

# Investment Manager's Discussion and Analysis



Dr. Huang Dazhan  
Chairman of the Board of the Investment Manager



# Investment Manager's Discussion and Analysis (continued)

## OVERALL PERFORMANCE

China Merchants China Direct Investments Limited and its subsidiaries (the "Fund") recorded a profit attributable to shareholders of US\$12.09 million for the year 2003, representing an increase of 163.5% over year 2002. This stronger performance was attributable to a substantial decrease in the provision for investments, coupled with an increase in dividend income from and unrealised holding gain on unlisted investments in financial services. As of 31 December 2003, the net assets of the Fund were US\$138.9 million, with a net asset value per share of US\$1.012, representing an 8.2% increase over year 2002.

Total turnover for the year increased by 19.3% to US\$2.91 million (2002: US\$2.44 million). Turnover included dividend income from unlisted investments, which increased 39.7% to US\$2.11 million (2002: US\$1.51 million). Another component of turnover was interest income, which decreased 23.0% to US\$0.67 million (2002: US\$0.87 million) due to interest rate declined throughout the year. The average 90-day US Treasury Bill rate declined from 1.6% in 2002 to 1.02% in 2003.

The net unrealised holding gain on unlisted investments for the year was US\$11.89 million (2002: US\$9.93 million), representing an increase of 19.7% over 2002. The increase came from the strong growth in Industrial Bank's profit for 2003, as well as from the improved results of investments in major securities companies over 2002.

In 2003, no impairment loss was required to provide for the Fund's investment in contractual joint ventures (2002: US\$2.4 million). The disposal of Weifang Real Estate project contributed a gain of US\$0.77 million (2002: Nil) to the Fund in 2003. The realised and unrealised gains from listed stocks totalled US\$0.76 million (2002: Loss of US\$1.27 million).

## MATERIAL ACQUISITIONS AND DISPOSALS OF INVESTMENTS

In February 2003, the Fund disposed of its entire interest in a wholly-owned subsidiary, Convoy Overseas Limited, which owned Beijing Longbao Mansion, through sale to an independent third party for a consideration of US\$3.00 million, which was received in full during the year. Since the carrying value of the investment was written down to the net proceeds of disposal at the end of 2002, there was no impact to financial results in the year.

In July 2003, the Fund disposed of its entire interest in Weifang Zhaoyin Real Estate Development Limited to a Chinese partner for a consideration of US\$0.80 million. The net proceeds of US\$0.77 million, equal to the sale price net of disposal expenses, was recognised as a gain on disposal in the year since this investment had been fully provided for in a prior year.

In November 2003, the Fund entered into an agreement with Shenzhen Harvest Environment Development Company Limited to jointly operate Chenzhou Heshang Environmental Protection Company Limited ("Heshang"), a Sino-foreign cooperative joint venture, for a total investment of RMB70 million. Heshang is formed to construct



## Investment Manager's Discussion and Analysis (continued)

and operate a landfill for domestic waste in Chenzhou, Hunan Province. Heshang owns the operation right of the landfill for 10 years. The Fund committed to invest US\$2.54 million for an equity stake of 30% of Heshang. The Fund injected US\$1.27 million as registered capital into Heshang in January 2004, and the remaining US\$1.27 million will be injected as a shareholder's loan according to construction progress. The designed capacity of the landfill is 3.2 million cubic metres, with a daily waste handling capacity of 500 tons. Construction work on the landfill has commenced and will be completed by the end of 2004. The project is expected to provide steady cash flow and a satisfactory investment return to the Fund after it comes into operation.

### **LIQUIDITY, FINANCIAL RESOURCES, GEARING AND CAPITAL COMMITMENTS**

Net cash increased by 10.5%, from US\$34.06 million as of 31 December 2002 to US\$37.62 million as of 31 December 2003, due to cash received from the disposal of the two unlisted investment projects.

As of 31 December 2003, the Fund had no outstanding bank loans (2002: Nil).

As of 31 December 2003, the Fund had capital commitments of US\$2.54 million (2002: US\$1.20 million), earmarked for an investment that has been committed to, but not yet provided for in the financial statements.

