

Management Discussion and Analysis



Market Growth

An increasing number of Chinese enterprises use management software to strengthen competitive edge



Industry Overview

1. The Enterprise Management Software and Middleware Market

(1) *The Market for Enterprise Management Software*

During the reporting period, the market of enterprise management software, including enterprise resource planning (ERP), supply chain management (SCM), customer relationship management (CRM) human resources (HR), etc., grew further on the back of the rapid growth of the Chinese economy and the imperative demand of enterprises to enhance their management competitiveness. This, coupled with the promotion of enterprise management software by the government and software developers caused customers to become more aware of, and practical about, enterprise management software and particularly concerned about whether enterprise management software could fulfill their personalized need.

Personalized need includes both industry-specific need and enterprise-specific need. The development of enterprise management software has evolved from the standardization stage in the past to the present personalization stage, characterized by the platformization of products, the development of industry-specific solutions and the personalization of services.

With the growing trend for personalization, customer demand for informatized management has become more certain and robust with soaring requirements for software products and services, resulting in the market's further turn to branded manufacturers with core technology, strong service capability and an extensive customer base.

According to the IDC report entitled "China Enterprise Application Solutions 2006-2010 Forecast and Analysis", the five-year compounded annual growth rate of enterprise application solutions from 2006 to 2010 will be 18.75% and the market value will reach USD4.139 billion in 2010. Among this, the five-year compound annual growth rate of enterprise resource management software from 2006 to 2010 will be 17.27% and the market value will reach USD1.894 billion in 2010.

(2) *The Middleware Market*

Personalized need arising from enterprise management and the platformization trend of software products further highlights the value of application server middleware. As a basic software platform supporting enterprise management software, application server middleware enables enterprise management software to be deployed flexibly and implemented rapidly to better serve the personalized needs of enterprises. Whether a software manufacturer has its own independent middleware technology has become an important consideration for corporate customers in choosing enterprise management software. According to the "2005-2006 Market Research Report on China Application Server Middleware" released by CCW Research, Kingdee, with its leading technology, captured the largest share in the application server middleware market in China among all the domestic manufacturers.

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Kingdee



Brand Reputation

Leading brand of China enterprise application software and personalized ERP

Kingdee 金蝶

帮助顾客成功

• 爱心 诚信 创新 •

2. The Group's Market Position

During the reporting period, leveraging on its industry – leading application server middleware technology, Kingdee Apusic and the business foundation software platform technology based on Service Oriented Architecture (SOA) – Kingdee BOS, the Group launched the “Personalized ERP Plan” to provide distinctive “Middleware + ERP” solutions that catered to the personalization trend and offered customers platformized products, industry-specific solutions and personalized services, making it an award-winning leader in personalized management software.

- (1) No. 1 market share of China application server middleware market among all the domestic manufacturers – CCW Research, “2005-2006 Market Research Report on China Application Server Middleware”
- (2) No. 1 brand of personalized management software, Ranked first in overall satisfaction among personalized management software users – CCW Research, “2006 China IT User Satisfaction Research”
- (3) Ranked first in maturity among business foundation platform products – CCW Research, November 2006
- (4) Launched an application server middleware product that is the fourth in the world and the first in China to have passed Java EE 5.0 certification – SUN, December 2006

Business Review

During the reporting period, the Group's business continued to grow steadily. Recognized by a large number of large-scale enterprise groups, Kingdee EAS achieved a breakthrough in the high-end market, which had the effect of acting as a demonstration for a wide range of small and medium sized enterprises. Kingdee K/3 continued to grow steadily and maintained its leading position in the small and medium sized enterprise market. Kingdee KIS products have been distributed solely through distribution channels to further increase its coverage in the low-end market. Apusic Application Server, Kingdee's middleware, continued to win the preference of customers from government departments and large-scale enterprises, and achieved ground-breaking development. As new business areas for the Group, the mobile commerce and Internet business achieved significant development. Customer service business grew rapidly and became an important source of growth as shown in the Group's results.

