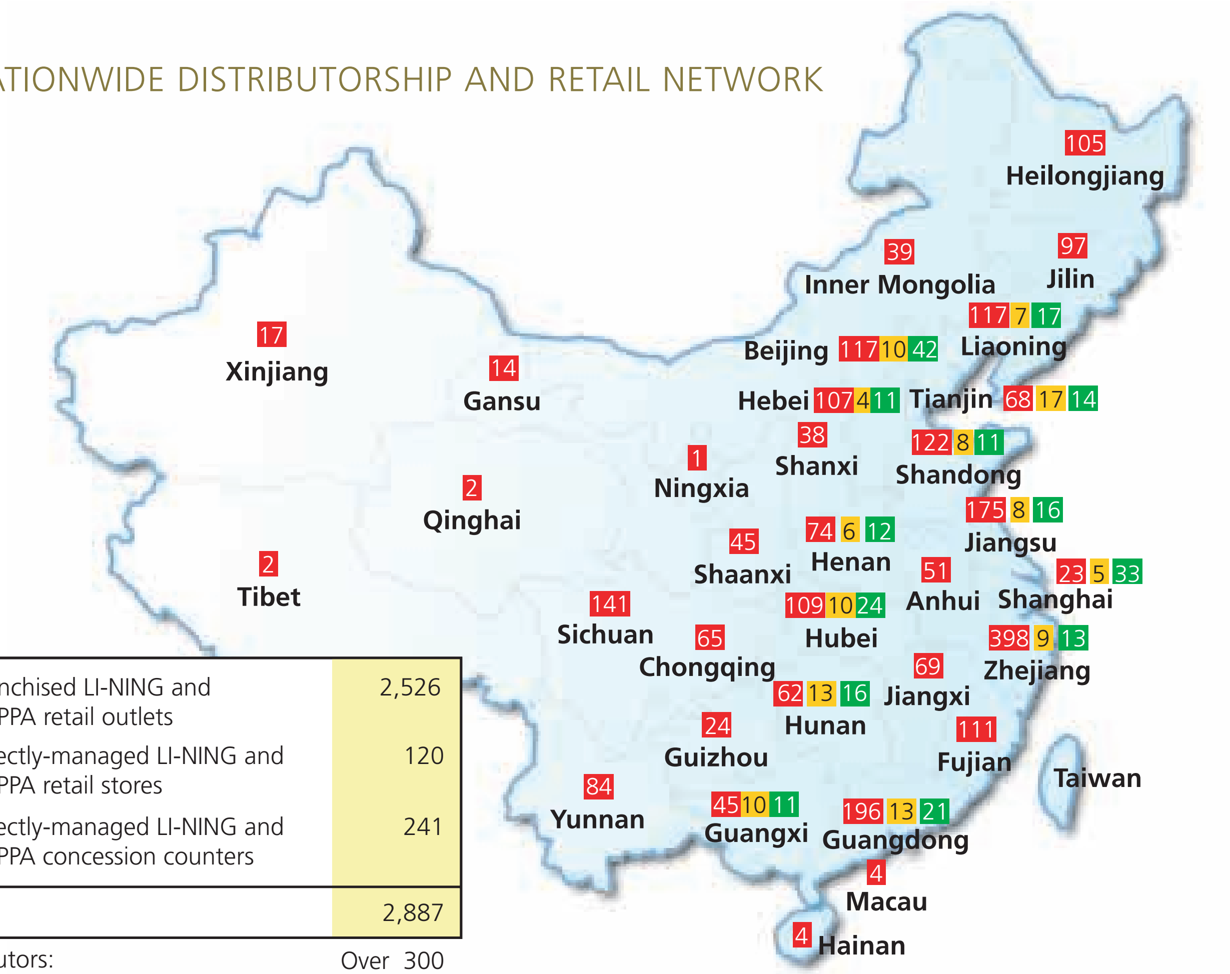
Sustainable, Fast-Growing **Business Opportunities in China**

BUSINESS OVERVIEW

The Group is one of the leading sports brand enterprises in the People's Republic of China ("PRC"). We have our own branding, product research and design, supply chain management, marketing, distribution and retail capabilities.

