

# Management Discussion and Analysis

## Financial Review

### *An Overview*

For the six months ended 30 June 2006, the Group's sales was US\$149.4 million (1H 2005: US\$185.7 million). The decline was mainly due to (1) average selling price erosion (2) weak market demand for OLED display and (3) the new business of m-TFT not growing as fast as the Group expected. During the review period, gross profit was US\$37.0 million. Through internal cost reduction measures and ongoing price discussion with contract manufacturers, the Group managed to offset part of the gross margin pressure brought by industry price erosion. For the first half of 2006, the Group's gross margin was about 25%.

Throughout the period, the Group continued to expend on R&D and business development, therefore there was a moderate increase in operating expenses. Coupled with a lower gross profit, the Group's net profit was US\$17.9 million, representing a net profit margin of 12%.

In light of the Group's healthy financial position as well as its cash generative business model, the Board resolved to declare an interim dividend of 2 HK cents per share to shareholders whose names appear on the Register of Members of the Company on 31 August 2006.

### *Financial Position and Liquidity*

Net cash outflow from operations during the period amounted to US\$1.3 million. The Group ended the period with US\$106 million of net cash, comprising all bank deposits, other financial assets, cash and cash equivalents less bank loans. Going forward, the Group intends to use the cash primarily for its product development, investment in securing production capacity, corporate venture investing as well as general corporate purposes. As at 30 June 2006, the Group had no borrowings and there were no charges on the Group's assets. The Group's cash balance was mainly deposited in interest-bearing accounts with reputable financial institutions.

The main trade receivables and payables of the Group are in US dollars. As regards payments of operational costs in currencies other than US dollars or Hong Kong dollars, the Group will convert US dollars or Hong Kong dollars into the currency of payment at the prevailing foreign exchange rate. During the review period, the Group did not use any derivative instruments to hedge its foreign currency exposure as the Directors considered the Group's foreign currency exposure to be insignificant.

### *Capital Expenditure*

Capital expenditure for the period was approximately US\$3.8 million (1H 2005: US\$1.5 million), the majority of which was spent on the purchase of computer hardware and critical manufacturing equipment (in cooperative arrangement with contract manufacturers) to ensure timely product delivery.

During the review period, the Group held no significant investments and did not make any material acquisitions nor disposals of subsidiaries and associated companies.

### *Capital Commitment and Contingent Liabilities*

The Group had no material capital commitments or contingent liabilities as at 30 June 2006.

## Business Review

### **Book to Bill Ratio and Backlog**

In the review period, the book to bill ratio stood at 1.05 (1H 2005: 0.93), indicating the business flows are fairly steady. As at 30 June 2006, the Group registered a backlog of orders in excess of 85 million units (as at 30 June 2005: 80 million units) for the second half of 2006.

### **Product Shipment**

The growth of unit shipment in the first half was healthy, representing an increase of 16% year-on-year. For the mobile phone related display IC shipment (i.e. monochrome STN, color STN and m-TFT), the growth was over 20%, comparable to the market trend. Going into the second half of 2006, the Group will concentrate on providing comprehensive services and solutions to customers, launching more new products and defending its market position. The shipment breakdown by product type is as follows:

<b>Units Shipped (million)</b>	<b>1H 2006</b>	<b>1H 2005</b>	<b>Growth (%)</b>	<b>2005</b>
Monochrome STN	23	18	28%	45
Color STN	81	62	31%	143
m-TFT	12	12	0%	34
OLED	8	16	-50%	40
Miscellaneous	1	—	NA	1
<b>Total</b>	<b>125</b>	<b>108</b>	<b>16%</b>	<b>263</b>

Note: Miscellaneous includes graphic controller, PDA driver ICs, large display driver ICs and others.

Abbreviation: STN stands for super twisted nematic, TFT thin film transistor and OLED organic light emitting device.

Total shipment of display ICs in the review period was 125 million units. According to recent forecasts made by iSuppli and Gartner, global shipments of mobile phones for 2006 are expected to be about 930 million units. The Group believes that its global market share in mobile phone display ICs for the first half was close to 20%.

Among the Group's products, monochrome STN display ICs found rising application in low-cost mobile phones and MP3 players, and their shipment grew by 28% to 23 million units. At the same time, color STN ("CSTN") display ICs recorded a solid growth, indicating the Group's strong product offerings in this area. The shipment for the period reached 81 million units, an increase of 31% as compared to the same period in 2005. Mobile TFT ("m-TFT") display ICs shipment remained broadly flat at 12 million units, mainly due to longer than expected design-in cycle time. OLED display ICs showed an unusual annual decline in shipment, because of the weak adoption of OLED display in MP3 players. The shipment of OLED display ICs reduced by half to 8 million units as compared to the same period in 2005. In the first half, the Group shipped small volume of large display TFT driver ICs which, in the Group's opinion, will take more time to be one of the major growth drivers in the future.

### **Business Relationships**

To win new business from existing or potential customers, it is recognized that in addition to competitive pricing, field application support and reliable solutions are equally important. In the first half, the Group added more resources to provide customers with more timely services and support.

For the Display Panel business, the Group currently serves most major display module makers in the world. It is the Group's objective to focus more on approaching ODM (original design manufacturer) and IDH (independent design house) directly so as to achieve better connections with the participants in the value-chain. During the period, the Group gained more business from Korean and Japanese customers, through whom it can broaden its relationship with top-tier mobile phone brand names.

