MANAGEMENT DISCUSSION AND ANALYSIS

During the period under review, Hung Hing was able to successfully implement a diversification strategy both in terms of product range and in terms of geographic customer spread. Hung Hing's paper manufacturing business grew to become the Group's second largest division, and the Group achieved steady growth in mainland China as well as Europe.

The first quarter of the period under review saw global adjustments in oil prices, which impacted customer confidence. This resulted in a short-term slowdown in orders during the first quarter of the period under review. Customer confidence improved during the following quarters, however, resulting in a steady flow of orders. Overall revenue for the Group declined by 2 per cent and operating profit declined by 2 per cent.

The paper and carton box printing and manufacturing division was impacted by a temporary slowdown in orders in the first quarter and revenues declined 5 per cent. The paper trading division took advantage of global adjustments in paper prices and grew its internal sales to record an overall increase of 13 per cent in revenues. The Group's corrugated carton and paper manufacturing division took advantage of the strong mainland China economy to record increases of 6 per cent and 7 per cent respectively in external sales.

The global oil price changes during the period under review impacted the Group in two ways. First, it had a direct impact on the Group's cost of sales due to items such as energy, transportation and material costs. Secondly, the adjustments also impacted customer confidence. Other macro economic factors continued to have an impact on the sector as a whole, such as the power shortage in southern China as well as continued regulation-driven increases in wage and benefits levels.

Despite these challenges, the Group leveraged its vertically integrated operations and exercised tight control over costs and expenses to control increases in its cost of sales.

The Group used the funds raised through its convertible bond (CB) issue to pay off some bank loans as well as to invest in some capital equipment. During the period under review, the Group recognised a significant change in the fair value of the derivative component of the CB which resulted in an exceptional gain of HK$64 million. In accordance with the accounting rules, this gain was reflected in the Group's income statement and led to an increase of 19 per cent in profit before tax.

Net profit attributable to equity holders of the parent increased 32 per cent to HK$227 million. Earnings per share increased 27 per cent to HK37.7 cents.

The Board of Directors has declared an interim dividend of HK9.5 cents per share.

Successful diversification of product and customer base

The Group successfully pursued a diversification strategy in terms of both product base and geographic regions to reduce its reliance on the economic cycles of any one market.

In its current 5-year plan, the mainland China Government encourages and emphasizes foreign investors who bring in advanced technology and know-how into the market, while providing new employment opportunities. The Group has been able to take advantage of these directions through the introduction of new capacity in Heshan and deployment of advanced printing equipment, as well as ongoing investment in research and development to broaden its range of products. Through these initiatives, the Group broadened its product base across business divisions.

The paper manufacturing division grew steadily, accounting for 22 per cent of the Group's total revenue. The printing division, which is the Group's largest division, expanded its range of products and increased its revenue from conventional book printing. The paper trading division also diversified the range of paper it offered, especially on the high end.

As a result of these strategic investments and ongoing economic growth, the Groups was able to increase its presence and revenues in mainland China, which accounted for 33 per cent of the Group's business during the period under review.

Marketing efforts drove sales in other overseas markets, especially Europe, with the Group securing customers in markets like the UK, Germany, Italy, Spain, Russia and Ireland, which altogether accounted for 13 per cent of the Group's business. The Group has appointed an agent in Scandinavia to further grow the business there. The Group's strategy in appointing an agent for South America proved successful with continued growth in the South and Latin American markets.

Paper and Carton Box Printing and Manufacturing

The Group's largest business division contributed 52 per cent and 60 per cent of the Group's revenue and operating profit respectively for the period under review.

The division was impacted by increasing labour and benefits costs driven by government regulations, resulting in pressure on margins. The Group's Wuxi plant continued to make progress and achieved success in both the mainland China and export markets, with a 38 per cent increase in revenue over the comparable period last year.

Trial runs are underway on the machinery installed at the new facility in Heshan. Operations are expected to commence at the end of 2006, with a focus on labour intensive printing projects.

The newly reopened Hong Kong plant has commenced operations on a small scale and made satisfactory progress with an increase in conventional book printing.

Paper Trading

The Group's paper trading division benefited from the paper price adjustments across the world to achieve an increase of 21 per cent in its contribution to the Group's operating profit. The Shenzhen logistic warehouse continued to drive sound performance for the Group. It is expected that the trend for local manufacturers to source paper from local suppliers such as Hung Hing would continue to grow, which would potentially benefit the Group.

