Management Discussion and Analysis

GROUP REVIEW

In 2006, the Group achieved remarkable growth amid rapid organic development and market consolidation, despite intensive competition. During the year under review, the Group recorded sales revenue of approximately RMB24,729 million, an increase of approximately 38% over last year. Net profit attributable to equity holders increased by approximately 64% to approximately RMB819 million. The business initiatives formulated by the Group at the beginning of 2006 also recorded satisfactory progress and helped reinforce the Group's leading market position and competitiveness in the household appliances and consumer electronics retail industry in the People's Republic of China (the "PRC" or "China").

The management of the Group believes that the nature of competition in the PRC household appliances sector has shifted to core competency enhancement and customer satisfaction and loyalty. Therefore, in 2006, the Group not only dedicated efforts to raise store service level with a "customer-first and service-oriented" approach, it also launched a series of initiatives including extended warranty, membership promotion, hassle-free exchange/return policy, and "Household Appliances Hospital" maintenance service. All these measures were aimed at raising customer satisfaction and loyalty, thereby maintaining a more quality and stable customer base.

In the area of enterprise information technology, the Group completed the development of customer relationship management (CRM), and office automation (OA) systems. During the period, the Group also commenced the build-out of a B2B-based commercial platform in collaboration with key suppliers. These systems were instrumental to optimizing the supply chain management, improving operating efficiency and reducing logistics expenses.

Management Discussion and Analysis

STRATEGIC ALLIANCE WITH WARBURG PINCUS

On January 28, 2006, the Group announced a strategic alliance with Warburg Pincus Private Equity IX, L.P ("Warburg Pincus"), under which Warburg Pincus made a strategic investment in the Company through the issuance of US$125 million convertible bonds and US$25 million warrants.

Under the subscription agreement, Warburg Pincus agreed to subscribe for five-year convertible bonds due 2011 in the aggregate principal amount of US$125 million. The bonds carry an annual coupon of 1.5% payable semi-annually and a yield to maturity of 3.26%, and will be convertible, subject to certain conditions, into the Company's new ordinary shares at an initial conversion price of HK$6.40 per ordinary share.

In addition, Warburg Pincus will also subscribed for US$25 million five-year warrants at a subscription price of US$3 million. Warburg Pincus has the right to exercise the warrants at an initial exercise price of HK$7.70 per ordinary share.

Warburg Pincus would hold approximately 176,680,630 ordinary shares in the Company, assuming the bonds and warrants are exercised and fully converted.

To further demonstrate his support and commitment, Mr. Wong Kwong Yu, the Chairman, an executive director and the controlling shareholder of the Company, has made additional undertakings to the Company with respect to the business and assets of the companies which he is beneficially interested in and are engaged in the retail sales and related operations of electrical appliances and consumer electronic products under the trademark of "GOME Electrical Appliances" in the cities other than the designated cities in which the Group operates (the "Parent Group"), including a financial audit and the eventual injection of the Parent Group's retail business into the Group.

The Group believes that Warburg Pincus, with its international experience and M&A expertise, will be invaluable in assisting the Group to achieve its growth objectives. The representation of Warburg Pincus on the Company's board will also advocate the adoption of international best practices and corporate governance standards.

Management Discussion and Analysis

ACQUISITION OF THE REMAINING 35% EQUITY INTEREST IN GOME APPLIANCE

On March 29, 2006, the Company announced the acquisition of the remaining 35% equity interest in Gome Appliance. Gome Appliance is the Company's major operating subsidiary in China. The total consideration for the acquisition was approximately HK$6,986.7 million and was satisfied:

- as to approximately Hk$5,235.3 million by the issue of 650,346,949 shares
- as to approximately HK$761.4 million by the set-off against a property in Beijing
- as to HK$990 million in cash

The acquisition was long awaited and widely welcome by the market as it simplified the Group's structure and consolidated the Company's interest in Gome Appliance. The transaction created both strategic and financial value in the following ways:

- Simplified its corporate structure
- Consolidated the Group's interest in GOME Appliance from 65% to 100%
- Enhanced financial strengths in terms of both profitability and market capitalization
- Accretion of EPS

The transaction was completed in early May 2006.

MERGER WITH CHINA PARADISE

The Group and China Paradise issued a joint announcement on July 25, 2006 regarding the Company's voluntary conditional offer to acquire all of the issued shares in the share capital of China Paradise. The consideration in respect of the offer was for each China Paradise share of China Paradise, the Company would offer 0.3247 new GOME shares in the Company and HK$0.1736 in cash. Total consideration for the transaction was approximately HK$4,897 million, out of which HK$402 million was paid by cash.

The transaction was completed on November 30, 2006 and China Paradise was delisted from the Main Board of The Stock Exchange of Hong Kong Limited on January 31, 2007. The management believes that integration work with China Paradise has mostly been completed and merger synergies and cost savings are beginning to materialize.

