

# Investment Manager's Discussion and Analysis



**Dr. Huang Dazhan**

*Chairman of the board of the  
Investment Manager*



# Investment Manager's Discussion and Analysis *(continued)*

## OVERALL PERFORMANCE

China Merchants China Direct Investments Limited and its subsidiaries (the "Fund") recorded a profit attributable to shareholders of US\$115.42 million for the year ended 31 December 2006, representing an increase of 1,374% over the year 2005. This was attributable to a significant increase in the fair value of financial assets at fair value through profit or loss (the "financial assets"). As of 31 December 2006, the net assets of the Fund were US\$262.87 million (31 December 2005: US\$146.67 million), with a net asset value per share of US\$1.917 (31 December 2005: US\$1.069).

Total turnover for the year increased by 74% to US\$5.44 million (2005: US\$3.12 million). This was due mainly to an increase in dividend income from China Merchants Bank.

For the year 2006, the fair value of the financial assets increased by US\$149.76 million (2005: US\$9.98 million). The significant increase in the fair value was attributed to the revaluation of both China Merchants Bank and Industrial Bank whose values increased by US\$116.01 million and US\$31.26 million respectively against the end of 2005.

## MATERIAL ACQUISITION AND DISPOSAL OF INVESTMENTS

The Fund has been actively searching for investment opportunities. Lots of studies were done on the projects in financial services sector and manufacturing sector. During the reporting period, the Fund did not have any concluded investment projects.

On 30 June 2006, the Fund entered into a share transfer agreement with China Merchants Financial Services Limited, a connected person of the Fund in relation to the disposal of its 10% equity interest in Houlder China Insurance Brokers Limited at a cash consideration of approximately US\$625,039. The transaction was completed on 31 July 2006. The Fund recorded a loss of approximately US\$26,282 from the transaction.

On 25 July 2006, the Fund entered into a share transfer agreement with two independent third parties in relation to the disposal of its 30% equity interest in Chenzhou Heshang Environmental Protection Company Limited at a total cash consideration of RMB18.5 million. As a part of the transaction, the Fund had received a full repayment of shareholder's loan of RMB10.5 million. The transaction was completed on 21 October 2006. The Fund obtained an internal rate of return of approximately 16% from the project.

## LIQUIDITY, FINANCIAL RESOURCES, GEARING AND CAPITAL COMMITMENTS

The Fund's cash on hand increased by 60%, from US\$17.35 million as at the end of 2005 to US\$27.67 million as of 31 December 2006, due to disposal of listed, unlisted investments and the interest in an associate.

As of 31 December 2006, the Fund had no outstanding bank loans (2005: Nil).

As of 31 December 2006, the Fund had no capital commitments (2005: Nil).

## EXPOSURE TO FLUCTUATIONS IN EXCHANGE RATES AND RELATED HEDGES

Most of the Group's investments are located in China where the official currency is the Renminbi ("RMB"). Since the People's Bank of China announced the reform of the RMB exchange rate regime in 2005, the RMB against the U.S. dollar appreciated gradually. Such RMB appreciation has a positive impact on the Group since the Group holds considerable amount of assets denominated in the RMB.

# Investment Manager's Discussion and Analysis *(continued)*

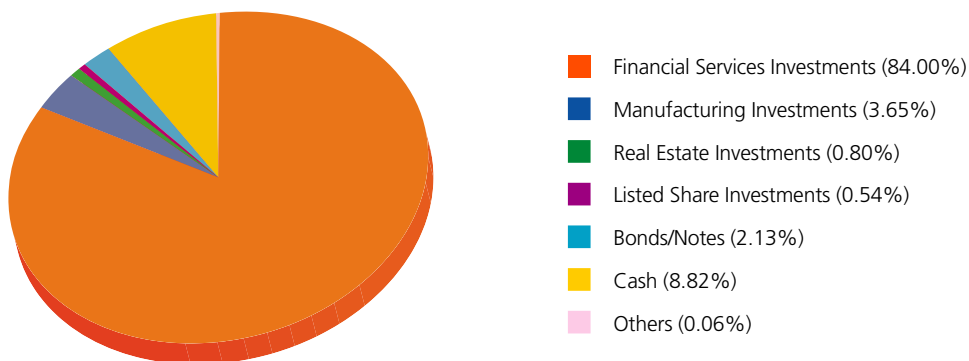
## EMPLOYEES

Other than a qualified accountant whose remuneration packages are borne by the Investment Manager, the Fund has no salaried employees. The Investment Manager handles the portfolio and day-to-day administration of the Fund.

