
BUSINESS

OVERVIEW

Hotel operation

The Group is an operator and consultant of budget hip hotels in the PRC. During the Track Record Period, the Group has four leased-and-operated hotels under operation. The Group focuses on delivering values to budget conscious hotel guests, such values included stylish design, cleanliness, comfort, friendly service, geographical convenience and safety. When designing the hotels, the Group pays attention on design details as well as placing emphasis on choosing cost effective yet durable building materials which it believes to be indispensable in delivering the aforesaid values to budget conscious travellers. The interior decoration is carefully thought out to create a stylish and modern ambience to the Group’s hotels. Providing comfort to its customers is also one of the Group’s top priorities. The Group’s hotels are budget hotels which use branded mattresses and the beds therein are furnished with fresh, crisp white linen and sumptuous pillows. Each room of the Group’s hotels is also provided with 24 hours free broadband internet access, air conditioning and a walk-in shower. The locations of the Group’s hotels are strategically selected through a very stringent and detailed process to ensure certain exposure and convenience for the hotel guests.

The Group develops its hotels through leasing of part of existing commercial buildings and converting them into hotel accommodations. This does not only open up a wider choice and increases flexibility in selecting potential sites for new hotels, but also substantially reduces the lead time and start up cost for hotel development when compared to a normal green field hotel project.

The values created by the Group’s hotels enjoyed very positive response from the market. To further enhance the loyalty of the customers, the Group launched a loyalty programme which requires customers to pay membership fee for the enjoyment of membership discount. As at 31 December 2010, the loyalty programme had approximately 7,300 members. Customers under the loyalty programme accounted for approximately 14.3% of Total Available Room Nights during the Track Record Period.

Hotel consultancy services

Leveraging on the expertise and valuable experience built up over the years in operating budget hip hotels, the Group has also started to provide hotel consultancy services to Independent Third Parties hotel investors in 2009. The Group’s ability to establish low cost yet stylish hotels with competitive room rates appeals to hotel investors. The hotel consultancy services provided by the Group include site selection through site analysis on location, traffic and people flow, questionnaires and environmental analysis, feasibility study, hotel interior design, preparing operating procedures and quality manual that complies with ISO 9001:2008 requirements and providing assistance in selecting contractors for building work. Up to the Latest Practicable Date, the Group had entered into five hotel consultancy agreements with three hotel investors, who are Independent Third Parties, for the provision of hotel consultancy services for Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel, Zhongxin Hotel and South China Hotel, of which the provision of

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hotel consultancy services for Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel and Zhongxin Hotel had been completed in 2010. The Company is in the process of site selection for South China Hotel.

Business trend

The Group incurred a net loss of approximately HK\$3.5 million for the year ended 31 December 2009 and a net profit of approximately HK\$9.5 million for the year ended 31 December 2010. The net loss for the year ended 31 December 2009 was mainly due to under-utilisation of the Group’s hotel and the high fixed costs in hotel operations. The Group’s financial result improved in the year ended 31 December 2010 mainly due to the new source of revenue generated from the hotel consultancy business and increased profit margin from the hotel operations as occupancy improved. Based on the unaudited management accounts of the Group, the Group was in a loss position for the four months ended 30 April 2011 mainly due to the lack of revenue from the hotel consultancy business recognised and the Group incurring non-recurring expenses in relation to [●] during the period. The financial result of the Group for the year ending 31 December 2011 will be affected by, among other things, the non-recurring expenses in relation to [●] and whether the Company is successful in entering into new hotel consultancy agreements and hotel management agreements. Further details are set out in the paragraphs headed “The financial performance of the Group during the Track Record Period” and “The financial performance of the Group for the four months ended 30 April 2011” under the section headed “Summary” of this document, the paragraphs headed “The Group has a limited operating history in hotel consultancy business and consultancy fee is paid on a project basis”, “The Group lacks experience in engaging in the hotel management business”, “The Group experienced significant fluctuation in its net profit during the Track Record Period and the four months ended 30 April 2011” and “The financial results of the Group are expected to be affected by the expenses in relation to [●]” under the section headed “Risk factors” of this document and the paragraph headed “The financial performance of the Group for the four months ended 30 April 2011” under the section headed “Financial information” of this document.

COMPETITIVE STRENGTHS

The Directors believe that the success of the Group is principally attributable to the following factors:

Unique interior design

The Group’s in house design team designs the interior for all its hotels. The advantage is that the experience accumulated and opinions on usage from customers of all previous projects are retained within the Group, this allows the elimination of deficiency and in return enhance the continuous improvement in the quality of design of subsequent hotel developments. With experience built up over time, not only the efficiency of use of hotel space be maximised, it also helps to identify cost efficient building materials with longer durability to be used in later hotels. The Directors believe, the use of appropriate building materials not only prolong the life span of the hotels and makes them look fresh and new at all time, but also substantially reduce its daily maintenance costs.

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Furthermore, the Group’s business development team through learning from their previous experience in hotel conversion, gained knowledge in efficient space planning to achieve maximum return on a given space. This is evidenced by the delineation of 87 guest rooms out of a limited space of approximately 2,000 sq.m. in Welcome Inn Caitian (with the gross area of approximately 17.5 sq.m. and net area of approximately 13.5 sq.m. in average per guest room). During the Track Record Period, the Group recorded a number of repeated hotel guests. The design of the Group’s hotels stresses on style, comfort and functionality, with an aim to build up the market position as a budget hip hotel. The Directors believe that the reasons for repeated patronage is largely due to the high level of cleanliness, comfort and quality of service that offered by the Group’s hotels.

For more details regarding the unique interior design, please refer to the paragraph headed “Design of hotels” in this section.

