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INTRODUCTION OF PACKAGING

Introduction

Packaging is the science, art, and technology of enclosing or protecting products for distribution, storage, sale, and use. Packaging also refers to the process of design, evaluation, and production of packages.

The main purpose of packaging is protection of the goods inside, but packaging also provides consumers with a recognisable logo, or packaging, to let consumers know what the goods are inside.

Specifically, packaging performs one or more of the following objectives: physical protection, barrier protection, containment or agglomeration, information transmission, marketing, security, convenience and portion control. Packaging plays an important role in the consumer products industry. Packaging was originally intended to provide an easy way to carry and protect goods; it is now also a vehicle for product marketing and to promote brand recognition. Package design and development are often thought of as an integral part of the new product development process. Development of a package (or component) must be linked closely with the product to be packaged.

According to the World Packaging Organization, global packaging industry output value was worth USD424 billion in 2004.

Also, according to the World Packaging Organization, the global packaging industry is projected to grow at a CAGR of 3.5% from 2004 to 2014, and the total industrial output is expected to reach USD597 billion in 2014.

The PRC Packaging Industry

The total PRC packaging industrial output value amounted to RMB328.3 billion (equivalent to approximately HK$360.8 billion) in 2004, representing 2.4% of China's GDP. Set out below is the industrial output value of different types of packaging in the PRC in 2004.

	Industrial output value *(RMB billion)*	%
Paper packaging	113.50	34.57
Plastic packaging	92.93	28.31
Glass packaging	8.87	2.70
Metal packaging	23.08	7.03
Packaging printing	62.82	19.13
Packaging machinery	16.96	5.17
Other packaging	10.15	3.09
Total	328.31	100.00

Source: China Packaging Yearbook 2005

Paper Packaging

Categorised by the materials used for packaging, the packaging industry comprises paper packaging, plastic materials packaging, glass packaging, metal packaging and others. Paper packaging includes all packaging that uses paper and board as its packaging materials as well as the manufacturing of paper and board. Most of the packaging printers are small in scale and the market is fragmented, and the major packaging printers are mainly located in Guangdong Province and Yangtze River Delta.

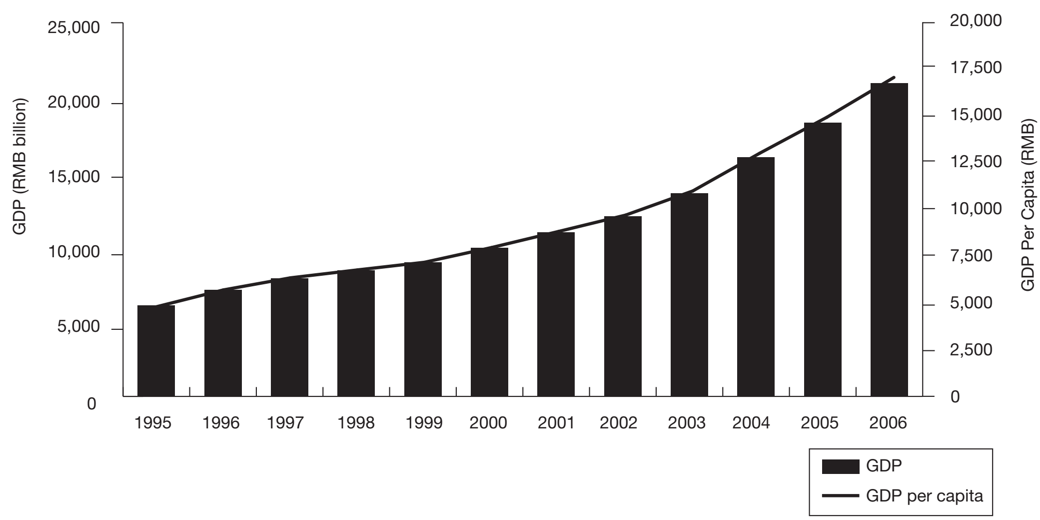
Paper packaging is the largest type of packaging in terms of industrial output value. Of the major categories of packaging materials (paper and board, plastic, glass, metal and others), paper and board products added up to 75.7% of total production of PRC packaging industry in 2004.

Based on statistics from the China Paper Association, packaging paper and board products represented more than 59.5% and 59.7% of total paper consumption in 2005 and 2006, respectively. Total consumption of packaging paper and board products was 39.4 million tons in 2006, and board products accounted for 86.6% of this total, or at 34.1 million tons.

