

Management's Discussion and Analysis

Business Review

With the completion of its acquisition of IBM's personal computer business in April 2005, Lenovo was transformed into a global PC company. The company met its first-year objectives for a smooth transition, business stability and operational profitability during the integration of the acquired business.

During the 2005/06 fiscal year, Lenovo continued its significant profitable growth in the China PC business and reached new heights in market share. Its efficient business model effectively addressed a broad range of customers – from large enterprises to consumers – with the products, sales channels, and support they preferred.

In contrast, the focus of the PC business acquired from IBM had traditionally been on large enterprise customers, with continued success from its premium ThinkPad notebooks. In February 2006, the company launched the Lenovo brand outside of China, along with products and sales channels to address the faster-growing market for Small- and Medium-Sized Businesses (SMB) and emerging markets such as India. These initiatives, together with the measures taken to improve operational efficiency, were designed to build on Lenovo's existing regional strengths so as to compete more effectively in the market and improve its profitability on a worldwide basis.

With 11 months of contribution from the acquired PC business, the Group's consolidated turnover surged 359 percent year-on-year to HK\$103,551 million. And despite the significant challenges of this transition, Lenovo's profit before taxation, excluding the cost of the strategic restructuring action, increased approximately 7 percent year-on-year.

Integration of IBM's Personal Computer Business

To ensure a successful integration of the IBM Personal Computing Division, Lenovo initiated a strategic phased plan, with sustained, profitable growth as its ultimate goal.

The first phase of the plan focused on ensuring a smooth transition and delivering on the Group's commitments to PC customers worldwide. Importantly, Lenovo retained key customers. In addition, Lenovo combined the strengths of the two PC businesses by integrating the separate product groups, supply and sales structures into unified global organizations in October 2005.

With this integration, Lenovo could begin the second phase of its development plan at the end of the fiscal year by bringing more innovative products and services to its customers worldwide, particularly in the high-growth segments of SMB and emerging markets, while maintaining its competitive edge in the large-enterprise market.

Although the business performance of the acquired PC business during the first year was stable and in line with the Group's expectations, its operational efficiency needed to become more competitive. To address expense and cost issues and improve responsiveness to customers, Lenovo announced a restructuring program in March 2006. Benefits of the restructuring are expected to come during the 2006/07 fiscal year.

Performance of Geographies

The worldwide PC market enjoyed a strong unit growth of 16 percent during the 2005/06 fiscal year, mainly driven by the growth in SMB and emerging markets. Lenovo benefited from this strong market demand, particularly in China where Lenovo has a broad product mix that addresses these high-growth segments. Lenovo's worldwide PC client shipments grew 11 percent year-on-year during the 2005/06 fiscal year, ranking third with approximately 7.4 percent market share.

Greater China: Greater China accounted for approximately 36 percent of Lenovo's overall revenue during the 2005/06 fiscal year. Lenovo's leadership position in the China PC market was further strengthened with a significant PC shipment increase of 31 percent year-on-year during the 2005/06 fiscal year, exceeding the market growth of 16 percent excluding Lenovo. Lenovo's market share in China reached a new height of 34 percent in the 2005/06 fiscal year with a gain of about 2.7 percentage points year-on-year. This outstanding performance in China was the result of the successful implementation of the Group's product and channel strategies and a smooth integration of the sales team for the acquired Think-brand business.

One of Lenovo's strategies in China was to leverage its end-to-end operations that address the needs of transaction-based SMB customers and consumers as well as relationship-based large enterprise customers. This dual go-to-market model led to strong business growth by enabling Lenovo to specifically design new product models that customers prefer, and to build up a focused sales and service system to better serve customers. The Group's supply chain was built to support both "build-to-stock" and "configuration-to-order" models.

During the 2005/06 fiscal year, Lenovo leveraged both its acquisition of IBM PC business and worldwide sponsorship of Olympic Games to boost its brand equity and reputation in China. A number of product marketing activities were centered on the Olympic Games by joining with other Olympic sponsors like Visa International and Coca-Cola. The strategically designed business model and marketing activities allowed Lenovo grow faster than the market in three focused market segments, including notebook computer, large enterprises and township markets, during the 2005/06 fiscal year.

Americas, EMEA, Asia Pacific: The acquired business outside of China was best positioned to address the large enterprise customer segment, based on a relationship model designed to meet the complex global needs of these customers. ThinkPad notebooks ranked number-one in customer satisfaction worldwide, with particular strengths on product design, quality, parts availability, phone support and time-to-repair in the United States. However, as the growth of worldwide PC market in 2005 was mainly driven by the SMB segment, Lenovo was under pressure from the need to expand product mix to address this segment.

