Management Discussion and Analysis

The board of directors (the "Directors") of Zhong Hua International Holdings Limited (the "Company") would like to present the Annual Report of the Company and its subsidiaries (together the "Group") for the year ended 31 December 2005.

Review of Results

The Group recorded a turnover of HK$17,213,000 (31 December 2004: HK$25,145,000) for the year ended 31 December 2005, representing a decrease of 32% compared with 2004. Net loss for the year attributable to ordinary equity holders of the Company was HK$13,771,000 (31 December 2004: net profit of HK$46,131,000 (restated)).

Final Dividend

The Directors do not recommend the payment of a final dividend for the year ended 31 December 2005.

Closure of Register of Members

The Register of Members of the Company will be temporarily closed from Monday, 28 August 2006 to Tuesday, 29 August 2006, both dates inclusive, during which period no transfer of shares will be effected. In order to qualify for the attendance at the Company's annual general meeting to be held on Wednesday, 30 August 2006 all completed transfer forms accompanied by the relevant share certificates must be lodged with the Company's branch share registrar in Hong Kong, Tengis Limited at 26th Floor, Tesbury Centre, 28 Queen's Road East, Wanchai, Hong Kong for registration not later than 4:00 p.m. on Friday, 25 August 2006.

Business Review

The Group's turnover in the year mainly comprised the rental income generated from the commercial podium in Chongqing in Mainland China, the leasing of Point-of-sale ("POS") equipment in Guangzhou and the provision of telecommunication and other related services in Mainland China.

In addition, the Group received HK$50,000,000 which formed part of the consideration receivable from the disposal of 51% equity interest in certain former subsidiaries in the year, which recognised a gain on disposal of HK$22,568,000.

Property investment

The rental income generated from leasing of the commercial units in Gang Yu Square in Chongqing in Mainland China, was increased in the year compared with 2004. The occupancy rate of the square in the year remained satisfactory. It is expected that the business will continue to generate a steady stream of income to the Group. HK$97,932,000 was attributable to property revaluation surplus following the adoption of new accounting standards since January 2005.

Leasing of equipment

Since 2003, the Group had engaged in leasing of corded and cordless POS equipment in Guangzhou for a term of five years with an option to extend till 17 July 2011. The demand for POS equipment remained steady during the year. The Group will explore business opportunities for other value added services adhered to the leasing of the POS equipment.

Provision of telecommunication and other related services

Since 2004, the Group had engaged in the business of providing integrated telecommunication network services to online game developers and other broadband media providers via its operating subsidiary. Due to cut-throat competition in the dynamic online business market in Guangzhou, the PRC, it was difficult for integrated telecommunication network service providers to secure a steady profit margin unless new and attractive online games and/or related broadband media products kept emerging from the market to drum up demand for such services. In this connection, an impairment of HK$49,000,000 has been made to this investment project. The management of the Company will continue to focus on developing new business models and, if practicable, to identify strategic investors to co-invest in new business developments.

Financial Review

Liquidity and financial resources

In the year ended 31 December 2005, the Group generally financed its businesses with internally generated cash flows, banking facilities and net proceeds from placing of new shares in the year.

Cash and bank balances for the Group as at 31 December 2005 amounted to HK$133,151,000 (31 December 2004: HK$106,254,000) and pledged deposits of HK$354,000 (31 December 2004: HK$776,000).

As at 31 December 2005, the Group had outstanding borrowings of approximately HK$84,437,000 comprising interest-bearing bank loans amounted to HK$54,140,000 (31 December 2004: HK$77,300,000), convertible bonds payable amounted to HK$29,782,000 (31 December 2004: HK$29,426,000 (restated)) and finance lease payables amounted to HK$515,000 (31 December 2004: HK$623,000). Of the Group's interest-bearing bank loans, 58%, 9% and 33% respectively are repayable within one year or on demand, in the second year and in the third to fifth years, inclusive. An amount of HK$26,564,000 bank loans as at 31 December 2005 were charged at fixed interest rates (31 December 2004: HK$45,120,000).

The Group's gearing ratio as at 31 December 2005 was 0.28 (31 December 2004: 0.25), calculated based on the Group's total liabilities, excluding deferred income, of HK$210,531,000 (31 December 2004: HK$193,286,000 (restated)) over total assets of HK$754,633,000 (31 December 2004: HK$758,442,000).