1. Products and Research and Development

During the reporting period, the Group made substantial progress in its products and in research and development.

(1) Enterprise Management Software

- (1) EAS was further improved and succeeded in assisting enterprises to solve the core problem of group control and management.

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During the reporting period, the Group launched Kingdee EAS V5.1 and V5.2, featuring further enhancements in group finance and BOS capability, and new breakthroughs in budget management, capital management, supply chain management and human resource management capabilities. The software effectively assisted a large number of large-scale enterprise customers to solve the core problem of group control and management. While rapidly satisfying customers' existing personalized needs, the software also constructs a management information platform that is essential for their future business expansion.

- (2) The continued upgrade of K/3 products has enabled the Group to maintain its leading position in the small and medium sized enterprise markets.

During the reporting period, the Group launched K/3's one important upgraded version, V10.3. This version features the in-depth application of the best management practices for a large number of customers, further optimizing standard management procedures. It also includes advanced enterprise planning models along with cost management and HR management solutions for the manufacturing industry. It represents a more comprehensive and advanced version of the K/3 solution. In addition, it further improves the functions and user-friendliness of the BOS software foundation platform, enabling customers and cooperative partners to satisfy their personalized needs through platform configuration in order to further strengthen the predominance of K/3 products in satisfying

personalized needs of customers with low maintenance costs. During the reporting period, the Group acquired Godline and completed its product integration, which further strengthened the functions of the K/3 manufacturing module and facilitated an upgrade for Godline's existing customers.

- (3) KIS served the needs of small enterprises more effectively to enable small enterprises to enjoy informatization services at low cost.

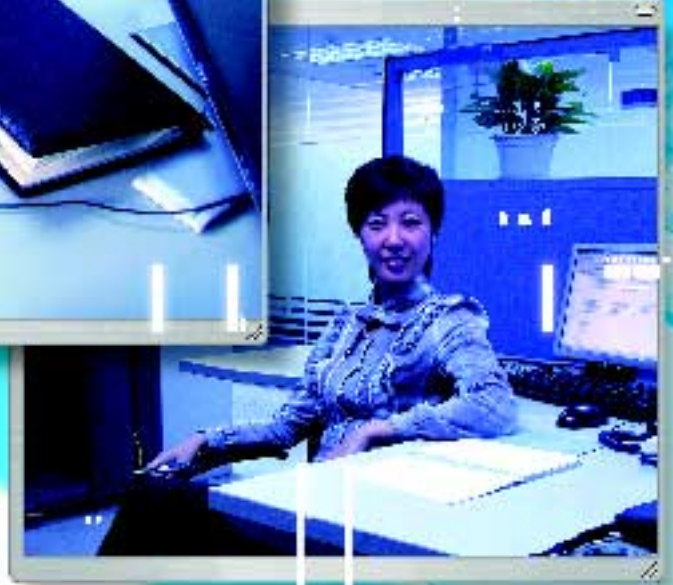
During the reporting period, the Group launched KIS V8.1 and the professional version V9.0, which targeted to satisfy the requirements of small enterprises for management software – "compact, easy to learn, user-friendly and low cost". The new version embodies "simplifying management" as its core design principle. It focuses on enhancing the adaptability of small enterprises, assisting them to flexibly use financial applications for business and further reduce the difficulty and cost of application and maintenance.

(2) *Middleware*

During the reporting period, the Group launched the Apusic 5.0 Application Server, a ground-breaking middleware product that is the fourth in the world and the first in China to have passed Java EE 5.0 (the next generation enterprise development standard) certification. The Group also launched Apusic MQ message middleware and the Apusic Studio, a series of integrated development environment products. These, together with the Apusic Application Server became a featherweight enterprise infrastructure software platform, providing operational support for e-government, e-commerce and large-scale industrial and enterprise application.

