

Management Discussion and Analysis

CONSOLIDATION OF HUNAN ZHUYE TORCH METALS CO., LIMITED ("ZHUYE TORCH") AND ZHUZHOU DIAMOND CUTTING TOOLS COMPANY LIMITED ("ZHUZHOU DIAMOND")

Due to the consolidation of Zhuye Torch and Zhuzhou Diamond since 1 June 2005 and deconsolidation of Zhuye Torch for the period from September 2004 to May 2005 as stated in the prospectus dated 21 March 2006, the financial and operating information set out below may not be comparable for 2004 and 2005.

GENERAL DESCRIPTION

During the year ended 31 December 2005, profit before tax decreased RMB75 million or 10.1%, from RMB746 million for the year ended 31 December 2004 to RMB671 million for the year ended 31 December 2005. The profit attributable to equity holders of the parent decreased RMB129 million or 23.2%, from RMB555 million for the year ended 31 December 2004 to RMB426 million for the year ended 31 December 2005.

The following is the comparison between years ended 31 December 2005 and 31 December 2004:

TURNOVER

Turnover increased RMB1,982 million or 27.1%, from RMB7,309 million during the year ended 31 December 2004 to RMB9,291 million for the year ended 31 December 2005, mainly due to the increased turnover before sales tax and surcharge from nonferrous metals mine segment of RMB544 million or 50.5%, nonferrous metals smelting segment of RMB967 million or 22.1%, cemented carbides, and tungsten, molybdenum, tantalum, niobium and their compounds segment of RMB495 million or 26.4%.

Our gross profit increased 32.8% from RMB1,138 million for the year ended 31 December 2004 to RMB1,511 million for the year ended 31 December 2005. Gross profit ratio stayed the same at approximately 16% for the years ended 31 December 2004 and 2005.

NONFERROUS METALS MINE SITE SEGMENT

Set out below is information on sales volume and average price of our nonferrous metals products:

	2004		2005	
	Sales volume	Average sales price	Sales volume	Average sales price
	tons	RMB/ton	tons	RMB/ton
Shizhuyuan				
Tungsten concentrates	2,381	27,899	1,778	64,020
Oxidized molybdenum	703	95,674	882	246,575
Huangshaping Branch				
Zinc concentrates	14,177	5,195	15,442	6,868
Lead concentrates	8,409	6,874	13,398	8,179
Hsikwangshan				
Antimony products	23,434	18,794	24,201	23,482
Zinc products	29,951	9,139	31,652	11,751

Turnover before sales tax and surcharge from nonferrous metals mine site segment increased RMB544 million or 50.5%, from RMB1,078 million for the year ended 31 December 2004 to RMB1,622 million for the year ended 31 December 2005, mainly due to positive market conditions and price trends for nonferrous metals such as tungsten, zinc, lead concentrates, oxidized molybdenum and antimony products. In response to the increased prices, the Group increased the production volume of primary ores. The Group believes that the increase in the prices of such nonferrous metal mine site products was driven by increased market demand and insufficient supply. For example, the average price of oxidized molybdenum for the year ended 31 December 2005 increased greatly compared to the same period in 2004. Such increase was also related to the rise of domestic market demand and stoppage of supply from certain suppliers in Chile.

Gross profit from nonferrous metals mine site segment increased 96.3% from RMB243 million for the year ended 31 December 2004 to RMB477 million for the year ended 31 December 2005. Gross profit ratio increased from 23% for the year ended 31 December 2004 to 30% for the year ended 31 December 2005, mainly due to favorable conditions for our products and the rise in average prices of products in this segment especially tungsten, zinc and lead concentrates, oxidized molybdenum and antimony products.

NONFERROUS METALS SMELTING SEGMENT

Set out below is information on sales volume and average price of our nonferrous metals smelted products:

	2004		2005	
	Sales volume	Average sales prices	Sales volume	Average sales price
		<i>RMB/ton or</i>		<i>RMB/ton or</i>
	<i>tons or kg</i>	<i>RMB/kg</i>	<i>tons or kg</i>	<i>RMB/kg</i>
Zinc products (<i>tons</i>)	198,434	9,515	221,347	12,195
Lead products (<i>tons</i>)	98,066	7,872	92,170	8,294
Precious metal-indium (<i>kg</i>)	55,070	5,448	35,000	8,306
Precious metal-silver (<i>tons</i>)	507	1,731,998	456	1,863,677

Turnover before sales tax and surcharge from nonferrous metals smelting segment increased RMB967 million or 22.1%, from RMB4,377 million for the year ended 31 December 2004 to RMB5,344 million for the year ended 31 December 2005, mainly due to the rise in average sales price.

