FLEXIBLE PRODUCT MIX WITH EMPHASIS ON HIGH PROFIT MARGIN PRODUCTS

Management Discussion and Analysis

FINANCIAL HIGHLIGHTS

Result Summary

	For the year ended 31 December		
	2006	2005	Change
	RMB'000	RMB'000	%
Turnover	**879,796**	837,529	5%
Gross Profit	**188,232**	160,355	17%
Profit Attributable to Shareholders	**90,272**	122,141	(26%)
Gross Profit Margin	**21%**	19%	2%
Net Profit Margin	**10%**	15%	(5%)

The board of directors (the "Board" or the "Directors") of China Special Steel Holdings Company Limited (the "Company") is pleased to announce that the audited consolidated turnover of the Company and its subsidiaries (the "Group") for the year 2006 was approximately RMB879.8 million, representing an increase of 5% as compared to 2005. Audited profit attributable to shareholders of the Company was approximately RMB90.3 million, representing a decrease of 26% when compared to 2005. Audited basic earnings per share for 2006 decreased by RMB0.121 to RMB0.163 when compared to 2005. Earnings per share was based on the weighted average of 552.6 million shares in issue in 2006, as compared to the weighted average of 430 million shares in 2005. The Directors are pleased to declare final dividend of HK$0.03 per share, totalling HK$17.4 million. The audited consolidated financial statements for the year ended 31 December 2006 have been reviewed by the Company's Audit Committee.

BUSINESS REVIEW

In the mid of 2006, the Group has successfully completed the capacity enhancing project which increased our special steel annual production capacity from 300,000 tonnes to 500,000 tonnes thus relieving our bottleneck in production. Furthermore, in respect of the major transactions of capital injection ("Capital Injection") in Anyang Steel Group Luoyang Anlong Steel Company Limited ("Anlong Steel"), the registration of the Capital Injection by regulatory body in PRC was finally completed on 5 January 2007 and Anlong Steel has been formally renamed as Luoyang Yongan Special Steel Company Limited ("Yongan Special Steel"). Leveraging on the Group's technical know-how and experience in special steel production, Yongan Special Steel has been converted from a loss-making generic steel producer to a manufacturer of high value added and higher margin special steel products. The total production capacity for special steel would be increased from 500,000 tonnes to 800,000 tonnes per annum.

Turnover and sales volume

Major products of the Group were bearing steel and spring steel. The table below sets out the turnover and sales volume of our major products for the periods indicated:

Turnover

	For the year ended 31 December			
	2006		2005	
	RMB'000	**%**	RMB'000	%
Bearing steel	**805,004**	**92%**	783,826	93%
Spring steel	**60,733**	**7%**	47,384	6%
Carbon structure steel & other steel	**4,758**	**0%**	6,319	1%
Sub-total for steel products	**870,495**	**99%**	837,529	100%
Pig iron	**9,301**	**1%**	—	0%
Total	**879,796**	**100%**	837,529	100%

Sales volume

	For the year ended 31 December			
	2006		2005	
	(tonnes)	**%**	(tonnes)	%
Bearing steel	**250,266**	**91%**	230,042	94%
Spring steel	**18,609**	**7%**	12,625	5%
Carbon structure steel & other steel	**1,475**	**0%**	1,770	1%
Sub-total for steel products	**270,350**	**98%**	244,437	100%
Pig iron	**4,991**	**2%**	—	0%
Total	**275,341**	**100%**	244,437	100%

The Group's turnover in 2006 increased by RMB42.3 million, or 5%, to approximately RMB879.8 million (2005: RMB837.5 million). This increase was principally due to the increase in sales volume.

The Group's sales volume in 2006 increased by 30,904 tonnes, or 13%, to approximately 275,341 tonnes (2005: 244,437 tonnes). With the self-developed technology and flexible production set-up, the Group mainly focus on producing more bearing steels which accounted for 92% of the total turnover, increased by 3% to approximately RMB805.0 million (2005: RMB783.8 million).

During 2006, the overall supply in the special steel products in PRC market increased with a slightly downward adjustment in the selling prices. The Group's average selling price in special steel (excluding pig iron) for 2006 decreased by 6% to RMB3,220 (2005: RMB3,426) and this was in line with the market trend.

