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heights





# Management Discussion and Analysis



**Mr. ZHANG Zhi Yong,**  
*Chief Executive Officer*

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Li Ning Company Limited • Annual Report 2006

## OVERVIEW

The Group's business objectives in 2006 were to sharpen the competitive edge of its core business to ensure strong sustainable growth and to propel new business development, thereby achieving steady profit growth and continual value creation so as to maximize shareholder values.

Strong economic growth and rising consumption power in the PRC, coupled with the imminent 2008 Beijing Olympic Games, have created a favourable macro operating environment for the Group. Riding on its strong brand and marketing capabilities, unmatched product research and development talents, extensive distribution channel and enhancement in supply chain management, the Group has achieved another year of distinguished results in 2006.

## RESULTS REVIEW

### Key Financial Indicators

Key financial indicators of the Group for the year ended 31 December 2006 are summarised as follows:

	Year ended 31 December 2006	2005 (Reclassified– Note 7)	Change (%)
<b>Items of income statement (audited)</b>			
<i>(All amounts in RMB thousands unless otherwise stated)</i>			
Turnover	<b>3,180,543</b>	2,450,536	29.8
Gross profit	<b>1,508,552</b>	1,126,189	34.0
Operating profit	<b>402,518</b>	271,497	48.3
EBITDA (Note 1)	<b>438,407</b>	296,435	47.9
Profit attributable to equity holders	<b>294,846</b>	186,800	57.8
Basic earnings per share (RMB cents) (Note 2)	<b>28.65</b>	18.25	57.0
<b>Selected financial ratios (audited)</b>			
Gross profit margin (%)	<b>47.4</b>	46.0	
Operating profit margin (%)	<b>12.7</b>	11.1	
Margin of profit attributable to equity holders (%)	<b>9.3</b>	7.6	
Effective tax rate (%)	<b>26.4</b>	31.1	
Return on equity holders' equity (%)	<b>23.0</b>	17.2	
Debt to equity holders' equity ratio (Note 3)	<b>0.53</b>	0.35	
Average inventory turnover (days) (Note 4)	<b>70</b>	84	
Average accounts receivable turnover (days) (Note 5)	<b>55</b>	44	
Average trade payables turnover (days) (Note 6)	<b>67</b>	68	

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#### Notes:

1. EBITDA refers to earnings before interest, tax, depreciation and amortisation.
2. The calculation of basic earnings per share is based on the profit attributable to equity holders for the year ended 31 December 2006 of RMB294,846,000 (2005: RMB186,800,000) and the weighted average of 1,029,030,000 ordinary shares in issue during the year less shares held for the Restricted Share Award Scheme (2005: 1,023,827,000 shares).
3. The debt to equity holders' equity ratio is based on total liabilities divided by equity holders' equity as at 31 December.
4. The calculation of average inventory turnover (days) is based on the average of opening and closing inventory balances divided by the cost of sales and multiplied by 365 days.
5. The calculation of average accounts receivable turnover (days) is based on the average of opening and closing balances of accounts and notes receivable divided by turnover and multiplied by 365 days.
6. The calculation of average trade payables turnover (days) is based on the average of opening and closing balances of trade payables divided by total purchases and multiplied by 365 days.
7. See note 2.23 to the consolidated financial statements.



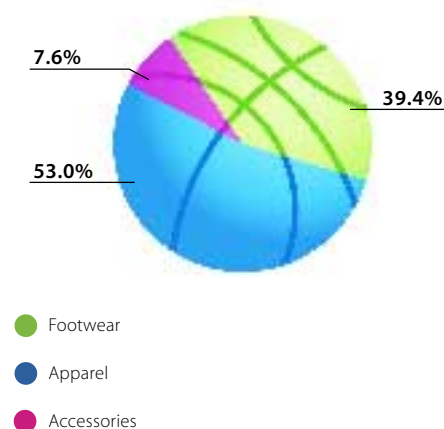
**Turnover**

For the year ended 31 December 2006, the Group's turnover reached RMB3,180,543,000, an increase of 29.8% as compared to 2005. Turnover of LI-NING branded products surged by 35.7% to RMB3,168,045,000 as compared to 2005. The growth was attributable to (i) distinguished brand differentiation and marketing capabilities; (ii) continual expansion of sales channels and network coverage; (iii) successful launch of new product series; and (iv) constant enhancement in supply chain management.