Management Discussion and Analysis

BUSINESS REVIEW

BUSINESS ENVIRONMENT

During the reporting period, the PRC economy grew by approximately 10.7% while the consumer retailing sector recorded RMB7.64 trillion in sales, representing an approximate 13.7% increase over the previous year. The sales in the electrical appliances and consumer electronics retail industry alone grew approximately 19.2% (source: State Statistics Bureau). The management of the Group believes that market outlook remains robust and will continue to fuel the growth of the Group's business.

The management of the Group believes that the Group, as one of the leading players in China for over 20 years, will continue to benefit from the rapid growth of the PRC market. The popularity of both "GOME" and "China Paradise" brands will play an important role in achieving further success in the Group's future development.

MARKET COMPETITION

The Group, together with the Parent Group, has firmly established the largest nationwide store network with presence in most first and second tier cities in the PRC (excluding Tibet, Taiwan, and Ningxia region). Leveraging the business scale and extensive network coverage, the Group enjoys strong competitive edge over its competition and cements its leadership in most of the markets the Group operates in.

Management Discussion and Analysis

Post the merger with China Paradise, the Group's share in Shanghai's traditional household appliances market reached approximately 40%. The management team of the Group believes that foreign competition is not likely to have a major impact on the Group's operation in next three to five years. Leveraging the depth and experience of the management team and the Group's more than 20 years of operating history in the PRC market, the Group is confident that it is best positioned to further grow its leading market position.

RECENT DEVELOPMENT OF THE GROUP

At the beginning of 2005, the Group announced the "Four-Year Growth Initiative" with the objective of expanding the retail network to 800 outlets under the combined coverage of the Group and the Parent Group and of boosting the combined market share from 5% in 2004 to 10-15% in year 2008. With the successful merger of the Company and China Paradise, the objective was achieved during the reporting period, well ahead of the original timeframe.

After merging with China Paradise, the management team of the Group has re-formulated the Group's development plans. The main strategic thrust is to increase the combined market share of the Group and the Parent Group to above 20% within the next five years from 2007 to 2011. In addition, capitalizing on the enhanced network scale and coverage, the management of the Group anticipates that future growth in sales will rely less on new store openings but more on store management enhancement and improvement of single-store sales efficiency.

Management Discussion and Analysis

RETAIL NETWORK EXPANSION

During the period under review, the Group continued to expand its network coverage. At the end of 2006, the network coverage of the Group was as follows:

	Total number of the Group	Gome Appliance	China Paradise
Traditional stores	572	391	181
Stores located in:			
First tier cities	368	250	118
Second tier cities	204	141	63
Digital stores	13	2	11
Flagship stores	2	2	0
Total no. of stores in 2006	587	395	192
2006 newly added stores	131	132	-1
No. of cities with outlets	160	120	60
No. of first tier cities	26	20	13
No. of second tier cities	134	100	47
No. of newly entered cities in 2006	58	51	9

In addition, the Parent Group operated total of 239 stores (excluding those stores in Hong Kong and Macau) at the end of 2006.

The size of traditional stores typically ranges from 3,000 to 6,000 square meters, averaging about 3,800 square meters. As at the end of the reporting period, the Group's total sales area stood at approximately 2.22 million square meters, representing an increase of about 108% as compared to the end of 2005. During the reporting period, 15 stores were self-occupied properties of the Group (7 of them owned by Gome Appliance and 8 by China Paradise), which were all located in the central business districts of respective cities.

Management Discussion and Analysis

List of stores under the Group (As of December 31, 2006):

	Traditional Stores		Digital Stores		Mega Stores
Region	Gome Appliance	China Paradise	Gome Appliance	China Paradise	Gome Appliance
Beijing	48				1
Shanghai		50		11	
Tianjin	26				
Chengdu	29	12			
Chongqing	20				
Xian	15	6			
Shenyang	18				1
Qingdao	14	3			
Jinan	13				
Henan		23			
Shenzhen	48				
Guangzhou	54	10	1		
Hubei	20				
Yunnan	13				
Fuzhou	28	9	1		
Xiamen		19			
Hangzhou		12			
Ningbo		9			
Nanjing	11				
Changzhou	5				
Suzhou	7	11			
Wuxi		5			
Anhui	7	4			
Xuzhou		8			
Tangshan	6				
Lanzhou	7				
Wenzhou	2				
Sub Total	391	181	2	11	2
Total	572		13		2

The management team of the Group believes that the Group has a leading edge over its peers in terms of network coverage. The Group also surpasses its competitors in terms of market position in first tier markets and progress of network expansion in second tier markets.

Management Discussion and Analysis

EXPANSION IN SECOND TIER MARKETS

The Group commenced its aggressive expansion in second tier markets in 2005. With the continued development of the PRC economy and household income growth in both urban and rural areas, the management of the Group believes that the low penetration of electrical appliances and consumer electronics products in the second tier cities presents enormous growth potential and opportunities for the Group.

As at the end of the reporting period, the Group had opened 204 traditional stores in these cities, accounting for approximately 36% of the Group's total number of traditional stores. These traditional stores in second tier cities generated sales revenue of approximately RMB5,100 million, representing approximately 20% of the total sales revenue.

