

Investment Manager's Discussion and Analysis



Dr. Huang Dazhan *Chairman of the Board of the Investment Manager*



OVERALL PERFORMANCE

China Merchants China Direct Investments Limited and its subsidiaries (the "Fund") recorded a profit attributable to shareholders of US\$4.59 million for the year 2002, representing an 8.1% decrease over that of 2001. Despite the increase in the unrealised holding gain of an investment following its successful listing, the Fund recorded a drop in its net profit as a result of the decrease in turnover and the increase in provision for investments. As of 31 December 2002, the net assets of the Fund were US\$128 million, with net asset value ("NAV") per share of US\$0.935, representing a 2.2% increase over 2001.

Total turnover for the year fell by 33.8% to US\$2.44 million (2001: US\$3.69 million). Turnover included dividend income from unlisted investments, which increased 60.9% to US\$1.51 million. Another component of turnover was interest income, which decreased 53.0% to US\$0.87 million (2001: US\$1.86 million) due to interest rates continued to decline throughout the year. The average 90-day US Treasury Bill rate declined from 3.5% in 2001 to 1.6% in 2002. In addition, following the disposal of a contractual fixed income investment in February 2002, there was no income from this investment for the year (2001: US\$0.75 million).

The net unrealised holding gain on unlisted investments for the year was US\$8.21 million, representing an increase of 259.5% over 2001. The gain resulted from the successful listing of China Merchants Bank on the Shanghai Stock Exchange in 2002.

As a result of the unsatisfactory performance of the Hong Kong stock market in 2002, the Fund took a provision of US\$1.31 million against listed securities. The Fund also took a provision of US\$2.40 million related to the sale of a real estate project in Beijing.

MATERIAL ACQUISITIONS AND DISPOSALS OF INVESTMENTS

On 5 February 2002, the Fund disposed of its entire interest in Maoming Tongfa Highway Company Limited for a consideration of RMB88.30 million (equivalent to approximately US\$10.67 million), which was received in full in the year.

On 29 May 2002, the Fund entered into an agreement with Oriental University City Development Company to form a joint venture in Langfang Economic Development Zone, Hebei Province, the PRC, to provide Phase I dormitory facilities for students studying at the University City. The Fund invested US\$5 million in the joint venture for an interest of 25%.

On 8 August 2002, the Fund, together with Jutian Securities Company Limited, Citic Guoan Information Industry Company Limited, Hantang Securities Company Limited, and Zhejiang Zhongda Holdings Company Limited, signed a promoter agreement to establish Jutian Fund Management Company Limited in Shenzhen, the PRC. The company will be engaged in the listed equity fund management business in the PRC. According to the agreement, the Fund will invest RMB10 million for an interest of 10% in the company. The company obtained approval to form at the end of 2002, and the investment was completed in February 2003.

LIQUIDITY, FINANCIAL RESOURCES, GEARING AND CAPITAL COMMITMENTS

Net cash fell by 7.9%, from US\$36.98 million as of 31 December 2001 to US\$34.06 million as of 31 December 2002, due to outlays for capital investments and dividend payments in excess of cash received from the disposal of investments.

As of 31 December 2002, the Fund had no outstanding bank loans (2001: US\$6.45 million).

As of 31 December 2002, the Fund had capital commitments of US\$1.20 million (2001: US\$1.00 million), earmarked for an investment that has been committed to, but not yet provided for in the financial statements.

EXPOSURE TO FLUCTUATIONS IN EXCHANGE RATES AND RELATED HEDGES

Most of the Fund's investments are located in China, where the official currency is Yuan. The Yuan remained stable during the reporting period, and is expected to remain so.

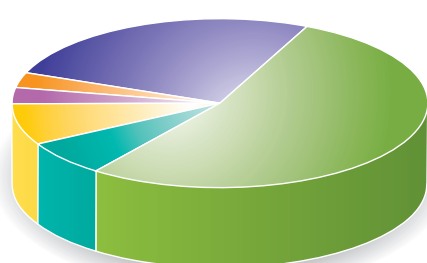
EMPLOYEES

The Fund has no employees, because its portfolio and operations are administered by the Investment Manager.

THE PORTFOLIO

As of 31 December 2002, the Fund had total investments of US\$94.96 million – US\$87.25 million in unlisted investment projects, US\$3.97 million in listed investments, and US\$3.74 million in certificates of deposit and notes. The major unlisted investment projects were in financial services (53.3% of net assets), manufacturing (6.8%), and real estate (7.9%). In addition, the Fund had net cash of US\$34.06 million, accounting for 26.6% of the Fund's net assets.

