

Management Discussion AND ANALYSIS

Turnover and Operating Profit/(Loss) by Brand For the year ended 31 December 2006

HK\$'000	Daphne	Shoebox	adidas Originals	Total
Turnover				
- Store	1,314,363	139,175	32,402	1,485,940
- Counter	473,059	-	160,914	633,973
- Others	192,452	3,432	513	196,397
	1,979,874	142,607	193,829	2,316,310
Gross profit	1,105,594	73,070	76,807	1,255,471
Operating profit/(loss)	326,838	(4,590)	7,955	330,203

Sales and Distribution Network of the Group As at 31 December 2006



North Eastern China

	STORE	COUNTER
Daphne	239	70
Shoebox	30	-
adidas Originals	2	16

Southern China

	STORE	COUNTER
Daphne	393	126
Shoebox	46	-
adidas Originals	-	10

Northern China

	STORE	COUNTER
Daphne	187	124
Shoebox	14	-
adidas Originals	-	21

Eastern China

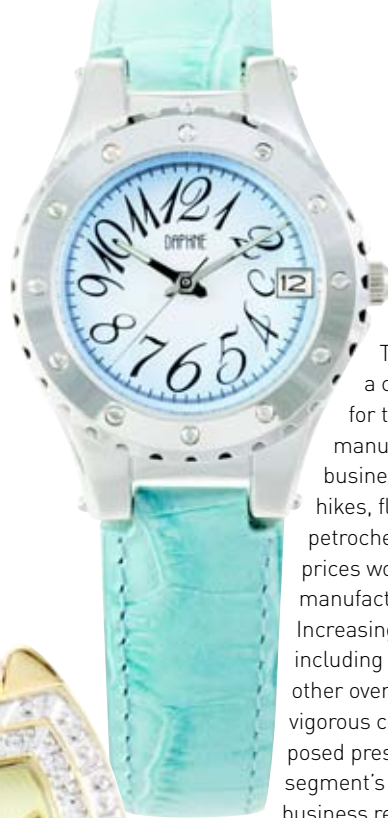
	STORE	COUNTER
Daphne	470	137
Shoebox	61	-
adidas Originals	6	30

West Central China

	STORE	COUNTER
Daphne	158	34
Shoebox	13	-
adidas Originals	2	17

Taiwan

	STORE	COUNTER
Daphne	34	-



BUSINESS REVIEW

The Group's businesses continued to progress steadily in the year 2006. Building on the encouraging results achieved in 2006 and with demands for quality and branded footwear in Mainland China growing continuously, the Group's brand business enjoyed strong drive during the year while the OEM business remained as one of the Group's major operations.

OEM Business

The segment accounted for 25% (2005: 30%) of the Group's total turnover by contributing a solid revenue of HK\$776,776,000 (2005: HK\$795,336,000). Its major customers are mainly from the US market.

The year 2006 was a challenging year for traditional manufacturing business. Interest rate hikes, fluctuating oil and petrochemical materials prices worked against manufacturers worldwide. Increasing production costs including labour costs and other overheads on top of vigorous competition also posed pressure on the segment's profit. The business reported a decrease

in operating profit of 38% to HK\$69,851,000 (2005: HK\$112,849,000). Gross profit margin and operating profit margin dropped to 18% and 9% (2005: 24% and 14%) respectively.

In response, the Group continued the strategic approach of pulling out resources from low margin operation to support higher margin orders. It also strived to foster relationship with key customers so as to maximize order volume and the segment's profit margin. The Group also spent on system enhancement and staff training during the year to make sure it was able to meet the increasingly sophisticated requirements of customers.

Brand Business

The Group's brand products were well received during the year by mainland consumers following the increasing household income and purchasing power. The Group offered diversified fashionable ladies' products including footwear, handbags and accessories sold under the "Daphne" brand in "Daphne D18" and "Daphne D28" chains, as well as "Shoebox" chain stores. The Group also owns the "adidas Originals" exclusive retail shop right in China. The Group's wide product portfolio, supported by intensive promotional tactics, had seen its brand business climb to a new level.

For the year ended 31 December 2006, the turnover of brand business increased by 27% to HK\$2,316,310,000 (2005: HK\$1,827,341,000), making up 75% of the Group's total turnover. Sales from "Daphne" demonstrated a satisfactory growth of 26% to HK\$1,979,874,000 (2005: HK\$1,574,100,000), accounting for a notable 64% of the Group's total turnover. Sales from "Shoebox" also witnessed a substantial 90% increase to HK\$142,607,000 (2005: HK\$75,207,000), accounting for 5% of the Group's total turnover. Sales from the "adidas Originals" exclusive retail shop business reached HK\$193,829,000 (2005: HK\$178,034,000), representing a 9% increment over the previous year and a 6% share of the Group's total turnover.

