

BUSINESS REVIEW AND PROSPECTS

Business Review

The Group's major businesses include research and development, and manufacturing and sales of HDDs and HDD related products, PCs and PC peripheral products, and products and services relating to software and system integration, as well as broadband network services and other telecommunications value-added services. These businesses were mainly conducted by the Company's subsidiaries and associated companies.

HDDs and HDD Related Products

Kaifa is one of the world's largest manufacturers, and the world's second largest supplier, of magnetic heads. During the Period, Kaifa's core businesses recorded an income of RMB3,174,276,879.01, representing a decrease of 15.87% from the corresponding period last year. Nevertheless, it recorded a net profit of RMB79,850,748.23, representing an increase of 11.73% over the corresponding period last year. There was an increase in profit despite the decrease in sales income. This is because while the market demand for HDD heads, a major product of Kaifa, has decreased compared with the corresponding period last year, Kaifa adopted advanced management measures that significantly reduced its various kinds of costs and expenses. Confronted by the volatile international HDD market, Kaifa has been actively responding to the pressure exerted on its operation by such market changes, and at the same time working hard to accelerate the creation of new sectors of profit growth with its non-core products and new products. In early 2004, Shenzhen Kaifa Optical & Magnetic Components Company Limited came into independent operation, which was highly significant to its business division-centered management model implemented in 2004. On 23 June 2004, Kaifa entered into a contract with three companies, including Payton Technology Corporation of the United States of America, to establish a joint venture company named "Shenzhen Payton Technology Co. Ltd.". The joint venture will have a total investment of US\$280,000,000 which include the registered capital of US\$100,000,000, 40% of which will be attributable to Kaifa. By investing in the joint venture, Kaifa will expand its business to include semi-conductor packaging and testing services. The successful establishment of the joint venture will enable Kaifa to pursue technologically-advanced, sophisticated and precise operations and products.

Kaifa Magnetics possesses the largest and most comprehensive substrates manufacturing base in China, enjoying a 20% global market share with its supply of substrates. During the first half of the year, substrates, being its major product, continued to maintain a strong growth momentum. The net profit was RMB52,775,977.37, representing an increase of 8.21% compared with the corresponding period last year. During the Period, Kaifa Magnetics completed the renovation of its polishing and cleaning workshop, and the installation and configuration of machines and equipment. As a result, the new workshop reached a purity of 100. After the new workshop commenced operation, product sanity was greatly enhanced to better satisfy customers' demand. In terms of management, Kaifa Magnetics continued its efforts to achieve better efficiency by implementing cost control measures, opening up new income streams, increasing the use of Chinese manufactured equipment and materials, streamlining its structure and personnel management. Meanwhile, Kaifa Magnetics also continued to strengthen its research and development of its next generation of products with a view to staying ahead of intense market competition.

ExcelStor Technology is the only company capable of designing and mass-producing HDDs in China. Its Jupiter HDD series and Gemini HDD series, which ExcelStor Technology developed on its own, filled the vacuum of such products in China. It possesses more than 70 patents in HDD mobile application technology, some of which are of leading international standards. By producing HDDs in collaboration with IBM of the United States of America and Hitachi, ExcelStor Technology further improved the quality of its products and strengthened its competitiveness, thereby establishing its own brand image. During the Period, the income from major businesses was RMB1,138,256,561.92, representing a decrease of 21% from the corresponding period last year. The decrease was mainly attributable to price fluctuations in the HDD market. ExcelStor Technology insisted on diversified development. Apart from the manufacture and sales of HDDs of its own design, it also cooperated with other major international corporations (such as Hitachi, IBM, Iomega and Exabyte) by becoming their OEM manufacturer. At the Global Suppliers' Conference 2004 (2004年度全球供應商大會) organized by Hitachi Global Storage Technology Company, ExcelStor Technology was awarded the "Hitachi Manufacturing Partner Award" (日立生產合作夥伴獎) for its high quality HDD processing services.

PCs and PC Peripheral Products

The first half of 2004 witnessed some major developments of CGC. Following the adjustments and reforms of the last two years, the performance of CGC's main businesses improved significantly during the first half of the year. The sales of major products such as PCs, power supply and monitors recorded growths of various degrees. In particular, the sales of monitors increased by 80.27% compared with the corresponding period last year. During the Period, the income from CGC's main businesses was RMB870,823,590.69, representing an increase of 37.8% over the corresponding period last year. The net profit was RMB170,857,035.85, representing an increase of 169.57% over the corresponding period last year.

