



# Management Discussion and Analysis

## Results and Provisions

The Group's loss from ordinary activities attributable to shareholders for the year ended 31 December 2002 was HK\$205,201,000 (2001: HK\$72,283,000). Turnover was HK\$529,055,000, a drop of 30.84% as compared to HK\$764,929,000 for the same period last year. The loss was primarily attributable to the major provisions and impairment loss totaling HK\$180,626,000 as follows:

- an impairment loss of goodwill of HK\$133,349,000 arising from the acquisition of Nanhai Tannery & Leather Products Co., Ltd.;
- a provision of HK\$28,531,000 for doubtful trade receivables;
- a provision of HK\$11,057,000 for inventories;
- a deficit of HK\$3,494,000 on revaluation of properties; and
- loss and provision of HK\$4,195,000 for assets disposal, restructuring and other purposes.

Net assets of the Group as at 31 December 2002 were HK\$285,436,000, decreased by HK\$70,940,000 and HK\$24,386,000 respectively as compared to 31 December 2001 and 30 June 2002.

## Operations Review

Since the beginning of 2002, the Group has taken a series of initiatives to streamline its operations. It has disengaged its interests in the leather ware and paper box packaging businesses given their limited turnover and development potential, and focused its resources on developing the more competitive leather business. As mentioned in our interim report, the Group disposed of its leather ware business at a total consideration of HK\$8.3 million, and the inventories and trade receivables of the packaging materials business to a third party at HK\$7,226,000. Certain plant and machinery was also leased to a third party at RMB800,000 per annum. In addition, the Group is actively resolving the issue of closing down Qingdao Nanhai Tannery by legal means, as described under the sub-heading "Litigations" below.

### *The Leather Markets and Products*

To stay ahead of increasing competition in China's leather market, the Group remains focused on developing the competitive black nappa cow leather and enhancing its product grading and quality. It also strives to open up the market for fashion leather, and strengthen the development of other new products. A team specialised in production techniques was set up at the Nanhai Tannery during



## Management Discussion and Analysis (Cont'd)

the second half of 2002. It aims to enhance the production efficiency by ensuring quality acceptance level in excess of 60% for black nappa cow leather. At present, black nappa cow leather accounts for more than 90% of the Group's leather production. To avoid the operational risks and obsolescence of existing technologies associated with over emphasis on one single product, the Group has established a research and development center to develop new lines of innovative products in order to mitigate the operational risks and sales pressure. Turnover and production volume of the leather business (by product line) in 2001 and 2002 are as follows:

Product	Turnover			Production Volume		
	2002 HK\$'000	2001 HK\$'000	+/(-) %	2002 '000 sq.ft.	2001 '000 sq.ft.	+/(-) %
Cow hides	321,232	386,402	(16.87)	24,870	36,635	(32.11)
Cow split, coated cow split & others	91,527	83,910	9.08	14,028	21,405	(34.46)
Total	<u>412,759</u>	<u>470,312</u>	<u>(12.24)</u>	<u>38,898</u>	<u>58,040</u>	<u>(32.98)</u>

### *Distribution of the Leather Business*

The thrust of the Group's distribution strategies lies in three main areas: maintain good relationship with existing distributors, seek new distributors and place greater emphasis on direct sale. Following its marketing policies based on locality and market responsiveness, the Group is striving to establish a new distribution network that covers various regional markets and distribution bases. Four regional markets are set up in China: Eastern China, Southwest China, Southern China and Northern China, and a total of 18 distribution bases spanning across these four regions are established. This distribution network enables the Group to gain better access to market information, mitigate market risks, and enhance its price negotiation capability. Meanwhile, the Group is actively venturing into the direct sale market given its tremendous potential for growth. Products are increasingly sold to major downstream enterprises by direct sale, instead of being sold via distributors.

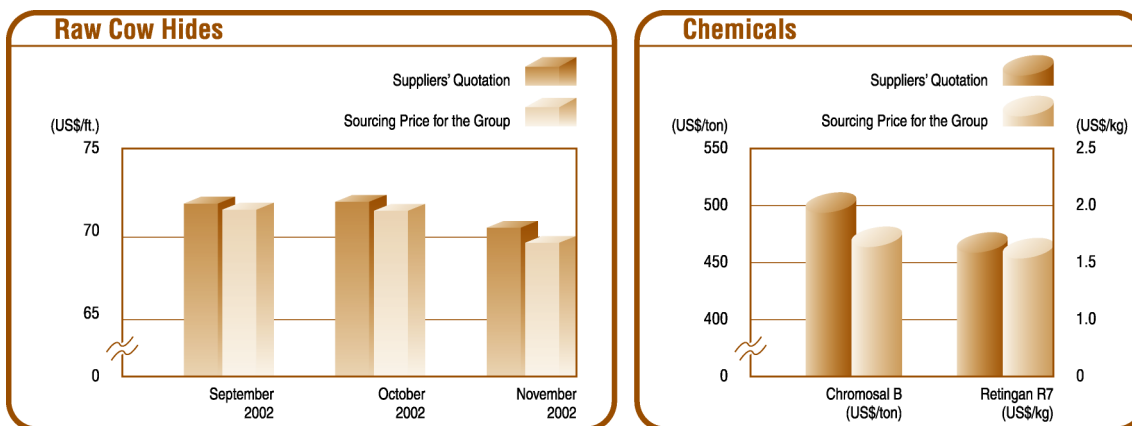
### *Operating Costs*

To minimise the production costs, sourcing activities of the Group were carried out by way of public tender under the "Yang Guang" program during the second half of 2002. A marked reduction in production costs was recorded following the establishment of a specialised sourcing team and the introduction of competition into the sourcing process through public tender. Sourcing prices for raw cow leather and certain chemicals were reduced since the "Yang Guang" program has been in place.