The Americas is Lenovo's second-largest geography, accounting for approximately 30 percent of total revenue and delivered steady profitability during the 2005/06 fiscal year. In the United States, Lenovo maintained a stable market position during the transition. However, Canada and Latin America proved more challenging as growth in those markets was driven by the home computing segment and lower-cost desktop segment respectively, where Lenovo did not compete.



Top: Lenovo i.lounges at the 2006 Turin Olympic Winter Games enabled athletes to stay in touch with their families and supporters.

Middle: Lenovo engineers at Turin Olympic Winter Games.

Bottom: Joining hands with Coca-Cola on large-scale promotional activities in China.

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EMEA (Europe, Middle East and Africa) accounted for 21 percent of Lenovo's total revenue during the 2005/06 fiscal year. The slowdown in commercial desktop growth in the region and, as in the Americas, the lack of suitable product offerings to address the fast-growing SMB segment affected Lenovo's overall performance in EMEA. However, in regions such as the Nordic countries, where Think-brand products are an excellent match for customer needs, Lenovo delivered better results.



Asia Pacific (excluding Greater China) contributed 13 percent of Lenovo's total revenue. Lenovo's financial performance in this region was affected by the need to pursue business opportunities in Japan more aggressively. However, despite weakness in Japan, Lenovo held the number-one market position for commercial notebooks in a number of key Asian countries, including Singapore, the Philippines and Vietnam. In India, a fast-growing emerging market, Lenovo saw improvement in market position with strong shipment growth and market share gain.

Performance of Product Groups

Lenovo is committed to offering the highest levels of innovation, quality, reliability, and design excellence in its products. During the 2005/06 fiscal year, Lenovo further strengthened its PC product portfolio with award-winning notebook and desktop computers as well as ThinkVantage Technologies software tools featuring one-button virus recovery and software that allows users to connect anytime or anywhere. In February 2006, Lenovo launched the new Lenovo 3000 series of notebook and desktop computers to address the needs of small businesses outside of China.

Top: In February 2006, Lenovo unveiled the first-ever Lenovo-brand PCs to be offered worldwide, the Lenovo 3000 product family.

Bottom: Unique functions of ThinkPad X41 Tablets help students discover new ways to learn in the classroom.

Notebook Computer: Upon the completion of the acquisition of IBM PC business, notebook computers became the largest contributor to Lenovo's total revenue and accounted for approximately 49 percent during the 2005/06 fiscal year. Lenovo ranked third in worldwide commercial notebook market. In China, Lenovo had a strong position in the notebook market with approximately 32 percent market share during the 2005/06 fiscal year.

Lenovo's notebook mix continued to increase in the worldwide PC market, with innovative products that led the market trends in widescreen, wireless access and security. In September 2005, Lenovo fully integrated Verizon's BroadbandAccess 3G technology in the ThinkPad Z60t. During the 2005/06 fiscal year, Lenovo sold its millionth ThinkPad notebook with an integrated fingerprint reader, making it the largest provider of biometric-enabled PCs in the world. Lenovo also reinvigorated the tablet PC market with the launch of the innovative ThinkPad X41 Tablet in June 2005. With its combination of a writable slate, full-size keyboard and light weight, the X41 Tablet has substantially broadened the appeal and potential applications for tablet PC technology.

Lenovo's notebook products enjoyed significant growth in China, where the Group's notebook shipments increased approximately 42 percent during the 2005/06 fiscal year. Lenovo's widescreen notebook Tianyi 100, with its entertainment features, was popular among consumers. To address the mobile computing need of SMBs in China, Lenovo launched Xuri 125 with a high performance-to-price ratio.

Desktop Computer: About 45 percent of Lenovo's total revenue came from this business segment. The growth of Lenovo's desktop computer shipments was also driven by strong growth in China where it accounted for approximately 35 percent of the market during the 2005/06 fiscal year. Lenovo ranked third in the worldwide commercial desktop market.

Lenovo's capabilities in customer segmentation and matching customer needs with competitive products was key to its outstanding performance in China's desktop market. Lenovo continued its successful penetration into the township market during the 2005/06 fiscal year by launching the new Jiayue with pre-installed software and on-line education service. For China's large SMB segment, Lenovo introduced the highly successful Yangtian series featuring "one-key virus kill" and "one-key system restoration."

The February launch of the Lenovo 3000 brand introduced the company's first mainstream product family outside of China targeting the price and function requirements of SMB and emerging markets. For managed computing, Lenovo led the industry by developing ThinkCentre-based solutions that leveraged Intel's Active Management Technology, and incorporating dual-core processing and 64-bit computing capabilities in its award-winning ThinkCentre line of business desktop products.

