

MANAGEMENT DISCUSSION AND ANALYSIS

During the reporting period, the Group realized a turnover of RMB7,186,403,000 and a net profit of RMB310,384,000, representing an increase of RMB2,289,280,000 and an increase of RMB180,863,000 respectively, as compared to the corresponding period last year.

Financial Review

Liquidity and Financial Resources

As at 30 June 2005, the Group's total cash and bank balances amounted to RMB1,709,580,000 (as compared to RMB2,112,029,000 as at 31 December 2004) and the Group's total bank borrowings amounted to RMB752,038,000 (as compared to RMB879,756,000 as at 31 December 2004). The structure of such borrowings were as follows:

- (1) 71.4% was denominated in Renminbi;
- (2) 7.7% was due and repayable within 2 to 5 years; and
- (3) 71.4% was made on fixed interest rates.

Gearing Ratio

As at 30 June 2005, the Group's total bank borrowings and shareholder's equity were RMB752,038,000 and RMB3,558,983,000 respectively, as compared to RMB879,756,000 and RMB3,298,904,000 respectively as at 31 December 2004.

The gearing ratio as at 30 June 2005 was 21.13%. The gearing ratio as at 31 December 2004 was 26.67%. The gearing ratio is defined as the ratio between total borrowings and shareholder's equity.

Current Ratio and Working Capital

As at 30 June 2005, the Group's current assets and current liabilities were RMB7,065,840,000 and RMB4,128,353,000 respectively. As at 30 June 2005, the Group's working capital amounted to RMB2,937,487,000. The current ratio was 1.71.

As at 31 December 2004, the Group's current assets and current liabilities were RMB5,622,800,000 and RMB3,745,615,000 respectively. As at 31 December 2004, the Group's working capital amounted to RMB1,877,185,000. The current ratio was 1.50.

Entrusted Deposit and Overdue Term Deposit

As at 30 June 2005, the Group did not have any entrusted deposit or any term deposit with any financial institution, which was non-recoverable after falling due.

Charge of Group Assets

As at 30 June 2005, the Group had pledged to banks its bank savings of approximately RMB161,425,000 (as compared to RMB281,485,000 as at 31 December 2004) to secure general banking facilities for the Group. As at 30 June 2005, no borrowings were guaranteed by Great Wall Group (this was also the case as at 31 December 2004), the ultimate holding company of the Group.

Exchange Rate Fluctuation

During the reporting period, approximately 82% of the turnover of the Group was received in US dollars. The loans of the Group were mainly raised in Renminbi. Any rise of the exchange rate of the US dollar against the Renminbi will have a positive impact on the Group. Any fall of the exchange rate of the US dollar against the Renminbi will have an adverse impact on the Group.

Disposal

On 21 June 2005, Shenzhen Kaifa Technology Co., Ltd ("Kaifa") entered into shareholding transfer agreements with Tu Shenzhen LLC ("Tu Company") and Sun Shenzhen LLC ("Sun Company") respectively, pursuant to which Kaifa agreed to transfer the 40% equity held by it in 深圳開發貝特科技有限公司 (Shenzhen Kaifa Payton Technology Co. Ltd.) to Tu Company and Sun Company each of which would pay a consideration of US\$20,172,531 and would be assigned 20% equity. For details of this transfer, see the circular dated 14 July 2005.

As at 30 June 2005, the Group accounted for the 40% interest in accordance with HKFRS 5 and accordingly, the interest was classified as asset held for sale.

BUSINESS REVIEW

The Group's business covers various fields, including computer components and the parts, computer manufacturing, software and system integration, broadband networks and value-added services. The Group's computer components and the parts products include magnetic heads, disk substrates, hard disk drives (HDDs), monitors, PCs power supplies and cards. Computer supply products include PCs, notebook computers, servers, ATMs, tax controlling cashing machines, projectors, digital TV sets, and network electric meters. In the field of software and system integration, our products include large information systems oriented to applications for the public security, taxation, industry and commerce, and financial sectors. Regarding broadband network and value-added services, we have set up a broadband network covering 30 large cities in China. The Group is one of the leading providers of diversified information products in the Mainland. Such business was mainly contributed from subsidiaries and associates of the Company.

During the reporting period, the Group maintained a good momentum of growth by focusing on giving further prominence to its principal business and fostering new sources of profit and cash inflow, carrying out a series of adjustments to optimize corporate governance and business structures, strengthening internal management, stepping up technological innovation, optimizing industry and supply chain structures, and extending market network. As a result, the Group recorded a year-on-year growth of 47% and 140% in sales revenue and net profit respectively during the reporting period.

