

## 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

As of 31 December 2004, the net assets of China Merchants China Direct Investments Limited and its subsidiaries (the "Fund") were US\$139 million, with a net asset value per share of US\$1.014 – representing a 0.2% increase over year 2003. The Fund recorded a profit attributable to shareholders of US\$1.10 million for the year 2004, representing a decrease of 90.9% from 2003. This decrease resulted largely from a drop in the valuation of China Merchants Bank, whose A Shares declined in price during the year.

Total turnover for the year decreased by 8.1% to US\$2.67 million (2003: US\$2.91 million). Turnover included dividend income from unlisted investments, which decreased 10.9% to US\$1.88 million (2003: US\$2.11 million). Turnover also included interest income, which decreased slightly to US\$0.65 million (2003: US\$0.67 million) due to a lower average deposit balance in 2004 and to declines throughout the year in deposit rates on the Hong Kong dollars in spite of a 1.25% increase in US interest rates since the middle of 2004.

The net unrealised holding gain on unlisted investments for the year was US\$0.16 million (2003: US\$11.89 million), representing a decrease of 98.7% from 2003. This decrease was attributable to a drop in the value of China Merchants Bank, as a result of the decrease of its share price. For listed stocks, both realised and unrealised gains together amounted to US\$0.52 million (2003: US\$0.75 million), in line with market indices.

## MATERIAL ACQUISITIONS OF INVESTMENTS

In September 2004, the Fund entered into an agreement with Yong Cheng Mei Dian (Group) Limited to acquire a 6.8167% stake in China Credit Trust Company, Limited ("CCT") for a consideration of US\$15.31 million. Established in 1995, the core businesses of CCT include trust management, fund management, investments and loan financing. At the end of 2003, total assets and net assets of CCT were RMB2.1 billion and RMB1.863 billion, respectively. The investment is awaiting approval by the China Banking Regulatory Commission ("CBRC").

In the interim report of 2004, the Fund disclosed that it had entered into a conditional agreement to invest in Maytron (BVI) Corporation. Since then, certain conditions in the agreement had not been fulfilled and the Fund decided to terminate the agreement on 19 October 2004.

# Investment Manager's Discussion and Analysis (continued)

## LIQUIDITY, FINANCIAL RESOURCES, GEARING AND CAPITAL COMMITMENTS

Net cash decreased by 9.9%, from US\$37.62 million as of 31 December 2003 to US\$33.88 million as of 31 December 2004, mainly due to a capital injection into an unlisted investment project and to an increase in bond and note investments.

As of 31 December 2004, the Fund had no outstanding bank loans (2003: Nil).

As of 31 December 2004, the Fund had capital commitments of US\$15.31 million (2003: US\$2.54 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 in the near future.

## EMPLOYEES

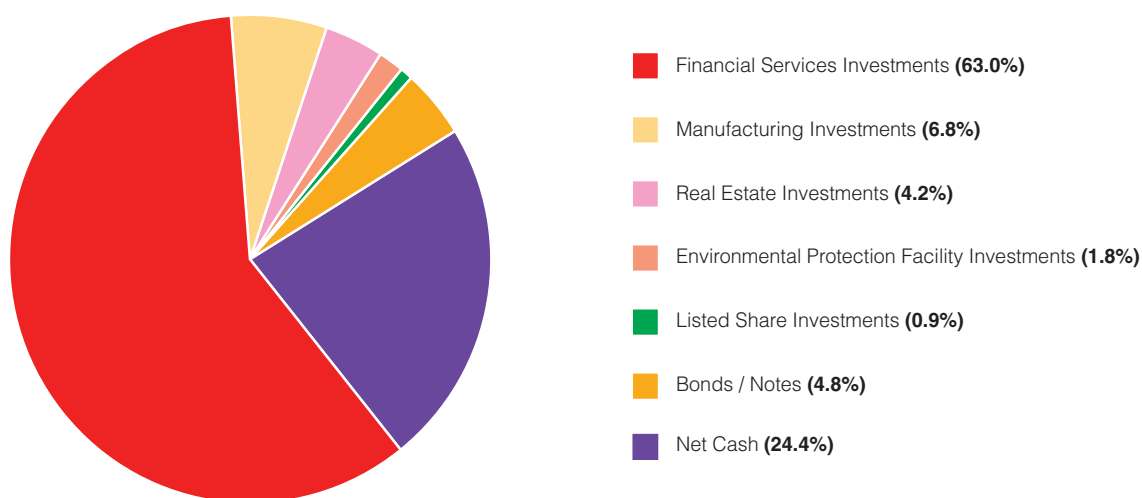
Other than a qualified accountant, the Fund has no employees. The Investment Manager handles the portfolio and day-to-day administration of the Fund.

