Management Discussion and Analysis

BUSINESS REVIEW & OUTLOOK

The Group is principally engaged in manufacturing high precision metal components for HDDs, hydraulic equipments and automotive parts. Equipped with fully automatic Computer Numerical Control ("CNC") lathe, grinding machines, die casting machines and heat treatment equipment, the Group is able to adjust its production lines, tooling and equipment to manufacture various kinds of high precision components according to customer's different specifications.

The Group's consistently high quality products continued to gain support from its customers during the year with the aggregate sales volume increased substantially by 48.5% as follows:

	Sales Volume		
	2005	2004	Growth
	million pieces	million pieces	%
HDD components	**299.43**	185.38	61.5%
Hydraulic equipment components	**14.19**	10.51	35.0%
Automotive components	**0.41**	0.05	720.0%
Other components	**34.57**	38.87	(11.1%)
	348.60	234.81	48.5%

CNC tool grinding line

Management Discussion and Analysis

HDD components

Market demand for HDDs grew significantly during the year, with worldwide HDDs shipment amounting to 377 million units, a 24.8% surge from 2004 (Source: TSR). The tremendous increase in demand was attributable to the emerging application of HDDs in the consumer electronics sector such as personal digital video recorder, set top box, game console and DVD-HDD recorder. In particular, broadband, online broadcasting and video-on-demand services require more storage capacity at the centralised network. High-definition programmes, which require 5 times more data volume than standard-definition programmes, should accelerate the scarcity of storage capacity. As such, the Group's sales of HDDs components in 2005 experienced strong growth with its sales surged 51.5% to HK$326,903,000 over the previous year.

HDDs business coming from consumer electronics devices will continue to grow and it is expected that in the next two to three years there might be more of a 50-50 split between personal computers and other consumer products for HDDs application. IDC, a market research specialist, sees a compounded annual growth rate of 15% for HDDs in the longer term from now on until 2009.

80% of the Group's HDD components are 3.5" HDD components and the remaining 18% and 2% go to 2.5" HDDs and 1" HDDs, respectively.

Looking forward, demand for desktop computers and notebook computers will grow steadily and the high-capacity solutions as offered by HDDs should stimulate the computers and HDDs replacement market. On the other hand, although the MP3 segment is dominated by flash-based options, HDD-enabled products such as the Video iPod continue to show promise. History shows a remarkable rate of capacity expansion of mainstream HDDs. The 3.5" HDDs jumped from less than 5 GB (gigabyte) to 500 GB in 10 years and 2.5" HDDs leapt from just 1 GB to 120 GB in the same period. With the introduction of "perpendicular" recording technology for HDDs, it could lift capacity of HDDs by 10 times. As such, the Group believes that sale of HDDs components will continue to provide a stable stream of income for the Group in the near future.

Management Discussion and Analysis

Hydraulic Equipment Components

Sale of hydraulic equipment components continue to generate stable and growing income for the Group. The Group is currently producing turning parts such as shafts, spools, cartridges, pistons, poppet, plungers and caps which are the critical components usually found in industrial valves, pumps and gear boxes. In 2005, the Group successfully secured new customers in hydraulic components sector, and therefore sales increased by 42.7% from 2004 to HK$62,986,000.

Growth in hydraulic equipment components business is mainly fuelled by the general outsourcing trend in China and the Group believes that growth in revenue is sustainable in near future.

Automotive Components

The Group began concentrating on automotive components market since 2002 when it was awarded QS9000 certification. In 2005, the Group achieved significant progress in penetrating the automotive components industry and has been qualified by global automotive component makers, Siemens VDO, Bosch, Delphi and TRW as a qualified vendor.

Furthermore, during the year under review the Group was able to secure 3 to 5 years' long term supplier contracts which the Group was committed to delivering components to customers from 2006 to 2010. Such long term supplier contracts laid down a solid foundation for the Group to penetrate automotive components industry in future. In addition, the Group became a TS16949 qualified vendor in March 2006.

Though sale of automotive components only accounted for 0.3% of the Group's turnover for the year ended 31 December 2005, the Group believes that sale of automotive components will become a significant part of the Group's turnover in 2006 and in near future, in view of the secured long term contracts with major automotive parts makers and the prevailing open projects currently under negotiation.

