Management Discussion and Analysis

Industry Overview

The global price of raw materials continues to escalate during 2006. Some of the raw materials witnessed the biggest price increase in the past three years, with price of copper surged by more than 39% over 2005 and the prices of steel stayed at high levels in 2006. During the year under review, the appreciation of RMB also exert direct impact on the profitability of export goods of the manufacturing industry. This, coupled with the continuous increase in operating cost, created a more challenging operating environment for the manufacturers of power tools and air tools. Furthermore, the slowdown of the economy and real estate market of the United States in the second half of 2006 also affected the demand for power tools and air tools.

From 1 July 2006, "the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Regulations" (RoHS Regulations) introduced by European Union came into effect, and prohibits the use of 6 hazardous substances such as lead, mercury and cadmium in electrical and electronic equipment, and promulgates higher standards of anticarcinogenic and environmental protection requirements. During the year under review, clients of power tools and a number of manufacturers adopted a cautious attitude towards production and distribution and the demand for the export of power tools during the year was relatively lower when compared with previous years.

Dividend

The Board of Directors resolved not to declare the payment of final dividend for the year ended 31 December 2006.

Business Review

The Group principally engages in the production and sales of mid- and high-end AC and DC power tools and air tools. During the year under review, affected by both external and internal factors, the business performance of the Group was not satisfactory. Prices of raw materials continued to rise, leading to an increase in the Group's overall cost. Though the Group has strived to transfer the increased cost to its clients, the prices of raw materials were accelerating ahead of the rises of product price. In addition, the RoHS Regulations promulgated by the European Union came into effect on July 1, 2006, which have short-term effects on the clients of power tools, who took a wait-and-see attitude when placing orders and delayed their purchase orders. Regarding the internal factors, due to the adjustment of the market development and positioning for the Company and its German associated company, overlapping of clients profile as well as absence of market participation were frequent among the Group and the German associated company during such transitional period, which had material adverse impact on the business of the Group while that orders from the German associated company decreased substantially. The Group had maintained a steady growth of orders from other clients, representing an increase of 8.8% as compared with 2005, the adverse impact attributable from the loss of sales of the German associated company was however not being offset.

For the year ended 31 December 2006, turnover and loss attributable to shareholders of the Group were HK$233,571,000 (2005: HK$263,406,000) and HK$116,546,000 (2005: HK$9,538,000) respectively. During the period under review, power tools remained the main source of revenue, accounting for 85%, while air tools, hand tools and other products accounted for 2% and 13% respectively (2005: power tools accounted for 83%, hand tools accounted for 7%, while other products accounted for 10%).

During the year, the Group continued to adopt a prudent business development strategy to reduce the impact of the external environment on the Group. During the period under review, the Group continued to adjust its product manufacturing strategy and focused on the production of medium- to high-end products that are capable of resisting risks and outsourced the production of low-end products to reduce production cost. In 2006, the Group's proportion of self-production was maintained at 39.3%, while the proportion of outsourced production was maintained at 60.7% (2005: the proportion was 36.6% and 63.4%).

Facing a difficult operating environment, the Group continued to strengthen its cooperation with brandname clients and directly cooperated with world renowned tool brands and chain stores in product development during the year under review. After the successful conclusion of a cooperative agreement with an Amercian well-known tool professional brand in 2005, however, due to the slowdown of the US economy and real estate industry, only small amount of the professional power tools and air tools series developed by the Group in 2006 were manufactured and delivered, profit contribution of which is less than that as expected. Nevertheless, the Group has successfully cooperated with numerous new clients during the year under review. The Group has secured six new clients during the year under review and negotiated with other clients during the year. The number of the Group's clients is on the rise and its major clients include world renowned chain stores and major power tools and air tools distributors in the US and Europe, such as Leory Merlin, Campbell Hausfeld, Senco, E.Leclero, and Skil.

The Group has always put much emphasis on product R&D and technological enhancement. It continued to conduct R&D of new products during the year to satisfy the demand of the clients. During the year under review, the Group has introduced 10 brand new professional power tools products and 3 brand new air tools products. Meanwhile, in order to improve product quality and ensure that the Group's products meet the requirements of various new regulations of the European Union, the Group also increased investment in its professional laboratories.

