MANAGEMENT DISCUSSION AND ANALYSIS

Business review

The Group's consolidated turnover for the six months ended 30th September, 2001 was HK$1,104 million, compared with HK$1,004 million for the same period last year, showing a 10% growth. Profit attributable to shareholders was HK$49 million, compared with HK$66 million for the corresponding six months last year, down by 26%. This decline in profit was attributable primarily to the start-up cost of the new plant in Australia and the costs associated with the launch of fresh soymilk and seasoned tofu products in the US aimed at developing our global markets. While we recognise that these costs have had a negative impact on the Group's performance in the short term, we feel strongly that they are a crucial part of investment in the VITASOY brand, as well as in our long-term market development.

Hong Kong

Hong Kong's production plant supports both the domestic sales and export markets. We are pleased with the continuing strong growth in our export markets and the steady sales growth in the competitive local market.

1. *Hong Kong Domestic Market*

   The poor retail environment in Hong Kong over the past few years has caused the closure of several general trade outlets, as well as one of the largest supermarket chains in the Special Administrative Region, having an adverse effect on our business. Nevertheless, the Group continued to enhance its responsiveness to market conditions through its ongoing pursuit of total quality management. The strategies of a corporate purchasing function and new sourcing contributed to the improvement in the gross margin. In addition, we achieved increased efficiency through the use of information technology and intensive training programs, which helped to streamline costs.

   More recently, over the past six months, our competitors have become very active in the Hong Kong market, using a low retail pricing strategy to gain market share and distribution within the general trade. Despite the difficult trading environment, we improved sales by around 7% over last year. This was made possible by the launch of 15 new products and effective marketing campaigns for the GOR YIN HAI Fruity Tea range and the VITA Green Tea range. Our most successful product launch was the GOR

YIN HAI range of specially formulated light fruit teas and flavoured waters, whose packaging featured happy, smiling fruit faces designed specifically to appeal to the young and the young at heart. We also saw good sales of our VITA Apple Green Tea, Q Ban (child's size) VITA Yoghurt Flavoured Drink featuring a duckling design, VITA Supreme Coffee in its premium slim metallic tetra pak container and Fresh VITA Family Milk with its "value for money" positioning.

We also launched a pilot Home Delivery Service for our products, available to customers who use our VITA Distilled Water Carboy, and established an Internet-based ordering system to complement this service.

Recognition of our success came with our VITASOY brand being elected one of the top 10 favourite brands in a poll organised by one of Hong Kong's biggest supermarket chains.

Over the past six months, Vitaland Services Limited continued the steady expansion of its tuckshop business, adding 22 operating outlets to reach a total of 166 during the period. Business turnover saw substantial growth due to this increase.

In order to ensure the quality of lunch boxes provided to our tuckshops, as well as to meet the growing demand for school meals, Vitaland Services Limited made a modest capital investment in the establishment of a central production kitchen under the name of Hong Kong Gourmet Limited, which provides high-quality, wholesome lunch boxes and services to the Hong Kong school community.

2. *Export Markets*

We are actively building our export markets by launching new products in current markets and developing new markets.

Our largest growth has come from Europe, where we saw a 77% increase in volume. This can be attributed to the start of new businesses in Spain and Croatia, as well as aggressive sales in the UK. The new products launched recently in Hong Kong were also made available for export, while the sale of the 250ml VITASOY Natural Soymilk product in the UK supermarket chain J.S. Sainsbury has boosted our position considerably.

Macau also showed a strong domestic growth in sales of 12% as our new ranges of GOR YIN HAI Fruity Tea and VITA Green Tea were readily accepted by consumers.

North America

During the six months ended 30th September, 2001, our sales in North America increased by a healthy 14% over the same period last year, with the overall soymilk category rising by 23% and tofu by 11%. In an effort to boost our product base, we introduced our seasoned and baked tofu product and are pleased to note that its distribution is gaining ground.

Because of the high costs associated with the launch of Refrigerated VITASOY Natural Soymilk in the dairy sections of mainstream supermarket chains, we continued our strategy of regional market development by selectively targeting the prime distribution outlets in the North-east and on the East Coast. This effective strategy resulted in our strong sales performance.

The soymilk market remains very competitive in North America. Trade and consumer promotions in the market have resulted in extremely competitive pricing, but we are delighted that Refrigerated VITASOY Natural Soymilk has taken over the Number Two spot ahead of our competitors in New England and New York.