Management Discussion and Analysis

Production Facilities

During the year under review, the Group has put the production facilities in its new Guangzhou Factory No. 1 into mass operation in March 2005. Besides, the Group also further renovated the existing facilities in Bangkok, Thailand and Dongguan, China. The increase in production facilities during 2005 and the expected further increase in production floor area in 2006 is estimated as follows:

	As at 31 Dec 2006 Expected production floor area Square metres	As at 31 Dec 2005 Actual production floor area Square metres	As at 31 Dec 2004 Actual production floor area Square metres
Bangkok Factory	**7,495**	7,495	7,495
Dongguan Factory	**10,630**	10,630	5,359
Guangzhou Xing Hao Factory No.1	**19,902**	19,902	–
Guangzhou Xing Hao Factory No.2	**19,902**	–	–
Guangzhou Xing Hao Factory No.3	**19,902**	–	–
Other auxiliary facilities	**54,827**	37,457	14,364
	132,658	75,484	27,218

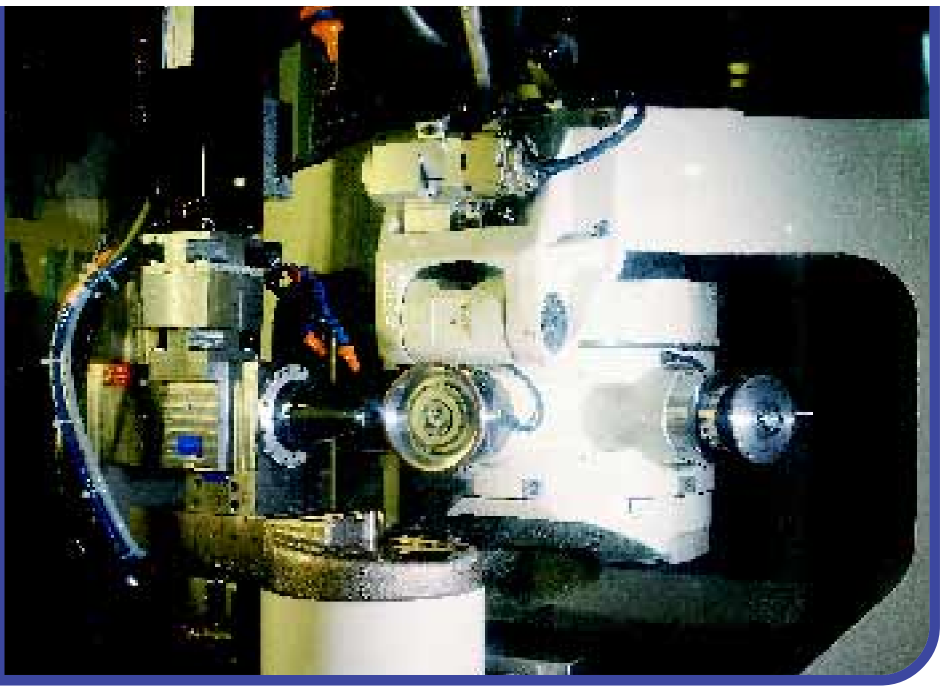
Induction heat treatment machine

Management Discussion and Analysis

Machinery and Equipment

During the year under review, the Group has added new machinery and equipment amounting to HK$221,433,000 to cope with the growing customers' orders and the following table illustrates the increase in the pool of machinery during the year:

	Machinery and equipment as at 31 Dec 2005 Units	Increase of new machinery and equipment during the year Units	Machinery and equipment as at 31 Dec 2004 Units
CNC automatic lathe	**975**	352	623
Processing centres	**105**	14	91
Grinding machines	**72**	26	46
Die-casting machines	**2**	2	–
Heat treatment lines	**10**	5	5
	1,164	399	765



CNC tool grinding line

Management Discussion and Analysis

FINANCIAL REVIEW

Turnover

During the year under review, the Group recorded an increase of consolidated turnover by 44.1% to HK$405,977,000. This substantial increase was attributable to the newly added production facilities in Guangzhou plant, coupled with the enhancement of facilities in Dongguan plant and Thailand plant, which led to an increase of the Group's average monthly production capacity by over 40%, so that the Group has extra production capacity to cater for customers' orders.