- Our products include sports footwear, apparel and accessories for sports and leisure use.
- Our products are primarily sold under the LI-NING brand, which is owned by us, and the KAPPA brand, which is exclusively licensed to us for use in the PRC and Macau.
- We have established an extensive distributorship and retail network with dedicated point of sales covering the PRC market. We sell products to our distributors who operate franchised LI-NING and KAPPA retail outlets under our supervision. We also operate our own LI-NING and KAPPA retail stores and concession counters.
- Internationally, we focus our sales of LI-NING branded products in Spain and Russia through our overseas distributors.
- We implement the supply chain management of our products by outsourcing production of the majority of our products to independent contract manufacturers in the PRC. We manufacture only a small portion of our apparel products.

NATIONWIDE DISTRIBUTORSHIP AND RETAIL NETWORK



Franchised LI-NING and KAPPA retail outlets	2,526
Directly-managed LI-NING and KAPPA retail stores	120
Directly-managed LI-NING and KAPPA concession counters	241
Total	2,887
Distributors:	Over 300

Management Discussion and Analysis

FINANCIAL REVIEW

Financial highlights

The overall results of the Group for the year ended 31 December 2004 were encouraging, with key performance indicators set out as follows:

	Year ended 31 December		Year-on-year
	2004	2003	**change**
	RMB'000	RMB'000	**(%)**
Profit and loss items (audited)			
Turnover	**1,878,102**	1,276,224	47.2
Gross profit	**873,524**	605,919	44.2
Operating profit	**191,443**	119,109	60.7
Profit after taxation	**134,778**	92,534	45.7
Net profit	**133,439**	93,960	42.0
Basic earnings per share (RMB cents) *(Note 1)*	**15.02**	12.53	19.9
Selected financial ratios (audited)			
Gross profit margin (%)	**46.5**	47.5	
Operating profit margin (%)	**10.2**	9.3	
Net profit margin (%)	**7.1**	7.4	
Effective tax rate (%)	**29.9**	19.2	
Return on shareholders' equity (%)	**19.1**	31.1	
Debt/equity ratio	**0.45**	0.93	
Average inventory turnover (days) *(Note 2)*	**112**	143	
Average accounts receivable turnover (days) *(Note 3)*	**33**	29	
Average trade payables turnover (days) *(Note 4)*	**77**	75	

Notes:

1. The calculation of basic earnings per share of the Company is based on the net profit of RMB133,439,000 for the year ended 31 December 2004 (2003: RMB93,960,000) and the weighted average number of 888,392,000 shares (2003: 750,000,000 shares) in issue in the year.
2. The calculation of average inventory turnover (days) is based on the average of opening and closing inventory balance divided by the cost of sales and multiplied by 365 days.
3. The calculation of average accounts receivable turnover (days) is based on the average of opening and closing balance for accounts receivable divided by the turnover and multiplied by 365 days.
4. The calculation of average trade payables turnover (days) is based on the average of opening and closing balance for trade payables divided by the total purchases and multiplied by 365 days.

Turnover

For the year ended 31 December 2004, turnover reached RMB1,878,102,000, representing a remarkable increase of 47.2% against 2003. Turnover growth was driven by the expansion of our sales channels and range of products, as well as our increased advertising and promotional efforts. Moreover, the Severe Acute Respiratory Syndrome ("SARS"), which broke out in China during Spring 2003, had no material impact on the Group's long term sales growth pattern.