## THE PORTFOLIO

As of 31 December 2006, the Fund had total investments of US\$285.84 million – US\$277.48 million in unlisted investments, US\$1.69 million in listed investments, and US\$6.67 million in bonds, notes and callable deposits. The major unlisted investment projects were in financial services (84.00% of total assets), manufacturing (3.65%) and real estate (0.80%). In addition, the Fund had cash on hand of US\$27.67 million, accounting for 8.82% of the Fund's total assets.

## TOTAL ASSETS DISTRIBUTION *(AS AT 31 DECEMBER 2006)*



## Investment Manager's Discussion and Analysis *(continued)*



**Mr. Xie Kuixing**

*Managing Director of the  
Investment Manager*

# Investment Manager's Discussion and Analysis *(continued)*

## REVIEW OF UNLISTED INVESTMENTS

The following table shows the major unlisted investment projects held by the Fund as at 31 December 2006:

Name of Projects	Location	Business Nature	Net Book Value (US\$ million)	Percentage of Total Assets
<b>Financial Services:</b>				
1. China Merchants Bank Co., Ltd.	Shenzhen, Guangdong	Banking	181	57.86
2. Industrial Bank Co., Ltd.	Fuzhou, Fujian	Banking	62	19.69
3. China Credit Trust Co., Ltd.	Beijing	Trust management	18	5.65
4. China Merchants Securities Co., Ltd.	Shenzhen, Guangdong	Securities	1	0.44
5. Industrial Securities Co., Ltd.	Fuzhou, Fujian	Securities	–	–
6. Jutian Securities Co., Ltd.	Shenzhen, Guangdong	Securities	–	–
7. Jutian Fund Management Co., Ltd.	Shenzhen, Guangdong	Fund management	1	0.36
<b>Sub-total</b>			263	84.00
<b>Manufacturing:</b>				
8. Zhaoyuan Jinbao Electronics Co., Ltd.	Zhaoyuan, Shandong	Copper foil & laminates	11	3.65
<b>Sub-total</b>			11	3.65
<b>Real Estate:</b>				
9. Langfang Oriental Education Facilities Development Co., Ltd.	Langfang, Hebei	Student dormitory	3	0.80
10. Shenzhen Man Kam Square	Shenzhen, Guangdong	Retail shops	–	–
11. China Merchants Plaza (Shanghai) Property Co., Ltd.	Shanghai	Office & commercial	–	–
<b>Sub-total</b>			3	0.80
<b>Total</b>			277	88.45



## Investment Manager's Discussion and Analysis *(continued)*

**China Merchants Bank Company, Limited ("CMB")**, a registered commercial bank in the PRC, is the first joint-stock commercial bank established by mainland enterprises and the shares of which were first listed on the Shanghai Stock Exchange in 2002. CMB now has over 400 branches and offices across the country. The Fund invested US\$14.06 million and held a 0.83% stake in CMB at the balance sheet date. After revaluation, the current net book value of investment in CMB was US\$181.45 million, representing an increase of US\$116.01 million from the end of 2005. CMB has announced that its net profit for 2006 was RMB7.11 billion, up 88% over the same period of the previous year. At the end of 2006, the net asset value per share of CMB was RMB3.75. A special cash dividend of RMB0.18 per share was approved by the shareholders meeting held on 19 August 2006. The Fund has thus received from CMB a special cash dividend of RMB22.06 million, giving rise to total dividend of RMB31.87 million received in the year.

Upon completion of the share reform plan in February 2006, all of CMB's non-tradable shares will be available for converting into tradable shares by stages. The shares of CMB held by the Fund will be available for converting into tradable shares in February 2008. In order to increase its capital base, CMB issued 2.42 billion new H Shares and became listed on the Hong Kong Stock Exchange in September 2006.

**Industrial Bank Company, Limited ("IBCL")** is a joint-stock commercial bank registered in the PRC with over 300 branches and offices throughout the country. Since 1998, the Fund has cumulatively invested RMB146 million (equivalent to US\$17.62 million) in IBCL and held a 2.10% equity interest in IBCL at the balance sheet date. After revaluation, the current net book value of investment in IBCL was US\$61.75 million, representing an increase of US\$31.26 million as compared with the end of 2005. In 2006, IBCL recorded a net profit of RMB3.80 billion, up 54% as compared with the same period of last year. At the end of 2006, the net asset value per share of IBCL was RMB4.05.