Comprehensive quality management system

The Group believes that standardised work procedures and a comprehensive quality management system are the key factors to achieve and maintain quality services. The Group adopts a quality management system covering various aspects of hotel operation to ensure that high quality services are delivered to customers. The Group therefore applied and was awarded ISO 9001:2008 quality management system certification for provision of hotel services (excluding restaurant service) for all the Group’s leased-and-operated hotels in the PRC. To the best knowledge of the Directors, the Group is one of the very few budget hotels which has obtained the ISO 9001:2008 certification. Further, the ISO 9001:2008 quality management system serves as a good platform for scalable expansion in the future as it ensures the stability of service being provided to the Group’s leased-and-operated hotels and for hotels under the hotel consultancy agreements. For more details regarding the Group’s quality management system, please refer to the paragraph headed “Quality control” in this section.

Comparatively short lead time in opening a budget hip hotel

The Group’s leased-and-operated hotels were converted from commercial buildings or industrial buildings, this conversion plus leased-and-operated model uses much less lead time when compared to a greenfield project.

Other than the leased-and-operated conversion model which shorten the lead time, the Group’s business development team also helps to speed up the hotel conversion process. The business development team is based in the head office in Shenzhen. It is primarily responsible for researching and evaluating new markets and locations, conducting feasibility studies and identifying potential investors. The business development team possesses working knowledge on and experience in hotel interior design, selection of building materials, cost control and quality control, which helps to reduce repetitive construction work and achieve more efficient floor space subdivision and planning, and hence leads to shorter lead time and lower costs in commencing hotel operations.

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Simple management structure

Salary is one of the major expenses in hotel management. In order to control the number of management personnel, the Group maintained a flat management structure so that more staff could be deployed to front line duties.

Guests rooms to staff ratio in the housekeeping department is another indicator in effective hotel management. The higher the ratio the lower the operation cost. The guests rooms to staff ratio of the Group is 5:1, which offers flexibility to the Group in allocating labour resources and hence reduce staff costs.

Ready for scalable expansion

The Directors believe that, in order to develop a scalable business, the Group should further its expansion capability by equipping structured workflow and implementing standardised management system.

The Group has prepared its structured workflow, which concerns the conversion of the leased-and-operated hotels, including floor space planning, site selection criteria and conversion project supervision. Coupled with years of accumulated experience of the Group in the hotel industry as well as the experience of the Group’s execution team, the Directors believe that the Group has engendered sufficient skills to accommodate larger scale of expansion.

The management of the Group is well-aware of the essence of hotel management and has therefore spent two years to hammer out effective working procedures, namely ISO 9001:2008 management standards, in 2008. The implementation of ISO 9001:2008 enables the Group to effectively reduce the training time for new hotel staff, equips any hotel that the Group will develop in the future with a comprehensive management system, and keeps employees in different posts in the Group’s leased-and-operated hotels well-informed of their duties and area of responsibilities. All the aforementioned merits, to the understanding of the Directors, are indispensable for the successful development of the Group.

The Directors consider that the Group has covered and strengthened the above areas which the Directors believe are crucial to the implementation of the Group’s future expansion plan.

STRATEGIES AND BUSINESS OBJECTIVES

The Group’s objective is to enhance the return to its Shareholders through exploiting its competitive advantages to grow further with an aim to becoming a leading budget hip hotel provider in the PRC.

Having considered the market potential and evaluated the Group’s market position and competitive strengths, the Group intends to achieve its business objectives and further growth through implementation of the following strategies:

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Continue to expand the Group’s leased-and-operated hotel portfolio with focus on the Southern PRC

The Group plans to continue to expand its network in the PRC with focus on the Southern PRC, in particular, the Guangdong Province in the next two to three years. In view of the proposal of urbanisation in the developing cities of the PRC introduced at the 中央經濟工作會議 (Central Economy Work Conference*), the Directors believe that such policy will attract corporations to seek business opportunities and expand their businesses across these cities and thereby stimulating a large demand for hotel accommodations. The Group plans to take this opportunity to expand its hotel operations in the second-tier and third-tier cities in the Southern PRC, such as Foshan, Xiamen, Fuzhou and Quanzhou. Furthermore, many of such second-tier and third-tier cities in the Southern PRC are major centres for manufacturing and trading businesses, conventions, exhibitions and events which attract business and leisure travellers to the regions and thus the demand for business hotels is stimulated.

As at the Latest Practicable Date, the Group had identified a location in the Fujian Province, the PRC, to develop a leased-and-operated hotel (“**Fujian Hotel**”). Fujian Hotel is expected to be refurbished in late 2011 with the commencement of operation in early 2012. In addition, the Group is planning to open a leased-and-operated hotel in Heyuan City, the Guangdong Province (“**Heyuan Hotel**”) in the second half of 2012.

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The table below illustrates the plans of Fujian Hotel and Heyuan Hotel:

	Fujian Hotel	Heyuan Hotel
Location	Quanzhou, Fujian Province, the PRC	Heyuan, Guangdong Province, the PRC
Expected capital expenditure and expenses	Approximately HK\$14.1 million	Approximately HK\$12.0 million
Number of rooms	About 100	About 100
Target average daily room rate	About RMB250	About RMB200
Area	Approximately 5,000 sq.m.	Approximately 4,000 sq.m.
Expected time of commencement of operation	Early 2012	Second half of 2012

Continue to expand the hotel consultancy business

The Group intends to continue an expansion of the hotel consultancy business. It will strengthen the business development team to help accelerate the growth. The Group will participate in tradeshow, exhibition and special public relation activities to identify potential hotel investors. The Company is currently identifying potential target customers and is in discussion with some potential hotel investors for the Group’s hotel consultancy business. However, no specific term has been agreed. The table below sets out the targeted number of hotel consultancy agreements to be entered into in the following years:

	From the Latest Practicable Date to 31 December 2011	For the year ending 31 December 2012	For the year ending 31 December 2013
Number of hotel consultancy agreements	4	4	4

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Expand the business by offering hotel management services

