Management Discussion and Analysis

Results and Provisions

The Group's loss from ordinary activities attributable to shareholders for the year ended 31 December 2003 was HK$101,294,000 (2002: HK$205,201,000). Turnover was HK$381,601,000, a drop of 27.9% as compared to HK$529,055,000 last year. The loss was primarily attributable to the major provisions and impairment loss totaling HK$88,757,000 as follows:

— A provision of HK$69,600,000 for the tax claim and tax penalty by the Guangzhou Customs from Nanhai City Tongyuan Tanning Company Limited/Nanhai Tannery & Leather Products Co., Ltd.;

— A provision of HK$816,000 for doubtful trade receivables;

— Provision for impairment of fixed assets amounting to HK$10,320,000; and

— Write off of fixed assets amounted to HK$8,021,000.

The above provision for the duty and tax recovered by the Guangzhou Customs was made as a prudential measure by the Board. Tongyuan Tannery will continue to follow up with the Guangzhou Customs to resolve the matter and will, if necessary, take all such steps as may be required to safeguard its rights and positions.

Net assets of the Group as at 31 December 2003 were HK$170,160,000, decreased by HK$105,483,000 and HK$94,003,000 respectively as compared to 31 December 2002 and 30 June 2003.

Tongyuan Tannery Incident

Pursuant to a business restructuring plan implemented by the Group, Nanhai City Tongyuan Tanning Company Limited ("Tongyuan") was established to operate the Group's tannery operations and businesses in the Guangdong province in January 2003. Tongyuan is a wholly-owned subsidiary of the Company which owns and operates factory and distribution operations in Nanhai, in the PRC. Tongyuan had purchased from Nanhai Tannery & Leather Products Co., Ltd. ("Nanhai Tannery") most of its fixed assets and inventories during the year.

On 31 December 2003, the Company entered into a conditional sale and purchase agreement with Yong Sheng Limited, a subsidiary of GDH Limited ("GDH") and a fellow subsidiary of the Company, for the disposal of the Company's entire 100% interest in Nanhai Tannery. The transaction was completed on 31 December 2003 and Nanhai Tannery became a wholly-owned subsidiary of GDH and a fellow subsidiary of the Company.

Subsequent to the balance sheet date, in February and March 2004, certain bank accounts of Tongyuan in the PRC containing in total approximately RMB7 million were frozen by 廣州海關緝私局 (the Anti-Smuggling Bureau of Guangzhou Customs) (the "Guangzhou Customs").

The directors and management of the Company are satisfied that all the business and operations of Tongyuan have been conducted strictly in accordance with all the applicable PRC laws and regulations, and that there has been no wrongdoing on the part of Tongyuan or any of its management or staff. Therefore, the Company's directors and management concluded that the actions taken by the Guangzhou Customs cannot be related to the business or operations of Tongyuan and must be related to the irregularities of Nanhai Tannery in 2002. Further details of the above are set out in the announcement of the Company dated 17 March 2004.

On 22 March 2004, the Guangzhou Customs has issued a demand letter to Tongyuan/Nanhai Tannery (i) claiming a tax of RMB36,989,000 (equivalent to approximately HK$34,800,000) payable within 30 days from the date of the demand letter in relation to the tax evaded by Nanhai Tannery during the period from 2000 to 2002; and (ii) asserting that Tongyuan/Nanhai Tannery failed to notify the Guangzhou Customs of the change from Nanhai Tannery to Tongyuan.

Although the Group has disposed of its entire interest in Nanhai Tannery to GDH and the tax evasion was related to the Parallel Operation of Nanhai Tannery, it cannot be precluded that the Guangzhou Customs may still claim the tax evaded by Nanhai Tannery against Tongyuan on the ground that Nanhai Tannery had transferred its fixed assets and inventories to Tongyuan after the commencement of the investigations taken by the Guangzhou Customs. The directors have sought PRC legal advice on such matters and consider that Tongyuan will be liable for the tax claim of HK$34,800,000 from the Guangzhou Customs if Guangzhou Customs consider that Tongyuan and Nanhai Tannery are one and the same entity. Accordingly, a provision of HK$34,800,000 has been made as at 31 December 2003.

