MANAGEMENT DISCUSSION AND ANALYSIS

Overview

During the year ended 31 December 2005 (the "year"), the Group was committed to the development of business operations in the automotive aftermarket. Apart from the manufacturing and distribution of automotive electronic and power-related parts and accessories, the Group also conducted retail sales through the automotive aftermarket service chain stores network established in the People's Republic of China ("PRC"). Despite the unfavourable factors such as a general rise in the prices of raw materials in the global market and the appreciation of Renminbi ("RMB"), the Group managed to attain encouraging growth in its results.

During the year, turnover of the Group grew by approximately 42% to approximately RMB507,471,000 (2004: RMB356,729,000). Profit attributable to shareholders increased by approximately 11% to approximately RMB55,618,000 (2004: RMB50,327,000). The increase in profit was primarily attributable to the market-driven and vertical integration business strategy of the Group. Through effective implementation of such strategy, the Group was able to capitalise on its research, development and innovative design strengths and to launch new products timely to cater for or even direct market trends. As such, the Group was able to enjoy long-term and stable sales and distribution, thus recording remarkable profit margin despite various unfavourable factors.

With the aim of sharing with shareholders the benefits of our growth, the Group will persistently provide shareholders dividends in line with the growth in profit. The Board recommended the payment of a final dividend of HK$0.08 per share (2004: HK$0.078), representing an increase of approximately 2.6% from that of 2004.

Analysis of manufacturing and distribution business of automotive electronic and power-related parts and accessories

The manufacturing and distribution business of automotive electronic and power-related parts and accessories accounted for approximately 95% of the Group's total turnover. Turnover and segment results for the year increased by approximately 41% and 34% respectively to approximately RMB480,959,000 and RMB77,252,000 respectively (2004: RMB340,778,000 and RMB57,497,000). Being the core business of the Group, this business segment displayed extraordinary growth potential, thanks to the Group's ability in seizing growth opportunities in the automotive aftermarket, an average growth rate of approximately 31% and 28% respectively in turnover and segment results over the past five years was recorded.

Business review of manufacturing business

The Group primarily distributes its products in various regions and countries such as North America, Europe, Asia-Pacific and the PRC through renowned retailers around the globe, including Wal-Mart, Costco, SAM's Club, Home Depot, SEARS, Carrefour, Metro and B&Q.

During the year, satisfactory growth was recorded for two of the key products of the Group inverters (accounting for 59% of the turnover of the manufacturing business) and multi-functional power packs (accounting for 25% of the turnover of the manufacturing business), with a growth in turnover of approximately 74% and 5% respectively from that of 2004. The growth reflected the increase in market demand for the low-priced and quality products of the Group.

North America remained the major market of the Group, accounting for approximately 76% of the turnover of the manufacturing business, which represented a growth of approximately 50% from that of 2004. Apart from this, the Group also made headway in exploring new markets and customers in the PRC and Europe. Turnover attributable from the Greater China (including Taiwan) market increased by approximately 5% and accounted for approximately 7% of the turnover of the manufacturing business, whilst turnover attributable from the European market increased by approximately 63% and accounted for approximately 10% of the turnover of the manufacturing business.

Business growth strategy of manufacturing business

Exploration of the OEM market for automotive parts and accessories and the development of products with high profit margins are the main focus of the growth strategy of the Group's manufacturing business for the coming years. The Directors believe that inverters and High Intensity Discharge ("HID") light ballasts will be the key products of the Group to achieve business growth driven by this strategy.

Due to the increasingly wide application of in-car consumer appliances, automotive assemblers such as Toyota and Volkswagen are adopting inverters as part of the standard accessories for certain motor vehicle models, thus providing potential opportunities for the development of the inverter OEM market. Since the appointment by Volkswagen as an OEM inverter supplier in 2004, the Group had sold 100,000 OEM inverters during the year. In the first quarter of 2006, the Group was further appointed as the OEM inverter supplier for Brilliance Jinbei and Dongfeng Auto Group. As such, the OEM sales volume of inverters is expected to rise to 150,000 units in year 2006. As competition in the global automotive market intensifies, automotive assemblers will upgrade their equipment and resort to external procurement of parts and accessories to reduce costs, thereby creating room for further development of the Group's OEM business.