Leveraging on the expertise and valuable experience built up over the years in managing budget hip hotels, the Group intends to expand its business by offering hotel management services to hotels invested by Independent Third Parties. The Company is currently identifying potential target customers and is in discussion with some potential hotel investors (including those who have entered into hotel consultancy agreements with the Group) for the Group’s hotel management business. However, no specific term has been agreed. The Group shall manage the daily operation of the hotel and shall determine all policies and procedures relating to the overall management and operation of the hotel. The hotel investor will bear all the operating expenses of the hotel and pay the Group management fee based on the revenue of the hotel. The table below sets out the targeted number of hotel management agreements to be entered into in the following years:

	From the Latest Practicable Date to 31 December 2011	For the year ending 31 December 2012	For the year ending 31 December 2013
Number of hotel management agreements	2	2	2

Continue to forge and strengthen strategic relationships with strategic partners

The Group has entered into the 1506 CC Strategic Agreement with 1506 CC for the development of the Group’s budget hip hotel business in 1506 CC’s creative industry parks in the PRC. The Group has also entered into the Shu Yong Strategic Agreement with Mr. Shu Yong, an international contemporary artist, who shall provide advice to the Group on the decoration of the Group’s hotels and act as an organiser in sourcing and providing work of art to the Group’s hotels in order to strengthen its market position as a budget hip hotel. For more details regarding the Group’s strategic cooperation with strategic partners, please refer to the paragraphs headed “Strategic cooperation with strategic partners” in this section.

The Group intends to continue to seek more opportunities to form strategic partnerships with established property or property-related groups with strong brand names, as well as strengthen its relationships with its existing strategic partners, in order to promote a mutually beneficial and long-term relationship. The Directors believe that this strategy provides an effective and efficient channel for expanding its hotel portfolio and exploring new markets. The Group expects that such partnerships with property or property-related groups will afford the Group greater recognition by benefiting from the strong brand names of the strategic partners. The Directors believe that these relationships can continue to provide the Group with a platform to develop the hotel business.

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Continue to enhance the awareness of the brand names “悦來客棧” and “Welcome Inn”

The Group intends to continue to promote the brand names of “悦來客棧” and “Welcome Inn”. The Group will achieve this by continuing to focus on providing quality service and creating a contemporary and artistic image for the Group’s hotels. The Group intends to strengthen and consolidate public recognition of “悦來客棧” and “Welcome Inn” as budget hip hotels brand names with unique contemporary and artistic design through the strategic partnership with Mr. Shu Yong, an international contemporary artist. Such public recognition will enable the Group to obtain premium value, such as attracting more guests and increase in brand awareness of its hotel business in the long term. The Group will continue to adopt brand promotion policies to facilitate consistent identification of “悦來客棧” and “Welcome Inn” and allocate more resources on sales and marketing promotion so as to enhance the public awareness of the brand names “悦來客棧” and “Welcome Inn”.

The Group is applying for the registration of word marks and logo marks containing “悦來客棧”, “悦來” and “Welcome Inn” as trademarks in the PRC. The applications were submitted in February and March 2011, accepted and currently being processed by the 國家工商行政管理總局商標局 (Trademark Department of the State Administration of Industry and Commerce*). It is expected that the registration will be completed within two years from the respective date of applications. Certain trademarks containing “悦來客棧” or “悦來” have already been registered by others in the PRC. However, the specific services in respect of which such trademarks were registered for do not include providing accommodation and operation of hotel business. As such, the Company’s PRC legal advisers advised that it is not expected that there will be any infringement from the use of “悦來客棧” or “悦來” by the Group for the operation of hotel business in the PRC prior to registration. If the Company fails to register its trademarks, it will consider other options including (i) modifying its trademarks to satisfy trademark requirements (if applicable); (ii) establishing new brands; or (iii) acquiring existing registered trademarks from the trademark department. The Company is advised that it would be allowed to operate under the acquired registered trademarks after completion of the acquisition and notarisation procedures which usually take approximately one week’s time. Further, the Company may consider using other brand names to operate new hotels in other regions.

HOTEL OPERATIONS

Overview

During the Track Record Period, the Group’s hotel portfolio comprised of four leased-and-operated hotels.

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The following table sets out the particulars of all leased-and-operated hotels of the Group:

Hotel	Commencement date	Location	Approximate GFA (sq.m.)	No. of rooms available	Lease term	Total cost of property, plant and equipment as at 31 December 2010 (HK\$ million)
Welcome Inn Caitian	11 December 2006	Futian District, Shenzhen	2,000	87	20 November 2005 – 19 November 2015	Approximately 10.5
Welcome Inn Nanshan	30 May 2008	Nanshan District, Shenzhen	7,000	192	1 January 2007 – 31 December 2014	Approximately 17.7
Welcome Inn Baoan	25 April 2008	Baoan District, Shenzhen	1,700	59	1 January 2011 – 30 December 2017	Approximately 6.5
Welcome Inn Luohu	26 November 2008	Luohu District, Shenzhen	2,000	80	1 February 2008 – 31 January 2018	Approximately 8.3

The following table shows information on the revenue from hotel operation, Total Available Room Nights, occupancy, ARR, and RevPAR of each of the Group’s leased-and-operated hotels for the Track Record Period:

	Year ended 31 December	
	2009	2010
Welcome Inn Caitian		
Revenue (<i>HK\$ million</i>)	5.0	6.2
Total Available Room Nights	31,133	31,425
Occupancy (%)	78.8%	96.1%
ARR (<i>RMB</i>)	183.9	188.1
RevPAR (<i>RMB</i>)	145.0	180.7
Welcome Inn Nanshan		
Revenue (<i>HK\$ million</i>)	10.1	13.2
Total Available Room Nights	64,711	67,337
Occupancy (%)	67.2%	87.7%
ARR (<i>RMB</i>)	191.2	194.3
RevPAR (<i>RMB</i>)	128.5	170.4
Welcome Inn Baoan		
Revenue (<i>HK\$ million</i>)	2.1	2.5
Total Available Room Nights	19,355	21,535
Occupancy (%)	63.7%	89.2%
ARR (<i>RMB</i>)	134.3	123.7
RevPAR (<i>RMB</i>)	85.5	110.4