Breakdown of turnover by product category

	Year ended 31 December				
	2004		2003		**Year-on-year**
		% of total		% of total	**change**
	RMB'000	**turnover**	RMB'000	turnover	**(%)**
Footwear	**562,889**	**30.0**	443,811	34.8	26.8
Apparel	**1,083,130**	**57.7**	658,649	51.6	64.4
Accessories	**232,083**	**12.3**	173,764	13.6	33.6
Total	**1,878,102**	**100.0**	1,276,224	100.0	47.2

For the year ended 31 December 2004, the Group recorded an overall increase in sales for all product categories compared to 2003. This growth was driven predominantly by the continual growth of the LI-NING brand, including the Group's successful introduction of a wide range of new products. Sales of apparel grew rapidly with a 64.4% increase compared to last year, boosted by the availability of a wide variety of newly designed apparel goods. Sales of accessories also achieved growth of 33.6%, and sales of footwear recorded an increase of 26.8% compared to 2003, respectively.

Management Discussion and Analysis

Breakdown of turnover by brand

	Year ended 31 December				
	2004		2003		**Year-on-year**
		% of total		% of total	**change**
	RMB'000	**turnover**	RMB'000	turnover	**(%)**
LI-NING	**1,772,559**	**94.4**	1,236,166	96.9	43.4
KAPPA	**105,543**	**5.6**	40,058	3.1	163.5
Total	**1,878,102**	**100.0**	1,276,224	100.0	47.2

For the year ended 31 December 2004, sales of LI-NING brand products grew by 43.4% compared to 2003, boosted by the rapid growth of its sales channels and a wider range of new products. Sales of KAPPA brand products recorded an increase of 163.5% in turnover.

Percentage of turnover by sales channel

	Year ended 31 December	
	2004	2003
	% of total	% of total
	turnover	turnover
PRC market		
Distributor sales	**75.0**	78.0
Concession sales	**12.0**	10.3
Retail store sales	**10.6**	8.8
International markets	**2.4**	2.9
Total	**100.0**	100.0

Percentage of turnover by geographical region

		Year ended 31 December	
		2004	2003
		% of total	% of total
	Notes	**turnover**	turnover
LI-NING brand			
PRC market			
Beijing and Shanghai		**9.9**	7.8
Central region	*1*	**12.4**	12.9
Eastern region	*2*	**21.9**	20.6
Southern region	*3*	**11.0**	11.9
Southwestern region	*4*	**8.2**	9.6
Northern region	*5*	**13.8**	15.2
Northeastern region	*6*	**12.5**	13.2
Northwestern region	*7*	**2.3**	2.8
International markets		**2.4**	2.9
KAPPA brand			
PRC market		**5.6**	3.1
Total		**100.0**	100.0

Notes:

1. Central region includes Hubei, Hunan and Jiangxi.

2. Eastern region includes Zhejiang, Jiangsu and Anhui.

3. Southern region includes Guangdong, Guangxi, Fujian and Hainan.

4. Southwestern region includes Sichuan, Chongqing, Guizhou, Yunnan and Tibet.

5. Northern region includes Shandong, Hebei, Henan, Tianjin, Shanxi and Inner Mongolia.

6. Northeastern region includes Liaoning, Jilin and Heilongjiang.

7. Northwestern region includes Shaanxi, Xinjiang, Gansu, Qinghai and Ningxia.

Management Discussion and Analysis

Cost of sales and gross profit

For the year ended 31 December 2004, the Group's cost of sales was approximately RMB1,004,578,000 (2003: RMB670,305,000). The overall gross profit margin for 2004 was 46.5%, a decrease of 1.0% as compared with 2003 which was caused by the increase in investment in product research and development. In general, gross profit margin was maintained at a relatively stable level. The Group's gross profit margin for footwear, apparel and accessories for 2004 stood at approximately 43.7%, 47.5% and 48.7% respectively.

Distribution and administrative expenses

For the year ended 31 December 2004, the Group's distribution expenses amounted to approximately RMB545,985,000 (2003: RMB335,717,000). Our distribution expenses mainly include advertising and promotional expenditures, salaries and benefits for sales staff, retail store rental and renovation expenses, sponsorship and other marketing-related expenses. Distribution expenses as a percentage of the total turnover increased to 29.1% from 26.3% in 2003, due mainly to the increase in the number of sales staff, new openings of directly managed retail outlets, additional overhead costs for newly-opened retail outlets, as well as increased spending on marketing and promotional expenses for brand building.