Turnover analysis by product categories is shown as follows:

	2005		2004		Growth
	HK$'000	**%**	HK$'000	%	%
HDD pivot components	**225,447**	**55.5%**	138,643	49.2%	62.6%
HDD spindle motor components	**101,456**	**25.0%**	77,105	27.4%	31.6%
	326,903	**80.5%**	215,748	76.6%	51.5%
Hydraulic equipment components	**62,986**	**15.5%**	44,150	15.7%	42.7%
Automotive components	**1,026**	**0.3%**	325	0.1%	215.7%
Others	**15,062**	**3.7%**	21,449	7.6%	(29.8%)
	405,977	**100%**	281,672	100%	44.1%

CNC automatic lathe

Gross Profit and Gross Profit Margin

During the year under review, the Group experienced wide fluctuation in prices of stainless steel and alloyed steel bar by around 5-10%, which has imposed pressure on the Group's production cost. Besides the increase in minimum wage level proclaimed by the Guangzhou Municipal Government as well as the rise in Renminbi denominated expenses due to its appreciation during the year had brought significant pressure on the Group's profitability. Further, the upsurge in depreciation cost of the Group by 86.9% to HK$45,834,000, as a result of the substantial investment in new machinery and equipment during the year to cater for future orders, also led to a drop in gross profit margin. Nevertheless the Group was able to secure longer raw material supplier contracts to protect itself from the wide fluctuation of raw material prices. Together with the continuous implementation of cost saving measures and improvement in the production process, the Group was able to maintain a gross profit margin at 30.5% (2004: 33.6%).

Other Income and Gains

During the year under review, the Group recorded a foreign exchange gain of HK$7,747,000 as a result of settlement paid in Japanese Yen while Japanese Yen was weakening during the year against US dollars (2004: net exchange loss of HK$2,397,000).

Other major income and gains comprised bank interest income of HK$2,411,000 (2004: HK$69,000), scrap sales of materials of HK$2,170,000 (2004: HK$2,828,000) and the revaluation gain on investment properties of HK$3,216,000 (2004: HK$2,559,000).

Selling and Distribution Costs

During the year under review, selling and distribution expenses increased by 75.6% to HK$13,652,000 (2004: HK$7,773,000), which was mainly attributable to the significant increase in outward bound freight and handling costs by approximately HK$3.7 million and marketing expenses of HK$1.7 million as a result of 44.1% increase in turnover.

Administrative Expenses

Administrative expenses increased by 33.5% to HK$48,113,000 (2004: HK$36,034,000), which was mainly caused by the recognition of share option costs of HK$7,577,000 during the year (2004: nil) as a result of the adoption of HKFRS 2 starting from 1 January 2005. The administrative expenses would have increased by only 12.5% from 2004 if the effect of recognition of share option expenses was not taken into account.

Finance Costs

For the year ended 31 December 2005, the Group recorded finance costs of HK$12,216,000 as compared to HK$5,109,000 in 2004, representing an increase of 139%. The significant increase in finance costs was mainly due to the draw down of a 3-year term loan facilities of HK$200,000,000 in August 2005. Besides, the continuous increase in HIBOR and the draw down of other finance lease loans during the year also contributed to the significant increase in finance costs.

To reduce the finance costs in year 2006, the Company placed 120,000,000 shares to institutional investors at the placing price of HK$1.87 per share on 12 April 2006, through a top-up placing exercise. The net proceeds of the subscription of approximately HK$212.5 million will be applied as to approximately HK$96 million for acquisition of new machinery and equipment and as to the remaining for general working capital uses. It is expected that further debt financing can be reduced.

Net Profit Attributable to Shareholders

Net profit attributable to shareholders increased from HK$53,235,000 for the corresponding previous year to HK$64,398,000 for the year ended 31 December 2005. This was mainly attributable to the increase in turnover of 44.1% over last year. Net profit margin dropped from 18.9% for the previous year to 15.9% for the year ended 31 December 2005 which was mainly attributable to the drop in gross profit margin caused by the fluctuation of raw material costs, the increase in depreciation costs arising from the rapid investment in machinery and the increase in share option expenses of HK$7,577,000 as a result of the adoption of HKFRS 2 starting from 1 January 2005.

Details of Charges on the Group's Assets

As at 31 December 2005 the Group's total secured borrowings of approximately HK$3,143,000 were secured by machineries, land and investment property of the Group with total net book value of approximately HK$56,312,000.

Currency Exposure and Management

The Group operates globally and is thus exposed to foreign exchange risk. Its revenue is mainly denominated in US dollars, while major raw materials, machineries and manufacturing overhead are settled in Japanese Yen, Renminbi, Thai Baht and Hong Kong dollars. Apart from US dollars and Hong Kong dollars which are pegged to US dollars, the Company entered into forward currency contracts, mainly for Japanese Yen, with a view to reducing the potential exposure to currency fluctuations.

