

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL RESULTS

The Group achieved a turnover of HK\$1,347 million for the year ended 30 June 2006 (the “Year”), an increase of 20 percent as compared with HK\$1,127 million for the previous year (the “Previous Year”). Profit attributable to equity holders of the Company for the Year was HK\$333 million, an increase of 24 percent as compared with HK\$268 million for the Previous Year. Earnings per shares for the Year was HK12.45 cents (2005: HK11.52 cents), an increase of 8 percent. EBITDA (earnings before interest, taxation, depreciation and amortisation) rose by 28 percent to HK\$448 million. Before taking into account of HK\$51.3 million of change in fair value of convertible bonds upon the adoption of new Hong Kong Accounting Standards (please refer to Note 2 to the consolidated financial statements for details), the Group’s profit before taxation was HK\$383 million, an increase of 43 percent over the Previous Year. The increase in turnover was mainly attributable to increased sales of existing and new products to the established customer base as well as the expanding clientele covering new markets.

Gross profit increased by 24 percent to HK\$519 million, and gross margin improved to 39 percent of turnover from 37 percent of the Previous Year, reflecting the Group’s continued investment in product development and systems advancement, thereby enhancing the value-added features of its products and solutions, and in turn helping drive industry-leading productivity. Total operating expenses have gone up largely in line with the increase in turnover and as a result of a general increase in staff costs on the back of a strengthening economy. General and administrative expenses were HK\$94.7 million, up 11 percent (2005: HK\$85.1 million); depreciation and amortisation expenses were HK\$111.9 million, up 55% (2005: HK\$72.2 million), which was attributed to the roll-out of several new projects; distribution costs have come down to HK\$45.7 million (2005: HK\$57.5 million), after continued efforts in expanding clientele in previous years. Thanks to efficient outsourcing and cost control measures, Kantone’s profit margin (before taking into account of HK\$51.3 million of change in fair value of convertible bonds and impairment losses of HK\$6.8 million recognised for available-for-sale investments) increased to 29 percent of turnover as compared with 25 percent of the Previous Year.

Despite the general increase in interest rates during the Year, finance costs of HK\$4.8 million for the Year (2005: HK\$9.1 million) were lower, attributed to a high level of liquidity, which had the effect of reducing the level of borrowings and its reliance on other means of debt financing.

BUSINESS REVIEW

The Group continued to benefit from China's robust economy, where sales maintained its momentum in line with the country's economic growth. Telecom and IT sectors were under increasing competitive pressure to invest in core network equipment to provide greater capacity as well as to improve the quality of their networks, hence the demand for enhanced network monitoring, network security equipment and software continued. The success of China's aerospace projects, the forthcoming award of 3G telecom licenses, as well as upcoming international events to be held in China such as the 2008 Olympics and the 2010 World Expo are also drivers to the growth in investment in the telecoms and related sectors. For the year under review, China sales accounted for HK\$868 million of the Group's turnover (2005: HK\$711 million), an increase of 22 percent over the Previous Year.

In Europe, Kantone continued to expand on its dominant position within the healthcare and emergency services Command and Control Communications (CCC) market space. UK sales registered stable growth. The award of key supplier status by the National Health Service (NHS) as part of the latter's Purchase and Supply Agency (PASA) has won Kantone a number of new contracts in the personal security arena. A revamp of the fire services in the UK subsequent to the terrorist attacks on London in 2005 also contributed to increased business activities. Turnover attributable to the operations in Europe was HK\$352 million (2005: HK\$309 million), an increase of 14 percent over the Previous Year.

In the US, Kantone's primary focus was on projects arising from the Government's spectrum migration programme for public sector networks.

Meanwhile, Kantone continued to invest in research and development, and has a number of exciting products and solutions in the development pipeline, presenting new opportunities for a global market development beyond the existing geographical footprint. At the same time, Kantone is also looking to utilise its skills and IPRs (intellectual property rights) in wireless technologies to expand into new business areas and markets within the rapidly expanding technology arena.

