Review of Operations

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"Rewarding China strategy lays a cornerstone with diverse revenue streams and growth engines to take business to new heights."

REVIEW OF OPERATIONS

Awarded "Hong Kong Outstanding Enterprises 2005" by Hong Kong Economic Digest

AWARD:	
2005-09-02	MediaZone: Hong Kong Most Valuable Companies 2006
2005-10-29	Hong Kong Economic Digest: Hong Kong Outstanding Enterprises 2005
2006-06	Best suppliers in Year 2005 from one of the customers

China

Watches have becoming more of a fashion accessory and luxury item than merely a time telling device. Strong demand of fashion and luxury items provided a favorable market condition for the watch business. Increased brand advertisings have contributed significantly to the morphological changes in consumer behavior in China.

The business climate in China's watch industry has been generally good. It was characterized by the strong growth of the middle-range to luxury watches and increased consumers' brand awareness. Peace Mark has been operating two independent business models for the fashion and luxury market.

Middle-range fashion brands

Subsequent to several acquisitions of retail networks in China in the course of last two years, this year Peace Mark was set to consolidate the business operations and grew the business organically. The strategy of providing a platform offering integrated services fledging from manufacturing, distribution to retailing in China was proven success. Peace Mark has been offering a turnkey solution to all fashion brands entering into the China.

The business turnover for this business segment has nearly double from HK$342 million to HK$609 million and the EBITDA margin was 18.9%, an increase of 2.8 percentage point from 16.1% in last year. Various acquisitions done in past two years have been showing progress and the synergies were realized.

TimeZone continued its strategy to expand its distribution network in China in the form of directly managed shop-in-store "SIS" format operating in the department stores. The number of SIS operating in China has been over 200 at the year-end. The number of brands within TimeZone has increased from approximately 30 in 2005 to 70 in 2006, approximately half of which were exclusive in distribution. This brand portfolio enabled TimeZone to suit diverse consumer preferences in China.

TimeZone aimed to provide a channel for the brands to develop a Greater China network. Other than mainland China, there were 13 and 1 TimeZone outlets at the year end in Hong Kong and Taiwan and additional 2 and 9 TimeZone outlets have rolled out in Hong Kong and Taiwan after the balance sheet date. These Greater China networks have enabled the brands to promote and distribute in the region in a more systematic and efficient manner.

Shanghai Shiqi, in which Peace Mark acquired an interest last year, reported record high in the sales of Swatch in the eastern part of China.

Other than the above two operations, through Dayuan, Peace Mark has partnered with various brands to expand the geographic footprint in China. Its strong local distribution capability and the wide coverage of retail network enabled the products to gain an access of more than 200 points of sales.

Luxury watch market

Since the Group opened its first luxury watch store in China in August 2005, the velocity of change of this business has been faster than expected. Tremendous business opportunities arose notwithstanding the fact that the retail competitive landscape was becoming more intense than ever.

Signs of increasing investment by the brands in this market have been apparent. Direct import of watches from Switzerland has surged from CHF279.5 million in 2004 to CHF351.3 million in 2005, an increase of 25.7%. Luxury watches have become one of the most popular items amongst the luxury good purchases.

Peace Mark demonstrated its long-term commitment to this market by joint venturing with Tourneau, the biggest luxury watch retailer in the USA. The partnership with Tourneau not only represented a big step forward in the business profile of Peace Mark but also benefited us substantially in terms of retail management and brand relationship.

On 31 March 2006, Peace Mark and Tourneau signed the Joint Venture (JV) agreement in Basel, Switzerland. At the inception of the JV, Peace Mark, Tourneau and International Watch Group own the capital sharing as to 65%, 25% and 10% respectively with the initial capitalization of US$15 million. We planned to roll out 30 stores in China, 1 in Macau and 1 in Hong Kong within a 3-5 years timeframe. We have rebranded two of our Solomon stores in Shanghai to Tourneau and three other locations were identified for expansion.

The JV is surely conducive to accelerating our business plans in China. Tourneau's commitment in the JV would benefit the long-term development of the JV. In a follow-up transaction, Peace Mark granted an extended option

Peace Mark and Tourneau signed the joint venture agreement in Basel, Switzerland.

Rolex and Tudor boutique in XinTianDi

to Tourneau on 2 May 2006 to acquire from it 14% of the shareholding in the JV at the fair value of the JV after 2 years.

For the past few months, the Group also formed local joint ventures in Chongqing, Ningbo and Shenzhen. In Chongqing, the Group operated 11 shops for luxury watches including brands like Omega, Rado, Longines, Gucci, Breguet, Blancpain, Glashutte. In Ningbo, the Group occupied 300 square metre retail space for brands like Rolex, Omega, Tudor, Piaget, IWC, Longines and Rado. In Shenzhen, the retail points were one Omega boutique shop and one multi-brands shop located in The Sun shopping mall.

The Group has been working closely with brands for managing and operating image and boutique shops in China.

US distribution/direct export

The turnover was HK$310 million, up 47.2% and the EBITDA margin was 14.5%, an improvement of 1.2% percentage points from 13.3% in last year.

In the USA, we have continued to develop the distribution business in order to serve the retailers directly. The US distribution business saw another year of growth. The cost containment and successful integration of the operations contributed to the improved results. The trend of the US customers buying directly from manufacturers continued. The pace of market consolidation and the tendency of supply chain de-layering have been well conceived by the Group since 2003 and distribution now becomes the leading edge service. Major US retailers have skewed to partner with well-established manufacturers that qualified their requirements. Manufacturers with captive distribution capability benefited from the trend. This helped the Group ward off the competitive threat of smaller competitors. Margin improved as a result of successfully executed integration and improved competitiveness.