### **EXPOSURE TO FLUCTUATIONS IN EXCHANGE RATES AND RELATED HEDGES**

Most of the Fund's investments are located in China, where the official currency is the Yuan. The Yuan remained stable during the reporting period, and is expected to remain so.

# Investment Manager's Discussion and Analysis (continued)

## EMPLOYEES

The Fund had no employees during the year, because its portfolio and operations are administered by the Investment Manager.

## THE PORTFOLIO

As of 31 December 2003, the Fund had total investments of US\$108.57 million – US\$102.79 million in unlisted investments, US\$1.43 million in listed share investments, and US\$4.35 million in bonds/notes. The major unlisted investment projects were in financial services (62.8% of net assets), manufacturing (6.4%), and real estate (4.8%). In addition, the Fund had net cash of US\$37.62 million as of 31 December 2003.

## NET ASSET DISTRIBUTION (As at 31 December 2003)



- Financial Services Investments (62.8%)
- Manufacturing Investments (6.4%)
- Real Estate Investments (4.8%)
- Listed Share Investments (1.0%)
- Bonds/Notes (3.1%)
- Net Cash (27.1%)

## Investment Manager's Discussion and Analysis (continued)



Ms. Zhou Linda L.  
Managing Director of the Investment Manager

# Investment Manager's Discussion and Analysis (continued)

## REVIEW OF UNLISTED INVESTMENTS

The following table shows the major unlisted investment projects held by the Fund as at 31 December 2003:

Name of Projects	Location	Business Nature	Net Book Value US\$ million	Percentage of Net Assets
<b>Financial Services:</b>				
1. China Merchants Bank Co., Ltd.	Shenzhen, Guangdong	Banking	57.06	41.1
2. Industrial Bank Co., Ltd.	Fuzhou, Fujian	Banking	23.69	17.1
3. Industrial Securities Co., Ltd.	Fuzhou, Fujian	Securities	0.60	0.4
4. China Merchants Securities Co., Ltd.	Shenzhen, Guangdong	Securities	1.40	1.0
5. Jutian Securities Co., Ltd.	Shenzhen, Guangdong	Securities	2.77	2.0
6. Houlder China Insurance Brokers Ltd.	Shenzhen, Guangdong	Insurance brokerage	0.61	0.4
7. Jutian Fund Management Co., Ltd.	Shenzhen, Guangdong	Fund management	1.10	0.8
<b>Sub-total</b>			87.23	62.8
<b>Manufacturing:</b>				
8. Zhaoyuan Jinbao Electronics Co., Ltd.	Zhaoyuan, Shandong	Copper foil & laminates	8.82	6.4
<b>Sub-total</b>			8.82	6.4
<b>Real Estate:</b>				
9. Langfang Oriental Education Facilities Development Co., Ltd.	Langfang, Hebei	Student dormitory	4.57	3.3
10. Shenzhen Man Kam Square	Shenzhen, Guangdong	Retails shops	2.12	1.5
<b>Sub-total</b>			6.69	4.8
<b>Total</b>			102.74	74.0

# Investment Manager's Discussion and Analysis (continued)

## Financial Services Investments

**Financial Services is one of the core investment sectors of the Fund, and has generated significant capital appreciation for the Fund in recent years. The Fund's financial services investments include the banking, securities, fund management and insurance brokerage industries. In addition to China Merchants Bank's successful A-share listing on the Shanghai Stock Exchange in 2002, Industrial Bank committed to issue new shares to foreign investors in 2003. Faced with an increasingly competitive market brought about by the entry of foreign banks, the issuance will improve Industrial Bank's financial strength, further enhance its competitiveness, and therefore position the bank to benefit from the inherent potential of the market.**