NET ASSET DISTRIBUTION (As at 31 December 2002)



- Financial Services Investments **(53.3%)**
- Manufacturing Investments **(6.8%)**
- Real Estate Investments **(7.9%)**
- Listed Investments **(3.1%)**
- CD/Notes **(2.9%)**
- Net Cash **(26.6%, after netting off other liabilities = 26.0%)**





Ms. Linda L. Zhou *Managing Director of the Investment Manager*

Investment Manager's Discussion and Analysis (continued)

REVIEW OF UNLISTED INVESTMENTS

The following table shows the major unlisted investment projects held by the Fund as of 31 December 2002:

Name of Projects	Location	Business Nature	Net Book Value US\$ million	Percentage of Net Assets
Financial Services:				
1. China Merchants Bank Co., Ltd.	Shenzhen, Guangdong	Banking	41.52	32.37
2. Industrial Bank Co., Ltd.	Fuzhou, Fujian	Banking	20.88	16.28
3. Industrial Securities Co., Ltd.	Fuzhou, Fujian	Securities	0.66	0.52
4. China Merchants Securities Co., Ltd.	Shenzhen, Guangdong	Securities	1.54	1.20
5. Jutian Securities Co., Ltd.	Shenzhen, Guangdong	Securities	3.13	2.44
6. Houlder China Insurance Brokers Ltd.	Shenzhen, Guangdong	Insurance		
		Brokerage	0.57	0.45
Sub-total			68.30	53.26
Manufacturing:				
7. Zhaoyuan Jinbao Electronics Co., Ltd.	Zhaoyuan, Shandong	Copper foil & laminates	8.81	6.87
Sub-total			8.81	6.87
Real Estate:				
8. Langfang Oriental Education Facilities Development Co., Ltd.	Langfang, Beijing	Student dormitory	5.07	3.95
9. Beijing Longbao Mansion	Beijing	Office & apartments	2.58	2.01
10. Shenzhen Man Kam Square	Shenzhen, Guangdong	Retails shops	2.45	1.91
Sub-total			10.10	7.87
Total			87.21	68.00



Financial Services Investments

Financial Services is one of the core investment sectors for the Fund. Recently, Initial Public Offerings ("IPOs") have become more prevalent for financial services companies as a way to raise capital and expand business capacity. A successful IPO can generate significant capital appreciation for the Fund. However, in light of the Fund's heavy exposure to this sector (over 50% of assets), the Fund will be more selective in investing in new projects in this sector.

The Fund's financial services investments are concentrated in the banking, securities and insurance brokerage industries.

China Merchants Bank Company, Limited ("CMB"), a registered commercial bank in China, is the first joint-stock commercial bank established by mainland enterprises. CMB has over 300 branches and offices across the country. The Fund invested US\$13.77 million and currently holds a 1.19% stake in CMB (Note: The shareholding has decreased from the original 1.62% due to the dilution effect arising from the bank's IPO). CMB became the fourth mainland commercial bank to go public when it issued 1.5 billion "A" shares at RMB7.30 per share on the Shanghai Stock Exchange on 9 April 2002. In the second-largest A-share IPO in China, CMB's subscription was well received and raised over RMB10 billion. The average stock price of CMB since its listing has remained over RMB9.50 per share. As the Fund's stake in CMB is in non-trading shares, the Fund, with reference to an independent valuation report and for prudence purpose, valued the shares at RMB5.64 per share as of 31 December 2002. At this valuation, the Fund recorded an unrealised holding gain of US\$9.19 million for 2002. CMB's net profit for 2002 was RMB1.73 billion, an increase of 26.10% over 2001. The Fund received dividends of US\$1.37 million in the year.

On 28 August 2002, CMB upgraded its Hong Kong representative office to a branch, in a strategic move toward globalisation. As the sixth mainland commercial bank with approval to establish business in Hong Kong, CMB focuses on the local wholesale banking business.

Industrial Bank Company, Limited ("IBCL"), formerly Fujian Industrial Bank Company, Limited, changed its name in 2003 with the approval of the People's Bank of China. IBCL is a commercial bank registered in China, with over 252 offices throughout the country. The Fund, in cooperation with the China Merchants Group, first invested in IBCL in 1998, and since then has increased its stake to US\$17.6 million, or 2.80%. For the year 2002, IBCL recorded a net profit of RMB477 million, representing a 1.20% decrease over 2001. With the increase in IBCL's net assets, the value of the Fund's investment in the bank increased to US\$20.88 million at the end of 2002, resulting in an unrealised holding gain of US\$0.99 million for 2002. The bank has been actively preparing for its IPO. It is expected that the pre-IPO coaching period will end in the middle of 2003 and that an IPO will be launched in the PRC at the end of this year.

