Management Discussion and Analysis

The Group produces and sells high quality float flat glass and processed glass for the construction sector and automotive and electronics industries. It also produces and sells soda ash to other glass makers and metallurgical, chemical and various other industries.

BUSINESS REVIEW

Glass business

Flat glass

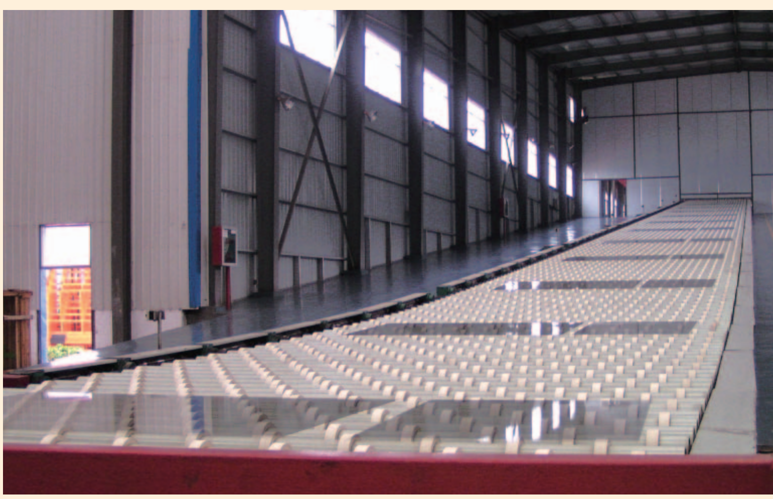
In 2006, China's flat glass market had to tackle the excess of the production capacity due to rapid expansion in 2004 and 2005. The over-investment in the industry resulted in oversupply, which triggered a decline in flat glass price and left almost the entire industry with a loss.

According to National Bureau of Statistics of China, the country's flat glass output rose by about 23% to approximately 439 million weight cases in 2006. Seven new float flat glass production lines with a combined annual production capacity of approximately 27 million weight cases came into operation in 2006, following the operation launch of 47 new production lines with combined annual production capacity of 140 million weight cases during 2004 and 2005. Although overcapacity remained a key problem in the industry, the growth in production capacity decelerated.

In view of the oversupply and a sharp decline in average selling price of flat glass in the first quarter of 2006 as well as the high fuel cost, a number of the country's leading flat glass makers reduced their production, and the Association of the Glass Industry agreed on a price rise. As a result, the average selling price of flat glass rebounced in the second quarter and stabilised at a reasonable level in the second half of 2006.

Average selling price of the 4 mm, 6 mm and 8 mm float flat glass, which are commonly used in buildings, hit the lowest of RMB50 per weight case in the first quarter of 2006 but rebounced to about RMB70 per weight case in the second half of the year. The 43 major flat glass makers' combined sales rose by 7.86% to approximately 288.4 million weight cases in 2006 according to the China Building Materials Industry Association ("CBMIA"). Their combined inventory level was about 14.45 million weight cases by the end of 2006, or about 17.6% lower than that at the end of 2005. The major glass makers' average sales-production ratio was about 99% in 2006, compared with that of about 95% in 2005.

During the Year, the Group produced approximately 15.1 million weight cases (2005: 15.5 million weight cases), or 755,000 tonnes (2005: 775,000 tonnes) of flat glass, with sales-production ratio of approximately 99% (2005: 99%). Sales of flat glass amounted to RMB966 million in 2006 (2005: RMB1,006 million), accounting for about 63.5% (2005: 85.1%) of the Group's turnover. The proportion of flat glass sales in turnover changed mainly because of the reduction in average selling price and the significant increase in revenue contribution from the soda ash business.



To cushion the impact of the oversupply in the regular flat glass market, the Group has been branching out into ultra-thin flat glass since 2005. The Group's sales of 1.1 mm ultra-thin flat glass, which are commonly used in the electronics industries, helped to mitigate the impact of declining selling price of the Group's regular flat glass. The overall average selling price of the Group's flat glass products fell by about 3% to about RMB68 per weight case (2005: RMB70 per weight case).

In addition, in November 2006, the Group launched the operation of its sixth float flat glass production line capable of making ultra-thin flat glass of 1.1 mm or below in thickness. The new production line has daily melting capacity of about 150 tonnes and an annual production capacity of about 10.12 million square meters. The launch of this sixth float flat glass production line is expected to bring the Group's total daily melting capacity to 2,500 tonnes.

The unit cost of flat glass production increased by 11% to RMB62 per weight case because of the rise in fuel cost. In 2006, the average cost of heavy oil was about RMB3,200 per tonne (inclusive of value-added tax), compared with the RMB2,400 per tonne in 2005.

In 2006, the Group consumed about 150,000 tonnes of soda ash, a key raw material for producing glass. The raw material was mainly supplied by Qinghai Soda Ash Company Limited ("Qinghai Soda Ash"), a subsidiary of the Company, which began commercial production in December 2005. The soda ash operation ensured a stable and lower-cost supply of quality raw material for the Group's glass production.