Since its launch in 2004, the HID light ballasts of the Group enjoyed higher profit margin due to its technical advantage. During the year, this product accounted for approximately 3% and 4% of the turnover and gross profit of the manufacturing business respectively. Turnover and gross profit recorded for this product achieved a growth of approximately 251% and 186% from that of 2004 respectively. Due to its strengths in terms of illumination area and intensity, energy consumption and durability, such product is widely used as automotive headlamp and other operating lights, which stimulated the rapid market expansion of HID light ballast. Given the leading strengths of the Group's HID lights ballasts in terms of price, size and stability, this product is anticipated to achieve outstanding performance in the automotive aftermarket and the OEM market.

Analysis of automotive aftermarket service chain stores business in the PRC

In order to capture the enormous opportunities arising from the sustained growth in sales and possession of motor vehicles in the PRC, the Group leveraged on its geographical advantage in Shanghai and strategically entered the automotive aftermarket service chain stores business in 2002 and became a pioneer in the sector.

The Group's operations were confronted by challenges arising from an immature market, disorderly competition and customer habits which are still being shaped. Nevertheless, in order to tap into the tremendous development potential of the PRC automotive aftermarket, the Group formulated robust plans to establish the nation's most extensive automotive aftermarket service chain stores network by constantly expanding its "Autolife" chain stores. For the short-term, the Group targeted to increase the number of chain stores to 350 in 2006 and 500 in 2007, and further to 3,000 in 2011 in the long run.

As at 31 December 2005, the number of chain stores had increased exponentially from 39 by the end of 2004 to 200, which includes 32 directly-operated stores and 168 franchised stores. During the year, revenue generated directly from the provision of automotive aftermarket services amounted to approximately RMB26,512,000, while sales revenue from the distribution of merchandise through the chain stores amounted to approximately RMB6,181,000, representing an increase of approximately 66% and 99% from that of 2004 respectively.

Business model and progress of automotive aftermarket service chain stores business

The operation model of the automotive aftermarket service chain stores of the Group consists of direct operation and franchise operation. Catering for the particular situation of the PRC market and with reference to the success of global automotive aftermarket service chain operators, the Group has formulated the following chain operation model with entities of three levels performing different functions:

Headquarter	District Centres	Chain Stores As direct service provider and merchandise retail channel	
• Development of proprietary merchandise/ equipment	To manage chain stores in the district:	Obtain profit from directly-operated stores	Obtain profit from franchise stores
• Procurement of brand name merchandise/ equipment for distribution	• direct management	• direct service revenue	• royalty fee
• Provision of effective logistics and distribution operation	• operational support	• merchandise retail revenue	• merchandise wholesale revenue
• Provision of cross-provincial training support	• network expansion		
• Nationwide brand promotion			
• Nationwide operation management support			

The provision of effective operational support to our growing number of chain stores is vital for the successful implementation of the expansion plan of the Group's chain stores business and the establishment of its competitive edge. In order to better support its expansion plan of ultimately covering 3,000 chain stores by year 2011, the Group continued to focus on the upgrade and improvement of various central functions of the headquarter of such chain stores during the year. Emphasis was placed on the headquarter of its principal functions namely, the development of merchandise/equipment under the proprietary "NFA" brand, procurement of brand name merchandise/equipment for distribution, effective cross-provincial logistics and distribution systems and training systems, operational management support to the nationwide chain stores network (including support for franchise expansion and acquisitions), and nationwide brand promotion, so as to provide the necessary service and support for the expanding network of chain stores. At present, the directly-operated chain stores of the Group are making profit. However, due to the necessary input required for the building up of the headquarter to effectively perform its functions, the chain stores business is still under the investment stage. Such investment represent the operating costs essential for nurturing the long-term competitive strengths of the Group's chain stores business.

