



## Management Discussion and Analysis

### OPERATIONS REVIEW

Performance of the Group's various businesses in 2001 and strategies for their future development are set out in this section.

#### The Leather Processing Business

The Group's existing advantage in manufacturing imported leather will become less significant given the indirect impact from China's successful accession to the World Trade Organization in 2001, and market competition is set to intensify. As China's economic conditions and consumer market come under pressure from the external economic uncertainties, negative impact will be further posed on the Group's leather business. The Group's leather production by product line for the two years ended 2000 and 2001 is as follows:

<i>Product</i>	2001 ( <i>'000 sq.ft.</i> )	2000 ( <i>'000 sq.ft.</i> )
Cow Hides		
Nanhai Tannery	23,182	23,221
Xuzhou Nanhai Tannery	10,364	7,203
Qingdao Nanhai Tannery	3,089	6,915
Cow Split	9,029	6,052
Coated Cow Split	12,092	11,775
Double-Face Lamb Leather	284	252
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Total	<u>58,040</u>	<u>55,418</u>

Black nappa cow leather in mass production continues to be the main product line of the Group's tanneries. While the ratio of imported and PRC raw leather is maintained at 7:3, the Group's product mix is set at a ratio of 8:2 – 80% of low-risk black nappa cow leather and 20% of new trendy products that may have a higher market risk but a higher gross margin. This ratio allows the Group to offer customers a more diversified range of products, to avoid over emphasis on one sole product, and to maintain the Group's advantage in technological advancement.



## Management Discussion and Analysis (Cont'd)

For new markets to be opened up, Shanghai is a major target for the Group. Regional sales centres will be set up in Hangzhou, Kunshan, Jiangdu and Danyang to facilitate its foray in eastern China. The Group also ventures into the southwestern China market with regional sales centres to be opened in Chongqing and Chengdu. By branching out into these new and exciting markets for shoe leather, the Group is able to extend its operational framework and avoid relying on the Wenzhou market. Major customer distribution by geographical location is as follows:

<i>Geographical location</i>	2001 (%)	2000 (%)
Zhejiang Province	41	30
Guangdong Province	31	33
Others	28	37

The Group is steadfast in strengthening its leading position in China's leather market. To expand the production capacity by acquiring the assets of two PRC joint venture partners in Xuzhou, and to increase the total leather production by outsourcing the upstream processing work, are strategies devised to extend further the Group's presence in China's leather market.

### The Leather Ware Business

The Group has shifted the marketing mode to franchise for its leather ware products in China since April 2001. The trademark franchise was granted at a fee of HK\$2,000,000 per year. As the agreement for the sale of a 25% interest in the trademark was unilaterally terminated by the agent given the adverse market conditions, the deposit of HK\$500,000 paid by the agent to the Group was forfeited as a compensation.

The leather ware market in Hong Kong was primarily hit by the slackening economy and the sluggish retail market where no visible improvement has been shown. In view of the shrinking number of wholesale shops and traditional retail counters at department stores, two Saint Jack specialty shops were opened in Shatin and Yuen Long in 2001. Nevertheless, the overall performance has not yet improved and a loss of approximately HK\$13,937,000 was incurred due to a rise in fixed expenditure and the provisions and impairment of inventories and properties.



## Management Discussion and Analysis (Cont'd)

### FINANCIAL REVIEW

#### Results, Provisions and Impairment

The Group's loss before tax and minority interests for the year ended 31 December 2001 was HK\$77,946,000. Total provisions and impairment of HK\$91,916,000 were made for the year as follows:

	HK\$
Deficit arising on revaluation of properties	19,169,000
Goodwill impairment	21,919,000
Leather ware trademarks	4,100,000
Impairment of an investment in an associate	5,624,000
Impairment of fixed assets and provisions for receivable, inventories and compensations	
– Curtailment of operations of one of leather processing subsidiaries	25,624,000
– Disengagement of interest in packaging materials business	7,163,000
– Leather ware business	8,317,000

As a result, the net loss of the Group attributable to shareholders for the year ended 31 December 2001 was HK\$72,283,000, an improvement of 14.5% as compared to the previous year.