Financial Review

Turnover and Profit Analysis

For the year ended 31 December 2006, the Group recorded an audited turnover of approximately HK$233,571,000, a decrease of 11.3% as compared to 2005. Loss attributable to shareholders was approximately HK$116,546,000 in 2006 (2005: HK$9,538,000).

The decrease in turnover and profit was mainly due to the decrease in sales of HK$54,410,000 in an associate, SBW, however, the Group was able to increase sales by HK$24,575,000 from customers other than SBW. The decrease in profit was mainly due to the decrease in turnover, a substantial increase in raw material prices, RMB revaluation and an impairment in assets. Full provision for outstanding amount of HK$39,713,000 from SBW, impairment of goodwill included in investment in associate of HK$9,798,000, provision for other receivables of HK$10,144,000, impairment loss in inventory of HK$5,769,000, impairment loss in fixed assets of HK$7,451,000 and impairment loss in intangible assets of HK$6,689,000 were made during the year under review.

Turnover Breakdown by Products and Geographical Locations

In term of products, power tools were still the major income source for the Group. In 2006, the sales of power tools, air tools and hand tools and other products represented 85%, 2% and 13% of the Group's turnover, respectively (2005: power tools 83%, air tools 7% and hand tools and other products 10%).

Geographically, Europe was still the major market of the Group. In 2006, the turnover proportion for the Group in Europe, Australia, North America and other markets was 83:12:5 (2005: 81:11:8).

During the year under review, the sales in European markets grew steadily except the German markets which was mainly due to the decrease in sales of the Group's associate, SBW. The sales in Australian and the US markets remained stable, accounting for 17% of the total turnover.

Gross Profit and Profit Margin Analysis

For the year ended 31 December 2006, the Group's gross profit decreased from approximately HK$26,758,000 in 2005 to approximately HK$11,638,000. The decrease in gross profit was mainly due to the significant increase in material prices. The Group's major raw materials are copper, aluminium, plastics and lead, the prices of these raw materials increased by 39%, 24%, 19% and 175% respectively on average during 2006.

During the year under review, the Group's gross profit margin decreased to 5% (10% in 2005). The profit margin of power tools was approximately 2.3% (2005: 8.6%) and the profit margin or air tools and other tool products was approximately 20.3% (2005: 14.7%). The decrease in gross profit margin was mainly due to the increase in cost of raw materials which represent over 90% of the Group's production cost.

Structure of Costs

For the year ended 31 December 2006, raw materials, salary, power and manufacturing overheads accounted for 95.6%, 1.2%, 0.1% and 3.1% of the total cost respectively. (2005: 96.3%, 1.5%, 0.1% and 2.1% respectively). Raw materials were still the major portion of production costs.

Cashflow Analysis

For the year ended 31 December 2006, the Group's net cash outflow was approximately HK$42,436,000.

Cash on Hand

As at 31 December 2006, the Group's cash on hand was HK$17,460,000 (2005: HK$61,140,000).

Debts Analysis and Gearing ratio

As at 31 December 2006, the long term and short term debts of the Group were HK$140,170,000 (2005: HK$138,001,000) in aggregate. The total debts were maintained at the same level of the year end of 2005.

As at 31 December 2005, the net debt to equity ratio (bank loans - cash/equity) of the Group was 155% (2005: 32%). The great increase in debt ratio was due the decrease in equity.

Capital Expenditure

The Group's capital expenditure in 2005 was approximately HK$18.2 million (2005: HK$37 million), of which new equipment to comply with RoHS requirements amounted to HK$1.7 million, expenditure for development of mould amounted to HK$6.2 million (2005: HK$10.7 million) and R&D expenditure and licenses fee amounted to HK$4.1 million (2005: HK$9.8 million)

The major infrastructure of the Group's PRC production base was completed. There is no need to inject a great sum of capital for the construction of production plants in short term. The expected capital expenditure of the Group in 2007 will be approximately HK$20 million, of which expenses for development of mould amounted to HK$10 million and R&D expenses and licences fee amounted to HK$5 million.