In view of the lower purchasing power in second tier cities, the Group has established regional management centers in cities with higher store concentration to coordinate local logistics distribution and supplier relations in order to accelerate business growth.

The management team of the Group believes that with improving network presence and developing market size, sales in second tier cities will gradually increase and economies of scale will start to emerge, which are conducive to the continued development of these markets.

STORE LEASES

At the end of 2006, out of the 572 traditional stores operated by the Group, 15 stores were self-occupied properties and the remaining 557 stores were under leases. The average remaining duration of the leases of these 557 stores was about 6.32 years. Of the above store leases, the number of leases expiring in 2007, 2008 and 2009 are 18, 45 and 51, representing approximately 3.23%, 8.08% and 9.16% of the total number of store leases respectively.

During the reporting period, the Group's rental expenses as a percentage of sales revenue was approximately 3.52%, representing an increase of approximately 1.09% as compared to that in 2005, as a result of the following:

- The limited choices of premier business districts in smaller cities does not mean that rental expenses in these areas would be much lower than in first tier cities, even though the purchasing power in these smaller cities was not as strong.

Management Discussion and Analysis

- Competition for highly desirable store locations among interested tenants has often driven up rental expenses.

- Newly opened stores in second and third tier cities require a longer time period to mature, which means that ramp-up in sales revenue was slower.

The Group believes that given the diversified nature of the lease portfolio and its proactive management of rental increments and lease tenors, it is in a good position to mitigate the rising trend in rental expenses ratio. As newly opened stores continue to mature and store performance continues to improve, pressure exerted by rental expenses is likely to be abating in the future.

PROCUREMENT AND RELATIONSHIP WITH SUPPLIERS

The purchases attributable to the Group's top five largest suppliers (in terms of brands) accounted for approximately 30.25% of total purchases in 2006, as compared to approximately 30.36% in 2005.

During the reporting period, the Group dealt with over 500 core suppliers, representing a 25% increase as compared to the 400 suppliers in 2005. The increase was a result of the Group's expanded product offerings in the digital, mini household appliances and IT product categories. The Group sold over 15,000 SKUs and direct procurement reached around 70%.

Through cooperation with suppliers in different areas, the Group has accumulated extensive experience in handling supplier relations. The Group believes that a sustainable and mutually beneficial relationship with key suppliers is critical.

LOGISTICS AND DISTRIBUTION SYSTEM

By the end of the reporting period, the Group had a total of 99 distribution centers, of which 34 were in first-tier markets and 65 were in second tier markets. Total gross floor area of these distribution centers reached 483,000 square meters, of which 269,000 square meters were in first tier markets and 214,000 square meters were in second tier markets.

The management of the Group believes that by taking full advantage of the regional distribution centers and extending the logistics services, the Group can reduce logistics costs and save time in product delivery. Hence, overall operating efficiency can be improved. The management of the Group anticipates that the establishment of the call center facility will allow effective tracking of the deliveries and on-site revisits which will further enhance customer satisfaction.

The Group is planning to build a major logistics center in Qingpu, Shanghai, and will continue to establish regional centers in core cities with large market capacity to improve logistics efficiency.

CUSTOMER SERVICE AND AFTER-SALE SERVICE ARRANGEMENTS

In 2006, the Group continued to improve customer and after-sales services by establishing a CRM system, intensifying membership program promotion, building a household appliances maintenance platform, and launching selected extended warranty service.

ESTABLISHMENT OF CUSTOMER RELATIONS MANAGEMENT SYSTEM

With the establishment of the CRM system, the Group is able to standardize customer service procedures on handling customer complaints, managing membership data, and collecting after-sales feedbacks, which are all essential in improving customer satisfaction.

Management Discussion and Analysis

The management of the Group believes that the establishment of the CRM system will not only enhance the Group's service level but also provide a platform for other business developments such as the "Household Appliances Hospital" maintenance service and the call centre management.

MEMBERSHIP PROMOTION

The Group started to roll out its membership program in 2005. At the end of the reporting period, the Group had a total of 6.7 million members, which vastly exceeded the membership target set at the beginning of the year. The membership program was implemented in 150 cities and the Group was the first household appliances and consumer electronics retailer to jointly launch the "Mudan GOME Credit Card" with Industrial and Commercial Bank of China and the "GOME Ctrip Card" with Ctrip.com to offer VIP privileges and discounts. These promotional initiatives have enhanced brand recognition and customer loyalty. In 2006, member purchases reached 61% and repeat purchases by members reached 23%.

The membership program is a market-driven move, aiming to raise customer loyalty. The management believes that the program will continue to attract value and brand conscious customers.

"HOUSEHOLD APPLIANCES HOSPITAL" MAINTENANCE SYSTEM

In 2006, the Group started to organize its own maintenance platform. The GOME "Household Appliances Hospital" maintenance system typically operates in key stores to provide a wide variety of convenient services to customers. As at the end of the reporting period, 15 locations had been set up. The management plans to extend the Household Appliances Hospital program to cover wider product categories in an increasing number of regions.