#### Turnover and Profit Contribution

The Group's businesses are basically categorised into the leather processing business, the merchandise trading business, the leather ware business and the packaging materials business. The leather processing business was the largest revenue contributor to the Group, accounting for 61.5% of its turnover. Cowhides were the major product line of the leather processing business and accounted for 82.2% of the turnover of leather processing business. Gross margin of the leather ware business, which stood at 66.2% for the year, was the highest among the four businesses. However, the net operating loss of leather ware business was due to the high distribution costs (see "Operating Costs" below). Turnover and profit contribution from the Group's principal businesses in 2001 are as follows:



## Management Discussion and Analysis (Cont'd)

	<i>Leather processing (HK\$'000)</i>	<i>Merchandise trading (HK\$'000)</i>	<i>Leather ware (HK\$'000)</i>	<i>Packaging Materials (HK\$'000)</i>
Turnover				
Cow Hides	386,402	221,870		
Cow Split	26,180			
Coated Cow Split	49,070			
Handbag			24,418	
Wallet			6,540	
Paper box				12,989
Colour printing				8,540
Others	8,660	19,390	400	470
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	470,312	241,260	31,358	21,999
Cost of Sales	430,142	222,740	10,600	20,480
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Profit Contribution	<u>40,170</u>	<u>18,520</u>	<u>20,758</u>	<u>1,519</u>

### Operating Costs

An analysis of distribution costs, administrative expenses and finance costs incurred by the Group's principal businesses during the year is as follows:

<i>Business</i>	<i>Distribution costs (HK\$'000)</i>	<i>Administrative expenses (HK\$'000)</i>	<i>Finance costs (HK\$'000)</i>
Leather processing	2,636	15,128	10,061
Merchandise trading	670	6,761	8,754
Leather ware	12,175	14,550	882
Packaging materials	2,039	2,504	3



## Management Discussion and Analysis *(Cont'd)*

The inventory turnover days was approximately 105 days for the year. Fluctuations in raw materials prices were witnessed during the first half of 2001, demonstrated by the volatile prices of raw leather, which rose from US\$73 to US\$90 per sheet early this year and then dropped sharply to US\$56. The problem of price volatility inevitably posed certain impact on the Group's production and operations. However, the impact was moderate as the Group established a sourcing centre in Xuzhou for raw leather produced in China and continued to pursue this sourcing policy. Accordingly, the Group's leather processing business was able to maintain a gross margin of over 8%. An analysis of the ratio of major costs for the leather processing business is as follows:

	2001 (%)	2000 (%)
Raw hides	68.35	66.03
Chemical	18.21	19.51
Others	13.44	14.46

### Production Volume and Product Lines

The Group's total leather production was 58,040,000 sq.ft. in 2001, a rise of 4.7% over 55,418,000 sq.ft. in 2000. The increase in production of cow split was the highest which surged by 49.19% from 6,052,000 sq.ft. to 9,029,000 sq.ft. Production volume of the Group's principal businesses is as follows:

	2001 Volume	2000 Volume	Change (%)
Leather processing business			
Cow Hides ('000 sq.ft.)	36,635	37,339	(1.89)
Cow Split ('000 sq.ft.)	9,029	6,052	49.19
Coated Cow Split ('000 sq.ft.)	12,092	11,775	2.69
Leather ware business			
Handbag ('000 units)	61	71	(14.08)
Wallet ('000 units)	60	62	(3.23)
Packaging materials business			
Paper box ('000 sq.m.)	3,511	3,584	(2.04)
Colour printing ('000 sq.m.)	20,833	30,527	(31.76)