Processed glass

In 2006, the Group's seven (2005: seven) production lines manufacturing mirror glass, tempered glass, insulating glass, laminated glass and low-E glass (a type of energy efficient glass) were in normal operation.

During the Year, the Group processed about 6% of its flat glass output into higher value-added products (2005: 6%). It sold approximately 2.9 million sq.m. (2005: 3.7 million sq.m.) of processed glass at the average selling price of RMB41 per sq.m. (2005: RMB46 per sq.m.). The business segment generated revenue of RMB118 million, or, 7.8% of the Group's turnover in 2006 (2005: 14.6%).

Soda ash business

In 2006, China's soda ash output grew at a slower rate than the country's demand for the commodity. The supply and demand were basically balanced. According to the China Soda Industry Association ("CSIA"), the country produced approximately 15.4 million tonnes of soda ash in 2006, or 9.2% more than that in 2005. Domestic consumption grew by 10.8% to about 13.7 million tonnes. China's net soda ash export amounted to 1.66 million tonnes in 2006, compared with the similar level of 1.70 million tonnes in 2005.

Management Discussion and Analysis

The Company's subsidiary, Qinghai Soda Ash, with a designed annual production capacity of 900,000 tonnes began to operate in mid-December 2005. In 2006, it produced about 630,000 tonnes of soda ash and sold about 620,000 tonnes of the commodity, of which about 150,000 tonnes were for the Group's internal consumption. Domestic soda ash price (inclusive of value-added tax but exclusive of transportation cost) was relatively stable in 2006 and was about RMB1,300 per tonne at the end of the Year.

As Qinghai Soda Ash only commenced its operations in mid-December 2005, it will take time for it to gradually adapt its production from light soda ash (which is for production of various chemical products including detergent) to dense soda ash (which is mainly for glass production and sold at higher prices than light soda ash by RMB100 to RMB200 per tonne). As a result, light soda ash accounted for the main portion of Qinghai Soda Ash's product mix in 2006. Moreover, the soda ash operation also carried out promotional sales upon the introduction of its products to the market. These factors caused Qinghai Soda Ash's products to be sold at an average price of about RMB1,100 per tonne (inclusive of value-added tax) in 2006. The soda ash business generated RMB433 million in revenue, or about 28.7% of the Group's turnover (2005: 0.3%). The operation recorded an operating profit before finance costs of about RMB38 million even though it had not yet reached full capacity to completely realize economy of scale during 2006.

Due to obstruction by the transportation problem caused by the trial run of the Qinghai-Tibet Railway, Qinghai Soda Ash had to rely mainly on the highway for transport of its products, the more expensive way to transport goods. Subsequently, Qinghai Soda Ash obtained support from the government of Qinghai Province and other authorities and it was able to ship out most of its products and maintain the inventory at normal level in the second half of 2006.

FINANCIAL REVIEW

The Group recorded an attributable loss of RMB57.0 million for the Year, against the attributable profit of RMB74.1 million for the year ended 31 December 2005. The loss was mainly due to a significant decrease in average selling price caused by overcapacity in the glass industry. The high price of heavy oil also resulted in high cost of operation. Despite these factors, the Group recorded a net cash inflow of about RMB451 million from operations (before the payment of interest and income tax). It also narrowed the loss from RMB75.8 million in the first half of 2006 to RMB57.0 million for the whole year of 2006 as Qinghai Soda Ash increased its utilization rate.

Turnover increased by 28% to RMB1.52 billion for the Year (2005: RMB1.20 billion).

Gross profit margin was 11%, compared with 21% for the year ended 31 December 2005.

Average inventory turnover of the Group's glass business was about 26 days in 2006, compared with 43 days in 2005. The decrease was mainly due to the drop in heavy oil price towards the end of 2006.

Average inventory turnover of the soda ash business was 85 days in 2006. The average inventory turnover was relatively long because Qinghai Soda Ash doubled its raw materials reserves from October to December 2006 to avoid any obstruction to production caused by potential problem with shipment of raw materials during winters.

OUTLOOK

Glass business

Flat glass

China's float flat glass production capacity expansion is expected to slow down in the next few years after the country's rapid increase in the number of float flat glass production lines from less than 100 in 2003 to about 150 in 2006. The National Development and Reform Commission and other authorities have directed that China's flat glass production capacity be limited to 550 million weight cases per year during the "Eleventh-Five year Plan" (2006-2010). They also required that energy consumption in production be decreased by 20%. Moreover, the government also encourages industry consolidation in which leading industry players will be given support. The Group believes the measures will limit the growth in production capacity during the next few years. As the country continues its industrialization and urbanization at fast pace under the "Eleventh-Five year Plan" while limiting the growth in production capacity in industries such as flat glass production, the supply and demand of the commodity will become balanced. Under the "Eleventh Five-year Plan", the Chinese government has set the target of having 70% of the glass market concentrated in the country's top ten glass makers. The Group believes that the flat glass industry is recovering from the trough in the industry cycle.