Industrial Securities Company, Limited ("ISCL") is a comprehensive securities company registered in China, with businesses in securities underwriting, brokering and investment, and investment consulting. The firm has over 16 offices located in major cities throughout the country, including Beijing, Shanghai, Shenzhen, Wuhan, Fuzhou and Xiamen. The Fund invested US\$1.03 million to acquire a 0.74% stake in ISCL. Due to depressed market conditions and a significant drop in the volume of stock trading in 2002, China's securities industry suffered losses across the sector for the first time. These market conditions also affected ISCL, which recorded a net loss of RMB402 million for 2002. At the end of 2002, the fair value of this investment decreased by US\$0.53 million, with the net value amounting to US\$0.66 million. Due to the drop in capital as a result of the significant losses, ISCL is preparing for the issuance of new shares in 2003 to strengthen its financial position.

China Merchants Securities Company Limited ("CMS"), formerly China Communication Securities Company Limited, changed its name in July 2002. This firm is a comprehensive securities company registered in China with over RMB2.4 billion in registered capital. Its businesses include securities underwriting, brokering and investment, and investment consulting. The Fund invested US\$1.57 million to acquire a 0.52% stake in CMS in 2001. Affected by sluggish stock market conditions in China, CMS's profit decreased significantly to RMB5.29 million in 2002 from RMB260 million in 2001. At the end of 2002, the value of this investment amounted to US\$1.54 million, a decrease of US\$0.11 million.

Jutian Securities Company Limited ("Jutian"), formerly Shenzhen Economic Special Zone Securities Company, Limited, was set up in 1987 as the first comprehensive securities company in the PRC. It is engaged in securities brokering, investment and underwriting. The Fund invested US\$4.26 million in Jutian, for an interest of 4.66%. As a result of slumping trading volumes in China's stock markets, the turnover of Jutian decreased to RMB172 million, or 55% of the 2001 level. The net loss for the year was RMB179 million. The Fund received dividend income of US\$0.13 million from Jutian during the year. However, following the loss of Jutian, the value of this investment decreased by US\$1.31 million. In view of the slowdown in China's securities industry, Jutian invested RMB30 million and teamed up with a few other companies to set up Jutian Fund Management Company Limited with registered capital of RMB100 million targeting at the fund management business. The management company obtained approval from the China Securities Regulatory Commission for formation and commencement of operations at the end of 2002 and early 2003, respectively.

Houlder China Insurance Brokers Limited ("Houlder") was founded in 2001. Its major shareholders are large prominent mainland enterprises and include China Merchants Group Limited, China Communication Import and Export Holding Company, China Ocean Shipping Company, China Shipping Group, Shenzhen Expressway Company, Hong Ta Group and Hope Group. The Fund invested US\$0.6 million in Houlder to acquire a stake of 10%. China's insurance brokerage industry faced a challenging 2002. With insurance brokers' status being in place, insurance broking companies have been aggressively expanding their business. Although Houlder obtained many major contracts, it faced challenges to further expansion. For the year ended 31 December 2002, Houlder's turnover increased 190% to RMB4.25 million, but it also recorded a net loss of RMB1.85 million. In response, the company has introduced a series of measures – including tighter cost controls, internal resource consolidation and an effort to strengthen policy implementation efficiency – designed to improve operating performance.



Manufacturing Investments

Manufacturing as a portion of the Fund's portfolio was small relative to other industry sectors. Still, the Fund continues to pursue high-return projects in this sector. With abundant, skilled, and relatively inexpensive labor, China has become a global manufacturing centre with a distinct competitive advantage in labor-intensive, low-cost products.

Zhaoyuan Jinbao Electronics Company Limited ("Jinbao"), located in Zhaoyuan, Shandong Province, is engaged in the manufacture and sale of electronics products, including copper foil and copper-clad laminates. The Fund invested US\$7 million for a 30% interest in Jinbao. In the year, a Chinese partner of the joint venture, Zhaoyuan Electronics Material Company, sold part of its interest in Jinbao to two Chinese enterprises, giving them a 6% and 2% interest, respectively. The number of company shareholders increased to five, fulfilling the statutory requirements of a joint-stock company and enabling Jinbao to list at an appropriate time in the future. The production line for high-grade copper foil commenced operations in the year. However, the line also encountered a few challenges – in particular, a longer than expected period for production trial runs and for the integration of new management talent. At the same time, the market for the company's products weakened due to consolidation in foreign markets, falling sales prices and fierce competition within the industry. Together, these forces resulted in a 71% slide in Jinbao's net profit for 2002, to RMB9.44 million. Since the end of 2002, market conditions have improved, demand and prices for Jinbao's products have increased, and profits are expected to rise in the coming year. The Fund is assisting the company for an IPO, with a goal to raise capital for expanding production capacity and broadening the company's product offerings. Dividend income from Jinbao amounted to US\$0.91 million in the year.