COMPUTER COMPONENTS AND THE PARTS: hard disk drive magnetic heads, hard disk drive substrates, hard disk drives, PCs power supplies, monitors

Hard Disk Drive Magnetic Head

Magnetic heads for hard disk drives are one of the most important components and the parts products of the Group. The product is produced and sold by Kaifa, a subsidiary of the Company. The output of Kaifa occupies 15% of the global OEM market and ranks second among professional drive producers. During the reporting period, the Group continued to expand market share and further cooperation with customers, thus creating advantageous conditions for it to maintain its status in the magnetic drive industry. During the reporting period, Kaifa set the groundwork for sustainable development, expansion of production capacity and scale and technological updating. In particular, the automated magnetic head production line, which was developed in-house by Kaifa, played a significant role in expanding the scale, reducing the cost and enhancing the efficiency of production. Given the Group's capability in technological design and cost control in mass production, the Group is competitively positioned in a competitive market characterized by ever-changing technologies.

Hard Disk Drive Substrates

Substrates for hard disk drives are produced and sold by Kaifa Magnetic, a subsidiary of the Company with a substrate output ranking third and occupying 20% of the worldwide OEM market. During the reporting period, the market demand for substrates increased. The sale revenue recorded a year-on-year increase of 59.6%. During the reporting period, Kaifa Magnetic also continued to make advances in technological research and development ("R&D") relating to the application of Nano-technology for disk substrates surface cleaning, the technological application of friction theory, and vertical recoding technology, paving the way for production scale expansion and technological updating. Kaifa Magnetic continued to improve the technological design of these products and successfully maintained their leading position internationally. During the reporting period, in the face of an everchanging range of products on the market, Kaifa Magnetic focused on product development trends and market opportunities.

Kaifa Magnetic, Marubeni Corporation of Japan and Toyo Kohan Co., Ltd. have agreed to set up a joint venture, 深圳東紅開發磁盤有限公司 (Shenzhen KTM Glass Substrate Co. Ltd), for the production of 2.5" glass disk platters. The preliminary preparation has been completed and the joint venture is gradually entering batch production stage. The project is pivotal to the enhancement of Kaifa Magnetic's product lines and its development towards high-end business.

Hard Disk Drive

The hard disk business of the Group is operated by ExcelStor Technology and ExcelStor Great Wall. ExcelStor Technology is responsible for the production and domestic sale of hard disk drives and for R&D. ExcelStor Great Wall is responsible for overseas R&D and sale of hard disk drives. The Group's output of hard disk drive ranks sixth and occupies 2% of the global market. During the reporting period, sales of hard disk drives amounted to 5.48 million units, representing a year-on-year growth of 80%. ExcelStor Technology has expanded its cooperation with Hitachi and other companies, and is expanding its customer base continuously. In its five-year-plan, Hitachi described ExcelStor Technology as its "principal cooperative partner in the production of 3.5" hard disk drives". Regarding the strengthening of production lines and the expansion of the sales chain, ExcelStor Technology and ExcelStor Great Wall also launched and commenced small-scale production of an encrypted hard disk with enhanced security ("GSTOR Security Cache") after R&D efforts on 2.5" hard disks. The GSTOR Security Cache is a pioneering product in the international context. It won praise from businessmen and industry counterparts when it was exhibited by ExcelStor Technology at the CeBit Exhibition held in Germany from 11 to 17 March 2005, and received nearly 10 media coverage, including Computer World Techannel and Toms Networking. Currently, GSTOR products are exported to Europe in large quantities.

PCs Power Supplies and Monitors

CGC, a subsidiary of the Group, is a renowned PC power supplies manufacturer and a principal supplier of monitors in the China market. Its products are highly regarded in China for their properties and quality. Its power supplies rank first and occupy 25% of the domestic OEM market. During the reporting period, both the production and sales of power supplies and monitors were strong. Sale of monitors amounted to 680,000 sets, representing a year-on-year increase of 15%. The sale of power supplies amounted to 1.88 million sets, representing a year-on-year increase of 21.2%. At the same time, orders flowed continuously from the United States, South Korea, India, the Middle East and Europe. Sales showed growing momentum.

Computer: PCs, notebook computers, servers, network electric meters

PCs, Notebook Computers

Regarding the PC business, the Group is the owner of the well known "Golden Great Wall" brand for desk-top computers and notebook computers. During the reporting period, CGC pursued a "high-end" development strategy and sought to upgrade and transform through cooperation. As at 30 June 2005, CGC earned a profit of RMB76.3 million in its mainline business, representing a year-on-year increase of 50%, thanks to its efforts to gain access to export markets and expand the OEM customer base. During the reporting period, CGC stepped up its R&D efforts in respect of high value-added products, such as security computers, notebooks and servers, and on gaining market access for them. In particular, the Great Wall Security Computer, which was researched and developed in-house by CGC, had successfully passed the tests of the Computer Technology Security Test Center (計算機安全技術檢測中心) of the Ministry of Information Industry of the PRC, and was issued a security system sales permit by the Ministry of Public Security.