Manufacturing

The net manufacturing business after elimination for this year was HK$1,297 million. Taking into account the US distribution business, the gross manufacturing business for the year edged up by approximately 1% which was in line with that of the industry. Strategically, Peace Mark has been re-positioning itself by moving towards making high margin products while the operating and raw materials costs continued to increase. We have increased outsourcing the manufacturing of low margin products and made use of the capacity for higher margin product manufacturing. The change in production mix led to stable gross profit margin notwithstanding increased cost environment.

The Group has 8 production facilities located in China, Switzerland and Hong Kong. The capacity of production facilities of the Group was approximately 80% utilized and will be sufficient to support the production demand for the next few years with out-sourcing support.

In the USA, the Group mainly targeted the mass-market watches. Its products were found in over 24,000 points of sales including supermarket chains, drug chains, direct marketing companies, home-shopping companies and sport products chains.

In order to strengthen the marketing of the European market, the Group had increased its presence in France and Germany. A subsidiary in France was set up for the penetration of France and the Eastern bloc of Europe. A marketing office was set up in Germany to strengthen its marketing capability there.

The China distribution business also benefited the manufacturing business, as many of the brands the Group has been selling in China also sought our manufacturing supports.

The mechanical watch movement factory in Shanghai had undergone substantial production upgrades. Although last year it had not yet started to contribute to the bottom line, it has repositioned itself to target the manufacturers of higher-end products in China and overseas.

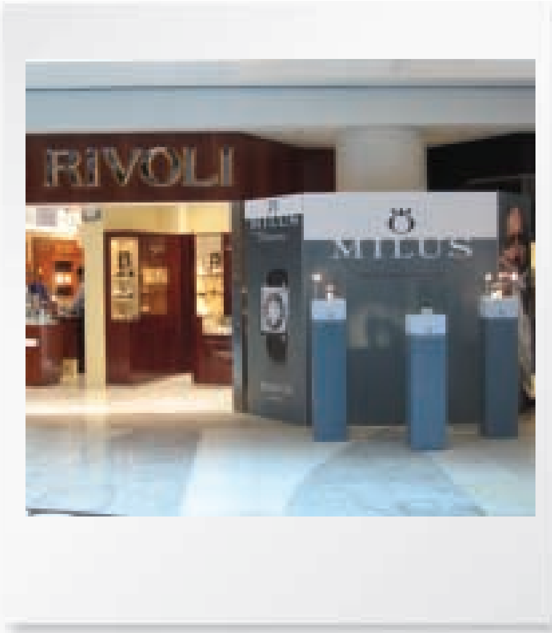
Milus

Milus, originated in Switzerland since 1919 and is one of the major own brands of the Group. The Group had repositioned Milus as a brand of unique design and targeted those with distinctive characters and lifestyles. Its worldwide presence covered Switzerland, Spain, Germany, Netherlands, Russia, China and Middle East. We have developed several highly outstanding designs that were well received by the market in the 2005 and 2006 Basel Fair.

In June 2005, Milus finished top 10 along side with other world renowned brands in the list of the Best Lady Watches 2005 presented by Chronos Magazine in Germany.

Outlook

The three core operating businesses of the Group look disparate but in fact complementary to each other, and they have founded a solid platform for the Group to expand. With this strength and flexible expansion strategy, the Group will continue to ally with strategic business partners that fit its strategic needs. The depth and breath of our businesses and products would certainly be imperative to diversify the revenue stream with a view to making the earning growth sustainable.



Milus special store promotional event in Dubai

Review of Operations

China

China's fashion and luxury markets are set to grow continuously. There has been no apparent sign of slowing down in these business segments amidst the implementation of the recent macro-economic measures. The macro economic climate, including the recent austerity and credit tightening measures, is believed to contribute to the healthy development of the market in the long term.

For the middle-range market in China, Peace Mark will continue to develop a strategic platform for all the brands by offering the services from manufacturing to retailing. By the end of financial year 2007, we expect to build a retail network of over 800 point-of-sales and hence achieve further economies of scale for improved margins.

For TimeZone, the Greater China concept will be further developed and more shop-in-stores will be rolled out. An advertising campaign will be launched and more shops will be refurbished to uphold its image. This retail network is highly scalable and we are studying new strategy to accelerate the network expansion plan spanning to second-and third-tier cities in China.

Peace Mark will accelerate its luxury watch retail network expansion plan in China. The opening of Tourneau stores is crystallizing as planned. We are actively looking for prime locations for store opening in strategic locations including major cities in China, Macau and Hong Kong.

Apart from the Tourneau joint venture, Peace Mark will form partnerships with domestic companies in certain areas for strategic purposes. We are also looking for more opportunities to manage the retail operations of boutique and image shops for various brands.

In our view, the new consumption tax in China announced in March 2006 has moderately impacted the luxury watch market. It is worth noting that the new consumption tax has been provisionally implemented. Nevertheless, the direct import of Swiss watches into China is still growing strongly. It seems that the luxury market is price-inelastic and has shown no signs of slowdown.

Manufacturing and US distribution

In the face of growing margin pressure of the low-end manufacturing caused by the rising raw materials and operating costs in China, shifting the focus to manufacture of higher-end products would provide additional gross margin to mitigate the increased costs. Downstream expansion would continue to add value along the supply chain and enhanced distribution margin on top of the manufacturing margin would lead to overall margin improvement.

Concerted management efforts taken during the year have contributed to the creation of a strong platform for sustainable growth across each of our core businesses. A broadened revenue base with strong growth coming from China enabled the Group to use its cash generating businesses to fund the investment of expansion plans. We are determined to deliver positive results, capitalizing on the exciting potential of the watch business we are building.