In addition, based on a PRC legal opinion, under the existing PRC laws and regulations, the relevant PRC authorities may also impose a tax penalty on Tongyuan of an amount equal to 1 to 5 times the tax evaded by the Parallel Operation of Nanhai Tannery, i.e. HK$34,800,000 to HK$174,000,000. The directors have sought legal advice on such matters and considers that a provision of HK$34,800,000 for the tax penalty is appropriate.

As the actions taken by the PRC authority have not yet been concluded, it is not possible to ascertain with any degree of reasonable certainty the amount of tax penalty which may finally be imposed by the PRC authorities against Tongyuan, which may be in the range of HK$34,800,000 to HK$174,000,000, other consequential actions that may be taken by the PRC authorities for the apparent breaches of certain PRC laws and regulations and the existence or otherwise of any other penalties and claims as a result of the aforesaid irregularities. Should additional tax penalty in excess of the amount provided of HK$34,800,000 be imposed against Tongyuan, the directors are of the opinion that Tongyuan would have adequate net assets and resources to fulfill such obligation should it arises.

Operations Review

Turnover

Turnover from leather business for the year was HK$381,601,000, a drop of HK$31,158,000 or 7.5% as compared to HK$412,759,000 in 2002. This was attributable to the negative impact on the Group's leather production and operations resulted from the outbreak of SARS in China and Hong Kong during the first half of 2003.

The leather market started to recover in the second half year, primarily boosted by the solid economic growth in China. Performance of Xuzhou Nanhai Tannery was particularly encouraging as continued to break new grounds in overall results.

The Group is actively strengthening its research and development effort to develop techniques that turn defective leather into innovative products. Focus is placed on the development of fashion and dyed leather with higher market acceptance, such as "imitation reindeer leather" and "kaibianzhu". These product development initiatives are devised to clear up the Group's defective leather inventories, to avoid too much reliance on the black nappa cow leather, and to increase the overall market share.

The lower turnover against last year was due to a number of majors factors — a drop of HK$25,967,000 as a result of discontinuation of the paper box packaging business and disengagement of the Group's interests in the leather ware business; a decrease of HK$90,329,000 in merchandise trading turnover; and a decline of HK$31,158,000 in turnover from the leather business. Turnover of the leather business (by product) in 2002 and 2003 are as follows:

	Turnover			
Product	**2003**	2002	+/(-)	+/(-)
	HK$'000	*HK$'000*	*HK$'000*	%
Cow hides	**314,003**	321,232	(7,229)	(2.25)
Cow split, coated cow split & others	**67,598**	91,527	(23,929)	(26.14)
Total	**381,601**	412,759	(31,158)	(7.55)

Costs

Leather sourcing cost accounted for approximately 80% of the total sourcing costs and reduced markedly following a number of effective measures. These measures include the adoption of tender for sourcing, cautious selection of suppliers based on competitive pricing and better product quality, strict control on sourcing costs, expansion of supplier network, introduction of competition into the sourcing process, and enhanced efforts in market research and price negotiation. Sourcing of chemicals and metals was carried out through open tender in order to lower the overall production costs.

Production

We have in place a more effective workshop management approach to ensure a steady production, and have set up a quality control department to achieve better controls on product quality. The Group's total leather production for the year was 31,148,000 sq.ft., declined by 7,750,000 sq.ft. from 38,898,000 sq.ft. in 2002. Production volume of the leather business (by product) in 2002 and 2003 are as follows:

	Production Volume			
Product	**2003**	2002	+/(-)	+/(-)
	'000 sq.ft.	*'000 sq.ft.*	*'000 sq.ft.*	%
Cow hides	**22,234**	24,870	(2,636)	(10.60)
Cow split, coated cow split & others	**8,914**	14,028	(5,114)	(36.45)
Total	**31,148**	38,898	(7,750)	(19.92)

Inventories

As at 31 December 2003, the Group's consolidated inventories amounted to HK$221,395,000, increased by HK$29,206,000 as compared to 31 December 2002. The increase primarily comprised a surge in sourcing inventories used to cope with the sales in 2004 given the satisfactory sales results of Xuzhou Nanhai Tannery in 2003.