Gross profit from nonferrous metals smelting segment decreased 13.0% from RMB639 million for the year ended 31 December 2004 to RMB556 million for the year ended 31 December 2005. While gross profit ratio decreased from 15% for the year ended 31 December 2004 to 10% for the year ended 31 December 2005, mainly due to the increase in raw materials costs. While the increase in average prices of nonferrous metals concentrates is favorable to the nonferrous metals mine segment, such an increase had negative impact on our nonferrous metals smelting segment, as concentrates are raw materials of our products.

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CEMENTED CARBIDES, AND TUNGSTEN, MOLYBDENUM, TANTALUM NIOBIUM AND THEIR COMPOUNDS

Set out below is information on sales volume and average price of our cemented carbides, and tungsten, molybdenum, tantalum, niobium and their compounds:

	2004		2005	
	Sales volume	Average sales price	Sales volume	Average sales price
	<i>tons</i>	<i>RMB/ton</i>	<i>tons</i>	<i>RMB/ton</i>
Cemented carbides	4,778	201,649	3,575	279,016
Tungsten and its compounds	7,588	85,604	5,301	190,483
Molybdenum and its compounds	416	299,814	258	678,387
Tantalum, niobium and their compounds	500	274,193	526	356,750

Turnover from cemented carbide, and tungsten, molybdenum, tantalum, niobium and their compounds before sales tax and surcharge increased RMB495 million or 26.4%, from RMB1,875 million for the year ended 31 December 2004 to RMB2,370 million for the year ended 31 December 2005, mainly due to the rise in average price compared with 2004. The increase in average price in cemented carbides, tungsten and their compounds was driven by a significant increase in the prices of tungsten concentrates. However, the increase in average selling prices was partially offset by decreased sales volumes due to our decision to reduce the production and sale of low-end products. For example, beginning from the end of 2004, the Group stopped the low-end cutting blade production. Therefore, the production and sales volume of cemented carbides in 2005 decreased compared to 2004.

Gross profit of cemented carbides, and tungsten, molybdenum, tantalum, niobium and their compounds increased 86.7% from RMB256 million for the year ended 31 December 2004 to RMB478 million for the year ended 31 December 2005. Gross profit ratio increased from 14% for the year ended 31 December 2004 to 20% for the year ended 31 December 2005, largely as a result of significantly improved average sales prices for our products, especially tungsten, molybdenum and their compounds.

OTHER REVENUE AND GAINS

Other revenue and gains decreased RMB333 million or 86.3%, from RMB386 million for the year ended 31 December 2004 to RMB53 million for the year ended 31 December 2005, mainly due to one-time acquisition gains realized in 2004, which comprised RMB171 million caused by acquisition of Zhuzhou Diamond Refractory Metals Processing Co., Ltd. ("Diamond Refractory") in 2004 and RMB121 million caused by the dilution of interest in Zhuye Torch upon the listing of Zhuye Torch on the Shanghai Stock Exchange in August 2004.

SELLING AND DISTRIBUTION COST

Selling and distribution costs increased by RMB20 million, or 13.8%, from RMB145 million for the year ended 31 December 2004 to RMB165 million for the year ended 31 December 2005 primarily due to the increase in turnover.

ADMINISTRATIVE EXPENSES

Administrative expenses increased by RMB60 million, or 12.0% from RMB500 million for the year ended 31 December 2004 to RMB560 million for the year ended 31 December 2005, primarily due to the increase in depreciation and amortisation charges, and maintenance and repair expenses for properties used for administrative purposes, research and development expenses, government levies, travel expenses, and entertainment expenses.

OTHER OPERATING EXPENSES, NET

Other operating expenses, net increased by RMB27 million, or 192.9%, from RMB14 million for the year ended 31 December 2004 to RMB41 million for the year ended 31 December 2005, primarily due to the execution of share reform scheme by Zhuye Torch in 2005. The Group's equity interest in Zhuye Torch was diluted from 31.1% to 26.9% and the dilution loss before minority interests of RMB56 million (dilution loss after minority interests was RMB38 million) was attributable to the decrease in the Group's share of the net assets of Zhuye Torch.

FINANCE COSTS

Finance costs increased by RMB26 million, or 17.6%, from RMB148 million for the year ended 31 December 2004 to RMB174 million, primarily due to the increased bank loans outstanding.

INCOME TAX EXPENSES

Income tax expenses increased by RMB38 million, or 39.6%, from RMB96 million for the year ended 31 December 2004 to RMB134 million for the year ended 31 December 2005. Our effective tax rate for the year ended 31 December 2005 was 20.0% due to lower income tax paid by some of our subsidiaries as they enjoyed income tax preferential policy. During the year ended 31 December 2004, apart from the above-mentioned reasons such as income tax preferences etc, we incurred non-taxable gains on acquisition of Diamond Refractory and gains on dilution of interests in Zhuye Torch aggregating to RMB292 million, which further reduced our effective tax rate to 12.9%.