During the year, the Group completed two small-scale chain stores business acquisitions, which had effectively driven the chain stores network expansion of the Group. The Board believes that full consolidation of the acquired business will help underpin the economy of scale of the chain stores network and effectively dilute the expenses contributed to the establishment of the headquarter and reinforce the Group's bargaining power with its suppliers. During the year, the Group also entered into strategic partnership with Carrefour (China), which will have profound influence on the brand promotion initiatives and establishment of a nationwide chain stores network of the Group.

Profit growth potential of automotive aftermarket service chain stores business

Through its strategy of establishing model stores under direct operation, adopting franchise operation as the primary means of chain stores network expansion and entering into strategic cooperation with good local operators through acquisition and merger, the Group will gradually attain its strategic goal of ultimately building up a chain stores network of 3,000 stores by year 2011. The benefit of scale of the chain stores network will emerge as the number of stores increases. In addition, the merchandise wholesale revenue and royalty income of the Group will also grow along with the scale of network. Our chain stores business is expected to breakeven in 2007 when the number of our chain stores reaches 500.

As the chain stores network grows in size, the profitability of the chain stores business will also be boosted with the enforcement of the following strategies:

- the store royalty fee will be substantially increased as the functions of headquarter and support for chain stores enhance;

- the Group will increase the gross profit margin for merchandise distribution as the distribution volume of merchandise increases and bargaining power with suppliers improves; and

- through development of merchandise/equipment under its proprietary "NFA" brand and securing distribution rights for premium brand merchandise, the resulting price advantage and quality assurance of the Group's merchandise will increase the merchandise supply of the Group to each store by folds.

Prospects

Looking ahead, the global automotive aftermarket will continue to grow in size. The room for development of automotive parts and components manufacturers in the OEM market and the buoyant development of the PRC's automotive industry present enormous opportunities for the Group's development.

For the manufacturing business, the inverters recorded a strong growth trend in the OEM market, while the launch of HID light ballasts was also successful. The Group will continue to reinforce its strengths in this business segment with the aim of maintaining a long-term and steady growth.

To further expand the product ranges and production capacity, lower production cost and optimize the location of manufacturing facilities of the Group, the Group has been actively in search of, and have successfully identified, certain potential investment projects and acquisition targets, out of which some are located in the booming Bohai Rim economic circle. Once such projects can be implemented, the Group will be able to successfully establish its manufacture in Northern China, thereby creating additional competitive advantages and enhancing resources sharing, so as to improve the profit margins of the Group. Moreover, to further develop the HID light ballasts business in a more focused and efficient manner, the Group is planning to establish a subsidiary to engage particularly in this business line. It is expected, additionally, that such new subsidiaries will be able to enjoy the preferential tax treatment offered by PRC tax policies applied to foreign investment.

The chain stores business is a segment in which the Group has devoted substantial efforts. The Group is committed to developing into the PRC's largest automotive aftermarket service chain stores operator and building "Autolife" as the leading brand in the automotive aftermarket service market. Being a scalable pioneer in the sector, the Group is well positioned to benefit from the maturing PRC market and industry regulation by the government authorities. While the headquarter's functions upgrading project is entering the final stage, the multi-tiered network expansion plan is also progressing smoothly. The Group has embarked on the establishments of district centres. Aggressive efforts have been devoted in the preparation work for the establishment of a district centre in the southwestern district of the PRC. By fusing the headquarter advantage of the Group and the advantage in resources of the local partner, the district centres will play a critical role in the Group's development in the Southwestern PRC market. The Group believes that, as the business expansion plan rolls out, the chain stores business will gradually grow into an important profit contributor of the Group.

