MANAGEMENT DISCUSSION AND ANALYSIS

Overview

A huge tree that fills one's arms grows from a tiny seedling; a nine-storey tower is built from a heap of earth; a long distance journey starts with the first step. After experiencing rapid growth for 5 consecutive years, the Group underwent adjustment in 2006. Under the throes of adjustment, the Group united as a whole and gained a more sober and rational insight into problems arising from its development. The Group is going to be positioned for consolidation in 2007. Armed with valuable experience gained from the last year, the Group will concentrate on integrating its own resources, and enhancing its core competitiveness to usher in a groundbreaking year.

During the period under review, the Group was still committed to the expansion of the automotive aftermarket business. Apart from focusing on the manufacture and distribution of automotive electronic and power-related parts and accessories in its manufacturing business, it also conducted retail sales of related services and products through the automotive aftermarket service chain network established in the Greater China region. During the period under review, turnover of the manufacturing segment, which is still the core business of the Group, accounted for 89% of the Group's total turnover. Meanwhile, the Group's chain business also gained ground, with turnover accounting for 11% of the Group's total turnover (the corresponding period of 2005: 10%), representing an increase of 1 percentage point.

During the period under review, turnover of the Group grew by 5% to approximately RMB533,302,000. Profit attributable to shareholders decreased by 74% to approximately RMB14,218,000. The decrease in profit was attributable to the fact that on the one hand, the Group's service business was still at an expanding stage, and could only made profit contribution after the gradual improvement of its chain store network, and on the other hand, unfavorable factors such as a general rise in the prices of raw materials in the global market, the appreciation of Renminbi ("RMB"), and inadequate protection of intellectual property right, resulted in an increase in the Group's production cost, severe product competition and decrease in profits.

Based on its established 5-year development strategy, the Group needed ample fund investment to maintain growth in its performance. After prudent consideration, the Board does not recommend the payment of a final dividend to its shareholders.

The Board recommends a bonus issue of one new share of HK$0.10 each credited as fully paid for every twenty issued shares of the Company ("Shares") held on the register of members of the Company on 18 June 2007. An amount standing to the credit of the share premium account of the Company will be capitalized and applied in making payment in full, at par, for the new shares. The issue of bonus shares is conditional upon the passing of the relevant resolutions at the Annual General Meeting, and the Listing Committee of the Stock Exchange granting approval to the listing of and permission to deal in the new shares. Such new shares will not, however, rank for the proposed bonus issue but will in all other respects rank pari passu with the existing.

MANAGEMENT DISCUSSION AND ANALYSIS

Analysis of the Progress of its Manufacturing Business

During the year, segment results of the manufacturing and distribution business of automotive electronic and power-related parts and accessories, which is contributed to the Group's total profit, decreased by approximately 36% to approximately RMB38,974,000. Therefore, the declining result was also a major factor for the decrease in profit attributable to shareholders.

Review of Business Progress

During the period under review, the Group continued to carry out the business growth strategy it formulated in 2005, and was committed to exploring OEM market for automotive parts and accessories and the developing business with high profit margins, such as the business of HID light ballasts, as well as taking the lead in the industrial integration of automotive illumination and power source fields.

During the year under review, overseas turnover for HID light ballast has increased to RMB21,296,000 (accounting for 4% of manufacturing business), which represents 118% growth compared to the corresponding period of 2005. (2005: RMB9,748,213). The growth reflected the company's competency in seizing market opportunities and its outstanding research and development.

North America remained the major market of the Group, accounting for approximately 61% of the turnover of its manufacturing business. The market continued to grow during the period. Turnover from this market decreased by 11% from that of 2005. On the other hand, the Group also made headway in exploring new markets and customers in the Greater China and Europe. Turnover from the Greater China market increased significantly and accounted for 17% of the turnover of the manufacturing business, whilst turnover from the European market accounted for 11% of the turnover of the manufacturing business.

Strategy for Business Growth

Exploration of the OEM market for automotive parts and accessories and development of products with high profit margins are the Group's main strategies to secure business growth for its manufacturing segment for the next three years. Under this strategy, inverters and HID light ballasts will be the Group's key products contributing to improving results. Research and development of these core products, protection of intellectual property right and integration of the industry will also be the next focus of the Group.