**Breakdown of turnover by brand and product category**

	Year ended 31 December		2005		Change (%)
	2006 RMB'000	% of total turnover	RMB'000	% of total turnover	
<b>LI-NING brand</b>					
Footwear	1,250,956	39.3	843,325	34.4	48.3
Apparel	1,673,924	52.7	1,280,634	52.3	30.7
Accessories	243,165	7.6	210,821	8.6	15.3
<b>Total</b>	<b>3,168,045</b>	<b>99.6</b>	<b>2,334,780</b>	<b>95.3</b>	<b>35.7</b>
<b>Other brands*</b>					
Footwear	1,663	0.1	23,372	1.0	-92.9
Apparel	10,730	0.3	85,168	3.4	-87.4
Accessories	105	0.0	7,216	0.3	-98.5
<b>Total</b>	<b>12,498</b>	<b>0.4</b>	<b>115,756</b>	<b>4.7</b>	<b>-89.2</b>
<b>Overall</b>					
Footwear	1,252,619	39.4	866,697	35.4	44.5
Apparel	1,684,654	53.0	1,365,802	55.7	23.3
Accessories	243,270	7.6	218,037	8.9	11.6
<b>Total</b>	<b>3,180,543</b>	<b>100.0</b>	<b>2,450,536</b>	<b>100.0</b>	<b>29.8</b>

**Percentage of turnover by product category in 2006**



\* Other brands include the KAPPA and AIGLE brands. Corresponding figures for 2005 relate to the KAPPA brand (disposed of in August 2005), while those for 2006 relate to the AIGLE brand.

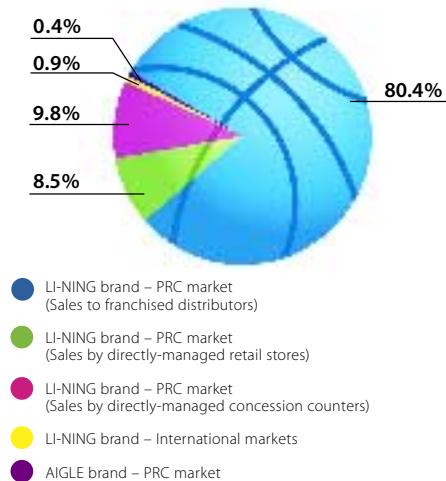
Turnover of the Group was mainly generated by the Group's core brand, LI-NING, which accounted for 99.6% of the total turnover. The LI-NING branded products focus on five key sport activities, namely, running, basketball, soccer, tennis and fitness. It has a broad product portfolio which encompasses footwear, apparel and accessories for professional athletes and for leisure. During the year under review, footwear products recorded a robust sales growth of 48.3% as compared to 2005. This was attributable to the Group's committed efforts in defining a clear positioning with strong product differentiation and in injecting personality and innovation into its product design. The oriental and innovative elements of the "Flying Armor" (飛甲) series of basketball shoes and the "Flying Feather" (天羽) series of running shoes were well-accepted by the market. In addition, the Group's shoe products with its proprietary core technology "LI-NING BOW" (李寧弓) launched in the second half of 2006 has received overwhelming market response with the support of a comprehensive sales strategy. As for apparel products, despite keen competition from both overseas and domestic brands, an increase of 30.7% in sales was achieved. Sales of accessories also rose by 15.3% as a result of the product mix optimisation implemented during the year under review.

Outdoor leisure sports apparel and footwear products under the AIGLE brand operated by the joint venture established by the Group and AIGLE of France were launched in the first half of 2006. Sales of the AIGLE branded products in 2006 amounted to RMB12,498,000.

Percentage of turnover by sales channel

	Year ended 31 December	
	2006 % of total turnover	2005 % of total turnover
<b>LI-NING brand</b>		
PRC market		
Sales to franchised distributors	<b>80.4</b>	72.8
Sales by directly-managed retail stores	<b>8.5</b>	10.0
Sales by directly-managed concession counters	<b>9.8</b>	11.2
International markets	<b>0.9</b>	1.3
<b>Other brands*</b>		
PRC market	<b>0.4</b>	4.7
<b>Total</b>	<b>100.0</b>	100.0

Percentage of turnover by sales channel in 2006



\* Other brands include the KAPPA and AIGLE brands. Corresponding figures for 2005 relate to the KAPPA brand (disposed of in August 2005), while those for 2006 relate to the AIGLE brand.

The Group's products are mainly sold through distributors. The Group also distributes LI-NING and AIGLE branded products through directly-managed retail stores and concession counters. In view of the development trend of the China sports product retail market and taking into consideration its core competency, the Group is disposing of certain retail stores of its sales subsidiaries to distributors with strong capability. The Group will therefore focus on the management of sales channels which facilitates brand building, e.g. flagship stores and factory outlets.