With regard to regional markets, the sustained rapid development of the PRC automotive industry and increasing domestic consumption power, the PRC has become the region with most market potentials. As such, it is a key development strategy of the Group to promote its proprietary "NFA" brand in this market. To date, the development efforts of the Group started to pay back. Besides its cooperation with retailers such as Metro, B&O, Wal-Mart and Carrefour and automotive manufacturers such as Brilliance Jinbei and Dongfeng Auto Group, the Group also recorded continued expansion in its retail chain network. The Group believes that the effective execution of the multi-tiered sales initiatives will propel the rapid growth of the Group's turnover in the PRC market and establish "NFA" as a leading automotive product brand in the PRC.

Review of operation

During the year, turnover, gross profit, operating profit and profit attributable to shareholders of the Group all continued to record a growth when compared with that of last year. Turnover increased by approximately 42% to approximately RMB507,471,000, gross profit increased by approximately 28% to approximately RMB121,655,000, operating profit increased by approximately 29% to approximately RMB66,019,000, while profit attributable to shareholders increased by approximately 11% to approximately RMB55,618,000.

Gross profit

Gross profit margin of turnover was approximately 24% (2004: 26.6%), representing a decrease of approximately 2.6 percentage points to that of last year. As a result, gross profit increased by approximately 28% to approximately RMB121,655,000, which growth was less than the growth in turnover.

During the year, due to the global increase in the prices of raw materials, the prices of the Group's major raw materials, copper and lead, have been increased by 83% and 37% respectively. Furthermore, RMB has been appreciated by a total of approximately 2.49% up to 31 December 2005. All these unfavourable factors affected the Group's profit margin. However, the Group still managed to contain the drop in gross profit margin within 3 percentage points, which was attributable to the Group's high operational efficiency, outstanding management capability and the rapid launch of new products with high added-value. During the year, turnover attributable to the new products amounted for over 40%.

Other gains

The Group recorded other gains of approximately RMB12,017,000 (2004: approximately RMB678,000). This was partly attributable to various government subsidies in the sum of approximately RMB3,576,000 and gain on disposal and fair value gains on investment properties totalling RMB6,341,000.

Expenditures

During the year, total selling and marketing costs and administrative expenses amounted to approximately RMB67,653,000 (2004: approximately RMB44,563,000), of which expenses of the manufacturing business accounted for approximately RMB36,589,000, while the chain stores business accounted for approximately RMB20,822,000, and unallocated expenses amounted to approximately RMB10,242,000.

This increase was attributable to (1) the expansion of the Group's directly-operated stores, and (2) the enhancement of the headquarter functions, such as merchandise procurement, training, logistics, management and marketing, and support for franchise operations and acquisitions and (3) the necessary additional expenses arising from the increase in sales. Likewise, the Group increased its inputs in human resources management, infrastructure and other necessary aspects.

Unallocated expenses for the year increased by approximately RMB9,689,000, which substantially comprised of additional administrative expenses incurred for the maintenance of the continuing listing status of the Company on the Stock Exchange.

Operating profit

Operating profit for the year was approximately RMB66,019,000 (2004: approximately RMB51,053,000), representing an increase of 29% which was attributable primarily to the substantial increase in turnover. Despite a drop in gross profit margin and marked increase in unallocated expenses and expenses in respect of the chain stores business, other gains increased by approximately RMB11,339,000, partially offsetting the impact of these unfavourable factors.

Finance cost and income tax expense

Finance cost for the year was approximately RMB477,000 (2004: approximately RMB1,135,000).

Income tax expense was approximately RMB9,924,000 (2004: approximately RMB37,000). The increase was primarily due to the expiry of the tax exemption applicable to New Focus Light and Power Technology (Shanghai) Co., Limited（紐福克斯科技光電（上海）有限公司）, the major operating subsidiary for the manufacturing business of the Group, during the year, the applicable tax rate increased to 12% pursuant to the relevant taxation policy and taxation bureau approvals in the PRC. The 12% tax rate is expected to remain unchanged up to the financial year ended 31 December 2007.

