

Management Discussion and Analysis

In the past one year, Hong Kong economy continued to recover, with a drop in the unemployment rate to 5.2% and an improvement in the investment and consumption sentiments, which was positive for the Company's business, especially as regards to receivable growth and credit quality. Interest rate conditions, however, remained challenging, with HIBOR continued in an upward trend throughout the year, resulting in an increase in the funding cost. During the year under review, there was an increase in both the card sales and personal loan sales despite more market players have moved aggressively into the consumer finance business, resulting in an increase in the overall sales volume by 13.2% when compared with last year.

KEY FINANCIAL HIGHLIGHTS

The Company achieved a profit growth of 27.6%, with net profit increased from HK\$145.9 million in the previous year to HK\$186.1 million. Earnings per share increased by 27.6% from 34.83 HK cents to 44.44 HK cents in 2005/06.

Operating income was HK\$770.1 million, an increase of HK\$15.1 million when compared with HK\$755.0 million in 2004/05. Operating expenses increased by 11.9% from HK\$262.3 million to HK\$293.6 million, with cost-to-income ratio increased to 38.1% from 34.7% in the previous year.

The Company's impairment losses and impairment allowances decreased by 20.2% or HK\$63.6 million to HK\$251.3 million from HK\$315.0 million in the previous year.

With the higher volume of consumer loan transactions and the adoption of HKAS 39 on the derecognition criteria, total debtor balance recorded an increase of 48.9% or HK\$1,113.9 million, from HK\$2,277.1 million at 20th February 2005 to HK\$3,391.0 million at 20th February 2006.

Net asset value per share (after final dividend) at 20th February 2006 was HK\$3.3, as compared to HK\$3.0 at 20th February 2005.

The Board recommended the payment of a final dividend of 11.5 HK cents per share. Together with the interim dividend of 6.5 HK cents per share already paid, the total dividend for the year increased to 18.0 HK cents per share from 16.0 HK cents per share in 2004/05, with the dividend payout ratio being 40.5%.

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INCOME STATEMENT ANALYSIS

Operating Income

The Company's net interest income recorded an increase of 36.1% from HK\$464.2 million in 2004/05 to HK\$631.6 million in 2005/06. With the pick up in sales transactions and the record of new credit card receivables transferred under asset securitizations in accordance with the new derecognition criteria in HKAS 39, interest income recorded an increase by 34.9% from HK\$549.7 million in 2004/05 to HK\$741.5 million in 2005/06.

Although there was an increase in HIBOR, with the fixing of interest rates through entering interest rate swaps and long-term bank loans, the average funding cost only moved marginally from 3.7% in the previous year to 4.7%. Interest expense for the year was HK\$109.9 million, an increase of 28.6% or HK\$24.4 million, when compared with last year.

Following the adoption of HKAS 39, no additional gain was recorded on new sales of credit card receivables transferred under asset securitizations. Together with an increase in the revaluation loss on interest-only strips, the Company recorded credit card securitization income of HK\$1.0 million this year, as compared with HK\$186.5 million in 2004/05. The higher usage of cash advance and the increase in late payment charges had resulted in an increase in other operating income by 25.9% from HK\$105.6 million in 2004/05 to HK\$132.9 million.

Other income of HK\$4.7 million was resulted from the gain on derivative financial instruments, unrealized gain on revaluation of investments held for trading and loss on disposal of computer equipment and leasehold improvements.

Operating Expenses

The Company incurred more on advertising expenses to capture the growth of demand in consumer finance market. In addition, following the launch of new products and marketing programs, the Company had incurred more on card and loan processing expenses. Together with the higher depreciation arising from the software development and hardware purchase to enhance the operating and security systems, total operating expenses increased by 11.9% from HK\$262.3 million in 2004/05 to HK\$293.6 million. Consequently, the Company's cost-to-income ratio increased to 38.1% in 2005/06 from 34.7% in 2004/05.

Impairment Losses and Impairment Allowances

As a result of the improved market conditions and lower unemployment rate, as well as the sharing of positive credit data in consumer finance, asset quality continued to improve during the year, with the total impairment losses and impairment allowances reduced by 20.2% from HK\$315.0 million in 2004/05 to HK\$251.3 million. Recoveries during the year increased by 72.7% from HK\$9.5 million in 2004/05 to HK\$16.4 million.

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BALANCE SHEET ANALYSIS

The Company's shareholders' funds at 20th February 2006 were HK\$1,389.9 million, representing a growth of 9.9%, or HK\$125.5 million, when compared with the balance at 20th February 2005.