For the year ended 31 December 2004, the Group's administrative expenses were approximately RMB168,658,000 (2003: RMB121,049,000). Administrative expenses mainly include staff costs, office rental expenses, depreciation charges relating to office premises and other general expenses. Administrative expenses decreased to 9.0% of the total turnover from 9.5% in 2003. The enhanced economies of scale enabled the Group to manage administrative expenses more effectively. As management efficiency increased, administrative expenses increased only by 39.3%, which was far below the 47.2% growth in sales revenues.

Other operating income/(expenses)

For the year ended 31 December 2004, the Group's other operating income was approximately RMB15,163,000 (2003: expenses of RMB38,190,000). The breakdown of other expenses is set out below:

	Year ended 31 December				
	2004		2003		**Year-on-year**
		% of total		% of total	**change**
	RMB'000	**(%)**	RMB'000	(%)	**(%)**
(Write-back of provision)/ provision for doubtful debts	**(7,030)**	**46.4**	14,894	39.0	(147.2)
(Write-back of provision)/ provision for obsolete and slow-moving inventories	**(5,201)**	**34.3**	11,873	31.1	(143.8)
Others	**(2,932)**	**19.3**	11,423	29.9	(125.7)
Total	**(15,163)**	**100.0**	38,190	100.0	(139.7)

Other operating income/(expenses) primarily included the write back of provision for doubtful debts and the write back of provision for obsolete and slow-moving inventories, impairment charges, loss on disposal of property, plant and machinery and other operating expenses.

Finance costs and taxation

For the year ended 31 December 2004, finance costs decreased to a net income of RMB821,000 from an expense of RMB4,546,000 recorded in 2003. Such decrease was mainly due to (i) our reduced level and better usage efficiency in bank borrowings; (ii) interest income from funds raised from the initial public offering; and (iii) gain on foreign exchange.

For the year ended 31 December 2004, taxation charge was approximately RMB57,486,000 (2003: RMB22,029,000). Our effective tax rate was approximately 29.9% for the year ended 31 December 2004 compared to 19.2% in 2003.

Net profit

For the year ended 31 December 2004, the Group recorded a net profit of RMB133,439,000, an increase of 42.0% compared to 2003. Although operating profit margin increased from 9.3% to 10.2%, the net profit margin was slightly lower than that in 2003 owing to the increase in the effective tax rate. During the year, net profit margin was approximately 7.1%, compared to 7.4% in 2003. The growth in net profit was mainly attributable to: (i) the Group's business growth driven by the expansion of sales channels and product variety, increased effectiveness of our advertising and promotional efforts and the fading adverse impact of SARS, which broke out in China during Spring 2003; (ii) better economies of scale resulting in lowering of operating expenses; and (iii) effective cost and expense control.

Provision for inventories

Inventories of the Group are stated at the lower of cost and net realizable value. Provision on the difference will be made by the Company, if the net realizable value of inventories is below the cost.

As at 31 December 2004, the accumulated provision for inventories amounted to approximately RMB10,228,000, as compared to the accumulated provision for inventories amounting to approximately RMB15,429,000 as at 31 December 2003.

Management Discussion and Analysis

Provision for doubtful debts

The policy for the provision for doubtful debts adopted by the Group remained unchanged from the year 2003.

The accumulated provision for doubtful debts was approximately RMB10,020,000 as at 31 December 2004, as compared to the accumulated provision for doubtful debts amounting to approximately RMB17,050,000 as at 31 December 2003.

BUSINESS REVIEW

The Group's businesses were established in 1989. In June 2004, the Company, following years of rapid expansion, was successfully listed on the Main Board of the Hong Kong Stock Exchange and became a constituent stock of the Hang Seng Composite Index Series and the Hang Seng Free Float Index Series in January 2005, which was an important milestone in recognition of the Group's leading market position, its business and financial strengths.