Regarding the Display System business, the Group provides customers with “total display IC solutions” for high volume specific applications. Given this enlarged product offerings, the Group can reinforce its business relationships with existing customers as well as new end-product manufacturers.

### **Research and Development**

In the past six months, research and development costs were approximately US\$7.9 million. To support business growth and to be competitive in the marketplace, the Group will keep on enhancing the features of existing products and developing future products, e.g. high speed interface ICs, LTPS m-TFT display ICs, AM-OLED display ICs and multimedia processors. In the first half of 2006, the Group filed two patents with the United States Patent and Trademark Office and had four technical articles published in international magazines such as *Display Devices* and *EEPW*.

As at 30 June 2006, the Group had over 250 professionals in the design and engineering function, representing approximately 65% of the Group’s total employees. The Group’s R&D team continually designed products using various wafer technologies as advanced as 0.13 $\mu$ m.

### **Human Resources**

As at 30 June 2006, the total number of the Group’s employees was close to 370, of which approximately 65% was based in its Hong Kong head office.

As a technology company, the Group highly values its human resources. To reward talent, the Group offers competitive remuneration to employees and constantly provides employees with trainings, career development programs, job satisfaction and a first-rate working environment in the hope that they will enjoy working with the Group and contribute their efforts to the Group’s success. Lately, the Group recruited two senior executives for its operation and corporate development departments.

In the first half of 2006, most employees were granted cash bonuses and Company’s shares in recognition of their performance in 2005. Further, at the Board level, Directors were awarded options for their past and forthcoming contributions to the Group.

### **Prospects**

Following the last year initiative to establish two distinct business units, namely Display Panel and Display System, the Group has made progress and is better positioned to grow its business with products diversification.

### **Display Panel**

#### **Mobile Display**

In the mobile phone market, there are essentially four Display Panel technologies, namely monochrome STN, color STN, m-TFT and OLED. Each of them is experiencing different phase of growth because of their uniqueness in display characteristics. Generally speaking, the market will see continued migration from monochrome to color display and will have more mobile phones with entertainment features such as embedded cameras, video recording function, Internet access, MP3, radio, MMS, photo albums, etc.

As regards the Group’s business in the next six months, it is expected that the growth of monochrome display ICs will likely remain flat. Despite the industry anticipating that m-TFT will gradually replace color STN display technology, the Group maintains a positive view on the 2006 unit shipment of color STN display ICs because (i) the overall demand for color display is relatively healthy (ii) the mobile phone sub display segment is still dominated by color STN and (iii) there is a trend of color STN being adopted in more mid to low-cost mobile phones and MP3 players.

The Group sees two factors that may affect the shipment of m-TFT display ICs in the second half, namely the speed of adoption of the Group's products by its customers as well as the Group's competitors' strategy toward m-TFT business in connection with pricing and market share protection. Going forward, the Group will put more efforts to introduce new and competitive products, and to actively engage ODM, IDH and module makers in exploring business opportunities.

About OLED display ICs, there may be a slight recovery in the second half subject to sales momentum of MP3 players. Nevertheless, OLED display ICs have been used in mobile phone main display and the Group will look at more new application opportunities, for instance, MP4 and notebook sub display.

### ***Large Display***

The Group continuously works with a few large panel makers in Japan and Greater China region on new design-ins. An ongoing project between the Group and one of its customers in Japan is underway.

In light of the merger of AU Optronics Corp. ("AUO") and Quanta Display Inc. ("QDI") announced in April 2006, the Group considers the merger is positive to its large display business as the merged entity will be a bigger potential customer to the Group and the Group has been working with AUO in the past on the mobile display area. However, as AUO has a number of large display driver ICs suppliers already, it will pose an uncertainty to the Group's near-term business. Despite such uncertainty, the Group will devote more resources to this business and aims to establish itself as a preferred supplier to the new AUO/QDI entity.

### ***New Display***

Two favorable developments are the volume shipment of microdisplay ICs and the forthcoming commercialization of bistable display ICs. For the former, the Group shipped thousands of units in the past six months to Kopin Corporation for their "Video On-the-Go" technology eyepiece. This new technology has drawn market attention and the eyepiece products, consisting of binocular display modules where the Group's microdisplay ICs are used, are for sale in the market. As for bistable display ICs, the Group has completed the product design and applied it to end-product application of electrophoretic display. The bistable display ICs are ready for mass production in the second half.

### **Display System**

Display System ICs are aimed for high growth applications. This business unit is developing three product families, namely high speed interface IC, controller and multimedia processor. High speed interface IC deals with connectivity inside a mobile phone, TV or other portable consumer products, such connectivity examples are MDDI, MIPI and LVDS. Regarding controller, the Group launched image processor for portable products and timing controllers for PC monitors, TV and soon for notebook computers. In the area of multimedia processor, the Group expects products developed for high volume applications to be introduced towards the end of this year or early 2007.

Display System will speed up its products development through strategic alliance, business cooperation and core IP rights acquisition. With the development of Display System business, the Group can further its relationship with customers by offering them "total display IC solutions". In the long run, the Group believes this business will bring in strong sales growth and a more balanced business mix.