E-GAMING AND ONLINE ENTERTAINMENT

In October 2005, Kantone completed its acquisition of a controlling stake in a pioneer systems developer and service provider in paperless betting systems in China. The newly-acquired operation has a track record in providing software solutions and technological support to PRC governmental welfare lottery administrative authorities for establishing a comprehensive paperless betting platform with complete payment solutions in return for recurring revenue sharing based on betting turnover. Through the acquisition, Kantone now holds a leading position in the e-lottery market in China, with existing paperless betting platforms in Shenzhen and Shanghai, where long-term agreements have been signed with the regional Welfare Lottery Centres. A third project to install a paperless betting operating system for the entire province of Anhui has been completed, and is currently under trial run.

Kantone now owns the IP (intellectual property) rights of a robust e-lottery platform complete with secure micropayment systems linked to banks which facilitated one-stop-shop automatic betting transactions for multiple lottery games. During the period, the Group continued to invest substantially on technology enhancement and enriched betting solutions to lay a solid foundation for further growth and expansion. A promotion program aimed at capturing a larger market share of betting customers was being developed. Betting turnover via the Group's e-platform has steadily increased, and the use of SMS on mobile phone and dedicated websites for paperless betting have proved particularly popular with young people and the more well-off white collar workers who have a generally higher level of spending.

Welfare lottery is one of the two authorised streams of betting in China, accounting for approximately 60 percent of the national lottery turnover; the other being sports lottery. For the first half of 2006, turnover of welfare lottery was about Rmb23 billion. In terms of lottery revenue per capita, China is still far below the level seen in developed markets, pointing to huge potential growth in the coming years.

PROFESSIONAL CONSULTANTS

The paperless lottery project in China represents a significant addition to Kantone's e-Gaming and Online Entertainment business with its growing portfolio of investments in betting software solutions and various gaming and entertainment websites, complementing its mainstream Telecoms and IT business. To boost the management expertise and operational skills of this expanding business, the Group appointed four professional consultants with broad international gaming experience who would prove to be of immense value in the Group's pursuit of e-Gaming and Online Entertainment in the global arena. These new appointments were:

- *John Schreck*, who has served as Chief Stipendiary Steward of the Hong Kong Jockey Club, Director of Racing in Macau, and Chief Stipendiary Steward of the Australian Jockey Club. His expertise lies in his great depth of knowledge of the global gaming operations and the various regulatory frameworks.
- *Michael Thornhill*, who has served as a steward of the Hong Kong Jockey Club and Senior Partner of Johnson Stokes and Master, with particular expertise in licensing arrangements and global strategy.
- *David Gairns*, who has served as a steward of the Hong Kong Jockey Club, Chairman of Hong Kong Lotteries Board, and Senior Partner of KPMG (Hong Kong). His expertise lies in financial planning and evaluation of business acquisitions.
- *Timothy McNally*, who has served as Director of Security and Corporate Legal Services of the Hong Kong Jockey Club, and Assistant Director-In-Charge of the Federal Bureau of Investigation (FBI), Los Angeles, California. His expertise lies in risk analyses and security management of global gaming operations.

The market of e-lottery in China is still at its developing stage, but if it were to follow the trend of the high adoption rate of other technologies such as mobile phones and Internet usage, e-lottery will have a significant impact on China's overall lottery market, and in turn, will impact positively on Kantone's results in the future.

LIQUIDITY AND FINANCIAL RESOURCES

The Group continued to maintain a strong financial position with a low gearing and a net cash position. The Group financed its operation and business development with a combination of internally generated resources, capital markets instruments, and banking facilities provided by its principal bankers. In October 2005, Kantone completed a top-up placing of 240 million Kantone shares of HK\$0.10 each at the issue price of HK\$0.73 per share to institutional investors (the "Placing"). Kantone raised net proceeds of about HK\$168 million from the Placing, which would be applied to the investment in and development of the e-lottery business, and the general working capital of the Group. As a result of the Placing, the Group's equity holders base has been enlarged and its liquidity position has been further enhanced.

As at 30 June 2006, the Group had HK\$252 million (2005: HK\$139 million) liquid assets made up of deposits, bank balances and cash. Current assets were approximately HK\$625 million (2005: HK\$503 million) and current liabilities amounted to approximately HK\$147 million (2005: HK\$219 million). With net current assets of HK\$479 million, the Group maintained a comfortable level of liquidity. The gearing ratio of the Group as at 30 June 2006, defined as the Group's total borrowings to equity attributable to equity holders of the Company, was 0.05 (2005: 0.12). The improvement in gearing ratio was mainly attributable to the Placing.

