

# Management Discussion And Analysis

## Operating Environment

During the year under review, the PRC economy maintained its strong growth momentum with a year-on-year GDP growth of 9.9%. During the year, the PRC government implemented macroeconomic control measures to curb overheat investment in the sectors, aggressively shifting investments in fixed assets to domestic consumption with an aim of stimulating economic growth. For the year ended 31 December 2005, total retail sales of consumer products in the PRC reached RMB6,717.7 billion, representing an increase of approximately 12.9% from 2004 (after deducting price factors, actual growth was 12%). Consumer price index (CPI) level of the PRC increased by 1.8% in 2005 from the previous year. The expedited growth of the PRC economy slowed down to a steady pace, while consumption power of urban and suburban citizens increases along with further economic development and a faster rate of growth of income. National disposable income per capita of urban citizens was RMB10,493. Taking no account of price factors, this represented an effective growth of 9.6%, which was 1.9 percentage points higher when compared with the previous year. Accordingly, consumer confidence of urban and suburban citizens increased gradually. The relevant government authorities implemented various measures to encourage the development of the retail industry. In the mean time, growth in the sector was also regulated to ensure healthy development, placing the retail industry in a favourable operating environment.



On the other hand, the domestic retail sector experienced increasing intensive competition as a result of the PRC market's full-scale opening up to foreign investment. According to the 2005 Global Retail Development Index released by A.T. Kearney in July 2005, the top ten countries that retailers should enter immediately are, in the following order, India, Russia, Ukraine, the PRC, Slovenia, Latvia, Croatia, Vietnam, Turkey and Slovakia. Though only in the fourth place, the PRC is the only market with advantages such as a large market size, huge volume and variety of consumer goods supplied and relatively less stringent employee protection among the top ten retail markets with the best investment potential. Accordingly, the PRC retail market will remain as one of the most attractive regional markets around the globe in the coming years. With a combination of rapid economic development, increased consumption power of the residents, expanding middle class population and the anticipated promulgation of policies to stimulate domestic consumption, the PRC retail market exhibited a compelling potential that further attracts a substantial horde of foreign-invested retail corporations.

In the past year of 2005, both the retailers and the government have been actively engaged in tackling the impact of full-scale opening up of the market. As a result of official deregulation, foreign-invested retailers, who have entered the PRC retail market, have expanded at an accelerated pace. Accordingly, the market share of foreign retailers in the PRC continued to grow. Looking into 2006, it is expected that foreign retailers in the PRC retail market will maintain their growth momentum, and the keenest competition will be seen between leading domestic and foreign market players. During this period of growth, which will be filled with both opportunities and competition, chain retailers will expand in scale and geographical coverage through launch of more new stores, mergers and restructuring. Consolidation is key to the success of acquisition and mergers. As competition intensifies, more emphasis will be attached to the optimisation of outlet network and consolidation of underperformance stores, which will be a trend in the development of the PRC retail sector.



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## Business Review

### Maintaining robust network expansion capability

In the course of development, the Group has strictly adhered to its centralised development strategy and maintained a robust growth speed. During the year

under review, there were 486 new outlets, all of which were located in existing markets for strategic expansion and to further benefit from the scale of operation in the region.

As at 31 December 2005, the number of outlets of the Group was as follows:

As at 31 December	Hypermarkets <sup>Note</sup>		Supermarkets		Convenience stores		Total	
	2005	2004	2005	2004	2005	2004	2005	2004
The Group	<b>97</b>	49	<b>1,553</b>	1,340	<b>1,959</b>	1,734	<b>3,609</b>	3,123
Direct operation	<b>97</b>	49	<b>653</b>	584	<b>1,245</b>	1,192	<b>1,995</b>	1,825
Franchise operation	<b>0</b>	0	<b>900</b>	756	<b>714</b>	542	<b>1,614</b>	1,298

Note: 2005 figures include 31 hypermarkets owned by Century Lianhua which were acquired by the Group during the year under review.