Notwithstanding surging costs such as material costs, rental costs and labour costs, the Group managed to shift part of the burden to ultimate consumers by adjusting the average selling price of its well-received brand products. Consequently, cost pressure did not affect the Group's ability to achieve an overall increase of 58% in operating profit of the business to HK\$330,203,000 (2005: HK\$209,471,000). The segment registered a gross profit margin and an operating profit margin of 54% and 14% (2005: 52% and 11%) respectively.

"Daphne" Business

The well-received brand "Daphne" continues to play an essential role in leading the Group's advancement. With an expanded brand portfolio, "Daphne" has gained popularity among different target customer groups. To ride on the popularity of the brand and capture increasing feminine spending in China, the Group added 495 new points-of-sale for "Daphne" during the year in China, bringing the total points-of-sale of the brand to 1,447 stores and 491 counters as of 31 December 2006 (2005: 1,070 stores and 373 counters).

Among them, 242 new points-of-sale are for "Daphne 18", which targets fashion-sensitive young ladies aged 15 to 25, bringing the chain's total number of points-of-sale to 517. For "Daphne 28", which appeals to female customers aged 26 to 50 with diverse product offerings, 253 new points-of-sale were added, taking the total to 1,421.

In 2006, "Daphne" for the first time established a foothold in Taiwan as a prelude to extend its geographical reach outside Mainland China. In less than a year, the Group established a distribution network with over 30 points-of-sale in Taiwan for the brand. However, with Taiwan being a very competitive market for branded and quality footwear compounded by a sluggish economy in recent years, it is believed that there was huge room for improvement of performance. Accumulating experience in Taiwan operations, the Group will be able to build further the image and consumer awareness for "Daphne" brand. It will also fine tune management and implement more effective cost control measures to improve the profitability of its Taiwan business. Though much work is still needed to cultivate the Taiwan market, the Group is confident of the potentials and long-term prospects of the business.

Through consistent dedicated advertising and promotion efforts, the Group has achieved strong recognition for its brand among customers. The Group sees value in the "Daphne" brand in assisting its penetration of different markets and target customer groups. Thus, during the year, the Group continued to appoint the popular girl pop group "S.H.E" as the spokesperson for "Daphne 18" and Ms Rene Liu as the spokesperson for "Daphne 28" to fortify the strong image of the brand. Other creative ways of promotion included sponsorships of concerts of well-known singers, Mr Jeff Zhang and Mr Emil Zhou, to attract mass attention to the brand in China,

Taiwan and Hong Kong. The Group has formulated plans for advertising and promotions and the relevant budgets are reviewed on a regular basis.

"Shoebox" Business

The business is a development focus of the Group. In 2006, the Group nearly doubled the number of "Shoebox" stores, and saw the segment turning from loss to breakeven in the second half of 2006. The brand is now well regarded by the market, which is evidence of success of the Group's effort to reach mass consumers by selling low-price yet high quality footwear and related products under its own brand.

During the year under review, the Group opened 89 "Shoebox" stores, making the total to 164 which indicated the Group's confidence in the brand. Today, "Shoebox" has an extensive point-of-sale network that covers most of the major cities, top tier to tier-three. Furthermore, the Group reengineered the store layout to better utilize the store area to cope with market needs, which resulted in improved per square foot sales.

In 2006, the Group increased its stake in "Shoebox" by 36% to 95% and it believed that the acquisition would benefit the Group in the long term.

"adidas Originals" Business

The "adidas Originals", being a stable business, maintained a consistent profitability for the year under review. As at 31 December 2006, there were 10 stores and 94 counters across all major cities in China. The Group also increased its stake in the brand by 43.75% to 94.75% to enlarge its profit share. Very confident that the Beijing 2008 Olympic Games will bring abundant business opportunities, the Group is accelerating the network expansion for the brand.

Development of Infrastructure

While the Group's logistics centre in Chengdu has yet to be completed as at 31 December 2006, its two logistics centres in Beijing and Shenyang were completed in the first half of 2006 and have entered into initial operation at the end 2006. With altogether four logistics centres in operation, the Group managed to improve the physical flow and centralized control over its inventories. During the year under review, the Group reduced inventory turnover days markedly from 156 days in 2005 to 147 days in 2006. The achievement was also owed to effective front-line sales and marketing strategy that worked in complement with improved inventory management.

FINANCIAL REVIEW

Results Performance

During the year ended 31 December 2006, the Group's turnover continued to grow steadily by 18% to HK\$3,093,086,000 (2005: HK\$2,622,677,000) and profit attributable to shareholders grew correspondingly by 15% to reach HK\$291,566,000 (2005: HK\$254,593,000). Earnings per share of the Group was HK17.80 cents (2005: HK15.72 cents). The Board recommended payment of a final dividend of HK2.5 cents (2005: HK2.5 cents) per share for the year ended 31 December 2006. Together with the interim dividend of HK2.0 cents (2005: HK2.5 cents) per share already paid, the total dividend for the year was HK4.5 cents (2005: HK5.0 cents) per share.