MINORITY INTERESTS

Minority interests increased by RMB16 million, or 16.8%, from RMB95 million for the year ended 31 December 2004 to RMB111 million for the year ended 31 December 2005, primarily due to the consolidation of Zhuye Torch and Zhuzhou Diamond starting from 1 June 2005. Both Zhuye Torch and Zhuzhou Diamond generated profits for the year ended 31 December 2005, as a result, minority interests thereof increased in 2005.

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NET PROFIT ATTRIBUTABLE TO THE EQUITY HOLDERS OF THE PARENT

Net profit attributable to the equity holders of the parent decreased RMB129 million, or 23.2%, from RMB555 million for the year ended 31 December 2004 to RMB426 million for the year ended 31 December 2005, and the profit margin decreased from 7.6% for the year ended 31 December 2004 to 4.6% for the year ended 31 December 2005 mainly due to the net effect of the increase in gross profit and gross profit margin caused by improved average sales prices for our products, not enough to offset against the decreases in other revenue and gains in 2005.

LIQUIDITY AND FINANCIAL RESOURCES

During the year ended 31 December 2005, funds resources were from operating activities and short and long term bank loans. Our funds were mainly used in operating activities, capital expenditures, and bank loan repayments. As at 31 December 2005, we had banking facilities of RMB9,571 million, of which RMB3,953 million had been utilised.

DEBT TO TOTAL ASSETS RATIO

As at 31 December 2005, our Group's debt to total assets decreased from 41% in 2004 to 40% in 2005. The debt to total assets ratio equals to total debt divided by total assets multiplied by 100%. No material fluctuation was noted on debt to total assets ratio as the amounts of total interest-bearing bank loans and borrowings and total assets were increased nearly by the same percentage.

FOREIGN EXCHANGE RATE FLUCTUATION RISK

The Group conducts operations primarily in the PRC and sells part of our products to customers in various foreign countries. Except for export sales which are mainly transacted in United States dollars, the Group currently receives its sales revenue in Renminbi. The Group's exposure to exchange rate fluctuations results primarily from the sales of products and purchase of raw materials in foreign currencies. The Group does not currently have a formal hedging policy and has not entered into any foreign currency exchange contracts or derivative transactions to hedge the Group's currency risk.

COMMODITY PRICE RISKS

The Group faces commodity price risks as prices of our nonferrous metals purchases and sales are based on global and domestic prices, which is subject to significant fluctuations. As commodity products, nonferrous metals prices are principally dependent on the supply and demand dynamics in the marketplace in the long term. The Group does not engage in trading contracts and has not entered into pricing arrangements to hedge the Group's exposure to fluctuations in the prices of nonferrous metals.

INTEREST RATE RISKS

The Group's exposure to interest rate risk relates primarily to our short-term and long-term bank loans and other borrowings, which totaled RMB4,016 million as at 31 December 2005. The Group's outstanding indebtedness is subject to fixed rates of interest. An increase in prevailing interest rates would lead to an increase in interest cost on short-term debt when such debt is rolled over. To date, the Group has not entered into any type of interest rate agreements or derivatives to hedge against interest rate changes.

CONTINGENT LIABILITIES

As at 31 December 2005, guarantees provided by the Group in connection with bank loans made to the following parties were as follows:

	2005 RMB'000	2004 RMB'000
Related parties and a third party	30,000	599,554

CAPITAL EXPENDITURES

The following table sets forth the Group's historical capital expenditures by different business segments for the year ended 31 December 2005 and the percentage of total capital expenditures allocated to each business segment.

	2005 RMB'000	Total (in percentage)
Nonferrous metal mine site	753,301	64.02%
Nonferrous metal smelting	171,322	14.56%
Cemented carbides, and tungsten, molybdenum, tantalum, niobium and their compounds	251,132	21.34%
Corporate and others	946	0.08%
Total	1,176,701	100.00%

Capital expenditures were primarily used to expand the Group's production capacities and to improve the Group's mining and processing technology.

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EMPLOYEES

As of 31 December 2005, the Group had approximately 21,242 full-time employees. Breakdowns by function and location are as follows:

Division	Employees	Total <i>(in percentages)</i>
Management and administration	2,143	10.1%
Engineering technician	3,790	17.8%
Production staff	12,119	57.1%
Repair and maintenance	1,800	8.5%
Inspection	900	4.2%
Sales	490	2.3%
Total	21,242	100%

The remuneration package of the Group's employees includes salary, bonuses and allowances. The Group has joined the social insurance contribution plans organized by local governments in the PRC. In accordance with the relevant national and local labor and social welfare laws and regulations, the Group is required to pay on behalf of employees a monthly social insurance premium covering pension insurance, medical insurance, unemployment insurance and housing reserve fund. According to the currently applicable local regulations, the respective percentages of the pension insurance, medical insurance, unemployment insurance and housing reserve fund that the Group must contribute are 20%, 8%, 2% and 5 to 20%, respectively, of employees' total monthly basic salary.