INCREASE IN CONSUMER SPENDING POWER IN THE PRC

According to statistics provided by the China National Bureau of Statistics, the PRC's gross domestic product, or GDP, grew at a CAGR of approximately 10.5% per annum from 1995 to 2006, with GDP per capita increasing from RMB5,046 (equivalent to approximately HK$5,545) to RMB15,931 (equivalent to approximately HK$17,507) during the same period. The PRC's GDP per capita exceeded USD1,000 for the first time in 2001. The following chart illustrates the growth trend of the PRC's GDP and GDP per capita from the years 1995 to 2006:

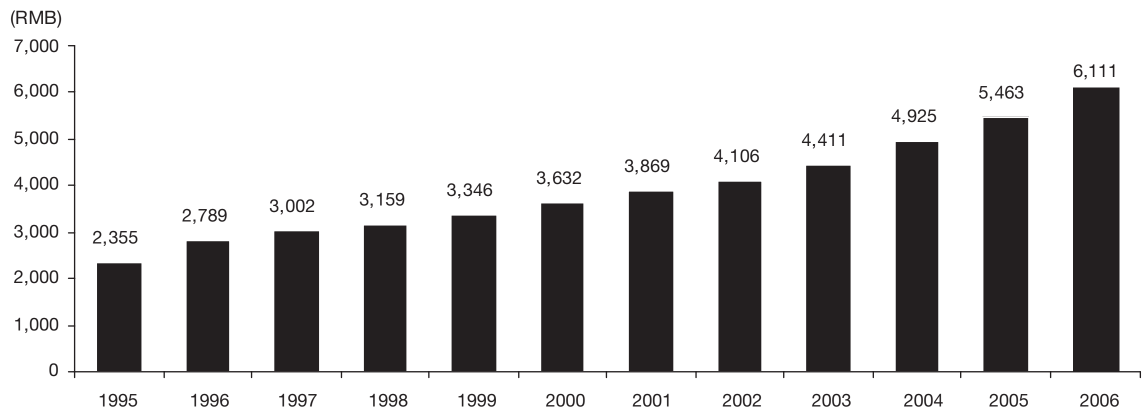
PRC's GDP and GDP per capita
(1995-2006)



Source: China Statistical Yearbook 2007, National Bureau of Statistics of China

The PRC's economic development has given rise to better living standards and higher levels of affluence for its population. This is evidenced by the gradual increase in the average consumption level of the population in the PRC, which enjoyed a CAGR of 9.06% from 1995 to 2006, increasing from approximately RMB2,355 (equivalent to approximately HK$2,588) in 1995 to RMB6,111 (equivalent to approximately HK$6,715) in 2006. The chart below illustrates the per capita annual consumption level in China from 1995 to 2006:

PRC Consumer Spending (1995-2006)

