Management Discussion and Analysis

"Greatwall" is one of the three major brands of dry wine in China.

Management Discussion and Analysis

Mr. Qu Zhe
Managing Director

During the year,

- the Group's consolidated turnover rose to HK$17,588 million, representing an increase of 4.7% over the previous year;
- profit attributable to shareholders reached HK$429 million, 50.1% more than that in the previous year (restated);
- basic earnings per share were 24.4 HK cents, an increase of 8.1 HK cents compared with 16.3 HK cents per share (restated) in the previous year;
- the proposed dividend of 8.7 HK cents represented a payout ratio of 35.7%, an increase of 2.2 HK cents compared with the 6.5 HK cents per share paid out in the previous year.

The Group has five food-related core businesses, namely, edible oils, soybean meal and related products; wineries; confectionery; flour milling; and trading.

The performances of these businesses during the year are set out below, together with further information on the Group.

Edible oils, soybean meal and related products

The Group is currently the largest producer of edible oils and soybean meal in the PRC. We are mainly involved in the oil extraction and refined oil businesses, as well as in the sale of related products, such as the "四海" brand soybean meal (an important ingredient used in animal and poultry feed), the retailing of bulk edible oils, "Fortune" brand consumer-pack oils, as well as other specialty oils in the PRC.

During the year, this business began its recovery, rising from the depths of 2004. Unfortunately, as international soybean prices went in an opposite direction to domestic soybean meal prices during the second quarter, results for the first half of the year were adversely affected. Although international soybean prices gradually stabilized in the second half of the year, the occurrence of avian flu in China adversely affected the sale of soybean meal, directly affecting results during this period.

However, as we adopted aggressive measures based on our past experiences, improved risk control mechanisms and rationalized our management system, hand-in-hand with the fact that the Chinese government has been able to prevent the spread of the avian flu, overall we were able to maintain slow but stable recovery growth during the year. In 2005, the business recorded a turnover of HK$11,871 million, with an increase of 1.8% over the previous year, accounting for 67.5% of the total Group turnover. During the year, the Group sold 2,470,000 tonnes of soybean meal, with a 13.6% increase over the previous year. Sales of bulk edible oils totaled 791,000 tonnes, representing an increase of 8.7% over the previous year, while sales of consumer-pack oils amounted to 297,000 tonnes, growing 15.9% over the previous year.

China's edible oils industry faces a number of challenges including surplus extraction capacities as well as the fact that the domestic soybean meal and oil prices are not well matched with international soybean prices. To keep abreast of market information, we have set up a market information analysis and research center to strengthen risk controls and enhance competitiveness. To cope with the intensifying competition, we will continue to maximize our economies of scale, realizing significant cost advantages. We will also foster the development of our "Fortune" and "Vitoil" consumer-pack oil brands and improve sales channels even further to capture greater market share. We will also expand production capacities for other consumer-

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pack oil products, such as sunflower seed oil and safflower seed oil, which have higher gross profit margins compared with soybean oil. The Group will also move towards the value-added deep processing of oils. Our efforts to adjust the product mix have seen significant achievement with the gradual increases in the sale of peanut oil. At the same time, we will continue to increase our investments in technological development and research to produce edible oil products that meet consumer demands, while in turn stimulating greater sales within the sector.

Wineries

The Group's winery business is mainly engaged in the production and sale of wines under the "Greatwall" brand in China. The business consists of the entire production process from vineyards to wine-making to sales and marketing. During the year, sales volume of "Greatwall" wines increased from 57,000 tonnes in 2004 to 78,000 tonnes in 2005, and sales rose to HK$1,527 million, representing a substantial increase of 31.2% over the previous year and accounting for an encouraging contribution of 8.7% to the total Group turnover.

