

# Business Environment Analysis and Outlook

To have a flexible operating strategy to dynamically balance domestic and export sales in order to maintain our long-term market share and to enhance our overall profitability



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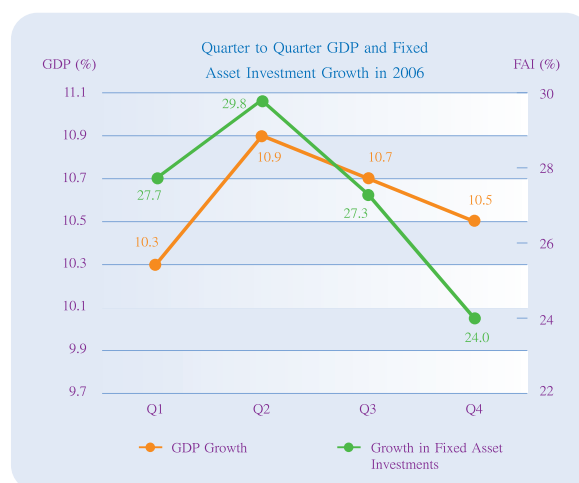
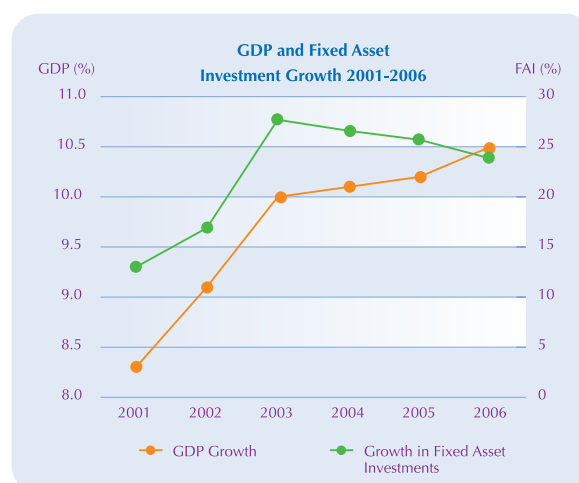
In 2006, both the general economy of the PRC and the cement industry had seen fast growth. In order to achieve sustainable growth of the national economy, the central government continued to implement austerity control policies. The curbing of the increase in the investment in fixed assets began to see results. In the wake of more thorough structural consolidation of the cement industry and given the rapid growth of the national economy, the cement industry began to bottom out and profitability in all regions was generally rising.

## I. ANALYSIS OF THE BUSINESS ENVIRONMENT IN 2006

### 1. Fast growth in the national economy; investment in fixed assets slightly faltered; energy supply has been alleviated

In 2006, China's economic growth was maintained at a high speed, and GDP grew by 10.7% over 2005, a decrease of 0.2 percentage point over the first half of the year, showing that growth in the first part of the year was faster, whereas growth had slowed slightly in the second half. This was mainly due to the austerity measures which had dampened the speed of growth, yet they had not created any significant volatility to the economic developments, which demonstrates that initially the austerity measures had worked.

In 2006, investment in fixed assets across the country grew by 24%, and the overdriven growth in the investment of fixed assets has been subdued, indicating that these austerity control measures were effective. However, the absolute value of the increase in fixed assets was still very high, resulting in the increase in cement demand in the second half of the year.



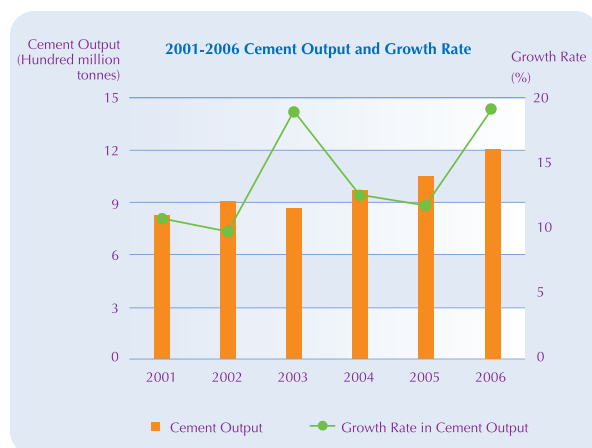
Source: National Bureau of Statistics of China

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Following the energy bottleneck in 2004 and the consistently high energy prices in 2005, the energy supply in 2006 had been eased. Although coal prices remained high, the increase had softened, and by the peak season at the end of the year, prices have not surged as the previous year. In 2006, power supply situation has also improved. Comparing with the compulsory limited supply for 25 provinces in 2005, there were only three provinces which suffered the compulsory limited power supply during summer when power consumption was at its peak. The fast growth in power and coal has also improved the position of energy supply in future.

