

# REPORT OF THE DIRECTORS

The Board presents to the shareholders their report together with the audited financial statements of the Group for the year ended 31 December 2003.

## The issue and listing of Shares

The Company listed its H Shares on the main board of the SEHK on 27 June 2003 and offered 172,500,000 H Shares (including the over-allotment option for the issue of 22,500,000 H Shares granted to BNP Paribas Peregrine Capital Limited by the Company) by means of public offer in Hong Kong (the "Public Offer") and international placing (the "Placing") (the "Listing") at an issue price of HK\$3.875 per Share.

The performance of H Shares in 2003:

Highest trading price per H Share	HK\$8.9
Lowest trading price per H Share	HK\$4.05
Total turnover volume of H shares	378,000,000 Shares
Closing price per H Share on 31 December 2003	HK\$8.2

## Accounts

The audited results of the Company for the year ended 31 December 2003 are set out in the Profit and Loss Accounts on page 36 of this annual report.

The financial conditions of the Company as at 31 December 2003 are set out in the Balance Sheets on page 37 of this annual report.

The cash flows of the Company for the year ended 31 December 2003 are set out in the Cash Flow Statements on page 40 of this annual report.

## Principal Activities

The principal activities of the Company are operating hypermarkets, supermarkets and convenience stores in the PRC, a majority of which are operated under the brands of "Century mart", "Lianhua supermarkets" and "Lianhua Quik convenience stores" respectively.

Percentages of purchases and sales accounted for by the major customers and suppliers of the Company during the year are as follows:

	2003 %	2002 %
<b>Purchases</b>		
Largest supplier	3.66	2.92
Five largest suppliers	7.70	6.80
<b>Sales</b>		
The largest customer	8.51	3.19
Five largest customers	12.68	4.84

To the best of the directors' knowledge, apart from Century Lianhua and Lianhua E-Business, neither the directors, the supervisors, their associates, nor any shareholders owned 5% or more of the share capital of the above customers of the Company of any time within the year ended 31 December 2003.

## Subsidiaries and associates

As at 31 December 2003, the Company's principal subsidiaries are Lianhua Quik convenience stores, Hangzhou Lianhua Huashang, Lianhua Supermarket Jiangsu Co., Ltd, Lianhua Distribution, Shanghai Lianhua Live and Fresh Produce Processing and Distribution Centre Co., Ltd.

As at 31 December 2003, the Company's principal associated companies are Shanghai Carhua, Shanghai Dia, Lianhua Retail Co., Ltd, Lianhua E-Business, Century Lianhua.

Please refer to note 39 to the financial statements in this annual report for the particulars of certain major subsidiaries and associates of the Company.

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## Profit appropriation

In accordance with the relevant requirements and the Company's actual circumstances, the Board held a meeting on 1 April 2004 to prepare the profit appropriation plan of the Company for 2003 as follows:

In accordance with the statutory financial statements of 2003 audited by Shanghai Certified Public Accountants, the profit after taxation of the Company in 2003 was approximately RMB164,110,000. In the Group's consolidated financial statement statutory common reserve fund of approximately RMB23,537,000 and statutory common welfare fund of RMB12,334,000 were appropriated respectively (in which RMB16,411,000 and RMB8,206,000 were appropriated for parent company and RMB7,126,000 and RMB4,128,000 were appropriated for subsidiaries). With the undistributed profit of RMB9,233,000 at the beginning of the year added, the profit attributable to shareholders was approximately RMB137,473,000 as at 31 December 2003.

Pursuant to the accounts of 2003 audited by PricewaterhouseCoopers in accordance with Hong Kong accounting principles, the profit attributed to shareholders in the Group's consolidated financial statement was approximately RMB163,623,000. The undistributed profit at the beginning of the year was approximately RMB793,500,000. After appropriation of statutory common reserve fund of RMB23,537,000 and statutory common welfare fund of approximately RMB12,334,000, the profit attributable to shareholders was approximately RMB135,687,000.