Mobile Handset: The performance of Lenovo's mobile handset business was very strong in the 2005/06 fiscal year. Shipments more than doubled from a year ago in China, the largest mobile handset market in the world. Lenovo successfully moved up its ranking in China from ninth place in March 2005 to fourth with an overall market share of approximately 7 percent by the fiscal year end. Mobile handset accounted for approximately 4 percent of Lenovo's total revenue with strong profitability.

Lenovo's mobile handset business employs a successful growth model. The segment's profitable growth reflects Lenovo's ability to respond quickly to new customer preferences in a very dynamic market. The decision to focus on the one-mega-pixel camera phone and MP3 music phone proved accurate and timely and drove strong shipment growth. Lenovo's in-house research and development capability won its first design award in the international *BusinessWeek/IDSA* competition in June 2005 with the Lenovo Smartphone ET960.

The mobile handset business also expanded its sales channel in electronics chain stores and partnered with mobile telecom service carriers to offer customized product design. In March 2006, Lenovo was added to the list of 12 best mobile phone partners of China Mobile, the biggest mobile telecom carrier in China.

During the year, to enhance its control over this profitable business, Lenovo acquired the remaining 19.2 percent equity interest in the mobile handset joint venture for a cash consideration of approximately HK\$69 million. Upon completion of the acquisition in 2006, the joint venture became a wholly-owned subsidiary of Lenovo.



Top: Lenovo addresses different customer needs with innovative products.

Bottom: Lenovo's mobile handset business employs a successful growth model.

Financial Review

Results Highlights

For the year ended March 31	2006 HK\$'000	2005 HK\$'000
Turnover	103,550,857	22,554,678
Earnings before interest, taxation, depreciation, amortization, impairment charge, gain / loss on disposal of available-for-sale financial assets and restructuring costs (EBITDAR)	2,978,519	1,173,616
Profit attributable to shareholders	173,236	1,120,146
Dividends per ordinary share (HK cents)		
Interim dividend	2.4	2.4
Proposed final dividend	2.8	2.8
Earnings per share (HK cents)		
Basic	1.97	14.99
Diluted	1.93	14.97

Results

For the year ended March 31, 2006, the Group achieved a turnover of approximately HK\$103,551 million. Profit attributable to shareholders was approximately HK\$173 million during the year, representing a decrease of HK\$947 million against HK\$1,120 million recorded last year. Basic earnings per share and diluted earnings per share were 1.97 HK cents and 1.93 HK cents, representing decreases of 13.02 HK cents and 13.04 HK cents respectively as compared to last year.

Segment Results

Due to the acquisition of IBM PC Business, the Group has adopted geographical segments as the primary reporting format. During the year, geographical turnover included the Americas, EMEA (Europe, Middle East and Africa), Asia Pacific (excluding Greater China), and Greater China.

In Greater China, the results include both the results from Legacy Lenovo and Greater China segment of newly acquired IBM PC Business.

Capital Expenditure

Apart from the acquisition of the IBM PC Business, the Group incurred capital expenditures of HK\$992 million during the year ended March 31, 2006, mainly for the acquisition of fixed assets, completion of construction-in-progress and investments in the Group's information technology systems.

Liquidity and Financial Resources

At March 31, 2006, total assets of the Group amounted to HK\$39,316 million, which was financed by shareholders' funds of HK\$8,142 million, minority interests of HK\$6 million, and non-current and current liabilities of HK\$31,168 million. The current ratio of the Group was 0.86.

The Group had a solid financial position and maintained a strong and steady cash inflow from its operating activities. At March 31, 2006, cash and cash equivalents totaled at HK\$7.84 billion, of which 33 percent was denominated in US dollars, 36.7 percent in Renminbi, 7.3 percent in Euros, 5.5 percent in Japanese Yen, and 17.5 percent in other currencies.

On March 13, 2006, the Group concluded a US\$400 million (approximately HK\$3,120 million) 5-Year Revolving and Term Loan Facility with a syndicated banks, bearing interest at the London Interbank Offered Rate plus 0.52 percent per annum. Also in March 2006, the Group arranged a US\$100 million (approximately HK\$780 million) 5-Year Fixed Rate Loan Facility with a policy bank in China. The purpose of these facilities was to replace the acquisition facility with which the Group funded the acquisition of IBM's PC Business in April 2005.