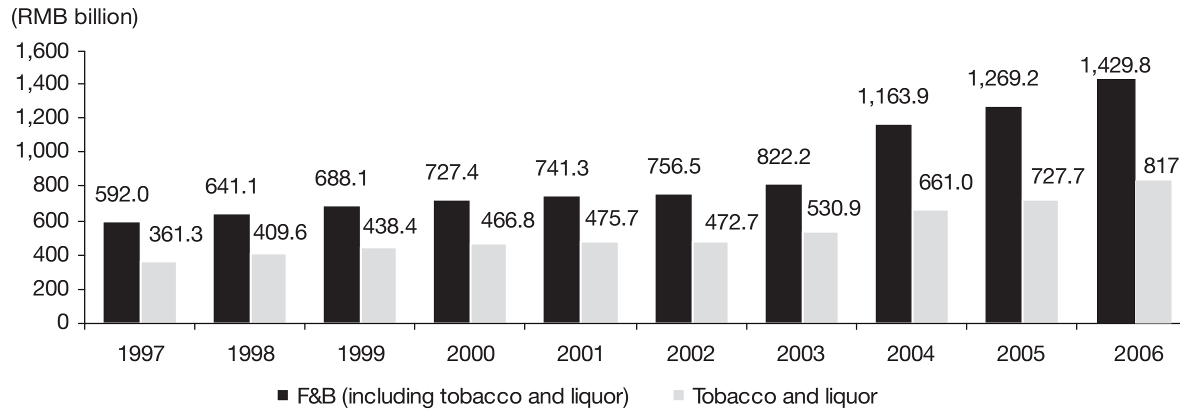


Source: China Statistical Yearbook 2007

As a result of strong economic growth and improved consumer spending power, China consumption has experienced rapid growth. According to the China National Statistics Bureau, total retail sales of consumer products in China increased from RMB4,305.5 billion (equivalent to approximately HK$4,731.3 billion) in 2001 to RMB7,641.0 billion (equivalent to approximately HK$8,396.7 billion) in 2006. As of October 2007, the accumulated total retail sales of consumer products in China reached RMB7,209 billion (equivalent to approximately HK$7,922 billion), representing year on year growth of 16.1%. With the surge in retail sales in consumer products, packaging is a direct beneficiary.

According to the China National Bureau of Statistics, China's consumption of food and beverage (including tobacco and liquor) had grew at a CAGR of 10.29% from 1997 to 2006. The following chart illustrates the total sales of food and beverage (including tobacco and liquor) above designated size and the total sales of tobacco and liquor above designated size from 1997 to 2006.

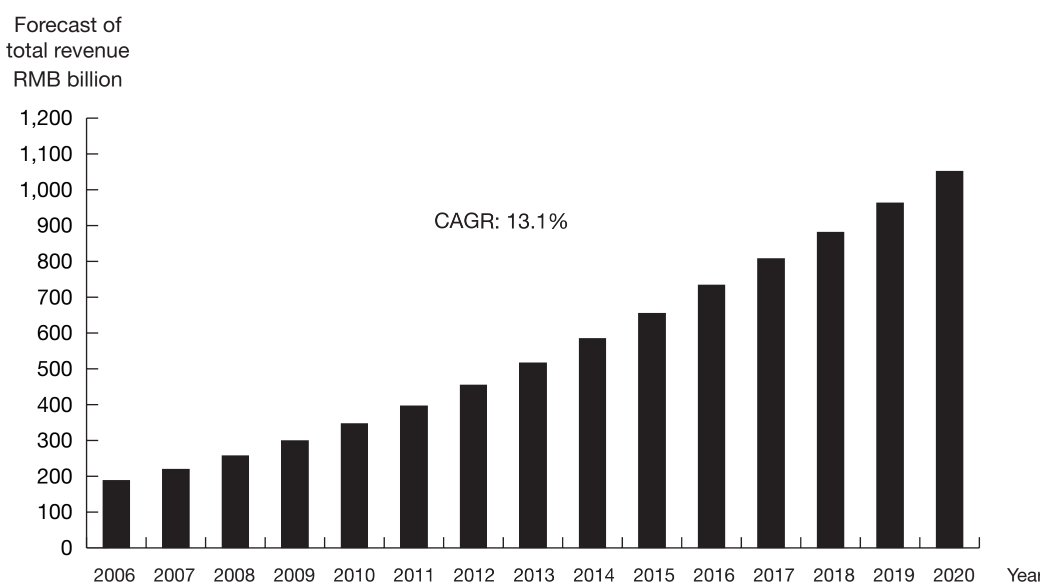
Total Sales of Food, Beverages, Tobacco and Liquor Above Designated Size (1997-2006)



Sources: China Statistical Yearbooks 1999-2007

The booming PRC economy and its surging exports, together with increased levels of advertising activity, as well as greater affluence and urbanisation, have all contributed towards the increase in the PRC's demand for printing packaging.

The following chart shows the forecast of total revenue of the China printing packaging industry from 2006 to 2020.



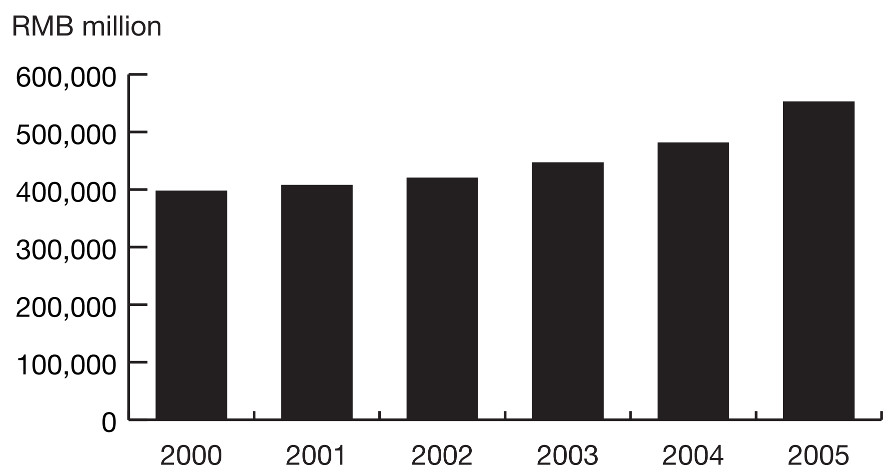
Source: Survey on the development of China's printing industry (1998-2020) (first published in January 2007) published by 印刷工業出版社

