was derived mainly from the sale of diesel engines used in heavy-duty trucks and construction machinery, which in total accounted for approximately 82.4% and each represented approximately 53.3% and 29.1% of the total turnover of the Group, respectively. During the year under review, the Group sold approximately 114,180 units of diesel engines, compared to 134,460 units in 2004, representing a decrease of approximately 15.1%, while the average unit selling price of the Group remained relatively stable. Of the diesel engines sold for the year ended 31st December, 2005, approximately 63,490 units (2004: 83,100 units) were trucks engines, representing a decrease of approximately 23.6% when compared to that for the same period in 2004.

SALES OF DIESEL ENGINE PARTS

Apart from the production and sale of diesel engines, the Group is also engaged in the production and sale of engine parts. The production and sale of engine parts not only contributed to the sales revenue of the Group, but also ensured the generation of revenue from the provision of after-sales services on the parts. During the year ended 31st December, 2005, the Group recorded an approximately 33.0% increase in sales of engine parts from RMB513.5 million in 2004 to approximately RMB683.0 million in 2005. The surge was mainly attributable to the increase in accumulated sales volume of diesel engines in previous years. The sales of diesel engine parts represented approximately 13.0% (2004: 8.3%) of the Group's total turnover in 2005.

FINANCIAL REVIEW

Turnover

The Group's turnover decreased by approximately 14.7% from RMB6,155.8 million in 2004 to approximately RMB5,250.7 million in 2005. The decrease in turnover was the result of a negative demand in the heavy-duty trucks industry for diesel engines due to the implementation of a series of micro-tightening measures which slowed down the investments in infrastructures in China in 2005 and the easing off of the national-wide crack-down on truck overloading practices. During the year ended 31st December, 2005, the Company sold approximately 114,180 units of diesel engines, compared to 134,460 units in 2004, representing a decrease of approximately 15.1% while the unit average selling price of its diesel engines remained relatively stable.

Gross profit and gross profit margin

During the year ended 31st December, 2005, the Group's gross profit decreased by approximately 23.3% from RMB1,504.7 million in 2004 to approximately RMB1,154.3 million in 2005 as a result of decrease in the sales volume from 134,460 units in 2004 to approximately 114,180 units of diesel engines in 2005. Gross profit margin decreased from 24.4% to approximately 22.0% in 2005. The decrease in gross profit margin was mainly due to the decrease in the sale of heavy-duty trucks diesel engines in 2005 which have a relatively higher gross profit margin than the sale of diesel engines for construction machinery.

Distribution expenses

Distribution expenses increased from RMB391.8 million in 2004 to approximately RMB404.0 million in 2005. As a percentage of turnover, distribution expenses increased from 6.4% in 2004 to approximately 7.7% in 2005, which was mainly due to the increase in repair and maintenance expenses and after-sales services charges resulting from the temporary extension of warranty period from an average of 180 days for the first half of 2005 to one year for the second half year of 2005 and substantial increase in the number of after-sales services centers from an average of 1,100 in 2004 to 1,540 in 2005.

Administration expenses

Administration expenses the Group decreased by approximately 9.6% from RMB301.1 million in 2004 to approximately RMB272.1 million in 2005. As a percentage of turnover, the administration expenses increased from 4.9% in 2004 to approximately 5.2% in 2005. The increase in administration expenses was mainly due to the increase in the depreciation charged during the year.

Net profit margin

The Company's net profit attributable to shareholders decreased from RMB533.3 million in 2004 to approximately RMB315.2 million in 2005, the net profit margin decreased substantially from approximately 8.7% in 2004 to approximately 6.0% in 2005. The decrease in the net profit margin was mainly due to the gross profit margin decrease and increases in the percentage of distribution expense and administration expenses over the turnover in 2005 as discussed above; the decrease of income tax credit granted by the PRC government from RMB63.6 million in 2004 to approximately RMB10.4 million in 2005 has also led to the decrease in net profit margin of 2005.