**Breakdown of turnover by geographical location**

	Note	Year ended 31 December		2005 RMB'000	2005 % of total turnover	Change (%)
		2006 RMB'000	2006 % of total turnover			
<b>LI-NING brand</b>						
PRC market						
Beijing and Shanghai		<b>238,387</b>	<b>7.5</b>	187,078	7.6	27.4
Central region	1	<b>395,959</b>	<b>12.4</b>	287,221	11.7	37.9
Eastern region	2	<b>701,378</b>	<b>22.1</b>	570,135	23.3	23.0
Southern region	3	<b>397,074</b>	<b>12.5</b>	313,583	12.8	26.6
Southwestern region	4	<b>320,812</b>	<b>10.1</b>	208,325	8.5	54.0
Northern region	5	<b>557,920</b>	<b>17.5</b>	384,851	15.7	45.0
Northeastern region	6	<b>451,955</b>	<b>14.2</b>	305,319	12.5	48.0
Northwestern region	7	<b>76,625</b>	<b>2.4</b>	45,455	1.9	68.6
International markets		<b>27,935</b>	<b>0.9</b>	31,844	1.3	-12.3
<b>Other brands*</b>						
PRC market		<b>12,498</b>	<b>0.4</b>	116,725	4.7	-89.3
<b>Total</b>		<b>3,180,543</b>	<b>100.0</b>	2,450,536	100.0	29.8

\* Other brands include the KAPPA and AIGLE brands. Corresponding figures for 2005 relate to the KAPPA brand (disposed of in August 2005), while those for 2006 relate to the AIGLE brand.

**Notes:**

1. Central region includes Hubei, Hunan and Jiangxi.
2. Eastern region includes Zhejiang, Jiangsu and Anhui.
3. Southern region includes Guangdong, Guangxi, Fujian and Hainan.
4. Southwestern region includes Sichuan, Chongqing, Guizhou, Yunnan and Tibet.
5. Northern region includes Shandong, Hebei, Henan, Tianjin, Shanxi and Inner Mongolia.
6. Northeastern region includes Liaoning, Jilin and Heilongjiang.
7. Northwestern region includes Shaanxi, Xinjiang, Gansu, Qinghai and Ningxia.

The Group has established a nationwide network which covers all provinces and municipalities in the PRC. The second and third-tier cities where the Group has strong presence in are the mainstream market for future growth.





### Cost of Sales and Gross Profit

For the year ended 31 December 2006, cost of sales of the Group amounted to RMB1,671,991,000 (2005: RMB1,324,347,000). Overall gross profit margin of the Group maintained at a healthy level of 47.4%, representing an increase of 1.4% from 46.0% in 2005. The margin expansion was attributable to the increased percentage of new products in the total sales mix and the enhancement in product design and development which allowed the Group to enjoy price premiums for its new products.

#### Gross profit margin of product categories

	Year ended 31 December	
	2006 (%)	2005 (%)
Overall	47.4	46.0
Footwear	47.1	45.3
Apparel	47.1	46.2
Accessories	50.9	46.7

### Other Income

For the year ended 31 December 2006, other income of the Group amounted to RMB29,561,000 (2005: RMB32,626,000), which mainly comprised government subsidies and gain on disposal of a subsidiary.

### Distribution Costs and Administrative Expenses

For the year ended 31 December 2006, distribution costs of the Group amounted to RMB900,865,000 (2005: RMB683,150,000). This mainly comprised advertising and promotional expenses, salaries and benefits of sales staff, rental and renovation expenses of retail stores, transportation and logistics expenses, and sponsorship and other marketing-related expenses. Distribution costs accounted for 28.3% of the Group's total turnover, representing an increase of 0.4% against 27.9% in 2005. Such increase was mainly due to (i) increased investment amounts in sports sponsorship and business promotion; (ii) rise in human resources expenses for sales personnel; and (iii) increased investment amounts in shop renovation and channel support.

Administrative expenses of the Group for the year ended 31 December 2006 amounted to RMB234,730,000 (2005: RMB204,168,000). These mainly comprised staff costs, consulting expenses, office rentals, depreciation of office premises and other general expenses. Administrative expenses as a percentage of the Group's total turnover decreased from 8.3% in 2005 to 7.4% in 2006 as a result of the increased economies of scale which led to more efficient control on human resources and daily expenses, offsetting the increased provisions for inventories and bad debt.