THE PRC TOBACCO INDUSTRY

Size of the PRC tobacco industry

The PRC is the largest nation of smokers in the world. According to 2007年中國控制吸煙報告 (the 2007 Report on Control of Smoking) in the PRC dated May 2007, there are approximately 350 million smokers in the PRC. The PRC tobacco market has maintained continuous growth, driven by rising living standards and spending power in the PRC.

Based on Euromonitor report, the retail sales value of tobacco in China increased from RMB397 billion (equivalent to approximately HK$436 billion) in 2000 to RMB522 billion (equivalent to approximately HK$574 billion) in 2005, representing a CAGR of 5.6%. The following chart shows the growth in volume in PRC retail sales of tobacco from 2000 to 2005.



Source: Euromonitor (December 2006)

Prospects for the PRC cigarette industry

As a result of increasing cigarette prices, the pre-tax profit of the PRC tobacco industry grew at a pace of approximately 21.6% per annum from 2002 to 2007 and is reported to be RMB388 billion (equivalent to approximately HK$426 billion) 2007. Premium products continued to gain ground in 2005, amounting to 16% of total volume sales, an 8-year consecutive growth from just under 15% in 1997. The firm expansion of premium products shows the strong impact of government policy on the industry. During 2000-2005, especially after 2003, generous budgets were set aside to promote premium brands, an attempt by the government to prepare for the potential competition from foreign brands, following the opening up of the market. The market share in the PRC of the top ten brands of cigarettes was approximately 37.8% in 2007.

The most dynamic band is the mid-price, a double beneficiary of both the government policy and the rising disposable income levels of Chinese. Due to a large proportion of rural smokers in China, low-end cigarettes continued to account for the bulk of sales in 2005, with a volume share of almost 47%, low-end cigarettes are typically priced at around RMB3.5 (equivalent to approximately HK$3.8) or less for a pack of 20. However, the volume share of low-end cigarettes fell throughout the review period, as the state monopoly initiated the closure of small and poorly performing cigarette factories. Economy cigarette market share fell 0.7% from 2004 to 2005, and about 5% from 1997.

Outlook

Concerns about mid-price products go beyond price. Key mid-price brands, which have grown rapidly, with little experience of competing internationally, will face barriers in the long term. Euromonitor forecasts that the mid-price market will overtake low-end products in 2008, becoming the mainstream price band of cigarettes in China.

Despite the tax hikes in premium and mid-price cigarettes, manufacturers have been repositioning their brands from low-end to mid-price responding to government policy of upgrading the quality and price of existing tobacco products.

Impact

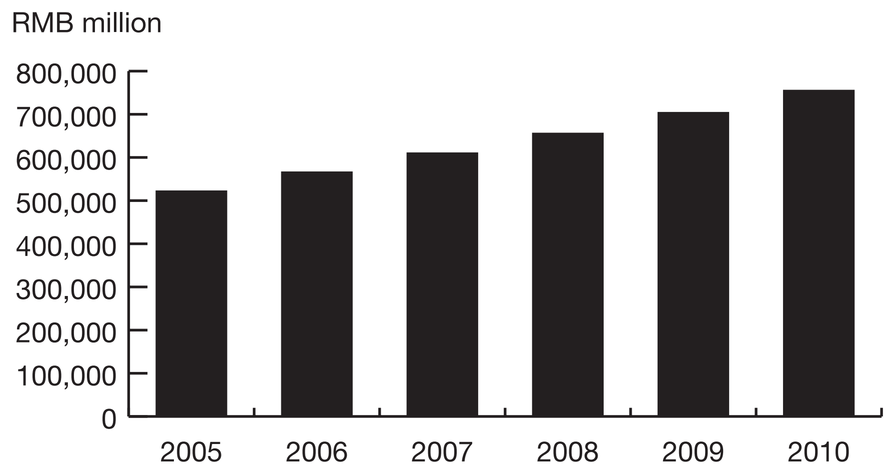
Consumers trading up to premium and mid-price cigarettes, and the government's assistance in developing the higher-end market, will both lift the sales value in the forecast period of 2005-2010. Value is therefore expected to peak more briskly than volume, as the overall unit prices rise.