## Management Discussion and Analysis (Cont'd)

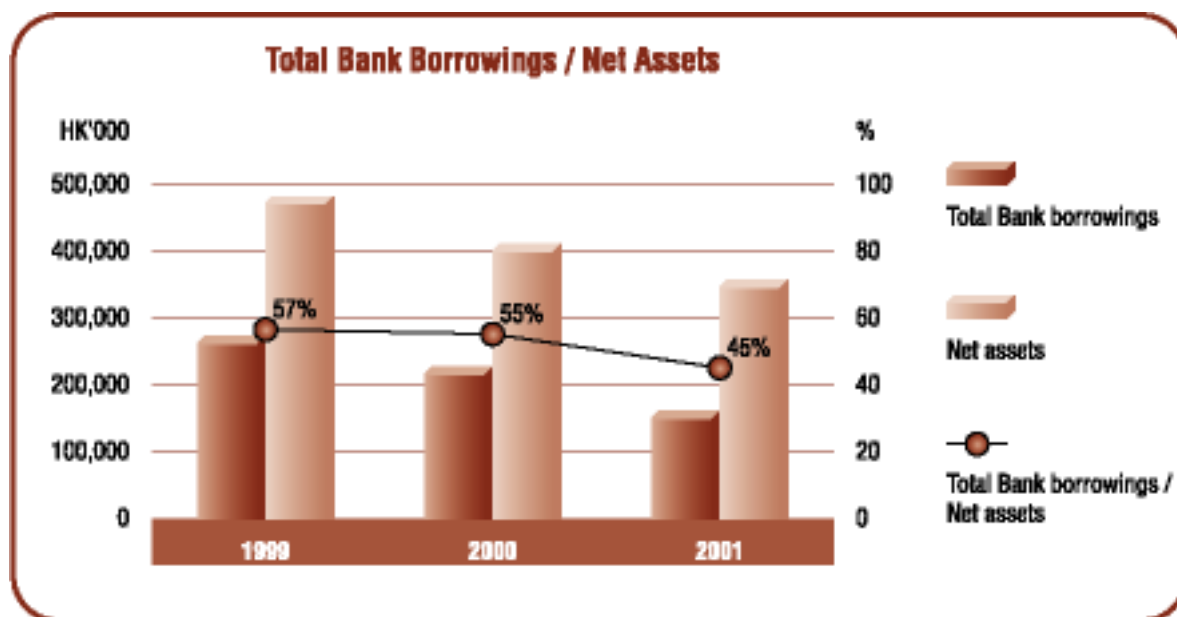
### Capital Expenditure

Fixed assets as at year ended 2001 were HK\$204,436,000, a reduction of HK\$53,365,000 or 20.7% from last year. The Group's capital expenditure during the year amounted to HK\$10,921,000 (2000: HK\$28,598,000). They were incurred mainly for the purchase of machinery and equipment to optimize the standard of the Group's production facilities. The Group also disposed of certain of its properties, machinery and equipment with a net book value of HK\$4,921,000 during the year. Further, the Group would continue to dispose its idle properties in 2002 which would generate approximately HK\$17 million so as to fund the Group's purchases of the plant and machinery in Xuzhou amounting to approximately HK\$12 million in a move to expand the production capacity of leather processing.

### Current Assets

As at 31 December 2001, the Group had cash and bank balances of HK\$115,440,000 (2000: HK\$150,964,000), including HK\$70,420,000, Rmb16,722,000 and US\$3,752,000. Other current assets mainly included inventories of HK\$181,126,000 (2000: HK\$211,311,000) and trade and bills receivables of HK\$61,030,000 (2000: HK\$66,748,000).

### Borrowings and Funds





## Management Discussion and Analysis *(Cont'd)*

As at 31 December 2001, the total bank borrowings to net assets of the Group was 45% which has been improved for the past few years. The Group had bank loans amounting to HK\$160,780,000 (2000: HK\$226,495,000), and cash and bank balances totalling HK\$115,440,000 (2000: HK\$150,964,000). After deduction of cash and bank balances, the Group's ratio of net bank loans to shareholders' equity was 13% (2000: 18%). Loan facilities offered by banks in Hong Kong and Mainland China bear interest at HIBOR/LIBOR plus 1.8% and 6.4% per annum, respectively. Of the Group's total bank borrowings, HK\$96,763,000 was repayable within one year while the remaining balance would be repayable before December 2003. The bank borrowings included Hong Kong dollar borrowings of HK\$24,473,000, United States dollar borrowings of HK\$83,544,000 and Renminbi borrowings of HK\$52,763,000.