### Operating Profit

For the year ended 31 December 2006, operating profit of the Group was RMB402,518,000, representing an increase of 48.3% from RMB271,497,000 in 2005. Benefiting from the expanded gross margin and the more efficient expenditure management, the Group's operating profit margin for the year was approximately 12.7%, representing an increase of 1.6% as compared to 2005.

### Finance Cost and Taxation

For the year ended 31 December 2006, finance cost of the Group amounted to RMB1,365,000 (2005: finance income of RMB1,954,000). Such increase in finance cost was mainly due to the exchange loss and increased cost of treasury management which was applied to minimize the risk of material foreign exchange fluctuation.

For the year ended 31 December 2006, taxation of the Group amounted to RMB106,090,000 (2005: RMB85,106,000). The effective tax rate was 26.4% (2005: 31.1%). Reduction in effective tax rate was the result of the continuous implementation of effective tax planning by the Group during the year under review.

### Profit Attributable to Equity Holders

Profit attributable to equity holders for the year ended 31 December 2006 was RMB294,846,000, representing an increase of 57.8% from RMB186,800,000 in 2005. Net profit margin attributable to equity holders for the year was 9.3%, representing an increase of 1.7% from 7.6% in 2005.

Basic earnings per share amounted to RMB28.65 cents (2005: RMB18.25 cents).

### Provision for Inventories

Inventories of the Group are stated at the lower of cost and net realizable value. In the event that net realizable value falls below cost, the difference is taken as a provision for inventories.

Accumulated provision for inventories as at 31 December 2006 amounted to RMB26,869,000 (31 December 2005: RMB14,227,000). In the light of business expansion, the proportion of provision for inventories was adjusted upward during the year according to the net realizable value, resulting in an increase in provision for inventories.

### Provision for Doubtful Debts

The Group's policy in respect of provision for doubtful debts in 2006 remained the same as that in 2005.

Accumulated provision for doubtful debts as at 31 December 2006 amounted to RMB8,720,000 (31 December 2005: RMB3,716,000). Provision for doubtful debts increased as a result of business expansion and extension of credit period to customers.

## BUSINESS REVIEW

During the year ended 31 December 2006, the Group continued to focus on its business development strategies, including (i) establishing brand differentiation and building integrated sales and marketing capabilities; (ii) strengthening product design, research and development capabilities; (iii) expanding sales channels and network; (iv) developing a market responsive supply chain; and (v) embarking on a multi-brand and new business expansion plan.

### Brand Promotion and Sponsorships

As a leading sports brand enterprise in the PRC, the Group has emphasized on sports marketing. In 2006, the four national teams under the Group's long-term sponsorship, namely, the Gymnastics Team, Diving Team, Table Tennis Team and Shooting Team, achieved remarkable results in the Doha Asian Games. The Gymnastics Team has obtained 8 gold medals out of 14 in total in the World Championship held in Denmark and the Diving Team was the winner of all World Cup diving events. In addition, the men's Spanish Basketball Team in LI-NING branded apparel, achieved its best ever results and won the World Champion in 2006. It is the honour of the Group in being the apparel sponsor of these world-leading sports teams.



In 2006, the Group continued to deploy considerable sales and marketing resources for the promotion of its core products, including sports sponsorship, advertisements and online media promotion, setting out the qualities which differentiate the LI-NING brand from its competitors and uplifting the brand profile by emphasizing the professional and athletic nature of its products. Key events of the Group in this respect took place in 2006 are summarised below:

**NBA – Official marketing partner in China**

Being the official marketing partner of NBA in China, the Group entered into agreements with two world famous NBA players, Damon Jones of Cleveland Cavaliers and Chuck Hayes of Houston Rockets in January and December 2006, respectively. The two players have put on LI-NING professional basketball shoes in the NBA league games since then. This partnership attests to the professional qualities and international standards of LI-NING branded sports footwear and marks a great stride for LI-NING brand in achieving its goal of becoming a top world-class sports goods brand.

In August 2006, the Group entered into a five-year agreement with the renowned NBA player, Shaquille O’Neal, who plays as a center at Miami Heat. He was selected as one of the 50 Greatest NBA Players in the NBA history. During the year, the Group and Shaquille O’Neal jointly launched the “LI-NING – SHAQ” co-branded basketball product series, in which the professional endorsement of Shaquille O’Neal, including his image, name, jersey with his player number and autograph are widely used. This collaboration is not only a pioneering effort in the sales and marketing of the China Sports brand, but also a significant breakthrough in the development of the China sports market and the strengthening of the Group’s position in the basketball sector.