During the year ended 31 December 2004, we have continued to focus on our growth strategies by (i) reinforcing our sales channels and distribution infrastructure; (ii) upgrading our product design and development capabilities; (iii) strengthening customers' brand awareness and loyalty to our products; and (iv) enhancing our supply chain management for faster response and better efficiency.

Distribution and retail network

We have established an extensive distributorship and retail network with dedicated point of sales throughout the entire PRC market. The Group adopted a diversified retail mode comprising franchised retail outlets and self-operated retail stores and concession counters. During the year, the Group continued to pursue the strategy of expanding its domestic sales channels. As at 31 December 2004, the Group's domestic distribution and retail network consisted of:

- over 300 distributors operating 2,526 franchised retail outlets for the LI-NING and KAPPA brands all over the PRC; and
- a total of 120 directly-managed retail outlets and 241 concession counters in Beijing, Shanghai and in 11 provinces in the PRC.

Number of franchised and directly-managed outlets:

(Number)	As at 31 December 2004	2003	Change (%)
LI-NING brand			
Franchised retail outlets	**2,272**	1,722	31.9
Directly-managed retail stores	**117**	87	34.5
Directly-managed concession counters	**233**	176	32.4
Total	**2,622**	1,985	32.1
KAPPA brand			
Franchised retail outlets	**254**	144	76.4
Directly-managed retail stores	**3**	3	0.0
Directly-managed concession counters	**8**	13	(38.5)
Total	**265**	160	65.6
Overall			
Franchised retail outlets	**2,526**	1,866	35.4
Directly-managed retail stores	**120**	90	33.3
Directly-managed concession counters	**241**	189	27.5
Total	**2,887**	2,145	34.6

During the year, there was a net increase of 742 new outlets, representing a 34.6% growth over 2003, bringing the total to 2,887 outlets. Most significantly, new flagship stores were opened at prime locations in large cities with larger store space and modern store format and decoration, in order to enhance our brand image and identity. In particular, the 200 sq.m. flagship store in Middle Huaihai Road in Shanghai and the 620 sq.m. flagship store in Wangfujing in Beijing were opened in May and June 2004 respectively.

Management Discussion and Analysis

Supply chain management

The Group has implemented a unified supply chain management system for all franchised and self-operated retail outlets, centralising all systems for procurement, inventory and logistics. During the year, the Group achieved better efficiency and faster response to market changes through effective supply chain management, as specifically described below:

- the Group expedited its pace of product development and order cycle by organising major sales events and special order fairs for our distributors in the PRC three times a year;
- the Group shortened its average inventory turnover to 112 days from 143 days in 2003 by improving inventory control and clearance measures;
- the average accounts receivable turnover increased by 4 days to 33 days from 29 days in 2003, which maintained at a healthy level; and
- the average trade payables turnover increased by 2 days to 77 days from 75 days in 2003 so as to fully utilise the credit period granted by suppliers.

Sponsorship, marketing and promotional activities

During the year, the Group, through our LI-NING brand, sponsored the Chinese Olympic delegation to the 2004 Athens Summer Olympic Games, a number of major Chinese national sports teams such as Table Tennis Team, Diving Team, Gymnastic Team and Shooting Team, as well as foreign sports teams such as the Spanish Men's and Women's Basketball Team.

The Group successfully increased the public awareness of its new footwear series such as soccer, basketball, tennis, running and fitness through an effective advertising strategy.

Our new advertising series with the theme "LI-NING. Flying High in China Sports." launched in April 2004 received encouraging response in the PRC. The belief "Everything is Possible" promoted by the Group gained increasing popularity in the PRC. According to a recent internet research conducted by a newspaper in the PRC, LI-NING brand has been selected by the internet users as one of their three favourite brands in the sports wear category.

Product development

During the year, the Group continued to expand its range of sporting products to meet the needs of different sports-related consumer groups.