In the meantime, the Group has engaged, after evaluation and feasibility studies, selected independent maintenance outlets to better serve our customers. At the end of the reporting period, the Group had established about 1,000 such maintenance outlets.

Management Discussion and Analysis

INFORMATION TECHNOLOGY

The Group's information technology (IT) infrastructure comprises network security system, corporate DID audio system, video conference set-up, financial information reporting system, B2B and B2C e-business platforms, office automation (OA) network, customer relationship management (CRM) system, and enterprise resource planning (ERP) system.

During the reporting period, the above enterprise information technology infrastructure delivered effective results to the Group: Enterprise Resource Planning (ERP) system has provided efficient support to the Group's core business operations; Office Automation (OA) system has reduced paper-based communication, resulting in better efficiency and reduced costs. The B2B supplier exchange system has strengthened communications with suppliers and streamlined information flow since the system came into service in the second half of 2006.

The management of the Group is of the view that information technology infrastructure is key to operating efficiency, cost control and quality service. The Group will continue to make investments in this area to meet the growing needs of the network.

COMPETITION IN DIFFERENT REGIONS AND PRODUCT CATEGORIES

During the period, the Group successfully enhanced its leading position in different geographical regions and product categories. In terms of product categories, audio visual products, refrigerators, washing machines, and small electrical appliances have seen stronger sales growth. However, telecommunication products, digital products and IT products did not perform as well as the Group had anticipated. The Group will seek to remedy performance in these product categories in 2007.

STORE MANAGEMENT ENHANCEMENT

In 2006, the Group sought to strengthen customer service and enhance store operating efficiency, through the establishment of the CRM system and implementation of various management initiatives. However, due to differentials in purchasing power and demographics in different cities and markets, and that it usually takes one to two years for a newly opened store to reach its full sales potential, revenue efficiency and operating quality of certain individual stores did not see meaningful improvement. The management team of the Group has therefore taken remedial actions in 2006 and will continue to implement further improvement initiatives in 2007.

Management Discussion and Analysis

GROUP PURCHASES

The Group capitalized on group purchases from schools, banks, government bodies, private enterprises, and property developers in 2006. The management of the Group considers group customers as an additional channel of sales and profit growth and has therefore established a separate department to capitalize on such opportunities. At present, the Group has secured approximately 18,000 group customers and will continue to explore potentials.

FURTHER DEVELOPMENT IN E-COMMERCE BUSINESS

The Group continued to maintain a leading position in on-line sales in the PRC. During the period under review, the maximum number of daily visits to the Group's online shopping mall reached 700,000, resulting in a robust increase of 200% in sales as compared to the corresponding period in 2005.

The management team of the Group considers e-commerce as one of the core strategies for future business expansion. As the market becomes more sophisticated and consumers' behaviors shift, on-line presence in changing from a mere advertising platform to a true online retail business experience.

INTEGRATION WITH CHINA PARADISE

As a result of the merger with China Paradise, in which the Group, which was ranked No. 1 in the PRC electronics retail market, merged with the China Paradise which was ranked No. 3 in the PRC electronics retail market, an enlarged and strengthened company was formed. The Group is now better positioned than ever to leverage synergies brought about by the merger and to utilize its enhanced bargaining power, stronger market position, complementary network coverages, and leaner cost structure to capitalize on future opportunities.

Through the integration with China Paradise, the Group has strengthened its market position in eastern China. The Group now claims the top ranking in terms of the number of retail outlets and sales volume in the Yangtze River Delta. The merger with China Paradise has also positioned the Group to further develop its market leadership position in individual cities, not simply as the No. 1 retailer nationally.

Management Discussion and Analysis

During the reporting period, integration with China Paradise in procurement, financial and information systems, and human resources was basically completed. A new management team has been formed to oversee different functional and geographical areas. Store networks were restructured and cost control measures were implemented. The Group is confident that integration work with China Paradise will substantially strengthen its market leadership in different regions in the PRC and lead to stronger economies of scale in terms of cost reduction in procurement, logistics and administration.

The Group is strongly confident that the positive impacts resulting from the integration work with China Paradise will come through in the near future.

MULTI-BRAND STRATEGY

The Group mainly operates two major brands, "GOME Appliance" and "China Paradise", as well as a few other regional brands which were secured as a result of prior acquisitions. Going forward, the Group will continue to develop the GOME brand and at the same time, retain and promote the China Paradise brand in the coastal areas, where are China Paradise's traditional strongholds. The Group will also strive to develop its regional brands in their respective local markets.

The Group will also seek to enhance its leading market position through the establishment of joint GOME-Eagle branded flagship stores to realize their channel value. These flagship stores will provide a wider range of products and customized services to a group of higher spending consumer in the market. The Group believes that brand differentiation, accompanied by respective product and offering strengths will further enhance the Group's competitive edge.