Real Estate Investments

In response to the increase in per capita national income and the level of living standards in the PRC, the demand for housing continues to increase. As such, the Fund is pursuing promising real estate projects with low risk and high potential returns. In the year, the Fund invested in a real estate project relating to education facility services.

Langfang Oriental Education Facilities Development Company Limited ("Oriental") is a Sino-foreign cooperative joint venture. The total project cost is US\$20 million, with a 20-year contractual period. In June 2002, the Fund invested US\$5 million, for an equity stake of 25%. Oriental is engaged in the operation and management of the Phase I dormitories of Oriental University City. This phase can accommodate about 15,000 students – or up to approximate 19,000 with further modification. Oriental University City is a modern education, science and technology centre with a mission to "bring prosperity to the country through science and education." Including the facilities provided by Phase II, Oriental University City is able to accommodate about 50,000 students. For the four months since the new school year started, i.e. from September 2002 to the end of the year, Oriental recorded a net profit of RMB2.11 million, which contributed about US\$60,000 to the Fund's profit.

Beijing Longbao Mansion ("Longbao") is situated near the Third Ring of the Chaoyang District in Beijing. It comprises two 17-storey apartment buildings and an office complex. The Fund invested US\$4.98 million (total investment is US\$5 million) in 1997 for a 35% interest under an agreement with the developer to jointly manage the property. According to the joint-management agreement, the developer should have paid a fixed investment return semi-annually to the Fund during the 3-year contractual period. However, the developer failed to make scheduled payments in the second year of the contract. As the developer's financial position has been severely worsen and it has been involved in a series of legal proceedings, the Fund took immediate steps to dispose of the investment entirely to an independent third party. In February 2003, the Fund transferred its entire stake for a consideration of US\$3 million – a 15% discount to the then independent appraised value of US\$3.55 million. The Fund recorded a provision of US\$2.40 million (including all transaction costs and legal fees) in the year.

Shenzhen Mankam Square ("Mankam") is a 33-storey commercial complex on North Wen Jin Road, Shenzhen. In 1994, the Fund invested US\$4.3 million through a 35% holding in Hansen Enterprises Limited ("Hansen") to purchase 5,262 square metres of retail space on the third floor of Mankam. Subsequently, the developer was forced into bankruptcy, and its first two floors of Mankam were never brought into use. As a result, Hansen has had difficulty in selling or leasing the third floor. Recently, Mankam's property management company conveyed a decision by the Shenzhen Municipal Government to clear up all uncompleted construction sites in the city. There are now plans to modify and upgrade Mankam and to set up a new, high-tech property zone for that location. The Fund expects that these actions will improve the prospects of this project.

REVIEW OF LISTED INVESTMENTS

In 2002, a global economic slowdown and the looming of threat of war in Iraq depressed stock markets worldwide. Despite the benefit of rapid economic growth in the PRC, the Hong Kong stock market was also affected negatively by these global market forces, as well as by Hong Kong's high unemployment rate and deflation. The Hang Seng Index, Growth Enterprise Index and Hang Seng China-Affiliated Corporations Index fell by 18%, 45% and 25%, respectively. The Hang Seng China Enterprises Index increased by 13%, outperforming the market. In 2002, the Fund recorded gains from disposals and dividend income amounting to US\$94,000 and unrealised losses of US\$1.31 million. At the end of 2002, the Fund held listed shares valued at US\$3.97 million, of which the two largest investments were (i) Hong Kong Exchanges and Clearing Limited (business: securities and futures exchanges; % of share capital: 0.106%; investment cost: US\$1.7961 million; market value: US\$1.3929 million; % of NAV: 1.086%; dividend received: US\$11,193) and (ii) Cheung Kong Holdings Limited (business: equity investments and project management; % of share capital: 0.007%; investment cost: US\$1.2829 million; market value: US\$1.1035 million; % of NAV: 0.860%; dividend received: US\$8,252).



PROSPECTS

It is believed that China's newly elected leaders will continue the existing economic development policy. The policy of privatisation of state-owned enterprises will bring many investment opportunities. The Investment Manager is actively pursuing and studying these projects. In particular, the Investment Manager will focus on those projects with the potential to offer stable income. Meantime, the Investment Manager is also assisting some of its investee companies to prepare for IPOs that should generate capital appreciation for the Fund.

Linda L. Zhou

Managing Director

China Merchants China

Investment Management Limited

Hong Kong, 23 April 2003

Directors of the Investment Manager



front row from right: Dr. Huang Dazhan, Ms. Kan Ka Yee, Elizabeth and Ms. Linda L. Zhou;
rear row from right: Mr. Wu Hui Feng, Mr. Lee York Wo and Mr. Tse Yue Kit