IBCL's A Shares were successfully listed on the Shanghai Stock Exchange on 5 February 2007, and a total of 1.001 billion new A Shares were simultaneously issued. The Fund's equity interest in IBCL was thus diluted from 2.10% to 1.68%. As stipulated by the Company Law of the PRC and the articles of association of IBCL, the Fund's equity interest in IBCL is subject to a lock-up period of one year from the date of listing.

**China Credit Trust Company, Limited ("CCT")** was established in 1995 and formerly known as China Coal Trust Company, Limited. Its principal activities are trust management, fund management, investments and loan financing. The Fund now holds a 6.8167% stake in CCT by investing US\$15.31 million in 2005. During the reporting period, the Fund received a cash dividend from CCT, totaling US\$403,000.

In 2006, CCT recorded a net profit of RMB275 million, representing an increase of 286% as compared with the same period of last year. The increase was mainly due to a substantial contribution from proprietary trading of securities and trust management.

**China Merchants Securities Company, Limited ("CMSC")** is a comprehensive securities company registered in the PRC. Its businesses include IPO sponsorship, securities underwriting, brokerage, proprietary trading, investment consulting and financial advisory. The Fund invested RMB13.05 million (equivalent to US\$1.58 million) in 2001 and held a 0.28% equity interest in CMSC at the balance sheet date. During the year 2006, the domestic stock market flourished with substantial increase in trading volume, and thus the unaudited brokerage income of CMSC grew tremendously to RMB975 million, representing an increase of 278% over the same period of the previous year. Moreover, unaudited gain from proprietary trading reached the amount of RMB660 million in 2006. CMSC's unaudited net profit in 2006 was RMB1.04 billion, as compared with only RMB52.85 million in the same period of last year. During the reporting period, the Fund received a cash dividend of RMB1.77 million from CMSC.



## Investment Manager's Discussion and Analysis *(continued)*

In September 2006, with the approval of the China Securities Regulatory Commission (the "CSRC"), CMSC successfully completed its capital enlargement exercise and its registered capital was increased to RMB3.227 billion. The Fund's equity interest in CMSC was then diluted from 0.52% to 0.28%.

On 1 September 2006, CMSC completed the acquisition of 21 sales offices and 1 services office from Beijing Securities Company Limited. CMSC thus has 54 branches and offices across the country.

At the end of 2006, the total size of composite financial products managed by CMSC amounted to RMB6.98 billion, ranking the first amongst domestic securities firms.

**Industrial Securities Company, Limited ("ISCL")** is a comprehensive securities company registered in the PRC. Its businesses include IPO sponsorship, securities underwriting, brokerage, proprietary trading and investment consulting. The Fund invested RMB8.51 million (equivalent to US\$1.03 million) in 1999 and now holds a 0.74% equity interest in ISCL. The Fund made a full provision for this investment in 2005. Benefiting from the buoyant domestic stock market, ISCL's net profit in 2006 was RMB307 million while a loss of RMB68.43 million was sustained in the same period of last year. At the end of 2006, ISCL still had an accumulated losses of approximately RMB565 million.

With the approval of a capital enlargement proposal by the shareholders meeting held in March 2007, ISCL will issue 600 million new shares with the hope of applying as an innovative securities firm after the capital enlargement exercise so as to widen its business scope.

**Jutian Securities Company, Limited ("Jutian Securities")** is one of the earliest comprehensive securities companies established in the PRC. Jutian Securities has 16 offices throughout the country. In 2001, the Fund invested RMB35.36 million (equivalent to US\$4.27 million) in Jutian Securities, representing an equity interest of 4.66%. The Fund made a full provision for this investment in 2005. Benefiting from the buoyant domestic stock market, Jutian Securities' unaudited brokerage income in 2006 increased by 199% as compared with the same period of last year. In 2006, Jutian Securities' unaudited consolidated net profit amounted to RMB36.10 million while a loss of RMB68.17 million was sustained in the same period of last year.

In 2006, although Jutian Securities had made various attempts to raise capital in order to replenish all of its customers' deposits so that its business operations could be kept, it failed to obtain the approval from the CSRC. On 13 October 2006, the CSRC appointed an Administrative Liquidation Working Team to conduct administrative liquidation against Jutian Securities, and simultaneously appointed CMSC to act as custodial body and to exercise the administrative takeover of Jutian Securities' brokerage business and all sales offices.

