MANAGEMENT DISCUSSION AND ANALYSIS

DIVIDEND

The Board of Directors recommends a payment of a final dividend of HK5.5 cents per share for the year ended 31 December 2005. Together with the interim dividend of HK9.5 cents per share, the total dividend for the year ended 31 December 2005 is HK15.0 cents per share. Subject to the approval of the shareholders at the forthcoming Annual General Meeting, the final dividend will be distributed on or about 29 May 2006 to shareholders whose names appear on the Register of Members of the Company as at the close of business on 26 May 2006.

Currently, the Directors anticipate that the dividend payout ratio will be maintained approximately 50% of the Group's distributable profit of the relevant financial year. However, the actual payout ratio in a financial year will be determined at the Directors' full discretion, after taking into account, among other considerations, availability of investment and acquisition opportunities.

FINANCIAL REVIEW

Chitaly managed to enjoy business growth despite the unfavourable environment brought by the Chinese Government's macroeconomic austerity measures and fewer new weds during the year under review. Turnover demonstrated a mild increase from HK$403.8 million last year to HK$413.3 million this year. The oil price surged to near US$70 per barrel from under US$45 per barrel and pushed up material costs. Nevertheless, the Group maintained its gross profit at HK$139.0 million (2004: HK$150.7 million) and a gross margin of 33.6%. The Group's retail sales for the year was about HK$43.7 million and had a gross margin of 59.9%. The gross margin of wholesales to franchisees decreased to 30.5% (2004: 37.3%). This was a result of the drop in selling price and the increase in manufacturing costs.

Net profit was HK$78.2 million (2004: HK$108.0 million). The drop in profit is as a result of several main factors: the decreased gross margin of wholesales by 6.8% from 37.3% to 30.5%, increased in promotion and advertising costs by approximately HK$12 million, and increased salary and allowances by about HK$6 million. In addition, operating retail outlets boosted selling and distribution expenses by about HK$21.8 million. Having incurred increased selling and distribution expenses, the retail operation recorded a net loss of about HK$0.7 million. Tax expenses were substantially decreased because of adjustment in respect of overprovision of taxation in prior years.

BUSINESS REVIEW

Distinguished Brand Building Strategies

Riding on the Group's strategy on profile enhancement of its renowned brands "Royal", "Knight" and "Simplified" in the medium to high-end home furniture markets in China, the Group was able to maintain a satisfactory performance under the unfavorable backdrop of the industry. Over the years, these brands have been well received and deeply rooted among the consumers via a wide range of promotions such as printed media, billboards and television featuring our spokesperson Ms. Rosmund Kwan.

On top of the brand building campaign, the Group opened its first "Royal" furniture flagship store in Beijing to further strengthen its reputation and leading position in the high-end furniture market. The 30,000 square-feet, 5-storey flagship store showcases the six major series of the Group's modern romantic furniture and over a thousand pieces of branded products. This spacious and comfortable furniture shopping place with superior products and services has set a new benchmark for the furniture market in Beijing at senses as a model for our franchise stores.

MANAGEMENT DISCUSSION AND ANALYSIS

Network Extension

Covering 29 provinces and municipalities in China, the extensive distribution network of the Group achieved over 1,000 specialty outlets in 2005. The Group also retrieved franchise rights in Shanghai and Shenzhen during the year and put those outlets under its direct supervision. These retail outlets also served as models for other franchisees throughout China. Beyond the nationwide distribution network in China, the Group extended its franchise system to Indonesia, Philippines and the United Arab Emirates, and a licensing agreement was forged with a distributor in Spain.

Product Expansion

Consumers are increasingly demanding for more choices. A few years back, we offered relatively limited selections to the market. This year, the Group marketed several series of home furniture, namely "Light Walnut", "Ebony", "Black Walnut", "Glossy", "Sabili", "New focus" and "Simplified", and the Group also launched a new product line of "愛子成龍" for children and "City Living" for young starter homes. To diversify its product range, the Group launched a healthcare product line, including a massage chair under the "Royal" brand. This new electronic healthcare furniture was well received in the market.

Design Capacity

Devoted to offering unique and innovative designs and superior quality products, the Group's products were accredited with "*CQC Environmental Product Certification*" by the China Quality Certification Center, which is an independent and specialized certification body authorized by governmental departments. Moreover, the Group won a prestigious acclaims of "*Top Ten Renowned Furniture Brands*" named by the People's Daily, the China Enterprise Culture Improvement Association and the China Industrial Design Association. These accolades demonstrated the Group's continuous efforts in production design and innovation as well as its commitment to customer service.

As a move to nurture and encourage designers of the new generation and to enhance its design capability, Chitaly held furniture exhibitions in 2005 – the "First National Quality Furniture Design Winning Entries Exhibition" in Beijing, displaying the outstanding original works of designers.

Investment in Production Facility

In order to meet the demand of consumers, more product lines which are narrowly focused are needed. The Group expanded its production facility by construction of a new production plant in Guangzhou. The first phase of the construction work was completed in the first quarter in 2006. When this phase is in full operation, the Group's total capacity will be increased by 20%.

Construction of the entire plant is scheduled for completion in three to five years. Upon completion, the Group's total production capacity will be boosted by 150%. With the existing Dongguan factory and the new Guangzhou plant, the Group will have adequate capacity to meet the expected demand in 2006.

Other Revenues

During the year, the Group secured other revenues by providing sourcing service on auxiliary furniture and accessories for the franchisees. Benefited from bulk purchase of sourcing items, such as mattress and sofa from its suppliers, the Group enjoyed better sourcing prices in the market. In addition, sourcing furniture and accessories had helped the Group to enrich product mix to its furniture. Furthermore, the Group can highlight its position as a close business partner of its franchisees thereby fortifying the relationship with them, and also ensuring all the specialty outlets share the consistency of image by providing sourcing services.

MANAGEMENT DISCUSSION AND ANALYSIS

PROSPECTS

2005 was a difficult year for the industry and as well as for Chitaly. It was a year of set backs and consolidation for the Company. Taking the opportunity of slower growth in the industry, the Company took steps to consolidate and restructure some of its operating units to fortify its foundation for future development.

Looking ahead, Chitaly will continue to strengthen its leading position in the medium to high-end home furniture markets with a thorough plan to explore opportunities on distribution network expansion. We are cautiously optimistic to the prospect of the the furniture industry with anticipation that the increasing proportion of middle to affluent class in China will be the Group's major growth driver in the future.

To enhance the competitive strength, the Group will continue to actively participate in various international furniture exhibitions and furniture design competitions. In the coming year, the Group will launch a new product line targeting the high-end market including solid wood and veneer furniture. We believe, through our innovative and diversified brand series open to customers' new concepts of modern and stylish living, our products will attract more customers with different styles and tastes. Seeing the successful launch of electronic healthcare furniture in 2005, we will continue our active plan to look for additional product lines to expand the scope of our core products.

During 2005, the Group raised HK$97.4 million through a new issuance of shares with the purpose of financing new acquisitions or internal expansion. Since the acquisition did not materialize, HK$29 million was spent on the Group's production facilities and HK$24.2 million has been for share repurchase. The remaining amount will be used for expansion of the Group's production facilities and distribution network to achieve further organic growth in the coming years.

Positioned as one of the leading furniture brands in China, the Group will continue to further strengthen its brand reputation and enhance its product presence. Through the Group's marketing strategies, superior design capabilities, high brand reputation, quality products and extensive distribution network, the Group is ready to capitalize on the future business opportunities in the enormous and rapidly growing PRC market.