Currency structure

The Group had limited exposure to foreign exchange rate fluctuations as most of its transactions, including borrowings, were mainly conducted in Hong Kong dollars or Renminbi and the exchange rates of these currencies were relatively stable throughout the year.

Pledge of assets

The Group had utilized bank loan facilities amounting to approximately HK$54,140,000 (31 December 2004: HK$77,300,000) as at 31 December 2005. The bank loans were supported by certain of the Group's investment properties, corporate guarantees executed by the Company and corporate guarantees provided by certain entities in Mainland China.

Contingent liabilities

As at 31 December 2005, guarantees given for mortgage loans granted by banks to certain purchasers of the Group's properties amounted to HK$3,395,000 (31 December 2004: HK$7,763,000).

Acquisition of remaining interest of a subsidiary

On 14 December 2004, Telesuccess International Limited, a wholly-owned subsidiary of the Company, entered into an agreement with then existing shareholder of Sky City Network Communication Limited ("Sky City") to acquire the remaining 19.1% equity interest in Sky City at a cash consideration of HK$60,000,000. The acquisition was completed in February 2005 and details of which had been set out in a circular to shareholders of the Company dated 21 January 2005.

Placement of new shares

On 18 May 2005, a placement agreement was entered into between the Company and a placing agent pursuant to which the placing agent, on a fully underwritten basis, agreed to procure subscribers to subscribe for 783,000,000 new shares (the "New Shares") at a subscription price of HK$0.02 per share. The New Shares represented approximately 19.98% of the Company's then existing issued share capital and approximately 16.65% of its issued share capital as enlarged by the issue of the New Shares. The New Shares were allotted and issued pursuant to the general mandate granted to the Directors at the Company's special general meeting held on 7 February 2005. Net proceeds of approximately HK$15,210,000 were raised from the issue of the New Shares and were utilized as general working capital of the Group. The New Shares were allotted and issued in June 2005.

Termination of a proposed rights issue

In July 2005, it was announced that a fund raising exercise by way of rights issue (the "Rights Issue") was proposed to the shareholders for their consideration and approval, with an intention of raising approximately HK$58,800,000 before expenses. Pursuant to the terms and conditions of the proposed rights issue, it was on a fully underwritten basis and to be issued on the basis of one rights share for every two to-be-consolidated (on a ten existing shares for one consolidated share basis) shares then held with two bonus shares for every fully paid rights share at an issue price of HK$0.25 per rights share. The underwriting agreement of the rights issue was terminated in September 2005 and accordingly the rights issue did not proceed.

Termination of proposed acquisition of operational rights of a passenger cruise line and a passenger cruise

In June 2005, it was announced that a wholly-owned subsidiary of the Company was conditionally contracted to acquire certain investment interests from an independent third party at a consideration of HK$150,000,000, subject to adjustments. The underlying assets of the subject transaction are the operational rights of a passenger cruise line between Guangzhou and Hong Kong and a passenger cruise vessel. An aggregate of HK$46,000,000 has been paid by the Group as deposits to the vendors upon execution of the transaction agreement.

The transaction agreement provided that completion of the subject transaction was conditional upon completion of the Rights Issue (as defined above). Given the Rights Issue did not proceed, the transaction agreement accordingly lapsed to become effect. In this connection and in September 2005, the purchaser to the transaction demanded full repayment of deposits from the vendor. An aggregate amount of HK$40,000,000 of the deposits has been refunded to the Group. Despite repeated demands, the vendor has not yet refunded the balance of deposits of HK$6,000,000 to the Group. A full provision of HK$6,000,000 has been made in this connection. The Group has taken legal actions to pursue the matter.

Deferred payment of balance of a consideration

In November 2002, it was announced that a wholly-owned subsidiary of the Company was contracted to dispose certain property interests to an independent third party at a consideration of HK$350,000,000, subject to adjustments and payable by installments. Subsequently, both the vendor and purchaser to the transaction agreed that the payment of the balancing consideration of HK$90,000,000 be deferred to not later than 26 July 2005. However, given the total gross floor area of a proposed development plan of the underlying property interests was not yet determined by the relevant governmental authorities, the related development plan has been held over. In this connection, the purchaser to the transaction has requested the payment of an amount of HK$40,000,000 be further deferred to not later than 31 January 2007. Up to the balance sheet date, the Group has received an accumulated sum of HK$310,000,000 out of HK$350,000,000 from the purchaser since 2002.