The popular use of in-car consumer appliances and the adoption of inverters as part of the standard accessories for certain motor vehicle models by automotive assemblers provide potential opportunities for the product to tap into the automotive aftermarket and OEM market in the PRC and overseas countries. After appointed by Germany's Volkswagen, Huachen Jinbei and Dongfeng Auto Group as an OEM inverter supplier, the Group has become Germany-based Audi's first OEM inverter supplier after Audi procured for the first time OEM inverters from the Group in early 2007. As competition in the global automotive market intensifies, automotive assemblers will upgrade their equipment and resort to external procurement of parts and accessories to reduce costs, thereby creating room for further development of the Group's OEM business.

Since its formal launch into the market in 2004, the Group's HID light ballast enjoyed higher profit margin due to its technical advantage. Due to its strengths in terms of illumination area and intensity, energy conservation and durability, HID light is widely used as automotive headlamp and other operating lights, resulting in the rapid growth in the capacity of the HID light ballast market. Given the leading strengths of the Group's HID lights ballasts in terms of price, size and stability, this product is set to achieve outstanding performance in the automotive aftermarket and the OEM business.

To maintain the long-term competitive advantages of these two core products, the Group has taken following measures:

– **Strengthen research and development**
  An R&D center has been established and technology talents recruited. A long-term R&D strategy and assessment mechanism has been laid down based on market demand. The Group maintains its leading position among its peers by fully taking advantage of resources in colleges and universities, and social resources. In 2006, the Group has acquired a total of 20 patent licenses.

– **Attach importance to intellectual property right protection**
  Legal experts who are familiar with relevant domestic and foreign laws and regulation were brought together to investigate numerous product infringements in the market, so as to protect the Group's intellectual property right according to laws and maintain the Group's advantage in product technologies.

– **Committed to the consolidation of the industry**
  The Group believes that further development of the PRC's economy would inevitably result in increasing production costs for labor-intense industries in areas along the Southeastern coast. To guarantee product diversification and sufficient production capacity for the Group's further expansion, effectively reduce production costs, optimize manufacturing business positioning, and strengthen negotiation capability in the OEM market, the Group will, after the establishment of its subsidiary in Shandong, the PRC ("Shandong Subsidiary"), further identify HID bulb, automotive lamp and ballast manufacturers in the Mainland China for the purpose of consolidating upstream and downstream business and steadily set up an business plan under which several production bases in inner provinces will be led by the Group's Shanghai R&D centre.

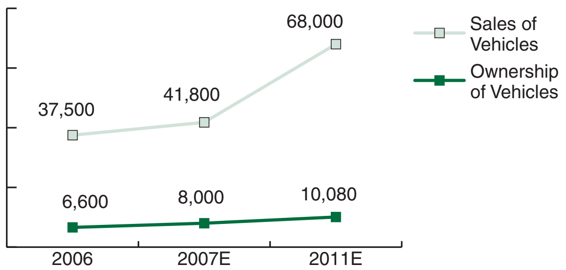
– **Step up efforts to increase its share in the domestic markets**

Confronted with increasingly saturated market in Europe and US and international pressure arising from dramatically expanding trade surplus, the China government will endeavour to expand domestic demand to adjust the structure of its formerly trade-driven economy. Domestic consumption will become the new driving force behind the national economic growth. Under such macroeconomic context, the Group proposed that the profit mode for its manufacturing business, which has been emphasized on export to one single market – the North American market be changed, that support to the domestic trade department in terms of staff, finance and resources be strengthened, and that the Group should seek a new growth point in the domestic automotive aftermarket and OEM market.

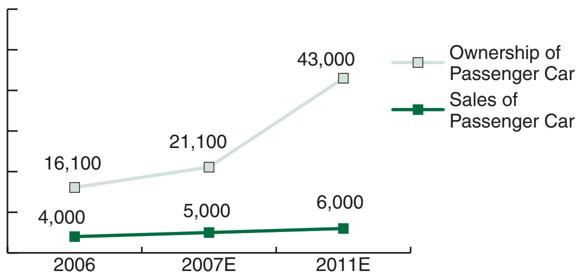
Analysis of the Progress of its Chain Business

With sustained and rapid growth of the PRC automotive industry in 2006, sales of automobiles reached 6.6 million units for the year, and ownership of passenger cars has exceeded 16.1 million units. The Group entered the automotive aftermarket service chain business in 2002, and has since then continued to explore the market rules, learn from the peers' experience, and actively introduce advanced technologies and equipment from developed countries with the view to delivering quality automotive services and merchandise retail sales to automobile users in the PRC.