Servers

The "Golden Great Wall" brand servers are well-known in China. Since last year, CGC has accelerated its pace of development based on its initiative to emphasize major business and strengthen technological innovation. In May 2005, it launched the Qingtian B9000 series of double-way high-density blade servers based on terabytes-link technology and modular design. The launch of the B9000 series is a sign of CGC's entry into a new era.

During the reporting period, CGC and IBM entered into a formal contract in relation to the establishment of International System Technology Company ("ISTC"), which has commenced production. Its existing products include the X series, the P series (including the Pen Power series) and RSS (Retail Series Solutions). ISTC is also active in R&D, production and manufacture of high-end servers, representing an important step by the Group towards the development of high-end technology products.

Network electric meters

Kaifa is one of the leading producers of the 4th generation smart network electric meters in China. Thanks to its R&D team exploring quality products, an international first-rate production line producing first-class electric and network products, and a strict quality assurance, Kaifa's smart network electric meters have maintained their position at the forefront of the international market. During the reporting period, the sales of smart electric meters amounted to 2,877,000 units, which represented a year-on-year increase of 3,800%. The products were principally exported to Italy and India.

Software and System Integration: Service software and system solutions

Service software and system solutions

GWCSS, the subsidiary of the Group, is qualified as an operator of domestic system integration services and a provider of comprehensive application solutions. Its main business is the provision of major application software, high value-added solutions and comprehensive consultancy services to the Government, financial industry, and social security sector.

During the reporting period, to develop the scale and competitive edge of its software and system integration business, the Company launched a software resources integration programme with GWCSS as the core. This increased the dissemination of GWCSS through an expansion of scale in respect of industry application, system integration, consulting service, software outsourcing and other fields. During the reporting period, by virtue of its technological strengths and industry experience, GWCSS came to the fore amid keen competition, as demonstrated by its successful bids for the first contract (TC045708-1 – infrastructure facilities) and second contract (TC045708-2 – internet application and development) for the platform construction project for enterprise credit monitoring (企業信用監管) of the State Administration for Industry and Commerce. Regarding its software sales agency business, GWCSS entered into a contract with TREND and became the exclusive general agent of TREND's products in the territory of China.

Information Products Design Business

The information products design business is operated by DigiPro, which is a subsidiary of the Group and a sino-foreign joint venture between the Company and Texas Instruments (TI), and principally engaged in digitalized product design services. During the reporting period, the Company recorded revenue of RMB2.2 million from its mainline business, representing an increase of 114% as compared with the corresponding period last year.

Broadband Network and Value-Added Services

GWBNS, an affiliate of the Company, was established in 2000. It is engaged in the construction of broadband network, and the provision of broadband products and various value-added services using a new generation of ether technology, and is a pioneer in the promotion of Internet broadband access in China.

During the reporting period, GWBNS increased its operating efficiency substantially and reduced its losses by 27%, as compared with the previous year, to RMB73 million, by pursuing a full-swing end-service strategy, rationalizing its institutions, tightening up cost and expense control, and implementing a series of operating and management measures, such as the adoption of the EBITDA index in appraising subsidiaries. During the reporting period, GWBNS opened 33,500 new accounts and an account-opening rate of 15.65%.

During the reporting period, GWBNS's broadband assets had an assets to liabilities ratio of 87.6%, and the guarantee and loan provided by the Company to GWBNS were RMB525 million and RMB305 million respectively.

Management and Technology

Management is pivotal to the production and manufacture of computers. During the reporting period, the Group attached importance to flexibility in production, acumen in manufacturing and zero stock management. For these purposes, a number of enterprises of the Group developed and applied the ERP system. At the same time, they also implemented a number of international management technology and management measures (such as 6-SIGMA, IE Technology), resulting in a significant reduction of overall expenses and more efficient use of funds, as well as an enhancement to international standards in relation to product passing rate, labour productivity, and the control of materials wastage and costs.

To encourage the support, participation and supervision of the Company's management, Kaifa adopted 6-SIGMA as an important part of the year-end appraisal on the performance of its mid-level management. Regarding technological innovation, the Company patented method and equipment to restore the magnetic resistance of big drive heads, after which the Company made further breakthroughs in magnetic head technology, and also patented its technology for assembling the catapulting frames of magnetic heads of wireless elastic arms.