Acquisition has always been an important and effective means of network expansion of the Group for efficient external development. During the year under review, the Group acquired 122 outlets, which represented 25.1% of the net increase in number of outlets. In March 2005, the Group acquired 14 supermarkets from Wuxi Zhongbai Supermarket Company Limited (無錫中百超市有限公司) ("Wuxi Zhongbai"). In April 2005, 77 stores, including 8 hypermarkets and 69 supermarkets, were incorporated into the Group through acquisition of Guangxi Jiayong Trading Company Limited (廣西佳用商貿股份有限公司) ("Guangxi Jiayong"). On 13 December 2005, an extraordinary general meeting of the Company approved the Equity Transfer Agreements entered into by the Company and its subsidiary with Shanghai Friendship Group Incorporated Company (上海友誼集團股份有限公司) ("Shanghai Friendship"), S.I. Commerce Holdings Limited ("SI Commerce") and Shanghai Liding Investment Company Limited (上海立鼎投資有限公司) ("Shanghai Liding") in respect of the acquisition of 80% equity interest in Shanghai Century Lianhua Supermarket

Development Company Limited (上海世紀聯華超市發展有限公司) ("Century Lianhua"), bringing 31 new hypermarkets to the Group. Operations in Guangxi area has benefited from synergy effect resulting from the enhanced consolidated efforts, group structure refinement and system improvements of the Group which strategically enhanced the Group's operating capability.

### Optimisation of the supply chain system

Optimisation of the supply chain system is an essential element for improving the core competitiveness of a retail enterprise. During the year under review, the Group cooperated with the globally renowned information technology enterprise IBM China Company to develop an advanced supply chain management platform system ("B2B project"). Total investment in this project is anticipated to amount to RMB120,000,000, which is to be invested by stages in six years period from 2005 to 2010 in accordance with the progress of the project. Up to date, B2B project is the Group's largest information technology investment project and one of the basic

components of the nationwide supply chain system infrastructure construction. The B2B project was honoured to receive “2005 Proposed Resolutions for Industry Award”, “Best Solutions for Retailing” and “Best Consultation on Supply Chain Management” in the 2005 China SCM Awards organised by Global Supply Chain Magazine, a specialist supply chain management publication, in conjunction with the Institute of Logistics and Transport, UK, the Chartered Institute of Purchasing and Supply, UK and the Cheung Kong Graduate School of Business. During the year under review, suppliers made preliminary use of this online platform during its trial-run with a substantial growth in order value with a high satisfaction rate of 77% from supplier. The Directors believe that the continued progress of construction of such supply chain platform, combined with reinforced project implementation efforts and close liaison with daily operations, will produce more remarkable results in 2006.

During the year under review, the Group continued to enter into new strategic partnership with various suppliers. Especially worth mentioning is the sophisticated pricing model jointly established by the Group and P&G. In order to build up a distinct image associated with attractive prices, the price of a particular product will be determined by the Group as the retailer with reference to its overall pricing strategy. The suppliers will then establish scientific product ranking and pricing framework pursuant to the pricing requirement of the Group, which will eventually strike a balance between turnover and gross profit margin.

The Group understands that good logistics efficiency is a non-reproducible core competitive edge of retailers. During the year under review, the Group embarked on a modernisation project with a total investment of approximately RMB47,150,000 on the Room Temperature Distribution Centre in Shanghai.

The project optimised the workflow and introduced world-class logistics equipment. After completion of the project, the Distribution Centre’s warehousing capacity was enlarged and the turnover of inventory was accelerated, with the distribution error rate and commodity damage rate reducing by 91.89% and 94.67% to 0.03% and 0.0016% respectively. The successful renovation of the Shanghai Room Temperature Distribution Centre substantially improved the efficiency of the entire supply chain and outlet order satisfaction levels, bringing direct economic benefits to the Company.

The Group believes that information technology is the core technology for optimizing supply chain system. During the year under review, the Group strengthened data collection capability, as well as the capability of database in terms of data analysis. During the year, the Group emphasized on enhancing the search function of data system by reinforcing multi-dimensional data analysis. It also completed the development of report system, which provides data support to decision-making.

### **Building up of consumers’ loyalty**

The building up of corporate brand image and consumers’ loyalty is an important part of the strategy and principle of the Group for expanding its competitive edge.

