

MANAGEMENT DISCUSSION AND ANALYSIS

Operating environment

During the year under review, GDP in the PRC rose 9.1% from that in 2002 despite the Severe Acute Respiratory Syndrome ("SARS") outbreak. Due to effective measures implemented by relevant PRC authorities for the control of SARS, the PRC economy revived and promptly regained its momentum. The retail sales of consumer products in the PRC in 2003 increased by 9.1% as compared to 2002.

At the same time, the retail industry of the PRC maintained its rapid growth. For the year ended 31 December 2003, the sales of consumer products in China reached approximately RMB4,584.2 billion, an increase of 9.1% from 2002 while the sales of consumer products in Shanghai reached approximately RMB222.1 billion, an increase of approximately 9.1% from the same period of last year. There has been huge potential in the development of fast moving consumer goods in China. Consumer price level of the PRC increased by approximately 1.2% in 2003 from that in 2002. Disposable income per capita of urban residents in the PRC amounted to approximately RMB8,472, a year-on-year increase of approximately 9.0%. Net income per capita of rural residents was approximately RMB2,622, a year-on-year increase of approximately 4.3%. The stable development in the state economy and a sustainable and prosperous retail industry contributed to a favourable environment for retail chain enterprises in the PRC.

In the mean time, competition of the domestic retail market has been more intense, especially ahead of the complete opening up of the retail industry to foreign enterprises in 2005. Therefore, in order to develop the PRC's retail industry rapidly and effectively performance of individual outlets and corporate management should be enhanced. In addition, capitalizing on the established and large chain network, measures for resources sharing like unified sales and marketing, unified distribution and unified operation management should be implemented to reduce operation cost of merchandise and to attain economies of scale. In the next few years, expansion, mergers & acquisitions, restructuring and integration will be the major ways for accelerating the expansion in scale and cross-regional development in the retail industry, which in turn will become the future trend for the development of the PRC's retail operators.



Operating review

During the year under review, Lianhua Supermarket achieved remarkable and satisfactory development. The Company was listed on the Main Board of The Stock Exchange of Hong Kong Limited ("SEHK") in June (the "Listing") and tapped into the international capital market. Through its listing, the Company has raised approximately HK\$668,000,000 which has provided sufficient financial resources for its future development.



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	2003	As restated 2002	Change
	RMB	RMB	(%)
Turnover	9,282,250,000	5,821,230,000	59.46
Operating profit	210,860,000	121,610,000	73.39
Profit attributable to shareholders	163,620,000	126,600,000	29.24

Turnover and net profit recorded remarkable increases, which represented the Company's prudent and stringent operating practice and scientific management style. The increase was also due to the Group's dedicated efforts in enhancing its brand awareness by adopting measures which included the establishment of a comprehensive membership system to strengthen customer loyalty to Lianhua Supermarket as well as the efforts to strengthen and centralize the development and management of the Group's own brand.

The Group successfully expanded its operations scale and adopted modern retail operational technology to further promote the standard of its supply chain management. During 2003, through the optimization of the integrated supplier service system, the quality of supplier services to the Group's outlets was further enhanced. The delivery cycle was expedited and the satisfaction rate of goods delivery was enhanced.

In 2003 the Group adopted the "management by benchmark" which was based on major operating indicators of leading retail operators in the world. This new measure significantly enhanced the Group's management and enabled the Group to implement more scientific analysis on sales and inventory level. This played a pivotal role in the management, control and planning capabilities of the Group.

