Management Discussion and Analysis

RESULTS OVERVIEW

Year 2006 has been a challenging period for the Group's operations. The sharp increase of raw material prices and other costs, the appreciation of Chinese currency (the RMB) versus the US dollar, and the reduction of tax rebates for export are major adverse factors. In addition, the slowdown of the US housing market and the associated weak demand of quality furniture, and the intense pricing competition resulted from overcapacity of this industry in China aggravate our business.

For the year ended December 31, 2006, the Group's turnover increased by 12.7% to RMB3,916.5 million (2005: RMB3,475.5 million), while its profit for the year decreased by 68.0% to RMB83.4 million (2005: RMB260.4 million). The profit attributable to equity holders of the Company for 2006 was RMB64.1 million, as compared to RMB265.7 million in 2005.

The Group's gross profit margin in 2006 was 10.9%, representing a decrease of 4.9 percentage points as compared to 2005.

The Group's principal raw materials are cowhides and wet blues, which accounted for approximately 44% of the total cost of sales in 2006. Other major raw materials include chemicals, foam, timber, and fabric.

Cost of Sales Breakdown

Item	**2006** **%**	2005 %
Raw cowhides and wet blues	**43.7**	46.5
Chemicals	**10.8**	11.9
Fabric	**8.3**	9.3
Foam	**7.8**	6.8
Timber	**5.3**	4.6
Other raw materials	**9.7**	5.0
Labour	**6.5**	6.9
Depreciation	**2.2**	2.3
Others	**5.7**	6.7

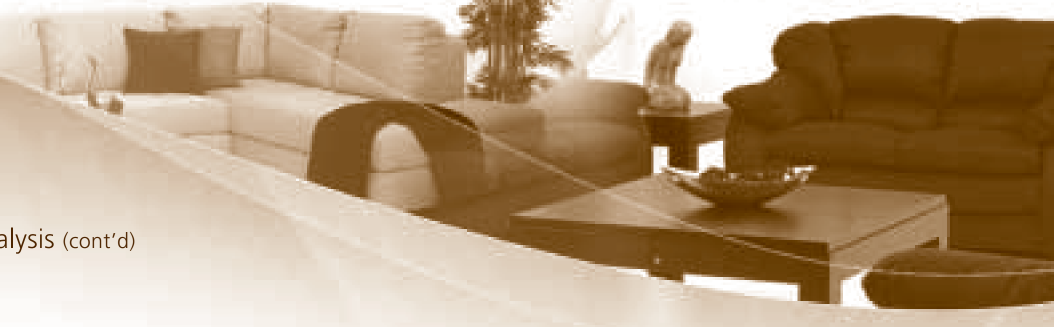
Since the beginning of 2006, the prices of raw cowhides in the global market have increased by approximately 30%. This was the major contributor to the decline of the gross profit margin. In addition, due to the global inflation of commodities prices, costs of chemicals, foam, timber and, to a lesser extent, labor, also increased.

Approximately 84% of the Group's sales are denominated in US dollars. Although the Group has a natural hedge of approximately 50% by importing raw cowhides and chemicals, the appreciation of the RMB against the US dollar still had a significant impact on the Group's gross margin.

The Group's gross margin was also adversely affected by the provision of RMB9.4 million for obsolete inventory of chemicals. This amount was recorded as cost of sales.

OPERATING EXPENSES, TAXATION AND PROFIT ATTRIBUTABLE TO EQUITY HOLDERS

Under the FOB trading terms, the marine freight charges of almost all the exporting business of the Group were borne by the customers. However, the Group's sales of finished upholstered furniture increased by 22.1%, this has led to an increase of RMB20.4 million, or 31.3% in land transportation costs. In addition, the Group incurred an additional RMB14.7 million in credit insurance, commission and customer clearance charges. As a result, the Group's distribution costs for the period increased by 32.4% compared to last year, and the percentage of distribution costs to turnover rose slightly to 2.8% (2005: 2.3%).



The increase of 51.2% in administrative expenses was mainly due to: (1) a charge of RMB15.4 million on the Group's granting of share options to its executives and employees; (2) an increased provision of RMB10.6 million on trade receivables; (3) an increase of RMB6.0 million in travel and entertainment expenses; (4) an increased exchange loss of RMB3.4 million on the Group's trade receivables arising from the RMB appreciation; and (5) an increase of RMB2.5 million on professional fees.

The Group has gradually reduced its bank borrowings and has been successful in negotiating reduced interest rates on these borrowings. As a result, the Group's finance cost reduced by 23.4% compared to the same period of last year.