The rapid increase in turnover and sales volumes show how well "Greatwall" wines are received among Chinese consumers. During the year, the business launched several wines produced in different areas, including its Huaxia Vineyard Cru B and Huaxia Vineyard Small Cru. These new wines aim to create a solid platform for the high-end wine market. However, due to the intense market competition and as the relatively immature section of the consumer market continued to grow, the sale of "Greatwall" wines saw some structural changes. The sale of low-end products grew at a faster pace, resulting in reductions in the average sales price of wine per tonne. Adjusting the product mix to deal with the situation, the Group set a unified and prescribed product price for low-end products while formulating a sales policy to support the sale of mid- and high-end products. We also expedited the construction work on the COFCO Navavalley Jundung Vineyard. Construction of this vineyard will be completed in 2007, with production capacities amounting to 1,000 tonnes. The construction of this vineyard will mark the evolution of "Greatwall" wines from the mid- to high-end to the premium chateau market. This will have a significant impact on western wines as "Greatwall" wines move up in prestige and quality and allow the business to compete on a higher level in the market.

Our wineries in Shacheng and Yantai received their Hazard Analysis Critical Control Point (HACCP) Management System Certification for Food Manufacturers in 2005, further ensuring product quality. The wineries also received ISO14000 and ISO9000 Certification and QS Certification (Permission of Market Access for Food Quality and Safety), taking the Group several steps forward in the enhancement of product safety standards. During the year, the Group made every effort to protect the "Greatwall" brand, adopting comprehensive and effective measures to guard against crack down on fake wines. These measures include market monitoring, tracking and investigation, prosecution by local administration bureaus of industry and commerce as well as litigation.

During the year, due to the unfavorable weather conditions, the grape output in Shandong Province fell substantially, though market consumption continued to rise. This led to a massive increase in the purchase of original wine by wine businesses. Grape prices rose dramatically, creating pressures on the prices of wine and substantially affecting gross profit margins. Seeking to stabilize the supply of raw materials, the Group will seek stable purchase channels, while arranging and implementing purchase plans in advance.

During the past two years, we have also been working to integrate our three wineries to eliminate internal competition and cost overlaps. At the present moment, the integration of raw material purchases, production management and brand marketing have been completed with notable results. The integration of our distribution channels will be expedited in 2006. This will further improve sales performances and enhance our profitability.

Looking forward, the domestic wine industry is expected to maintain its double digit growth with promising prospects. As a leader in the industry, we will promote awareness and acceptance of a wine-drinking culture, while actively developing a mature wine consumption market. To strengthen our leading position in the market, we will

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implement a multi-brand strategy that focuses on the "Greatwall" brand and strategically select grape production bases for the setting up of wineries and investing in the construction of vineyards; we will optimize product lines and subdivisions in the market, by implementing a focused strategy characterized by growing market penetration, market and product development; and we will build our own sales teams as well as progressively set up regional sales companies. We believe that these measures will bring faster and more substantial growth for our "Greatwall" wine business.

Confectionery

The Group produces and distributes the "Le Conte" brand confectionery products and chocolates in China. During the year, "Le Conte" brand chocolate and confectionery products remained the Company's main products in this sector. In 2005, the turnover of this sector totaled HK$381 million, representing an increase of 10.8% over the previous year and accounting for 2.2% of the total Group turnover.

Affected by the rising international prices of raw materials in the market, the costs of raw materials for chocolate products including cocoa butter, almonds and hazelnuts recorded double digit increases, greatly pressuring operations. However, the sector managed to achieve an increase not only in gross profit margins, but also in turnover with the implementation of effective cost controls, flexible purchase, production and sales policies, strong internal management, as well as the introduction of a direct supply model instead of the previous dealership system among large and medium-sized points of sale in Beijing and Shanghai.

To expand our brand's base, strengthen brand image and reduce the gap in awareness between our brand and other leading brands in the market, we increased our investment in marketing and promotions. We dedicated more resources into product promotion with a focus on TV advertising supported by press and magazine advertisements as well as outdoor advertisements on signposts and subways. These advertisements communicate with our target customer groups and promote the "Le Conte" brand. Although these activities have temporarily affected earnings performance, they have strengthened our brand's base and will help to promote long-term growth of the business.