Account Receivables Analysis

For the year ended 31 December 2006, the account receivables of the Group were HK$56,815,000 (2005: HK$51,747,000). The Group's debtors' turnover days were 89 days (2005: 71 days).

Account Payables Analysis

For the year ended 31 December 2006, the account payables of the Group were HK$52,839,000 (2005: HK$62,574,000).

Inventories Analysis

For the year ended 31 December 2006, the inventories of the Group were HK$38,970,000 (2005: HK$37,253,000) while the inventory turnover days were 54 days (2005: 58 days).

Dividend

The Board of Directors does not recommend any payment of a final dividend.

Shareholding Structure

The Group has an extensive shareholder base. For the year ended 31 December 2006, the shareholding of the major shareholder remains 55.61% (2005: 55.61%), while the second largest shareholder, Arisaig Greater China Fund Limited held 9.93% (2005: 10.47%).

Pledge of Assets

For the year ended 31 December 2006, the Group did not have any pledged bank deposits (2005: HK$2,491,000).

Exposure to Foreign Exchange Risks

The Group's income and expenses are mainly denominated in US dollars and RMB and partly in Euro. During the year under review, the appreciation of RMB increased the Group's operating cost and raw material costs.

Employee Benefits and Training

For the year ended 31 December 2006, the Group had approximately 852 employees, of which, 180 employees were management staff and 118 employees were engineers.

The Group focuses on the enhancement of the quality of staff through offering all kinds of staff training. During the year under review, the Group organized internal training courses once a week for staff at all levels. Topics of the training courses included moral, ethic, languages, technical and management skill trainings. The Group also organized hundreds of on-the-job training programs in its production plant at Golden Harbour.

To increase the incentive of its staff and management executives, the Group granted share option with a total 15,610,000 shares on 18 August 2006. 14.8% (equal to 2,310,000 shares) was granted to the 7 Directors of the Group, while 85.2% (equal to 13,300,000 shares) was granted to 48 staff as a reward for their excellent performance and their contribution to the Group during the period. This will help to increase their incentive at work, which will enhance the Group's overall performance in long run.

Prospect

Looking ahead, the external operating environment remained challenging. It is expected that prices of raw materials will stay at high levels. The new quotation of the Group is now based on the current price of raw materials. The Group strives to transfer the increased cost to the clients and shortens the quotation period for the clients, so as to minimize the potential impact brought about by the fluctuation in raw material prices. The Group also further implements stringent measures of cost control, including strict cost control of human resources and enhancement of production efficiency, in order to mitigate the adverse effect of the external environment and improve overall efficiency of the Group. In addition, the Group was actively considering adopting hedging strategies to offset the impact of rising raw material prices on the Group.

With the RoHS regulations coming into force, the Group has proven that its products meet relevant requirements through its professional laboratories so as to lay a solid foundation for the Group to further develop its European clientele. In addition, in an attempt to secure more orders, the Group will continue to strengthen its cooperation with several world renowned brand enterprises and chain stores that the Group successfully concluded cooperative deals. With the launch of professional tools with higher technological content into the market, the Group will have more new opportunities of cooperation. In future, the Group will further strengthen its cooperation with professional brands or chain stores in the joint development of new professional tools and consider sharing the investment of product development with the clients, in order to reduce the risk to which the Group is exposed. Considering the trade conflict with the German associated company, SBW, the Group will adjust the sales strategy for the German market to secure more orders from clients other than distributors by directly cooperating with world renowned brand enterprises and chain stores.

With an aim to enhance its capability of self-supply and further reduce the overall production cost and improve the operating efficiency, the Group is considering to enhance the production capacity by expansion of production of the accessories for power tools and air tools. Moreover, the Group also considers expanding to the production of garden tools and power tools powered by lithium batteries, in order to increase its sources of revenue and expand its market coverage by diversification of products.

The Group is confident that its sustained effort is able to maintain the development of its power tools and air tools business. By pursuing continuous internal and external corporate reform, the Group hence consolidates its operation and management skills. It is expected that outstanding performance will be achieved in the key areas such as distribution, sales and production of the Group and its overall business performance will be improved in 2007.