Cost of sales

The cost of sales in 2006 increased by RMB14.4 million, or 2%, to approximately RMB691.6 million (2005: RMB677.2 million) which is lower than the increase in turnover over the same year.

The unit cost of sales in 2006 decreased by RMB258 per tonne, or 9%, to RMB2,512 per tonne (2005: RMB2,770), reflecting the result of the continuous cost reduction.

The table below shows a breakdown of our total production costs for the years indicated:

Cost of sales

	For the year ended 31 December			
	2006		2005	
	RMB'000	**%**	RMB'000	%
Raw Materials	**387,118**	**56%**	417,470	62%
Fuel	**161,634**	**23%**	133,291	20%
Utilities	**79,233**	**12%**	71,912	10%
Depreciation	**44,359**	**6%**	42,101	6%
Staff Cost	**16,884**	**3%**	12,213	2%
Repair	**587**	**0%**	49	0%
Others	**1,749**	**0%**	138	0%
	691,564	**100%**	677,174	100%

Gross profit

As a result of the factors discussed above, the gross profits in 2006 increased by RMB27.8 million, or 17%, to RMB188.2 million (2005: RMB160.4 million).

The unit gross profit in 2006 increased by RMB27 per tonne, or 4%, to RMB683 per tonne (2005: RMB656 per tonne).

The Group's gross profit margin in 2006 increased by 2% to 21% (2005: 19%).

Administrative costs

Administrative costs in 2006 increased by RMB8.3 million, or 35%, to RMB32.3 million (2005: RMB24.0 million). This is mainly due to the increase in additional staff cost and professional fee of RMB3.7 million and RMB3.3 million respectively incurred after listing to cope with the statutory requirements in Hong Kong.

Finance costs

Finance costs in 2006 increased by RMB0.8 million, or 3.6%, to RMB23.4 million (2005: RMB22.6 million). This increase was slightly lower than the increase in sales of 5%.

Income tax expenses

No provision of Hong Kong profit tax has been made as the Group had no assessable profits arising in Hong Kong for 2006 and 2005. Yongtong Special Steel is exempted from corporate income tax of PRC for the year ended 31 December 2004 and 2005 and is entitled to a 50% reduction in corporate income tax of the PRC for the year ended 31 December 2006 and years ending 31 December 2007 and 2008. As a result, the Group's income tax expenses in 2006 was RMB17.3 million while it was nil in 2005.

Profit attributable to shareholders

As a result of the factors discussed above, the profit attributable to shareholders in 2006 decreased by RMB31.8 million, or 26%, to RMB90.3 million (2005: RMB122.1 million).

The unit net profit in 2006 decreased by RMB172 per tonne, or 34% to RMB328 per tonne (2005: RMB500 per tonne).

The Group's net profit margin in 2006 decreased by 5% to 10% (2005: 15%).

Key financial ratios

	Note	For the year ended 31 December 2006	2005
Current ratio	1	**135%**	89%
Inventories turnover days	2	**121 days**	54 days
Debtor turnover days	3	**61 days**	38 days
Creditor turnover days	4	**151 days**	156 days
Interest cover	5	**6 times**	7 times
Gearing ratio	6	**48%**	28%

Note:

1 current asset/current liabilities X 100%

2 $\frac{\text{Inventories}}{\text{Cost of sales}}$ X 365 days

3 $\frac{\text{Trade and notes receivables}}{\text{Turnover}}$ X 365 days

4 $\frac{\text{Trade and notes payables}}{\text{Cost of sales}}$ X 365 days

5 $\frac{\text{Profit before interest and tax}}{\text{Net interest expense}}$

6 $\frac{\text{Interest-bearing loans and other borrowings}}{\text{Equity attributable to the shareholders}}$ X 100%

Construction in progress

Our construction in progress as at 31 December 2006 was reduced to RMB48.7 million (2005: RMB119 million) after the transfer of completed construction in progress to fixed assets during 2006.

Cash and bank balances

The increase in cash and bank balances by approximately RMB41.4 million, or 25%, to RMB209.9 million as at 31 December 2006 compared to that as at 31 December 2005 was mainly due to the net proceeds from issuance of share capital of approximately RMB170.2 million, net increase in bank loans and other borrowings by RMB227.5 million and cash outflow generated from operation by approximately RMB9.4 million, offset by the acquisition of property, plant and equipment and construction in progress for refinement of production process by approximately RMB119.9 million, prepayment in respect of acquisition of Yongan Special Steel (formerly known as "Anlong Steel") of RMB171.7 million, interest payment of RMB21.6 million, and dividend payment of RMB36.9 million to the shareholders of the Company.