Pursuant to its strategy of establishing presence in the field of high definition digital display, CGC successfully launched a number of advanced products which included the fully digital high definition all-in-one television display series, the high definition television, notebook computers with superior three dimensional display capabilities and digital projectors. With its superior brand name and the implementation of channel adjusted sales, CGC, as a highly competitive Chinese brand name coupled with the mainstream price range, has further expanded its product line. Three self-developed broadband switches (GES-4108BF switch V3.5, GES-4108BF V7.0 and GES-3125 24+1 port smart switch) successfully passed the Certification Test on Network Access of Telecommunications Products (電信產品入網檢測) conducted by the Ministry of Information Technology, and was awarded the Network Access Licence for Telecommunications Device (電信設備進網許可証) by the Ministry of Information Technology. The award of such licence is of great significance to the future promotion of our products, and at the same time indicates that we have reached an advanced level in the product quality management of communication products.

Software Services and System Solutions

During the Period, GWCSS recorded an operating income of RMB149,905,070.63, representing an increase of 76.59% over the corresponding period last year. In 2004, GWCSS refined its earnings model, engaged experts to carry out the overall planning of the various divisions' operations, established product development teams, set a clear annual product target and strengthened project-based budget management. Through sustained effort, GWCSS was named the "IBM (China) Supplier of Core Technology Services" (IBM (中國) 核心技術服務供應商) by IBM. GWCSS will begin to provide high quality technology services to IBM China Software Development Laboratory (IBM (中國) 軟件發展實驗室) and IBM China Solutions and Services Company (IBM (中國) 方案與服務公司), which are two global resources divisions of IBM.

Broadband Network

During the first half of the year, GWBNS recorded an operating income of RMB1 19,353,336.83, representing an increase of 14% over the corresponding period last year. As at 30 June 2004, there were in total 2,500,000 broadband network users, representing an increase of 24% over the corresponding period last year. GWBNS is principally engaged in the broadband business, and has strived to achieve “scale and efficiency at equal pace” with its network resources. While it will strive to improve its financial performance maintaining the current growth speed of its market share, and provide customer with high quality network services. At the same time, it will gradually increase the investment in key regions, distinguish itself in value-added services, and minimize network costs in order to achieve the objective of creating value for its shareholders.

Management and Technology

During the Period, the Group continued its efforts to reform and perfect the management system by introducing advanced international management models, resulting in evident enhancement of the Group’s overall economic efficiency.

By further implementing and promoting the 6SIGMA management initiatives, Kaifa successfully improved its production efficiency and reduced the waste of materials and unnecessary consumption. It also implemented the “Vendor Management Inventory (VMI)” system, thus further lowered logistics costs.

Following the ISO9001 and ISO14001 certifications, ExcelStor Technology began to make preparations for the OSHA 18001 occupational safety and hygiene administration system certification earlier this year. In early March, professional instructors from SGS (Societe Generale de Surveillance) were invited to provide training for “OHSAS 18001” internal verification personnel.

During the first half of the year, CGC continued to adopt a monthly budget approval system for its business division, as well as new quarterly budget approval measures for its functional divisions. It has redefined the examination and approval procedures for expenditure application and disbursement. A tender management committee was also formed to oversee tender matters. The implementation of such management initiatives has yielded remarkable results: While the sales income rose by 3 7.8% during the first half of the year, the mother company’s operation expenses and management expenses dropped by 11.4% and 53.1% respectively.

In order to strengthen the company's competitiveness and establish a scientific and standardized software development management system consistent with the standard of the international software market, GWCSS carried out the CMM (Capability Maturity Model for Software) evaluation.

Outlook for the Second Half of 2004

During the first half of 2004, the Group continued to maintain a strong growth momentum. In particular, the HDD heads business, substrates business and PC business, achieved excellent performance. In the second half of the year, the Group is expected to maintain steady economic growth by adopting measures in response to the respective characteristics of different businesses and market demand.

In respect of HDDs and HDD related products, Kaifa will further optimize its product mix and speed up the production of next generation of magnetic heads. At the same time, it will actively develop semi-conductor installment and testing services, photomagnetic parts products and micro-electronic products. Kaifa will further enhance its profitability by fully capitalizing on its competitiveness in the international market and the field of hi-tech manufacturing.