Merchandise procurement is the beginning stage of the retail operation flow, to which the Group attaches great importance. In 2005, in line with its consumer-oriented approach and in rapid response to changes in the market, the Group refined its centralised procurement structure, thereby continued to expand the scope of centralised procurement and the advantage of scale. In addition, the Group also expedited the restructuring of product mix of the acquired companies to achieve sharing of resources.

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As the living standard continues to improve, “health and green” become indispensable elements in the trend of consumption, which brought about both opportunities and challenges to the market of fast moving consumer goods. In order to build up the brand name of our merchandise as “Healthy, Safe and Hygienic”, the Merchandising Department stepped up its efforts in developing new merchandises to establish an image of “Green, Healthy, High Quality and Fresh”.

During the year under review, the Group continued to push ahead with the development of private brand products. Through cooperation with an internationally renowned private brand operator, the Group leveraged on this partner’s rich experience and established mode of private brand product development to enhance its own development capability and marketing efforts of its private brand products across various business segments. In particular, certain private brand products were launched as propriety merchandise at purchasing conferences for franchised supermarkets. By the end of 2005, the Group had developed over 2,500 private brand products.

While reinforcing centralised procurement, the

Group revamped the design and product mix of its outlets across different business segments in accordance with consumers’ preference in the local regions and adopted effective sales and marketing activities.

During the year under review, substantial efforts were committed to the development and management of membership system. By the end of 2005, the total number of the Company’s members exceeded 5,000,000. The proportion of total consumption of members to total turnover of the Group increased by approximately 7.83 percentage points over the corresponding period of last year. The average purchase per transaction of members increased by approximately 15.83% over the corresponding period of last year. Lianhua OK membership (聯華OK會員卡) has substantially become the top brand among membership systems in the fast moving consumer goods sector in Shanghai and Zhejiang. The satisfactory development of the membership system was mainly attributable to our reinforced focus over member purchase and enrichment of service offerings catering to members’ needs. The Group will further strengthen its analysis of the spending patterns of members to provide better merchandises and services that cater to the needs of the members.

## Segment Results

### Segment turnover

	For the year ended 31 December				
	2005		2004		Change
	Turnover	Percentage of total turnover	Turnover	Percentage of total turnover	
Hypermarkets	7,153.55	49.98	4,717.02	43.45	51.65
Supermarkets	5,642.60	39.42	4,952.97	45.63	13.92
Convenience stores	1,470.48	10.27	1,119.82	10.32	31.31
Other operations	45.87	0.33	65.16	0.60	-29.60
Total	14,312.50	100	10,854.97	100	31.85



## Segment operating profit

	For the year ended 31 December				
	RMB million				
	2005	Percentage of total operating profit	2004	Percentage of total operating profit	Change
	Operating profit		Operating profit		
Hypermarkets	54.19	19.37	75.05	29.12	-27.79
Supermarkets	193.49	69.16	157.68	61.19	22.71
Convenience stores	32.10	11.47	24.97	9.69	28.55

## Hypermarkets

Directly operated stores 97 (Note)

Note: Including hypermarkets owned by Century Lianhua which was acquired by the Company during the year under review.

## Segment results

Hypermarkets have gradually become the Group's principal business segments. Currently, this business segment accounted for 49.98% of total sales attributable to the Group and has become the largest turnover contributor to the Company. As at 31 December 2005, the number of directly operated hypermarkets of the Group increased by 48 compared with the same period last year, which included the 31 hypermarkets of Century Lianhua which were acquired by the Company.

Segment turnover of the Group's hypermarket business was approximately RMB7,153,547,600, accounting for approximately 49.98% of the turnover of the Group and representing an increase of approximately 51.65% over RMB4,717,019,300

in the previous year. Pursuant to the acquisition of an aggregate of 80% equity interest in Century Lianhua by the Company and its subsidiary from Shanghai Friendship, SI Commerce and Shanghai Liding, which was approved and confirmed by the extraordinary general meeting of the Company held on 13 December 2005, the voting rights in Century Lianhua held by Shanghai Friendship, Shanghai Industrial United (Group) Commercial Network Development Company Limited ("Shanghai Industrial Commercial Network") and Shanghai Liding being former shareholders of Century Lianhua, were transferred to the Company. Accordingly, the segment results incorporated the turnover of Century Lianhua for the period from 13 December 2005 to the end of the year.