Pursuant to the relevant regulations, the Company should adopt the lower of the two figures in terms of its distributable profits. Therefore, the distributable profit of the Company for the year 2003 was approximately RMB135,687,000. The Board recommended a final dividend of RMB0.08 per ordinary share. The total dividend distributed will be approximately RMB47,000,000. The balance of unallocated profit of RMB88,687,000 will be brought forward to next year. The profit distribution proposal will be put forward to the shareholders' general meeting of 2003 for approval by way of an ordinary resolution.

## Dividend

The Board passed a resolution to distribute a final dividend of RMB0.08 per ordinary share. The distribution proposal will be implemented subject to consideration and approval in the Company's annual general meeting of 2003. The dividend will be distributed to the shareholders whose names appear on the Company's Register of Members on Friday, 16 April 2004. The H Shares register of the Company will be closed from Saturday, 17 April 2004 to Tuesday, 18 May 2004 (both days inclusive), during which no transfer of H Shares will be effected. In order to vote at the Annual General Meeting and to qualify for the final dividend, persons holding the H Shares shall lodge share transfer documents and the relevant share certificates with Computershare Hong Kong Investor Services Limited at Rooms 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, not later than 4:00 p.m. on Friday, 16 April 2004.

The dividends to be distributed will be denominated and declared in Renminbi. It will be distributed to the domestic shareholders in terms of Renminbi, to the holders of non-listed foreign shares in terms of relevant foreign currencies and to the holders of H Shares in terms of Hong Kong dollars. The dividends to be distributed in Hong Kong dollars will be converted into Hong Kong dollars at the average exchange rate of Renminbi to Hong Kong dollars announced by the People's Bank of China a week prior to the dividend distribution date.

## Reserves

The movements in the reserves during the year are set out in note 33 to the financial statements of this annual report.

## Properties and equipment

The movements in the properties, plants and equipment during the year are set out in note 14 to the financial statements of this annual report.

## Share Capital

Classes of shares	Number of issued shares	Percentage
Domestic Shares	355,543,000	60.52
Unlisted Foreign Shares	59,457,000	10.12
H Shares	172,500,000	29.36
<b>Total</b>	<b>587,500,000</b>	<b>100.00</b>

## The legal status of Unlisted Foreign Shares

The summary on legal opinion given by Grandall Legal Group on the rights attached to Unlisted Foreign Shares is set out as follows:

Although the Mandatory Provisions for Articles of Association of Companies to be Listed Overseas (the "Mandatory Provisions ") provide for the definitions of "domestic shares ", "foreign shares " and "overseas listed foreign shares "(which definitions have been adopted in the articles of association of the Company (the "Articles of Association ")), the rights attached to the Unlisted Foreign Shares (which are subject to certain restrictions on transfer as referred to the Prospectus and may become H Shares upon obtaining the requisite approvals from, among other bodies, the China Securities Regulatory Commission (the "CSRC ") and the SEHK) are not expressly provided for under the existing PRC laws or regulations. However, the creation by the Company and the subsistence of the Unlisted Foreign Shares do not contravene any PRC laws or regulations.

At present, there are no clear applicable PRC laws and regulations governing the rights attached to the Unlisted Foreign Shares. The Company 's PRC legal counsel advises that until new laws or regulations are introduced in this aspect, the holders of the Unlisted Foreign Shares will be treated as if they are in the same class as the holders of the Domestic Shares (in particular, in respect of the rights to attend and vote at general meetings and class meetings and to receive notice of such meetings in the same manner as the holders of the Domestic Shares), except that the holders of the Unlisted Foreign Shares enjoy the following rights to which the holders of the Domestic Shares are not entitled:

- (a) to receive dividends declared by the Company in foreign currencies;
- (b) in the event of the winding up of the Company, to remit their respective shares of the remaining assets (if any) of the Company out of the PRC in accordance with the applicable foreign exchange control laws and regulations in the PRC.