Taxation

	2005 RMB'000	2004 RMB'000
PRC Enterprise Income Tax:		
Current year	**106,379**	269,371
Overprovision in prior year	**(203)**	(240)
Tax credit	**(10,407)**	(63,647)
	95,769	205,484
Deferred tax	**(1,850)**	—
	93,919	205,484

PRC Enterprise Income Tax is calculated at the statutory income tax rate of 33% (2004: 33%) of the assessable profit of the Group, except on assessable profit derived from the production in the high technology development zone, which is taxed at a preferential rate of 15% since current financial year pursuant to the Notice of Ministry of Finance and the State Administration of Taxation concerning certain preferential policies on enterprise income tax (財政部、國家稅務總局《關於企業所得稅若干優惠政策的通知》) and the Notice of the State Administration of Taxation concerning proper implementation of the continuing administrative work after the cancellation delegation of the examination and approval procedure for enterprise income tax (國家稅務總局《關於做好已取消和下放管理的企業所得稅審批項目後續管理工作的通知》).

Liquidity and financial resources

The Group has a very solid financial position. As at 31st December, 2005, the net cash and cash equivalents of the Group amounted to approximately RMB710.0 million (2004: RMB1,774.2 million).

The Group will have sufficient financial resources to fund its operations, as well as its current investment needs and development plans.

Capital structure

During the year, the Group's bank borrowings were primarily denominated in RMB while its cash and cash equivalents were held in RMB and Hong Kong dollars.

It is the intention of the Group to maintain an appropriate mix of equity and debt to ensure an efficient capital structure from time to time. As at 31st December, 2005, the Group had debts of approximately RMB334.2 million in aggregate and the gearing ratio was approximately 6.0% (2004: 0.4%) (total debt/total asset).

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Business and geographical segments

During the year, the Group was principally engaged in the business of manufacture and sale of diesel engines and related parts and substantially all of the Group's turnover and operating results were derived from the PRC and accordingly, no analysis of business and geographical segment is presented.

Pledge of assets

At 31st December, 2005, bank deposits of approximately RMB371.7 million (2004: RMB334.4 million) were pledged to banks to secure bills payable issued and bills receivables discounted by the Group.

At 31st December, 2004, bills receivable of approximately RMB119.9 million were pledged to banks to secure bills payable issued by the Group.

The pledged bank deposits carry prevailing bank interest rates. The pledge will be released upon the settlement of the relevant bank borrowings. The fair value of the bank deposits at 31st December, 2005 approximates the carrying amount.

Foreign exchange risk exposure

As almost all of the operations of the Group are located in the PRC. Its operating expenses as well as most of capital expenditure of the Group were denominated in RMB for the year. Therefore, the Group did not experience any material difficulties or effects on its operations or liquidity as a result of fluctuations in currency exchange during the Period. The Directors believe that the Group will have sufficient foreign exchange currency to meet its foreign exchange requirements.

Contingent liabilities

The Group had no material contingent liabilities as at 31st December, 2005.

Capital commitments

As at 31st December, 2005, the Group had approximately RMB234.9 million (2004: RMB423.6 million) capital commitments, principally for the capital expenditure in respect of purchase of property, machinery and equipment.

Capital expenditure

During the year, the Group's capital expenditure amounted to approximately RMB807.2 million (2004: RMB774.9 million). This was mainly attributable to the acquisition and installation of new production lines, modification of existing production lines, research and development of Euro III diesel engines,

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but excluding the formation of the joint venture — 濰柴動力(濰坊)投資有限公司 (Weichai Power (Weifang) Investment Co., Ltd.) — for the acquisition of approximately 28.12% of shareholding interest in TAGC, a company listed on the Shenzhen Stock Exchange.

Human resources practice

As at 31st December, 2005, the Company had a total of over 6,550 employees. As the Company believes people are the cornerstone of its success, the Company has long been concerned with its employees' development by organizing various training courses to broaden their horizon. During the year, some of the senior management of the Company attended training courses organised by reputational domestic and overseas universities. Employees are remunerated based on their performance, experience and the prevailing industry practices, with compensation policies and packages being reviewed on a yearly basis. Bonus and commission may also be awarded to employees based on internal performance evaluation.

The Group has established an incentive scheme for its senior management. Under this scheme, up to 5% of the audited annual profit after tax of the Group will be paid as bonus to the Directors and other senior management staff each year.