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			Excluding wholesale to Century Lianhua at cost	
	2005	2004	2005	2004
Gross profit margin (%)	<b>7.96</b>	8.69	<b>9.74</b>	11.14
Consolidated income margin (%)	<b>16.53</b>	15.70	<b>20.25</b>	20.13
Operating profit margin (%)	<b>0.76</b>	1.59	<b>0.93</b>	2.04

## Business development

Hypermarket business is also one of the highly competitive business units in the chain food store operations in the PRC. During the year under review, the Group strengthened its outlet distribution in the strategic development areas. In the meantime, an overall analysis on the organisational framework of the existing hypermarket operational management was conducted to identify the characteristics of the Group's hypermarket operations in various areas. Such analysis strengthened the regional hypermarket management models of the Group and improved the overall organisational management framework. The Group also engaged senior management personnel with extensive experience in multinational corporations, thereby effectively combining advanced expertise of international retailers with localised characteristics in the PRC.

Furthermore, product mix was optimised on a nationwide and regional basis in accordance with local spending power and patterns. As a consequence, the well-designed and multi-tiered product mix increased customer traffic and transaction volume of customers of outlets.

The hypermarket business remained to be the most potential business segment of the Group. The Group will continue to enhance the profitability of this segment. Meanwhile, efforts will be stepped up to further incorporate Century Lianhua into the overall development plan of the Group, so as to lower management costs and create economy of scale.

## Supermarkets

Directly operated stores	653
Franchised stores	900

## Segment results

Supermarkets remained the most mature business segment amongst the Group's retail chain business and a major profit contributor for the Group. As at 31 December 2005, the number of the Group's supermarkets amounted to 1,553. During the year under review, the number of directly operated supermarkets increased by 69, while the number of franchised supermarkets increased by 144.

Segment turnover of the Group's supermarket business for the year under review was approximately RMB5,642,602,900, accounting for approximately 39.42% of the Group's turnover and representing an increase of approximately 13.92% from approximately RMB4,952,964,100 in the previous year.

	2005	2004
Gross profit margin (%)	<b>14.13</b>	14.96
Consolidated income margin (%)	<b>22.71</b>	22.24
Operating profit margin (%)	<b>3.43</b>	3.18

### *Business development*

During the year under review, the Group completed trial transformation of 10 supermarkets including stores. As part of the transformation, the stores were fully revamped with reference to the characteristic environment of the local region. The product mix was shifted towards the middle- to high-end market, while processing of raw and fresh food was strengthened by the addition of relevant equipment. The proportion of imported goods was also increased. As such, the stores underwent substantial upgrades in terms of decoration, product mix and service quality. During the year under review, sales and transaction volume of customers of the transformed stores recorded a year-on-year increase of 48.84% and 23.04% respective. The successful trial transformation established a robust foundation for the further expansion of the supermarket business. The transformation represented more than just a facelift of the shopping environment, but a radical revamp of the entire operating system as well as further optimisation of the operating flow.

In the course of development of the supermarket business segment, the Group adhered to the dual strategic focuses of direct operation and franchise operation. Persistent efforts were devoted to promote the healthy development of franchised supermarket operations as a whole. In 2005, the Group also stepped up its regulation and management of franchised stores, particularly with the implementation of on-site supervision. Additional efforts were devoted to guide the operating activities of the franchised stores, where the Group's experiences derived from its supermarket operations were fully shared among the franchised stores. The Group's dynamic

franchise team kept growing in scale. Two of the franchisees were recognised as "Outstanding Franchise Operators of China" (中國優秀加盟者) by the China Chain Store & Franchise Association. The supermarket franchise business of the Group recorded franchise fees of approximately RMB17,855,600 which represented an increase of approximately 15.87% from last year.