We also remain the market leader in the unseasoned tofu category, with, according to data from A. C. Nielsen, almost a 50% share of the national retail market. Growth in the tofu category will continue to be driven by the introduction of such innovative new products as our seasoned Baked Tofu products.

Despite this, in the period up to September this year, we experienced broader losses in North America than over the same period last year, due primarily to increased expenditure on advertising and promotions, especially for Refrigerated VITASOY Natural Soymilk, which included for the first time a TV commercial broadcast in a few key cities on the East Coast. This loss is however viewed as market development investment and our long-term commitment to a growing category rather than as a periodic expense.

The Mainland

The production plants in the Mainland support both domestic sales and export sales to the Hong Kong market.

1. *The Mainland Domestic Market*

This market saw mixed results in terms of sales during the period under review.

Despite a very competitive environment, the Group achieved healthy growth in both sales value and sales volume in Southern China, attributable mainly to the continuing success of VITASOY Soymilk and VITA Tea in returnable bottles in the Guangdong market, as well as the introduction of new flavours and new package designs supported by aggressive advertising and promotional campaigns.

However, the positive growth in Southern China was offset by the expected decline in sales caused by measures to trim discounts and consolidate distribution channels, as well as to streamline unprofitable products in Eastern China. For example, we implemented a range of key initiatives in the first half of the year, which aimed to improve overall efficiency and reduce operating losses at the Shanghai plant. The results were very much within our expectations. Our next step is to launch new, profitable products in PET plastic bottles next year.

Overall, the non-alcoholic beverage market in the Mainland is showing encouraging growth, fueled particularly by the ready-to-drink tea and juice segments. Water and carbonated drinks also continued their upward trend, although soymilk remained soft with an estimated growth rate for the year of 5%.

2. *Export to the Hong Kong Market*

During the interim period under review, sales to the Hong Kong market have fallen in line with our target to allocate more capacities to future domestic growth in the Mainland.

Australia and New Zealand

Further boosting our position in Australia was the commencement of operations at our new joint venture plant in Wodonga, Victoria, which marked another step in the Group's long-term market diversification. The new plant carries production lines for both refrigerated and UHT (ultra high temperature) soymilk.

The joint venture is a result of close collaboration between our Group and National Foods Limited of Australia, and makes full use of the synergy each party brings to the relationship.

Our main area of contribution was our technical know-how, garnered over 60 years of experience in soymilk production. National Foods Limited, Australia's largest listed dairy company, contributed its comprehensive knowledge of the distribution system in the Australian market.

During the interim period under review, the joint venture completed a national launch of domestically produced Refrigerated VITASOY Natural Soymilk in key supermarket chains across Australia, supported by strong marketing campaigns. It may still be too early to gauge the product's acceptance by the market but the initial reception was encouraging.

The start-up cost of the new plant, and the advertising and promotion expenses associated with the launch of domestic production largely accounted for the losses experienced in the six months ended 30th September, 2001.

Associate

Despite the tough economic environment and a competitive operating environment, Sodexho (Hong Kong) Limited generated a higher operating profit, driven mainly by a strategic plan to create added-value services for its customers and a consolidation of operations. The gains were however completely eroded by the write off of certain intangible assets for the six months ended 30th September, 2001.

General outlook

The market situation in Hong Kong is expected to become even more difficult over the next 18 months due to recession. This will place greater pressure on our margins, with promotional activities becoming even more aggressive as companies fight to protect volume in a shrinking spending environment. As we introduce more new products over the coming months and spend more in marketing our core products, we expect to further improve our volume and total market share, but with some erosion of our profit margin.

We expect Vitaland Services Limited's tuckshop business to continue its expansion. With the establishment of Hong Kong Gourmet Limited, we are broadening our product and service range, and providing one-stop-shop services for our customers.

In North America, the general outlook remains cautious under current economic conditions, although we project finishing fiscal year 2001/2002 with solid growth in sales compared with last year. Guided by the experience and strength of a new president and CEO, the Vitasoy USA Group is currently undergoing restructuring wherein the West Coast operation will move to the East Coast to be consolidated into a single operation. We expect this move to achieve substantial long-term savings in operational costs. The West Coast sales team will remain in place to serve existing customers and source new ones. Measures have also been taken to scale back some of the planned increases in marketing expenses in the second half of the year in order to concentrate on existing Refrigerated VITASOY Natural Soymilk outlets in strategic markets.

