

Management Discussion and Analysis

BUSINESS REVIEW

Fuelled by a favorable market environment characterized by continued economic growth and rising purchasing power in the PRC, the Group continued to achieve remarkable results in 2006. The improvement of living standard helped promote health consciousness among the population in the PRC. Cane sugar is currently widely used in a variety of food and beverage products. More health-conscious consumers prefer starch sweeteners such as glucose as they are more easily absorbed by the human body and is less sweet than cane sugar. Coupled with the surge in the cane sugar price in the first half of 2006, an increasing number of manufacturers, particularly those in the food and beverage industry, are looking for substitutes for cane sugar. Moreover, the growth in various industries such as chemical, fermentation and pharmaceutical industries also increased the demand for crystallised glucose, which is widely used as a raw material for their products. As a result of the strong demand, the selling price of our major products and the turnover of the Group increased substantially as compared with 2005.

In solidifying our position as a leading manufacturer of starch-based sweetener in the PRC, we placed strong emphasis on four core areas that were crucial to our success: (i) strengthening our market-leader position, (ii) enhancing operating efficiency, (iii) strengthening research and development (“R&D”) capability and (iv) strengthening quality control of our products.

(i) Strengthening our market-leader position

Aggressive production capacity expansion program

During the past few years, in order to capture the fast expanding market, we embarked on an aggressive production capacity expansion program. After the completion of our new starch paste and glucose production plants in the first quarter of 2007, the annual production capacity of starch paste increased from 400,000 tonnes to 1,000,000 tonnes while the production capacity of crystallised glucose increased from 250,000 tonnes to 800,000 tonnes.

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Expanding geographical coverage

During the year under review, the Group has successfully expanded its domestic sales network of crystallised glucose which now covers the southern part of the PRC and the coastal regions in the eastern region of the PRC. The number of sales offices in the PRC increased from 7 in 2005 to 17 in 2006. The Group also strengthened its sales support, marketing and after-sale services of its existing distribution centers. These help to reinforce the corporate image and strengthen the sales capacity of the Group.

The Group is aggressively expanding its overseas customer base. During the year under review, we made good progress in penetrating into overseas markets. Revenues from our overseas markets jumped about 147.9% from approximately RMB65.2 million in 2005 to approximately RMB161.6 million in 2006. Revenue from overseas market as a percentage of Group's turnover increased from about 6.3% in 2005 to about 11.7% in 2006. The revenue was derived from overseas markets in the Asia Pacific region, Middle East and Europe.

Commitment to environmental protection practices

The Group considers that the implementation of environmental protection practices and the maintenance of high environmental standards are among the Group's valuable assets and a competitive strength. By pursuing a recyclable production chain, all components extracted from corn kernels and most of the residual materials generated from the production process are being utilized. The Company was accredited with an ISO certification for its environmental protection system in 2004 and awarded as one of the National Environmental Friendly Corporations in October 2005.

(ii) Enhancing operating efficiency

Vertically integrated production line

We have a highly vertically integrated production line. Our production facilities are connected by an enclosed pipeline system to enhance overall production efficiency, minimize wastage of water and raw materials and avoid contamination. With our recyclable production system, we are able to utilize each of the components of a corn kernel. We use recycled steam water instead of fresh underground water to lower production cost. During the year under review, our R&D team successfully developed new production technologies to improve our overall production efficiency.

With the new production capacities for starch paste and crystallised glucose, the Group can further benefit from economy of scale, which will improve the overall profitability and efficiency.

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Sourcing of raw materials

During the year under review, the average corn price increased by about 3% compared with 2005. As corn kernel is our major raw material for production and accounted for over 75% of our cost of sales, the Group has carried out the following measures to maintain a stable source of high quality corn kernel at a reasonable price:

- (a) Forming strategic alliances with our major suppliers and entering into longer term supply contracts for the purchase of corn.
- (b) Diversifying the sources of our raw material from other provinces and overseas - During the year under review, we purchased 52,000 tonnes of corn from the US. The Group will continue to apply for import quotas of corn from the Government of the PRC in 2007.
- (c) Increasing our storage capacity of corn - Our new corn warehouse, was completed in the first quarter of 2007 which increased our total storage capacity for corn from approximately 54,000 tonnes to approximately 250,000 tonnes.

(iii) Strengthening R&D capability

Xiwang Sugar's strong R&D team constantly strives to improve production techniques and develop new technologies and products to further enhance its core capabilities. During the year under review, our R&D efforts continued to drive our growth as we continued to launch new higher-value products to the market. An important development is the invention of a new type of starch sweetener, namely, Crystallised Fructose-Glucose (CFG). As the new product is healthier and 10% sweeter than cane sugar, this product will be targeted at customers in the food and beverage industry. The Group is currently applying for a patent for this product and expects to commence mass production of this product in 2007. We have sent samples of this new product to our existing and prospective customers. The responses have been encouraging and we expect this new product will contribute positively to our financial results in the years ahead.