Debtor Balance

Since the new transfer of credit card receivables after 21st February 2005 were not derecognized and together with the increase in sales volume, credit card receivables increased by HK\$1,102.5 million from HK\$1,039.0 million at 20th February 2005 to HK\$2,141.5 million at 20th February 2006. With the use of the Company's branch and merchant networks to cross-sell different loan products, instalment loans receivable reached HK\$1,110.7 million, an increase of HK\$105.6 million when compared with last year. Total debtor balance recorded an increase of 48.9% or HK\$1,113.9 million, from HK\$2,277.1 million at 20th February 2005 to HK\$3,391.0 million at 20th February 2006.

Considering the drop in overdue debtor balance for 3 months or above, the Company reduced the amount of impairment allowances. Impairment allowances amounted to HK\$128.2 million at 20th February 2006, a decrease of HK\$46.0 million when compared with previous year and representing 3.7% of total debtor balance (including interest receivable and other debtors).

Set out below is an analysis of gross debtor balance of hire purchase debtors, instalment loans receivable and credit card receivables, excluding impairment allowances, which was overdue for more than 1 month:

	20th February 2006		20th February 2005	
	HK\$'000	%*	HK\$'000	%*
Over 1 month but less than 2 months	64,785	1.9	94,046	4.1
Over 2 months but less than 3 months	24,396	0.7	18,094	0.8
Over 3 months	70,862	2.1	84,570	3.7
	<u>160,043</u>	<u>4.7</u>	<u>196,710</u>	<u>8.6</u>

* Percentage of total debtor balance

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Retained Interests in Securitisation Trust and Issued Debt Securities

The Company raised a total of HK\$850.0 million through the realisation of credit card receivables originated and selected by the Company to a special purpose entity, which issued trust certificates backed by such receivables.

The securitisation programme was originally treated as off balance sheet and the credit card receivables transferred are derecognized from the financial statements. The entitlements to interest-only strips and cash reserve account are stated at fair values whereas seller and subordinated interests are stated at their allocated amounts and subject to amortisation. The interest-only strips, which are retained by the Company, represent the present value of expected cash flows generated from the securitised credit card receivables during their estimated lives.

With effect from 21st February 2005, any new transfer of credit card receivables to the special purpose entity has not been derecognized and remained as credit card receivables in the Company's financial statements. Funding for the credit card receivables was recorded as issued debt securities.

At 20th February 2006, the Company had retained interests in the securitisation trust in the forms of seller interest, subordinated interest, interest-only strips and cash reserve account amounting to HK\$456.6 million, as compared with HK\$937.5 million at 20th February 2005. The amount of issued debt securities at 20th February 2006 was HK\$587.5 million.

Bank Borrowings and Capital Financing

The Company relied principally on its internally generated capital, bank borrowings and structured finance to fund its business. The principal source of internally generated capital is from retained earnings.

Besides the securitisation program mentioned above, at 20th February 2006, the Company had bank borrowings amounted to HK\$2,056.0 million, with 77.4% being fixed in interest rates. Out of these borrowings, 32.1% will mature within one year, 15.7% between one and two years, 20.3% between two and three years, 14.2% between three and four years and 17.7% over four years. Moreover, the Company had available HK\$360.0 million of undrawn committed borrowing facilities as at balance sheet date in respect of which all conditions precedent had been met. Besides, the HK\$850.0 million credit card securitization had started amortisation in March 2006 and will be financed by bank borrowings and new structured finance.

The Company continued to maintain a strong financial position. At 20th February 2006, total debt-to-equity ratio was 2.02. All the Company's borrowings were denominated in Hong Kong dollars.

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The net asset value of the Company at 20th February 2006 was HK\$1,389.9 million, or HK\$3.3 per share, as compared with HK\$3.0 per share at 20th February 2005. Credit card receivables of HK\$805.0 million were pledged for the issued debt securities at 20th February 2006.

The Company's principal operations were transacted and recorded in Hong Kong dollars and thereby did not subject to any exposure on exchange rate fluctuation. During the year, the Company engaged in derivative financial instruments mainly to hedge its exposure on interest rate fluctuations.

Capital expenditure for the year amounted to HK\$54.1 million as compared to HK\$43.9 million in the previous year. This was mainly related to the purchase of new ATMs and computer equipment as well as the software development to enhance the operating and security systems. At 20th February 2006, capital commitments entered were mainly related to the purchase of property, plant and equipment.

Taking into account the financial resources available to the Company, including internally generated funds and available banking facilities, the Company has sufficient working capital to meet its present requirements.

