

# MANAGEMENT DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS

## BUSINESS ENVIRONMENT

Reviewing last year's performance, the economy of the PRC, the key market of the Group, recorded continuing growth, with increasing demand for the Group's products, which provided a favourable operating environment, while markets in overseas remained stable.

With the PRC's accession to the WTO, changes including reduction in import tariffs and extension of import quotas create pressure on the market price of petroleum products. As a result, the average selling price of most of the Group's products adjusted downward due to increasing competition. At the same time, the crude oil prices started to rise at the beginning of 2002, price of petrochemical products, which is the Group's principal raw material, increase to certain content.

Despite the price increase in the Group's principal raw material due to the volatility of crude oil costs, the Group continues to mitigate the adverse effect by implementing effective operational strategies and adopting a strategy of bulk purchase of raw materials at competitive prices that minimize the effect of price fluctuations on production costs.

## FINANCIAL PERFORMANCE

During the year, in spite of the drop in selling price of most of the Group's products, the Group achieved continuous growth in its result. Sales and net profit from ordinary activities attributable to shareholders increased by approximately 20.2% and 10.9% respectively, compared to the previous financial year.

## SALES OVERVIEW

The PRC remained the principal market of the Group and accounted for approximately 97% of the Group's total turnover while the remainder was sales to overseas countries, including North America, Europe and other Asia countries.

The sale of lubricants increased approximately from HK\$211.6 million in 2002 to approximately HK\$229.7 million in 2003, representing an increase of approximately 8.6%. The encouraging increase was mainly attributable to the HK\$22 million contract with Changchun First Automobile Petroleum Product Company, a subsidiary of China First Automobile Group, the RMB20 million contract with Dazhong Lubricant for the production of lubricants in 2003 and the RMB60 million contract with CNPC for the supply of lubricants for heavy machines to oil fields in 2003 obtained by the Group.

The sale of anti-corrosive coating increased from approximately HK\$90.0 million in 2002 to approximately HK\$133.2 million in 2003, representing an increase of approximately 48%. Such dramatic increase in sales was mainly due to the RMB20 million contract for the "Shenzhen East Water Supply Project", the RMB5 million contract for "West – East Gas Pipeline Projects Lanzhou – Chengdu – Chongqing section" and the RMB40 million contract for the "Dongjiang Water Project" obtained by the Group during the year.



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## FINANCIAL PERFORMANCE (Cont'd)

### GROSS PROFIT GROWTH

In 2003, the gross profit of the Group increased by 9.1% to HK\$126.9 million. Such advancement was mainly derived from the additional sales volume of Group's products.

Gross profit from lubricants decreased to HK\$74.0 million, representing a decrease of 4.5%, while gross profit margin of lubricants dropped by 4.4% to 32.2% in 2003 largely due to increasing competition, raw material price and price competition mentioned above.

Gross profit from anti-corrosive coating increased to HK\$51.7 million, representing an increase of 37.2%, while gross profit margin of anti-corrosive coating dropped slightly by 3.0% to 38.8% in 2003 due to increasing raw material price.



### NET PROFIT GROWTH

The operating expenses net of other revenue and other than those for research and development amounted to approximately HK\$24.0 million (2002: HK\$18.2 million). The increase was primarily due to the higher transportation costs resulting from an increase in sales volume, expansion of the PRC markets and rental expenses for the Ningbo factory.

The Group operates in the high and new technology industrial development zone in Daqing, and is still enjoying a reduced income tax rate of 7.5% up to 2003 and a reduced income tax rate of 15% thereafter. In the absence of significant changes in the bases and rates of profits tax, the effective tax rate on the Group's profit remained at approximately 7.8% (2002: 17.1%).

Combining the effects of increase in sale, stringent control of operating expenses and stability of rates of taxation, the Group's net profit from ordinary activities attributable to shareholders increased 10.9% to approximately HK\$84.4 million.

## LIQUIDITY AND FINANCIAL RESOURCES

### APPLICATION OF NET PROCEEDS FROM THE NEW ISSUE AND PLACEMENT

Total net proceeds of approximately HK\$40.8 million was raised from the equity market through the issue and placing of new shares in 2001. As at the date of this report, the Group had fully utilized the proceeds. Approximately HK\$9 million, HK\$11 million, HK\$3 million, HK\$1 million and HK\$16.8 million had been applied towards the establishment of new production facilities, purchasing additional machinery in the PRC, expansion of the Group's distribution and sales network, research and development activities and as general working capital, respectively.