Capital Expenditure

To cater for the business growth, the Group is building up more production capacity to facilitate greater flexibility to schedule production efficiently and has invested HK$387,474,000 in land and buildings, plant and machinery during the year (2004: HK$156,119,000).

In particular, the Group, through Integrated Precision Engineering Company Limited (a wholly-owned subsidiary) and Integrated Precision Engineering (Thailand) Co., Ltd. (a 99.99% owned subsidiary), has entered into various contracts with Kowloon Engineering Limited ("KEL") for the acquisition of machineries comprising CNC automatic lathes, grinding machineries and their related accessories to increase the production capacity of the Group in Bangkok, Dongguan and Zengcheng of the PRC since the Listing Date, details of which are set out in the announcement and circular of the Company dated 7 March 2006 and 29 March 2006, respectively.

KEL has been the exclusive dealer for certain well known Japanese made CNC automatic lathe such as "Miyano" and "Tsugami" which are commonly used by the Group in its production and the Group has been purchasing machineries from KEL for more than 13 years. KEL and its ultimate beneficial owners are third parties independent of the Company and connected persons of the Company.

As disclosed in the prospectus of the Company dated 19 October 2004, the Group's manufacturing process basically consists of the following stages: (i) primary process which involves raw materials inspection and CNC turning; (ii) secondary process which involves drilling, tapping, slotting or milling plane; (iii) finishing process which involves visual checking, packing and storage. The machineries acquired from KEL were all CNC machines which enable the Group to manufacture the metal parts and components with high degree of precision and quality that are suitable for various kinds of equipment and devices. These machineries are all standard ones for mass production, they are not tailor-made to the Group's individual customer's needs and the existing machineries of the Group will still continue to be applied to its production process and therefore the value of the existing machineries would not be affected by the acquisition. Except for those machineries acquired by Integrated Precision Engineering (Thailand) Co., Ltd., to be located in the production plant in Thailand, all other machineries purchased from KEL are all located in the PRC. All relevant approvals have been obtained for the import of the machineries into the PRC and Thailand and the payment for the acquisition. The import of the machineries in the PRC was recognised as an increase in the registered capital of the relevant members of the Group in the PRC.

When the relevant contracts for the acquisition of machineries are entered into by the Group, the amount will be treated as a capital commitment. Upon the machineries have been delivered to the Group, the costs of the machineries would be capitalised as fixed assets of the Group and the Group would therefore be liable to pay the costs within the credit period.

It is expected that the Group will continue to purchase similar machineries from KEL and from other suppliers of not less than HK$200 million in the following 12 months to match with the expansion plan of the Group. After the completion of the second phase and third phase of the development project in Zengcheng, Guangzhou city in the PRC, the Group's production capacity will increase by approximately 50% in 2006 and a further 50% in 2007.

Assets and Liabilities

As at 31 December 2005, the Group had total assets of HK$1,134,261,000 (2004: HK$557,967,000), total liabilities of HK$649,518,000 (2004: HK$264,194,000) and shareholders' equity of HK$484,743,000 (2004: HK$293,773,000). The net assets increased by 65% (2004: 82.6%) to HK$484,743,000 as at 31 December 2005 (2004: HK$293,773,000) which was mainly attributable to a share placement of 100,000,000 shares to institutional investors and individual investors at HK$1.15 per share in May 2005 and the increase in retained profits in year 2005.

Liquidity, Financial Resources and Financial Ratios

As at 31 December 2005, cash per share was HK26 cents (2004: HK10.5 cents) and net asset per share was HK80.6 cents (2004: HK58.8 cents), based on 601,070,000 issued ordinary shares (2004: 500,000,000 issued ordinary shares).

The Group had cash to current liabilities ratio of 0.39 (2004: 0.28) as at 31 December 2005.

Net debt (all interest-bearing bank and other borrowings less cash) to equity ratio was 0.42 (2004: 0.27) as at 31 December 2005.

Human Resources and Remuneration Policies

In line with the Group's business expansion, experienced engineers and skillful talents were recruited during the year. As at 31 December 2005, the total headcount of the Group was 3,044 (2004: 2,024).

We place high value on own employees as they are our greatest assets to grow with the Group. We encourage on-job training in diversified fields that address to both personal developments and work skills. We also provide workshops for staff at different level to improve work safety and build up team spirit. Our staff were rewarded based on performance of the Company as well as their personal performance and contributions.

A share option scheme was adopted for selected participants (including full-time employees) as incentives or rewards for their contributions to the Group. A mandatory provident fund scheme and respective local retirement benefit schemes are also in place.