

Management Discussion and Analysis

The following discussions should be read in conjunction with the audited financial statements of the Company and its subsidiaries (collectively as "the Group") and the notes thereto contained in this annual report and other sections.

1. Market Overview

For the year ended 31 December 2006, the continuous growth of the world economy and the weakening of US dollar have sustained the bullish metal commodities market. The continuous increase of energy prices alongside the influence of the investment institutions and geographical political tensions contributed to a bullish gold market in 2006.

The average spot price of international gold in 2006 was US\$603.46 per ounce (based on afternoon fix price of London Gold Market), representing an increase of approximately 35.69% from the average price of US\$444.74 per ounce in 2005. The opening price was US\$530 per ounce, and the closing price was US\$632 per ounce respectively in 2006. The highest price was US\$725 per ounce and the lowest price was US\$524.75 per ounce. The trend of the domestic gold price is basically in line with international market with gold price increasing significantly. On the Shanghai Gold Exchange, the Au9999 gold price recalled a historical high of approximately RMB186.51 per gram in 2006.

The average price of gold sold by the Company during the year was approximately RMB154.76 per gram (approximately US\$616.8 per ounce), representing an increase of approximately 31.4% compared to the prior year.

2. Industry Position

During the year ended 31 December 2006, the Company maintained its position as the leading gold producer in the PRC, and stayed as a gold "pure play". According to the statistics of the China Gold Association in 2006, the national gold production amounted to approximately 240,078 kg including approximately 179,848 kg of mine-produced gold, representing an approximately 0.72% growth over last year. The Group produced approximately 15,648 kg (approximately 503,095 ozs) of gold in 2006, including approximately 6,271 kg of mine-produced gold, representing approximately 6.5% of the total gold output in the PRC, and approximately 3.5% of mine-produced gold in the PRC.

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3. Revenues

For the year ended 31 December 2006, the Group's revenues were RMB1,164,415,000, representing an increase of approximately 34.2% as compared to the prior year.

For the year ended 31 December 2006, the Group had attained an aggregate gold production of 15,648 kg (approximately 503,095 ozs), representing an increase of approximately 25.4% as compared to the prior year.

4. Net Profit

For the year ended 31 December 2006, net profit was approximately RMB349,651,000, representing an increase of approximately 119% as compared to the prior year.

5. Earnings per Share

For the year ended 31 December 2006, earnings per share of the Group amounted to RMB0.54 (before interest income arising from share application funds) and RMB0.65 (after interest income from share application funds) respectively.



6. Analysis of Results

The significant growth of earnings was mainly attributable to the substantial increase of gold production of the Group, effective cost control, and a higher average selling price of gold.

7. Business Review

Significant achievement in construction projects

For the year ended 31 December 2006, the Group regarded construction projects as an important measure to enhance its profitability and further enlarge its production scale. During the year, the Group had seven construction projects in aggregate, details of which are set out as below:

- Mining and processing expansion project for Xiadian Gold Mine, depth mining and processing renovation project of low grade ores for Dayingezhuang Gold Mine, depth extensions and redevelopment of auxiliary facilities for Jintingling, and redevelopment of processing and cyanidation technology for Jinchiling Gold Mine (extension project).
- Depth extension and redevelopment of processing dehydration system for Hedong Gold Mine as planned by the Group, depth extension and improvement of facilities and auxiliaries on the ground for Xiadian Gold Mine, development project for Hainan Dongfang Zhaojin Mining Industry Company Limited (“Hainan Dongfang”).
- Hainan Dongfang has developed a production system comprised of mining, processing, refining auxiliary facilities with production capacity of approximately 100 tonnes per day, which is in trial run.

Increasing capital investment in innovative technologies

During the year, the Group continued to increase its investment in technology in order to enhance its self reliance and level of innovation and accelerate the core competitiveness of the Group’s technology. 18 projects were carried out throughout the year, and progress had been made with respect to areas relating to geological and scientific research, technological research and development, energy-saving technology, information technology development and new materials application.