The Group launched and promoted new specialised footwear series for individual sports categories such as soccer, basketball, tennis, running and fitness. For example, the professional "Tie" series soccer shoes designed for the Chinese soccer star, Li Tie, and the new basketball footwear series have received positive response from the market.

To strengthen our investment in product research and development, in November 2004, the Group set up a new design and R&D centre in Hong Kong, which will focus on establishing the overall design features of LI-NING brand products, initiating concepts and strategies on brand design, improving our technology and concentrating on image design of high-end products. Currently, the centre is in co-operation with institutions and colleges in Hong Kong and overseas including the Department of Sports Science & Physical Education of the Chinese University of Hong Kong.

FINANCIAL CONDITION

Net asset value

As at 31 December 2004, the Group's total net asset value was RMB1,027,225,000 (31 December 2003: RMB404,901,000). Net asset value per share was RMB115.63 cents, as compared to RMB53.99 cents per share in 2003. The increase in net asset value per share was mainly due to the increase in retained profits and the proceeds from the new issue of shares in June 2004.

Liquidity and capital resources

For the year ended 31 December 2004, the Group's net cash flow from operations was RMB134,417,000, which grew by 44.3% compared to that of 2003. The Group ended the year with RMB282,568,000 of net cash (cash and cash equivalents less bank borrowings), representing an increase of RMB143,080,000 over the net cash as at 31 December 2003. Such increase included net proceeds of RMB517,600,000 from the new issue of shares in June 2004 and the exercise of the over-allotment option on 8 July 2004 with net proceeds of RMB75,718,000, less dividend payment of RMB105,772,000, total net capital expenditures of RMB38,625,000 on the purchase of office and production facilities and refurbishment of fixed assets, plus interest received RMB1,356,000, less bank borrowing interest paid of RMB4,369,000 and fixed deposits of RMB437,245,000.

As at 31 December 2004, the Group's cash and cash equivalents were RMB322,568,000 (31 December 2003: RMB224,488,000). Total outstanding borrowings amounted to RMB40,000,000 (31 December 2003: RMB85,000,000). Shareholders' equity amounted to RMB1,010,017,000 (31 December 2003: RMB389,032,000) and the Group was in a net cash position. The debt to equity ratio, expressed as a percentage of total outstanding borrowings over shareholders' equity, was 4.0% (31 December 2003: 21.8%).

Management Discussion and Analysis

As at 31 December 2004, all of the outstanding borrowings were secured by certain bank deposits of the Company and guarantee of a subsidiary of the Group.

As at 31 December 2004, the Group's borrowings were at fixed rates. The Group has not used any interest rate swaps to hedge its exposure to interest rate risk.

Pledge of assets

As at 31 December 2004, the Group had pledged fixed deposits amounting to RMB66,212,000 to secure the bank borrowings in favour of its subsidiaries. As at 31 December 2004, the Group's bank borrowings arising from such fixed pledged deposits amounted to RMB20,000,000.

Contingent liabilities

As at 31 December 2004, the Group had no material contingent liabilities.

Foreign exchange risk

Substantially all of the Group's revenues and operating costs were denominated in RMB. Proceeds from the new issue of shares in June 2004 were received in Hong Kong dollars. As such, the Group did not encounter any significant difficulties arising from, and its operating cashflow or liquidity was not subject to, any exchange rate fluctuations. The Group did not enter into any foreign exchange hedging arrangements during the year ended 31 December 2004.

Use of net proceeds from the new issue

The shares of the Company were successfully listed on the Main Board of the Hong Kong Stock Exchange on 28 June 2004, with a total number of offer shares of 273,038,000 shares (including shares issued as a result of the exercise of the over-allotment option), and the net proceeds from the new issue aggregated to HK$559,101,000. As at 31 December 2004, the net proceeds from the new issue have been utilized as follows:

- approximately HK$32,818,000 for the expansion and improvement of the coverage of distributorship and retail network;
- approximately HK$19,652,000 for brand promotional and marketing activities;
- approximately HK$4,870,000 for establishing our basic product research capabilities, developing new product series and setting up our design and R&D centre in Hong Kong; and
- approximately HK$3,930,000 for improving management information systems and logistics operations.

