

# MANAGEMENT DISCUSSION AND ANALYSIS

## Overview

2006 was a challenging year for the Group having to manage industry and company specific issues. Nevertheless, with shrewd foresight, the Group was able to devise and implement proactive measures which allowed it to exit the year on a stronger foundation. Apart from stronger customer ties and better product offerings, it has expanded business coverage to beyond mobile phones. The Group has also enhanced its infrastructure including its information technology system and organization structure so as to support its increasingly spread out and diverse business needs. The Group as a flexible fabless designer sees business cycles offering it opportunities to improve.

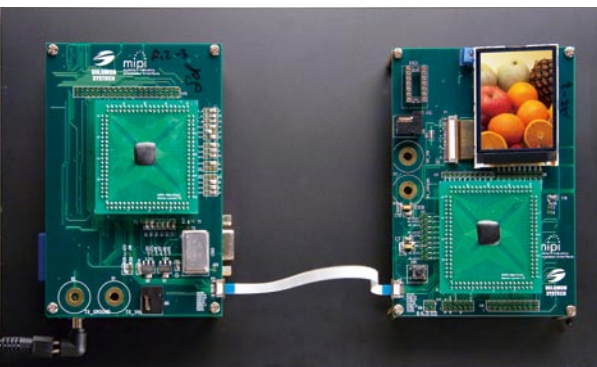
For the full year, the Group shipped some 230 million units of display IC (2005: 263 million units), mainly in the CSTN LCD category. It missed the business targets set for OLED and L-TFT as a result of unanticipated exit of customers in the display industry. A severe slow down in demand was recorded in 3Q 2006, making it difficult to achieve sequential unit growth. Nevertheless, momentum returned in 4Q 2006 with the Group achieving the second highest quarterly unit shipment in its history. As a positive note in 2006, the Group began volume shipment of bistable display driver IC for E-paper applications in 4Q 2006 and shipped more than 10 million units of the IC as at the end of the year. The Group also made progress in business development of Display System.

In 2006, the mobile phone industry grew approximately 25%. As for the Group's share in the mobile phone display driver IC market for the year, the estimate was 16-18%, compared to 20% in

2005. The decline was the result of the slower than expected growth of the Group's m-TFT business. To rectify the situation, the Group executed business plans to strengthen ties with more top-tier phone brand names as well as their preferred module makers. The Group also brought in technology differentiators to strengthen customer ties. As an example, the Group introduced the world's first MIPI compliant master bridge chip for mobile applications that boasts high video quality.

OLED and L-TFT had setbacks because several OLED panel customers and the anchor L-TFT panel customers chose to scale down or exit the market. The Group continued to deploy resources in these businesses because of the abundant sales opportunities presented by organic display and large display. Efforts are being undertaken to design into new applications and new customers to re-ignite growth momentum.

The Group's bistable display IC supports Motorola's Motofone, the world's first mobile phone with E-paper display. After Motofone was launched, the market has shown keen interest in exploring different potential applications of E-paper with features that enable new display functions beyond the capability of other display technologies. The Group has been approached by potential customers in different sectors from consumer electronics, communications to computer and a wide array of industries to evaluate and explore the application of E-paper in their products as a new value-added feature. The Group has invested resources into extend volume application of the new display technology beyond mobile phones to such as smart cards, timepieces, memory cards, price tags and gift items.



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To realize the maximum value of its key asset – its human resources, the Group improved its infrastructure during the year. In 2006, the Group adopted Oracle's Enterprise Resource Planning (ERP) System to help meet its operational needs. Apart from ensuring smooth operation, the ERP system also provides detailed operational analysis that can facilitate fast and accurate decisions by the management. The Group also realigned human resources to maximize internal efficiency and capability.

The Group continued to focus on IP generation and introducing new products, which it sees as critical initiatives to support its current and future successes. The Group's design team rose to the challenge and achieved a record high of 181 design-wins in 2006, up 25% year-on-year.