Ownership and Sales of Vehicles in the PRC ('000)



Ownership and Sales of Passenger Car in the PRC ('000)



* *The above chart shows that ownership of motor vehicles and passenger cars in the PRC in 2011 will be able to catch up with the market scale of Japan in 2006.*

The automotive aftermarket industry consists of several value chains such as automotive service, repair, insurance, financing, leasing, and second-hand trading and culture communication. Up to now, the Group's automotive service business has been focusing on delivery of such four major automotive services, namely clean & beauty, light maintenance, accessories without service and accessories with service.

The Group's operations were confronted by challenges arising from an immature market, disordered competition and customer habits which are still being shaped. Nevertheless, in order to tap into the tremendous development potential of the PRC automotive aftermarket, the Group formulated robust plans to establish the nation's most extensive automotive aftermarket service chain network by constantly expanding its "Autolife" chain stores. For the short-term, the Group targeted to increase the number of chain stores to 420 in 2007, and 580 in 2008.

As at 31 December 2006, the number of chain stores had increased exponentially from 39 by the end of 2004 to 282, which includes 29 directly-operated stores and 253 franchised stores. Up to now, the Group has opened 28 large Superstores across Beijing, Taipei, Shanghai and Chengdu, the four major cities with the highest ownership of motor vehicles in the Greater China region, and aggressively expanded its franchised shop network in developed cities such as Guangzhou, Suzhou, Chongqing and Nanjing.

Analysis of Business Model and Business Progress

Committed to delivering professional, fast and low-priced but high-quality services to consumers and rapidly increasing its market share, the Group has been implementing the strategy of expanding its multi-tiered (three kinds of shops: Super, Express and Beauty) and multi-mode (M&A, cooperation, establishment and franchise) chain store network, as well as establishing the business strategy of building directly-operated stores that cater to industry features as models and franchise stores as the primary operation mode of its chain store network. Up to now, Super stores have been run mainly under the direct operation model whereas all other stores have been run mainly under the franchise model.

During the period under review, the Group established regional headquarters by regions as scheduled after taking into account the unbalanced development of regional economy and great differences in market environment across the vast area of the PRC. The regional headquarter will ensure effective business support and control through directly-operated Superstores and be responsible for the expansion of new outlets within the respective region. During the period, the regional headquarters in Shanghai, Chengdu and Taiwan have been established one after another. The regional headquarter in Beijing has also been established in the first half of 2007 after the acquisition of 51% stake in Beijing Aiyihang Auto Services Ltd. ("Aiyihang") by the Group.

The Group has shut down some small-scale directly-operated stores strategically as well as accelerated the expansion of Superstores and franchise stores. At present, the Group's first large-scale one-stop automotive service plaza in Shanghai has commenced formal operation, and acquisition and consolidation of 1 Superstore in Chengdu, 8 Superstores of Taiwan's Richahaus, and 9 Superstores of Aiyihang has either been completed or under progress.

Progress of Construction of Business Support Function

The Group has established a 2-tiered (chain store business headquarters-district centre) business support system, which guarantees the achievement of economies of scale in business support while assuring comprehensiveness, convenience and flexibility of business support through each regional headquarter. During the period, greater progress has been made in the construction of business support functions, and the Group will gradually enhance market competitiveness of its chain store network, strengthen control of franchise stores and increase the proportion of commodity supply.

In terms of supply and procurement of commodities, the Group can deliver increasingly diversified automotive commodities and service items (more than 16,000 items) from audio visual equipment, tire and aluminum rim, maintenance and repair tools, collection of general merchandise, and refitting and a wide range of equipment and tools, and has achieved initial success in developing its own brands and acting as agent of other brandname products, During the period, products launched under the Group's own brands include in-car commodities, such as air bag, abrasive agents, cleaning chemicals, washer fluid, anti-freezer, air-conditioner detergent, towel, foot mat, seasonal cushion and brake shoe. Besides, the Group is acting as agent for in-car commodities of more than 50 brands. Regarding technological support, the Group was authorized to run Shanghai Hualiang Vocational Professional Technical School, which is the first school qualified to certify national professional qualification of automotive beauty care and refit under approved procedure and installation and the Group has also established the multi-tiered technological support system covering "Comprehensive Technical Training to Support from Technical Team to Development and Promotion of New Technologies". Cross-province cooperation on technical training, the enrichment of technical support content and projects of new technologies to be researched and developed have been progressing and improved on an ongoing basis. In terms of logistics distribution, the construction of a nationwide logistics distribution system that features various ways of distribution, including independent distribution, supplier distribution and professional logistics distribution, is in full swing. Regarding brand promotion, service brands are promoted via Internet, mobile outdoor advertisement and the launch of co-branded credit card with banks, as well as through traditional media such as newspapers, auto magazines, and broadcasting. The Group also enhanced its brand recognition by establishing chain stores in strategic locations, and has successfully opened a new outlet at Pudong International Airport, a gateway to Shanghai.