### **Convenience stores**

Directly operated stores	1,245
Franchised stores	714

### **Segment results**

During the year under review, the convenience store business was still concentrated in the six cities of Shanghai, Beijing, Guangzhou, Dalian, Hangzhou and Ningbo, which were relatively more economically developed with residents of better income and spending power. As at 31 December 2005, the number of convenience stores of the Group reached 1,959. During the year under review, the number of directly operated convenience stores increased to 1,245, while that of franchised convenience stores increased to 714. Following Shanghai and Dalian, Hangzhou, Ningbo and Beijing became the new profitable districts for the convenience store business of the Group.

Segment turnover of the Group's convenience store business for the year under review was approximately RMB1,470,475,200, accounting for approximately 10.27% of the Group's turnover and representing an increase of approximately 31.31% from approximately RMB1,119,819,600 in the previous year.



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			Excluding wholesale to franchised convenience stores at cost	
	2005	2004	2005	2004
Gross profit margin (%)	<b>16.07</b>	17.87	<b>20.50</b>	19.98
Consolidated income margin (%)	<b>25.31</b>	29.34	<b>32.28</b>	32.82
Operating profit margin (%)	<b>2.18</b>	2.23	<b>2.78</b>	2.49

## Business development

The convenience store business of the Group celebrates the eight anniversary of operation, during which period our convenience store network has been expanding from a single location to six cities. In just eight years, “Quik” won wide recognition from consumers and became one of the most famous brands in the convenience chain store sector in the PRC.

Through nearly eight years of development, the Group has established a relatively mature model of operation in its convenience store business, which has improved management systems and a professional team of management. As such, the Group was well prepared to push ahead with the development of franchised convenience stores in full force. During the year under review, leveraging on its advantages in terms of operating scale and resources and with reference to general practices in the international market, the Group pursued expansion primarily through franchised operations. Accordingly, the number of franchised convenience stores increased by 172, which accounted for 76.44% of the net increase in number of convenience stores throughout the year.

During the year under review, the Group attached strong emphasis on the optimisation of product mix of convenience stores in accordance with the local business environment and spending patterns of consumers. Increased efforts were devoted to the

development of commodities suitable for convenience store sales. Specifically, substantial breakthrough was achieved in the sales of instant food such as lunch-boxes, accumulating positive experience for the sale operation of convenience food. Furthermore, management efforts on the product mix of convenience stores were also strengthened. In particular, best selling new products for convenience stores were identified through life-cycle testing of the newly introduced products. In addition, on the basis of the existing utility payment services, the Group sought to differentiate itself by actively pursuing diversification into other services, such as ticketing service, insurance service and ATM, etc., according to changes in the market.

During the year under review, upon the abovementioned management upgrade, 400 convenience stores of the Group have adopted the new corporate identity (“CI”) design, further enhancing the brand awareness of “Quik” among consumers.

The convenience store operation of the Group established a mature mode of operation and occupied leading market shares in the six existing municipal markets. In future, the Group will implement differentiated development to fortify this segment’s image as one of the top brands in the convenience chain sector of the PRC.

## Associated companies

During the year under review, Shanghai Carhua Supermarket Company Limited ("Shanghai Carhua") operated a total of 8 hypermarkets in Shanghai. Upon acquisition of a hypermarket in Qibao district, Shanghai, from Next-Mart, as at the date of this report, Shanghai Carhua operated a total of 9 hypermarkets in Shanghai.

The Group launched Shanghai Dia-Lianhua Retail Co., Ltd. ("Shanghai Dia") discount stores in Shanghai. At present, there are a total of 131 discount stores in Shanghai. As a result of the relatively high initial fixed costs, low gross profit margin and the lack of economy of scale in operation, Shanghai Dia has not yet reached the break-even point. Despite this, the existing scale of operation provides a robust foundation for its future development.

As at 31 December 2005, net profit from the associated companies was approximately RMB94,287,000, accounting for approximately 39.3% of the Group's profit attributable to shareholders.

## Financial Review

### Liquidity and financial resources

For 2005, the capital resource of the Group was mainly cash inflow from operations. As at 31 December 2005, the Group had non-current assets of approximately RMB3,613,094,000. Non-current assets were mainly comprised of construction in progress and fixed assets and land use right of approximately RMB2,993,956,000, intangible assets of approximately RMB197,302,000, investments in associates of approximately RMB335,261,000, and available-for-sale financial assets and other non-current assets of approximately RMB86,575,000.

