



Management Review and Prospect

Year 2006 is the first year of China's "11th Five-Year Plan" period and also the beginning of building "new socialist countryside" in China. The Chinese government continues to adopt preferential policies to benefit the farmers and increase investment in the agricultural sector. This includes RMB339.7 billion invested in the rural areas, the farmers and the agricultural sector, in addition to the abolishing of agricultural tax, the enacting of floor-price for grain purchasing, as well as increasing subsidies to grain-growers and subsidies on agricultural means of production. Such policies have boosted the farmers' willingness to increase inputs in agricultural production. As a result, agricultural value added rose by 5% in 2006, and grain output reached 497.45 billion kg, increasing continuously in the past three years. The net income per capita of the farmers increased 7.4%, being the third successive year with annual increase over 6%. The Chinese agriculture and the rural economy have maintained the good momentum of sustainable growth.

Such supportive agricultural policies have led to the steady growth in demand for fertilizers and other agricultural inputs. During 1996-2005, the annual compound growth rate of China's fertilizer consumption reached 3.5%, higher than the world's average of 2%. The Group, as the largest fertilizer enterprise in China, will be able to benefit from the macro-environment of the sustained development of the Chinese agriculture.

Under the guidance and support from the Board of Directors, the Group adhered to the preset development strategy, proactively adopted a series of important measures, and successfully overcame the adverse factors in business operations. As a result, sustained growth was achieved in year 2006.

Product Subdivision Strategy

Potash Fertilizers: China lacks potash resources, and the production of potash is limited, with 70% of potash demand relies on import. In 2006, the annual potash contract negotiations were not concluded until late July, and as a result, the import of sea-borne potash fertilizers to China was suspended for the first eight months of the year. During this period, the Group made full utilization of the strategic potash inventories to stabilize market supply, and on the other hand increased the business volume of domestic potash and maintained the cutting edge of the Group in the potash business. Despite the negative effect of 1.27 million ton less of imported potash sales due to the prolonged potash contract negotiations, the returns remained basically the same as 2005. Total sales volume was 4.56 million ton, accounting approximately 45% of China's potash consumption, and the leading position of the Group in the Chinese potash market was further consolidated.

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Nitrogen Fertilizers: China's nitrogen production capacity is more than adequate, and nitrogen supply exceeds demand. With the implementation of supply-chain management, the Group has continuously expanded the domestic nitrogen supply channel through strategically investing in nitrogen manufacturers with competitive strengths and signing long-term contracts with core suppliers. In addition, by taking the advantages of the distribution network and financial resources, the Group carried out off-season stocking programs by sourcing nitrogen fertilizers while the prices were at low points. This has enabled the rapid expansion of nitrogen sales and improved profitability. In 2006 the Group realized nitrogen sales of 3.71 million ton, increasing by 105% over the same period of last year. This figure accounts for approximately 8% of China's total nitrogen consumption.

Phosphate Fertilizers: China's phosphate production increased rapidly in recent years, and domestic production is adequate to meet the demand. Phosphate import has been on the decline due to increased cost and prices. However, phosphate production in China is concentrated in the regions with rich resources of phosphoric rock, which is at far distance from major consumption areas. As supply increasing from investment projects due to their enlarged capacity, the Group has formed a product mix of both domestic and imported high concentration phosphate fertilizers. By making full use of the Group's distribution network and logistics advantages, we proactively expand the market and have increased our share in the Chinese phosphate market. In 2006 the Group's phosphate sales reached 1.46 million ton, up by 16% year on year.

Compound Fertilizers: China's compound fertilizer production far exceeds demand, with numerous compound fertilizer factories competing fiercely in a disorderly market. The average profit margin of the industry has been in decline. However, imported high quality compound fertilizers are well received by the market. With the supply of various types of specialized compound fertilizers made for different crops and soils from self-owned factories, and through the signing of long-term supply contracts with European compound fertilizer manufacturers to import high quality products needed by the domestic market, the Group is able to meet the diverse needs of different customers. In 2006 the Group's compound fertilizer sales was 1.93 million ton, up by 34% year on year. Compound fertilizer import by the Group accounted for 53% of China's total import, and the dominating position in high-quality compound fertilizer market was further consolidated.



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Upstream Production

In 2006 the Group had equity interest in seven fertilizer production enterprises. While improving their production management, these factories also increased production capacity by 0.3 million ton, bringing the total capacity to 3.03 million ton, or an increase of 11% year on year. Altogether these factories supplied 2.55 million ton of various fertilizers (including supplies from enterprises under consignment by Sinochem Corporation) to the Group, up by 0.68 million ton, or an increase of 36% year on year.

In 2006 the Group attached top priorities on expanding the supply mechanism of domestic fertilizers. By strategically investing in nitrogen manufacturers with competitive strength such as Luxi Chemical and Hualu Hengsheng, which are publicly listed on the Shenzhen and Shanghai stock exchange, respectively, the Group had formed a stable base for domestic fertilizer supplies.

Sinochem Corporation, the ultimate controlling shareholder of the Company, has always extended its full support to the development of the Group, and granted the Group the options and preemptive right to purchase the three fertilizer production companies in which Sinochem Corporation has equity interest at fair market value and at appropriate time. The total production capacity of these three enterprises is 2.9 million tonnes, of which 1.7 million tonnes is potash fertilizer produced from the non-renewable resource. In addition, the Group has preference as to the sales of the products of these three enterprises, which has further enhanced the Group's position as a major fertilizer producer in China.