**Jutian Fund Management Company, Limited ("JFM")** was set up in 2003 with a registered capital of RMB100 million. The Fund invested RMB10 million (equivalent to US\$1.21 million) in 2003 and now holds a 10% equity interest in JFM. In 2006, JFM's net profit was RMB7.92 million while a loss of RMB5.92 million was sustained in the same period of last year.

Despite their relatively high returns, the two equity investment funds managed by JFM have shrunk in size, with total fund size decreased significantly from RMB1.1 billion at the beginning of the year to RMB285 million at the end of the year. This is due to the negative impact brought about by the reorganisation of its major shareholder – Jutian Securities and the high dividend payout in a way to attract investors. On the other hand, JFM successfully launched the Jutian Money Market Fund with an initial size of RMB1.3 billion in early August 2006. As the domestic stock market was much more robust than the money market, size of the money market fund reduced to RMB214 million at the end of the year.



## Investment Manager's Discussion and Analysis *(continued)*

Although the asset under management of JMF reduced and resulted in a drop of management fee income, JFM still made a profit in 2006 since gain from proprietary trading of securities was satisfactory.

In October 2006, JMF's major shareholder – Jutian Securities was forced into administrative liquidation. Although the event has not shown any direct influence on the daily operation of JMF, it has led to a certain number of institutional investors redeeming their fund units, and the application for the launching of new fund products has also been adversely affected.

**Zhaoyuan Jinbao Electronics Company, Limited ("Jinbao")** was set up in 1993 in Zhaoyuan City of Shandong Province as a manufacturer of copper-foil and laminates. The Fund owns a 30% equity interest in Jinbao and has made a cumulative investment of US\$7.85 million. In 2006, Jinbao's sales revenue amounted to RMB1.14 billion, representing an increase of 54% as compared with the same period of last year. This was attributable to the products selling prices going up in a rate higher than the raw materials costs and the product sales recording a satisfactory growth. Jinbao's net profit in 2006 reached RMB52.83 million, which was increased by 126% as compared with the same period of last year.

The board meeting of Jinbao held on 8 July 2006 resolved to promote the listing of Jinbao on the domestic A share market. The preparation work for listing is now undergoing.

**Langfang Oriental Education Facilities Development Company, Limited ("Oriental")** is a Sino-foreign cooperative joint venture established in Langfang City of Hebei Province. The total project cost is US\$20 million, with a 20-year contractual period. In June 2002, the Fund invested US\$5 million for an equity interest of 25%.

Oriental is engaged in the operation and management of the Phase 1 dormitories of Oriental University City of Langfang City. Current capacity of the Phase 1 dormitories is about 17,000 students. It accommodated some 16,000 students in the school year of 2006/2007, a remarkable increase over the school year of 2005/2006. Except for those of lower quality, most of the rooms have been occupied.

Increase in number of residents in the school year of 2006/2007 has offset the impact brought by the increase in operating expenses, such as property management fee. Oriental's net profit in 2006 was RMB7.29 million, representing an increase of 68%, as compared with the net profit of RMB4.35 million in 2005.

**Shenzhen Mankam Square ("Mankam")** is a 33-storey commercial complex on North Wen Jin Road, Shenzhen. In 1994, the Fund invested US\$4.30 million through a 35% holding in Hansen Enterprises Limited to purchase 5,262 square metres of retail space on the third floor of Mankam. The Fund made a full provision for this investment in 2005. The Fund is continuously seeking sales opportunity for Mankam.

**China Merchants Plaza (Shanghai) Property Company Limited ("China Merchants Plaza")** was established in Shanghai in 1994 to be engaged in the development of a commercial complex. The Fund invested US\$5.685 million in 1994 and now holds an effective equity interest of 19.8% in China Merchants Plaza. The commercial complex developed by China Merchants Plaza is a 28-storey office/shop building located at North Chengdu Road, Qingan District, Shanghai, with a total saleable area of 60,086 square metres, of which 49,438 square metres remaining unsold. The Fund made a full provision for this investment in 2000 due to huge accumulated losses sustained by China Merchants Plaza from the high finance charges incurred in previous years. Despite the robust development of the Shanghai property market in recent years and China Merchants Plaza having profit turnaround in 2006, it is expected that because of still having huge accumulated losses, it is hard for China Merchants Plaza to resume dividend distribution in the near future.

