

MANAGEMENT DISCUSSION AND ANALYSIS

STRENGTHENING THE CAPITAL BASE

An open offer to raise funds by issuing 69,500,000 offer shares at the price of HK\$0.20 per offer share on the basis of one offer share for every two new shares held on 10 March 2005 was completed on 14 April 2005. Net proceeds from the open offer was approximately HK\$13 million, of which approximately HK\$9.1 million was applied to repay outstanding indebtedness and the remaining balance of approximately HK\$3.9 million used as general working capital of the Group.

CAPITAL REORGANISATION

With effect from 11 March 2005, every ten (10) reduced shares have been consolidated into one new share. Pursuant to the special resolution passed at the extraordinary general meeting held on 31 December 2004, the issued share capital of the Company has been reduced by canceling paid-up capital to the extent of HK\$0.099 on each existing share of HK\$0.10 of the Company in issue as at the effective date of capital reduction on 10 March 2005, so that each such share shall be treated as one fully paid up share of HK\$0.001 each.

RAISING FURTHER CAPITAL

On 20 October 2005, Prime Orient International Limited ("POIL") entered into the placing and subscription Agreement pursuant to which a placing agent agreed with POIL to place up to 41,700,000 shares at the placing price of HK\$0.79 per placing share on behalf of POIL to not less than six individual investors who were third parties independent of the Company and its connected persons on a best effort basis. Immediately after the completion of the aforesaid placing, the Company issued 41,700,000 new ordinary shares at HK\$0.79 per share to POIL on 3 November 2005. POIL is wholly and beneficially owned by Mr. Lam Shu Chung, a substantial shareholder and executive director of the Company.

The aforesaid placing broadened the capital and shareholder base of the Company, and the subscription raised net proceeds of approximately HK\$32.4 million for repayment of the Group's indebtedness, working capital and future business development requirements of the Group.

As at 31 December 2005, the Group had interest-bearing bank borrowings of approximately HK\$2 million (2004: HK\$10 million) which are repayable within one year, are interest-bearing at the prevailing interest rates and denominated in Hong Kong dollars. The Group's bank borrowings were secured by (i) a pledge of HK\$2 million fixed deposits of a subsidiary, and (ii) personal guarantee executed by a director of the subsidiary.

As a significant portion of the Group's sales and purchases were denominated in Hong Kong dollars and Renminbi, the directors considered the Group has no significant exposure to foreign exchange fluctuations in view of the stability of the exchange rates of Hong Kong dollars and Renminbi. During the year under review, the Group did not use any hedging instrument.

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CURRENT AND GEARING RATIO

As at 31 December 2005, the Group has total assets of approximately HK\$110 million (2004: HK\$175 million), total liabilities of HK\$25 million (2004: HK\$95 million), indicating a gearing ratio 0.23 (2004: 0.54) on the basis of total liabilities over total assets. The current ratio of the Group for the year was 1.23 (2004: 0.74).

CONTINGENT LIABILITIES

As at 31 December 2005, the Company Group did not have any significant contingent liabilities except as described below:

A wholly-owned subsidiary of the Company namely HZO CM has been made a defendant of a proceeding in the PRC. The proceedings were brought by 深圳華興建設有限公司 against HZO CM at the Peoples Court of the Hui Yang District, Hui Zhou City, Guangdong Province in respect of installation cost due and interest payable. The amount claimed under this set of proceedings was HK\$1,461,000 (RMB1,520,000) and interest payable of HK\$2,137,000 (RMB2,223,000). HK\$1,461,000 was provided in the Group's financial statements. No provision was made on the interest payable of HK\$2,137,000 as in the option of the directors, this probably will not require an outflow of resources of the Group. The proceedings were adjourned for hearing on a day to be fixed in due course.

EMPLOYEE INFORMATION

As at 31 December 2005, the Group employed a total of 141 (2004: 136) full-time employees, mostly at the Group's subsidiary factories for manufacturing carpets. The Group's emolument policies are formulated on the performance of individual employees and are reviewed annually in line with industry practice. The Group also provides provident fund schemes (as the case may be) to its employees depending on the location of such employees.

SHARES OPTION SCHEME

The Company adopted a share option scheme (the "Share Option Scheme") pursuant to an ordinary resolution passed by the shareholders of the Company on 6 June 2002. The purpose of the Share Option Scheme is to provide incentives or rewards to participants for their contributions to the Group and/or to enable the Group to recruit and retain high-caliber employees and attract human resources that are valuable to the Group.

The shareholders of the Company have approved the refreshment of the general scheme limit on the grant of options under the Share Option Scheme on the extraordinary general meeting held on 10 March 2006. The general scheme limit has been reset to 52,520,000 shares, allowing the Company to grant further options carrying the rights to subscribe for a maximum of 52,520,000 shares.

The Company did not grant any share options during the year.

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CHANGE OF CONTROLLING SHAREHOLDER

On 15 April 2005, the Company entered into the subscription agreement with L & L Holdings Limited (“LLHL”), pursuant to which the Company conditionally agreed to issue the convertible note (the “Convertible Note”) in an aggregate principal amount of HK\$33,000,000 to the subscriber. On 10 August 2005, the Company received a conversion notice from LLHL in respect of the Convertible Note in an aggregate principal amount of HK\$33,000,000, pursuant to which LLHL exercised the conversion rights in full attaching to the Convertible Note at the conversion price of HK\$0.12 per share, resulting in the issue of 275,000,000 new shares by the Company to LLHL.

Upon such conversion, LLHL was interested in 56.88% of the issue share capital of 483,500,000 shares of the Company as at 10 August 2005. A whitewash waiver was applied and granted by the Securities Futures Commission, which waived the obligation of LLHL and its shareholder and parties acting in concert with any one of them to extend a general offer to acquire the issued share (excluding the issued shares which are owned by the subscriber and its shareholder and parties acting in concert with any one of them) under Rule 26 of the Takeovers Code arising from the exercise of the conversion rights attached to the Convertible Note.

As at 31 December 2005, L & L Holdings Limited, which is wholly and beneficially owned by Mr. Tsao Ke Wen, the Chief Executive Officer and an executive director of the Company, held 281,352,000 shares, representing 53.57% of the issued share capital of the Company.

CHANGE OF AUDITOR

Grant Thornton Certified Public Accountants was appointed as the auditors of the Company and of its subsidiaries with effect from 16 September 2005 to fill the vacancy left by RSM Nelson Wheeler, which was not reappointed at the Company’s annual general meeting on 30 June 2006, and to hold office until the conclusion of the next annual general meeting of the Company.

DIVIDEND

The Directors do not recommend the payment of any dividend for the year ended 31 December 2005 (2004: Nil).