Segment Results

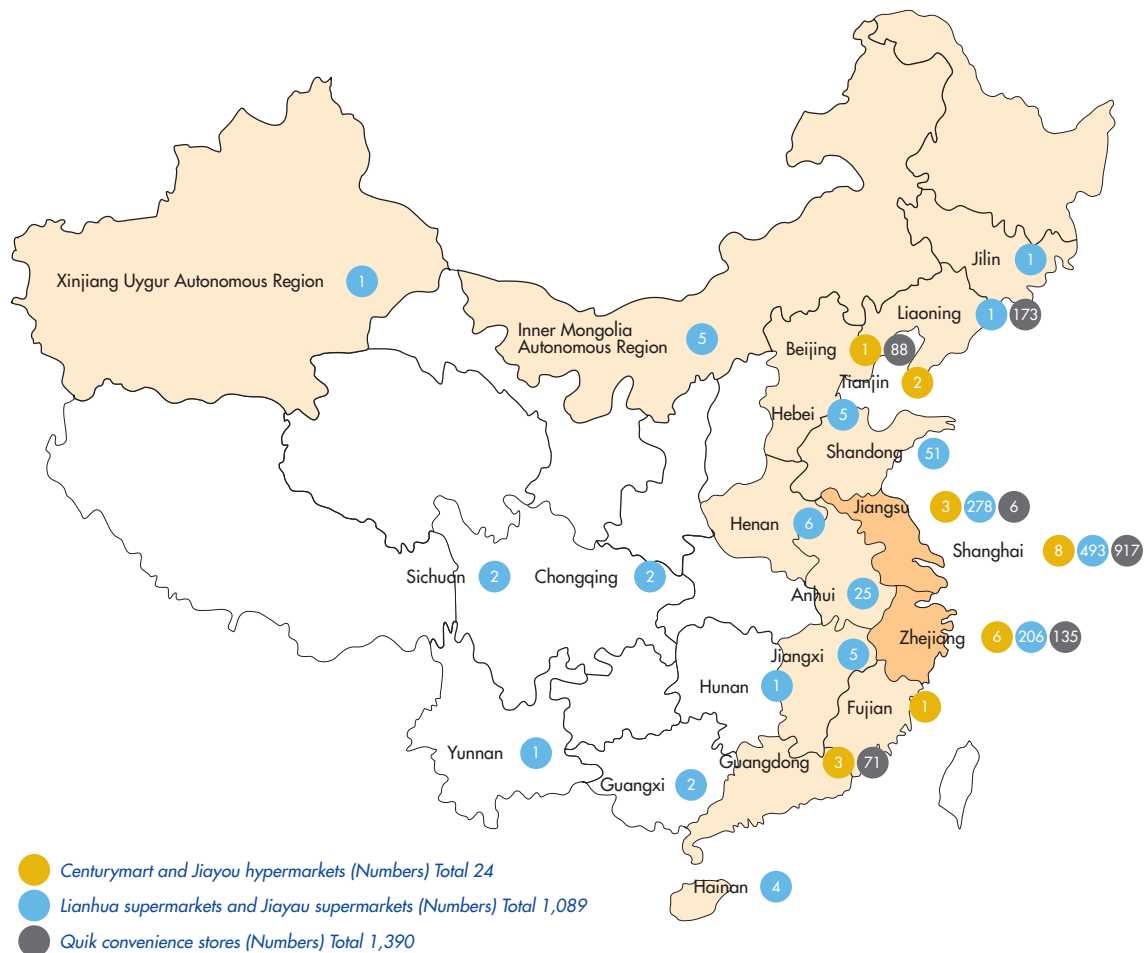
For the year ended 31 December 2003, an analysis of the Group's turnover in terms of segments was as follows:

Type of business	For the year ended 31 December				
	2003		2002		Change
	RMB	%	RMB	%	%
Hypermarkets	3,375,410,000	36.36	947,720,000	16.28	256.16
Supermarkets	4,929,510,000	53.11	4,085,420,000	70.18	20.66
Convenience stores	899,850,000	9.69	702,440,000	12.07	28.10
Other businesses	77,480,000	0.84	85,650,000	1.47	-9.54

As at 31 December 2003, the total number of the Group's outlets reached 2,503 (excluding those operated by the Company's associated companies) (2002: 1,884), representing an increase of approximately 32.86% from that in 2002. Among the 619 new opened stores, the number of hypermarkets, supermarkets and convenience stores opened were 13, 261 and 345 respectively.