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## LIQUIDITY AND FINANCIAL RESOURCES (Cont'd)

### CAPITAL EXPENDITURE

During the year under review, capital expenditure on non-current assets amounted to approximately HK\$33.8 million, which were mainly used for the acquisition of two properties as sale and administration offices in Daqing City to support the expansion of the Group's business and establishment an anti-corrosive coating production line in Ningbo to support the rapid expansions in anti-corrosive coating market.

### LIQUIDITY AND FINANCIAL RATIOS

At 30 June 2003, the Group had total assets of approximately HK\$367.0 million (30 June 2002: HK\$272.3 million) which were financed by current liabilities of approximately HK\$53.0 million (30 June 2002: HK\$52.3 million), non-current liabilities of approximately HK\$4.4 million (30 June 2002: HK\$4.6 million), minority interests of approximately HK\$20.4 million (30 June 2002: HK\$10.2 million) and shareholders equity of approximately HK\$289.2 million (30 June 2002: HK\$205.3 million).

At 30 June 2003, the current assets of the Group amounted to approximately HK\$235.9 million (30 June 2002: HK\$201.9 million) comprising inventories of approximately HK\$59.4 million (30 June 2002: HK\$46.6 million), trade receivables of approximately HK\$103.8 million (30 June 2002: HK\$89.8 million), other receivables of approximately HK\$15.4 million (30 June 2002: HK\$3.5 million), cash and bank balances of approximately HK\$57.4 million (30 June 2002: HK\$62.0 million).

The increase in trade receivables was in line with the growth of sales amount while the debtor turnover period at approximately 103 days (30 June 2002: 107 days). The Group normally allows credit terms to established customers ranging from 30 to 150 days. All trade receivables as at 30 June 2003 were aged less than 150 days from the date of recognition of the sale and approximately 93.6% of the trade receivables were settled as at 31 August 2003. In order to purchase raw materials at more competitive price, the Group adopted the policy of direct bulk purchases from suppliers, which were mainly conducted on cash basis. As a result, the inventory turnover period remained approximately 90 days (30 June 2002: 90 days) while the turnover period of trade payables shortened to approximately 20 days (30 June 2002: 31 days).

At 30 June 2003, the Group's current ratio (current assets/current liabilities), quick ratio ((current assets – inventory)/current liabilities), gearing ratio (total debts/total assets) and debts to equity ratio (total debts/shareholders' equity) of the Group were approximately 4.4 (30 June 2002: 3.9), 3.3 (30 June 2002: 3.0), 15.6% (30 June 2002: 20.9%) and 19.9% (30 June 2002: 27.7%), respectively. These changes reflected an improvement in the Group's structure of assets and liabilities.



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## LIQUIDITY AND FINANCIAL RESOURCES (Cont'd)

### FOREIGN EXCHANGE EXPOSURE

Although most of the operations were carried out in the PRC in which transactions were denominated in RMB, the Directors consider that the Group has no significant exposure to foreign exchange fluctuations in view of the stability of the RMB in recent years. The Directors also consider that there will be sufficient cash resources denominated in Hong Kong dollars for the repayment of borrowings and future dividends. During the year under review, the Group did not use any financial instrument for hedging purposes and the Group did not have any hedging instrument outstanding as at 30 June 2003.

### RESEARCH AND DEVELOPMENT

In 2003, the Group spent approximately HK\$5.7 million (2002: HK\$1.9 million) in the research and development, representing increases of approximately 200% from that of last year. The Group had over 15 experienced scientists working in the research and development department. The Group continued research and development on quality control, techniques on new product development, improvement of production technologies and operational efficiency, etc. In addition, to further strengthen the Group's research and development capabilities, the Group collaborates with the Research Institutes of Daqing Petrochemical Complex, Institutes of Chemical Engineering, Heilongjiang University and Qiqihar University to gather up-to-date information on the latest development of the petrochemical products, to perform analysis, to improve the Group's products, to formulate production processes and to develop the environmentally friendly products.

### NUMBER AND REMUNERATION OF EMPLOYEES

At 30 June 2003, the Group had 123 full time employees in the PRC and Hong Kong. The Group recognizes the importance of human resources to its success. Remuneration is maintained at competitive levels with discretionary bonuses payable on a merit basis and in line with industry practice. Other staff benefits provided by the Group include mandatory provident fund, insurance schemes and performances related commissions.

During the year under review, no share options were granted to any staff. At 30 June 2003, a total of 42 million share options were outstanding with exercisable periods up to 19 August 2004 with exercise prices HK\$0.2344 per share.