During the year under review, the Group assessed the recoverable amount of goodwill arising from previous acquisitions, and determined that goodwill associated with the Group's automotive leather operation and a non-operating subsidiary was impaired by an aggregate of RMB23 million (2005: Nil). This impaired amount was recorded as Other Expenses. For details, please refer to Note 14 to the Consolidated Financial Statements.

The overall effective tax rate of the Group increased to 20.6% (2005: 6.6%) because: (1) the provisions for share based payment expenses, goodwill impairments, foreign exchange losses etc. are made at consolidation level while income tax is calculated based on profitability at subsidiary level; (2) tax reliefs for the Group's two major profit making subsidiaries have expired; and (3) the provisions made at subsidiary level for bad debts and inventory are non-deductible expenses for PRC tax computation. As a matter of prudence, deferred tax assets have not been recognized in respect of temporary differences arising from the provisions set out above.

For reasons mentioned above, profit attributable to equity holders of the Company decreased by approximately 75.9% to RMB64.1 million (2005: RMB265.7 million).

SALES ANALYSIS BY PRODUCTS

The table below shows the total turnover by product category for the year under review:

	2006		**2005**		**Y-O-Y Change**
	RMB'Million	**%**	RMB'Million	%	%
Upholstered furniture					
Leather Sofa	**1,841.5**	**47.0%**	1,550.5	44.6%	18.8%
Fabric Sofa	**408.1**	**10.4%**	292.4	8.4%	39.6%
Leather Cut-and-Sew	**626.2**	**16.0%**	542.2	15.6%	15.5%
Fabric Cut-and-Sew	**247.1**	**6.3%**	370.0	10.7%	(33.2%)
Furniture Leather	**615.1**	**15.7%**	593.1	17.0%	3.7%
Automotive Leather	**150.1**	**3.8%**	126.9	3.7%	18.3%
Others	**28.4**	**0.8%**	0.4	0.0%	N.M.
Total	**3,916.5**	**100%**	3,475.5	100%	12.7%

N.M. – Not meaningful.

Upholstered Furniture

The upholstered furniture (including leather and fabric sofas, leather and fabric cut-and-sew) remained the core products of the Group, and its sales accounted for 79.7% of the total turnover in 2006 (2005: 79.3%). The Group's sales of sofa cut-and-sew kits remained largely unchanged as major OEM customers have opted to place more orders on finished sofas. During the year, leather sofa sales increased by 18.8% and fabric sofa sales increased by 39.6%.

Furniture Leather

The Group's priority in furniture leather production is to meet the internal leather requirement of its growing upholstered furniture division. Due to the increase in raw cowhide price and the shortage in cowhide supply pipeline, the Group's external sales of furniture leather only recorded a modest growth of 3.7%.

Automotive Leather

The automotive leather operation, although achieved an 18.3% increase in turnover, continued to be under-performing. Through major US automotive seating companies, such as Intier Automotive and Johnson Controls, we were able to secure supply contract for some major US automotive models. However, due to the reduction in tax rebates for finished leather exports, our price advantage was undermined, which led to less than expected sales volume.

SALES ANALYSIS BY REGIONS

The table below shows the total turnover by geographical market for the year under review:

	2006		**2005**		**Y-O-Y Change**
	RMB'Million	**%**	RMB'Million	%	%
USA	**2,825.8**	**72.2%**	2,383.8	68.6%	18.5%
Europe	**160.3**	**4.1%**	120.3	3.5%	33.3%
Australia	**122.3**	**3.1%**	187.5	5.4%	(34.8%)
PRC, including HK	**736.1**	**18.8%**	727.0	20.9%	1.3%
Others	**72.0**	**1.8%**	56.9	1.6%	26.5%
Total	**3,916.5**	**100.0%**	3,475.5	100.0%	12.7%

The Group continued to expand its markets in the US during the year. In line with the ongoing outsourcing trend of consumption products in the US, the Group's sales increased strongly in this market. After years of efforts, the Group has established long term cooperation with five of the top ten upholstered furniture manufacturers. The Group's sales in the US increased by 18.5% and, as a percentage to the total sales, the turnover in the US accounted for 72.2%.

The Group's expansion into the European market is still at its initial state. The 33.3% increase for this segment is mainly from a one-off sales of finished leather to Russia. As for upholstered furniture, although the total volume remained unchanged, the Group was able to consolidate its customer base by establishing stronger relationships with some major customers.

The Group's strategy of working with retail customers in Australia had caused the termination of supply relationship with a major OEM customer, as a result, the Group's sales to Australia recorded a decrease of 34.8% in 2006.

The Group's sales to the PRC domestic market mainly involved furniture leather and automotive leather, the turnover of which represented 18.8% of its total sales. Business in this segment increased by 1.3% in 2006.