Nevertheless, the Group is still facing price fluctuation of heavy oil, which impact over the production cost remains uncertain.

Processed glass

Under the "Eleventh-Five year Plan", the National Development and Reform Commission and other authorities require 40% of the national flat glass output to be processed into higher-value added products to satisfy the country's demand, representing a rise from the rate of 25% at present. The government policies of stepping up efforts to protect the environment and save energy will also generate demand for energy-saving low-E glass. According to CBMIA, market penetration of energy-saving glass is less than 10% in China, compared with more than 50% in the United States and Europe. There is large market potential for the energy-saving glass products.

As one of the key suppliers of quality low-E glass in China, the Group expects that its low-E glass operation will become a growth driver when it takes off in 2007.

Soda ash business

CSIA projected that the country's soda ash output will grow by about one million tonnes, or about 6.5% to 16.4 million tonnes in 2007 while domestic consumption will increase by 6.9% to 14.7 million tonnes. The net export of the commodity is forecasted to increase by about 3% to 1.7 million tonnes.

The country's soda ash production capacity expansion is expected to be limited by the PRC government measures to control over-investment and more stringent environmental protection policies. Prospective new entrants to the industry will meet higher barriers.

On the demand side, the national output of downstream products such as glass, alumina, detergent and monosodium glutamate is expected to continue to have stable growth. The supply and demand of the commodity will remain basically balanced.

As Qinghai Soda Ash already reached full production capacity in early 2007, it could meet the annual production target of 900,000 tonnes in 2007 and make more revenue contribution to the Group.

Management Discussion and Analysis

CAPITAL STRUCTURE, LIQUIDITY AND FINANCIAL RESOURCES

During the Year, the Company raised approximately HK$255.8 million (equivalent to approximately RMB263.5 million) by issuing 142.12 million new H shares at HK$1.8 each to International Finance Corporation ("IFC") and four funds managed by Scion Capital LLC ("Scion Capital"), a United States investment consultancy firm. On 11 May 2006, the Company received letters of intent from IFC and Scion Capital dated 10 May 2006 and 9 May 2006 respectively, which included indicative terms of investment (including a fixed subscription price of HK$1.80 per H share of the Company). The closing prices of the Company's H shares on 9 May 2006 and 10 May 2006 were HK$1.93 and HK$1.92 per H share respectively. The subscription agreement was eventually signed on 26 June 2006 between the Company and IFC and four funds managed by Scion Capital. Trading of shares in the Company was suspended from 9:30 a.m. on 26 June 2006 and was resumed on 28 June 2006, and the closing price of the Company's H shares on 23 June 2006, being the last trading day before 26 June 2006 when the terms of the new shares issue were fixed in the said subscription agreement, was HK$1.84 per H share. The Company would use the proceeds to repay part of the Company's outstanding short-term bank loans. The Company also secured a long-term loan of US$68 million (equivalent to approximately RMB531 million) from IFC which would be due in 2013 for restructuring part of the Company's short-term loans into long-term loans. The move would improve the Company's financial health.

As at 31 December 2006, the Group's cash and cash equivalents amounted to RMB539 million, compared with about RMB561 million as at 31 December 2005.

The Group's total bank loans amounted to about RMB2.81 billion as at 31 December 2006, compared with RMB3.23 billion as at 31 December 2005.

The net debt to equity ratio (total borrowing net of cash and pledged deposits divided by total equity) decreased from 164% as at 31 December 2005 to 130% as at 31 December 2006.

EXCHANGE RATE RISK

Most of the Group's businesses were settled in RMB, which is not freely convertible into foreign currencies. The Group's export business, which was conducted in foreign currencies, accounted for an insignificant portion of the Group's turnover. The purchase of materials from abroad also accounted for a very small portion of the Group's total materials purchase in value. The Group's borrowings were also predominantly denominated in RMB, except for the long-term loan from IFC which is denominated in US dollar. The Group neither entered into any foreign exchange forward contracts nor adopted other hedging instruments to hedge against possible exchange rate fluctuations. Management expects the exposure to the Group arising from adverse fluctuations in exchange rates would not be significant.

CAPITAL COMMITMENT AND CONTINGENT LIABILITIES

As at 31 December 2006, the Group had total capital commitment of approximately RMB4.6 billion, which was mainly related to the proposed investment in the construction of the second soda ash production line in Qinghai Province (approximately RMB1.1 billion) and the proposed investment in the construction of several glass production lines in Zhejiang Province (approximately RMB3.5 billion). However, the Group is entitled to adjust the schedule of these proposed investments, and in particular, the Group has the right to adjust the amount or to terminate the execution of the investments in the proposed construction of several glass production lines in Zhejiang Province. It is expected that these proposed investments will be funded by the Group's continuous cash inflow from operations and also potential new debts and/or equity funding in future. The Group did not have any contingent liabilities as at 31 December 2006.