Management Discussion and Analysis

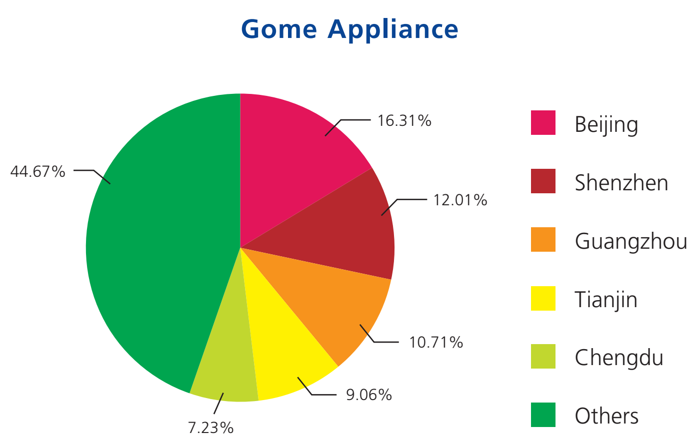
FINANCIAL REVIEW

REVENUE

In 2006, the Group's revenue reached approximately RMB24,729 million, as compared to approximately RMB17,959 million in 2005, representing an increase of approximately 38%. During the year, the Group's weighted average sales area was approximately 1,361,000 square meters, compared to approximately 692,000 square meters in 2005, representing an increase of approximately 97%. Sales per square meter in the reporting period and in 2005 were RMB18,170 and RMB25,900 respectively. Sales per square meter during the year declined by approximately 30% from 2005.

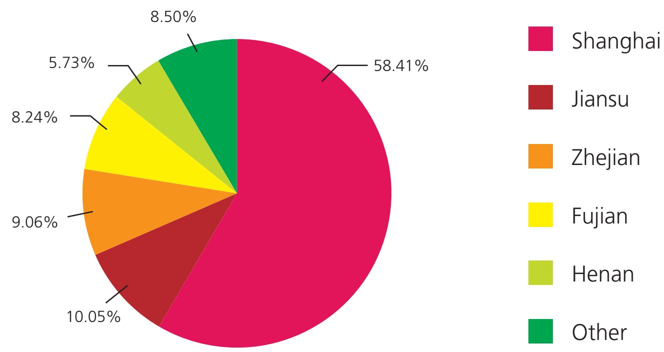
During the reporting period, the sales at the Group's 107 stores, which were qualified as comparable stores, accounted for approximately 47% of total revenue in the reporting period, representing a decline of approximately 2.51% when compared to the corresponding period in 2005.

Sales percentage by regions:

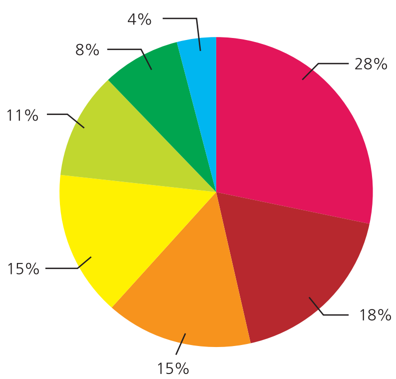


Management Discussion and Analysis

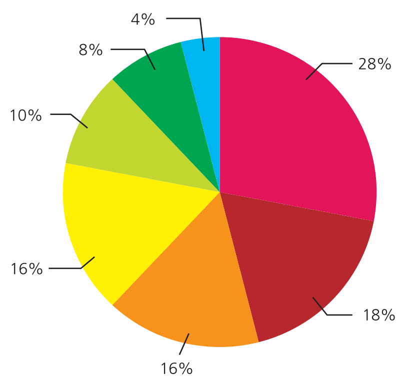
China Paradise



Sales percentage by product categories:



FY06



FY05

- Audio visual
- Refrigerators and washing machines
- Air-conditioners
- Telecommunication products
- Small electrical appliances
- Digital
- IT products

Management Discussion and Analysis

Average selling price of different products has increased, which represented a marked turnaround in the past few years. Selling price for color TV sets increased by 47% due to a significant increase in flat screen TV sales during the reporting period. Selling price of mobile phones recorded the smallest increase and therefore, contributed a lower percentage to the total sales revenue.

The management of the Group believes that the increase in the average selling price was a result of more frequent product upgrades and shorter replacement cycles. It also reflected the Group's better customer structure and stronger purchasing power of its customers.

Local brands contributed 67% of the total sales revenue of 2006, the rest was contributed by international brands. The management believes that the ratio reflected customers' diversified preference and the Group's ability to work with both local and international brands and sell the products effectively through its sales channels.