In view of the development features of the Group in the year of 2003, all retail formats recorded growth in turnover, of which hypermarkets posted the most remarkable growth in turnover. Turnover contribution of hypermarket to the Group significantly increased from approximately 16.28% in 2002 to approximately 36.36%, which was attributable to the rapid expansion of hypermarket together with the improving profitability of its outlets.

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Hypermarkets

The operation of hypermarkets plays an important role to the core business of the Group. Growth and development potential of hypermarket increase as the consumption pattern of the PRC evolved. During the year under review, high growth rate was recorded for its turnover as the Group opened 13 new outlets and focused on enhancing the operations of existing outlets. During the year under review, gross profit margin and operating profit margin of the segment were approximately 8.41% and 1.54% respectively. Excluding the wholesales to Century Lianhua, the associated company at cost price, gross profit margin and operating profit margin were approximately 10.98% and 2.01% respectively.

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As at 31 December 2003, the Group directly operated 24 hypermarkets. Together with the 6 hypermarkets operated by Shanghai Carhua and 19 hypermarkets operated by Shanghai Century Lianhua Supermarket Co., Ltd. ("Century Lianhua"), the Group has a total of 49 hypermarkets.



Supermarkets

Among these three retail operating formats, supermarket remained as the most mature operating format and the major profit contributor of the Group. Gross profit margin and operating profit margin for the year under review were approximately 15.12% and 3.15% respectively. The turnover growth in this segment was mainly due to the Group's efforts on enhancing the operational continuity of existing outlets, and the adjustment on product mix to cater for the needs of target customer groups in the region and the improvement on the operations of live and fresh produce.

As of 31 December 2003, the number of supermarkets of the Group reached 1,089, among which 536 were directly operated supermarkets and 553 stores were operated under franchise arrangement.



Convenience stores

Turnover from convenience stores also recorded remarkable growth during the year under review. This retail format is complementary to the other business formats and inaugurated a comprehensive and regionally focused retail chain outlet network. The turnover growth in this segment was mainly attributable to the Group's increasing concentration of its outlets network so as to attain economies scales. Gross profit margin and operating profit margin for the year ended 31 December 2003 were approximately 16.91% and 2.01% respectively.

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As at 31 December 2003, the number of convenience stores of the Group reached 1,390, of which 978 were directly operated by the Group and 412 were operated under franchise arrangement. Among the stores newly opened during the year, 38 convenience stores were opened in gas stations operated under the Sinopec brand name so as to expand the customers reach of this retail format.

Discount stores

The Group entered into an agreement to establish a joint venture named Shanghai Dia-Lianhua Retail Co., Ltd. ("Shanghai Dia") with Distribuidora Internacional De Alimentacion S.A. of Spain. Shanghai Dia set up its first Shanghai Dia discount store in Shanghai on July 2003, and introduced a new retail format into the booming retail market of the PRC. In total, Shanghai Dia established 40 discount stores in Shanghai during the year.

Recent development of other business

During the year under review, the Company dedicated much efforts in expansion through mergers and acquisitions. In order to obtain controlling stake in Hangzhou Lianhua Huashang which the Company acquired in 2002, the Company further increased its equity interest to 74.5%. Through development, integration and enhancement, turnover and profit attributable to shareholders of Hangzhou Lianhua Huashang were approximately RMB2,476,000,000 and RMB39,482,000 respectively for the year under review. This further strengthened the Group's leading position in the region and also demonstrated the Company's success in mergers and acquisitions, posting promising prospects for future mergers and acquisitions.

Apart from the retail chain business, the Group also proactively pursue for business opportunities that can create synergy with its existing retail business. The Group reached agreement with Japan Izumiya Co., Ltd. in Japan, an integrated retail chain operator based in Japan, to jointly develop products that cater to the consumer needs of each party. These products will be distributed in China and Japan under the brand names of Lianhua and Izumiya respectively. In addition, the Group also cooperated with Trading Zhou (Group) S.R.L. of Italy and Hui Feng Handles

G.M.B.H. of Austria to jointly develop distribution business in Europe. As at the end of 2003, the business operation was under the stage of preparation.

