MANAGEMENT DISCUSSION & ANALYSIS

FINANCIAL REVIEW

The business environment remained difficult in the first half of 2006 for all plush stuffed toy manufacturers with material costs escalating, labour shortage persisting and competition mounting. The adverse market conditions inevitably affected the profitability of Dream International Limited (the "Company") and its subsidiaries (collectively the "Group"). The Group reported a slightly increase in turnover of HK$445.4 million (2005: HK$430.1 million), and its gross profit decreased to HK$64.4 million (2005: HK$83.5 million). As a result, it recorded loss attributable to equity holders of HK$36.6 million (2005: HK$16.5 million).

Nevertheless, the Group maintained its leadership in the industry and implemented various strategies to address the different market challenges. The Group pursued manufacturing automation and relentless efforts were made to improve workflow and rationalize the workforce to enhance production efficiency. During the period, its steel and plastic business managed deeper market penetration and made inroads into the scooter and inline skate market.

BUSINESS REVIEW

PRODUCT ANALYSIS

For the six months ended 30 June 2006, sales of plush stuffed toys amounted to HK$364.2 million, representing 81.8% of the Group's total turnover. The Original Equipment Manufacturing ("OEM") business remained the Group's core business and contributed 94.5% of the turnover from the plush stuffed toy segment. Adding to its solid client base comprising renowned international brand and character licensors, the Group secured a new customer, Old Navy, a well-known clothing brand that also carries plush toys in its stores, and broadened its revenue stream at the same time.

The Original Design Manufacturing ("ODM") business accounted for the remaining 5.5% of this segment's turnover. The Group launched its new bedding and infant products in the US this year and this new product line received positive market response. Encouraged by this good start, the Group is striving to market this product line to more major US retailers.

The Group's steel and plastic toys business accounted for 18.2% of its total turnover, and the performance of this segment was encouraging during the review period. In October 2005, the Group set up a joint venture ("JV") to invest in C&H HK Corp., Ltd. and J.Y. Plasteel (Suzhou) Co., Ltd. ("J.Y. Plasteel") with the aim of expanding its steel and plastic toy segment. Construction of the new plant under J.Y. Plasteel in Taicang, Jiangsu province was completed during the period and it commenced full operation in August 2006. The new plant has allowed the Group to enrich its steel and plastic product mix and achieve a more balanced product portfolio, and in turn broaden exposure of its products in the international toy market. Moreover, the demand for bicycles and steel and plastic toys is rising in China. To capture the growing demand, the Group invested a further US$2,500,000 in the JV. This raised the Company's shareholding up to 66.5% in the JV with paid up registered capital of US$8,500,000.

MARKET ANALYSIS

For the six months ended 30 June 2006, the North American market accounted for 38.5% of the Group's total turnover, followed by Japan at 29.1%. Europe became another major market and its contribution to the Group's turnover increased to 25.2%, which was mainly driven by the acquired distribution channel of the well-known "Great" and "Far Great" brands in this market. Supported by the distribution channels acquired by the JV, the Group successfully tapped the China market.

OPERATIONAL ANALYSIS

The Group operated ten plants in China and two in Vietnam with the average utilization rate of the Group's production facilities maintained at above 90% level during the period. In China, the plants in Shuyang and Beiliu became fully operational during the review period. Thanks to the automated manufacturing processes, the new plant in Taicang had less reliance on labour. Together with the higher margin of steel and plastic products, the JV's business managed to achieve the breakeven point in the first half of 2006.

PROSPECTS

With persistently high raw material costs and lingering labour shortage in China, the toy industry will continue to face challenges ahead. The increasing minimum wage in Shenzhen and the eastern coastal areas of China will pose pressure on many manufacturers, especially the smaller ones. The Group expects consolidation of the toy industry to continue with only the well-established players surviving in the long run.

To combat labour shortages and rising wages in coastal areas of China, the Group will continue to relocate and invest in production facilities inland. Besides the Group's new plants in Shuyang and Beiliu, two other new plants in Mingguang and Chaohu of Anhui province commenced operation early this year. With its inland factories in full operation in the second half of this year, the Group expects to see its production capacity boosted by 30%.

Plush stuffed toy will remain as the Group's core products. The Group will continue to inject resources into its OEM and ODM businesses and strive to enhance its ability to provide innovative product designs to existing clients, as well as look for ways to develop new designs and functions that agree with market trends. To improve its overall performance, the Group will concentrate on major customers and discontinue non-profitable accounts. It will also expand its ODM product lines and strive to extend their reach to other major US retailers.

On the other hand, the Group will also step up development of its steel and plastic toy segment. Since the performance of this segment was better than expected during the first half of the year, we are confident it will deliver strong performance for the whole year, especially in its peak season in the second half. Capitalizing on the well-established distribution network of the "Great" and "Far Great" brands acquired in 2005, the Group will seek to expand both the domestic and overseas markets and explore business opportunities with character licensors and increase exposure of its products by participating in international toy fairs.

The Group started to restructure its business in 2005. The benefits of this exercise are expected to be reflected in the second half of this year. To expand its markets in the future, the Group is studying the possibility of selling its products to South America and Russia. It is believed that such endeavors will help to strengthen the Group's position as the largest plush stuffed toy manufacturer in the world.

NUMBER AND REMUNERATION OF EMPLOYEES

At 30 June 2006, the Group had 10, 11187, 95, 8, 6 and 2240 employees in Hong Kong, Mainland China, South Korea, US, Japan and Vietnam respectively. The Group values its human resources and recognizes the importance of attracting and retaining quality staff for its continuing success. Staff bonuses and share options are awarded based on individual performance.

LIQUIDITY AND FINANCIAL RESOURCES AND GEARING

The Group continued to maintain a reasonable liquidity position. As at 30 June 2006, the Group had net current assets of HK$173.2 million (31 December 2005: HK$217.9 million). The Group's total cash and bank deposits as at 30 June 2006 amounted to HK$115.7 million (31 December 2005: HK$173.0 million). The total borrowings of the Group as at 30 June 2006 amounted to HK$112.8 million (31 December 2005: 105.6 million). As a result, the Group's net total cash and bank balance as at 30 June 2006 amounted to HK$2.8 million (31 December 2005: HK$67.4 million).

The Group has consistently adhered to its prudent treasury policy. Most of the Group's liquid fund is placed in principal guaranteed short-term dual currencies deposits in various banks to enhance return from the liquid assets of the Group within the controllable risk level.

The Group's gearing ratio, calculated on the basis of total borrowings over the total shareholders' equity, was slightly increased to 21.1% (31 December 2005: 18.9%) to fund the expansion of the production plants in Vietnam and establishments of various satellite production plants in further inland area of Anhui and Jiangsu provinces of PRC.

PLEDGE ON GROUP ASSETS

As at 30 June 2006, the banking facilities of the Group were secured by mortgages over their land use rights, buildings and bank deposit with aggregate carrying value of HK$4.2 million (31 December 2005: HK$4.3 million), HK$35.4 million (31 December 2005: HK$36.2 million) and HK$61.4 million (31 December 2005: HK$69.8 million) respectively. Such pledged banking facilities were utilised to the extent of HK$88.8 million (31 December 2005: HK$42.3 million).