Progress of Business Acquisition

During the period, according to the strategy for the expansion of chain stores network, the Group's subject of business acquisition is targeted at the quality Superstores operators in the region. By acquiring new Superstores to complement the supporting system of the existing business and building strategic cooperation, the Group establishes regional headquarters and expands the network and supports the business in the region under such regional headquarters.

Project of Taiwan Richahaus

Following the establishment of the regional headquarters at Chengdu by successfully acquired a Superstore in Chengdu, the Group has implemented the acquisition of the business of Taiwan Richahaus on 8 September 2006. Richahaus operates totally 8 Superstores in Taiwan and has more than 10 years of experience in the operation of large scale stores. It is one of the largest operators of the automotive aftermarket service chain stores in Taiwan. Currently, the ownership of passenger cars in Taiwan accounts for one-fifth of that in the Great China Region. The automotive aftermarket of Taiwan is more mature and its service is of higher quality as compared to that of China. The acquisition of such large scale business of Richahaus in Taiwan represents a remarkable step towards the development of the Group's chain store business and realization of strategic targets.

The acquisition will speed up the expansion of the scale of the Group's merchandise purchases and further increase the number of projects and channels of purchases and distribution. The Group will also acquire extensive experience in the operation of chain store business and different skills in services, boosting the integrated competitiveness of the Group. Leveraging on the enhanced integrated competitiveness, the Group's capability in the acquisition and merger and integration of operators of automotive aftermarket services chain store business in different regions in China will therefore further be enhanced, which in turn strengthens its control and support of the chain services network of China.

Prospects

Looking ahead, the capacity of the global automotive aftermarket will continue to grow. The room for development of automotive parts and components manufacturers in the OEM market and the Group's advantageous position in the PRC's gradually developing automotive industry present boundless opportunities for the Group's development.

Regarding the manufacturing business, the Group's core products witnessed a strong growth trend in the OEM market and automotive aftermarket, while the domestic market also provided the Group with a huge room for making profit. The Group's active cooperation approach towards the upstream and downstream segments will leave room for further growth anticipation. The Group will continue to consolidate its established strengths in its business so as to maintain a long-term and steady growth.

The chain business is a segment in which the Group has devoted substantial efforts. The Group is committed to developing itself into the PRC's largest automotive aftermarket service chain network operator and building "AUTOLIFE" as the leading brand in the PRC automotive aftermarket service industry. Being a pioneer with a large-scale operation, the Group is well positioned to benefit from PRC's increasingly rational consumers and the Group's sound development. While the headquarter's function upgrading project is entering the final stage, the multi-tiered network expansion plan is also progressing smoothly. By combining the headquarter's functional advantages and the resource advantage of local partners, the regional centres will play a crucial role in the Group's exploration of the PRC market. In 2007, the Group will concentrate on resource integration of business entities joining the Group recently to take advantage of synergy arising from such cooperation. Furthermore, the Group will seek new acquisition and merging targets in Jiangsu and Zhejiang and the regions along the southern coast of the PRC to expedite strategic deployment of the Group. The Group has already identified suitable cooperation partners in such regions and the specific way of cooperation is under discussion. The Group believes that with the gradual implementation of its business expansion plan, the chain store business will gradually grow into an important source of profit for the Group.

Review of operation

During the period under review, turnover increased by 5% to approximately RMB533,302,000, gross profit, operating profit and profit attributable to shareholders all recorded a decrease. Gross profit decreased by 25% to approximately RMB91,667,000, operating profit decreased to approximately RMB22,005,000, while profit attributable to shareholders decreased by 74% to approximately RMB14,218,000.

Gross profit

Gross profit margin of sales of the Group was approximately 17% (the corresponding period of 2005: 24%), representing a decrease of 7 percentage points.

