MANAGEMENT DISCUSSION AND ANALYSIS

Business review

Summary of results

The consolidated turnover of Arts Optical International Holdings Limited (the "Company") and its subsidiaries (collectively, the "Group") and profit attributable to the equity holders of the Company increased by 36% and 38% to HK$509.2 million and HK$67.4 million respectively (2005: HK$375.6 million and HK$49.0 million) in the six months ended 30th June, 2006. Basic earnings per share increased by 36% to 17.6 HK cents (2005: 12.9 HK cents) in the period under review.

Although the gross margin of the Group was still under severe pressure imposed by higher raw material costs, labour wages, record energy prices and appreciation of Renminbi, the trend of declining gross margin was successfully reversed in the first half of 2006 due to the positive effects of the economies of scale arising from the increase in volume output by 24% as compared with the corresponding period of 2005. Gross margin percentage increased by 1.2% from 29.2% in the first six months of 2005 to 30.4% in the corresponding period of 2006. Net profit margin percentage (ratio of profit attributable to the equity holders of the Company to turnover) also increased slightly by 0.1% from 13.1% to 13.2%.

Original design manufacturing (ODM) division

The Group had been incurring substantial capital expenditure since 2004 to boost its production capacity in order to meet the market demand for its products. Sales to ODM customers increased by 35% from HK$339.4 million in the first 6 months of 2005 to HK$458.3 million in the corresponding period of 2006. Europe and the United States remained as the main export markets of the Group's ODM division. As a result of the relatively robust performance of American economy and gradual transfer of sourcing from European manufacturers to Far East manufacturers, sales to Europe and the United States registered strong growth rates of 51% and 21% and amounted to HK$302.9 million and HK$130.8 million respectively (2005: HK$200.8 million and HK$108.1 million) during the period under review. On a geographical basis, sales to Europe, United States, Asia and other regions accounted for 66%, 29%, 4% and 1%

respectively of the sales of this division during the period under review (2005: 59%, 32%, 7% and 2% respectively). Demand for quality and trendy sunglasses remained high, resulting in greater demand for plastic frames. Sales of sunglasses grew by 51% to HK$198.1 million (2005: HK$131.0 million) whereas sales of prescription frames also grew by 25% to HK$260.2 million (2005: HK$208.4 million). Sales of metal frames, plastic frames and spare parts accounted for 50%, 48% and 2% respectively during the period under review (2005: 53%, 44% and 3% respectively).

Distribution and retailing divisions

Sales of the Group's own-branded and licensed branded products (including both spectacles and lenses) increased by 59% to HK$42.1 million in the six months ended 30th June, 2006 (2005: HK$26.5 million). Stepper eyewear, the German brand owned by the Group, remained as the best selling brand among the brand portfolio of this division. Successful commercial launch of Fiorucci eyewear, the licensed Italian fashion brand, in Europe and Asia also boosted the sales of the division in these two regions. Sales to Europe, Asia, North America and other regions increased by 61%, 123%, 13% and 10% and accounted for 48%, 30%, 12% and 10% respectively of the Group's turnover of distribution division in the period under review (2005: 47%, 21%, 17% and 15% respectively).

Turnover of the retailing division decreased by 9% to HK$8.8 million in the first half of 2006 (2005: HK$9.7 million), primarily due to the closure of non-performing shops during the period under review. The Group operated a total of 14 shops (31st December, 2005: 18) including 8 shops in Beijing and 6 shops in Shenzhen as at 30th June, 2006 (31st December, 2005: 10 and 8).

Prospects

ODM division

Despite the Group's success in reversing the downward trend of the gross margin in the first half of 2006, the management maintains its vigilance of potential market upheaval arising from unexpected slowdown in the global economy, volatile interest rates and commodity prices movements. The management will continue to execute its capacity expansion plan after due consideration of latest market development and availability of internal resources. Costs pressure on the Group's products remains high, but the management believes that through the lowering of average fixed costs by output expansion and modest price adjustments on its products since late 2005, the Group can still maintain a satisfactory and stable margin in the second half of 2006. The Group currently has three months sales orders on hand and the management anticipates this to remain stable in the second half of 2006.