# Investment Manager's Discussion and Analysis (continued)

## THE PORTFOLIO

As of 31 December 2004, the Fund had total investments of US\$113.41 million – US\$105.51 million in unlisted investments, US\$1.23 million in listed investments, and US\$6.67 million in bonds and notes. The major unlisted investment projects were in financial services (63.0% of net assets), manufacturing (6.8%), real estate (4.2%) and environmental protection facility (1.8%). In addition, the Fund had net cash of US\$33.88 million, accounting for 24.4% of the Fund's net assets.

## NET ASSET DISTRIBUTION *(As at 31 December 2004)*



## 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 2004:

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	54.92	39.50
2. Industrial Bank Co., Ltd.	Fuzhou, Fujian	Banking	26.59	19.12
3. Industrial Securities Co., Ltd.	Fuzhou, Fujian	Securities	0.56	0.41
4. China Merchants Securities Co., Ltd.	Shenzhen, Guangdong	Securities	1.07	0.77
5. Jutian Securities Co., Ltd.	Shenzhen, Guangdong	Securities	2.77	1.99
6. Houlder China Insurance Brokers Ltd.	Shenzhen, Guangdong	Insurance brokerage	0.62	0.45
7. Jutian Fund Management Co., Ltd.	Shenzhen, Guangdong	Fund management	1.03	0.74
<b>Sub-total:</b>			<b>87.56</b>	<b>62.98</b>
<b>Manufacturing:</b>				
8. Zhaoyuan Jinbao Electronics Co., Ltd.	Zhaoyuan, Shandong	Copper foil & laminates	9.48	6.82
<b>Sub-total:</b>			<b>9.48</b>	<b>6.82</b>
<b>Real Estate:</b>				
9. Langfang Oriental Education Facilities Development Co., Ltd.	Langfang, Hebei	Student dormitory	3.90	2.81
10. Shenzhen Man Kam Square	Shenzhen, Guangdong	Retail shops	1.99	1.43
<b>Sub-total:</b>			<b>5.89</b>	<b>4.24</b>
<b>Environmental Protection Facility:</b>				
11. Chenzhou Heshang Environmental Protection Co., Ltd.	Chenzhou, Hunan	Landfill operation	2.54	1.83
<b>Sub-total:</b>			<b>2.54</b>	<b>1.83</b>
<b>Total:</b>			<b>105.47</b>	<b>75.87</b>

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

**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 about 400 branches and offices across the country. The Fund invested US\$14.06 million and currently holds a 1.19% stake in CMB. In November 2004, CMB successfully issued RMB6.5 billion of listed convertible bonds. During the reporting year, upon receiving approvals from CBRC, CMB's branches in Yantai, Shaoxing and Dongguan commenced operations, enhancing its national service network.

CMB sustained rapid growth in 2004, with deposits and loans increasing by 26% and 22%, respectively. Net profit jumped by 41% to RMB3.1 billion. According to the adopted valuation method, CMB's shares were valued at RMB5.56 per share as of 31 December 2004, and the value of the Fund's investment in CMB decreased by US\$2.30 million from the year end value of 2003 as a result of a drop in CMB's share price. The Fund received 2003 dividends of RMB6.26 million in the year.

**Industrial Bank Company, Limited ("IBCL")** is a registered commercial bank in the PRC, with over 260 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 2.1% stake. During the reporting year, IBCL successfully completed the issuance of new shares and increased issued share capital to RMB3,999 million. IBCL also successfully acquired Foshan Commercial Bank, helping to enhance its service network coverage.

For 2004, IBCL recorded a net profit of RMB1.1 billion based on the new accounting standards for financial enterprises – an increase of 12% over the same period of last year. The Fund recorded an unrealised holding gain of US\$2.89 million from its investment in IBCL. To fulfill listing requirements, the shareholders' meeting of IBCL held in November 2004 resolved to amend the bank's Articles of Association and approved other resolutions related to the listing. The Fund received 2003 dividends of RMB9.24 million during 2004.

**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 23 offices in China. The Fund invested RMB8.51 million (equivalent to US\$1.03 million) to acquire a 0.74% stake in ISCL.

ISCL's revenue rose by 20% in 2004, to RMB451 million. However, for the same period, ISCL's net profit decreased by 56% to RMB16.74 million due to a significant increase in provisions for non-performing assets. In addition, as of 31 December 2004, ISCL's net asset value was adjusted down by 5% to RMB631 million. As a result, the fair value of this investment decreased by US\$33,000 for the year. ISCL is still preparing for the issuance of new shares in order to strengthen its balance sheet.