Business Analysis

In 2003, the business of the Group achieved satisfactory growth mainly due to the strategical missions "development, transformation and enhancement" set at the beginning of the year. The major measures of the Group on operations include:

- **Increased capability of sustainable development**

The Group adopted the expansion strategy for sustainable development and successfully completed the framework of a nationwide retail network. It attained leading market position in key regions and made a balance between development pace and profitability.

- **Strengthened integration and achieve economies of scale**

The Group integrated the resources from suppliers across the nation to reduce procurement cost of products. It also integrated the information management system for sharing data within the Group. In addition, it centralized procurement of assets and reduced the investment cost of its outlets.

- **Reinforced internal management and increased profitability**

Under a comprehensive budget management, the Group further strengthened its cost control by KPI (key performance indicators). Meanwhile, the Group also enhanced training for staff and managers to meet the demands for Lianhua Supermarket's nationwide expansion.

Liquidity and financial resource

The Group's source of funds in 2003 was mainly derived from operating income in cash and proceeds from its

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Listing. As at 31 December 2003, the Group had non-current assets of approximately RMB2,101,200,000. Such non-current assets comprised projects under construction and fixed assets of approximately RMB1,687,410,000, intangible assets of approximately RMB94,970,000, investment in associated companies of approximately RMB279,510,000, long-term investment and other non-current assets of approximately RMB39,310,000. The net proceeds obtained by the Group in the public offer was about HK\$615,120,000.

As at 31 December 2003, the Group had net current liabilities of about approximately RMB557,690,000. Current assets of the Group mainly comprised cash and bank deposits of approximately RMB758,150,000, inventory of approximately RMB906,530,000, receivable and prepayment account of approximately RMB155,170,000, the receivable account from associates company was approximately RMB137,450,000. Current liabilities of the Group mainly comprised unsecured short-term bank loan of approximately RMB208,000,000 (including notes payable of approximately RMB138,000,000), account payable and accruals of approximately RMB2,255,340,000 and taxes payable of approximately RMB39,290,000.

Turnover of the Group's payable accounts for the year ended 31 December 2003 was 59 days, which was increased from 57 days for the year ended 31 December 2002. Turnover of inventory for the period reduced from 33 days for the year ended 31 December 2002 to 30 days for the year ended 31 December 2003.

The Company allocated the uncommitted capital for two short-term investments on trust. The amount of each investment was approximately RMB50,000,000. As at 31 December 2003, all investment amounts on trust was recovered, generating gains of approximately RMB1,625,000.

During the year under review, the Group did not use any financial instrument as tool to hedge risk. As at 31 December 2003, there was no financial instrument issued by the Group which was outstanding for value arbitraging.

Capital Structure

As at 31 December 2003, the Group's borrowings were mainly settled in Renminbi, whilst its cash equivalent was mainly held in Renminbi.

It is the Group's plan to maintain a ratio of equity and debt as appropriate to assure that it has an effective capital structure from time to time. As at 31 December 2003, approximately RMB208,000,000 of the Group's short-term borrowings were outstanding and the Group's gearing ratio was 5.12% (total loans/total assets). All bank borrowings bore fixed interest rate. The outstanding banking facility of the Group was approximately RMB1,002,000,000.

During the year under review, the Group's shareholder's equity increased from approximately RMB587,110,000 to approximately RMB1,279,190,000.

Details on the pledge of the Group's assets

As at the date hereof, no assets were pledged by the Group.

Foreign exchange exposure

The Group's revenue and expenditure were mostly denominated in Renminbi. During the year under review, the Group did not suffer from any difficulty as a result of foreign exchange exposure or its operation or working capital and became affected as a consequence. The directors of the Company believe that the Group will have sufficient foreign exchange to meet with its foreign exchange requirements.

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Employment, training and development

As at 31 December 2003, the Group had 26,346 employees, representing an increase of 4,584 employees from that of 31 December 2002, and incurred expenses of approximately RMB507,740,000 in total.