For the year 2006, the average trading volume of the Group's share rose to 22.2 million a day, compared to 13.6 million in 2005. The Group continued to be a constituent in the MSCI Standard Index Series and Small Cap Index Series for its share liquidity, free float, industry and country representation. The Group's free float stayed above 80%. The Group conducted share buybacks and cancelled 8.5 million shares to enhance the net asset value.

Last but not least, the Group received a great number of awards presented to it by various entities, ranging from customers, the semiconductor industry to the investment community.

## MANAGEMENT DISCUSSION AND ANALYSIS (continued)

### Financial Review

#### 5-year Financial Summary

US\$ million	2006	2005	Restated <sup>v</sup> 2004	2003	2002
Sales	254.1	394.1	308.2	109.3	60.0
Gross profit	59.3	119.6	96.6	46.0	20.9
Net profit	22.4	76.3	57.9	22.7	6.8
<b>Assets and liabilities</b>					
Total assets	221.1	270.3	250.1	81.6	48.5
Total liabilities	(41.2)	(63.3)	(73.4)	(31.7)	(15.1)
Shareholders' funds	179.9	207.0	176.8	49.9	33.4
<b>US cents</b>					
Earnings per share					
Basic <sup>i</sup>	0.91	3.12	2.63	1.09	0.33
Diluted <sup>ii</sup>	0.90	3.08	2.50	N/A	N/A
Dividends per share	0.77	2.44	1.88 <sup>iii</sup>	0.85 <sup>iii</sup>	3.40 <sup>iv</sup>
Net asset per share <sup>i</sup>	7.29	8.47	8.02	2.41	1.61

The Company was incorporated on 21 November 2003. The financial information for the year 2002 to 2003 has been prepared using the merger basis of accounting regarding the Group comprising the Company and its subsidiaries as a continuing entity.

- i The basic earnings and net assets per share are based on the weighted average of 2,074,852,711, 2,074,852,711, 2,204,501,037, 2,445,135,773 and 2,467,035,647 ordinary shares in issue during each of the years ended 31 December 2002, 2003, 2004, 2005 and 2006, respectively. In determining the weighted average number of ordinary shares in issue, a total of 1,808,846,553 ordinary shares were deemed to be issued as at 1 January 2002. For 2004, 2005 and 2006, the number is based on the weighted average of ordinary shares in issue excluding own shares held during the year.
- ii The diluted earnings per share information was not presented for each of the years ended 31 December 2002 and 2003 as there were no dilutive potential ordinary shares. For 2004, 2005 and 2006, the diluted earnings per share information is based on 2,320,846,751, 2,473,217,108 and 2,491,931,274 ordinary shares respectively, which are the adjusted weighted average number of ordinary shares outstanding to assume conversion of all share options outstanding but excluding unallocated own shares held during the year.
- iii As the first interim dividend of 2004 paid on 1 March 2004 was attributable to the results of 2003, such interim dividend has been included in the computation of dividend per share for 2003 and excluded from the computation for 2004.
- iv The dividend was paid by Solomon Systech Limited ("SSL"), a wholly owned subsidiary of the Company, to its then shareholders during the year. The number of SSL's shares in issue at the time of the payment was 183,290,271 shares.
- v The results for 2004 and the assets and liabilities as at 31 December 2004 have been restated to reflect the adoption of the new / revised standards and interpretation of Hong Kong Financial Reporting Standards.

#### Sales and profit

The Group's sales were US\$254 million (2005: US\$394 million). The decline was mainly due to (1) average selling price erosion of 26%, (2) severe demand slowdown in 3Q 2006 and (3) the new business of m-TFT not taking off as quickly as the Group had expected. Gross profit at US\$59 million was 50% lower year-on-year as a result of the lower unit shipment and average selling price. The Group's effort to lower manufacturing cost had limited the decline of gross profit margin. The gross profit margin for the year was 23.3% (2005: 30.3%).

The Group employed more resources to conduct business and product development, leading to moderate increase in SG&A and R&D expenses. For other operating expenses, the Group took a provision of US\$1.4 million for impairment loss of investment because an invested entity planned to cease operation in 2007. With the higher expenses and lower gross profit, the Group's net profit for the year was US\$22.4 million (2005: US\$76.3 million).