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

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

CMSC closed out 2004 with a net profit of RMB52.08 million – a turnaround from its net loss in the previous year. To satisfy requirements of the China Securities Regulatory Commission ("CSRC") for becoming a test point for product/service innovation ("Innovation Test Company"), CMSC conducted an interim audit review. The audit report indicated that CMSC should make a considerable provision for non-performing assets in 2004, leading to a decrease of 24% in net assets to RMB1.7 billion. Consequently, the fair value of this investment decreased by US\$0.338 million. During the reporting period, CMSC successfully became one of the first-round securities companies approved to be an Innovation Test Company, allowing it to explore a diversified range of business opportunities. CMSC is preparing for the issue of new shares to facilitate its business expansion.

**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. Jutian Securities has 17 offices throughout the country. The Fund invested RMB35.36 million (equivalent to US\$4.27 million) in Jutian Securities, representing an interest of 4.66%. China's stock market was slightly more active in 2004 than in 2003. Nevertheless, the recovery was not sustained due to the difficult market environment. Jutian Securities recorded a small net profit of RMB0.74 million for the year, compared to a loss of RMB39.17 million in the previous year.

**Houlder China Insurance Brokers Limited ("Houlder")**, set up in 2001, is an insurance broker approved by the China Insurance Regulatory Commission. Houlder's businesses include insurance risk assessments, risk management consultation, preparing insurance proposals and handling insurance policy issuance. The Fund invested RMB5 million (equivalent to US\$0.6 million) to acquire an interest of 10%. After several years of business restructuring and development, Houlder recorded a turnover of RMB9 million for 2004, representing an increase of 66% over last year. However, due to an increase in operating costs and a drop in investment income, Houlder recorded a net profit of RMB1.12 million, representing a decrease of 58% from 2003. This year, Houlder will focus on business training, business development and team construction to enhance shareholder value.

**Jutian Fund Management Company Limited ("JFM")**, a fund management company, was approved by the CSRC to register in China with a total investment of RMB100 million. JFM's businesses include fund management and promotion of equity funds. The Fund invested RMB10 million (equivalent to US\$1.21 million) in JFM to acquire an interest of 10%. In March 2004, JFM's first fund, the Jutian Infrastructure Equity Investment Fund, was launched and was well received by the market. As of 31 December 2004, the Jutian Infrastructure Equity Investment Fund had a total of 1.845 billion units subscribed, with a NAV per unit of RMB0.934 and an aggregate NAV of RMB1.723 billion.



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

A promotional outlay was required to be expensed in the year when it occurred, and, consequently, JFM recorded a loss of RMB5.97 million in 2004. The Fund recorded a decrease in the value of this investment of US\$72,000. In order to achieve breakeven as soon as possible, the board of directors of JFM resolved to launch two new funds, one of which is planned to be launched in May 2005. Also, JFM will set up a Beijing office to expand its regional sales service network.

**Zhaoyuan Jinbao Electronics Company Limited ("Jinbao")** is a Sino-foreign equity joint venture set up in 1993 in Shandong, China as a manufacturer of copper-foil and laminates. The Fund owns a 30% interest in Jinbao and has made a cumulative investment of US\$8.12 million. Since the market bottom triggered by the outbreak of SARS in 2003, China's electronics market has recovered steadily and product prices have enjoyed a sustained increase. For the year ended 31 December 2004, Jinbao's turnover and net profit reached RMB562 million and RMB18.34 million, respectively, representing growth of 61% and 113% over the same period last year. Both figures grew remarkably and turnover reached a new high. The Fund's share of net profit was US\$0.66 million. Due to the funding requirements of business expansion, the board of Jinbao resolved that all 2003 and 2004 dividends would be reinvested in the company. The Fund was entitled to a dividend of US\$0.265 million for year 2003.

Construction of the second phase of a high-grade copper foil plant was completed at the end of 2004 and its trial production commenced smoothly. Once this new plant is fully operational, annual production capacity of high-grade copper foil will increase to 5,000 tons from the present level of 2,500 tons, helping to improve the overall product quality, and thus to increase the profitability of Jinbao. The management of Jinbao is studying a reorganization plan to prepare for its listing in the future.