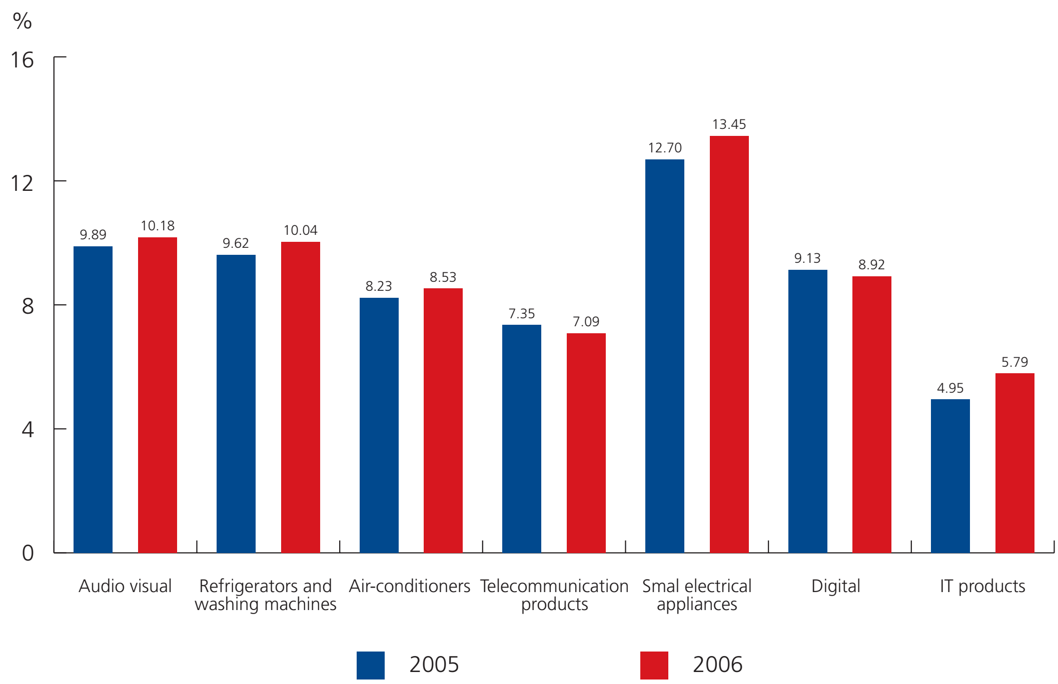
Sales from international brands increased slightly as compared with 2005, which was mainly attributable to a higher proportion of higher-spending customers and of high-end product purchase.

COST OF SALES AND GROSS PROFIT

Cost of sales of the Group was approximately RMB22,369 million in the reporting period, compared to approximately RMB16,307 million in 2005. Gross profit of the Group was approximately RMB2,360 million, compared to RMB1,652 million in 2005. Overall, growth in cost of sales was lower than the growth in sales revenue.

As a result, gross profit margin increased to approximately 9.54% in the reporting period from approximately 9.20% in 2005. The management of the Group is of the view that growth in gross profit margins of the products reflected further enhancement of the Group's economies of scale and better implementation of its product management and pricing strategy.

The following chart illustrates gross profit margin by product category in 2005 and 2006:



OTHER INCOME

Other income of the Group increased from approximately RMB741 million in 2005 to approximately RMB1,252 million in 2006. The increase was mainly due to an approximately 89% increase in incomes from suppliers, which were approximately RMB493 million (or approximately 2.74% of sales revenue) in 2005 to approximately RMB929 million (or approximately 3.76% of sales revenue) in 2006, following the expansion of scale of the Group. Higher management fee received from the Parent Group is also one of the factors contributing to the increase in other operating income.

Other income as a percentage to revenue increased from approximately 4.12% in 2005 to approximately 5.06% in 2006.

Management Discussion and Analysis

OPERATING EXPENSES

The Group's operating expenses principally include selling and distribution costs, administrative expenses and other expenses. The following table sets out a breakdown of operating expenses as a percentage to sales revenue in 2005 and 2006:

	2006 **% to sales**	2005 % to sales
Selling and distribution costs	8.59%	6.84%
Administrative expenses	1.69%	1.50%
Other expenses	0.63%	0.54%
Total	10.91%	8.88%

SELLING AND DISTRIBUTION COSTS

Selling and distribution costs of the Group primarily represent shops rental expenses, staff cost of sales-related staff, advertising, promotional expenses, and utility charges. The following table illustrates the major selling and distribution costs items as a percentage to sales revenue:

	2006 % to sales	2005 % to sales
Rental	3.52%	2.43%
Salaries	1.57%	1.26%
Advertising expenses	0.82%	0.77%
Delivery expenses	0.42%	0.40%
Promotional expenses	0.27%	0.41%
Utility charges	0.83%	0.67%
Others	1.16%	0.90%
Total	8.59%	6.84%

Management Discussion and Analysis

Out of selling and distribution costs of the Group in 2006, rental, salary, advertising expenses, delivery, and promotional expenses in aggregate accounted for approximately 6.60% of the sales revenue, representing an increase of approximately 5.27% as compared to 2005.

Increase in selling and distribution costs, rental expenses in particular, was significant mainly due to the large number of newly opened stores in 2006, and the start-up costs, including the establishment of logistics centers and management offices, procurement of office equipment as the Group entered 58 new cities during the period. Increase in rental expenses as a percentage of sales revenue was also caused by rental rises of retail properties in first tier cities. Salaries also saw a relatively big increase as the Company needed to recruit staff before new store openings.