The continuous surging retail price will not hamper the volume sales as is usually anticipated, as cigarettes have such a strong consumer base in China. Smoking in China is an important part of the social activity. People exchange cigarettes to show respect and trust when they interact with each other. Cigarettes therefore are a sign of income level and social status of the person. Coupled with rising disposable income, consumers are unlikely to be over-sensitive to the rising unit price.

The PRC tobacco industry is undergoing consolidation, which is resulting in a reduction in the number of tobacco companies and simplifying the sales and marketing channels for cigarette packaging companies. As a result, cigarette packaging companies have a smaller pool of potential customers and must focus more on securing larger orders from the remaining cigarette companies.

Given the significant investment costs involved in operating in the packaging industry, the Directors believe that the companies standing to benefit from this competition would be those which adopt diversified business models to take advantage of economies of scale; in addition, companies with low-end products may experience significant declines in profit margins and perhaps even losses.

With the smoking population in China continuing to expand and consumption power continuing to grow, the retail sales of tobacco products are expected to grow from RMB522 billion (equivalent to approximately HK$574 billion) in 2005 to RMB755 billion (equivalent to approximately HK$830 billion) in 2010, which represents a CAGR of 7.7%. The following chart shows the forecasted growth in volume in PRC retail sales of tobacco from 2005 to 2010:



Source: Euromonitor (December 2006)

THE PRC CIGARETTE PACKAGING INDUSTRY

Overview

China is the largest cigarette market globally. Chinese cigarette manufacturers are seeking to increase market shares, and as a result the cigarette packaging industry is experiencing increased demand and growth with certain cigarette packaging techniques surpassing those used by world famous cigarette brands. Brand marketing and promotion, which are directly associated with packaging, will become increasingly important for tobacco companies as competition becomes more fierce amidst the ongoing industry consolidation. As a result, cigarette packages are shifting towards higher quality packaging and cigarette packaging companies are experiencing fierce competition.

Tobacco packaging has characteristics that differ from packaging for other products. As tobacco companies are not allowed to advertise their products and market promotion is restricted, the role of tobacco packaging in product promotion is more important. Tobacco companies have to focus more on unique packages to differentiate their brands among various peers. Therefore, newly implemented tobacco restriction measures will instead bring additional opportunities for the tobacco packaging industry. The functionality of tobacco packaging will switch from simple protection of products to include brand promotion and marketing. High quality packaging plays a critical role in adding value to tobacco products, enhancing product competitiveness and developing opportunities in the international market.

Prospects for cigarette packaging in the PRC

In 2007, the total number of tobacco brands produced in the PRC was 173, 53 fewer than 2006. The number of tobacco producers declined from 185 in 1998 to 31 in 2007. In 2007, there were 13 brands whose volume of production and sales exceeded 1,000,000 cartons.

In the same year, the total volume of tobacco production in the PRC was 42.83 million cartons. Based on the expectation of three major customers of the Group in the PRC in relation to their production volume, the aggregate of such expected production volume will account for more than 15% of total.

The State Tobacco Monopoly Bureau issued "Catalogues of One Hundred Brands of Tobacco Products" on August 23, 2004, and plans to reduce the number of brands of tobacco products in the PRC to approximately 100 in the coming 2-3 years. In 2006, the market share of the top 100 brands of tobacco products was 89.4%.