The Group continued to expend on R&D and business development in order to stay competitive and facilitate capture of more business opportunities by its innovative products.

### **Liquidity and financial resources**

Net cash flow from operations during the year was US\$25 million. Net cash of the Group amounted to US\$122 million at year-end, compared to US\$163 million as at 31 December 2005. The change in cash position was mainly a result of (1) dividends payments of US\$55 million, (2) fixed asset purchase of US\$9 million, and (3) corporate strategic investment of US\$7 million. The Company conducted share buybacks that consumed US\$1.5 million, resulting in the cancellation of 8.5 million shares. Regarding the cash reserves, the Group will continue to invest in product development, to secure production capacity, and to invest in corporate ventures while keeping a healthy level of cash to meet general corporate purposes. As at 31

December 2006, the Group had no borrowings and its cash balance was mainly deposited in interest-bearing accounts.

All of the Group's account receivables and most of its payables are quoted in US dollars. The Group closely monitors foreign exchange rates, and seeks to obtain favorable exchange rates for conversion of US dollars into other currencies for the payment of local operating expenses. During the review period, the Group did not use any derivative instruments to hedge its foreign currency exposure as it considered the exposure to be insignificant.

In light of the Group's net profit and relatively rich cash position, the Board of the Company proposed a final dividend of 4 HK cents per share to shareholders whose names appear on the Register of Members of the Company on 3 May 2007. In summary, the full year dividends per share of 6 HK cents represent a payout ratio of approximately 86%, or a yield of 2.5% based on the average daily closing price of HK\$2.38 for 2006.

### **Capital expenditure and contingent liabilities**

In 2006, the Group spent a total of US\$16 million in capital expenditure, of which US\$9 million belonged to fixed asset purchase and US\$7 million belonged to strategic investment. Fixed asset purchase was primarily consisted of spending on computer hardware and software, intellectual property ("IP") licenses, research and development tools, critical packaging and testing equipment. Currently, all research and development tools are located in the Group's offices while all production equipment is consigned to sub-contractors or located in the manufacturing subsidiary in Dongguan. As at 31 December 2006, the Group had no material capital commitments or contingent liabilities.

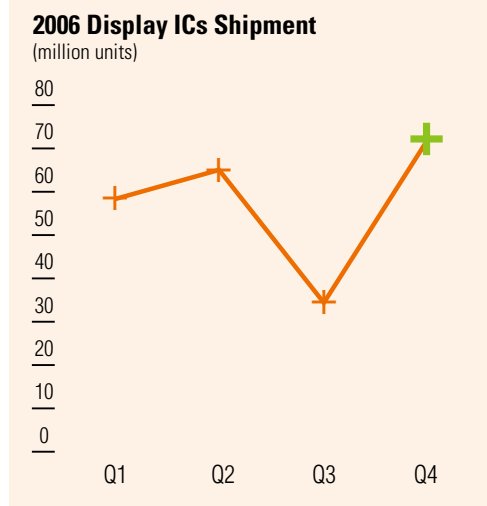
## MANAGEMENT DISCUSSION AND ANALYSIS (continued)

### Business Review

#### Products shipment

For 2006, the book to bill ratio stood at 1.0 (2005: 0.93). In total, the Group shipped 229.7 million units of display IC. The unusually weak demand in 3Q 2006 caused the annual unit shipment to decline by 13% year-on-year. After achieving a strong start in 1H 2006 with unit shipment growth of 16% year-on-year, the Group experienced a severe demand slowdown in 3Q 2006 and shipment plunged to the lowest level for the year. Demand picked up again in 4Q 2006 and shipment amount bounced back to the second highest quarterly unit shipment in the Group's history. The blended average selling price (ASP) of the Group's products was US\$1.11, down from US\$1.50 for 2005. The decrease was mainly due to the pricing pressure exerted at the end-customer level.