ExcelStor Technology will continue its healthy and rapid development by actively developing new products, forming strategic alliances with suppliers of major products (such as magnetic heads, disks, motors and chips), accelerating the integration of its resources and developing applications in consumer electronics market.

In the first half of the year, Kaifa Magnetics achieved a significant improvement in performance. In the second half of the year, it will strengthen its research on products with higher memory density. It will also carry out reforms in skills and technology, as well as increase the use of domestically manufactured materials in order to reduce costs and enhance the company's capability for sustainable development.

As for PC businesses, CGC will expand its operation around its desktop computer and desktop computer parts businesses. Apart from consolidating and developing the current markets and scale, it will also actively participate in the mobile and wireless application businesses, the Internet and broadband businesses, and the digital television business, which will gradually become the emphasis of its business development and profit center in the future. CGC will attach importance to the development of notebook computers in order to capture the opportunity created by the emerging notebook computer market in China, making notebook computers one of its new core businesses.

In respect of software and system integration, GWCSS will standardize its technology systems and management measures by extracting common platforms or modules in order to reduce development costs. It will actively explore new businesses and develop information security products with their own intellectual property rights, while paying close attention to the applications to current businesses and endeavouring to secure core application of its products.

As for broadband network, GWBNS has positioned itself as a provider of "broadband communication services plus user-oriented IT services", further consolidating its core competitiveness. It will also seek cooperation opportunities to explore online value-added services (such as network video, games and broadband network telephone), so that the value of its value-added business will increase in a sustainable manner, which will in turn accelerate the development of its main businesses.

In sum, in the second half of the year, the Group will continue to optimize its product mix and develop new products and projects based on the market trend. It will also continue to adopt advanced management models to enhance its overall operational efficiency, so that the Group's businesses will develop at a steady and rapid pace and will bring long-term and steady return to shareholders.

Investment

On 23 June 2004, Kaifa, a 55.96% owned subsidiary of the Company, entered into a joint venture agreement with Payton Technology Corporation, Tu Shenzhen LLC and Sun Shenzhen LLC to establish a joint venture company named "Shenzhen Payton Technology Co. Ltd.". The business scope of the joint venture company will be the development, production and processing in specific materials for semi-conductor and their components, large-scale integrated circuits (below 0.35 micron), advanced electronic parts and their components, and advanced instruments assemblies and their components. The total investment of the joint venture is US\$280,000,000, which includes the registered capital of the joint venture company of US\$100,000,000. Kaifa will hold 40% of the interest in the joint venture company, with US\$40,000,000 in the registered capital of the joint venture company attributable to Kaifa. Each of Payton Technology Corporation, Tu Shenzhen LLC and Sun Shenzhen LLC will hold 20% interest in joint venture company respectively. For details of the joint venture, please refer to the published version of the announcement in China Daily dated 30 June 2004 and the circular sent to shareholders dated 21 July 2004.

FINANCE ASSISTANCE AND GUARANTEE GIVEN TO ASSOCIATES

As at 30 June 2004, the aggregate amount of advances made by the Group to its associates was approximately RMB931,179,000. The balance arose out of the Group's ordinary course of business. All the advances have no fixed repayment terms.

As at 30 June 2004, the total guarantees given by the Group to banks in respect of banking facilities granted to its associates amounted to approximately RMB480,000,000.

The proforma combined balance sheet of such associates as at 30 June 2004, which includes the assets and liabilities of Great Wall Broadband Network Service Co., Ltd., International Information Products (Shenzhen) Co., Ltd., Shenzhen GKI Electronics Co., Ltd., Excelstor Group Ltd., O-Net Communications (Shenzhen) Limited, O-Net Integrated Technology (SZ) Ltd. and SZ O-Net Crystal Ltd., is as follows:

	RMB'000
Non-current assets	<u>1,974,534</u>
Current assets	13,018,234
Current liabilities	<u>(11,984,864)</u>
Net current assets	<u>1,033,370</u>
Non-current liabilities	<u>(28,525)</u>
The Shareholders' funds	<u>2,979,379</u>
Group's attributable interest	<u>617,010</u>

EMPLOYEES

As at 30 June 2004 the Group had approximately 10,000 employees (also 10,000 employees as at 31 December 2003). The Group's employees were remunerated, compensated and granted incentive policies according to their positions in and contributions to the relevant companies within the Group.

INTERIM DIVIDEND

The Board does not recommend payment of any interim dividend for the Period.