Liquidity and Financial Resources

Except for the short term bank loan of HK$6 million of the newly acquired Kangol Headwear (Panyu) Limited ("Panyu Factory"), the Group continues to enjoy financing for its operations by internally generated cash flows. The bank loan, in RMB and at fixed interest rate, was secured by the land and building of the factory with carrying value of HK$20.5 million as at 31 December 2006.

As at 31 December 2006, the Group had liquid funds of approximately HK$139.2 million (2005: HK$145.4 million). About 67% and 25% of these liquid funds were denominated in US dollars and Renminbi respectively and the remainder mainly in HK dollars and Pound Sterling.

The Group acquired the Panyu Factory in June 2006 at a cash consideration of approximately HK$44 million which was financed by internal resources. In late December 2006, the Group disposed of the business and related assets and liabilities of Drew Pearson Marketing Inc. ("DPM"), a wholly owned subsidiary of the Group. The consideration of the disposal of about HK$62 million was received in January 2007. In addition, outstanding trade receivable from DPM of approximately HK$68 million as at 31 December 2006 has been fully settled as of the date of this announcement.

Excluding the effect of the acquisition of the Panyu Factory and the disposal of DPM, the working capital of the Group as at 31 December 2006 remained at a similar level as previous year.

As at 31 December 2006, in addition to the HK$6 million bank loan of the Panyu Factory, the Group had other banking facilities of HK$67 million (2005: HK$95.3 million), of which HK$60.4 million (2005: HK$88.5 million) was not utilised.

The Group continued to maintain its gearing ratio (being the Group's net borrowings over total equity) at zero. In view of the strong financial and liquidity position, it is evident that the Group will have sufficient financial resources to meet its commitments and working capital requirements.

Acquisition of subsidiaries

On 30 June 2006, the Group acquired Panyu Factory which manufactures headwear of the top-tier fashion headwear brands, including Kangol. There are two parts of considerations: (i) adjusted cash consideration of US$5,720,000; and (ii) an earnout ranging from US$2,475,000 to US$4,800,000 to be calculated by reference to the operating profit of the Panyu Factory for the three years ending 31 December 2010, payable within three years ending 31 December 2011, subject to adjustments of the compensations for any loss in the first year and shortfalls in purchase commitment as detailed below.

According to the sale and purchase agreement, the vendor will compensate the Group for any operating loss up to US$1,200,000 (equivalent to approximately HK$9,360,000) incurred by the Panyu Factory for the year from 1 July 2006 to 30 June 2007. Post-acquisition loss of the Panyu Factory for the year to 31 December 2006 amounted to HK$7,391,000. The vendor has also committed to place purchase orders with the Panyu Factory totaling US$20,000,000 in the two years starting 1 July 2007.

Goodwill arising from the acquisition amounted to HK$3,203,000, the calculation of which is set out in note 18 to the financial statements.

This acquisition will not only help the Group to further penetrate the US market, but also facilitate its planned expansion into the Japanese and European markets, which are more fashion conscious.

Other details of the acquisition have been included in the Company's circular to shareholders dated 14 July 2006.

Disposal of assets and liabilities of a subsidiary

On 31 December 2006, the Group disposed of the business and related assets and liabilities of DPM at a cash consideration of US$8,000,000 which is subject to downward adjustment for any shortfall between the value of net assets disposed of, excluding the tax provision on the profit on disposal, and US$6,700,000. As of the date of this annual report, the value of net assets subject to the disposal has not been agreed between the Group and the buyer. The Group is in negotiation with the buyer on certain proposed downward adjustments to the net assets value of DPM relating to prepaid royalties, trade receivable reserve and inventory markdowns, and accordingly the consideration received may need to be adjusted. The result of the negotiation is unknown. However, the management has reviewed the proposed downward adjustments and believes that they are without merit. As a result, there would be no significant impact on the financial position of the Group.

As part of the disposal, the buyer has entered into a 7 year manufacturing agreement with the Group with annual minimum purchase commitment ranged from US$20 million to $35 million (or 65% of the buyer's annual total purchases whichever the lower) for the 7 years commencing 1 May 2007.

After tax profit of HK$8,047,000 has been realized from the disposal of DPM.

Other details of the disposal have been included in the Company's circular to shareholders dated 29 December 2006.

Capital Expenditure

During the year, the Group spent approximately HK$16.8 million (2005: HK$6.9 million) on additions to plant and equipment to further upgrade its manufacturing capabilities. The Group had also spent HK$6.6 million (2005: HK$7.3 million) on the retail systems and opening of new retail stores in 2006.

For the year 2007, the Group has budgeted approximately HK$26.3 million for capital expenditure to enhance production capacity. About HK$20 million of the budget is for the construction of an additional factory building. This will increase the production capacity by up to 40% eventually. Another HK$1.6 million is budgeted for the expansion of the Lids and Sanrio operations.

The above capital expenditure is expected to be financed by internal resources of the Group.

Contingent Liabilities

As disclosed in the Company's 2005 annual report, DPM has been subject to a tax investigation by the tax bureau of the United States. As at the date of this announcement, there has been no development of the case. Under the agreement for the disposal of DPM, the Group will indemnify the buyer in respect of unrecorded tax liabilities prior to the disposal.

As disclosed in the section headed "Disposal of assets and liabilities of a subsidiary", the Group is in negotiation with the buyer on certain proposed downward adjustments to the net assets value of DPM relating to prepaid royalties, trade receivable reserve and inventory markdowns, and accordingly the consideration received may need to be adjusted. The result of the negotiation is unknown. However, the management has reviewed the proposed downward adjustments and believes that they are without merit. As a result, there would be no significant impact on the financial position of the Group.

Exchange Risk

Most assets and liabilities of the Group are denominated either in HK dollars, US dollars or Renminbi. The Group estimates that any 2% appreciation of the Renminbi is expected to reduce the gross margin of the Manufacturing Business by about 0.6%. However, as the businesses in the PRC market grow, the expected positive contribution will provide a hedge against the adverse effect of any appreciation of Renminbi to the manufacturing costs.

Employees and Remuneration Policies

At 31 December 2006, the Group employed 108 (2005: 104) employees in Hong Kong, and 3,719 (2005: 2,750) employees in the PRC and a total of 7 (2005: 96) employees in the UK and USA. The expenditures for employees during the year were approximately HK$158 million (2005: HK$124 million). The Group ensures that the pay levels of its employees are competitive and employees were remunerated based on their position and performance. Key employees of the Group, including Directors, are also granted share options under the share option schemes operated by the Company.