(iv) Strengthening quality control of our products

The Group has always placed strong emphasis on the quality control of its products by establishing quality control procedures for each production process. The Group has obtained ISO certifications and was approved as a glucose quality inspection centre for the China Fermentation Industry Association, which represented extensive market recognition of its quality control system.

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FINANCIAL REVIEW

During the year under review, the Group has achieved continuous growth in turnover and net profit. Turnover increased to approximately RMB1,384.9 million, representing a significant rise of about 33.5% as compared to approximately RMB1,037.7 million in the previous year. Net profit for the year was approximately RMB290.2 million representing an increase of about 38.3% as compared to approximately RMB209.8 million in 2005. Basic earnings per share for the year was RMB0.356 (2005: RMB0.365).

TURNOVER

The Group's turnover by product types is as follows:

	Year				
	2006		2005		Percentage Change
	<i>RMB'000</i>	% to sales	<i>RMB'000</i>	% to sales	
Corn refined products	444,117	32.1	286,605	27.6	54.9
Corn-based biochemical products	940,828	67.9	751,106	72.4	25.2
Total	1,384,945	100.0	1,037,711	100.0	33.5

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The significant increase in turnover in 2006 as compared to 2005 was mainly due to the following reasons:

Firstly, as the Group launched its lysine products in May 2005, contribution from the sales of lysine products were fully reflected in this year's turnover. Sales of lysine products increased by about 77.6% from approximately RMB170.3 million in 2005 to approximately RMB302.5 million in 2006.

Secondly, the selling prices for crystallised glucose and glucose syrup increased as a result of the surging price of cane sugar in the first half of 2006. The average selling price of crystallised glucose and glucose syrup increased from approximately RMB2,660 and approximately RMB1,840 per ton in 2005 to approximately RMB2,911 and approximately RMB2,274 per ton in 2006.

Thirdly, the sales of corn refined products, particularly animal feed and starch paste, increased substantially compared with 2005. The sales of corn refined products increased by about 54.9% from approximately RMB286.6 million to approximately RMB444.1 million over the 2005.

GROSS PROFIT

The Group's overall gross profit in 2006 increased by approximately RMB103.8 million, representing an increase of approximately 39.7% as compared to that of 2005. The overall gross profit margin slightly increased from about 25.2% in 2005 to about 26.4% in 2006. The increase in gross profit margin was mainly attributable to the increase in the average selling price of crystallised glucose, glucose syrup and animal feed.

OTHER GAINS, OPERATING EXPENSE AND FINANCE COSTS

Other gains

The increase in other gains by approximately RMB6.1 million in 2006 was mainly due to the increase in interest income by approximately RMB3.7 million and the subsidy income from the PRC Government for the development of new products of approximately RMB2.8 million.

Selling and marketing costs

Selling and marketing costs increased by approximately RMB7.1 million from approximately RMB28.7 million to approximately RMB35.8 million. Such an increase was principally a result of the increase in sales commission and transportation costs which were in line with the growth in turnover. Sales commission represented the commissions paid to salesmen of the Group and was calculated with reference to the sales of products generated by the respective salesmen. Transportation costs mainly represented export and local transportation expenses for the sales of products. Selling and marketing costs as a percentage of turnover decreased to about 2.6% in 2006 (2005: about 2.8%).

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Administrative expenses

Administrative expenses increased by approximately RMB14.7 million from approximately RMB8.3 million to approximately RMB23.0 million. The increase was mainly due to the increase in expenses for the newly established Hong Kong office, staff costs, amortization of land use right acquired during the year, administrative costs associated with the maintenance cost of listing and an increase in professional costs. Administrative expenses expressed as a percentage of the Group's turnover increased to about 1.7% in 2006 (2005: about 0.8%).

Finance costs

Finance costs mainly represented bank interest expenses amounting to approximately RMB26.6 million and RMB18.1 million in 2006 and 2005 respectively. Bank interest expenses increased sharply in 2006 mainly due to the increase in bank borrowings during the year to finance the capital expenditure and general working capital requirements of the Group.

PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY

Profit attributable to equity holders of the Company for the year ended 31 December 2006 was approximately RMB290.2 million, which represented an increase of 38.3% from approximately RMB209.8 million in 2005. Net profit margin (profit for the year expressed as a percentage of sales) attributable to equity holders of the Company for the year was 21.0%, representing an increase of 0.8% as compared to 20.2% in 2005.