Trade and notes receivables

The debtor turnover days increased from 38 days in 2005 to 61 days in 2006. As at 31 December 2006, trade and notes receivables balance increased by RMB60.6 million, or 69%, to RMB147.9 million. This was mainly due to increase in sales at year end.

Inventories

The inventories turnover days increased from 54 days in 2005 to 121 days in 2006. As at 31 December 2006, inventories balance increased by RMB127.9 million, or 127%, to RMB228.8 million. This was mainly due to the increase in iron ore inventory by RMB104.0 million which was reserved for the production in the first quarter of 2007.

Prepayments, deposits and other receivables

As at 31 December 2006, prepayment, deposit and other receivables balance increased by RMB5.9 million, or 6% to RMB108.8 million. This was mainly the increase in receivables from Anlong Steel Group by RMB20.7 million while the prepayment to suppliers dropped RMB8.5 million.

Trade and notes payables

The creditor turnover days decreased from 156 days in 2005 to 151 days in 2006. As at 31 December 2006, trade and notes payables balance decreased by RMB2.0 million, or 1%, to RMB286.6 million. This was in line with the credit period in trade facilities provided by the Group's bankers.

Interest-bearing loans and other borrowings

As at 31 December 2006, the total interest-bearing loans and other borrowings balance increased by RMB227.5 million, or 132%, to RMB399.9 million which was also represented by the increase in cash and bank balances, inventories and amount due from Anlong Steel Group as explained in the above discussion. The gearing ratio increased from 28% in 2005 to 48% in 2006.

Liquidity and capital resources

Our working capital has been principally sourced from cash generated from operations and from long-term and short term debt. We also utilise advances we received from our customers to finance part of our working capital requirements. As at 31 December 2006, the advance from customers amounted to RMB6.2 million. We also make prepayments to our suppliers which amounted to RMB32.8 million as at 31 December 2006.

As at 31 December 2006, we had current liabilities of RMB515.7 million, of which RMB164.6 million were interest-bearing loans repayable within one year, and RMB286.6 million were trade and notes payables in respect of purchase of raw materials.

Foreign currency risk

Since 2004, the Group has begun the purchase of iron ore from overseas suppliers. Since the contracts are in US$ and the US$ and RMB exchange rate is quite stable and the RMB is in a favourable trend now, no hedging is considered necessary at the moment. However, the Group will closely monitor the foreign currency risk and consider to use necessary financial instruments for hedging purposes. Except for the trust receipt loan related to the above contract of US$2.5 million (equivalent to RMB19.6 million) and syndication loan of US$24.5 million, net of transaction cost (equivalent to RMB192.3 million), all other bank loans are in RMB.

Security

As at 31 December 2006, the Group had an aggregate banking facilities of RMB576.2 million, consisted of long-term bank loans of approximately RMB235.3 million, short-term bank loans of approximately RMB164.6 million, notes payables of RMB176.3 million (secured by pledged deposit of RMB129.1 million). The Group's banking facilities are secured by:

(i) certain buildings, plant and machinery situated in Gongyi factory with a net book value of approximately RMB391.2 million as at 31 December 2006.

(ii) land use rights with a net book value of approximately RMB5.4 million as at 31 December 2006.

(iii) pledged deposits of RMB129.1 million.

(iv) notes receivable of RMB10 million.

(v) the Group's entire equity interests in Infonics International Limited ("Infonics") and Group Rise Trading Limited.

Capital commitment

As at 31 December 2006, the Group had capital commitments in the amount of approximately RMB6.4 million for remaining parts of equipment refinement project, and capital commitments in the amount of approximately RMB15.1 million for acquisition of Zhengzhou Xiangtong Electricity Co., Ltd.

EMPLOYEE AND REMUNERATION POLICY

As at 31 December 2006, the Group had approximately 1,700 employees, of whom 14 were management personnel. As at the same date, about 98% of our workforce had completed technical school or higher education.

The Group implemented remuneration policy of linkage between duties and efficiency. The remuneration of employee consists of a basic salary and a performance-based bonus. In 2006, the staff costs of the Group amounted to RMB26.9 million (2005: RMB23.2 million).