The division will continue to expand the range of papers it sells and introduce more varieties of paper to the market.

Corrugated Carton Manufacturing

This key division recorded a slight increase in revenue of 3 per cent, driven by an increase of 6 per cent in external sales due to diversification of customer base to the electronic and food industries. However, this sector continued to face keen competition and price pressure, which, combined with the increased labour and energy costs, affected margins. The division also incurred a higher depreciation charge for the new corrugator at the Zhongshan facility.

Paper Manufacturing

The Group's paper manufacturing division continued to enhance performance and operational efficiency and succeeded in capitalizing on strong domestic demand in mainland China to increase external sales by 7 per cent. The division took advantage of the prevalent adjustments in paper prices to achieve growth of 44 per cent in contribution to the Group's operating profit. The steady improvement in performance has validated the Group's decision in acquiring the division in 2004.

Liquidity and Capital Resources

The Group continued to invest strategically in new equipment and facilities in the period under review. Capital expenditure during the period amounted to HK$152 million, of which HK$31 million was spent on buildings and HK$121 million on plant and machinery.

As at 30 September 2006, the Group had total bank borrowings of HK$582 million, of which HK$413 million was repayable within one year and HK$169 million was repayable within two to four years.

Of the Group's total bank borrowings, 66 per cent was in Hong Kong dollars, 27 per cent was in Renminbi and 7 per cent was in U.S. dollars.

The Group has accrued loan interest of HK$19 million for the convertible bonds (CB), assuming that it has to repay CB in full at the end of the fifth year in March 2011. This has resulted in an increase in the Group's interest expenses of 106 per cent to HK$31 million.

Excluding the loan interest on the CB, interest expenses declined by 19 per cent to HK$12 million, reflecting a lower level of bank borrowings amidst generally higher interest rates prevailing during the period.

MANAGEMENT DISCUSSION AND ANALYSIS *(continued)*

Liquidity and Capital Resources *(continued)*

As at 30 September 2006, the Group had total cash on hand of HK$982 million, of which HK$775 million was placed in time deposits. Of the total cash on hand, 44 per cent was in Hong Kong dollars, 35 per cent was in Renminbi, 20 per cent was in U.S. dollars and 1 per cent was in Euros.

The total debt of the Group, including the loan component of the CB, was HK$1,242 million. Net debt (total debt net of cash on hand) was HK$260 million which, as a ratio to shareholders' equity, was 12 per cent.

Employees

As at 30 September 2006, the Group employed a total of 16,694 people in Hong Kong and China. Of the total, 353 were employed in Hong Kong and 16,341 in China. As the Heshan facility comes onstream, the number of employees based in China is expected to trend upwards.

The Group continues its policy of remunerating its employees competitively. The Group's scheme of continuous improvement and enhancement of employee care and benefits continued during the period under review.

Contingent Liabilities and Pledge of Assets

As at 30 September 2006, guarantees amounting to HK$985 million were given to banks by the Company for banking and trading facilities granted to the Group's subsidiaries. The Company has also given a guarantee to the extent of HK$760 million to a subsidiary for the settlement of convertible bonds issued.

Certain buildings and plant and machinery of the Group with a total net book value of HK$273 million as at 30 September 2006 have been pledged to secure banking facilities granted to the Group.

Prospects

As a result of the policies in the Chinese Government's current five-year plan, the business environment in China will likely shift gradually from emphasizing only quantity to an emphasis on value, moving the economy as a whole up the value chain. At the same time, a clear preference is emerging among global customers for quality partners who are highly reliable and have the ability to provide value added services.

Businesses such as Hung Hing, with its vertically integrated operations and long-time emphasis on quality and continuous investment in printing technology, are well placed to capitalize on the opportunities arising from this shift in the macro economic climate.

The Group is optimistic about the long term growth of the China domestic market. We expect that demand from the mainland China market will likely continue to be strong in the months ahead. A trend of consolidation in the industry is anticipated. The Group continues to strategically explore suitable avenues for long-term expansion.

Hung Hing, with its strong financial situation, market reputation, as well as the new capacity and capability which will shortly be created through its new facilities, is cautiously confident of continued steady growth in the months ahead.