LIQUIDITY, CAPITAL RESOURCES AND GEARING RATIO

For the year ended 31 December 2006, the net cash inflow from operations of the Group amounted to approximately RMB243.8 million, as compared with net cash inflow of approximately RMB230.7 million for 2005.

Net borrowing (cash and cash equivalents less bank borrowings) as at 31 December 2006 amounted to approximately RMB208.5 million, representing a decrease of approximately RMB365.9 million as compared with the net cash position as at 31 December 2005. The change of net cash position in 2005 to net borrowing position in 2006 was mainly due to the increase in fixed assets investment amounting to approximately RMB647.5 million in 2006. As at 31 December 2006, the consolidated bank borrowings of the Group were approximately RMB871.1 million (2005: approximately RMB344.7 million), representing an increase of about 152.7% or approximately RMB526.4 million over that as at the previous year end date. The Group's net debt gearing ratio (bank borrowings net of cash on hand and bank deposits to equity) was approximately 17.8% (2005: Nil).

The Group entered into an unsecured syndicated loan agreement for a loan facility of up to US\$60 million on 21 November 2006 for the future capital expenditure requirements and working capital requirements of the Group. The interest rate applied to these facilities is London Interbank Offered Rate (LIBOR) plus 100 basis points. These facilities enabled the Group to increase the proportion of non-RMB loans to the Group's total loans. In addition, the Group could also better utilize its RMB income and accelerate the repayment of RMB loans in order to maximize the benefit from the appreciation of RMB brought to the Group.

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CONTINGENT LIABILITIES

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

FOREIGN EXCHANGE RISK

Most of the Group's income and expenses are denominated in Renminbi. For the year ended 31 December 2006, the Group did not experience any material difficulties or negative effects on its operations or liquidity due to currency exchange rate fluctuation. The Group did not enter into any foreign exchange hedging arrangement during the year ended 31 December 2006.

HUMAN RESOURCES

As at 31 December 2006, the Group had about 2,044 employees (2005: 1,403 employees).

In addition to basic remuneration packages and discretionary bonuses for Directors and employees, share options may also be granted to Directors and eligible employees based on the Group's results and the performance of individuals.

FUTURE PROSPECTS AND DEVELOPMENT STRATEGIES

2007 is the second year of the implementation of the Eleventh Five-Year Plan of the PRC. The economy in the PRC will be gradually transforming from an investment driven model to a consumption driven model, helping the PRC to become one of the world's consumption giants. China's increasing purchasing power will drive the demand for consumer products which will in turn lead to an increasing demand for the Company's products. The growth in various processing industries will lead to the increase in demand for crystallised glucose, which can be widely applied as raw material in various industries such as fermentation, chemical, food and beverage and pharmaceutical industries.

In order to leverage on these growth trends, the Group is establishing new production facilities to further expand the production capacity to capture these rising opportunities. The Group contemplates to increase each of the production capacity of starch paste and crystallised glucose by 600,000 tonnes and 550,000 respectively. The new production facilities for starch paste and crystallised glucose commenced production in the first quarter of 2007. Through establishment of new production facilities, the Group's leading position in glucose industry in the PRC will be further strengthened.

Due to the weak market condition of lysine products, the Group switched the production of lysine products to glutamic acid which is a raw material for monosodium glutamate ("MSG") in late 2006. The production facility of glutamic acids is similar to that of lysine products and the demand for glutamic acids is strong in the market. The annual production capacity of glutamic acids will be increased to 80,000 tonnes in the 3rd quarter of 2007.

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In response to the increasing cane sugar demand and the persistent gap between the supply and demand of cane sugar in the PRC, the Group successfully developed a new product, namely, Crystallised Fructose-Glucose. As the new product is healthier and sweeter than cane sugar, the Group will target this product to customers in the food and beverage industries. The Group is currently applying for a patent for this product and expects to commence mass production of this product in 2007. Samples sent to existing and potential customers have been met with positive feedback and the Group expects this new product to be an important growth driver for the coming years.

In addition to actively expanding the production capacity to meet the growing demand for glucose, the Group strives to step up its sales and marketing efforts in the overseas markets, especially in other Asian and European countries. Moreover, the Group values its relationship with its customers by strengthening its sales support, marketing and after-sale services as well as reinforcing its corporate image and expanding its customer network.

Looking forward, the Group will leverage on its scale of production capacity, vertically integrated operation model, strong research and development capability and experienced and professional management team to capture new business opportunities and explore potential market, with the view to becoming a global leading starch-based sweetener producer and maximizing shareholders' returns.





GROWTH IN PRODUCTS



In response to the increasing cane sugar demand and the persistent gap between the supply and demand of cane sugar in the PRC, the Group successfully developed a new product, namely, Crystallised Fructose-Glucose. As the new product is healthier and sweeter than cane sugar, the Group will target this product to customers in the food and beverage industries.