In determining the dividend payment, the objective is to reward shareholders with dividend income while retaining funds for future business development and expansion. As the economic situation is expected to continue to recover in the coming year, demand for consumer finance loans will increase. Moreover, shareholders generally expect a reasonable return on their investments and would expect a higher dividend amount when the share price goes up. In order to meet shareholders' expectation, the Board decided to increase the absolute dividend amount by 2.0 HK cents. For the year ended 20th February 2006, the Board recommended the payment of a final dividend of 11.5 HK cents per share, which together with an interim dividend of 6.5 HK cents per share, making a total dividend of 18.0 HK cents per share and a payout ratio of 40.5%.

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SEGMENT INFORMATION

The Company's business comprised mainly three operating divisions, namely credit card, hire purchase and instalment loan. In 2005/06, credit card operation accounted for 66.7% of the Company's turnover, as compared to 70.8% in 2004/05. For operating income after deducting impairment losses and impairment allowances, credit card operation accounted for 57.8% in 2005/06, as compared to 64.7% in 2004/05.

Following the adoption of HKAS 39 and the launch of more affinity cards and marketing programs, net interest income from credit card operation recorded an increase of HK\$100.6 million, from HK\$266.4 million in 2004/05 to HK\$367.0 million in 2005/06. Since no additional gain was recorded on further sales of credit card receivables this year, coupled with the increase in revaluation loss on the interest-only strips, credit card securitisation income dropped from HK\$186.5 million in 2004/05 to HK\$1.0 million in 2005/06. The pick up of cash advance transactions and the increase in late payment charges had resulted in the increase in other operating income from credit card operation by 40.3% from HK\$81.4 million in 2004/05 to HK\$114.2 million. With a drop in the impairment losses and impairment allowances from HK\$249.6 million in 2004/05 to HK\$182.3 million in 2005/06, operating results from credit card operation recorded an increase by 5.3% from HK\$284.8 million in 2004/05 to HK\$299.9 million in 2005/06.

With the higher usage of card instalment plan, there was a decrease in hire purchase sales, resulting in the drop in interest income and other operating income from hire purchase transactions by 35.0% from HK\$7.2 million in 2004/05 to HK\$4.7 million in 2005/06. However, there was a release of impairment allowances of HK\$1.4 million in 2005/06 as compared with an impairment loss of HK\$4.4 million in 2004/05. As a result, the operating results from hire purchase operation increased from HK\$2.8 million in 2004/05 to HK\$6.1 million in 2005/06.

With the gradual recovery of the economic situation and the availability of positive data from credit bureau, the Company is active in further developing its personal loan business. Together with the use of new marketing channels, personal loan sales continued to record a stable growth in the reporting year. Net interest income from instalment loan operation recorded an increase of 24.8% or HK\$51.7 million, from HK\$208.4 million in 2004/05 to HK\$260.1 million in 2005/06. The increase in sales also helped to boost up certain related charges, resulting in an increase in other operating income by 99.3% from HK\$9.1 million in 2004/05 to HK\$18.2 million in 2005/06. Although there was an increase in impairment losses and impairment allowances from HK\$61.0 million in 2004/05 to HK\$70.5 million in 2005/06, operating results from instalment loan operation recorded an increase of HK\$51.2 million as compared with HK\$156.6 million in 2004/05 to HK\$207.8 million in 2005/06.

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COMPETITIVE ADVANTAGES

Synergy

The Company continued to benefit from the strong connections with affiliated merchants by launching various affinity cards and using the merchants' networks as card acquisition base resulting in the continuous growth in the number of cardholders.

Know-how and Expertise

AEON Credit Service Co., Ltd. has extensive know-how and expertise in the consumer finance industry and brings in innovative ideas on the marketing and card acquisition programs.

Customer Base

The customer base of the Company is widely diversified. Using merchant networks as the card acquisition base, the Company had launched several new affinity cards to capture new customer sectors. The new cardholders recruited in this financial year were mainly through the affinity cards related to merchants in the retail, catering and beauty sectors. Around 60% of the customers are in the age range of 26 to 45, out of which 40% are young generation. With the launch of more affinity cards, the percentage of female cardholders is 65%.

Convenient Service

In providing consumer credit services to customers, the Company emphasises on convenience. For ease of payment, customers can settle their payments via branch counters, convenience stores networks, phone banking, internet banking and ATM network. Customers can also have easy access to speedy and convenient cash advance and personal loan services via the extensive ATM networks in Hong Kong and Guangdong Province in China as well as the Company's branch network and the call centres in Hong Kong and Shenzhen. For card spending, the extensive discount merchant network continues to provide convenience and wide-ranging choices to cardholders.

GROWTH PHILOSOPHY

The four key elements of the Company's growth philosophy are (1) ongoing product and service innovation; (2) total consumer credit services; (3) operational cost effectiveness; and (4) a strong network of affiliated companies. Consumers in Hong Kong have widely accepted and appreciated the innovative consumer credit finance services provided at low costs by the Company.