As at 31 December 2005, the Group had net current liabilities of approximately RMB1,402,118,000. Current assets were mainly comprised of cash and bank balances of approximately RMB1,083,221,000, inventories of approximately RMB1,757,363,000, accounts receivable and prepayments of approximately RMB528,088,000, and amounts due from associates of approximately RMB863,000. Current liabilities were mainly comprised of accounts payable, other payables, accruals and coupon liabilities of approximately RMB4,193,450,000 and tax payable of approximately RMB40,006,000. As at 31 December 2005, the Group's gearing ratio was 0.27%.

For the year ended 31 December 2005, the Group's accounts payable turnover was 61 days. During the year, inventory turnover was 31 days.

For the year under review, the Group did not use any financial instrument for hedging purposes and the Group did not have any hedging instrument outstanding as at 31 December 2005.

### Capital structure

As at 31 December 2005, the Group's cash and cash equivalents were mainly held in Renminbi. The Group's borrowings were primarily denominated in Renminbi.

It is the intention of the Group to maintain an appropriate mix of equity and debt to ensure an efficient capital structure from time to time. As at 31 December 2005, the Company and its subsidiaries had no borrowings outstanding, and was in a net cash position, save for the secured borrowing of RMB18,910,000 arising from the acquisition of a subsidiary, during the year under review. The Group is engaged in retail chain business. Since the sales peak season for the Group is near the year end, cash flow at year end is relatively adequate. The Group considered that

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reasonable management of the cash flow is helpful for reducing capital costs.

## Details of pledged assets of the Group

The Group's bank borrowings of RMB18,910,000 are secured liabilities, which arose from the Group's acquisition of a subsidiary, Guangxi Lianhua Supermarket Joint Stock Company Limited (formerly known as Guangxi Jiayong), during the year under review. As at 31 December 2005, the borrowings were secured by certain buildings of the Group with a total net book amount of RMB55,238,000.

## Exposure to foreign exchange risk

Most of the income and expenditures of the Group are denominated in Renminbi. During the year under review, the Group had not experienced any material difficulties or negative effects on its operations or liquidity as a result of fluctuation in currency exchange rates. The Group has not entered into any agreements or purchased any financial instruments to hedge the foreign exchange risks of the Group. The Directors believe that the Group would have sufficient foreign exchange resource to meet its foreign exchange requirements.

## Contingent liabilities

As at 31 December 2005, the Group did not have any significant contingent liability.

## Material acquisitions and disposals

In March 2005, Lianhua Supermarket (Jiangsu) Company Limited (聯華超市(江蘇)有限公司) ("Lianhua Jiangsu") and Wuxi Zhongbai Supermarket (Distribution) Company Limited ("Wuxi Zhongbai") entered into an agreement, pursuant to which Lianhua Jiangsu acquired the assets of 14 chain supermarkets of Wuxi Zhongbai, and contributed approximately RMB14,500,000 to establish Wuxi Lianhua Zhongbai Supermarket Company Limited (無錫聯華中百超市有限公司) ("Lianhua Wuxi"). Lianhua Jiangsu holds

approximately 90.625% equity interests in Lianhua Wuxi so as to operate the aforementioned assets. Such acquisition further enhanced the concentration advantages of the Group in the Jiangsu region.

In May 2005, the Group contributed approximately RMB107,000,000 and RMB92,306,000 respectively to complete the capital injection and acquisition of 95% shareholding interests in Guangxi Jiayong Trading Company Limited (廣西佳用商貿股份有限公司) ("Guangxi Jiayong"). Such acquisition rendered 77 new stores joining the Group, including 8 hypermarkets and 69 supermarkets. This acquisition will help enhance the concentration of the Group's outlet distribution in the southern region of the PRC thereby consolidating the Group's strategic deployment in the southern region of the PRC.