Highlights include:

- In June 2006, the Department of Science & Technology of Shandong Province hosted a conference on “Research on consolidated technology in respect of recovery by lower middle section of dry-type backfilling” (《幹式充填體下中段礦柱回採綜合技術研究》) of Hedong Gold Mine, in which the department and the experts together recognised that the research had reached a premier level throughout the country and overseas;
- The project of hydro-extraction of metallic copper for Jinchiling Gold Mine has completed scientific research experimental stage, and is currently undergoing small-scale trial production;
- The “Research and Development of Safety Inspection System for Gold Mines” (《黃金礦山安全監測系統的研究與開發》) project of Xiadian Gold Mine had its initial design scheme of inspection and alarm system for underground mine completed. The prior stage of investigation and research of “Research on Mineralization Pattern and Estimates of In-depth Deposits” (《成礦規律研究及深部預測》) was also completed, with success attained eventually;

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- Other projects of “Research and Production of Low Cost and Wear Resistant Steel-plastic Composite Filling Pipe” (《低成本耐磨鋼塑複合充填管研製》) and “Technology of Controlling Grouting in respect of Exceptionally Long Anchor Shaft Mine Roof” (《注漿超長消杆採場頂板控制技術》) of Dayingezhuang Gold Mine were completed and commenced manufacturing operations with ideal results.
- Research on pattern of sulphur-iron ores mineralization of Jingtingling’s Xiejiagou mine was also completed, and was further verified during exploration.

The continuous declining ore grade has also imposed stricter requirements on smelting technologies, and the fact that a substantial portion of gold reserves in the PRC being laborious to process and smelt also created new challenges for the entire gold smelting industry. The Company possesses the self-developed Catalytic Oxidation Acid Leaching (“COAL”) smelting technology in addition to the largest gold smelting plant in the PRC.



The COAL method, which is unique in the PRC at present, can increase the recovery rate in the process of smelting arsenic concentrates that are laborious to process and smelt. With a processing capacity of 200 tons per day, the COAL method is used to process gold and silver concentrates acquired by the Group, which are laborious to process and smelt. Given that approximately 50% of the present gold reserves in the PRC are gold ores that are laborious to process and smelt (50% of which contain arsenic and the remaining 50% contain high sulphur content), the recovery rate would be less than 50% should traditional methods be employed. By employing the COAL method, the recovery rate would raise to above 80% and may even reach 94%. For this reason, the COAL method is of huge potential in the future which will bring us unique edges in the smelting industry in the PRC.

Acknowledgment of results of scientific research

The scientific research of the Group achieved great success in the year being awarded one First Prize of Shandong Province Scientific Technology (山東省科學技術一等獎) and one Second Prize of Shandong Province Scientific Technology; two First Prize of China Gold Association Scientific Technology (黃金協會科學技術一等獎) and two Third Prize of China Gold Association Scientific Technology; the Group



was also awarded with two national patents. The Company was recognized as a technologically advanced nationwide gold group in the “11th Five-Year Plan”, in which two employees were commended as outstanding contributors of technology, three employees were commended as outstanding technology officers and two employees were commended as outstanding personnel of technological management.

Comprehensive development of geological exploration

In the year, the Group has emphasized geological exploration, maintaining its effort in proving, defining, and exploring the depth, boundaries and surrounding areas of old mines, and researching and exploring new areas. The Group cooperated with China Geosciences University (中國地質大學) in conducting the project of “Formation and preservation of Composite Mineralization System and Demonstration of exploration of replacing resources of typical ore deposits in Northwest Jiaodong area” (《膠西北複合成礦系統形成與保存及典型礦帶接替資源勘查示範》), which laid foundations for understanding the mineralization pattern of Zhaoping fault and Jiaojia Wangershan fault. Through the main shafts and no.7 hollow channels, the mineralization pattern was analyzed and comprehensive geological exploration was undertaken. Satisfactory results were attained, indicating a blank orebody with large-scale and lengthy (more than 300 meters) strikes, considerable thickness and high grade. Over the year, the Group altogether invested RMB28,000,000 in exploration, completing a 26,264-meters-long underground exploration project, and a 29,518-meters-long drilling exploration project, which increased the amount of gold reserves by 12.54 tons.

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In order to further increase the reserves and resources of the Group, the Company had increased its developments in other areas outside Zhaoyuan district in the PRC, and completed inspection in areas including Hebei Province and Liaoning Province.

8. Financial Review

Revenues

For the year ended 31 December 2006, the Group's revenue was approximately RMB1,164,415,000, representing an increase of 34.2% as compared to the prior year. Such increase was attributable primarily to the increase in the sales of gold bullion of approximately 36.8% as a result of the increase in the average selling price and sales volume of gold bullion of 31.4% and 3.7% respectively.