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	Year ended 31 December	
	2009	2010
Welcome Inn Luohu		
Revenue (<i>HK\$ million</i>)	2.2	5.4
Total Available Room Nights	25,011	28,812
Occupancy (%)	40.6%	95.6%
ARR (<i>RMB</i>)	171.3	175.6
RevPAR (<i>RMB</i>)	69.5	168.0
Total		
Revenue (<i>HK\$ million</i>)	19.4	27.3
Total Available Room Nights	140,210	149,109
Occupancy (%)	69.7%	92.8%
ARR (<i>RMB</i>)	178.9	179.4
RevPAR (<i>RMB</i>)	124.7	166.6

Welcome Inn Caitian

Welcome Inn Caitian, the Group’s first budget hip hotel in the PRC, commenced operation in 2006. The hotel has three floors and a total GFA of approximately 2,000 sq.m., comprising 87 rooms. The hotel is conveniently located at a commercial area in the Futian District and in proximity of the Shenzhen central business district, surrounded by CoCo Park (國際蘇活購物公園) (a shopping complex), the Shenzhen Convention and Exhibition Centre (深圳會展中心) and Huaqiangbei Commercial Street (華強北商業街) (a large electronic market). Welcome Inn Caitian is also situated near transportation hubs such as the Futian bus terminal, the Luohu train station and the Huanggang border (皇崗口岸).

Welcome Inn Nanshan

Welcome Inn Nanshan commenced operation in 2008. The hotel has five floors and a total GFA of approximately 7,000 sq.m., comprising 192 rooms, including an executive suite. The hotel is conveniently located at the commercial area in the Nanshan District and in proximity of the Guang Cai Xin Tiandi (光彩新天地) (a commercial complex), and theme parks such as the Window of the World (世界之窗) and the World at Sea (海上世界). Welcome Inn Nanshan is situated near the Hong Kong-Shenzhen Western Corridor and the Shekou Port (蛇口碼頭).

Welcome Inn Baoan

Welcome Inn Baoan commenced operation in 2008. The hotel has four floors and a total GFA of approximately 1,700 sq.m., comprising 59 rooms. The hotel is conveniently located at a commercial area in the Baoan District and adjoining the Baoan Airport, the Nan Tou custom (南頭海關), the Baoan coach terminal and the Xi Xiang Pier (西鄉碼頭).

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Welcome Inn Luohu

Welcome Inn Luohu commenced operation in 2008. The hotel has one floor and a total GFA of approximately 2,000 sq.m., comprising 80 rooms. The hotel is conveniently located at the financial centre area in the Luohu District, adjoining the World Financial Centre (世界金融中心), the Shenzhen Book Store (深圳書城), The Mixc (萬象城), the Citic City Plaza (中信城市廣場), the Shun Hing Square (信興廣場地王大廈), the Shenzhen Grand Theatre (深圳大劇院) and the Dongmen Commercial Pedestrian Street (東門商業步行街). Welcome Inn Luohu is also situated near Huaqiang North Commercial Street and Shenzhen train terminal.

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Set out below is a map showing the locations of the Group’s leased-and-operated hotels in Shenzhen, the PRC:



Note:

The locations of the hotels under the hotel consultancy agreements are as follows:

- Da Mei Sha Hotel is located in Yantian District, Shenzhen, the PRC. This hotel is not in proximity of the Group’s leased-and-operated hotels in Shenzhen.
- WBT Hotel, Gaomiao Hotel and Zhongxin Hotel are located in Foshan, the PRC.
- South China Hotel is in the process of site selection.

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Site selection

The Group’s strategies on site selection apply to both (i) the Group’s leased-and-operated hotels and (ii) hotels under hotel consultancy agreements.

The business development team of the Group will consider factors, including but not limited to the following, when identifying sites for new hotels:

- (i) examining physical condition of the building themselves as to whether it is suitable for hotel operations;
- (ii) proximity to centre of commercial activities, central business district or tourist attraction;
- (iii) attractiveness of location and accessibility;
- (iv) flow of the crowd;
- (v) facilities available in the vicinities, such as restaurants and parking facilities;
- (vi) forecast growth and economic development of the market; and
- (vii) proximity to convention and exhibition centres or transportation hubs.

Site selection for and conversion of leased-and-operated hotels

The Group’s multi-step conversion process starts with planning and site selection by the Group’s business development team. After careful and detailed site analysis, the site will be approved by the Group’s chief executive officer, the Group will negotiate with the relevant property owners or landlords for lease, which are subject to the final approval of the Group’s chief executive officer. After the lease has been executed by the owner or lessor, the business development team will proceed to the design stage. The business development team will develop a detailed layout plan and proposed design concept. The Group will then engage contractors for the conversion work through a tender process. The Group will invite qualified construction contractors to submit competitive bids for the conversion and related work. The decision to award a contract is made by the Group’s business development team after taking into consideration the bidder’s capability to satisfy contract requirements, and its reputation for quality and price. The construction contractors are responsible for completing various phases of conversion. Construction materials are selected by the Group’s business development team and are then purchased by the construction contractors. The Group’s business development team will conduct periodic reviews of the work of the contractors to ensure that the quality meets the requirements and the costs are within budget.

The Company’s PRC legal advisers confirmed that the Company has obtained all necessary licences and permits to operate hotels in the PRC, such as 特種行業許可證 (Licence of Special Trade*) and 衛生許可證 (Public Area Hygiene Licence*). Since hotel is under the category of commercial and service land use, there is no change in land use by

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converting commercial building areas into hotels. The Company’s PRC legal advisers confirmed that the conversion of commercial building areas into the Group’s leased-and-operated hotels is in compliance with the relevant PRC laws and regulations.

Design of hotels

The interior of the Group’s leased-and-operated hotels are designed by the Group’s business development team. With carefully thought out design details such as lighting effects and the use of cost effective yet durable, visually matching and appealing materials, the Group aims to create a high standard of interior decoration to attract the hotel guests.