LCD (STN, TFT) remained the most popular and dominant display technology found in mobile devices. Therefore, a vast majority of the Group's shipments still fall under the LCD category while transition from STN to TFT is underway. m-TFT had a severe sequential decline caused by customers'



product transition as well as slower than expected ramp in new designs. On the OLED front, several panel makers announced their withdrawal from this area of business in 2006, and that affected the overall market demand for OLED driver IC and in turn the size of shipments made by the Group. Bistable display IC achieved strong growth with over 10 million units shipped in 2006, reflecting the successful adoption of E-paper technology in mobile phones and watches. Meanwhile, Large Display of Display Panel and Display System shipped a small amount of ICs in 2006.

Display IC Shipped (million units)	2006	2005	Growth
Monochrome STN	43.3	45.3	-4.4%
Color STN	133.6	142.5	-6.2%
m-TFT	18.9	33.5	-43.6%
OLED	22.0	40.5	-45.7%
Bistable	10.3	—	+%
L-TFT	0.8	0.3	+166.7%
Miscellaneous	0.8	0.9	-11.1%
<b>Total</b>	<b>229.7</b>	<b>263.0</b>	<b>-12.7%</b>

Note: Miscellaneous includes graphics controller, image processor, microdisplay controller and others.



The world's first MIPI master bridge chip introduced by the Group should find applications in portable devices that require high video quality such as mobile TV.



The Group currently serves most of the major display module makers in the world. It will focus on approaching ODM and IDH directly to tighten connection with essential constituents in the value-chain.

### ***New products and customers***

The Group added 26 new products in 2006 for customer design-in and volume production, similar to 2005's total of 27. 16 of the 26 new products were mobile phone related ICs, including 9 belonging to the m-TFT. As part of its efforts to expand sales beyond mobile phones, the Group introduced a new bistable display IC for electronic signs, digital timepieces and smart cards. Regarding products under Display System, four new image processors were released for applications such as car AVs, digital photo frames, electronic dictionaries, MP4 players, Global Positioning Systems (GPS) and industrial products. Moreover, the Group introduced a world first MIPI master bridge chip that contained an interface in compliance with MIPI specifications. It should find applications in portable devices that require high video quality such as mobile TV and game consoles.

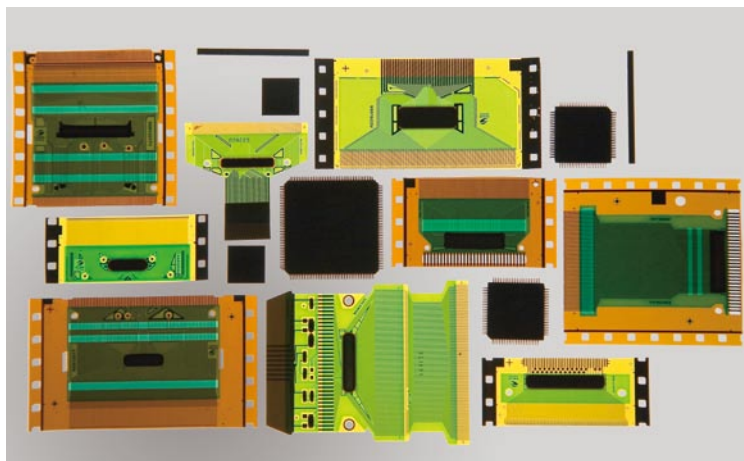
To win new business from existing or potential customers, the Group believes that apart from competitive pricing, its capability to offer field

application support and reliable solutions are equally important. In 2006, the Group directed more resources in providing customers with more timely services and support.

In the Display Panel segment, the Group currently serves most of the major display module makers in the world. It is the Group's objective to focus on approaching ODM (original design manufacturer) and IDH (independent design house) directly so as to tighten connection with essential constituents in the value-chain. The Group plans to develop more business with Korean and Japanese customers, which will give it the leverage to ultimately forge relationships with more top-tier mobile phone brand names.

In the Display System segment, the Group provides customers with "total display IC solutions" for high volume specific applications. With an enlarged product offering, the Group is able to reinforce its business ties with existing customers and build relationship with new end-product manufacturers.

## MANAGEMENT DISCUSSION AND ANALYSIS (continued)



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Research and development capability is one of the Group's core competences.

### **Research and development**

Research and development capability is one of the Group's core competences. The Group's management team regularly keeps track of the Group's research output and its customers' new requirements in connection with product features or specifications.