Cost of sales

For the year ended 31 December 2006, the Group's cost of sales was approximately RMB541,240,000, representing an increase of approximately 26.4% from RMB428,300,000 in 2005.

Such increase was attributable primarily to the increase of the purchase cost per unit and the cost of raw material as a result of the Group's higher production capacity, growth in purchases volume and the rise in gold price.

Gross profit and gross profit margin

During the year, the Group's gross profit and gross profit margin were approximately RMB623,175,000 and approximately 53.5%, representing an increase of approximately 41.8% and approximately 2.9% respectively from those of 2005. The increase is mainly resulted from the increase in gold spot price.

Other revenues

During the year, the Group's other revenues were approximately RMB16,411,000, representing an increase of approximately 84.6% from that of the last year. Such changes were attributable primarily to the increase in interest income.

Selling and distribution costs

For the year ended 31 December 2006, the Group's selling and distribution costs were approximately RMB5,669,000, representing an increase of approximately 18.2% from that of the prior year. Such increase was in line with the increase in sales.

Administrative and other operating expenses

The Group's administrative and other operating expenses were approximately RMB149,289,000 in 2006, representing a decrease of 4.7% from RMB156,683,000 in 2005. Such decrease was attributable primarily to effective cost control of the Group.

Finance costs

For the year ended 31 December 2006, the Group's finance costs were approximately RMB54,346,000, representing an increase of approximately 17.9% from RMB46,107,000 for the year ended 31 December 2005. Such increase was attributable primarily to the unrealised exchange loss of RMB6,561,000. In addition, the increase was also due to the fact that the People's Bank of China raised its benchmark interest rate from 5.76% in 2005 to 6.3% in 2006.

Income tax

The statutory income tax rate in the PRC is approximately 33%. For the year ended 31 December 2006, the effective tax rate (i.e. the total tax expense divided by its profit before tax) payable by the Group was approximately 32.4% which is comparable to the effective tax rate in 2005.

Profit attributable to Shareholders of the Company

For the year ended 31 December 2006, the Group's profit attributable to Shareholders was approximately RMB351,190,000, representing an increase of approximately 115.6% from RMB162,891,000 for the year ended 31 December 2005.

The net profit margin for the year ended 31 December 2006 was approximately 30%, representing an increase of approximately 11.6% from approximately 18.4% in 2005.

It is recommended that a dividend of RMB0.15 per share, based on a total of 728,715,000 shares, shall be distributed.

Liquidity and capital resources

The working capital and long-term funding required by the Group primarily comes from its operating cash flows and borrowings, while the Group's capital resources are used in its capital expenditures, operating activities and repayment of borrowings.

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Net cash inflow/(outflow) from the followings:

	Year ended 31 December	
	2006	2005
	RMB'000	RMB'000
Operating activities	540,589	338,817
Investing activities	(244,814)	(657,888)
Financing activities	2,261,057	107,832
	<hr/>	<hr/>
Net cash inflow (outflow)	<u>2,556,832</u>	<u>(211,239)</u>

Cash flows and working capital

The Group's cash and cash equivalents have increased by approximately RMB2,556,832,000 from approximately RMB138,565,000 as at 31 December 2005 to approximately RMB2,695,397,000 as at 31 December 2006, attributable primarily to the raising of capital from the Company's successful listing on the Stock Exchange in December 2006.

Net cash flows from operating activities

The Group's current fund primarily comes from cash flows generated from its operating activities. Its net cash inflow from operating activities increased from approximately RMB338,817,000 in 2005 to approximately RMB540,589,000 in 2006, representing an increase of approximately 59.6%, which was attributable primarily to the increased sales volume together with the rise in gold price.

Net cash flow used in investing activities

The net cash flow used in investing activities is mainly affected by its acquisition of properties, plants and equipment, as well as its construction in progress. The net cash flow used in investing activities decreased by 62.8% from approximately RMB657,888,000 in 2005 to approximately RMB244,814,000 in 2006, which was attributable primarily to the Group's cash outflow of over RMB400,000,000 in 2005 for the Group's acquisitions of a subsidiary and a mining operation.

Net cash flow from financing activities

The net cash flow from financing activities is mainly affected by proceeds raised from IPO exercise and movement in the bank loans. Its net cash flow from financing activities increased by 1996.8% from approximately RMB107,832,000 in 2005 to approximately RMB2,261,057,000 in 2006, which was attributable primarily to the proceeds received from its successful listing in Hong Kong in December 2006.