The Group places a strong emphasis on improving the competitiveness of the "Le Conte" brand, and will continue to invest resources in marketing and promotions. With regard to product development, the Group will selectively develop products, based on market demand, which can be sold in small sales channel, such as individually packaged chocolate. At the same time, the Group will further improve the sales network, conduct research into small sales channel networks, integrate distribution resources, work with small channel dealers, establish a dedicated department and employ experienced staff to drive the expansion of distribution channels, formulate policies on channel sales, and put dedicated sales teams in charge of the expansion of small channel products. We believe that these measures will stimulate growth in the confectionery and chocolate sector and make a positive contribution to the overall business of the Group.

Flour Milling

During the year, the Group's flour business recorded a turnover of HK$604 million, with a 2.6% increase over the previous year, accounting for 3.4% of the total Group turnover.

China's flour industry is characterized by large scale and scattered markets with a geographically wide area of consumption. The industry faces excess capacities and is in the process of being streamlined. The Group owns several regionally well-known brand names such as "神象". Apart from cultivating these brands, enhancing brand prominence and devoting a great deal of effort to developing these brands into national names, we will continue to improve the ratio of high-end flour production and sales to realize higher consolidated gross profit margins.

To improve profitability, in addition to expanding the flour sales network, we will develop new products and downstream products, and strengthen cost controls and product management. At the same time, we will enhance the management of our procurement, production and sales activities to increase synergies among our flour mills.

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Trading

The Group has been engaged in the domestic trading of, as well as the import and export of, foodstuffs, grains and animal feedstock for some time. In 2005, we were mainly involved in the bulk, mainly back-to-back, commodity trading of rice, soybeans, red beans, sugar, fruit and vegetables. We also processed raw materials for export and provided foodstuffs trade agency services on a commission basis. Our total trading business consists of approximately 66% in exports, 32% in imports and the remaining 2% in domestic trade.

During the year, the consolidated turnover for the trading business totalled HK$3,205 million, representing an increase of 5.5% over the previous year and accounting for 18.2% of the total Group turnover.

Since 2004, grain production in China has resumed growth with an increase in rice exports. Among the Group's rice exports in 2005, the proportion of polished round-grain rice, which has a higher gross profit margin, increased significantly. The gross profit margin for rice product exports therefore improved markedly, benefiting our trading business as a whole.

Responding to market developments, the Group will continue to open new trading channels and introduce new products. With our diversified trading model, more than 50 years' experience in the food trade, established international trade network and our well-established and vigorous risk management system, we believe the trading business will continue to generate promising and steady operational profits for the Group.

Liquidity and Financial Resources

The Group's financial position is sound with stable cash flows. As at 31 December 2005, the Group's total shareholders' equity stood at HK$4,686 million, representing an increase of 8.7% compared with that at 31 December 2004 (restated). As at 31 December 2005, the Group's cash and bank deposits (including pledged deposits) totaled HK$1,385 million (31 December 2004: HK$1,105 million (restated)). The Group's net current assets were approximately HK$922 million (31 December 2004: HK$1,068 million (restated)).

Based on the above, together with bank loans and other loans and facilities available to the Group, the management believes that the Group's financial resources are sufficient for all debt payments, day-to-day operations and capital expenditures.

As the Group's monetary assets, liabilities and transactions are principally denominated in Hong Kong dollars, Renminbi and United States dollars, the management believes that the Group's exposure to exchange rate risks is limited. The management is of the view that the new management mechanism for the Renminbi exchange rate introduced in July 2005 will not have a material negative impact on the Group's liquidity and financial resources.

Capital Structure

During the year, the issued share capital of the Company increased by 1,350,000 shares as a result of an executive director of the Company exercising his share options. Save as above, there were no other changes in the share capital of the Company during the year.