During the year, the Group spent roughly US\$17 million on research and development. As at 31 December 2006, the Group had a research and development workforce of more than 210. The expanded R&D headcount mirrored the Group's determination to expand its business, capture more business opportunities and stay ahead in the competition by developing and offering innovative products for tomorrow's applications.

The Group's existing and future products are supported by three technology centers located in Hong Kong, Shenzhen and Singapore. The research and development team in Hong Kong helps the Group with developing products across its entire portfolio, while the Shenzhen operation takes on OLED and Large Display projects and the Singapore team focuses on multimedia IC and IP development.

In terms of wafer technology under development, the Group's products employ a range of fine technologies from 0.13 $\mu\text{m}$  to 0.6 $\mu\text{m}$ , depending on cost performance measure against customers' specific requirements. Last but not least, the Group filed 6 patents and published 3 technical articles in 2006.

### **Human Resources**

As at 31 December 2006, the Group had 394 employees, 23% more than the previous year. Approximately 59% of the employees was based in its Hong Kong head office. In 2006, the Group recruited three senior management members for its operation and corporate development departments.

As a technology company, the Group highly values its human resources. To reward good performance and retain talents, the Group offers competitive remuneration to employees and provides employees with relevant trainings, career development programs, job satisfaction and a first-rate working environment in the hope that they will enjoy working for the Group and contribute their efforts to the Group's success.

In the first half of 2006, most employees were granted cash bonuses and shares of the Company to reward their performance in 2005. At the Board level, directors were awarded options for their past and forthcoming contributions to the Group.

## Prospects

Following the 2005 initiative to establish two distinct business units, namely Display Panel and Display System, the Group has made progress and is better positioned to grow its business through product diversification.

### **Display Panel**

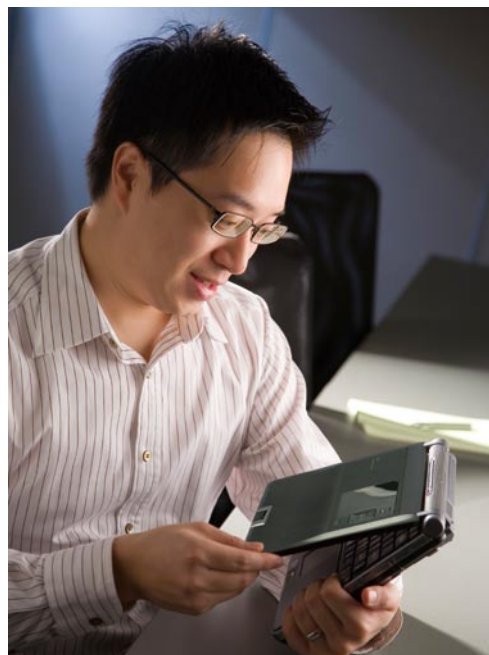
#### **Mobile display**

Mobile phone will remain to be the dominant application for mobile display driver ICs. m-TFT had surpassed color STN to become the top display technology in 2006. m-TFT, color STN and monochrome STN will continue to be the major display technologies in 2007. OLED and bistable display technologies will continue to improve and accordingly gain greater market acceptance. The different technologies are in different phases of growth because of their uniqueness in display characteristics. Generally speaking, the mobile phone market will continue to migrate towards incorporating displays that are larger (e.g. from 1.0-in to 3.2-in) and can support more colors (e.g. from monochrome to 1,600k colors), higher resolution (e.g. from QCIF to VGA) and more demanding multimedia features (e.g. 3MP embedded camera, mobile TV).

Although market researchers forecast mobile phone's unit growth to taper towards 10% (2007) from around 25% (2006), the Group expects its unit shipment to grow at a rate above the industry average in 2007 now that it has a complete set of display solutions fitting requirements of all segments. With mature presence in the

monochrome and color STN segment, the Group sees potential growth primarily for its m-TFT and bistable display business. Seeing flat to low unit growth rate for STN products, the Group intends to strive for market share gain by introducing more cost competitive products.