**China Merchants Bank Company, Limited ("CMB")**, a registered commercial bank in China, is the first joint-stock commercial bank established by mainland enterprises. CMB has around 350 branches and offices across the country. The Fund invested US\$14.06 million and holds a 1.19% stake in CMB. CMB recorded remarkable business growth in the year, with deposits and loans increasing by 34% and 49% respectively. Net profit jumped by 28.6% to RMB2.23 billion. CMB's Shareholder Meeting of 19 March 2004 resolved to declare a cash dividend of RMB0.92 per 10 shares and to issue 2 bonus shares for every 10 shares by capitalising the capital reserves. In addition, the meeting resolved to issue RMB6.5 billion of convertible bonds and RMB3.5 billion of subordinated bonds. All proceeds are to be used to support quality enterprise financing and to invest in government bonds and other financial products. In a move toward further globalisation, CMB opened a representative office in the United States in order to gain access to more international business opportunities. According to the adopted valuation method, CMB's shares were valued at RMB6.93 per share as of 31 December 2003, and the value of the Fund's investment in CMB increased US\$10.35 million over 2002. The Fund received 2002 dividends of RMB8.17 million in the year.

**Industrial Bank Company, Limited ("IBCL")** is a registered commercial bank in China with over 252 branches and offices throughout the country. Since 1998, the Fund has cumulatively invested RMB146 million (equivalent to US\$17.62 million) in IBCL and currently holds a 2.8% stake. In January 2004, the shareholders' meeting of IBCL resolved to form a strategic alliance with overseas investors and to issue 999 million new shares at RMB2.7 per share to the new investors, representing a 24.98% stake after the new issuance. Pending the approval of the regulatory authority, of the newly issued shares, 639 million shares will go to Hang Seng Bank Limited, with the rest to GIC Special Investments Pte Limited (200 million shares) and International Finance Corporation (160 million shares). The issuance of new shares will improve IBCL's capital adequacy ratio, and raise the bank's managerial and operational standards. The Fund's holding in IBCL will be diluted to 2.1% upon the issuance.

IBCL recorded tremendous growth in 2003, and net profit increased by 106.6% to RMB985 million. Consequently, as of 31 December 2003, the value of the Fund's investment in IBCL increased to US\$23.69 million, creating an unrealised gain of US\$2.20 million. The Fund received 2002 dividends of RMB9.24 million in the year.





## Investment Manager's Discussion and Analysis (continued)

**Industrial Securities Company, Limited ("ISCL")** is a comprehensive securities company registered in China, with a presence in securities underwriting, brokerage, proprietary trading and investment consulting. It has over 23 offices in major cities throughout the country, including Beijing, Shanghai, Shenzhen, Wuhan, Fuzhou and Xiamen. The Fund invested RMB8.51 million (equivalent to US\$1.03 million) to acquire a 0.74% stake in ISCL.

Benefiting from an increase in underwriting, ISCL recorded a net profit of RMB38.86 million in 2003, compared to a loss of RMB402 million in 2002. However, ISCL's net asset value declined by 3.6% to RMB668 million due to adjustments to reflect a loss from its 2002 asset management business. As a result, the fair value of the Fund's investment in ISCL declined by US\$66,000 in 2003. Due to this drop in net asset value, ISCL is preparing for the issuance of new shares in 2004 to strengthen its financial position.

**China Merchants Securities Company, Limited ("CMSC")**, CMSC is a comprehensive securities company registered in China with over RMB2.4 billion in capital. Its businesses include securities underwriting, brokerage, proprietary trading and investment consulting. In 2001, the Fund invested RMB13.05 million (equivalent to US\$1.58 million) to acquire a 0.52% stake in CMSC.

The turnover of CMSC was RMB419 million in 2003, representing a 18% decrease over 2002. The investment bank division completed three underwriting projects during the year. Due to a significant provision that was made for operating losses at some branches, CMSC recorded a loss of RMB203 million. As of 31 December 2003, the value of this investment was US\$1.40 million, representing a reduction of US\$0.135 million from 2002. In 2002, CMSC invested RMB40 million and worked with several companies (including ING Group) to set up China Merchants Fund Company, Limited, with registered capital of RMB100 million. The establishment of the joint venture was approved by the China Securities Regulatory Commission ("CSRC") at the end of 2002, making it the first Sino-foreign fund management joint venture. The first lot of funds was launched in March 2003 and was well received by the market.