## Management Discussion and Analysis (Cont'd)

### Operating Costs (Cont'd)



### Financial Position

As at 31 December 2002, the Group's interest-bearing borrowings and cash and bank balances are analysed as follows together with their comparative figures as at 31 December 2001:

	2002 HK\$'000	2001 HK\$'000
<b>Interest bearing borrowings</b>		
<i>Currencies:</i>		
Hong Kong dollar	24,400	24,473
Renminbi	69,694	52,763
United States dollar	28,548	83,544
	<u>122,642</u>	<u>160,780</u>
<i>Interest rates:</i>		
At fixed rate	69,694	52,763
At floating rate	52,948	108,017
	<u>122,642</u>	<u>160,780</u>
<b>Cash and bank balances</b>		
Hong Kong dollar	666	70,420
Renminbi	43,094	15,755
United States dollar	21,066	29,265
	<u>64,826</u>	<u>115,440</u>



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

At 31 December 2002, after deduction of cash and bank deposits, the Group's ratio of net interest-bearing borrowings to shareholders' equity was 20.25% (2001: 12.7%). Loan facilities bear interest at approximately 3% to 6% per annum. Of the Group's total borrowings, HK\$105,975,000 is repayable within one year. Interest expense incurred by the Group during the year was reduced by 58.04% as compared to the same period last year.

In January 2002, a refinance arrangement was made by the Group under which a facility of HK\$50,000,000 was advanced from a bank in Mainland China. This facility, together with the Group's internal funding, was applied to repay in full the outstanding loan of approximately HK\$108,000,000 as at 31 December 2001 under the Tannery Override Agreement. Net cash outflow from operating activities for the year was HK\$14,505,000. Cash inflow from new financing was HK\$182,865,000 and cash outflow for repayment of the loan principals and accrued interest was HK\$228,063,000. Net cash outflow for the year amounted to HK\$46,938,000.

Fixed assets as at the year end of 2002 were HK\$180,994,000, a reduction of HK\$23,442,000 or 11.47% from last year. The Group's capital expenditure during the year amounted to HK\$15,476,000 (2001: HK\$10,921,000). It was incurred mainly for the purchase of the land & buildings, machinery and equipment from the previous Chinese joint venture partners of two plants in Xuzhou to cope with the long-term development of the leather business. During the year under review, the Group also disposed of certain of its properties, machinery and equipment with a net book value of HK\$18,134,000. Subsequent to the year end, the Group has further disposed of properties which generated approximately HK\$12,101,000.

As at 31 December 2002, certain of the Group's leasehold land and buildings and bank deposits with a total net book value of HK\$48,972,000 (2001: HK\$31,162,000) were pledged to secure general banking facilities granted to the Group.

### Litigations

1. In September 2002, the Company submitted a claim to China International Economic and Trade Arbitration Commission (the "Arbitration Commission") in Shenzhen, Mainland China against a PRC joint venture partner of a subsidiary of the Company at Qingdao seeking, amongst others, termination of the joint venture agreement and compensation of losses and damages of approximately RMB24,000,000. However, the PRC joint venture partner also applied to the Arbitration Commission in Beijing against the Company claiming for loss of fixed return under the said joint venture agreement in question and damages in an aggregate of RMB15,000,000. The two arbitration proceedings are still in progress.



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

### **Litigations (Cont'd)**

2. 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. 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. In August 2002, a conciliation agreement was entered into between the plaintiffs and defendants, whereby the defendants agreed to make a payment of US\$500,000 to GDNA and Harbour Hill by three installments. The first and second installments have been paid in August and September 2002, and the third installment will be paid in August 2003.

### **Major Customers and Suppliers**

For the year ended 31 December 2002,

- (a) the amount of purchases attributable to the Group's largest supplier represented 11.53% 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 38.87% of the Group's total purchases;
- (c) the amount of turnover attributable to the Group's largest customer represented 38.15% of the Group's total turnover;
- (d) the aggregate amount of the turnover attributable to the Group's five largest customers represented 60.62% 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 2002, a total of 1,075 employees (2001: 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 has adopted a new share option scheme ("Share Option Scheme") in May 2002, and the purpose of which is to provide incentives to participants to contribute to the Group, and to enable the Group to recruit and retain quality employees to serve the Group on a long-term basis. Details of the Share Option Scheme are set out in note 30 to the financial statements.

### 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:

	2002 HK\$'000	2001 HK\$'000
Taxation Service	11	41
Assessment of internal control	–	185
Interim results review	350	125
Other consultancy service	–	3