The management of the Group is of the opinion that higher initial investment costs and operating expenses are natural in the initial development stage in new cities but will pave the path for future growth opportunities.

Administrative Expenses

Administrative expenses as a percentage of sales revenue increased from approximately 1.50% in 2005 to approximately 1.69% in 2006 due to expansion of the Group's operations and start-up investment in newly entered cities.

Other Expenses

Other expenses of the Group, which mainly comprise business tax, bank handling charges and miscellaneous expenses, were approximately RMB156 million in 2006 and approximately RMB97 million in 2005, representing approximately 0.63% and 0.54% of the sales revenue respectively. During the reporting period, increase in other expenses was mainly caused by a higher percentage of customers using credit card for payment, resulting in an increase in processing charges. Moreover, installment purchases also led to an increase in bank handling charges.

FINANCE INCOME, NET

The net finance income of the Group was approximately RMB61 million and RMB70 million in 2006 and 2005 respectively.

PROFIT BEFORE TAX

During the reporting period, the Group's profit before tax was approximately RMB1,068 million, representing a margin of approximately 4.32%, as compared to approximately RMB869 million, or a margin of approximately 4.84% in 2005.

The decline in the profit before tax margin was generally in line with the management's expectation. In accordance with the Group's "Four-Year Growth Initiative" formulated and announced at the beginning of 2005, the Group start to carry out rapid network expansion in 2005 and in the reporting period, resulting in an increase in the number of immature stores and a rise in operating expenses as a percentage of sales revenue. The management of the Group considers such moves are essential in achieving the objectives of the Growth Initiative and are beneficial to the Group's business development and corporate interest in the long run.

INCOME TAX

Income tax paid by the Group was approximately RMB126 million and approximately RMB92 million in the reporting period and in 2005 respectively. Effective tax rate in 2006 and 2005 was approximately 11.76% and approximately 10.58% respectively. The management of the Group considers that the effective tax rate during the reporting period is within an acceptable range.

Management Discussion and Analysis

PROFIT FOR THE YEAR AND EARNINGS PER SHARE ("EPS")

As a result of the foregoing, the Group's profit for the year was approximately RMB943 million and approximately RMB777 million in 2006 and 2005, representing a profit margin of approximately 3.81% and approximately 4.33% respectively. In 2006 and 2005, profit for the year attributable to equity holders after minority interest was approximately RMB819 million and approximately RMB499 million respectively, representing a profit margin of approximately 3.31% and approximately 2.78% respectively. Accordingly, basic EPS of the Group was approximately RMB38 fen in 2006, as compared to approximately RMB30 fen in the corresponding period of 2005.

CASH AND CASH EQUIVALENTS

At the end of the reporting period, the Group's cash and cash equivalents were approximately RMB1,452 million, as compared to approximately RMB1,079 million at the end of 2005.

INVENTORY

At the end of the reporting period, the Group's inventory amounted to approximately RMB4,883 million and its inventory turnover days increased from approximately 43 days in 2005 to approximately 53 days in the reporting period (after excluding the impact of merger with China Paradise). The increase in inventory turnover days was mainly due to the increase in the number of second tier cities and the longer logistics flow and supply chain.

PREPAYMENT AND OTHER RECEIVABLES

At the end of the reporting period, prepayment and other receivables of the Group amounted to approximately RMB1,298 million, as compared to approximately RMB467 million at the end of 2005.

TRADE PAYABLES AND BILLS PAYABLES

At the end of the reporting period, trade payables and bills payables of the Group amounted to approximately RMB12,615 million, as compared to approximately RMB6,805 million at the end of 2005. The turnover days of trade payables and bill payable were approximately 135 days for the reporting period, slightly longer than the approximately 112 days in 2005.

CAPITAL EXPENDITURE

During the reporting period and 2005, capital expenditure incurred by the Group amounted to approximately RMB434 million and approximately RMB958 million respectively. The main reason for the decrease was that the Group did not purchase any properties during the reporting period.

CASH FLOW

During the reporting period and 2005, net cash outflow and inflow from operating activities amounted to approximately RMB126 million and approximately RMB523 million respectively. Cash outflow from investing activities amounted to approximately RMB1,004 million and approximately RMB1,092 million respectively during the periods.

Cash inflow from financing activities of the Group during the reporting period amounted to approximately RMB1,506 million, while there was no cash flow from financing activities in 2005. During the reporting period, cash flow from financing activities mainly arose from the issuance of convertible bonds to Warburg Pincus and bank loans secured by China Paradise.