CAPITAL EXPENDITURES

Capital expenditure in 2006 decreased by 53.7% to RMB107.3 million (2005: RMB231.5 million), as most of the expansion for manufacturing facilities was completed prior to 2005. The capital expenditure in 2006 was mainly used in (1) addition of property, plant and machinery for the Higher Point operations; (2) maintenance and replacement of machinery for furniture leather production; and (3) purchase of land. The principal expenditure for these items were approximately RMB44.9 million, RMB28.6 million and RMB33.5 million respectively.

In addition to the above, the Group spent RMB49.9 million in 2006 to acquire the minority interests in two Higher Point subsidiaries.

FINANCIAL RESOURCES AND LIQUIDITY

Net Borrowings

As at December 31, 2006, the Group's net borrowings amounted to RMB1,257.1 million (December 31, 2005: RMB1,291.7 million). The Group's net borrowings primarily comprise of (1) short-term borrowings of RMB1,246.7 million provided by local banks, bearing an interest rate ranging from 4.65% to 8.78% per annum; and (2) government debt of RMB10.4 million, bearing an interest rate of 2.55% per annum. For details, please refer to note 27 to the Consolidated Financial Statements.

Turnover Period, Liquidity and Gearing

The Group's inventory primarily represented raw cowhides and wet blues used for production, accounting for approximately 44.7% of the total inventory of RMB1,326.2 million (2005: RMB1,378.8 million). In 2006, the Group endeavoured to control inventory level and managed to decrease its inventory turnover period to 139 days (2005: 172 days).

In 2006, the Group continued to maintain a strict credit policy, resulting in a decrease in account receivables turnover days to 46 days (2005: 54 days).

The Group attempted to shorten the accounts payable credit term so as to cut the purchase costs. As a result, the accounts payable turnover days decreased to 51 days (2005: 77 days).

As at December 31, 2006, the Group's current ratio and quick ratio decreased slightly to 1.35 (December 31, 2005: 1.38) and 0.65 (December 31, 2005: 0.71), respectively. The Group's cash and cash equivalent balance was RMB381.0 million (December 31, 2005: RMB372.3 million). This represents a gearing ratio of 57.1% (December 31, 2005: 55.8%) and a net debt-to-equity ratio of 39.7% (December 31, 2005: 39.6%). The gearing ratio is based on bank borrowings to shareholders' equity and the net debt-to-equity ratio is based on bank borrowings net of cash and cash equivalent to shareholders' equity.

The Group had drawn down a syndicated loan in aggregate of HK$125,000,000 arranged by CITIC Capital Markets Limited in January 2006. The syndicated loan, with a term of three years, bears interest at 2.00% over 12-month Hong Kong Interbank Offering Rate per annum. In late September 2006, the Group repaid the full amount of loan principal and interest payable to the borrowers of the syndicated loan arrangement.

CONTINGENT LIABILITIES

During the year, the Group has terminated all cross-guarantee arrangements previously entered between the Group and Haining Changhai Packaging and Printing Co., Ltd. ("Haining Changhai"). As of the balance sheet date, the Group has no material contingent liabilities.

PLEDGE OF ASSETS

Certain of the Group's assets have been pledged to secure the borrowings of the Group. For details, please refer to note 34 to the Consolidated Financial Statements.

FOREIGN EXCHANGE EXPOSURE

Starting from July 2005, the Chinese government changed its policy of pegging the value of the RMB to the US dollar. Under the new policy, the RMB has fluctuated within a narrow and managed band against a basket of certain foreign currencies. As a result of this policy change, the RMB appreciated approximately 2.5% and 3.4% against the US dollar in 2005 and 2006, respectively. It is possible that the Chinese government could adopt a more flexible currency policy, which could result in a more significant fluctuation of the RMB against the US dollar.

Considering the limited alternatives of hedging instruments and the restricted currency convertibility of the RMB, the Group neither used any financial instrument for hedging purposes during the year, nor had any hedging instrument outstanding as at December 31, 2006.

The Group's businesses are principally export-related and transactions are primarily denominated in US dollars (approximately 84%). Although a substantial portion of the Group's procurements is denominated in US dollars, management considers that the Group is still exposed to foreign exchange fluctuation risks. Therefore, in the long term our strategies would tend to minimize the mismatch between the US dollar revenue and the RMB costs.

EMPLOYEES AND EMOLUMENTS POLICIES

As at December 31, 2006, the Group employed a total of approximately 14,800 full time employees (2005: 16,000) which included management staff, technicians, salespersons and workers. For the year ended December 31, 2006, the Group's total expenses on the remuneration of employees is RMB286,659,000 (2005: RMB237,063,000) and represents 7.32% (2005: 6.82%) of the operating revenue of the Group. The Group's emolument policies for employees are formulated on the performance of individual employees, which will be reviewed regularly every year. Apart from the provident fund scheme (according to the provisions of the Mandatory Provident Fund Schemes Ordinance for Hong Kong employees) or state-managed retirement pension scheme (for the PRC employees) and medical insurance, discretionary bonuses and employee share options are also awarded to employees according to the assessment of individual performance.