On 27 October 2005, the Company and Hangzhou Lianhua Huashang Group Co., Ltd. (杭州聯華華商集團有限公司) ("Hangzhou Lianhua"), a non wholly-owned subsidiary of the Company, jointly acquired the equity interest in Shanghai Century Lianhua Supermarket Development Company Limited (上海世紀聯華超市發展有限公司) ("Century Lianhua") at an aggregate consideration of RMB94,972,000 by separately entering into Equity Transfer Agreements with Shanghai Industrial Holdings Limited ("Shanghai Industrial"), Shanghai Friendship Group Incorporated Company (上海友誼集團股份有限公司) ("Shanghai Friendship") and Shanghai Liding Investment Company Limited (上海立鼎投資有限公司) ("Shanghai Liding"). Upon completion of the above three Equity Transfer Agreements, the Company and Hangzhou Lianhua held 77.91% and 22.09% in Century Lianhua. As the Company has been managing the hypermarkets for Century Lianhua under the Century Lianhua Management Agreement since 2003, the hypermarkets of both Century Lianhua and the Company have adopted the same set of standards over their procurement, information and operating

systems. The Equity Transfers will further enlarge the Company's operating scale with the benefit of synergies and will enhance the management efficiency by reducing the amount of connected transactions of the Company.

### Employment and training

As at 31 December 2005, the Group had a total of 47,289 employees, representing an increase of 15,971 employees from 31 December 2004. As a result of the acquisition of 80% equity interest in Century Lianhua by the Company and its subsidiary from Shanghai Friendship, SI Commerce and Shanghai Liding, which was approved and confirmed by the extraordinary general meeting of the Company held on 13 December 2005, the number of employees of the Group was increased by 6,297. For the year under review, total staff costs of the Group was approximately RMB798,953,000.

Remuneration to the Group's employees was determined based on individual performance, qualifications and experience and prevailing market practices. The compensation policies and remuneration packages are subject to regular review. Apart from basic salary, welfare allowances and performance bonus, the Group also provides employees with housing allowances, medical and other subsidies. Pursuant to applicable laws and regulations of the PRC, all employees of the Group participate in various retirement benefit schemes organised by the relevant provincial or municipal governments. During the year, monthly contributions were made to these schemes at a certain percentage of the employees' salaries by the Group and its employees under the retirement benefit schemes.

On 1 May 2004, the "Administration on the education and training of employees" was adopted to regulate the flow of training work in all aspects. During the year under review, the "Administration on the education and training of employees" was further implemented and promoted. Building on the basis of high efficiency and innovation training for regular first-tier employees, the training focus was shifted to the nurturing of management talents in terms of professional and management skills. The various functional departments reinforced the organisation and implementation of professional operation training. In addition, the training department of the Company optimised its staff structure, information management and logistics arrangements so as to enhance and upgrade the programme structure for various business segments.

### Establishment of corporate culture

The Group places great importance to the establishment of corporate culture because the Group believes that rapid growth of corporate results is achieved by employees sharing the same corporate value. The Group upheld the theme of "Innovation, Perfection, Teamwork and Tolerance" and adopted result-oriented culture as the core culture. The Group promoted team spirit among the staff by relaying the corporate culture and the general value of the Group.

"Lianhua Spirit" (聯華魂) is an award set up by the Group in recognition of the outstanding contribution of an employee or a group of employees to the development or operation of the Company and is the most honorary title within the Group. During the year under review, the third round of award assessments were conducted, which produced five awardees for "Outstanding Individual Award" (先進個人獎) and two for "Outstanding

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Team Award” (先進集體獎). The recipients of these awards were model staff in terms of their positive thinking, pro-active work attitude, surpassing skills and leading participation rate. Their exemplary effect was well received by the staff, stimulating their colleagues’ entrepreneurship, understanding of our corporate culture and cohesion to the Group.

The Group also attached strong emphasis on its appraisal system of “Star-grade service”, with the aim of simulating the innovative and competition spirit of the staff and their eagerness in strengthening and protecting the Group’s brand name. For the past five years, the appraisal scheme identified and built up an excellent staff team of star-grade services.