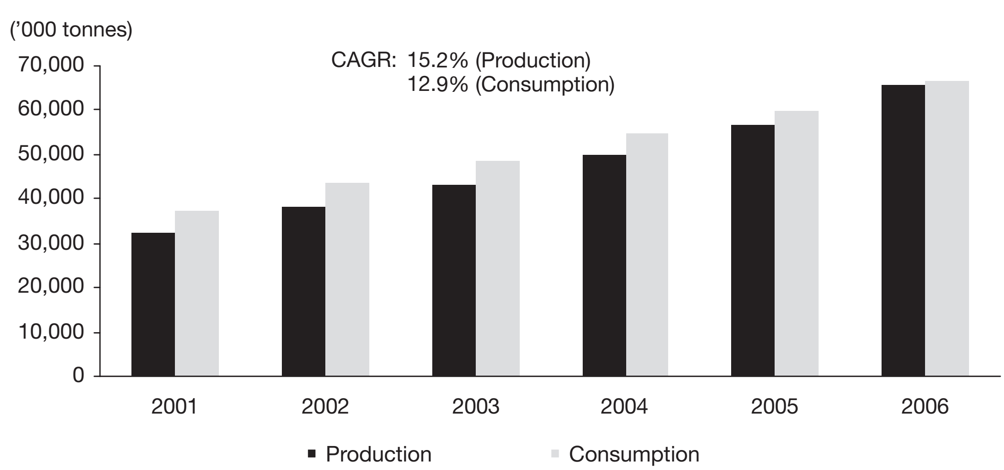
The consolidation of the tobacco industry presents an opportunity for larger packaging solution providers. As the business scale of larger tobacco producers expands through tobacco industry consolidation, larger packaging solution providers that can partner with large cigarette producers will also benefit.

THE PAPER AND PAPER BOARD MANUFACTURING INDUSTRY

Paper and paper board are the principal raw materials for paper packaging, the largest type of the packaging industry.

According to the China Paper Association, in 2006, total consumption of paper and paper board reached 65 million tonnes, which represented 16.07% growth compared over 2005 levels. The average annual growth of total production of paper and paper board has outpaced the growth of GDP at 13.44%. The following chart shows the total production of paper and paper board in China between 2001 and 2006.

Production and Consumption of Paper Products in PRC



Source: Annual Report on China paper making industry 2006, China Paper Association

Although China was ranked second in the world in terms of paper and paper board consumption, the PRC's annual per capita consumption of paper and paper board products in 2005 was still relatively low at approximately 50 kg, whereas those of United States, Japan and Taiwan were approximately 300 kg, 247 kg and 215 kg respectively. Growth in PRC demand is therefore expected to increase. There is a clear shortage of supply in the PRC with the PRC being a net importer of such paper products. Therefore, there is room for expansion in PRC domestic production capacity.

The following chart sets forth the production and consumption of major paper and paper board products in the PRC. Amongst all the different types of paper and paper board products, containerboard and uncoated printing and writing paper are the two largest products, with 35.1% and 18.8% of the production and 37.0% and 18.3% of the consumption in 2006, respectively.

Type	**Production** *('000 tonnes)*	*%*	**Consumption** *('000 tonnes)*	*%*
Newsprint paper	3,750	5.8	3,440	5.2
Uncoated printing and writing paper	12,200	18.8	12,110	18.3
Coated art paper	4,600	7.1	4,000	6.1
Household paper	4,700	7.2	4,360	6.6
Packaging paperboard	5,200	8.0	5,280	8.0
Duplex board	9,400	14.4	9,720	14.7
Of which Coated duplex board	9,000		9,310	
Containerboard	22,800	35.1	24,430	37.0
Specialty paper and paperboard	1,100	1.7	1,310	2.0
Other paper and paperboard	1,250	1.9	1,350	2.1

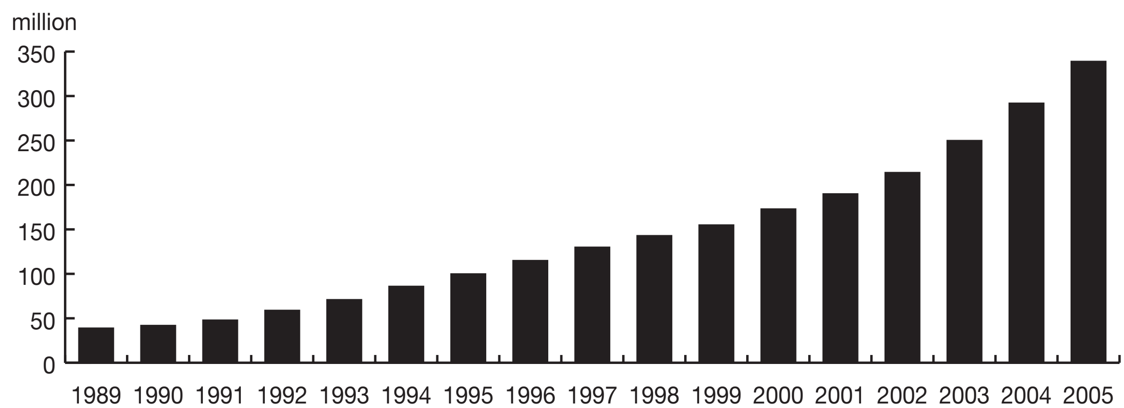
Source: 2006 中國造紙年鑒 (2006 Almanac of China Paper Industry)