Trade Receivables

Balance of trade receivables as at the end of the year was HK$52,568,000. After deducting the provisions for doubtful debts of HK$35,406,000, trade receivables amounted to HK$17,162,000, a drop of HK$4,310,000 as compared to 31 December 2002. Trade receivables turnover was 19.8 times and average collection period was 18.43 days, improved from 13.3 times and 27.44 days in 2002. The decrease in trade receivables was mainly attributable to faster payments from customers of Xuzhou Nanhai Tannery in the fourth quarter of 2003.

Financial Position

As at 31 December 2003, the Group's interest-bearing borrowings and cash and bank balances are analysed as follows together with their comparative figures as at 31 December 2002:

	31 December 2003 *HK$'000*	31 December 2002 *HK$'000*
Interest-bearing borrowings		
Currencies:		
Hong Kong dollar	**17,000**	24,400
Renminbi	**45,957**	69,694
United States dollar	**70,691**	28,548
	133,648	122,642
Interest rates:		
At fixed rate	**100,557**	69,694
At floating rate	**33,091**	52,948
	133,648	122,642
Cash and bank balances		
Currencies:		
Hong Kong dollar	**1,985**	666
Renminbi	**51,232**	43,094
United States dollar	**31,115**	21,066
	84,332	64,826

At 31 December 2003, after deduction of cash and bank deposits, the Group's ratio of net interest-bearing borrowings to shareholders' equity was 28.98% (2002: 20.97%). Loan facilities bear interest at approximately 3% to 6% per annum. Of the Group's total borrowings, HK$33,091,000 is repayable within one year. Interest expense incurred by the Group during the year was HK$5,948,000, a drop of 6.87% as compared to the same period last year.

Net cash outflow from operating activities for the year was HK$29,371,000 and net cash inflow from financing was HK$23,672,000. Net increase in cash and cash equivalents for the year amounted to HK$25,323,000.

Fixed assets as at 31 December 2003 were HK$118,406,000, a reduction of HK62,588,000 as compared to 31 December 2002. The Group's capital expenditure during the year amounted to HK$3,044,000 (2002: HK$15,476,000). It was incurred mainly for the replacement of the leather manufacture machinery and equipment, a move to cope with the operations and development of the leather business.

As at 31 December 2003, certain of the Group's buildings, investment properties and bank deposits with a total net book value of HK$15,295,000 (2002: HK$48,972,000) were pledged to secure general banking facilities granted to the Group.

Litigations

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 Qingdao Nanhai Tannery Co., Ltd. ("Qingdao Tannery") seeking, amongst others, termination of the joint venture agreement of Qingdao Tannery (the "Qingdao 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 Qingdao Joint Venture Agreement and damages in an aggregate of RMB15,000,000. The two arbitration proceedings are still in progress.

Major Customers and Suppliers

For the year ended 31 December 2003,

(a) the amount of purchases attributable to the Group's largest supplier represented 10.9% 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 39.0% of the Group's total purchases;

(c) the amount of turnover attributable to the Group's largest customer represented 26.7% of the Group's total turnover;

(d) the aggregate amount of the turnover attributable to the Group's five largest customers represented 41.9% 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.

Employees

As at 31 December 2003, a total of 1,018 employees (2002: 1,075 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 the Report of the Directors and note 29 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:

	2003	2002
	HK$'000	*HK$'000*
Taxation Service	**—**	11
Interim results review	**180**	350
Others	**10**	—