The Group's emolument policies for Directors and other senior management are formulated with reference to their qualification and experience, responsibilities undertaken, contribution to the Group, and the prevailing market level of remuneration for executives of similar position. No Director is involved in deciding his or her own remuneration.

FUTURE PLANS AND PROSPECTS

Looking forward, export-oriented manufacturers for household products in China will continue to face challenges as the RMB is expected to accelerate its appreciation and the Chinese government is under pressure to implement policies to manage the country's massive trade surplus. The Group is of the view that the current macro environment is not favorable to the Group's core businesses.

However, the Group will make every effort to strengthen its position as China's leading manufacturer of leather products and upholstered furniture. The Group aims to achieve its growth with the following initiatives:

Maintaining and strengthening our position as a major OEM partner for the US upholstered furniture industry

The US is currently the largest market for the Group's upholstered furniture products. The slowing down in the US home sales and residential remodeling expenditure has had adverse impact on the sales of residential furniture in 2006. This has in turn affected the Group's sales in the second half of 2006 as its US customers slowed down their orders. However, the Group maintains its view that US brand name furniture companies will continue to outsource their manufacturing to low cost countries.

Compared with other competitors, the Group has a unique advantage in its vertically integrated production and large scale manufacturing capabilities. These advantages were demonstrated by the Group's continued ability for timely delivery of high quality products at competitive prices during difficult times. The Group's reputation as a quality OEM partner and its business relationships with major US customers were strengthened. The Group will maintain its uncompromising commitment to customer value in order to achieve modest growth in both its North America sales and profitability.

Actively exploring market opportunities in Europe and other countries

With the low penetration rate of Chinese made furniture, the European market may offer greater potential to the Group's products. The Group has recently allocated more resources to this market segment by recruiting new personnel and by developing branded products more suited for this market.

Over the past few years, the Group has been able to accumulate product know-how, and design capabilities have improved significantly. The Group's own design accounted for more than 30% of the Group's total sales volume in 2006. The Group's design capabilities will enable the Group to meet the varying demands of the European customers who are operating under even more fragmented markets.

Improving operational efficiency and rationalizing costs

The Group has been expanding its capacities over the last few years, and it is now time to leverage on its economy of scale to improve profitability. The Group recognizes the importance of business process efficiency, and will continuously improve its raw material procurement and its supply chain management. In addition, the Group proposes to implement new incentive schemes to motivate its business units. The Group believes that these initiatives are important to maintain and to strengthen the Group's competitiveness.

The price hike of raw materials is unlikely to diminish in the near term, and as a result, the Group is undertaking actions to develop new products with alternative raw materials to reduce reliance on raw cowhides. Management strongly believes that rationalization of cost base would be able to partially mitigate the adverse effect of raw material price increases.

Establishing domestic presence to tap into China's growth potentials for consumption goods

The upholstery furniture market in China is currently very fragmented. Sofas are mainly being sold by small independent specialty stores within furniture malls. Customers not only have limited choices, but also have to bear additional costs arising from inefficient marketing channels. The Group believes that, with its fast growing economy, China's residential furniture market will be going through major changes in the next few years. The mid to higher end segments are likely to offer better growth potentials, while large players will emerge as stronger competitors in the market. The Group is planning to tap into China's growth potentials for mid to higher end residential furniture by opening large furniture malls in major cities in China. For the year of 2007, two to three flagships stores are to be opened in Shanghai and Hangzhou. These stores will be established through leasing arrangement, so the capital requirement will not exceed RMB20 million.

To further diversify its revenue sources and implement its domestic marketing plans, the Group has formed a joint venture company with Haining Leather Market, a well-known and experienced developer and operator of large leather product shopping malls in China, and Haining Zhengyang Trading. The joint venture company, in which the Group will have a 51% equity interest, will be looking for new sites in major cities to develop large specialized leather product shopping malls. On January 29, 2007, the joint venture partners, through Haining Higher Point, the Group's wholly-owned subsidiary, have successfully tendered a land of approximately 145,078 square meters in Changsha, Hunan province with a consideration of RMB253.75 million. The Group believes that, by leveraging on the Group's strong capabilities as leather product manufacturer and its joint venture partner's extensive knowledge and experience in successfully developing and operating leather product shopping malls, the Group will be able to establish a strong foothold in China's domestic leather product market.