Liquidity and Financial Resources

As at 31 December 2006, the Group maintained a healthy cash position with cash and cash equivalents of HK\$148,699,000 (2005: HK\$146,467,000) and unutilized banking facilities of HK\$136,496,000 (2005: HK\$114,343,000). The Group's current ratio being the proportion of total current assets divided by total current liabilities dropped to 1.62 (2005: 1.70) as at 31 December 2006.

The gearing ratio, calculated on the basis of bank loans of HK\$183,194,000 (2005: HK\$133,062,000) over shareholders' equity of HK\$981,308,000 (2005: HK\$744,207,000), was 19% (2005: 18%) as at 31 December 2006. All bank loans were at floating rates during the year under review. Expecting steady cash inflow from operations and extendable banking facilities readily available, the Group has adequate financial resources to cope with future expansion.

Foreign exchange risk management

The Group's monetary assets, liabilities and transactions are mainly denominated in Hong Kong dollars, Renminbi, US dollars, Euros and New Taiwanese dollars. The management believes that the Group's working capital is not exposed to any significant risk from currency exchange rate fluctuations. Foreign exchange risks arising from transactions denominated in foreign currencies are managed by the Group's treasury with the use of foreign exchange forward contracts, whenever necessary, with major and reputable financial institutions.

Pledge of Assets

As at 31 December 2006, the Group's short-term bank loans of HK\$52,326,000 (2005: HK\$71,753,000) were secured by certain land use rights and leasehold buildings of a total net book value of HK\$18,264,000 (2005: HK\$13,613,000); a bank deposit of HK\$6,000,000 (2005: HK\$6,000,000) and available-for-sale financial assets with nil (2005: nil) carrying value.

Significant Capital Investments

During the year, the Group had capital expenditure of approximately HK\$170 million and it has completed the construction of logistics centres in Beijing and Shenyang and planned to complete the construction of logistics centre in Chengdu by 2007. As at 31 December 2006, the Group

had several office buildings under construction in Shanghai and Zhengzhou. The Group has added a new processing plant in Jiangxi in 2006 and has planned to set up another in Taizhou.

Material Acquisitions and Disposals

During the year, the Group acquired 36% additional interest in "Shoebox" brand business and 43.75% additional interest in "adidas Originals" brand business at cash considerations of HK\$40,874,000 and HK\$34,506,000 respectively. Goodwill arising from the acquisitions of "Shoebox" and "adidas Originals" amounted to HK\$15,079,000 and HK\$10,404,000 respectively.

Contingent Liabilities

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

Human Resources

As at 31 December 2006, the Group had over 24,000 (2005: 24,000) employees in Hong Kong, Taiwan and China. Employee expenditure for the year under review amounted to HK\$408,829,000 (2005: HK\$374,140,000). The Group values human resources and recognizes the importance of retaining high caliber employees. Remuneration packages are generally structured by reference to market terms and individual qualifications. In addition, share options and discretionary bonuses are granted to eligible employees based on the Group's and individual performance. The Group also provides mandatory provident fund schemes, medical insurance schemes, staff purchase discounts and training programs to employees.

PROSPECTS

OEM Business

Challenged by consistently rising production costs, the Group plans to set up more new processing plants for its OEM and brand products. By taking up more processing tasks, the

Group hopes to control costs more effectively. The processing plants are strategically located in regions possessing lower production and labour costs and hence safeguard the overall profit margin under challenging operating environment.

At the same time, the Group aims to select higher margin orders to ensure resources are used most effectively and sustains further business growth. The Group seeks to sharpen staff knowledge and skills and strengthen the quality of its manufacturing outputs.

Brand Business

The robust Chinese economy is expected to continue to bolster the Group's brand business. "Daphne" including "Daphne 18" and "Daphne 28" is an established brand, which will continue to gain predominance in the mainland market and eventually take the Group outside China to markets overseas. As for "Shoebox", the Group expects it to perform well in the coming year, catering for mass demand for quality footwear products. The "adidas Originals" brand is to help the Group capturing the quality sports apparel market in China with demand fuelled by the approaching Beijing 2008 Olympic Games.

To grow its brand business, the Group plans to step up marketing and promotion efforts for different brands especially for "Daphne" which is already a stable and major income source of the Group. It will continue to apply creative marketing strategies and ride on celebrity endorsement to promote its products. Meanwhile, the Group actively seeks to expand its brand product series to cover different types of accessories.

Having an excellent business foundation incorporated with comprehensive supply chain establishment, the Group believes that it is perfectly equipped to perform well as well as facing challenges in the future.