During the year, the global increase in the prices of raw materials continued. Compared to the beginning of the year, RMB has been appreciated against USD by approximately 3.2% up to 31 December 2006. All these factors affected the Group's profit margin. However, due to the Group's high operational efficiency, outstanding management capability and the rapid launch of new products with high added-value, during the period under review, turnover attributable to the new products amounted for over 40%.

Other gains

The Group recorded other gains of approximately RMB14,591,000.

Expenditures

Total selling and marketing expenses and administrative expenses amounted to approximately RMB84,253,000 (2005: approximately RMB67,653,000), of which expenses of the manufacturing business accounted for approximately RMB36,592,000, while the chain stores business accounted for approximately RMB34,564,000, and unallocated expenses amounted to approximately RMB12,948,000.

Expenses of the manufacturing business increased due to the great expansion in domestic business of the Group.

Expenses for chain stores business was increased because of the expansion of the directly-operated stores, and the enhancement of the headquarter functions, such as merchandise procurement, training, logistics, management and marketing, and support for franchise operations and acquisitions and mergers. The Group increased its inputs in human resources management, software and hardware facilities and other necessary aspects.

Operating profit

Operating profit was approximately RMB22,005,000 (2005: approximately RMB66,019,000), representing an decrease of 67%.

Finance cost and tax

Finance cost was approximately RMB2,238,000 (2005: approximately RMB477,000).

Income tax expense was approximately RMB4,201,000 (2005: approximately RMB9,924,000). The decrease was primarily attributable to the decrease in profit for the year.

Profit attributable to shareholders

Profit attributable to shareholders was approximately RMB14,218,000 (2005: approximately RMB55,618,000), representing a decrease by 74%.

Financial conditions and liquidity

The Group maintained its stable financial status during the period. As at 31 December 2006, the Group had adequate cash and bank balance of approximately RMB67,089,000. As a result of its outstanding working capital management capability, cash inflow from operating activities of the Group for the period was approximately RMB27,923,000 (2005: RMB37,489,000).

As at 31 December 2006, current assets of the Group maintained at a healthy level of approximately RMB303,649,000 with a liquidity ratio of 1.43 (31 December 2005: 2.49). Gearing ratio calculated by dividing total liabilities by total assets increased from 28.9% as at 31 December 2005 to 50.3%.

As at 31 December 2006, total bank borrowings were approximately RMB41,353,000, of which approximately RMB38,213,000 are secured by a mix of collateral including certain buildings of the Group, corporate guarantee and personal guarantee from Mr. Hung Wei Pi.

The Group will continue to maintain a healthy financial status. Given a positive cash inflow from operating activities and available bank facilities, the Group has sufficient financial resources to meet its obligations, and requirement for working capital and future expansion investment.

During the year, the Group incurred an investment of approximately RMB68,370,000 (2005: approximately RMB38,779,000) for the addition of machinery and equipment, construction of new plants and property investment.

Use of proceeds

The Group offered and placed 100,000,000 new shares in February 2005. The net proceeds raised after the relevant listing expenses were approximately HK$74,700,000.

Use of proceeds in the manufacturing business:

(1) approximately RMB10,671,000 for the development of automotive electric and power related parts and accessories.

(2) approximately RMB9,585,000 for the construction of new production lines of factory.

Use of proceeds in the chain stores business:
None in the year under review.

Exchange risk

During the period under review, approximately 83% of sales and 18% of raw material purchases were conducted with overseas customers and mainly settled in USD. In response, the Group has signed a forward contract of group exchange settlement with the Bank of China. The Group has enhance the sales in the PRC market; further heighten the proportion of overseas procurement and strict control over costs and expenses to mitigate the impact of such exchange rate movement. Meanwhile, the Group will also leverage on its strong bargaining power and established relationships with customers and suppliers to transfer to them the additional costs arising from movements in exchange rates. The Group has no material exposure to foreign exchange risks.

Employees and remuneration policy

As at 31 December 2006, the Group employed 1,804 full-time employees, of which 245 were managerial staff and 70 were dedicated to the research and development of new products. The Group has been committed to the recruitment of talents to enrich its human resources structure. In order to attract and retain outstanding employees, the Group provided benefits such as medical insurance and housing benefits in addition to the various mandatory pension schemes stipulated by the municipal governments. Outstanding employees of the Group will be granted discretionary bonus and share options as incentives. As at 31 December 2006, 50 employees have been granted share options. It is the Group's plan to grant more options to a larger proportion of staff out of the 16,460,000 share options available, thereby further reinforcing the sense of belonging and responsibility to the Company.