The business development team helps create unified designs to the hotels operated by the Group and also maintains the Group’s stringent approach to control costs and minimise lead time in the design stage. In order to ensure the accurate implementation of design and high standard in finishing, the Group’s business development team works closely with the construction contractors during the hotel conversion stage.

Caring for the guests is part of the working life in Welcome Inn, the Group puts effort in making sure the customers feel at home and comfortable. The Group is one of the very few hotels in the budget sector to use branded mattresses and beddings in the guest rooms. The Group is also aware of the fact that people are more cautious on their health and well being than ever, therefore, the Group has also introduced a number of non-smoking rooms in each of the hotels to give the customers a choice of smoke free environment.

Besides, in all of the Group’s hotels, the Group has dedicated a zone for only lady’s guest rooms.

HOTEL CONSULTANCY SERVICES

Since 2009, the Group has started to provide hotel consultancy services for hotels invested by Independent Third Parties. The Group identifies potential hotel investors through business networks of the Directors and senior management of the Group and participating in tradeshow, exhibition and special public relation activities. The Directors believe that the Group’s ability to establish low cost stylish hotels with competitive room rates appeals to hotel investors. The Directors also believe that the successful track record of the Group’s hotel is one of the reasons that attract hotel investors.

Principal terms of the hotel consultancy agreements

Subject to the negotiations with individual hotel investors, the principal terms of the hotel consultancy agreements are generally similar. Pursuant to the hotel consultancy agreements, the Group provides to the hotel investors, the following services:

- (i) site selection through detailed studies on the traffic flow etc.;
- (ii) site assessment and feasibility analysis;
- (iii) preparing ISO 9001:2008 operating procedures and quality manual;

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- (iv) hotel interior design; and
- (v) construction contractor selection.

The Group will provide assistance in selecting construction contractors and the hotel investors will engage construction contractors themselves. The Group is not responsible for assisting the hotel investors to obtain relevant hotel operation licenses.

The duration of the hotel consultancy agreements is from the date of agreements up to the date of identifying construction contractors.

The consultancy fee payable to the Group under the hotel consultancy agreements are determined after arms’ length negotiation between the Group and the hotel investors after taking into account the size of the hotels, the estimated number of guest rooms of the hotels and the complexity of the projects. The hotel consultancy agreements also set out the additional consultancy fee payable to the Group should the actual number of guest rooms of the hotel pursuant to the finalised hotel interior design package exceeds the number estimated at the signing of the hotel consultancy agreement.

The initial consultancy fee is payable in four instalments whereby 30% of the total initial consultancy fee will be payable at each of the following three stages, namely:

- (i) the date of hotel consultancy agreement;
- (ii) within seven days upon the delivery of ISO 9001:2008 operating procedures and quality manual;
- (iii) within seven days upon the delivery of hotel interior design package; and

the remaining 10% of the initial consultancy fee is payable within seven days upon the commencement of the construction or conversion work. The initial consultancy fee for the services of site selection, site assessment and feasibility analysis is covered by the first instalment payable upon signing of the hotel consultancy agreement.

Should the actual number of guest rooms of the hotel pursuant to the finalised hotel interior design package exceeds the number estimated at the signing of the hotel consultancy agreement, additional consultancy fee is payable according to the above instalment schedule. The first instalment of the additional consultancy fee is payable upon the delivery of hotel interior design package calculated based on the percentage of total initial consultancy fee paid or payable by that stage. The remaining payments of the additional consultancy fee will be payable the same as the remaining schedule of the initial consultancy fee. The hotel investor shall reimburse the Group upon demand for all reasonable expenses incurred by the Group in relation to the hotel consultancy services. In no circumstances shall the fee paid by the hotel investor to the Group be refundable.

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Duration of hotel consultancy services

The provision of services under the hotel consultancy agreements are typically completed within five months. The general time line of hotel consultancy services is as follows:

Services	Period
Site selection	approximately 2 weeks
Site assessment and feasibility analysis	approximately 2 weeks
Preparing ISO 9001: 2008 operating procedures and quality manual	approximately 2 weeks
Hotel interior design	approximately 10 weeks
Construction contractor selection	approximately 2 weeks

The services of site selection, site assessment and feasibility analysis are performed concurrently, following the completion of which the Group will begin drawing the hotel interior design and preparing the operating procedures and quality manual. Upon completion of the hotel interior design, the Group will begin selecting the construction contractor.

Up to the Latest Practicable Date, the Group had entered into five hotel consultancy agreements with three hotel investors for the provision of hotel consultancy services for Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel, Zhongxin Hotel and South China Hotel.

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The following table sets out the details of each hotel consultancy agreement entered by the Group during the Track Record Period and up to the Latest Practicable Date:

	Location	Background of hotel investors	Date of engagement	Major terms of the hotel consultancy agreement	Approximate no. of rooms available	Current status of hotel consultancy services	Hotel construction status (Note 3)	Commencement date of operation (Note 3)
Da Mei Sha Hotel	Dameisha, Shenzhen, the PRC	These hotel investors are Independent Third Parties who do not have any relationship with the Group other than entering into the hotel consultancy agreements with the Group. These hotel investors are not engaged in other hotel development and operation business.	17 December 2009	Pursuant to each of the hotel consultancy agreements, the Group provides to the hotel investors, among other things, the following services: (i) site selection via detailed studies on the traffic flow etc.; (ii) site assessment and feasibility analysis; (iii) hotel interior design; (iv) preparing ISO 9001:2008 operating procedures and quality manual; and (v) construction contractor selection.	76	Completed on 6 April 2010	Under construction	Expected to be July 2011
WBT Hotel (Note 1)	Creative City, Foshan, the PRC		1 August 2010		150	Completed on 2 December 2010	Under construction	Expected to be in the second half of 2011
Gaomiao Hotel (Note 1)	Creative City, Foshan, the PRC		1 August 2010		80	Completed on 2 December 2010	Under construction	Expected to be in the second half of 2011
Zhongxin Hotel (Note 1)	Creative City, Foshan, the PRC		1 August 2010		50	Completed on 2 December 2010	Under construction	Expected to be in the second half of 2011
South China Hotel	(Note 2)		18 March 2011		(Note 2)	In the process of site selection (Note 2)	(Note 2)	(Note 2)

Notes:

1. These agreements were entered into with the same hotel investor.
2. The Company is in the process of site selection for South China Hotel and therefore the location, the construction status, the commencement date of operation, the number of rooms available and the expected completion date are unavailable.
3. Pursuant to the hotel consultancy agreement, the Group is not required to oversee the construction of the hotel. The Group’s obligations under the hotel consultancy agreements will be completed upon the construction contractors being identified. As such, the Company does not keep track of the construction status of each of Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel and Zhongxin Hotel. To the Company’s understanding, Da Mei Sha Hotel is expected to commence operation in July 2011 and WBT Hotel, Gaomiao Hotel and Zhongxin Hotel are expected to commence operation in the second half of 2011.