Distribution and retailing divisions

The well established global network of over 30 distributors for Stepper eyewear provides an excellent platform for the future growth of the Group's distribution business. The successful launch of the Fiorucci eyewear collections in the Asian and European markets reinforces the Group's determination in further penetrating into untapped markets and strengthening its brand portfolio by additions of more house and licensed brands.

In view of the intensifying competition in the retail business environment in mainland China, the Group intends to maintain its current scale of operations and its current focus on the cities of Beijing and Shenzhen. The management continues to place emphasis on profitability enhancement by internal streamlining and closure or relocation of non-performing shops.

Summary

The management believes that the encouraging financial results reported in the first half of 2006 is attributable to its adherence to its guiding principle of balance sheet management and emphasis on cash earnings. The adjustment on the dividend payout in the first half of 2006 reflects the cautiousness of management in implementing the expansion plan. Despite the challenges discussed above, the directors of the Company (the "Directors") are still optimistic about the financial performance of the Group in the second half of 2006.

Financial review

During the period under review, the Group's operating activities generated a net cash inflow of HK$114.7 million (2005: HK$95.7 million). Capital expenditure incurred during the period amounted to HK$67.8 million (2005: HK$55.9 million) and was wholly financed by the Group's internal resources. The net cash position of the Group (bank and cash balance less bank borrowing, if any) increased from HK$65.0 million as at 31st December, 2005 to HK$81.2 million as at 30th June, 2006. The Group did not have any interest bearing borrowings at 30th June, 2006 and 31st December, 2005.

The current ratio of the Group as at 30th June, 2006 was 2.4 to 1 (31st December, 2005: 2.8:1) with HK$535.4 million of current assets (31st December, 2005: HK$475.1 million) and HK$219.2 million of current liabilities (31st December, 2005: HK$170.6 million). Inventory turnover period (ratio of inventory balance to cost of sales) increased from 83 days in the first six months of 2005 to 87 days in the corresponding period of 2006, but this was still shorter than the inventory turnover period of 104 days for the whole year of 2005. Debtors turnover period (ratio of the total of debtor and discounted bills balances, if any, to sales) increased from 88 days in the first six months of 2005 to 93 days in the corresponding period of 2006 and this was also shorter than the debtors turnover period of 108 days for the whole year of 2005.

The Group had 383,650,000 shares in issue as at both 30th June, 2006 and 31st December, 2005 with equity attributable to equity holders of the Company amounting to HK$669.5 million and HK$623.2 million as at 30th June, 2006 and 31st December, 2005 respectively. Net asset value per share (equity attributable to equity holders of the Company divided by the total number of shares in issue) as at 30th June, 2006 was HK$1.75 (31st December, 2005: HK$1.62). Total long term liabilities and debt to equity ratio (expressed as a percentage of total long term liabilities over equity attributable to equity holders of the Company) were HK$15.3 million (31st December, 2005: HK$13.3 million) and 2.3% (31st December, 2005: 2.1%) respectively.

The Group had limited exposure to foreign exchange rate fluctuations as most of its transactions were conducted in either United States dollars, Hong Kong dollars and Renminbi and the exchange rates movements between these currencies were relatively stable during the period under review, except to the extent of the gradual continuous appreciation of Renminbi against United States dollars and Hong Kong dollars.

Employee and remuneration policies

The Group employed approximately 10,500 full time staff as at 30th June, 2006. The Group remunerates its employees based on their performance, experience, qualifications and prevailing market price while performance bonuses are granted on a discretionary basis after considering individual performance and the operating results of the Group. Other employee benefits include insurance and medical cover, subsidised educational and training programmes, mandatory provident fund scheme as well as a share option scheme.

Ng Hoi Ying, Michael
Chairman

Hong Kong, 21st September, 2006