
MANAGEMENT

Discussion and Analysis



Management Discussion and Analysis

BUSINESS REVIEW

The financial year ended 31 March 2005 was a remarkable year of financial performance for the Group where the Group's turnover grew an impressive 29% to HK\$2.3 billion and net profit attributable to shareholders surged 67% to HK\$210 million. Below are the highlights of the Group's performance for the year under review:

- Turnover increased 29% to HK\$2.3 billion
- Gross profit increased 10% to HK\$166 million
- Net profit attributable to shareholders increased 67% to HK\$210 million
- Shareholder funds increased 54% to HK\$474 million
- Earnings per share increased 56% to HK 51.9 cents
- Final dividend per share increased 200% to HK 16 cents

As in the previous year, the Group disposed of a significant portion of the Group's investment in Reigncom Limited ("Reigncom"), a company incorporated in the Republic of Korea ("Korea") and listed on the KOSDAQ Stock Exchange, Inc. (the "KOSDAQ"), resulting in a net gain on disposal of investment of HK\$173 million for the year ended 31 March 2005.

Increased market share achieved on the Group's distribution of Samsung Electronic semiconductors and significant growth in the sale of the Group's own-designed and own-brand MP3 products both contributed to increase turnover by 29% to HK\$2.3 billion. Gross profit increased by 10% to HK\$166 million. Higher selling and distribution costs has lowered the net profit from operations by 26% to HK\$37 million.



The management has, throughout the past few years, carefully observed the changing market environment and made corresponding strategic decisions to address different market situations. The Group has full confidence in consistently exploring new profitable business development opportunities as well as strengthening existing operations.

Marketing and Distribution

During the year under review, turnover from the marketing and distribution business recorded growth of 27% reaching HK\$1.9 billion. The business remained as a core revenue contributor accounting for 82% of the Group's total turnover. Profit from the segment fell 26% to HK\$30 million.

AV Concept is one of the largest distributors for Samsung Electronics flash memory products in Hong Kong and the PRC, and Samsung Electronics is the world's largest flash memory product manufacturer. Backed by rising demand and increased market share, the Group's flash memory product sales rose by 63% to HK\$ 593 million. Samsung Electronics competitive pricing strategy kept the prices of flash memory products low, in particular, in the first half of the financial year, to compete for market share. Gross margin of flash memory products sale improved in the second half of the financial year.



Management Discussion and Analysis

BUSINESS REVIEW *(continued)*

Marketing and Distribution *(continued)*

Due to the relatively lower margin of flash memory products, their increased sales have lowered the overall gross profit margin for the segment business. AV Concept flash memory products customers are predominately manufacturers and the Group does not engage in any speculative trading of flash memory products.

During the year under review, other products in the distribution business category also recorded steady growth in sales. LSI products, micro-controller units, LCD driver IC's and power devices IC all achieved improvements in sales with margins maintained.

The Group continued to differentiate itself from competitors in the region by providing also technical design and engineering support to customers. These value-added elements are fundamental to the Group's business practices and crucial to the development of long-term relationships with major customers.

As the Group distributes mainly to customers from the Pearl River Delta region, the region's emergence as one of the world's prominent manufacturing centres for electronic products has presented and will continue to present enormous business opportunities for AV Concept. Increased business volume with existing customers and the rising number of new customers have enabled the Group to maintain healthy business growth. The Group will continue to expand its sales and engineering teams to meet with the growing demand in the region.

In October 2004, the Group moved into its new headquarter office in Kowloon Bay, providing much needed space and improved telecommunication and information technology infrastructure for the Group's businesses.

Design and Manufacture

The design and manufacture business of the Group covers three major operations: electronic manufacturing services ("EMS"), original design manufacture ("ODM") and own brand manufacture ("OBM").

The segment's turnover for the year surged by 42%, reaching HK\$ 409 million, and segment profit decreased by 27% to HK\$ 18 million.



Management Discussion and Analysis

BUSINESS REVIEW *(continued)*

Design and Manufacture *(continued)*

During the year under review, the Group manufactured over 4 million units of MP3 players, a rise of over 70% when compared to previous year, thus making the Group a significant MP3 manufacturer worldwide. Increased EMS MP3 orders, where the Group records the manufacturing fees as turnover for the services provided, accounted for much of the production volume growth. The increase in turnover and gross profit was attributable mainly from the Group's ODM and OBM MP3 products. The Group's products are popular and very successful in a number of markets, including US, Europe and Korea.



As the MP3 market becomes more mature and competition becomes more acute, margins are inevitably squeezed. Tight margins are unlikely to change in the coming year in both EMS and ODM MP3 business as the market is continuously flooded by low priced “me-too” MP3 products. The Group has taken a strategy to maintain gross margin by continuous investment in product design and brand building.



During the year, two of the Group's OBM MP3 products have won three international design awards, being an iF Design Award for 2005 and two Reddot Design Awards for 2005. These awards are prestigious international design awards and the Group is very proud of its product team's achievement in this area.

During the year, the Group set up a design and marketing office in Seoul, Korea, to compliment and support the Hong Kong product design team.