Recognition of revenue from provision of hotel consultancy services

The revenue recognition policy in relation to provision of hotel consultancy services is as follows:

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when (i) the amount of revenue can be measured reliably; (ii) it is probable that the economic benefits associated with the transaction will flow to the entity; (iii) the stage of completion of the transaction at the balance sheet date can be measured reliably; and (iv) the costs incurred for the transaction and the costs to complete the transaction can be measured.

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In practice, the Group has developed a policy that the stage of completion of each transaction is determined based on the proportion of time cost incurred at the end of the reporting period compared to the estimated total time costs of the transaction. To facilitate this, the Group has developed an internal budgeting system for each specific consultancy service project, only those time costs that reflect work performed are included in costs incurred to date. The staff who works on the individual project is required to fill in the time sheet monthly and the time sheet is reviewed and approved by the finance manager. The charge out rate for time incurred by the project team and the time cost incurred to date are also reviewed by the Directors at the quarter-end. The Directors will review and, when necessary, revise the estimates of contract revenue and contract costs if there is a change of the arrangement (i.e. charge additional consultancy fee) as the contract progresses. The Directors consider that it is appropriate to perform those reviews at the quarter-end since the contract duration was short (ie. normally completed within five months), it is unlikely to have overrun for these contracts and this is in line with the timing of the Group’s internal management reporting. Also, the investors are required to provide a written acknowledgment to the Group upon the completion of each phase specified in the hotel consultancy agreements and the receipts of the related deliverables. Since the hotel consultancy services for Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel and Zhongxin Hotel have been completed before 31 December 2010, the revenue in relation to provision of these hotel consultancy services was recorded in full for the year ended 31 December 2010. During the year ended 31 December 2010, no additional consultancy fee is recognised since there is no significant change to the actual number of guest rooms from the number of guest rooms estimated at the signing of the hotel consultancy agreements. The revenue contribution from each of the hotel consultancy agreements for Da Mei Sha Hotel, WBT Hotel, Gaomiao Hotel and Zhongxin Hotel for the year ended 31 December 2010 ranges between about HK\$2.2 million and HK\$2.6 million. There is yet to be any revenue recognised from the hotel consultancy agreement for South China Hotel up to 30 April 2011.

The timing of revenue recognition in relation to provision of hotel consultancy services is different from the billing schedule. When the Group collected money from the customer for revenue not yet recognised, the amount collected would be recorded as customer deposit until the revenue was recognised.

Site selection

The hotel investors will discuss with the Group’s business development team on the choice of location of the hotels. The Group’s business development team will recommend suitable sites based on the result of detailed site analysis and feasibility study to the hotel investors for hotel development. As part of the site analysis to assess the demand and competition environment of the proposed location, the Group will conduct customer analysis such as assessing the traffic flow of the location, proximity to landmarks and transportation hub, and buying habits, lifestyle preferences and perception of budget hotels of the residents of the area. The Group will also conduct competitor analysis such as ascertaining the number of hotels in the proximity. In conducting the site analysis, the Group will also take into consideration whether any of its leased-and-operated hotels are

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located in the proximity of the proposed site to avoid competition. Further, the management of the Group will discuss with the potential hotel investors before entering into the hotel consultancy agreements regarding the regions in which the hotels are expected to be located (i.e. the province or the city) and would not enter into the hotel consultancy agreements should the hotel investors insist that the hotels be set up in regions which the Company considers will compete with the Group’s existing or proposed leased-and-operated hotels. The actual locations of the hotels are determined after the site selection process under the hotel consultancy agreements. As advised by the Company’s PRC legal advisers, there would not be conflicts between the Group’s leased-and-operated hotel business and hotel consultancy business which would lead to a breach of the terms of hotel consultancy agreement and/or contravention of relevant PRC laws and regulations.

Once the sites have been approved by the hotel investors, the Group will negotiate with the relevant property/land owner for lease or purchase of the property/land. The business development team will discuss the proposed design of the hotels with the hotel investors and develop the hotel interior design package for them. The Group will assist the hotel investors in inviting qualified construction contractors to submit competitive bids for the construction, conversion and related work. The decision to award a contract is made after taking into consideration the bidder’s capability to satisfy contract requirements, and its reputation for quality and price.

STRATEGIC COOPERATION WITH STRATEGIC PARTNERS

During the course of identifying the sites for WBT Hotel, Gaomiao Hotel and Zhongxin Hotel at the Creative City, owners of the Company and 1506 CC, the developer and operator of the Creative City, came to know each other. After the completion of site selection for the aforesaid hotels, the Company and 1506 CC agreed to establish a long term strategic cooperation partnership. In November 2010, the Group entered into the 1506 CC Strategic Agreement with 1506 CC for a term of three years. Pursuant to the 1506 CC Strategic Agreement, during its term, 1506 CC will give priority to the Group as the hotel service provider in its creative industry parks in the PRC. Upon the expiry of the agreement, the Group may renew the agreement subject to negotiation with 1506 CC. In November 2010, Mr. Qiu, the legal representative of 1506 CC, became a shareholder of Legend Strategy when he was interested in 8% of the issued share capital of Legend Strategy. This only arose in November 2010 when 1506 CC and the Company wanted to have strategic cooperation along with the 1506 CC Strategic Agreement.