To boost its relatively low share in the m-TFT market, the Group will devote more efforts into improving customer relationships, developing product leadership and extending into other volume applications. The Group is making progress in improving relationships with mobile phone brand names and IDH as well as module makers who are gaining influence in m-TFT supply chain management. The Group will continue to improve the competitiveness of its m-TFT products with die shrinkage and through enhancing their functions and integrating different features. Driven by the launch of Microsoft's Vista, the Group has recently extended m-TFT to cover Sideshow applications in notebook computers.



Mobile Display – Driven by the launch of Microsoft's Vista, the Group has extended application of its m-TFT to cover Sideshow applications in notebook computers.



## MANAGEMENT DISCUSSION AND ANALYSIS (continued)



New Display – The Group is developing new high volume applications for its bistable ICs such as in flash memory card, electronic signs, and IC cards, which did not have displays incorporated previously.



New Display – The Group's microdisplay IC can be applied in high definition movies, stereo 3D games entertainment as well as viewfinders of high-end digital cameras.

The Group will continue to develop OLED applications. Initial volume drivers, namely mobile phone (especially sub-display) and MP3 player, will require new OLEDs. Portable video player (e.g. MP4) and notebook sub-display are examples of new drivers and other potential applications of new OLEDs include Bluetooth headset, timepiece, radar detector, GPS, and industrial applications. Although several panel makers who saw uncertainties in the future of OLED exited from the market, the Group intends to extend its leadership into active matrix OLED (AMOLED) which commercial use is expected to begin in 2007.

### Large display

In spite of lacking a new anchor customer after Quanta Display Inc.'s merger with AU Optronics, the Group continues to see potential reward from

persistently developing its large display driver IC business with an estimated market value of more than US\$3 billion a year. The Group is working with a few large TFT LCD panel makers in Japan and the Greater China region on new design-ins. To improve customer service, timing controller products are relocated from Display System to Large Display to facilitate bundling into total solutions. In the short run, progress will possibly be affected by low likelihood of imminent shortage in driver IC due to panel demand seasonality and slower than planned capacity ramp as panel makers encounter challenging times to stay profitable.

### New display

The Group expects bistable display IC business to emerge as an important future growth driver. While mobile phone will be the major application

in 2007, the bistable IC business is expected to grow faster than the Group's average growth as more applications adopt E-paper display. The Group is developing opportunities in high volume applications besides mobile phones and watches, namely flash memory cards (e.g. SD cards), electronic signs (e.g. remotely controlled price tags) and IC cards (e.g. smart cards) which did not have displays incorporated previously.

The Group continues its collaboration with Kopin to promote the application of microdisplay technology in video-on-the-go eyewear systems. The Group's microdisplay IC can be applied in high definition movies, stereo 3D games entertainment as well as viewfinders of high-end digital cameras. As the pricing of microdisplay module with VGA resolution has lowered to a level affordable for the mass market, the Group is well positioned to reap financial benefits from sales of the product. Overall, the Group believes the demand for new display applications will surge, thus it will keep researching and expanding this business to make sure it stays ahead in the competition.

### ***Display System***

This business unit focuses on developing total solutions that complement display panel IC or enrich the image, graphics or functionality of a display. It covers three product families, namely high-speed interface IC, controller and multimedia processor. High-speed interface ICs, for example, the MIPI, MDDI and LVDS, deal with connectivity in a mobile phone, TV or other portable consumer products. Regarding controller, the Group launched image processor for portable products. In the area of multimedia processor, the Group will develop total solutions for high volume applications with strategic alliances.

The Group expects Display System to contribute higher sales in 2007 with its higher level of product readiness. Leveraging its early leadership in MIPI, the business unit will develop more products including IP to grow with increasing demand for mobile TV and VGA features. The Group will promote reference designs using its multimedia processor to accelerate customer's time-to-market of their products. By offering "total display IC solutions" to customers, the Group's Display System business can help to fortify the Group's relationship with key customers. In the long run, the Group believes this business will see strong sales growth and a more balanced business mix.



Display System – With early leadership in MIPI, the Group will develop more products including IP to grow with increasing demand for mobile TV and VGA features.