



Management Discussion and Analysis

Results

For the year ended 31 December 2000, the Group recorded a turnover of HK\$721,141,000 and a loss before taxation and minority interests of HK\$114,716,000. Total provisions of HK\$111,313,000 were made for the year including, inter alia, HK\$26,000,000 for impairment of trademarks; HK\$54,441,000 for trade receivables due from debtors; HK\$4,669,000 for inventory; HK\$10,421,000 for revaluation deficit of properties; HK\$12,478,000 for the goodwill written off related to the impairment in value of an investment in a subsidiary. As a result, the loss of the Group attributable to shareholders for the year ended 31 December 2000 amounted to HK\$84,550,000.

Cost Review

While the leather market in Mainland China has been better off, the Group experienced an upsurge of operating costs in certain areas, particularly the prices of raw materials. However, the Group's gross margin has picked up to 11% primarily attributable to its strict cost control.

The Group has been dedicated to enhancing its operational efficiency. This is well demonstrated by the retrenchment program initiated since June 2000 to streamline the Group's organizational structure. As a result, the employees' expenditure during the year reduced by 4% against the previous year.

Production Volume and Product Lines

In line with the Group's strategy of mass production of high quality and low cost products, the sales of leather increased significantly during the year with total sales amounting to HK\$483,428,000, a rise of 13% over last year. Production of cow hides increased by 2.5% to 26,439,000 sq. ft. while production of coated cow splits decreased by 12% to 6,102,000 sq. ft.

The leather ware business in Hong Kong maintained a gross margin of over 60%. Total sales for the year reached HK\$54,457,000, with a total of 75,000 handbags and 69,000 leather ware products being sold.

Discussion on Leather and Leather Ware Operations and Markets

The Leather Business

No visible recovery has been seen for the overall leather market in the year 2000, when the leather industry remained in an elimination phase that only the superior players can survive the continuing keen competition. The Group has adjusted its product mix since late 1999,



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Discussion on Leather and Leather Ware Operations and Markets (Cont'd)

The Leather Business (Cont'd)

illustrated by the active development of the new generation of black nappa cow leather. As this new product is well received and suitable for mass production, the Group is allowed to increase the sales and reduce the inventories of finished goods, thereby improving its liquidity and providing ample cashflow for its working capital. We expect that the prospects for this type of leather will remain positive in 2001, while in the face of a highly competitive market.

The acquisition of the machinery and equipment from Guangzhou People's Tannery through a tender in year 2000 will facilitate the Group's standard enhancement for the facilities at the Nanhai tannery. Downstream capacity is expected to increase to 25 million sq. ft per year. This coupled with the additional capacity achieved by outsourcing part of the crust processing work will significantly expand the overall capacity of the Group.

Leather Ware Business

The leather ware market in Mainland China was flooded with imitation and fake products due to the less stringent rules in governing such activities. As losses were recorded for its leather ware business in Mainland China over the past two years, the Group decided to shift from direct sales to franchise for its leather ware products in this market. Agreements have been reached between the Group and an agent for the grant of the trademark franchise at a fee of Hong Kong dollar two million per year and the sale of 25% interest in the trademark to the agent. On the other hand, the Group made a provision of HK\$26,000,000 for the impairment of trademark value regarding the "D Collection" leather ware products in the Mainland China market to their estimated recoverable amounts, given that this brand was hard hit by the competition from fake products and the adverse impact of resulted trademark litigation in the second half of the year.

The leather ware market in Hong Kong is primarily affected by the performance of the local economy and tourism. Hong Kong's economy has been revitalized since the second half of 2000. Tourist arrivals for the first half of 2000 also picked up to the level in 1997 despite weaker consumption by tourists. A moderate economic growth is anticipated in Hong Kong in year 2001 when the retail market will be slightly improved. However, Hong Kong is unlikely to stage a strong economic rebound and the market there will be highly competitive as it is more open to the global competition. Saint Jack planned to expand the proportion of its products targeted at the younger generation from 10% to 30% in year 2001, to take advantage of the stronger consumption sentiment among the youngsters who are less worried about the economic downturn. As the wholesale network for leather ware products has been shrinking, Saint Jack planned to open three additional specialty shops in Hong Kong, one of which has been opened in Shatin in late March 2001.