In addition, as the official marketing partner of NBA Jam Van in 2006, the Group has participated in a wide range of activities with the NBA Jam Van and supplied products used in these activities. In 2006, the Group organized 63 activity days in 10 different cities, including Shanghai, Nanjing, Wuhan and Guangzhou. These activities have reinforced the bondage between LI-NING brand and NBA and subsequently enhanced the professional image of the LI-NING brand.

**CUBA – Sponsorship for one of the top three basketball associations in the PRC**

In December 2005, the Group announced a partnership with the China University Basketball Association (“CUBA”) and has become a key partner of one of the top three basketball associations in the PRC. In the PRC basketball sector, CUBA is a leading association in terms of geographical coverage, participation and cultural sophistication. The role of the Group as the sponsor of sports apparel of CUBA has further reinforced the professional image of LI-NING brand in the basketball sector, which in turn has enabled the Group to leverage on the relevant promotional resources in markets at the university level. Such cooperation has also contributed to the setting up of a long-term marketing platform for the Group in the basketball sector.

**ATP – Official marketing partner in China**

On 16 March 2006, the Group announced its agreement with ATP, the world's premier men's professional tennis tournament association, to become ATP's official marketing partner in China. During the seven-year term of the agreement, the Group would be granted the exclusive right for manufacturing, selling and marketing tennis products including apparel, footwear and accessories co-branded by LI-NING and ATP. These co-branded products would appear in the ATP events as part of the promotion campaign.

Furthermore, ATP would assist the Company in identifying and signing up tennis players for endorsement purposes. Nikolay Davydenko, a Russian tennis player who ranks third in the world was sponsored by the Group and put on LI-NING branded tennis apparel at the Tennis Masters Cup Shanghai in November 2006.

**CUFL – Sponsorship for China University Football League**

Football is one of the most popular sports activities among university students. The China University Football League ("CUFL") is a major event that attracts participation of the largest number of high school students with the highest level of skills. It exerts the most extensive influence in the football sector amongst high schools in the PRC. In April 2006, LI-NING and the Federation of University Sports of China jointly announced a brand new league game — the LI-NING China University Football League. In the coming 10 years of cooperation, LI-NING will leverage on its multi-faceted advantages in technical know-how and market presence to render its full support to the development of football activities among university students in the PRC by way of event naming, event marketing, brand promotion and sponsorship for sports apparel and goods etc.

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**Sponsorship for Sudan National Track & Field Team**

The LI-NING brand commenced its sponsorship for Sudan National Track & Field Team on 1 January 2006. The track and field athletes of Sudan will put on LI-NING branded products in the 2008 Beijing Olympic Games. The Sudan National Track & Field Team is a team with outstanding performance especially in the middle and long distance races. Their young athletes, who have achieved distinguished results and ranked at the international forefront will play an important role in the 2008 Beijing Olympic Games. The sponsorship will uplift the professional image of the Group in the running events.

**LI-NING iRUN Running Club**

On 15 October 2006, the LI-NING iRUN Running Club, an interactive professional running platform was officially launched online at the iRUN website (www.irun.cn). This website contains information of professional runners, members' communities and forums, running products introduction, entertainment and activities etc. The launching of this online media offers an all-rounded resource platform for the Group's running products.

**Media advertisements**

The Group has adopted an effective advertising strategy by using a number of media, such as television commercials and indoor and outdoor media to promote the brand image and to provide product updates. The new series of advertisements launched in 2006 is a perfect integration of oriental essence into the spirit of sports with an international outlook. This effectively delivers the unique character of LI-NING brand by highlighting the distinctive cultural difference between LI-NING brand and its international peers. It also allows LI-NING brand to stand out from the crowd and further expresses the Group's motto, "Anything is Possible." The commercials have deeply impressed the consumers and four of them have won the Grand Prize and other five major awards in the Chinese Element International Creative Contest at the 13th China Advertising Festival held by the China Advertising Association. The Group was also awarded "The Most Creative Organisation" at the First Grand Ceremony of Creative China held in May 2006.

**Product Research and Development**

The Group has a team of talented product development and design professionals who continuously conduct research and development works for the Group's products. Of a wide array of new products launched during the year, the "Flying Feather" (天羽) running shoes and the "Wind Galloper" (馭風) marathon running shoes series have been applied with innovative designs and advanced technology which not only offers consumers with better product choices, but also further uplifts the professional features and fashion elements of LI-NING branded products.