The Group has also arranged other short-term credit facilities for contingency purposes. At March 31, 2006, the Group's total available credit facilities amounted to HK\$12,287 million, of which HK\$2,138 million was in trade lines, HK\$1,327 million in short-term and revolving money market facilities and HK\$8,822 million in forward foreign exchange contracts.

Turnover and Segment Results

For the year ended March 31	2006		2005	
	Turnover HK\$'000	Segment operating results HK\$'000	Turnover HK\$'000	Segment operating results HK\$'000
Americas	30,899,631	197,451	–	–
Europe, Middle East and Africa	21,615,023	(353,794)	–	–
Asia Pacific (excluding Greater China)	13,037,997	(86,435)	–	–
Greater China	37,998,206	2,176,473	22,554,678	979,653
Amortization of marketing rights and intangible assets		(770,065)		(48,605)
Amortisation of share-based compensation		(232,013)		–
Impairment of assets		(22,785)		(51,364)
(Loss) / gain on disposal of investments and available for-sale financial assets		(4,913)		156,958
Finance income		188,986		105,677
Finance costs		(438,126)		(6,667)
Total	103,550,857	654,779	22,554,678	1,135,652

At March 31, 2006, the Group's outstanding bank loan represented the term loan of HK\$780 million and short-term bank loans of HK\$1,001 million. When compared with total equity of HK\$8,148 million, the Group's gearing ratio was 0.22.

The net cash position of the Group as at March 31, 2005 and 2006:	2006 HK\$ million	2005 HK\$ million
Cash	7,839	3,019
Less: Bank loans	1,781	–
Net cash position	6,058	3,019

The Group adopts a consistent hedging policy for business transactions to reduce the risk of currency fluctuation arising from daily operations. At March 31, 2006, the Group had commitments in respect of outstanding foreign exchange forward contracts amounting to HK\$4,368 million.

The Group's foreign exchange forward contracts are used to hedge a percentage of future intercompany transactions which are highly probable. Any gain or loss on these contracts is more than offset by movements in the value of the underlying transactions.

The Group issued 2,730,000 convertible preferred shares at an issue price of HK\$1,000 per share and unlisted warrants to subscribe for 237,417,474 shares for an aggregated cash consideration of approximately HK\$2,730 million. The convertible preferred shares bear a fixed cumulative preferential cash dividend, payable quarterly, at the rate of 4.5 percent per annum on the issue price of each convertible preferred share. The convertible preferred shares are redeemable, in whole or in part, at a price equal to the issue price together with accrued and unpaid dividends at the option of the Group or the convertible preferred shareholders at any time after the maturity date at May 17, 2012. The fair value of the liability component and equity component of the convertible preferred shares as at March 31, 2006 amounted to approximately HK\$2,433 million and HK\$84 million respectively. The warrants will expire on May 17, 2010.

Contingent Liabilities

The Group had no material contingent liabilities as at March 31, 2006.

Human Resources

At March 31, 2006, the Group had a total of approximately 19,500 employees, 14,200 of whom were employed on the Chinese mainland, 2,200 in the U.S. and 3,100 in other countries. Details of the remuneration of employees are set out in Note 11 to the financial statements.

The Group's remuneration policies, bonus, share options schemes and long-term incentive programme, designed to adjust total remuneration according to the performance of the Group and individual employees. The Group also provides benefits such as insurance, medical and retirement funds to employees to sustain competitiveness of the Group.

Future Prospects

With the integration of the acquired PC business progressing steadily, Lenovo will continue to take the necessary actions that enable sustained, profitable growth. As indicated by industry analysis, growth in the worldwide PC market in the coming few years will be driven by notebook computers, the SMB segment and emerging markets such as China and India. Lenovo is positioning itself to address these segments while it builds on its large enterprise customer business. In line with this goal, Lenovo has newly established a business unit for services, software and peripherals to focus on customer experience and their ability to use computing tools. Lenovo's demonstrated strengths in the China market and its strong notebook market leadership should enable it to successfully pursue these market opportunities.

The Chinese PC market is expected to continue its growth momentum on the back of a strong economy. In the coming year, Lenovo will take advantage of the combined strengths of the Lenovo and Think brands and to further leverage its dual model to address the high-growth notebook and township consumer markets and SMB segments.

Improve Operational Efficiency

In March 2006, Lenovo announced an action plan aimed at improving the Group's overall operating expense and cost structure and to better position itself to pursue growth aggressively.