As at the Latest Practicable Date, 1506 CC had developed a theme park, the Creative City, which is located at Foshan and within the centre of the Pearl River Delta of the PRC. To the best knowledge of the Directors, WBT Hotel, Gaomiao Hotel and Zhongxin Hotel are the only hotels which will be developed in the Creative City. Since the 1506 CC Strategic Agreement was entered into after the determination of the sites for WBT Hotel, Gaomiao Hotel and Zhongxin Hotel, such hotels were not developed pursuant to the 1506 CC Strategic Agreement. The investor of WBT Hotel, Gaomiao Hotel and Zhongxin Hotel is independent of and not connected with 1506 CC or its affiliates. According to the website of the Creative City, the development of the Creative City is supported by the local government and it is funded and operated by private enterprises. The Creative City was

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converted from several old factories and has a total constructed area of approximately 380,000 sq.m.. The Creative City offers a platform for the promotion of intellectual property and the development of the creativity industry. Since its opening in 2007, there have been many large-scaled culture promotion programmes conducted in the Creative City, and about 800 private enterprises, including ceramic shops, antique shops, home furniture shops and designer products shops, have setup their offices or even headquarters within the Creative City. According to the development plan of the Creative City, it is expected that there will be about 1,000 private enterprises located in the Creative City by the end of 2011.

To the understanding of the Company, 1506 CC has no intention to develop other new hotels in the Creative City and/or to develop other creative industry parks in the PRC as at the Latest Practicable Date, therefore no negotiation on the provision of hotel services has started between the Company and 1506 CC.

In March 2011, the Group also entered into the Shu Yong Strategic Agreement with Mr. Shu Yong, an international contemporary artist who was awarded the Life Achievement Award in the Florence Biennale of Contemporary Art 2009. Pursuant to the Shu Yong Strategic Agreement, Mr. Shu Yong shall provide advice to the Group on the decoration of the Group's hotels, design or produce masterpieces for these hotels or advise the Group on sourcing of masterpieces. Mr. Shu Yong shall act as an organiser in producing and sourcing work of art which suites the Group's hotels. The fees to be payable under the Shu Yong Strategic Agreement will be set out under separate agreements to be entered into between the Group and Mr. Shu Yong.

The Directors believe that the strategic partnership arrangements are mutually beneficial to the strategic partners and the Group. The Directors consider that 1506 CC can leverage on the Group's experience in developing hotels in its creative industry parks and the Group can benefit from the well-equipped facilities in the creative industry parks to further its hotel business. Further, the Directors consider that the work of art introduced by Mr. Shu Yong into the Group's hotels will help enhance the artistic image of the Group's hotels while it will offer a place for Mr. Shu Yong to promote his art work.

CUSTOMERS

The Group's customers can be categorised into two types, namely hotel guests and hotel investors under the hotel consultancy agreements who are Independent Third Parties. Hotel rooms are available for three hours per section, daily and monthly rental. For each of the two years ended 31 December 2010, the Group's five largest customers in aggregate accounted for approximately 3.0% and approximately 29.6% of the Group's revenue respectively. For the two years ended 31 December 2010, the Group's largest customer accounted for approximately 0.8% and 19.1% of the Group's revenue respectively. None of the Directors, their respective associates, or any Shareholder who, to the knowledge of the Directors, owns more than 5% of the issued capital of the Company, has any interest in any of the Group's five largest customers during the Track Record Period.

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Hotel guests can be categorised into three types, namely guests with contractual arrangements, members of the Group’s loyalty programme and individual guests. Individual guests accounted for the majority of occupancy of the Group’s leased-and-operated hotels.

Guests with contractual arrangements

Guests with contractual arrangements include (i) guests under commercial sales agreements; (ii) guests under intermediaries sales agreements and (iii) guests under long term sales agreements.

Guests under commercial sales agreements

Guests under commercial sales agreements consist of corporate customers. Under the commercial sales agreements, the Group agrees to provide the employees of the corporate customers accommodation at discounted prices during the term of the agreement. The commercial sales agreements do not require the guests to guarantee staying for a minimum number of room nights. The duration of the commercial sales agreements generally range from three months to one year. The rates and discounts under these agreements will normally be reviewed at the end of each year. The discounts offered to each guest under commercial sales agreements are generally the same. The discounted room rates vary from hotel to hotel. The aim of entering into these commercial sales agreements is to build a recurrent customer base.

In general, there are two ways to settle the hotel rental payments. The guests under commercial sales agreements may settle the hotel rental payments on a monthly basis or over the front desk counter at the Group’s hotels upon check-in. The guests under commercial sales agreements may settle the invoice by way of cash, cheque or telegraphic transfer to the Group’s designated bank account.

For the two years ended 31 December 2010, the revenue generated from guests under commercial sales agreements accounted for approximately 14.1% and approximately 10.7% of the Group’s total revenue for each of the respective years. The guests under commercial sales agreements include, among others, enterprises engaging in information technology, airlines and apparels industries.

Guests under intermediaries sales agreements

Guests under intermediaries sales agreements consist of internet and hotline intermediaries. Under the intermediaries sales agreements, the Group agrees to provide the intermediaries accommodation at discounted prices during the term of the agreement. The intermediaries sales agreements do not require the intermediaries to guarantee staying for a minimum number of room nights. The duration of the intermediaries sales agreements generally range from three months to one year. The rates and discounts under these agreements will normally be reviewed at the end of each year. The discounts offered to each guest under intermediaries sales agreements are generally the same. The discounted room rates vary from hotel to hotel. The Group will pay commission to the intermediaries on the

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actual stay of the referred guests. The customers who make reservations through the intermediaries may settle payments at the Group’s hotels upon check-in by way of cash, debit cards or cheque.

The discounts offered to guests under intermediaries sales agreements are smaller than those offered to guests under commercial sales agreements.