Downstream Distribution

In 2006 the Group set up three new branches in northwest China, southwest China and Guangxi region. Meanwhile, new distribution centers were being built to cover the targeted 1,800 agricultural counties throughout the country, with 312 distribution centers newly added. By the end of 2006, the Group's distribution network boasted 1,375 distribution centers and sales outlets, covering 22 agricultural provinces and 80% of the country's arable land. In 2006, sales realized through the distribution network was 7.86 million ton, increasing by 0.58 million ton over 2005.

Aiming to develop and maintain a customer base with those customers at the township level being the majority, the distribution centers had won over 25,000 such customers. Meanwhile, the farmers-oriented service system was further improved. Following the joint project of "Sinofert-CAU R&D Center" set up in 2003 and the "Sinochem Agrichem Square", a radio program for public welfare co-sponsored by Sinofert and the Central People's Radio Station in 2004, in 2006 the Group jointly set up the "Sinofert-CAAS Balanced Fertilization Technological Center" and a laboratory with the Chinese Academy of Agricultural Sciences. A total of 3,300 workshops and events were held to teach the farmers on balanced fertilization; 175 "model villages for scientific fertilization" were set up, and altogether over 2.1 million booklets and fact sheets on fertilizer application techniques were given out to farmers throughout the country. All these activities not only promoted sales and the Company's brand value, but also amplified the image of the Group as a socially responsible company.

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Internal Control and Management

The management of the Company has always attached top priority to the security of shareholders' asset value, and therefore taking the building of an advanced and standardized internal control and management system as the foundation for the Company's long-term, healthy development. In 2006 the Company readjusted the organizational structure to ensure the smooth progress of various operations in line with the need of strategic development. Referring to the COSO framework, the whole business procedures were continuously improved to optimize the internal control and risk management system. On the basis of the existing SAP and DMS (distribution management system) systems, in 2006 a CMP (cash management platform) system was jointly set up with the Agricultural Bank of China to further improve the integration effects of logistics, cash flow and information flow, which has proved effective in risk prevention and control. In addition, the Group has optimized its internal control measures through continued reviews and identification of problems by a dynamic internal auditing mechanism. As a result, the Group's risk prevention capabilities have been constantly improved.

Strategic Planning

In 2006, the Group carried out yearly revision works of the Three-Year Strategic Development Plan (SDP 2007-2009), which was completed through joint efforts of all the staff and members after repeated modifications on the basis of prudently analyzing industrial development trend of the global agricultural inputs market. The plan has been approved by the Board of Directors. In the years to come, the Group will, in line with the preset strategic positioning of "marketing-service", make greater endeavor to fulfill the strategic goal of "centering on marketing and distribution and expanding both downstream and upstream along the industrial chain." We will continue to enhance the Group's market leadership as the largest fertilizer distributor in China, and strive to achieve leaping-forward growth in pesticide and seed businesses through merger and acquisitions. Aiming to turn the Company into the largest comprehensive service provider of agricultural inputs in China with a global lead, we will continue to bring higher returns to the shareholders, create wealth for society, and make more contributions to the nation's food security and agricultural development.

Corporate Culture

The core of the Group's corporate culture is "To Be: Honest, Collaborative, and Adroit in Learning; To Do: Conscientiously, Innovatively, and in Pursuance of Excellence." The rapid development of the Company is fundamentally originated from the constant advocacy of and adherence to a unified corporate culture by the top decision-makers, the management and the employees alike. On such basis a work team featuring unified cultural conceptions, high quality and an adamant working style can be forged, and the environment for being proactive and pursuing high performances can be created. In 2006 the Group, in compliance with the above-mentioned corporate culture, further improved the regulations on new employee recruitment, employee training, performance evaluation, and remuneration and incentives. A number of outstanding employees were selected and appointed to management positions and/or key positions, becoming the new force to push forward the Company's strategic development and business growth.



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Outlook

In 2007 the Chinese government is expected to further increase its support to the development of the rural areas, the farmers and the agricultural sector, and government expenditure in this field will reach RMB391.7 billion, which is an increase of RMB52 billion, or up by 15.3% over year 2006. Such preferential policies will help to stimulate the demand for fertilizers and other agricultural inputs to maintain the momentum of stable, sustained growth, therefore providing a favorable external environment for the Group's future development.

Under the leadership of the Board of Directors, in 2007 the management will adhere to the preset development strategy of "centering on marketing and distribution and expanding both downstream and upstream along the industrial chain," and continue to expand the scale of the distribution network by building distribution centers in China's 1,800 agricultural counties. We will also strengthen the global and domestic multi-channel supply system and improve product mix and marketing services so as to uplift the business scale and profitability of the Company. We will continue to make strategic investment to improve the efficiency of the domestic fertilizer business and ensure stable and sustained growth, and push forward the exercise of the options and preemptive right to purchase the three fertilizer production companies in which Sinochem Corporation has equity interest at fair market value and at appropriate time. At the same time, we will grasp the opportunities and strive for rapid progress in the pesticides and seeds businesses by mergers and acquisitions. We will continue to give top priority to the safety of shareholders' assets value, and constantly improve the internal control system in compliance with the requirements of the listing rules and corporate development so as to achieve fast and stable growth and create higher value and returns for all the shareholders.