Product Leadership

Personalised ERP can fulfill customers' needs to construct a management information platform for business expansion



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(3) *Mobile Commerce and Internet Business*

During the reporting period, the Group tapped into the mobile commerce and Internet business and launched mobile ERP products. The new products embody "Business Anywhere, Management Anywhere" as their core value and complement the development trend of the mobile and Internet markets to provide enterprises with informatization services anywhere and any time.

2. Sales and Distribution

During the reporting period, leveraging on its 40 direct subsidiaries in the Mainland and Hong Kong, the Group expanded its direct sales business on a gradual basis and further widened its network of cooperative partners through the "Personalized ERP Value-Added Partner Scheme".

(1) *Direct sales was highly effective in securing benchmark customers in various industries and has achieved steady growth*

During the reporting period, EAS products achieved a breakthrough in growth due to recognition by a number of large-scale group enterprises. Contracts in relation to EAS were entered into with large-scale group customers such as China Vanke Co., Ltd, China South Locomotive and Rolling Stock Industry (Group) Corporation, China Huadian Corporation, Shanghai Airlines Co., Ltd, Want Want Group, Zhejiang Communications Investment Group, Hopson Development Holdings Limited, Guangzhou Automobile Group Co., Ltd, Dalian Port Corporation Limited and Lutianhua Group. The contracts with these large-scale enterprise groups made a strong impression on a wide range of small and medium sized enterprises and helped the Group to further consolidate its leading position in the small and medium sized enterprise market.



During the reporting period, K/3 maintained its leading position in the small and medium sized enterprise market and successfully established its presence in the machinery, electrical appliance, vehicle parts and equipment and transport industries. It also secured a large number of benchmark customers in various industries, such as Truly Semiconductors Ltd., Fuji Xerox High Technology (Shenzhen) Co., Ltd, Mitsubishi Electric Dalian Industrial Products Co., Ltd, US Tenneco (Asia Pacific), Shenzhen Lianchuang Industry Co., Ltd, Sahn Heavy Duty Machine Co., Ltd and Karl Mayer Textile Machinery Ltd. These customers also had a strong and positive effect in demonstrating the strength and benefits of K/3 for a wide range of small and medium sized enterprises.

During the reporting period, the middleware business achieved ground-breaking development and contracts were entered into with large government authorities such as the General Administration of Quality Supervision, Inspection and Quarantine and the Ministry of Supervision, and renowned enterprises such as Lutianhua Group and Ningxia Coal Group.

During the reporting period, the Group established strategic cooperation with several subsidiaries of China Mobile to jointly promote enterprise mobile application products. Customers of the Group's mobile business products include distinguished enterprises such as Hunan AvaDairy Company Limited, Shenzhen Lianchuang Industry Co., Ltd and Shanghai Siyuan Electric Co., Ltd.

(2) *The distribution business grew steadily, and the number of consultation partners and value-added development partners rose, further increasing market coverage*

During the reporting period, the Group continued to implement its distribution strategy of "Partner Oriented". While assisting existing partners to enhance their capabilities, the Group also continued to step up the recruitment of partners and enlarge its distribution network to cover municipalities so as to get closer to its customers and ensure prompt response in terms of sales and service delivery. At the end of 2006, the Group had approximately 1,200 distribution partners. With the establishment of the partner grading system, KIS was distributed solely by distribution channels, enabling a further increase in market coverage.

During the reporting period, the Group continued to strengthen cooperation with consulting firms, setting up the "Kingdee&IBM Cooperative Lab for ERP" and forming strategic alliances with more than 10 renowned domestic consulting firms to provide services in a number of professional areas such as finance, IT planning and HR. These measures contributed significantly to the Group's exploration of the high-end market and the provision of value-added services to its customers.