No provision is made for the settlement of disputes between the holders of the Unlisted Foreign Shares and the holders of the Domestic Shares in the Mandatory Provisions nor in the Articles of Association. According to the PRC laws, in the case of disputes between the holders of the Unlisted Foreign Shares and the holders of the Domestic Shares, if there is no settlement after negotiation or mediation, either party could choose an arbitration commission in the PRC or any other arbitration commission to conduct arbitration for dispute resolution pursuant to a written arbitration agreement; if there is no prior arbitration agreement and the parties are not able to reach an agreement to arbitrate their disputes, either party could bring suit in the PRC courts with competent jurisdiction.

According to the requirements under Clause 163 of the Mandatory Provisions and Clause 194 of the Articles of Association, in general, disputes between the holders of the H Shares and the holders of the Domestic Shares are required to be settled through arbitration. Such dispute resolution requirements are equally applicable to disputes between the holders of the H Shares and the holders of the Unlisted Foreign Shares.

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As advised by Grandall Legal Group, the following conditions must be satisfied before the Unlisted Foreign Shares can be converted into new H Shares:

- (a) the expiry of a period of three years from the date on which the Company was converted from a limited company into a joint stock limited company;
- (b) the approvals from the original approval authority or authorities in the PRC for the establishment of the Company being obtained by the holders of the Unlisted Foreign Shares for the conversion of the Unlisted Foreign Shares into H Shares after the expiry of the three-year restriction period for any transfer of the Unlisted Foreign Shares (in the case of the Company, the three-year restriction period will end on 18 December, 2004 as prescribed by Article 147 of the Company Law of the PRC);
- (c) the approval from the CSRC being obtained by the Company for the conversion of the Unlisted Foreign Shares into new H Shares;
- (d) approval being granted by the SEHK for listing of and permission to deal in the new H Shares converted from the Unlisted Foreign Shares;
- (e) approval being granted by the shareholders of the Company at a general meeting and the holders of the H Shares, the Domestic Shares and the Unlisted Foreign Shares at their respective class meetings to authorise the conversion of the Unlisted Foreign Shares into new H Shares in accordance with the Articles of Association; and
- (f) full compliance with relevant PRC laws, rules, regulations and policies governing companies incorporated in the PRC which seek permission to list their shares outside the PRC and with the Articles of Association and any agreement among the shareholders of the Company.

When all of the conditions mentioned above and other conditions as may be imposed from time to time by the SEHK have been satisfied, the Unlisted Foreign Shares may be converted into new H Shares.

## Shareholding structure

The total number of Shares as at 31 December 2003 was 587,500,000. The shareholders of the Company are Shanghai Friendship (Group) Joint Stock Company Limited, Shanghai Industrial United (Group) Commercial Network Development Company Limited, Mitsubishi Corporation, Wong Sun Hing (Hong Kong) Investment Company Limited, Shanghai Liding Investment Company Limited and overseas holders of H Shares, holding 211,640,000 Shares, 131,683,000 Shares, 41,900,000 Shares, 17,557,000 Shares, 12,220,000 Shares and 172,500,000 Shares, respectively. They account for 36.03%, 22.41%, 7.13%, 2.99, 2.08% and 29.36% of the total share capital of the Company, respectively.

## Number of shareholders

As at 31 December 2003, the details of shareholders recorded in the register of the Company are as follows:

Total number of shareholders	41
Holders of Domestic Shares	3
Holders of Unlisted Foreign Shares	2
Holders of H Shares	36

## Shareholding of Substantial Shareholders

As at 31 December 2003, Shanghai Friendship (Group) Joint Stock Company, the largest shareholder of the Company, owns 211,640,000 Domestic Shares, which represent 36.03% of the total share capital of the Company. In addition, Shanghai Industrial United (Group) Commercial Network Development Company Limited owns 131,683,000 Domestic Shares, which represent 22.41% of the total share capital of the Company.