In 2006, the Group made a breakthrough in product innovation by adding a touch of oriental flavour in its design concept, element and style. The perfect combination of oriental culture and fashion sense is a new concept which distinguishes LI-NING brand from other international brands and has been highly praised by consumers. Among which, the "Flying Armor" (飛甲) basketball shoes which deliver high professional performance and carry strong oriental flavour in design, have won the German "iF China 2006 Industrial Design Award", making the Group the first ever China sports brand awarded such an honour. The Group has also collaborated with international institutions to embark on the research and development of core technologies for sports footwear. During the year under review, the Group launched the proprietary "LI-NING BOW" (李寧弓) anti-shock technology which was inspired by the ancient Chinese arch and bridge structures to design an innovative anti-shock concept that matches the highest international standard.

In relation to apparel products, the Group has made considerable progress in establishing an apparel technology platform with the employment of a wide spectrum of new fabrics, techniques and craftsmanship.

Furthermore, during the year under review, the Group recruited a team of world-class designers to strengthen its design caliber so as to found a solid ground for future business development.

### Distribution and Retail Network

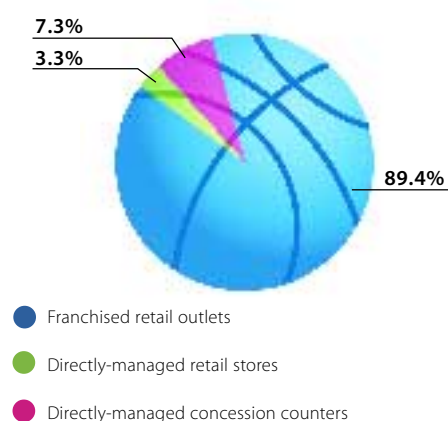
During the year under review, the Group continued to reinforce its edge in network coverage. A notable increase in the number of outlets throughout the PRC, in particular in the second and third-tier cities, was recorded. There was a net increase of 960 new stores during the year, bringing the total number of stores of the Group to 4,333. As at 31 December 2006, the domestic distribution and retail network of the Group comprised:

- over 210 distributors operating 3,875 franchised retail outlets under the LI-NING and the AIGLE brands across the PRC; and
- a total of 141 directly-managed retail stores and 317 concession counters in Beijing, Shanghai and 13 provinces in the PRC.

#### Number of franchised and directly-managed retail stores

	As at 31 December 2006	2005	Change (%)
<b>LI-NING brand</b>			
Franchised retail outlets	3,860	3,005	28.5
Directly-managed retail stores	138	111	24.3
Directly-managed concession counters	299	257	16.3
<b>Total</b>	<b>4,297</b>	<b>3,373</b>	<b>27.4</b>
<b>AIGLE brand</b>			
Franchised retail outlets	15	—	100.0
Directly-managed retail stores	3	—	100.0
Directly-managed concession counters	18	—	100.0
<b>Total</b>	<b>36</b>	<b>—</b>	<b>100.0</b>
<b>Overall</b>			
Franchised retail outlets	3,875	3,005	29.0
Directly-managed retail stores	141	111	27.0
Directly-managed concession counters	317	257	23.3
<b>Total</b>	<b>4,333</b>	<b>3,373</b>	<b>28.5</b>

#### Percentage of franchised and directly-managed retail stores in 2006



With a view to establish an international, professional and trendy image for LI-NING brand and to enhance store efficiency, the Group has continued to enhance store image, display and renovation. During the year under review, 672 shops were renovated. As at 31 December 2006, there was a total of 1,889 fourth generation stores. The Group will continue to explore suitable locations for the opening of flagship stores and brand stores in metropolitan and first-tier cities in the PRC. As at 31 December 2006, the Group operated 26 flagship stores.



### Supply Chain Management

The Group has adopted a comprehensive supply chain management regime encompassing procurement, supplies, manufacturing and sub-contracting for its product lines. During the year under review, the Group continued to adopt a flexible and effective supply chain management strategy which enabled it to respond efficiently and timely to market changes. Key attributes of the supply chain management are highlighted as follows:

- Four large-scale sales fairs for distributors were organised to shorten the cycle from product development to order placements;
- The inventory management system has undergone reform and continual sophistication, thereby shortening the average inventory turnover from 84 days in 2005 to 70 days in 2006. The improvements in inventory turnover was a strong evidence of the Group's sound inventory management capability;
- Average accounts receivable turnover was increased from 44 days in 2005 to 55 days in 2006, as a result of the Group's strategy to extend the credit period granted to customers in line with the rapid business growth and industry practice; and
- Average trade payables turnover stood at 67 days, approximated to the 68 days for 2005.