**Jutian Securities Company Limited ("Jutian Securities")** is the first comprehensive securities company registered in China, with a presence in securities underwriting, brokerage, proprietary trading and investment consulting. It has 16 offices throughout the country. In 2001, the Fund invested RMB35.36 million (equivalent to US\$4.27 million) in Jutian Securities, representing an interest of 4.66%. Although the performance of the PRC equity markets improved in 2003, most securities companies did not return to profitability. Jutian Securities recorded a loss of RMB39.17 million in 2003, an improvement of 78% when compared to the loss of RMB179 million in 2002. The value of this investment was reduced by US\$0.356 million over the year. During the first half of 2003, Jutian Securities successfully launched two new investment products and is continuing to actively explore new products.



## Investment Manager's Discussion and Analysis (continued)

**Houlder China Insurance Brokers Limited ("Houlder")** was founded in 2001. Its core businesses include insurance risk assessments, risk management consultation, preparing insurance proposals and handling insurance policy issuance. Houlder has registered capital of RMB50 million, and the Fund invested RMB5 million (equivalent to US\$0.6 million) to acquire a stake of 10%. After a series of moves to restructure the business, Houlder recorded a net profit of RMB2.65 million, compared to a loss for 2002.

**Jutian Fund Management Company Limited ("JFM")** has received approval from the CSRC to form as a fund management company registered in China. JFM's businesses include fund management and promotion of equity funds. In February 2003, the Fund invested RMB10 million (equivalent to US\$1.21 million) in JFM, representing an interest of 10%. Since operations commenced in March 2003, JFM has focused on refining operating and management systems, designing financial products and applying for regulatory approval of new funds.

In February 2004, the CSRC granted approval to JFM to form the Jutian Infrastructure Equity Investment Fund, and the fund is now being marketed via sales channels throughout the country. During the reporting year, JFM showed no income, aside from interest income, due to the developmental stage of the business. JFM recorded a loss of RMB8.75 million in 2003. Following the launch of several funds, the performance of JFM is expected to improve.

### Manufacturing Investments

**Although the proportion of manufacturing investments represented only 6.4% of the net asset value of the Fund, the Fund has not overlooked industrial development in China and has studied a number of industrial projects, searching for good opportunities with competitive returns.**

**Zhaoyuan Jinbao Electronics Company Limited ("Jinbao")** was established in 1993 to manufacture and market copper foil and copper-clad laminates. The Fund cumulatively invested US\$7.0 million, representing an interest of 30% in Jinbao. Although affected by the outbreak of SARS and the rise of copper prices during the first half of 2003, Jinbao achieved a record turnover of a 25% increase to RMB350 million in 2003, as electronics markets rebounded during the second half of 2003. However, due to an increase in finance expenses, resulting from investments in production line capacity, and a rise in management expenses, Jinbao recorded a net profit of RMB8.62 million – a decrease of 8.8% from 2002. In order to raise product standards and profitability, Jinbao plans to invest RMB120 million in Phase II of its high-grade copper foil plant, with annual capacity of 2,500 tons. Construction is expected to be completed before the end of 2004. Dividend income from Jinbao amounted to US\$0.29 million in the year.



# Investment Manager's Discussion and Analysis (continued)

## Real Estate Investments

**Due to sustained high economic growth, the PRC real estate market remained strong and property prices held steady during 2003. As such, the Fund will continue to look for investment opportunities in this sector.**

**Langfang Oriental Education Facilities Development Company Limited ("Oriental")** is a Sino-foreign cooperative joint venture in Langfang, Hebei Province. The total project cost is US\$20 million, with a 20-year contractual period. In June 2002, the Fund invested US\$5 million for an equity stake of 25%. Oriental is engaged in the operation and management of the Phase I dormitories of Oriental University City in Langfang. After the completion of certain modifications, the capacity of Phase I dormitories increased from 15,000 to 17,000 students. Phase I currently accommodates 13,700 students, a 17% increase over 2002-2003 school year. For 2003, Oriental recorded a profit after taxation of RMB7.52 million, which contributed about US\$0.22 million to the Fund's net profit. The Fund received 2002 dividends of US\$57,000 and repayment of capital through a depreciation distribution of US\$0.67 million.