Save as aforesaid, the Company has not been informed of any interest and short positions which are required to be disclosed pursuant to the Securities and Futures Ordinance (the "SFO") as at 31 December 2003.

## Ultimate Controlling Shareholder

Shanghai Friendship Group, a state-owned enterprise established in the PRC, is the ultimate controlling shareholder of the Company. On 6 April 2003, the Shanghai Municipal Government announced that it would effect the merger of Shanghai Friendship Group, Yibai Group, Hualian Group and Wuzi Group into Shanghai Bailian (Group) Company Limited ("Shanghai Bailian"). The merger aims to facilitate collaboration among these Shanghai retail enterprises so as to enhance their competitiveness in the PRC retail market. During the period under review, Shanghai Bailian has not made any propositions through Shanghai Friendship Group concerning matters related to business cooperation or organisational restructuring to the Company's Board of directors.

## Share capital interests attributable to the directors and supervisors

None of the directors, the supervisors or their associates have any interest in the shares and debt securities of the Company or any associated corporation (within the meaning of SFO) which are required to be notified to the Company and the Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short positions in shares and debentures) or are required, pursuant to section 352 of the SFO (including interests and short positions which they are taken or deemed to have under such provisions of SFO), or are required, pursuant to the Model Code for Securities Transactions by Directors of Listed Companies to be notified to the Company and the Stock Exchange.

## Directors' service contracts

Each of the directors has entered into a service contract with the Company for a term starting from 27 June 2003 to 17 December 2004.

## Directors' and supervisors' interests in contracts

No contracts of significance to which the Company or its fellow subsidiaries were a party and in which a director or supervisor had a material interests were subsisted at the end of the year or at any time during the year.

## Interest acquired by the directors and supervisors

During the year, the Company or its fellow subsidiaries have not arranged for the directors or supervisors of the Company to acquire for the shares or bonds of the Company.

## Highest paid individuals

The highest paid individuals of the Company during the year included the directors and senior management. Details are set out in note 12 to the financial statements in this annual report.

## Purchase, sale or redemption of Shares

Since the listing of the H Shares on 27 June 2003, neither the Company nor any of its subsidiaries has purchased, sold or redeemed any of the Company's shares during the year.

## Bank loans, overdrafts and other borrowings

Besides the short-term loans set out in note 30 to the financial statements in this annual report, the Company and its subsidiaries have not borrowed other loans as at 31 December 2003.

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## Pre-emptive Rights

There are no provisions under the Company's Articles of Association requiring the Company to offer pre-emptive rights of new Shares to its existing shareholders.

## Connected Transactions

Transactions	Amounts (RMB million)
I. The sales of merchandise with connected parties	2,136.09
1. Distribution of merchandise to Century Lianhua	790.08
2. Sales of merchandise to supermarkets by certain subsidiaries of the Company	935.91
3. Sales of merchandise to Lianhua Quik	311.07
4. Sales of merchandise to supermarkets owned by certain subsidiaries of the Company	99.03
II. Purchase of merchandise from Lianhua Distribution	1,447.16
III. Management of Century Lianhua	0.96
IV. Lease of property by the Company to Lianhua Distribution	4.59

The independent non-executive directors have reviewed the above transactions and confirmed that the transactions have been entered into:

- (1) in the ordinary and usual course of business of the Group;

- (2) on normal commercial terms (to the extent that there are comparable transactions) or if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms not less favourable to the Group than terms available to or from (as appropriate) independent third parties; and

- (3) in accordance with the arrangement on terms that are fair and reasonable and in the interests of the independent shareholders of the Company as a whole;

The auditors of the Company have reviewed the above transactions and provided a letter to the board of directors confirming that the above transactions:

- (1) have received the approval of the board of directors;
- (2) have been entered into in accordance with the relevant agreement governing the transactions;
- (3) are in accordance with the pricing policies as stated in the Company's accounts;
- (4) have not exceeded the respective cap (as appropriate).