Borrowings

As at 31 December 2006, the Group had outstanding bank loans and other borrowings of approximately RMB733,190,000, of which approximately RMB125,400,000 shall be repaid within 1 year, approximately RMB450,000,000 shall be repaid after 1 year but within 2 years, approximately RMB150,000,000 shall be repaid after 3 years but within 5 years and approximately RMB7,790,000 shall be repaid after 5 years. The gearing ratio as at 31 December 2006 was 14.9%, which is calculated by dividing the total borrowings by the total assets.

All loans of the Group are fixed interest rate loans.

Market Risks

The Group is exposed to various types of market risks, including fluctuation in gold prices and changes in interest rates, foreign exchange rates and inflation.

Gold price and other commodities' price risk

The Group's revenue and profit are sensitive to fluctuations in the gold prices and prices of other commodities. This is due to the fact that the Group generates substantially all of its revenue and profit from the sale of gold and other commodities within the PRC. The Group does not enter into commodity derivative instruments or futures to hedge any potential price fluctuations of gold and other commodities or for trading purposes. Therefore, fluctuations in the prices of gold and other commodities may have a material effect on the Group's revenue and profit.

Interest rate risk

The Group is exposed to interest rate risk. The Group incurs debt obligations in order to satisfy its ordinary corporate uses, such as its capital expenditures and working capital requirements. Interest rates on the Group's bank loans are subject to adjustments by the lenders in accordance with interest rates set by the People's Bank of China (the "PBOC"). Increases in the PBOC interest rate will increase the Group's financing costs. In addition, should the Group need any additional debt financing in the future, the cost of new borrowings would increase due to the increase in interest rate. Our loans are only denominated in RMB and not in any other currencies.

Foreign exchange risk

All of the Group's sales and purchases transactions are carried out in RMB. The fluctuation of the RMB/USD exchange rate may affect the international and local gold price, therefore it may affect the Group's operating results. In the past few years, the exchange rate of RMB has been generally stable. RMB is not a freely convertible currency. However, on 21 July 2005, PBOC increased the exchange rate of RMB against U.S. dollar by 2.1%, and allowed the exchange rate of RMB against a basket of currencies to fluctuate. In view of the above circumstances, the PRC government might take further actions and measures on the free trade of RMB. Therefore, fluctuations in exchange rates may have an adverse effect on our net assets, earnings and any dividend declared, which shall be converted or translated into Hong Kong dollars. The Group has been monitoring the exchange rate between RMB and Hong Kong dollar closely as the proceeds raised by the Group from IPO are denominated in Hong Kong dollars. Meanwhile, appropriate measures aiming at reducing the risk of fluctuation in exchange rates have been taken to minimize such risks. See note 36 on page 150 of this report for details of such measures.

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Number of Staff

Currently there are 4,345 staff in the Group.

Charges

For the year ended 31 December 2006, no charge has been made by the Group.

Substantial Investment

For the year ended 31 December 2006, apart from investments in properties, plants and equipments, no other substantial investment has been made by the Group. Details are in note 13 to the consolidated financial statements in the annual report on pages 113 to 115.

Substantial Acquisition and Disposal

For the year ended 31 December 2006, no substantial acquisition and disposal has been made by the Group.

9. Business Outlook

The influence of instability in geographical politics and the weakening of US dollar continue to contribute to a bullish international gold market. We anticipate an uptrend for the gold price for a certain period of time. Given that over 90% of our profit arises from our gold business due to our "gold pure play" nature, both our turnover and profit are likely to grow should the gold price remains stable in the year 2007.

Due to the rapid development in the international gold industry and advancement in mining technologies, open-pit mines and shallow depth mines of low cost and high grade have been depleting, therefore, the underground resources will become the future focus of the gold mining industry which will in turn increase the complexity and cost of mining. In this respect, we are highly experienced in underground mining over the years as all of our mines are underground mines. With our edge in advanced mining technologies, the Group are well positioned to compete for gold resources.

The Group endeavors to become a leading world-class gold company in PRC and throughout the world, and shall continue to focus on pure gold production for the year 2007 in line with its strategies including:

Expanding deposits by exploration and be a leader in terms of resources

In 2007, the Group plans to establish a site exploration department to reinforce its focus on site exploration and deposit building, and achieve "Four unifications" including unified usage of exploration capital, unified arrangement of exploration projects, unified implementation of exploration operations and unified analysis and evaluation of exploration results. The Group will concentrate on the following four tasks:

1. Exploring ore bodies in existing mines

The exploration in existing mines focus on two wings, two panels and deep levels underground.