The Tannery Override Agreement ("TOA") was entered into by the Group in December 2000. Interest of the TOA loans reduced from HIBOR/LIBOR plus 2.375% to HIBOR/LIBOR plus 2% as HK\$54,500,000 was repaid by the Group in January 2001. It further reduced to HIBOR/LIBOR plus 1.8% after the Group repaid part of the TOA loans in June 2001 and December 2001 totalling HK\$35,488,000. In January 2002, a refinance arrangement was made by the Group under which a facility of HK\$50,000,000 was advanced from a PRC bank. This facility, together with the Group's internal funds, was applied to repay the whole amount of the TOA loans as at 31 December 2001 amounting to approximately HK\$108,000,000. The TOA loans bear interest at either 3 month's HIBOR/LIBOR plus 1.8% per annum whereas the remainder of the Group's total bank loans amounting to HK\$52,763,000 bear interest at floating rate. The Group has an intention to replace all the existing bank loans by the funding from the Company's holding company. This move can enhance the Group's flexibility in fund management. Owing to this respect, the Group had borrowed several loans from its holding company and fellow subsidiaries amounting in aggregate to HK\$71,607,000 to fully repay the Renminbi borrowings of HK\$52,763,000.

As at year ended 2001, the Group still had Renminbi banking facilities of HK\$94,220,000 of which HK\$52,763,000 was utilised by the Group.

### **Pledge of Assets**

At 31 December 2001, certain of the Group's leasehold land and buildings, investment properties and bank deposits with a total net book value of HK\$31,162,000 (2000: HK\$62,653,000) were pledged to secure general banking facilities granted to the Group.

### **Cash Flow**

Net cash inflow from operating activities in 2001 was HK\$18,953,000. Cash inflow from new financing was HK\$110,884,000 and cash outflow from repayment of the loan principal and accrued interest was HK\$170,362,000. Net Cash outflow for the year amounted to HK\$35,803,000.



## **Management Discussion and Analysis** *(Cont'd)*

### **OTHERS**

#### **Litigation**

In January 2001, Guangdong Enterprises (North America) Fur Holdings Limited ("GDNA") and Harbour Hill International Limited ("Harbour Hill"), wholly owned subsidiaries of the Company, commenced an action in the Southern District of New York against a company called Hennessy International Group, Inc. ("HIGI") and its owners/controllers. HIGI is one-third held by GDNA and is an associate of the Group. GDNA and Harbour Hill are attempting to recover from the corporate defendant and the individual defendants approximately US\$2.25 million in financing that GDNA and Harbour Hill provided to HIGI. Defendants have counterclaimed for US\$2 million amount, claiming that GDNA and Harbour Hill wrongly terminated HIGI's financing. Both plaintiffs and defendants are moving for summary judgment, which motions have been fully submitted to the court by 8 March 2002.

#### **Major Customers and Suppliers**

For the year ended 31 December 2001,

- (a) the amount of purchases attributable to the Group's largest supplier represented 18.27% 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 55.99% of the Group's total purchases;
- (c) the amount of turnover attributable to the Group's largest customer represented 34.72% of the Group's total turnover;
- (d) the aggregate amount of the turnover attributable to the Group's five largest customers represented 68.55% of the Group's total turnover; and
- (e) none of the Directors of the Company or their associates holds or any shareholders (which, to the best knowledge of the Directors, owns more than 5% of the Company's issued share capital) had any beneficial interest in the Group's five largest suppliers or customers.





## Management Discussion and Analysis *(Cont'd)*

### Employees

As at 31 December 2001, a total of 1,757 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 few 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 Report of the Directors.

### Auditors – Services provided other than audit

Messrs. Ernst & Young, the auditors of the Group, have provided to the Group services other than the statutory audit work. Charges of such services are listed below:

	2001 (HK\$'000)	2000 (HK\$'000)
Taxation service	41	40
Assessment of internal control	185	–
Interim results review	125	50
Other consultancy service	3	3