In the Mainland, we aim to consolidate the Group's leading position in the ready-to-serve premium soymilk markets in Eastern and Southern China. We will also continue efforts to execute critical sales and distribution strategies in new channels and markets; introduce trendy, healthy and profitable new products; and improve operating efficiency by controlling production and administrative costs. Overall, we expect a steady business environment for the Group's products in the Mainland for the remainder of the year.

Meanwhile, in Australia, we have seen some slowdown in the overall soymilk market growth over the past few months, due partly to lower advertising and marketing support for the category and partly to pricing pressure from the deregulation of the dairy industry. However we anticipate that the growing health consciousness of consumers and increased publicity of the health benefits of soy foods in this market will result in a future growth in sales. With our Wodonga plant now in production, our presence in Oceania has been greatly enhanced, improving our ability to deliver chilled products directly to retail outlets throughout Australia. We are optimistic that we are well positioned to leverage on future market growth.

Generally, as the worldwide recession deepens, it is likely that sales in our export markets in Europe and South East Asia will decline as we price our products at premium levels compared to local players. However, we will continue to explore new markets and introduce new products, and expect to equal last year's sales figures even after excluding the Australia and New Zealand volume.

Employment, training, development and remuneration policy

The Group employs a total of 3,152 people worldwide and adopts a competitive remuneration package for its employees. Promotion and salary adjustments are assessed on a performance-related basis, and the Group sponsors external training and education programs to improve work performance and long-term career development.

The Group's overall policies on human resources management and details of the share options scheme remain unchanged from those described in the 2000/2001 Annual Report.

Capital expenditure

During the interim period, the Group's capital expenditure totalled HK$55 million (2000: HK$40 million). This expenditure was funded partly by internal resources and partly by bank borrowings. A major portion of the capital expenditure went to the acquisition of sales equipment, balancing payment on the construction of the manufacturing plant in Australia and the expansion of our tuckshop business in Hong Kong.

Liquidity and financial resources

As at 30th September, 2001, the Group had a healthy net cash position of HK$121 million (31st March, 2001: HK$159 million). Undrawn facilities available to the Group totalled HK$287 million.

The Group's total borrowings as at 30th September, 2001 amounted to HK$285 million (31st March, 2001: HK$241 million). The maturity profile is spread over a period of five years, with HK$237 million repayable in the first year, HK$10 million in the second year and HK$38 million within the third to the fifth years. The amounts of borrowings denominated in US dollars, Renminbi and Australian dollars were the equivalent of HK$127 million, HK$79 million and HK$71 million respectively, in addition to HK$8 million in Hong Kong dollars.

The Group continued to maintain a low gearing ratio, calculated on the Group's borrowings of HK$285 million (31st March, 2001: HK$241 million) over the shareholders' fund of HK$1,175 million (31st March, 2001: HK$1,178 million), at 0.24 at the interim period end date.

With adequate funds and as yet unused banking facilities, the Group's liquidity position remains strong, with sufficient financial resources to meet current commitments and working capital requirements.

Charges on group assets

As at 30th September, 2001, assets of the Group with an aggregate carrying value of HK$342 million (31st March, 2001: HK$330 million) were pledged to secure loan facilities used by subsidiaries.

Financial risk management

The Group maintains a prudent approach to foreign exchange exposure management, with income and expenditure streams denominated mainly in Hong Kong dollars, US dollars, Australian dollars and Renminbi. To manage currency risks, non-Hong Kong dollar assets are financed primarily by matching local currency debts as far as possible. Forward foreign exchange contracts are also used to cover future currency risks associated with major committed capital expenditure programs, when appropriate.

The cost of major raw and packaging materials remained stable during the period under review. The strategy of making the Mainland our chief source of materials while continuing to explore alternative sources in other parts of the world proved effective in containing costs. The Group's consistent policy of covering forward purchases of key commodities based on production plans has helped to stabilise production costs.

Payment terms with customers are largely on credit. In order to minimise the credit risks associated with trade receivables, credit evaluations of debtors are performed periodically and, when appropriate, security is obtained. Bad debts have been insignificant.

Vote of thanks

We were deeply saddened by the passing of Mr. Eoghan Murray McMillan, an Independent Non-executive Director of the Company, on 2nd October, 2001. Mr. McMillan, who was appointed to the Board in September 1993, will be remembered as a brilliant and zealous co-worker, and for his insightful guidance and valuable contribution to the Company throughout the past eight years.