Management Discussion and Analysis

OUTLOOK AND PROSPECTS

2007 OPERATIONAL PLANS AND STRATEGIES

First, the Group aims to enhance its market share in different regions and cities through the establishment of "flagship stores" and "core traditional stores", and to realize their channel value and improve store operating quality through effective network control. To cope with the Group's rapid development and to cater to the needs of different customer groups, the Group will categorize its existing and future stores into "flagship stores", "traditional stores", "supermarket stores" and "specialized stores" in 2007. Flagship stores aim to capture market share and enhance brand image through leveraging supplier resources. At the same time, the Group seeks to cater to the needs of different customer groups by using different story layouts and operating models through the categorization of stores. The Group will also seek to improve its performance in telecommunication products, which has been a relatively weak segment.

Second, the Group will view primary cities as its core markets while further expanding into second and third tier markets to establish a comprehensive nationwide network. The Group will also continue to fine-tune its store model in second tier markets in an effort to accelerate growth and profitability. The Group will seek to enhance its competitiveness in these markets through improved efficiency in logistics and distribution arrangements, product offerings, after-sales services as well as nimble human resources deployment.

Third, the Group is committed to increasing its profitability through product mix optimization. To this end, the Group will strengthen product management and replicate its success in selling traditional home appliances in the IT and digital products sectors.

Fourth, the Group targets to enhance profitability by product differentiation. The Group will continue to pay close attention to shifts in market dynamics and consumer preferences and work closely with our suppliers in areas of product development and introduction. The Group will leverage its economies of scale to enlarge its portfolio of exclusive models in order to take better control of pricing in the end retail market and enhance profitability.

Last but not least, the Group will further extend its scope of value-added services. The Group will seek to expand the newly introduced extended warranty service for mobile phones and digital products to other product categories. The move is expected to improve the Group's service scope while generating new sources of profit growth. In order to increase revenue and profit margin of telecommunication products, the Group will strengthen cooperation with telecommunication operators. The management of the Group also believes that IT and digital products present future revenue growth opportunities for retailers.

2007 EXPANSION PLAN

For the year ahead, the Group plans to add around 170 new stores and enter approximately 15 new cities.

Enhancing operating efficiency of individual stores will be the top priority of the Group in 2007. At the same time, the Group may adjust its new store opening plan as its business development plan and revenue level progresses. The Group will also close uncompetitive stores and seek to increase sales per square meter by exploring sub-leasing opportunities, lease term adjustments and lease transfers. Refurbishment of older and aged stores will also be undertaken. Forming alliances with leading property developers to ensure access to prime retail locations and partnership with other chain retailers in sharing customer information will be explored.

ESTABLISHMENT OF CALL CENTER

As discussed in the previous sections, the Group has established the "Household Appliances Hospital" maintained platform and "membership program", and improved its logistics and distribution and e-commerce infrastructure to provide better customer services. To centralize these resources, the Group has decided to set up a call center in 2007.

LOGISTICS INVESTMENTS

In terms of logistics improvement, the Group will focus on the construction of Shanghai Qingpu Logistics Center in 2007, which will includes state-of-the-art inventory management and control functions.

The management of the Group believes that the Shanghai Qingpu Logistics Centre will be a critical component of the Group's logistics infrastructure and will contribute to the overall improvement of such functions in both first tier and smaller cities.

Management Discussion and Analysis

DECLARATION OF DIVIDEND AND DIVIDEND POLICY

The board of directors of the Company (the "Board") has recommended to declare a final dividend of HK3.6 cents (equivalent to RMB3.6 fen) per share. Together with the interim dividend of HK4.2 cents (equivalent to RMB4.3 fen) per share paid during the year, the total dividend for the year would amount to HK7.8 cents (equivalent to RMB7.9 fen) per share. Currently, the directors of the Company (the "Directors") anticipate that the dividend payout ratio will be maintained at approximately 30% of the Group's distributable profit of the relevant financial year. However, the actual payout ratio in a financial year will be determined at the Directors' full discretion, after taking into account, among other considerations, availability of investment and acquisition opportunities.

CONTINGENT LIABILITIES AND CAPITAL COMMITMENT

There were no material contingent liabilities as at the end of the reporting period. However, the Group had capital commitment of approximately RMB101 million at the end of the reporting period.

FOREIGN CURRENCIES AND TREASURY POLICY

All of the Group's revenues and most of its expenses are denominated in RMB. The Group does not believe that it currently has any significant direct foreign exchange risk at its retail business. However, as a result of the issuance of convertible bonds, which are denominated in USD, to Warburg Pincus, the Group does have exposure to foreign exchange risk on its financial liabilities. Should USD strengthens relative to HKD or RMB, the Group's financial liability associated with the convertible bonds, if left unconverted into the Company's common shares, will increase. The Group has not hedged such exposure but may consider doing so in the future. It is the Group's treasury policy to manage its foreign currency exposure, if any, only when its potential financial impact is material to the Group. The management of the Group estimates that less than 10% of the Group's current purchase is imported products, which are sourced indirectly from distributors in the PRC and the transactions are denominated in the RMB.

HUMAN RESOURCES

During the reporting period, the total number of employees of the Group was over 37,000. The Group values human resources management and development. Through the establishment of GOME Management Institute in seven major cities across the country, the Group has further strengthened its capability in management training.