During the year, the Group has reformed the supply chain management mechanism by turning it into a demand-driven mode so as to accelerate response to market needs and to establish a competitive integrated supply chain system.

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### New Business Development

The joint venture established by the Group and AIGLE of France commenced operation in the first half of 2006. AIGLE is a world-renowned company which specializes in the business of apparel and footwear products for outdoor sports and leisure activities. Pursuant to the agreement between the Group and AIGLE, a wholly foreign-owned enterprise set up in the PRC by the joint venture has been granted the exclusive right by AIGLE to manufacture, market, distribute and sell apparel and footwear products for outdoor leisure activities and extreme sports with the AIGLE trademarks in the PRC (excluding Hong Kong, Taiwan and Macau) for a term of 50 years. Satisfactory progress has been made in the sales outlet expansion. As at 31 December 2006, there were 36 AIGLE outlets in the PRC. Going forward, the Group will rapidly expand the retail network and adjust AIGLE's product portfolio and pricing in order to boost sales.

The Group will continue to seek mutually beneficial partnerships with international brands to introduce them to the PRC market, and in turn, to develop itself into a multi-brand operator with a strong portfolio of reputable brands.

## FINANCIAL POSITION

The Group is committed to the development of a risk-resistant, ever-growing and healthy cashflows so as to maintain a solid and strong financial position.

### Net Asset Value

As at 31 December 2006, the Group's total net asset value was RMB1,417,079,000 (31 December 2005: RMB1,178,296,000). Net asset value per share was RMB137.38 cents (31 December 2005: RMB115.09 cents).

### Liquidity and Capital Resources

For the year ended 31 December 2006, the Group's net cash inflow from operating activities amounted to RMB293,390,000 (2005: RMB138,605,000).

Net cash (cash and cash equivalents less bank borrowings) as at 31 December 2006 amounted to RMB838,867,000, representing an increase of RMB460,499,000 compared with the net cash position as at 31 December 2005. The increase represents the aforesaid cash inflow from the operating activities of RMB293,390,000, proceeds from the issue of new shares upon exercise of share options under the Company's share option schemes of RMB15,769,000, interest income received of RMB17,723,000 and net return of fixed deposit of RMB334,059,000, less dividend payment of RMB88,270,000, expenditure on purchase of shares under the Restricted Share Award Scheme of RMB6,367,000, net capital expenses of RMB105,185,000, net cash outflow from disposal of a subsidiary amounting to RMB109,000 and cash reduction of RMB511,000 due to fluctuation in the exchange rates.



As at 31 December 2006, the Group's cash and cash equivalents amounted to RMB838,867,000 (31 December 2005: RMB378,368,000). There were no outstanding bank borrowings (31 December 2005: nil). Equity holders' equity amounted to RMB1,399,490,000 (31 December 2005: RMB1,160,924,000). The debt to equity holders' equity ratio, expressed in total outstanding bank borrowings as a percentage of equity holders' equity, was nil (31 December 2005: nil).

As at 31 December 2006, the Group did not enter into any interest rate swaps to hedge against interest rate risks.

#### **Pledge of Assets**

As at 31 December 2006, no asset of the Group was pledged to secure bank borrowings or for any other purpose.

#### **Contingent Liabilities**

As at 31 December 2006, the Group had no material contingent liabilities.

#### **Foreign Exchange Risk**

The operation of the Group mainly carries out in the PRC with most transactions settled in Renminbi, the lawful currency of the PRC. Proceeds from the initial public offering of the Company in June 2004 were denominated in Hong Kong Dollars, part of which has been invested in fixed deposits denominated in US Dollars or Hong Kong Dollars. The Company also pays dividends in Hong Kong Dollars. The Group may be exposed to foreign exchange fluctuation in relation to its deposits.

## **HUMAN RESOURCES**

As at 31 December 2006, the Group had approximately 2,365 employees (31 December 2005: 2,890 employees). The decrease in the number of employees was mainly due to (i) the outsourcing of sales activities which led to a reduction in the number of sales staff; and (ii) the reduced number of workers who engaged in manufacturing.