## Significant litigation

During the year, the Company was not engaged in any significant litigation.

## Retirement schemes

Employees of the Group participate in various pension plans organised by the relevant municipal and provincial governments, to which the Group needs to make monthly contributions. In accordance with the rules and regulations in the PRC, the employees of the Group participate in various defined contribution retirement benefit plans organised by the relevant municipal and provincial governments in the PRC under which the Group and the employees are required to make monthly contributions to these plans calculated as a percentage of the employees' salaries during the relevant periods.

## Capitalized interests

During the year, there was no capitalized interests of construction in progress.

## Other events

### I. The proposed amendments to the Articles of Association

In view of amendments made to the Rules Governing the Listing of Securities on the Stock Exchange of the Hong Kong Limited (the "Listing Rules") effective on 30 January 2004, the following amendments are proposed by the Board made to the Articles of Association of the Company (the "Articles"):

#### 1. The following words be added at the end of the existing Article 78:

"Where any shareholder is, under the rules governing the listing of securities at the place of listing of the Company, required to abstain from voting on any particular resolution or restricted to voting only for or only against any particular resolution, any votes cast by or on behalf of such shareholder in contravention of such requirement or restriction shall not be counted."

#### 2. The existing Article 96 Clause 2 be replaced in its entirety by the following Clause :

"Article 96 Clause 2: The period for lodgment of notices regarding notice to the Company of the intention to propose a person for election as a director, and during which notice to the Company by such person of his willingness to be elected may be given, will commence no earlier than the day after the despatch of the notice of the meeting appointed for such election and end no later than 7 days prior to the date of such meeting."

#### 3. The existing Article 134 Clause 2 shall be replaced in its entirety by the following Clause:

"Article 134 Clause 2: A director shall not vote on any board resolution approving any contract, transaction or arrangement in which he or any of his associates has a material interest nor shall he be counted in the quorum present at the same board meeting."

### II. The Board has accepted the resignation of Mr. Hua Guo-ping as a non-executive director of the Company, which shall become effective from 17 May 2004. The Board has nominated Mr. Shi Zu-qi to be a non-executive director of the Company. A resolution will be put forward to the general meeting for approval.

### III. In accordance with nomination by the general manager of the Company, the Board agreed to appoint Mr. Jiang Xiao-fei as the deputy general manager. The Board also accepted the resignation of Mr. Hua Guo-ping as deputy general manager and the resignation of Mr. Zhang Guo-hong as assistant to the general manager.

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- IV. A resolution was put forward to the shareholders' general meeting to approve the authorization of the board of directors to determine the annual remuneration package and incentive scheme for the directors and supervisors for the year ended 31 December 2003 and beyond. The Remuneration and Appraisal Committee under the Board of Directors will assess the performance of the directors and supervisors of the Company in accordance with the development pace and standard of operations. The salary adjustment of such persons shall not exceed the profit growth rate of the year and the aggregate salaries shall not exceed the 20% of the remuneration package of last year. The management bonus (including subsidies, bonus, etc) shall not exceed 1% of the audited profit after taxation for the year. The relevant adjustment proportion will be determined by the committee and subject to approval from the Board of Directors.

## The Code of Best Practice

The Board of directors of the Company is pleased to confirm that the Company has complied with the Code of Best Practice of the Listing Rules for the period under review.

None of the directors is aware of any information that would reasonably indicate that the Company is not or was not for any part of the period under review in compliance with the Code of Best Practice as set out in appendix 14 to the Rules Governing the Listing of Securities of the SEHK.

## Auditors

The 2003 financial statements prepared in accordance with the Hong Kong accounting standards have been audited by PricewaterhouseCoopers, the Company's auditor. A resolution will be submitted to the forthcoming annual general meeting of the Company to reappoint PricewaterhouseCoopers as the international auditor of the Company.

By order of the Board  
*Chairman*  
**Wang Zong-nan**

1 April 2004  
Shanghai, The PRC