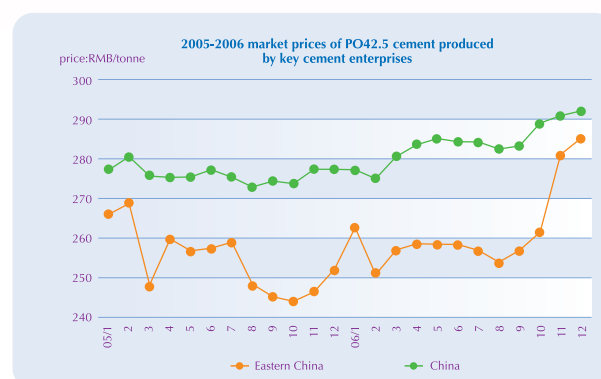
## 2. Fast growth of the cement industry; deepening of structural consolidation; industry bottoming out from its trough; increase in exports attractive

After almost two years in its trough, in 2006, the cement industry has generally shown signs of recovery. It was particularly so in the fourth quarter, when the overall cement demand was robust and growth in production was more than 2005. The annual national cement production amounted to 1,204,000,000 tonnes, an increase in 19.14 percentage points over 2005. With the turnaround in the domestic market and the deepening of structural consolidation and the slowing of increase in new production capacity, certain regions had even seen demand over supply in the fourth quarter of the year.



Source: China Cement Association

In 2006, cement prices increase and corporations in the industry had enjoyed improvements in their profitability. The national sales profit for the year was on the rise. It was particularly so in the fourth quarter when cement price increased more than usual in Eastern and Central China, resulting in the overall significant increase in efficiency of cement corporations. Rise in prices was mainly due to the seasonal increase in demand, slower increase in new supply capacity, and the industry players' realization of the importance of maintaining an orderly market to avoid vicious competition.



Source: China building Material Information Website

In 2006, mergers and acquisitions of the cement industry have been intense and the industry was further concentrated. Large corporations enjoyed remarkable growth over the year and the austerity control measures have pushed the entry barrier for small to medium enterprises to invest in the cement industry higher and higher. The constraints in capital, environmental regulation and resources are becoming more and more formidable, making it more apparent that the industry has come to two extremes where the strong is becoming stronger and the weak is becoming weaker. The pace for overseas capital to invest in the cement market of the PRC has been quickened as their presence can be felt in almost all the six major regions across the country.

With the reducing tax rebate for export and the domestic market upturn as well as the slackened overseas demand, the export volume for the second half of the year gradually slipped. However, increases in the national export volumes of cement and clinker for the year were nevertheless significant. As at the end of December, the national accumulated export volume amounted to 19.41 million tonnes, representing an increase of 70.65%; the national clinker accumulated export volume amounted to 16.72 million tonnes, representing an increase of 55.06%.

## II. THE BUSINESS ENVIRONMENT FOR 2007

### 1. Development of the overall economy will continue to be remarkable; the rate of economic growth will be more gradual; the overall supply and demand of energy will be more or less balanced

It is anticipated that with the austerity controls in 2007, the speed of economic growth will come down to some extent, yet, the growth will be rapid all the same. According to the forecast by the China Science Institute, growth in the GDP of China will be approximately 9.6% to 10.1%, which will be slightly less than 2006.

Investment in fixed assets in the PRC will also be weighed down by the austerity measures and the speed will be further moderated. However, the high increase will continue to be strong and boost the cement demand. Also, local governments will come to their reelection for a new term of office, which will likely lead

to a greater emphasis on economic growth. The sizeable contribution of investment in fixed assets to the economic indicators will draw much attention from the local government, which to a certain degree will raise the demand of cement in 2007.

Following the dipping of crude price in the international market, the domestic energy market will also be affected. Though coal prices will continue to remain at high levels, the increase in coal prices will be subject to some constraints. Since both power and coal are considered by the NDRC as potential oversupply sectors, it may hinder the increase in price. Therefore, we consider that the energy prices in 2007 will be steady or may even decline by a small margin.

## **2. The overall position of the cement industry will improve with mergers and acquisitions being the focus of the industry, and increase in export may come down**

The announcement of the “Cement Industry Policy” and the “Special Program Concerning the Development of the Cement Industry” will guide the development direction of the cement industry. Structural adjustments will progress further aided by the State’s control on the energy consumption indicators. It is anticipated that in 2007, more efforts will be put in weeding out backward production capacity in all quarters, and the weeded out capacity means more room for new dry process technology, further improving the overall position of the cement industry.

Growth in new dry process capacity will be slower than the growth in demand, alleviating the pressures of supply over demand. Thus, it is expected that cement prices should not be lower than that of 2006. However,

different regions will be different. For instance, growth in dry process capacity in Guangdong, Guangxi, mid-South and Southwest is fast, creating uncertainty in the prices of these regions, whereas in the Northwest, demand has slackened. It is anticipated that supply over demand situation is unlikely to improve in the short term, with prices remaining low. For Eastern and Northern China, there is the possibility that prices will be maintained at the levels of fourth quarter 2006.

Mergers and re-structuring of the cement industry will continue to be the focus and a hot topic for 2007. With the key support of the State, large cement enterprises will benefit from various preferential policies, and this will lead to a higher concentration of the industry. The cement market of the PRC has also drawn more attention from large overseas corporations. In spite of the restrictions in policy over the shareholdings of overseas capital, the exploration of the PRC market will not falter. The whole market will find itself amid opportunities and challenges arising from mergers and re-structuring.

In the wake of the slowing of economic development of the United States and the world as well as the decreasing tax rebate for export, the significant increases in the export of cement and clinker from the PRC will be moderated, and the upturn of the domestic market will direct the focus of cement producers to domestic sales.

To summarize, the cement industry in 2007 will continue with the recover from 2006. With our strategic adjustments, our profitability will see further improvement and we are positioned to capture new development opportunities.