Higher product development and selling and marketing expenses were incurred thus causing the net profit from the segment to fall during the year. The Group recognises that such costs are investments and necessary for the long term success of the Group's manufacture business and the benefit of these expenses are not immediate. The Directors have maintained a pragmatic approach to these expenses.

Investment in Reigncom

During the year, the Group disposed of a substantial portion of its investment in Reigncom shares resulting in a net gain on disposal of investment of HK\$173 million for the year. The Group's interest in Reigncom was reduced to 3.3% after the disposals. As at 31 March 2005, the market value of the Group's remaining interest in Reigncom was approximately HK\$68 million. In May 2005, subsequent to the year end, the remaining Reigncom shares held by the Group were disposed of.

Management Discussion and Analysis

PROSPECTS

Looking ahead, while seeking to consolidate and strengthen its existing business operations, AV Concept will proactively explore other favorable business opportunities. From expanding product portfolio to cover a greater diversity of digital electronics products, to seeking investment opportunities or international co-operations, the Group's endeavors will allow it to achieve the long-term business goal of generating satisfactory returns for shareholders.



The Group will strive to maintain its position as one of the leading semiconductors distributors in Asia distributing Samsung Electronics' products. It will also consider expanding its distribution portfolio when the right opportunities arise. The distribution business will continue to serve as a strong and steady revenue source for the Group, supporting its future business developments.



In April 2005, the Group entered into a cooperative arrangement with its long-term business partner,

BreconRidge Manufacturing Solutions Corporation ("BreconRidge"), a Canadian EMS manufacturer. AV Concept agreed to transfer equity interests in its wholly-owned subsidiary, AV Chaseway Limited ("AV Chaseway") in exchange for certain interests in the common shares of BreconRidge. Leveraging BreconRidge's world-class engineering expertise and prominent client base, the management believes the cooperation will enable the Group to extend its manufacturing scope. BreconRidge's professional and experienced team of industry specialists is also expected to bring valuable technical know-how to the Group, which will in turn enhance the Group's design and manufacturing capabilities. Having a direct interest in a world-class EMS solutions provider will result in more significant returns for AV Concept and its shareholders.

New EMS orders from BreconRidge and other MP3 customers and increased own brand MP3 production has replaced Reigncom EMS MP3 business at the factory since May 2005 as the Group's manufacturing agreement with Reigncom expired.



Management Discussion and Analysis



market. Previously, the Group marketed and distributed its products in Japan under the “SiGN” brand through agent distributors. To fully exploit the immense potential of the Japan market and more effectively cater to the changing tastes of customers there, the Group decided to implement more aggressive promotional strategies and manage the market directly through introducing the new “SIGNEO” brand.

The manufacturing business will continue to be one of the Group’s growth driver. Apart from improving design and quality to meet increasingly sophisticated market demands, the Group will put more resources into brand building. In June 2005, the Group launched its flagship brand – “SIGNEO” – and at the same time established its first office in Japan. The move symbolized the Group’s full-force penetration of the lucrative Japanese digital audio player



Boosting award winning product designs, the Group is motivated to continue refining both the industrial and exterior designs of its products. Given the remarkably positive response from the Japan market, the management believes the OBM business will become one of the Group’s major growth drivers. Riding on the Group’s solid fundamentals and its management’s shrewd visions, the Group will continue to identify potential niche markets and profitable business opportunities with the aim of enhancing long-term shareholders’ value.

Also in June 2005, the Group made a strategic investment in Ness Display, an OLED display module manufacturer. OLED is widely considered to be the next generation of display of choice for digital electronic products. The investment further strengthens the Group’s relationship with Ness Display, whose products are carried by the Group’s distribution business and complements the Group’s Samsung Electronics and Fairchild Semiconductors line of products.

Management Discussion and Analysis

LIQUIDITY AND FINANCIAL RESOURCES

As at 31 March 2005, the Group had cash and bank balances and time deposits of HK\$219 million (2004: HK\$153 million).

The gearing ratio as at 31 March 2005 was 0.28 (2004: 0.35). This is calculated based on the Group's total bank borrowings, net of cash and bank balances and time deposits of HK\$135 million (2004: HK\$106 million), and the Group's net tangible assets of HK\$472 million (2004: HK\$304 million).

In March 2005, the Group entered into a discretionary management agreement appointing UBS to manage a portfolio of HK\$78 million with full authority based on investment guideline agreed by the Group. The scope of the investments comprises a balanced mix of fixed income, equity and alternative investments. The amount represents reserves held for the Group's long term business development and forms an integral part of the Group's treasury.

The management is confident that the Group has adequate financial resources for its business growth and forecast requirement for the coming year.

EMPLOYEES

As at 31 March 2005, the Group employed a total of approximately 2,400 (2004: approximately 1,900) full-time employees.

The Group recruits and promotes individuals based on merit and their development potentials for the positions offered. Remuneration package is determined with reference to their performance and the prevailing salary levels in the market. In addition, the Group operates a share option scheme for eligible employees to provide incentive to the participants for their contribution and continuing efforts to promote the interests of the Group.