As at 31 December 2005, the Group had no significant borrowings apart from certain bank loans, loans from minority shareholders of the Company's subsidiaries and loans from a fellow subsidiary totaling HK$3,472 million (31 December 2004: HK$2,672 million). During the year, all the Group's bank borrowings bore fixed annual interest rates of between 4.09% and 5.58% (31 December 2004: between 2.57% and 6.34%). Other borrowings were interest-free or bore fixed annual interest rates ranging from 4.2% to 5.58% (31 December 2004: from 2.31% to 5.58%).

As at 31 December 2005, net debts (the total of debts excluding loans from minority shareholders of subsidiaries that were of capital nature less cash and bank deposits) were HK$2,018 million (31 December 2004: HK$1,506 million). Based on the above, the Group's gearing ratio was approximately 43.1% (31 December 2004: 34.9% (restated)).

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Contingent Liabilities and Assets Pledged

As at 31 December 2005, the Group had no material contingent liabilities.

As at 31 December 2005, certain bank loans of the Group were secured by charges over certain time deposits, fixed assets and investment properties with net book value of approximately HK$727 million (31 December 2004: HK$151 million).

Employee and Remuneration Policy

As at 31 December 2005, the Group employed approximately 7,717 staff in China and Hong Kong (31 December 2004: 6,507). Employees are paid according to their performance, experience and prevailing trade practices, and are provided with on-the-job and professional training. Employees in Hong Kong receive retirement benefits, either in the form of a Mandatory Provident Fund Exempted ORSO scheme or Mandatory Provident Fund entitlement. There is a similar scheme for employees in mainland China. Details concerning employee benefit schemes are set out in note 2.5 to the financial statements headed "Summary of Significant Accounting Policies" under sub-heading "Employee Benefits" on pages 65 to 67 of this annual report.

The Company has implemented a share option scheme (the "Scheme") to reward eligible employees (including executive directors of the Company) according to individual merit. During the year, an executive director of the Company exercised share options in respect of 1,350,000 shares, while share options with regard to a total of 9,120,000 shares lapsed. As at 31 December 2005, share options with regard to a total of 57,104,000 shares were still outstanding.

Share options can be exercised at any time within four years after the expiration of a 12-month period from the date when the options are granted. During the year, the Company granted no share options to the Company's executive directors or other eligible employees of the Group.

Details of the Scheme are set out in note 32 to the financial statements headed "Share Option Scheme" on pages 100 to 103 of this annual report.

Changes in the Group's Structure

During the year under review, the Group established a wholly-owned subsidiary which is engaged in the oils and fats business. On 12 January 2006, a wholly-owned subsidiary of the Company and a connected party established a joint venture, in which the Company holds a 55% equity interest. Details of the joint venture and the Company's capital commitment are set out on pages 30 and 31 of this annual report.

Apart from the above, there were no other material changes in the structure of the Group during the year.

Prospects

In conclusion, in 2005, the wineries and trading businesses recorded promising results. However, the edible oils, soybean meal and related products business saw a relatively slow recovery due to market factors, while earnings from the chocolate business registered a temporary decline in view of the increases in promotion costs and adjustments in sales and marketing practices.

The appreciation of the Renminbi has attracted widespread attention. As the Group's assets are principally denominated in Renminbi, the principal raw material for the edible oils and soybean meal business (which accounts for the largest contribution to turnover) is imported soybeans, and the trading business (of which exports account for a comparatively large share) operates under a back-to-back model, the appreciation of the Renminbi has had a positive impact, benefiting the Group's operations.

The Group will devote considerable effort to business strategy research, further our business strategies and upgrade our product, brand, marketing and service strategies. Improved management practices will also enhance the development of our various businesses and create further value for our shareholders.

We have every confidence and high expectations for the future. With our pro-active spirit and effective measures, we will accelerate our development and take a major step towards our target to become a market leader in China's consumer food industry.

Qu Zhe
Managing Director
Hong Kong, 7 April 2006

"Le Conte" chocolate and confectionery products secured the second place in the market with a 13.2% share in China.