Apart from basic salaries, welfare, allowance and performance bonus, the full-time employees are also entitled to dormitory allowance, medical subsidies and other subsidies. In addition, the Group will contribute to retirement plan as prescribed by the government. Contributions to such plan were made by the Group and employees on a monthly basis in accordance with certain percentage of the employee's salary. Furthermore, the Group will continue to provide training for employees so as to improve their retailing skills and product expertise as well as their understanding to quality standard prevailing in the retail industry.

Use of proceeds

The net proceeds raised by the Company from the placing and public offer of H Shares amounted to about HK\$615,120,000, after the exercise of the over-allotment option. Net proceeds were applied in accordance with the plans as set out in the prospectus.

Use of proceeds	Actual use in 2003 (RMB million)	Percentage of usage in 2003
Approximately RMB140 million to invest in the network expansion of the hypermarket business of the Group	127.24	90.89
Approximately RMB80 million to invest in the network expansion of the convenience store business of the Group	75.20	94.00
Approximately RMB50 million to establish inter-regional management information system for the Group	35.04	70.08
Approximately RMB180 million to establish logistics and distribution centres to complement the Group's retail chain business	18.99	10.55
Working capital	202.96	100

Major acquisitions and disposals

In January 2003, the Group and the then existing shareholders of Hangzhou Lianhua Huashang entered into an agreement. Pursuant to the agreement, the 24.5% shareholding of Hangzhou Lianhua Huashang was acquired for a consideration of RMB135,240,000. Upon the acquisition, the Company's equity in Hangzhou Lianhua Huashang has increased to 74.5%. This information has been disclosed in the Company's prospectus.

Contingent liabilities

As at 31 December, 2003, the Group did not have any significant contingent liability.

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STRATEGIES AND PLANS

After careful and comprehensive discussions, the directors and management of the Company believed that the PRC economy will continue to post steady growth. The directors of the Company believe that the macroeconomic factors will continue to benefit the growth of Lianhua Supermarket. Such factors include accelerating urbanization in the PRC, improving living standard, increasing demand for a convenient, hygienic and comfortable lifestyle by PRC citizens as well as continuous economic growth momentum fuelled by the opening up of the economy.



By capitalizing on its competitive edge in operation, including internationalized management standard, in-depth understanding of the local consumption pattern, state-of-the-art supply chain management system and improving economies of scale, it is expected that the Group will stay at the forefront in the rapidly growing market in the PRC.

Under the PRC market with vast development potentials, the Group will continue to expand its market share in the PRC, and improve the Group's outlets coverage in key areas. Through expansion strategies including collaboration, merger and acquisition, the Group will further consolidate its leading position as the largest and most widely covered retail chain operator to achieve higher returns.

In the coming year, Lianhua Supermarket will outline its plan in nationwide logistics construction, strengthen the logistics and distribution management, improve logistics technology, and optimize its supply chain system in accordance to its business development. The Group will further integrate and improve its management information system. It will also strengthen the functional analysis on business information so as to improve the Group's market responsiveness and to understand the demand of customers accurately.

The Group's successful Listing last year also laid a strong foundation to its business development. In 2004, we aim to "expand sales", "reduce costs" and "increase efficiency" by the adoption of the core strategies of "development, transformation and improvement". We have introduced key performance indicators and will match our standard with that of other international operators. The Group firmly believes that its various operational indicators will improve significantly in future. On the other hand, the Group intends to reduce operational costs by further improving the operation flow.

Upon the completion of basic network expansion in the nation, the Group will improve its nationwide procurement to cater for needs of various investors. At the same time, the Group will leverage on the economies of scale of the existing network of outlets and strengthen the development of its own brand products.

In order to achieve better performance, the Group's management together with a strong team of employees across the country will devote full efforts to achieve success. The Group will proactively implement measures to motivate its staff, and foster an equilibrium between the interests of the management and investors. Faced with the promising prospects as well as challenges, the Group is committed to create maximum value for its staff, business partners and consumers and to bring satisfactory return to its shareholders.