## Strategies and plans

2005 marks the first year of full deregulation of the PRC retail market and a critical year for the Group’s development. Under an intense competitive environment, the Group continued to pursue the objectives of internationalisation, consolidating domestic predominance, optimising nationwide network, strengthening core competitiveness and focusing on the three core business segments. The Group aimed at fulfilling the needs of customers and further consolidating its leading position in the retail industry, so as to enlarge its market share in the PRC. The Group strove to fortify its leading market position as reflected by its network scale and various competitiveness indicators.

Looking into 2006, market competition will sustain along with enormous room for development. The market is thus filled with both opportunities and challenges.

Upholding its strategy of centralised development to further underpin the advantages of centralisation in its dominating regions, the Group will persistently set up quality stores in existing municipal and core

markets at a pace of around 500 new stores per year. Development of the hypermarket business will be focused on the Yangtse River Delta region, while over 80% of the new store area will be located in Eastern China.

The Group will further pursue its strategy of acquisition and mergers in the PRC. In order to open up more flexible channels of expansion in core regions, the Group will explore diversified modes of acquisition, such as equity acquisition, asset acquisition, equity swap and asset exchange. It is the Group’s intension to rapidly complete post-acquisition consolidation to maximise the favourable effect of acquisitions.

The Group also will actively identify appropriate franchise modes, expedite the establishment of a chain supporting framework for franchise operations, implement demand-oriented management, embark on thorough research on the needs of franchise operators, and providing franchise operators with better services through brand building.

The Group will focus on enhancing its core capabilities in the following aspects in order to elevate its profitability:

The Group plans to enhance operation management and maintain high growth rate for individual stores with an aim of further improving store performance. For the hypermarket business segment, focus will be put on strengthening operating flow for further regulation and standardisation. For the supermarket segment, efforts will be committed to further push ahead with the transformation of supermarkets, targeting to complete the transformation of one third of the directly operated stores in Shanghai region (i.e. around 100 stores). The convenience store segment will pursue organic development and strengthen refined management.

The Group will further reinforce its operating capability for fresh produce, self-operation and procurement, purchase of fresh produce and the processing capability of fresh good distribution centres, so as to establish a standard fresh produce system and refrigerating storage chain and strengthen food safety and hygiene monitoring, thereby better satisfying the growing demand of consumers.

The focus of retail chain competition in the future will be controlling costs. The Group plans to exercise strict control over operating costs by improving management and enhancing efficiency through innovation.

The Group will continue to optimise its supply chain. It plans to enhance its procurement capability and further consolidate the strategic cooperation with suppliers to enlarge the market share, brand influence and competitiveness of both parties through information sharing and cooperation in joint promotion, inventory management and quality control. The Group intends to maximise the synergy between operations of different regions and segments, and promote the sharing of supply chain resources between various business segments in dominating regions. In addition, it will formulate a nationwide logistics and implementation proposal and expand the logistics centre in Jiangsu region for distributions to hypermarkets and supermarkets in the region. As for the hypermarket business segment, the Group plans to implement a supply chain management platform system ("B2B project") so as to reduce the rate of inventory inadequacy, increase the satisfaction rate of order and improve inventory turnover.

In the coming year, the Group will further promote the brand building of its membership system and enhance the attraction on membership prices to consumers. Marketing work will be focused on boosting sales to members by promoting the

awareness of membership exclusive prices. With reference to the successful membership operation of overseas retailers, the Group will reinforce the analysis and application of membership data, especially on the classification, geographic region and consumption patterns of customers, so as to boost the purchase frequency and transaction volume of members.

Additional efforts will be committed to the establishment of corporate culture, staff training and organisation capability. An internationalised and professional management team is an important asset for the Company. In order to push ahead with implementation, development and operational strategies of the Company, it will be essential to strengthen personnel training and retain sufficient staff to resolve the bottleneck arising from the lack of human resources and build up a professional team of management. The Group will further enhance its multi-level training framework and highlight the training goals of various levels. Training efforts will be stepped up to improve the education level and overall quality of staff to cater for the development needs of the Group. Furthermore, the Group will guide changes in staff mindset and management, so as to upgrade its organisational and implementation capabilities at various levels of the Company.