# Investment Manager's Discussion and Analysis *(continued)*

## REVIEW OF LISTED INVESTMENTS

In 2006, with the resort of the persistent high economic growth of China, increasing profit level of mainland enterprises, gradual appreciation of the RMB, and the strong performance of the peripheral stock markets, the Hong Kong stock market had been on the rise though there was a sudden correction in May 2006. In addition, the IPO upsurge became the focus of Hong Kong stock market during the year, with capital raising activities of new shares, particularly new H shares, reaching a climax. The Fund had participated in the subscription of several new H shares and was placed with a certain number of such shares, enabling the Fund to obtain a satisfactory return from this investment.

For 2006, profit from listed shares amounted to US\$1.38 million, which included US\$43,000 of dividends, US\$668,000 of gain from sales of listed shares and US\$664,000 of unrealised gain. At the end of December 2006, the value of listed shares held by the Fund was US\$1.69 million.

As at 31 December 2006, the Fund's holdings in bank notes and corporate bonds amounted to US\$6.67 million (2005: US\$6.67 million). Details are listed below:

Issuer	Business Nature	Investment Amount (US\$ million)	Net Book Value (US\$ million)	Coupon	Yield to Maturity	Date of Maturity
<b>Corporate Bonds:</b>						
China Insurance International Holdings (BVI) Limited	Insurance Business	0.695	0.696	5.800%	5.887%	12 November 2013
Hutchison Whampoa International Limited	Property, ports, telecommunication and hospitality business	1.004	1.004	6.250%	6.193%	24 January 2014
Citic Ka Wah Bank	Banking	0.998	0.998	4.250%	4.290%	17 November 2009
<b>Notes:</b>						
Lloyds TSB Bank LIBOR Structured note		1.000	0.969	Note 1	–	20 August 2013 if no early redemption
Hang Seng Bank Fixed Rate Callable Deposit		2.000	2.000	Note 2	–	9 December 2008 If not called
Hang Seng Bank Callable Deposit		1.000	1.000	Note 3	–	16 March 2009 If not called
		<b>6.697</b>	<b>6.667</b>			



## Investment Manager's Discussion and Analysis *(continued)*

Note 1: Coupon rate for the first year is 10.5% and for subsequent years is 10% – (2 x 6-month LIBOR) per annum.

The note will automatically be redeemed at par when accumulative coupon reaches 13.7%, or on 20 August 2013, whichever is the earlier.

Note 2: Interest rate for the first, second, third and fourth year are 3.55%, 3.85%, 4.15% and 4.45% respectively.

Note 3: Interest rate for the first, second, third, fourth and fifth year are 3.50%, 4.00%, 4.00%, 3 month LIBOR + 4% and 3 month LIBOR + 5%, provided that 3 month LIBOR less than 6% for the first three years and 3 month LIBOR less than 7% for the last two years.

### PROSPECTS

Looking forward into 2007, it is expected that the central government continues to implement macro-economic control policies, promote the construction of new rural villages and step up efforts in rationalising industry production, conserving energy and protecting the environment while pushing forward further reforms and opening up. With internal factors that drive the rapid economic growth gathering further momentum and the global economic outlook remaining promising, China is believed to be able to maintain its steady and relatively rapid economic growth in 2007. Meanwhile, the year of 2007 will be a year that witnesses the deepening of system reforms and the further opening up. Both the taxation reforms and the end of the transition period for World Trade Organisation Members will exert pressure on the Fund's operation. However, the long-term steady and coordinated development of the national economy resulted from the system reforms will benefit the Fund's financial services investment that already accounted for a major portion of the Fund's portfolio. In the meantime, it will also bring more business opportunities for the Fund to invest in other industries. As always, the Fund will actively identify investment projects with relatively low risks and stable returns, and focus on investment in financial services sector, while switching projects on a timely basis so as to provide shareholders with more stable returns.

**Mr. Xie Kuixing**

*Managing Director*

**China Merchants China Investment Management Limited**

Hong Kong, 20 April 2007

## Investment Manager's Discussion and Analysis *(continued)*



Front row from left:  
Mr. Ng Chi Keung, Dr. Huang Dazhan and Mr. Xie Kuixing;  
Rear row from left:  
Mr. Tse Yue Kit, Mr. Wu Huifeng and Mr. Yam Kam Shing.