**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 1 dormitories of Oriental University City. Current capacity of the Phase 1 dormitories is about 17,000 students. The average number of residents in 2004 increased by 12% to 13,300. In addition, after recognizing a portion of rental fees that were deferred in 2003, the profit after tax for 2004 increased by 22.9% to RMB9.245 million. The Fund received a 2003 dividend of US\$0.209 million and the repayment of capital through a depreciation distribution of US\$0.73 million. In March 2005, the Fund also received a 2004 dividend of US\$0.251 million. The Chinese partner of the joint-venture had completed its restructuring and its new business license was issued on 21 January 2005. The restructuring has no effect on the investment of the Fund.

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

**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 in Hansen Enterprises Limited ("Hansen") to purchase 5,262 square meters 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. According to the valuation report issued by an independent assessor, as of 31 March 2005, the value of the property decreased by 6% from the same date of 2004 to HK\$48.16 million (equivalent to US\$6.20 million).

**Chenzhou Heshang Environmental Protection Company Limited ("Heshang")** is a Sino-foreign cooperative joint venture formed by the Fund and Shenzhen Harvest Environment Development Company Limited in November 2003. Total investment in the project is RMB70 million. In 2004, the Fund invested US\$2.54 million for an equity stake of 30% of Heshang. Heshang owns the right to construct and operate a landfill for domestic waste in Chenzhou, Hunan Province for 10 years. The designed capacity of the landfill is 3.2 million cubic meters, with a daily waste handling capacity of 500 tons. Construction work first commenced in April of 2004. However, since the government was several months behind schedule in the relocation of current residents, the completion of the construction work, originally planned to conclude at the beginning of this year, will be postponed to December 2005 instead. According to the terms of the concession agreement, the Fund has so far received a fee prepayment of RMB2.04 million.

### REVIEW OF LISTED INVESTMENTS

In 2004, driven by the outstanding performance of foreign trade and retail sales, the Hong Kong economy maintained an upward trend in growth. Although the performance of the stock market fluctuated in the middle of the year because of rising crude oil prices and interest rates, investors gradually regained confidence in Hong Kong stocks as risks of deflation abated. After reinstating the sale of land, the auctioned land prices were repeatedly over market expectation. Stimulated by various favourable factors, the Hang Seng Index climbed to a new high since March 2001. The Index rose 13.2% for the year. However, the performance of the H shares was affected by the mainland's macroeconomic controls and reforms of the capital market, and recorded a 5.6% drop for the year. The Fund recorded a gain of US\$0.66 million from stock investments in 2004. At the end of 2004, the market value of the listed stocks held by the Fund reached US\$1.23 million.

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

As at 31 December 2004, the Fund's holdings in bank notes and corporate bonds amounted to US\$6.67 million (2003: 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 Insurance International Holdings (BVI) Limited	Insurance Business	0.695	0.696	5.800%	5.887%	12 November 2013
Hutchison Whampoa International Limited	Property, ports, telecommunication and hospitality business	1.004	1.004	6.250%	6.193%	24 January 2014
Citic Ka Wah Bank	Banking	0.998	0.998	4.250%	4.290%	17 November 2009
<b>Notes:</b>						
Lloyds TSB Bank LIBOR Structured Note		1.000	0.969	Note 1	—	20 August 2013 if no early redemption
Hang Seng Bank Fixed Rate Callable Deposit		2.000	2.000	Note 2	—	9 December 2008 if not called
Hang Seng Bank Callable Deposit		1.000	1.000	Note 3	—	16 March 2009 if not called
		6.697	6.667			

**Note 1:** Coupon rate for the first year is 10.5% and for subsequent years is 10% - (2 x 6-month LIBOR) per annum. The note will automatically be redeemed at par when accumulative coupon reaches 13.7%, or on 20 August 2013, whichever is the earlier.

**Note 2:** Interest rate for the first, second, third and forth year are 3.55%, 3.85%, 4.15% and 4.45% respectively.

**Note 3:** Interest rate for the first, second, third, forth and fifth year are 3.50%, 4.00%, 4.00%, 3 month LIBOR +4% and 3 month LIBOR +5%, provided that 3 month LIBOR less than 6% for the first three years and 3 month LIBOR less than 7% for the last two years.

### PROSPECTS

China's economy will sustain rapid growth, amid continuous reforms and market openings. It is forecasted that China's GDP will grow at an annual average rate of 8% for the eleventh five-year plan. This will provide a large and growing market for world economic development. This, of course, will also benefit the Fund's investment operations in China. In this favourable environment, we will continue to pursue new investment opportunities. We will also evaluate strategic exit opportunities in order to realise capital gains and to create value for our shareholders.

**Linda L. Zhou**

*Managing Director*

**China Merchants China Investment Management Limited**

Hong Kong, 21 April 2005

### Directors of the Investment Manager



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