During the reporting period, the Group accelerated the construction of a software industry eco-chain to cater to the trend of personalization, leveraged on its leading business foundation software platform – Kingdee BOS – to step up the recruitment of value-added development partners, and successfully launched solutions specifically designed for the pharmaceutical distribution, pharmaceutical manufacturing, chemical, food, property management and foreign trade sectors so as to satisfy the personalized needs of its customers.

(3) *International business continued to grow at a rapid pace*

During the reporting period, the Group's international business continued to grow at a rapid pace and contracts were entered into with a number of renowned international enterprises which are global bellwethers in the logistics, electrical machinery and machinery industries, including FedEx and Noble Group.

During the reporting period, the Group successfully tapped into the markets of Association of Southeast Asian Nations such as Singapore, Indonesia and Malaysia with its distribution model. The Group established cooperative partner relationships with numerous local IT companies and entered into contracts with a number of local customers engaged in the manufacturing business.

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3. Customer Service

During the reporting period, the Group's service business experienced rapid growth. Leveraging on its large customer base and adhering to its service principle of "Proactive Services, Prompt Response", the Group focused on promoting sales to existing customers, setting up a Kingdee online customer service center and a call center with the aim of providing personalized services for a wider range of customers at a lower cost and higher speed, and succeeded in raising the satisfaction level of its customers. The Group also established a project management platform and effectively monitored implementation procedures, shortened the implementation cycle, lowered implementation costs and promoted the sharing of implementation cases and experience. In addition, the Group began to step up the exploration of the training and education markets and set up ERP laboratories with 83 colleges and universities so as to strengthen the training and development of ERP talent and the education of Kingdee's potential users in future.

4. Organization and Culture

During the reporting period, the Group continued to strengthen its organization capabilities, further optimized its organization structure, implemented matrix management in the product department and seven major segments, with the view to ensuring quicker response of the product research and development department to market trends and faster delivery of products by distributors. The Group continued to uphold the principle of "Enable staff's success", attract high caliber talent and strengthen the training of internal professional and management staff. The Group also continued to optimize its control and management system and promote the "business standardized, management systemized and employee professionalized" so as to lay a solid foundation for the Group's sustainable, rapid and steady development.

Financial review

For the year ended 31 December 2006, the Group's turnover amounted to RMB611,443,000, representing an increase of 16% over 2005 (2005: RMB529,343,000). This was mainly attributable to steady growth of demand for enterprise application software from Chinese enterprises as well as the proper implementation of the Group's operation strategies.

During the year, the Group realised revenue of software of RMB413,114,000, representing an increase of 10% over 2005 (2005: RMB377,105,000), and service revenue of RMB186,144,000, representing an increase of 27% over 2005 (2005: RMB147,137,000). During the year, the Group's cash flow generated from operating activities was RMB210,124,000, representing an increase of 50% over 2005 (2005: RMB140,523,000).

During the reporting period, the debtor turnover days was 81 days (the average of the debtor balance at the beginning and the end of the year divided by the total revenue of the year times 365 days) (2005: 85 days). During the reporting period, the Group made efforts to manage and recover the receivables and hence maintained the account receivables turnover at a reasonable level.

For the year ended 31 December 2006, the profit attributable to equity holders of the Company was RMB97,377,000, representing an increase of 35% over 2005 (2005: RMB72,290,000). During the year, the net profit margin was 16% (2005: 14%) and the basic earnings per share was RMB0.22 (2005: RMB0.16). The improvement of net profit was attributed to the Group's appropriate control over the costs and expenses while maintaining a growth in revenue, reflecting the Group's achievement in economies of scale.

Gross profit

The gross profit of the Group increased by approximately 15% from RMB425,497,000 for the year 2005 to RMB490,248,000 for the year 2006. During the period, the gross profit margin was approximately 80% (2005: approximately 80%).