Kaifa Magnetic implemented 6 Sigma, I.E. and other management systems and methods to enhance production efficiency. While carrying on day-to-day production, it also continued technological R&D on the application of Nano-technology for disk substrates surface cleaning, the technological application of friction theory, and vertical recoding technology. Currently, Kaifa Magnetic is working in collaboration with Qinghua University and other institutions to explore the feasibility of producing polishing and other agents in China.

Through the implementation of two phases of the ERP/SAP project, ExcelStor Technology accomplished a sole access arrangement for its electronic information management system, further improvement of its data analysis, enhancement of its enterprise supply chain, improved information support regarding corporate operations and decision-making, integration of financial and business affairs, and increased financial control over business, leading to a unification of logistic, fund and information flows.

In order to speed up the collection of accounts receivable, CGC issued the Measures for the Administration of Overdue Accounts Payable (2005) to address the issue of overdue accounts receivable and to control operating risk, as well as contribute to the healthy growth of the Company's business. CGC also launched its 世恒雙網個人計算機 (Shi Heng Double Net Computer) to ensure the security of information for computer user, and installed its self-developed 雙網物理隔離卡 (Double Net Segregation Card).

GWCSS has been dedicated to the enhancement of its technology R&D and project management capability since it passed the CMM Level 2 Assessment, and has been carrying out tracking management of projects in strict accordance with the requirements of CMM Level 2. Currently, its various projects are progressing smoothly. During the reporting period, GWCSS also participated in the formal assessment of CMM Level 12. This will enhance GWCSS's capability for R&D and management, and will serve with an important foundation for future development.

PROSPECTS FOR THE SECOND HALF OF 2005

On the basis of the satisfactory results for the first half of 2005, the Group will continue to integrate and explore its internal resources in the second half of 2005, to take advantage of the dominance of its mainline business and to develop new growth opportunities, with a view to providing the roots for sustainable corporate growth.

Computer Components and the Parts

Regarding its magnetic heads business, Kaifa will continue to consolidate and raise its status and scale in the market for magnetic heads, and increase its capability to manage market risks, promote its management system characterized by the 6SIGMA, and introduce advanced technology to gain more orders from its customers. At the same time, it will continue to capture market opportunities, penetrate new markets, consolidate its OEM business, and develop its ODM/OBM business, with a view to maintaining stable, healthy and continuous development.

Regarding the development of substrates, Kaifa Magnetic will ensure its leading position by closely following market trends and enhancing the level of its technology and management, with a view to winning customer confidence and consolidating and expanding its customer base. In the second half of 2005, Kaifa Magnetic will complete the fourth expansion and renovation of its nickel sheet production workshop, the area of which is envisaged to increase by 92% with a further reinforcement of production capacity. Meanwhile, measures will be taken to increase the proportion of revenue from glass disk platters in its disk substrates business.

In respect of hard disk drives, ExcelStor Technology and ExcelStor Great Wall will further their co-operation with Hitachi, expand the scale of their existing production facilities for 3.5" hard disk drives, and aim to increase market share. Both companies will also expand market share and profitability of their 2.5" hard disk drives, intensify their R&D of such products and their various marketable applications, further develop and increase production of mobile hard disk drives, and seek to gain access to the application market for consumer electronic products, with a view to rendering support to the rapid development of their overall business. The sales of hard disk drives for the year 2005 are forecast to record a significant growth as compared with 2004.

In the fields of PCs power supplies and monitors, CGC will continue to expand the production scale of PCs power supplies and monitors, enhance awareness of its brands, increase the OEM proportion in its PCs power supplies and monitors business, increase export of PCs power supplies and monitors, and, while consolidating its status in the domestic market, endeavour to gain a share in the international market.

Computers

Regarding its PC business, CGC will continue its strategy of high-end development, by increasing investment in technological R&D and paying more efforts in new product development, look to new industries for new points of business growth, aim to enhance market recognition for its existing computer products, increase business scale and efficiency, explore and build up downstream sales channels through horizontal and vertical cooperation, and integrate its supply chain and resources.

As regards its network smart electronic meters, Kaifa will boost its efforts to gain further access to domestic markets while consolidating its position in the international market.

Software and System Integration

Regarding software and system integration, GWCSS will further develop its software business into a business pillar and a principal source of profit of the Company by increasing R&D and investment. The Company has initiated a software integration programme with GWCSS software at its core, with a view to positioning itself advantageously by building up an intra-Group resources pool and an interface of advantages, lending to synergistic development.