Subscription of new shares and grant of option

On 31 August and 23 September 2005, a subscription agreement and a supplemental agreement were respectively entered into between the Company, a subscriber and a guarantor who are both independent third parties, pursuant to which the subscriber had conditionally agreed to subscribe for 200,000,000 new shares (the "Subscription Shares") at a subscription price of HK$0.036 per share, and the Company had conditionally agreed to grant an option (the "Option") to the subscriber at a price of HK$2,280,000. Pursuant to the terms of the deed of the Option, the subscriber will be entitled to subscribe a maximum of 570,000,000 new shares (the "Option Shares") at an exercise price of HK$0.038 per share, subject to adjustments, anytime from the date of the completion of the supplemental agreement and up to 31 December 2006.

The aggregate of 200,000,000 Subscription Shares and the maximum number of 570,000,000 new shares to be issued, representing approximately 16.37% of the Company's then existing issued share capital and approximately 14.07% of its enlarged issued share capital by then, was issued pursuant to the general mandate granted to the Directors by the shareholders at the Company's annual general meeting held on 3 June 2005. Assuming the Option Shares are fully exercised by the subscriber within the exercise period, the total funds to be raised by the Company under the subscription agreement will be HK$31,140,000, out of which HK$9,480,000 has been received by the Company. The Subscription Shares were allotted and issued to the subscriber in October 2005.

Subsequent to the balance sheet date, on 18 April 2006, the Subscriber served the notice for subscription of 100,000,000 Option Shares at an exercise price of HK$0.038. The 100,000,000 Option Shares were allotted and issued on 25 April 2006, and a gross proceeds of HK$3,800,000 was raised by the Company.

Litigation

(a) A writ of summons was issued in August 2005 by a former director of a subsidiary of the Company (the "Former Director") against, inter alia, the Company, and a director and certain accounting staff of the Company. According to the summons, the Former Director claimed certain damages in relation to the acquisition of a subsidiary by the Group from a private company controlled by the Former Director in December 2000. In the Indorsement of Claims, the Former Director claimed that a receipt for a consideration of HK$33,500,000 signed by the private company controlled by her be set aside and demanded for payment of outstanding consideration in the amount of HK$33,500,000.

    The Company has filed an acknowledgement of service to defend the proceedings. Given that the aggregate amount under all the claims is not material to the Group as a whole and the litigation is expected to continue for a period of time before a judgment is made, the Group is of the view that the proceedings will not have any immediate material adverse impact on the financial position, cashflow and business operation of the Group. No provision for the proceedings has been made at this stage.

(b) In November 2005, a writ of summons was filed against the Company by a third party (the "Plaintiff") which alleged that a cheque drawn in the name of the Company in the sum of HK$33,000,000 was returned by the bank upon presentation by the Plaintiff. The Plaintiff claimed against the Company for a sum of HK$33,000,000 and interest thereon. In December 2005, the Plaintiff discontinued the legal action. The Company did not commit to pay any amount to the Plaintiff.

Employee and remuneration policy

The Group employed approximately 28 full time staff in Hong Kong, Chongqing and Guangzhou as at 31 December 2005. Employees are remunerated according to the nature of their job and market trend, with built-in merit components incorporated in the annual increment to reward and motivate individual performance. In Chongqing and Guangzhou, the Group provides staff welfare and bonuses to its employees in accordance with the prevailing labour law. In Hong Kong, other staff benefits include medical schemes, Mandatory Provident Fund Scheme and employee share option scheme.

Prospects

The Group is principally engaged in property investment, leasing of point-of-sale equipment and provision of telecommunication and other related services in the Mainland China. Given that the Group had extensive experience in property development and investment in the Mainland China since 1992, the Directors consider that they should capitalize their expertise and connections in this area for the Group's future business development. Hence, it is expected that the Group will consolidate its business sectors and formulate a new business direction in the coming year. In this respect, the Directors are optimistic that the continuing economic growth in the Mainland China will serve to facilitate the business growth of the Group.