**Shenzhen Mankam Square ("Mankam")** is a 33-storey commercial complex on North Wen Jin Road, Shenzhen. In 1994, the Fund invested US\$4.3 million through a 35% holding of Hansen Enterprises Limited ("Hansen") to purchase 5,262 square metres of retail space on the third floor of Mankam. Hansen has had difficulty in selling or leasing the third floor because the first two floors of Mankam have not yet been brought into use. In 2003, the Fund recorded a loss of US\$0.31 million in this investment. The Fund has learned that title to the first two floors has changed hands from a financially distressed developer to a third party, and Hansen is in contact with the new owner in order to explore opportunities for cooperation, as well as exit strategies.

## REVIEW OF LISTED INVESTMENTS

The Hong Kong economy went through a sharp gyration in response to the spread of SARS during the first half of 2003. The labour market weakened distinctly in response to the abrupt fall-off in economic activity, and the Hang Seng Index recorded a new low for the period since 2000. Yet, local sentiment rose after the Central Government launched the Individual Visit Scheme and signed the Closer Economic Partnership Arrangement ("CEPA") with Hong Kong. The remarkable turnaround of the Hong Kong economy was further driven by a strong pick-up in the tourism and retail sectors. In 2003, the Hang Seng Index, the Hang Seng China-Affiliated Corporations Index and the Hang Seng China Enterprises Index rose by 35%, 41% and 152%, respectively. Given the upbeat market sentiment, the Fund increased the proportion of its portfolio in listed stock investments, which contributed to the Fund's profit US\$0.877 million for the year. At the end of 2003, the Fund held listed shares valued at US\$1.43 million.

# Investment Manager's Discussion and Analysis (continued)

Bank interest rates remained consistently low, and in order to increase the rate of return on cash, the Fund expanded its holdings of bank notes and corporate bonds to US\$4.35 million. Details are listed below:

Issuer	Business Nature	Investment Amount (US\$ million)	Net Book Value (US\$ million)	Coupon	Yield to Maturity	Date of Maturity
<b>Corporate Bonds:</b>						
China Mobile (HK) Limited	Mobile communications and related service in PRC	1.090	1.040	7.875%	2.902%	2 November 2004
China Insurance International Holdings (BVI) Limited	Insurance Business	0.695	0.695	5.800%	5.887%	12 November 2013
Hutchison Whampoa International Limited	Property development and investment, ports and related service, telecommunication and hospitality business	1.004	1.004	6.250%	6.193%	24 January 2014
<b>Bank Notes:</b>						
Hang Seng Bank Certificates of Deposit		0.644	0.644	3.750%	3.750%	20 December 2004
Lloyds TSB Bank LIBOR Structured Note		1.000	0.969	13.700%	Note	—
				whole period		
		<b>4.433</b>	<b>4.352</b>			

Note: Coupon rate for the first year : 10.5%  
 Subsequent coupon rate : 10% – (2 x 6-month LIBOR )  
 The Note will automatically be redeemed at par when accumulated coupon rates reach 13.7%, or on 20 August 2013, whichever is the earlier.

## PROSPECTS

After experiencing several years of economic adjustment, the global economy moved towards recovery in 2003. The continuous growth of China's economy has drawn the attention of the world, and China's economy will likely continue to grow at a stable and fast pace of about 7% this year. In light of the favorable conditions brought about by CEPA and China's entry into the WTO, the Fund will continue to increase the value of its existing investments, and to search for the best new investment opportunities in a growing market.

**Zhou Linda L.**

*Managing Director*

**China Merchants China Investment Management Limited**

Hong Kong, 22 April 2004

# Investment Manager's Discussion and Analysis (continued)

## Directors of the Investment Manager



*front row from left: Dr. Huang Dazhan, Ms. Kan Ka Yee, Elizabeth and Ms. Zhou Linda L.;  
rear row from left: Mr. Wu Hui Feng, Mr. Lee York Wo and Mr. Tse Yue Kit*