Profit attributable to shareholders

Profit attributable to shareholders for the year increased by approximately 11% to approximately RMB55,618,000 (2004: approximately RMB50,327,000). The increase was less than the increase in operating profit due to an increase in taxation. Basic earnings per share was RMB0.145 (2004: RMB0.168), which was primarily resulted from the dilution effect of public offering and capitalisation issue in February 2005.

Financial conditions and liquidity

The Group maintained its stable financial status during the year. Operation of the Group was financed by internally generated resources and bank facilities, in addition to the net proceeds of approximately HK$74,700,000 from the public issue and placement of new shares in February 2005. As at 31 December 2005, the Group had adequate cash and bank balance amounting to approximately RMB94,616,000, including a term deposit of RMB20,000,000 with initial terms of over three months. As a result of its outstanding working capital management capability, cash inflow from operating activities of the Group for the year was approximately RMB28,792,000 (2004: RMB56,754,000).

As at 31 December 2005, current assets of the Group maintained at a healthy level of approximately RMB232,531,000 with a liquidity ratio of 2.49 (31 December 2004: 1.74). Gearing ratio calculated by dividing total liabilities by total assets was approximately 28.9% (2004: approximately 41.2%).

As at 31 December 2005, total bank borrowings were approximately RMB9,927,000, all of which were repayable within one year. The Group had no material pledged asset, material contingent liability or external guarantee.

The Group will continue to maintain a healthy financial status. Given a positive cash inflow from operating activities and available bank facilities, the Group has sufficient financial resources to meet its liabilities and requirement for working capital and future expansion investment.

During the year, the Group incurred an investment of approximately RMB38,779,000 (2004: approximately RMB11,084,000) for the addition of machinery and equipment, construction of new plants and property investment.

Use of proceeds

The Group offered and placed 100,000,000 new shares in February 2005. The net proceeds raised after the relevant listing expenses were approximately HK$74,700,000.

Use of proceeds in the manufacturing business:

(1) approximately RMB8,431,000 for the research and development of automotive lights and automotive electronic products;

(2) approximately RMB8,238,000 for the construction of new production lines and plant in Phase III development.

Use of proceeds in the chain stores business:

(1) approximately RMB1,849,000 for the upgrade of headquarter functions;

(2) approximately RMB9,338,000 for the expansion of chain stores; and

(3) approximately RMB3,577,000 as general working capital.

The balance of the unused net proceeds has been placed on short-term deposit with banks in the PRC.

Exchange risk

During the year, approximately 89% of sales and 25% of raw material purchases were conducted with overseas customers and mainly settled in USD. On 21 July 2005, the People's Bank of China lowered the exchange rate of USD against RMB by approximately 2%. In response, the Group has mitigated the impact of such exchange rate movement in the PRC market, further heighten the proportion of overseas procurement and strict control over costs and expenses. In addition, the Group will also leverage on its strong bargaining power and established relationships with customers and suppliers to transfer to them the additional costs arising from movements in exchange rates. The Group has no material exposure to foreign exchange risks.

Employees and remuneration policy

As at 31 December 2005, the Group employed 1,964 full-time employees, of which 64 were dedicated to the research and development of new products. The Group has been committed to the recruitment of talents to enrich its human resources structure. In order to attract and retain outstanding employees, the Group provided benefits such as medical insurance and housing benefits in addition to the various mandatory pension schemes stipulated by the municipal governments. The Group also arranged for all Hong Kong employees a provident fund scheme registered under Chapter 485 of the laws of Hong Kong. Outstanding employees of the Group will be granted discretionary bonus and share options as incentives. It is the Group's plan to grant more options to a larger proportion of staff out of the share options available, thereby further reinforcing the sense of belonging and duty to the Company.