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Liquidity

As at 31 December 2000, the Group had bank loans amounting to HK\$226,495,000, and cash and bank balance totalling HK\$150,964,000. After deduction of cash and bank deposits, the ratio of the Group's net bank loans to shareholders' equity was 18%. Interest rates of the bank loans ranged from 6.4% to LIBOR/HIBOR plus 2.375% per annum. Of the Group's total borrowings, HK\$112,677,000 was repayable within one year while the remaining balance would be repayable before December 2003.

Capital Expenditure

The Group was awarded the tender last year for all the machinery and equipment originally owned by the Guangzhou People's Tannery at a consideration of RMB9,985,000. This would help underpin the Group's active drive for improving the standard of the facilities at the Nanhai production plant.

The Group's capital expenditure during the year under review amounted to HK\$28,598,000, they were mainly incurred for the purchase of machinery and equipment to optimize the standard of the Group's production facilities.

Litigation

1. A petition was submitted by 深圳市金利暉實業有限公司 in April 2000 to the Trademark Arbitration Committee of the State Administration for Industry and Commerce, P.R. China (中國工商行政管理局商標評審委員會) (the "Committee") for the revocation of the alleged improper trademark registration made by the "D Collection" leather ware products of the Group. Defense to the petition was made by the Group in August 2000. This case is pending hearing by the Committee.
2. Claims for damages of RMB10 million were brought by the Group in January 2001 at the Beijing First Intermediate People's Court (北京市第一中級人民法院) against 深圳市金利暉實業有限公司 and 北京百盛輕工發展有限公司 for their infringement of the trademark of the "D Collection" leather ware products. This case has been taken up by the Beijing First Intermediate People's Court (北京市第一中級人民法院).



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Litigation (Cont'd)

3. In February 2001, Guangdong Enterprises (North America) Fur Holdings Limited (“GDNA”) and Harbour Hill International Limited (“HHL”) filed suit against Hennessy International Group, Inc. (“HIGI”) and others, including one of HIGI’s shareholders, on account of a loan from GDNA and HHL to HIGI, guaranteed by the said shareholder. The loan amount outstanding is in excess of US\$2.25 million. The defendants have answered the compliant, denying liability, and brought a counterclaim, in the amount of US\$2 million, for alleged breach of a Shareholders’ Agreement. The court has conducted a pre-trial status conference, and set a discovery schedule. Discovery and pre-trial preparation is ongoing. GDNA and HHL are contesting the counterclaim vigorously.

Pledge of Assets

At 31 December 2000, certain of the Group’s leasehold land and buildings, investment properties and bank deposits with a total net book value of HK\$62,653,000 (1999: HK\$43,153,000) were pledged to secure general banking facilities granted to the Group.

Major Customers and Suppliers

For the year ended 31 December 2000,

- (a) the amount of purchases attributable to the Group’s largest supplier represented 14% of the Group’s total purchases;
- (b) the aggregate amount of purchases (not including the purchases of items which are of a capital nature) attributable to the Group’s five largest suppliers represented 45% of the Group’s total purchases;
- (c) the amount of turnover attributable to the Group’s largest customer represented 22% of the Group’s total turnover;
- (d) the aggregate amount of the turnover attributable to the Group’s five largest customers represented 52% of the Group’s total turnover; and
- (e) none of the Directors of the Company or their associates holds, nor does any shareholder owning (to the knowledge of the Directors) more than 5% of the Company’s equity capital holds any interests in any of the Group’s five largest suppliers or customers.



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Employees

As at 31 December 2000, a total of 1,905 employees were employed by the Group. The pay levels of employees are made with reference to the Group's operating results and the employee's performance. Over the past three years, there was a salary freeze for the employees of the headquarters in Hong Kong. The Group offered social and medical insurance and provident fund to all employees in different areas. The Company adopted a share option scheme for the benefit of its Directors and employees. Details of the share option scheme are set out in the Directors' Reports.

Prospects

The Group's principal activities are leather processing and sale of leather ware products primarily in the Mainland and Hong Kong. Its future performance will heavily hinge on the economic conditions in the Mainland. China is able to continue its positive economic growth in 2001, so long as the government's stimulus package for the local consumption remains in place; the global economic situation shows no significant volatility; and China's entry to the World Trade Organization is permitted this year. The Group is cautiously optimistic towards the prospects for the leather industry, although a visible improvement of the leather market is still awaited amid very keen competition.