Total borrowings comprised bank borrowings of HK\$55 million (2005: HK\$59 million); other borrowings, which represented block discounting loans, of HK\$5 million (2005: HK\$9 million); and convertible bonds of HK\$18 million, after taking into account of the change in fair value with the adoption of new accounting standards (see Note 2 to the consolidated financial statements) (2005 (restated): HK\$61 million). Finance costs for the Year amounted to HK\$4.8 million (2005: HK\$9.1 million).

Included in the bank borrowings of HK\$5 million were bank loans and overdrafts of HK\$1.8 million (2005: HK\$2.9 million) being secured by the Group's land and buildings with a net book value of HK\$11.9 million (HK\$10.3 million). These borrowings comprised debts of HK\$54 million, HK\$0.7 million and HK\$0.3 million repayable within one year, in the second year and the third year respectively. The unsecured bank borrowings of HK\$53.3 million were repayable on demand.

The other borrowings of HK\$5 million were unsecured, with HK\$2.7 million repayable within one year, HK\$1.7 million repayable in the second year and the remaining repayable in the third and fourth year.

As at 30 June 2006, the Company had outstanding convertible bonds with face value of USD0.1 million which will mature on 1 April 2008.

Except for the USD convertible bonds, all other borrowings were used by the subsidiaries of Group, bearing interest at floating rates, and were denominated in local currencies. The currency risk exposure associated with the Group's borrowings was insignificant.

CAPITAL COMMITMENTS

As at 30 June 2006, the Group's capital commitments authorised but not contracted for was HK\$179 million (2005: HK\$112 million). The group had set aside sufficient internally generated funds for the acquisition of property, plant and equipment, and development of systems and networks.

EXPOSURE TO EXCHANGE RATE FLUCTUATIONS

The Group does not engage in interest rate or foreign exchange speculative activities. It is the Group's policy to manage foreign exchange risk through matching foreign exchange income with expense, and where exposure to foreign exchange is anticipated, appropriate hedging instrument will be used.

MAJOR ACQUISITION

In October 2005, Kantone completed the acquisition of 60 percent interest in an investor of a paperless betting systems developer and service provider in China, for a consideration of HK\$52 million. Through this acquisition, Kantone commands a leading position in the e-lottery market in China, with existing paperless betting platforms in Shenzhen and Shanghai.

FINAL DIVIDEND AND SCRIP DIVIDEND SCHEME

Subject to the approval of shareholders at the forthcoming annual general meeting, the directors have proposed a final dividend of HK2 cents per share for the year ended 30 June 2006 (2005: HK1.1 cents per share) to shareholders whose names appear on the register of members of the Company on 22 November 2006. Taking into account the interim dividend of HK1.1 cents per share paid on 14 June 2006, total annual dividend per share is HK3.1 cents, an increase of 48 percent over last year; and total dividend payment for the year would be HK\$93 million, an increase of 87% as compared with HK\$50 million of last year.

The final dividend will be satisfied by allotment of new shares of the Company, credited as fully paid, by way of scrip dividend, with an alternative to the shareholders to elect to receive such dividend (or part thereof) in cash in lieu of such allotment (the "scrip dividend scheme").

The scrip dividend scheme is subject to the granting by the Listing Committee of The Stock Exchange of Hong Kong Limited of a listing of and permission to deal in the shares to be issued pursuant thereto. A circular setting out the details of the scrip dividend scheme together with the form of election will be sent to the shareholders of the Company as soon as practicable.

It is expected that certificates for shares to be issued under the scrip dividend scheme and dividend warrants will be despatched to those entitled thereto on or before 26 January 2007.

CLOSURE OF REGISTER OF MEMBERS

The register of members of the Company will be closed from 15 November 2006 to 22 November 2006, both days inclusive, during which period no transfer of shares will be effected. In order to qualify for the final dividend and the scrip dividend scheme, all transfers of shares accompanied by the relevant share certificates, must be lodged with the Company's Branch Share Registrars in Hong Kong, Secretaries Limited at 26th Floor, Tesbury Centre, 28 Queen's Road East, Wanchai, Hong Kong no later than 4:00 p.m. on 14 November 2006.