2. Geological exploration of blank space in Zhaoyun District

The Company holds 31 exploration licenses in the Zhaoyun District, covering an area of 405 square kilometer. The Group will undertake systematic geological research in this area including, differentiating ore pieces for scientific research, general survey, detailed inspection and exploration, and determining among physical, chemical, drilling and underground exploration. Meanwhile the Group will carry on research on mineralization in the ductile structural zone within the Zhaoyun boundary.

3. Exploration in other areas

The Group will expand its exploration programme in the areas covered by the exploration licences held by Hainan Dongfang and also in Xinjiang as well. It will undertake deep geological exploration project of No. 2 vein and at depth exploration in the No. 1 and 3 mine sites. In addition, we will conduct geological exploration in other potential areas.

4. Acquisition of advanced exploration projects

The Group will try to increase its exploration area and expand its future reserves through acquisitions of exploration rights.

Expanding technical conversion and enhancing production capacity

The Group will apply approximately HK\$500,000,000 (*Note*) of the proceeds raised from its listing for expansion of Dayingezhuang Gold Mine and Xiadian Gold Mine, which will increase production afterwards. Among which:

- As planned, the expansion project of Dayingezhuang Gold Mine includes completing 8,300 meters, 4,300 meters and 21,000 meters of tunneling for auxiliary shaft, the main roadways and conveyor roadways respectively in 2007. Selection of mining and processing facilities as well as purchasing will also be completed in 2007.

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- As planned, the expansion project of Xiadian Gold Mine includes completing 400 metres of tunneling for shaft excavations, the installation of shaft towers, renovation of processing plants and construction of surface auxiliary facilities during 2007.

After completion of these two projects, the ore processing capacity per day for each of these two mines is expected to increase by approximately 1,000 tonnes, which is expected to increase ore processing capacity of the Group to 11,000 tonnes per day.

The Group has planned to invest in total around RMB45 million in conducting 20 technical advancement projects, the majority of the investment will be put into advancement of the current production systems.

External expansion by acquisitions

The Group will fasten its pace of acquisitions as disclosed in the prospectus. The Company plans to gradually invest approximately HK\$500 million (*Note*) in acquisitions and mergers of gold mines. The Group has considered external expansion as the “No. 1 project” in 2007 and a team that leads external developments has been set up with the general manager as its leader. The Group will establish development offices in the northeast, northwest and southwest regions of PRC, in pursuit of acquisition opportunities.

Note: The net proceeds from the Listing are more than what was disclosed in the prospectus, so the Board intends to apply the additional proceeds in the same manner and same proportion as shown in the prospectus.

Developing scientific research and striving for innovative technology

- The main focus of the Group will revolve around three aspects, including scientific innovations, technological research and development as well as advancement in equipment. The Group aims at building modernized gold mines with mechanization, auto- mechanism, and information systems. In order to achieve these goals, the Company will set up a technological centre of Zhaojin Mining Industry (招金礦業技術中心), including an experimental laboratory and a chemical laboratory. An incentive policy and innovative plans will be formulated.
- The Group plans to invest RMB47 million in over 30 new technology development projects. Emphasis will be placed on utilising three-dimensional geological survey software in order to lay solid foundations for building digitalized management system and provide information platforms for deployment and guidance of dynamic production. This will enable management to maximize reserves and resources by adjusting cut-off grades to take account of cost minimization programs and fluctuating gold prices.

Saving energy with production safety

The Group will continue to reinforce its management of safety production through its effective risk analysis and control system, the emergency support system and the management and review system. An information platform in respect of safety management will be established, incorporating safety management software system and personnel positioning system. In addition, upgrades and implementation of auto-reformation of shaft ventilation and water discharge, and reinforcement of adherence to technically safe production levels will be undertaken.

The Group will conduct research on energy-saving developments of existing electric machines, construct energy-saving network, and foster mine mechanization. For mines suitable for mechanized operations, the Group will invest in appropriate equipment, and increase the rate of mechanization to 90% and above.

The Group will continue to focus on environmental protection and workplace safety. It will adhere to safety standards in production especially in focal areas, key devices and vital positions, while acting to improve operational procedures and the rules and regulations system. It will promote educational training, and make funds available to resolve safety issues. The Group will reinforce its management of environmental exposures in order to eliminate sources of pollution and construct a harmonious corporation.