First, Lenovo integrated its sales, services, support and fulfillment operations into one highly responsive customer-service unit in the Americas, EMEA and Asia Pacific. Second, Lenovo streamlined its global sales and marketing by reducing layers in the structure to empower sales leaders and bring decision-making closer to customers. Third, Lenovo is ensuring that teams are centralized for better performance and efficiency wherever appropriate. Lenovo centralized the desktop team in China and moved corporate functions currently located in Purchase, New York to Raleigh, North Carolina. This plan involves resource reductions, staff relocation and real estate consolidation. Lenovo expects most of these actions to be carried out during the first half of the 2006/07 fiscal year. Upon completion, Lenovo will have a lower cost structure and will be able to use part of the savings to support its growth initiatives.

Operational efficiency demands a high performance corporate culture. Lenovo will continually look at ways of simplifying its business processes from product development to supply chain to sales to remain competitive in an increasingly competitive marketplace.

Drive Product Competitiveness

Lenovo delivers wide-ranging computer products that serve a full spectrum of customer segments in China. To address the high-growth opportunities such as emerging markets and SMB outside of China, Lenovo must broaden and strengthen its product line with innovative, high-quality, appropriately priced products.

In late February 2006, Lenovo announced its Lenovo 3000 family of desktop and notebook computers outside of China to meet the needs of the high-growth SMB customer segment. These Lenovo-brand products complement the existing Think-brand products targeted at large enterprises worldwide. Building on Lenovo's branding and marketing success in the Turin Olympic Winter Games, Lenovo 3000 products were launched to good reviews. The Lenovo 3000 products are positioned as great value for carefree computing for the SMB customers. In the 2006/07 fiscal year, Lenovo will be focused on the success of Lenovo 3000 series.

Lenovo also plans to drive its desktop business by further leveraging its leadership position in the China desktop computer market. With the integration of the desktop team in China, Lenovo will be in a better position to roll out and market desktop products that operate in converged product platforms and serve customer needs more efficiently worldwide.

Fully Implement the Transaction/Relationship Model

The effectiveness and efficiency of Lenovo's dual business model is the cornerstone of its success in the China PC market. The model makes products available in the channels that customer prefers. During the 2006/07 fiscal year, Lenovo will implement this globally to enhance its competitiveness in the worldwide PC market.

Lenovo took a major step in its implementation of the transaction model by launching a new business partner program – the Lenovo Partner Network – in March 2006 to complement the rollout of the Lenovo 3000 product line. The new program covers the entire lifecycle of the partner relationship and features a simplified framework with two levels of membership. Built with incorporated feedback from more than 100 of Lenovo's channel partners, industry influencers and members of the analyst community, this channel program will grow the business of Lenovo's partners along with its own.

This expansion has already resulted in new business relationships with leading business partners such as Best Buy and Office Depot, where very small businesses shop for computer products in the United States.

Develop Emerging Markets

With its proven success in China, Lenovo plans to actively develop other emerging markets in the coming years.

According to industry analysis, the India market – currently accounting for about 2 percent of worldwide shipments in the 2005/06 fiscal year – will grow more than 20 percent compounded annually over the next few years. Lenovo aims to replicate its China business model in India. It has already established a large channel presence in the market, ranking second in the notebook computer market during the year. It will also address the consumer market opportunity by increasing retail coverage.

Maintain Growth in Mobile Handset Business

Building on the outstanding business performance during the 2005/06 fiscal year, Lenovo aims to sustain the growth of its mobile handset business and strengthen its market position in China in the coming year. According to industry analysis, the China mobile handset market is expected to continue its rapid growth in 2006, driven by the middle- to low-end replacement market and the efforts of mobile telecom service carriers to grow their customer base.

During the 2006/07 fiscal year, Lenovo's mobile handset business will emphasize user experience from product development to sales to after-sales services. At the same time, its research and development team will develop products that respond to increasing demand for MP3 and MP4 multimedia and other feature trends. Lenovo's new mobile phone manufacturing facility in Xiamen, China, will commence operations during the second half of 2006, ensuring a stable supply of mobile handset products for the market.

It is generally expected that 3G mobile service licenses will be issued in China in 2006. Lenovo has been actively preparing for the burgeoning 3G market and has completed the construction of its platform for 3G phone development. In April 2006, Lenovo rolled out for the first time two 3G mobile handset models.

Building on Existing Strengths

Lenovo has proven success in complementary PC businesses of its newly formed company. In the coming years, Lenovo plans to further leverage on its highly efficient and effective operating platform in China on a worldwide basis. For example, it will optimize its global supply chain network to support the dual model worldwide and implement industry-leading supply/demand processes to achieve better results.

Lenovo's plan is straightforward – to combine and build on the best of these successful models with increasing operational efficiency on a global basis. Lenovo will take the necessary steps to achieve sustained, profitable growth.



Lenovo 3000 N100 Notebook