As disclosed in the Listing Prospectus, the Group will continue to utilize the net proceeds from the new issue to finance our future development plans.

SUBSEQUENT EVENTS

On 15 January 2005, Beijing Li Ning Sporting Goods Co., Ltd, a subsidiary of the Company, entered into a marketing and advertising agreement with NBA Properties, Inc., the marketing and licensing arm of the National Basketball Association ("NBA", a recognized global leader in basketball and sports marketing). Under the agreement, the Group will utilize NBA's extensive marketing and media resources in the PRC market to promote the LI-NING brand, marking another milestone for international co-operation and brand development of the PRC sporting goods industry.

HUMAN RESOURCES

As at 31 December 2004, the Group had approximately 4,402 employees (31 December 2003: 3,131 employees).

In addition to offering basic remuneration packages and discretionary bonuses to employees, share options may also be granted to eligible employees based on the Group's and individual employee's performance. Prior to the Company's listing on the Hong Kong Stock Exchange, the Group granted options to 190 eligible employees to subscribe for 16,219,000 shares in the Company under a pre-IPO share option scheme.

SOCIAL RESPONSIBILITY

Our Company seriously considers our responsibility towards society, actively participates in various social services, to fulfill the responsibility of a good corporate citizen. During the year, we joined and supported charitable community activities in various forms. For instance, we sponsored the Promotional Walk for Beijing-Hong Kong Environmental Protection, which was organised by agencies including the Chinese Environmental Protection Fund, by providing a series of sports products. It was a charitable activity with an aim to promote environmental protection. Our staff members expressed their care and condolence in January 2005 in response to the tsunami of South Asia, by spontaneously organising a donation to help the victimised orphans.

STAFF TRAINING

Our Company always pays attention to the training of our staff members, and acknowledges the upbringing of our talents as a long-term strategy. In 2004, the Li Ning Learning and Development Centre was established to create a new platform for the upbringing of talents in our Company. Within the year we have held 5 orientation camps for new staff members, dozens of training projects of specific capabilities, to advance the skills of our staff at different levels and scopes.

Management Discussion and Analysis

OUTLOOK AND GROWTH STRATEGIES

According to PRC domestic statistics, aggregate retail sales of consumer products recorded a compound annual growth rate of 10.5% from 1995 to 2003, higher than GDP's compound annual growth rate of 9.1%. Per capita GDP and disposable income of urban households exceeded USD1,000 per year in 2003. According to statistics, there is a strong growth in domestic retail consumption, and remarkable change has taken place on the consumption pattern. Consumption on sports, health and entertainment has increased significantly and this pattern will bring attractive growth potentials to the business of the Group.

Moreover, the 2008 Beijing Olympic Games will significantly enhance public awareness of, and interest in, sports and fitness among the general public in the PRC, and thus stimulate the demand for sporting goods. The Group believes that, as a premier national sports brand in the PRC with solid business infrastructure, the Company is set to benefit from these market potentials.

Leveraging on advantages of its current distribution network coverage, the Group will continue to enhance its core competitive edges in product development, brand building and sales and marketing for a fully integrated sporting goods company. Our target is to further enhance such competitive edges by 2008. It is expected that by elevated product development capability, innovative ideas and improved application of proven technology, our products will be further upgraded. We will continue to enhance our unique market positioning with market targeted strategy, by focusing on core consumer group and types of sports with appropriate pricing and leveraging on the varying economic development of the geographical regions in China.

The Group will continue to strengthen its underlying capabilities, such as to reinforce supply chain management to quicken response to market demand and shorten inventory turnover, strengthen retail distribution channels, provide support to our distributors in product display and sales and marketing so as to increase the efficiency and profitability of outlets.

The Group's management strives to create quality sporting goods for consumers, to foster a spirit of satisfaction and dedication for employees and generate greater returns for shareholders and investors by leveraging the Group's competitive edges.