Selling and marketing expenses

The selling and marketing expenses for the year 2006 was approximately RMB279,175,000 (2005: RMB256,134,000), representing an increase of 9% over last year. The selling and marketing expenses accounted for 46% of the turnover while the percentage for 2005 was 48%. The reduction in proportion of selling and marketing expenses was mainly due to the fact that there were appropriate controls over spending on advertisement. In addition, with the transformation to distribution sales model, the Group stressed on strict control over the number of direct sales staff and improvement of staff capabilities, and thus the salary of sales staff increased at a slower pace.

Administrative expenses

Administrative expenses for 2006 amounted to RMB180,679,000 (2005: RMB150,340,000), representing an increase of approximately 20%. During the period, administrative expenses accounted for 30% of the turnover while the percentage for 2005 was 28%. This was mainly due to the increase of investment in EAS, K/3 manufacturing and new business such as internet and mobile commerce. The cost of R&D was approximately RMB69,858,000, representing an increase of 38% as compared with 2005 (2005: RMB50,476,000). Other administrative expenses were effectively controlled.

Capital expenditure

For the year ended 31 December 2006, the Group's major capital expenditure included the construction cost for Shanghai and Shenzhen Research Centers of RMB36,935,000 (2005: RMB12,271,000), the R&D capitalised expenses of RMB 53,356,000 (2005: RMB39,128,000), and the purchase of computer and related equipments of RMB11,214,000 (2005: RMB8,530,000).

Financial resources and liquidity

The Group possessed a healthy cash flow position. As at 31 December 2006, the Group had cash and cash equivalents amounting to approximately RMB358,845,000 (2005: RMB242,053,000). Current ratio was 2.05 (2005: 2.13) and gearing ratio (defined as the ratio of bank borrowings to shareholder equity) was approximately 8% (2005: 8%).

As at 31 December 2006, the Group's short-term bank loan amounted to RMB37,150,000 (2005: RMB30,000,000). As at 31 December 2006, the Group did not have any long-term bank loan.

As at 31 December 2006, the Group was not subject to any material exchange rate exposure, and had not entered into any foreign exchange futures contract to hedge against any fluctuation in exchange.

As at 31 December 2006, the Group did not have any material contingent liabilities (2005: nil).

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Future Prospects

As the Chinese economy maintains its rapid growth in future, an increasing number of distinguished Chinese enterprises will select and use the Group's enterprise management software solution. The Chinese management model derived from the working experience with these outstanding enterprises will provide product differentiation and a stronger competitive edge for domestic software manufacturers over overseas competitors. In addition, the trend towards personalization by corporate customers represents a higher entry barrier for software manufacturers, but with its competitive edge in "Middleware + ERP" core technology and services, the Group will gain more development opportunities.

The Group is fully confident of the development prospects of the enterprise management software and middleware market and the expansion of its new mobile and Internet business. The Group will continue to implement the "Personalized ERP Plan", so as to further consolidate its leading position in the personalized management software market. The Group endeavors to become the No. 1 company in the small and medium sized enterprise ERP market in Asia Pacific, the brand that ranks first in China enterprise application software market and the leader in China middleware software market.

In 2007, the Group will further increase its investment in the research and development of enterprise management software and middleware products, construct a value-added development partner eco-chain, tap into the mobile commerce and the Internet application markets and provide personalized products and services to a wider range of customers. This will add value to customers' businesses and continue to strengthen the Group's competitive edge in product differentiation. Leveraging on its large customer base, the Group will step up sales promotions to existing customers and increase customer service income on an ongoing basis. The Group will also explore the training and education market by focusing on customer training and certification.

In addition, the Group will leverage on its product and technological strength to actively seek overseas cooperation partners, complete the localization of its products and services and accelerate the expansion of its international business. While strengthening its corporate governance structure and its investor relationships, the Group will continue to pursue appropriate merger and acquisition opportunities that are in line with its business development strategies.



Partner Oriented
Number of distribution partners has reached approximately 1,200



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Customer Services
Established online customer service platform
and call center to increase customers'
satisfaction