Talents are invaluable assets of the Group. The Group aspires to offer a good working environment, a wide range of training and personal development programs as well as an attractive remuneration package to the employees. The Group endeavors to motivate its staff with performance-based remuneration. On top of a basic salary, staff with outstanding performance will be rewarded in the form of cash, share options, honorary awards or a combination of these. On 14 July 2006, the Board adopted its Restricted Share Award Scheme. Through shares award, staff benefits can be effectively aligned with the growth of the Group and such arrangement can further achieve the goal of attracting and motivating talented employees in the long run.

## SUBSEQUENT EVENTS

### ***Joined hands with CCTV to launch a new image for National Sports TV Channel***

The Group announced on 5 January 2007 the signing of a cooperation agreement with CCTV National Sports TV Channel. Pursuant to the agreement, all hosts and reporters of the National Sports TV Channel will put on the apparel, footwear and accessories of the LI-NING and AIGLE brands in all programs broadcasted in the channel, including the Olympic Channel which will be released during the 2008 Beijing Olympics, for the period from 1 January 2007 to 31 December 2008. CCTV National Sports TV Channel is the professional sports TV channel in China which relays the largest number of international sports programs. It is also the most influential and popular sports TV channel. The cooperation has marked the commencement of a highly integrated sales and marketing model of sports goods. The Group will make use of this important channel to facilitate external communication and promote the international and professional image of LI-NING brand.

### ***Cooperation with Argentina National Basketball Teams***

The Group announced on 12 January 2007 an important milestone for its international brand expansion. It forged an agreement with the Argentina basketball federation Confederación Argentina de Basquet to be its official partner for a term of six years. Pursuant to the agreement, the Group will sponsor a series of specially designed sports apparel for the men's and women's Argentina National Basketball Teams who will wear LI-NING branded apparel at major international sports events such as the 2008 Beijing Olympics and the 2012 London Olympics. This has been another remarkable accomplishment of the Group in sports marketing in the basketball sector since the signing of the four-year agreement with the Spanish Basketball Federation in 2004. It is also an important step for the Group's international brand extension strategy and a proof of recognition on the professional quality of the Group's sports products by the world's top national teams.

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### ***Cooperation with Swedish Olympic Committee***

On 24 January 2007, the Group announced the agreement entered into with the Swedish Olympic Committee for a term of four years, under which the Group has become the designated official partner of the Swedish Olympic Committee in supplying the Swedish Olympic Delegation with a range of sports apparel in the 2008 Beijing Olympics and 2010 Vancouver Winter Olympics. Under the agreement, the Group is also authorized to sell Olympics-related products in Sweden. The LI-NING brand will therefore appear in a wide range of Olympic promotional activities in Sweden. The Group is the first Chinese sports brand that entered into such form of agreement with an overseas Olympic delegation. This cooperation is considered a major step in the Group's brand international expansion.

## OUTLOOK AND DEVELOPMENT STRATEGIES

The economy in the PRC is expected to remain strong in the near future. With the approaching of the 2008 Beijing Olympics, the China sports goods industry will maintain a strong growth. Nevertheless, competition in the industry would also be intensive.

The Group aspires to unleash its potential to achieve breakthrough through innovation so as to strengthen its market leading position and to hone its competitive edge in the international sports arena. We will continue to enhance the core competency of LI-NING brand and to strengthen the foundation through a number of measures such as optimization of product mix to maximize different geographical market potentials, adjustments in sales organisation and further enhancement of supply chain management platform. At the same time, the Group will also strengthen brand differentiation through innovative integrated sales and marketing network adjusted in accordance with the needs of different regional markets. The growth strategies will place strong emphasis on the second and third-tier cities by extending the Group's network and by increasing efficiency on retail level so as to strengthen the core business and to accelerate the pace of growth.

The Group will continue to adopt the multi-brand business strategy in order to expand its business to new areas. This will enable the Group to increase its competitiveness and add new engines to fuel its future development.

As the final countdown phase for the 2008 Beijing Olympic Games has been reached, the Group has activated a series of campaigns, mainly in the metropolitan and the first-tier cities, to capitalize the commercial opportunities arising from the event. Innovative sales and marketing strategies as well as brand and product marketing programmes will be launched to realize the Group's goal in achieving remarkable stride at this grand event so as to establish a new foundation for the future development of LI-NING brand.

In line with its development strategies and objectives, the Group has adjusted its organisation structure in 2006 in order to develop a high caliber professional management structure and team. Leveraging its competitive advantages, the Group is committed to offer high quality products to consumers, work satisfaction and a sense of belonging to employees, and attractive returns to shareholders and investors.