THE CONTAINERBOARD INDUSTRY

The PRC Containerboard Market

Overview

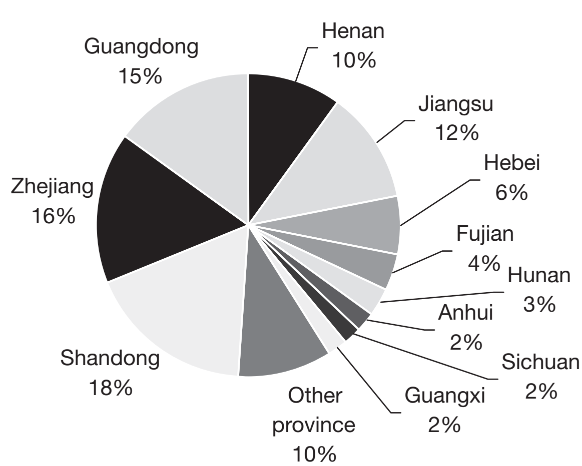
With the increase in the PRC's demand for paper and paper board products, containerboard has become one of the fastest growing paper products in the PRC in terms of production. According to RISI report, total production of containerboard increased from USD0.39 billion (equivalent to approximately HK$3.04 billion) in 1989 to USD3.39 billion (equivalent to approximately HK$26.44 billion) in 2005, representing a CAGR of 15.5%. The following chart shows the growth in industry production of containerboard.



Source: Euromonitor (December 2006)

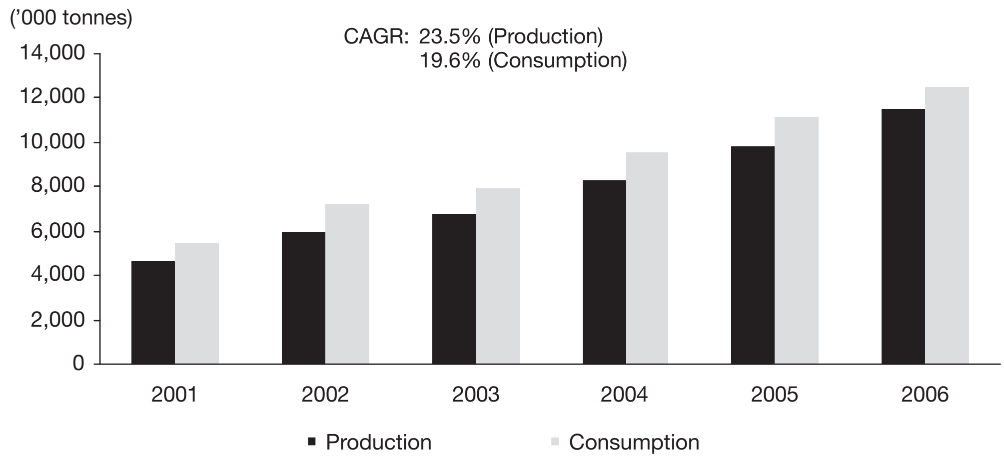
The PRC domestic paper and paper board market is largely driven by regional demand, and the major players have formed production and consumption bases along the east coast around the Pearl River Delta, Yangtze River Delta and Bohai Sea Rim regions where transportation links are convenient.

The following chart shows the top ten paper and paper board manufacturing provinces in the PRC in 2006 in terms of annual production volume:



Source: China Paper Association 2006

Domestic consumption of paper and paper board within the PRC is expected to remain strong. According to 中國造紙協會關於造紙工業"十一五"發展的意見 (Comments on the 11th Five-year Plan of Paper Making Industry by the China Paper Association) dated August 2007, the consumption of paper and paper board within the PRC is expected to sustain an average annual growth rate of 7.5% from 2005 to 2010. Based on such forecasts, the PRC domestic consumption and the PRC's annual per capita consumption of paper and paperboard are expected to reach approximately 85 million tonnes and 62 kg respectively in 2010. The following chart illustrates the PRC historical production and consumption of containerboard from 2001 to 2006:



Source: China Paper Association 2006