As at the Latest Practicable Date, the Group had signed 32 intermediaries sale agreements with 32 internet intermediaries. Those contracts are normally for a term of one year and the Group intends to renew the contracts with the internet intermediates on an annual basis at reasonable rates. The revenue from the guests under intermediaries sales agreements during the Track Record Period accounted for approximately 1.8% and approximately 4.4% of the Group’s total revenue for the two years ended 31 December 2009 and 2010 respectively.

As at the Latest Practicable Date, the Group had signed two intermediaries sale agreements with two hotline intermediaries. These contracts are normally for a term of one year. The Group will renew the intermediaries sales agreements on an annual basis.

Guests under long term sales agreements

Under the long term sales agreements, the guests are offered discounted room rates but are required to stay for a minimum number of room nights of not less than 30 consecutive days. Guests are required to pay not more than one month’s rental payment as security deposit upon check-in. The guests under long term sales agreements may settle payments by way of cash, debit cards, cheque or telegraphic transfer to the Group’s designated bank account.

For the two years ended 31 December 2010, the revenue generated from guests under long term sales agreements accounted for approximately 3.2% and 3.3% of the Group’s total revenue for each of the respective years.

Loyalty programme

In 2008, the Group established a loyalty programme, which serves as a platform to communicate with the hotel guests and promote customer loyalty, and a medium to promote sales of the Group’s hotel rooms to the existing guests and potential guests. The Group invites the customers to join the loyalty programme with a membership fee ranging from RMB40 to RMB200. The fact that the Group’s customers are willing to pay for the hotel membership indicates that they are satisfied with the services of the Group’s hotels and intend to return in the future. There are two types of membership cards, namely Black Card and Green Card, of which the holders are entitled to discounts on room rates and benefits, such as membership points accumulation and early check-in. These two types of membership cards differ in the level of discounts. This membership programme generates business from repeated guests by rewarding membership points which can be used to redeem free hotel nights and other rewards. The revenue from the guests under the loyalty programme accounted for approximately 14.8% and approximately 9.7% for the two years ended 31 December 2009 and 2010 respectively. Further, the Group’s marketing team sends

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information with respect to the Group’s latest promotions and news to the members from time to time. The Directors believe that this marketing campaign helps to raise the profile of the Group among potential customers and enhance the possibility of recommendations by the existing members, thereby expanding the Group’s customer base.

SALES AND MARKETING

Sales

The Group’s sales activities are mainly conducted by a dedicated sales manager who is responsible for maintaining the Group’s relationship with the existing guests under commercial sales agreements and looking for such new potential customers. The branch manager of each leased-and-operated hotel will also perform the sales function. The front desk employees of the Group’s leased-and-operated hotels take bookings over the phone from hotel guests and are encouraged to promote sales of the hotel rooms.

The sales manager of the Group meets with the branch manager of each leased-and-operated hotel on a monthly basis in order to understand the occupancy statistics of each hotel and by each category of hotel guests so as to determine the sales strategy in the following months. The sales manager of the Group also visits the guests under commercial sales agreements from time to time to maintain good customer relationships. The sales manager of the Group also prepares an annual sales plan with annual sales targets for the branch managers of the leased-and-operated hotels.

Room reservation

Hotel room reservations can be made through two channels, namely internet websites and hotel reservation hotlines.

Internet websites

The internet has become an increasingly important sales channel for the Group. On-line room reservation can be made both through the Group’s own hotel website, www.welcomeinn.com.cn, and through internet intermediaries.

For bookings made through internet website of the internet intermediaries, the internet intermediaries will reserve the hotel room(s) at the requested hotel of the Group in advance by sending facsimile to the hotel for confirmation of availability of the hotel rooms. The relevant personnel of each hotel will manually input the bookings received from the internet intermediaries instantly and the information technology personnel will from time to time update the reservation system of each of the Group’s hotels to ensure they share the same database. The reservation system can only be accessed by those hotel staff with authority.

Hotel reservation hotlines

Customers may also make room reservations through the reservation hotlines of the Group as well as reservation hotlines provided by hotline intermediaries.

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MARKETING

The Group’s marketing team is responsible for planning and developing marketing strategies and coordinating all marketing activities of the Group’s hotels.

The total amount of expenses attributable to marketing activities (excluding staff costs) during the Track Record Period accounted for approximately 0.9% and approximately 1.0% of the Group’s total operating costs, respectively.

During the Track Record Period, the following marketing and promotion activities have been carried out:

- (i) distribution of free privilege cards with discounted room rate for the first night of stay and free enrollment to the Group’s membership programme;
- (ii) certain free services such as free laundry services offered to guests who stay at the Group’s hotel for five consecutive days;
- (iii) celebrating the anniversary of the establishment of the Group’s hotels with discounted room rates for all guests;
- (iv) “trial price” for the first night of stay offered to the new members of the Group’s membership programme;
- (v) sale of packages of coupons providing discounted room rates redeemable within three months; and
- (vi) celebrating the National Day with discounted room rates offered to the Group’s members whose identity cards with “60” as the last two digits or whose birthday falls on a specific period of time.

The Group values comments from its hotel guests as they can serve as an indicator for the Group to formulate strategies and enhance its quality of services. The Group’s customer complaint handling procedure complies with the guidelines of ISO 9001 : 2008. Upon check-in, the hotel front desk staff will encourage the hotel guests to fill out a feedback form. The hotel managers will follow up with the hotel guests to resolve the complaints. The hotel managers will record all feedbacks and summarise them into a monthly report to be provided to the Group’s marketing team, which will also follow up with the relevant hotel guests where necessary. The Group’s marketing team will also make follow up telephone calls to the hotel guests and conduct surveys to understand their personal experience after staying at the Group’s hotels. The Group’s marketing team will analyse the feedbacks to design appropriate marketing activities. Most of the complaints the Group received in the past were related to relatively high hotel room price, small size of hotel rooms, poor soundproofing facilities, early check out time and the lack of digital television. The Group will follow up with the customers to resolve the complaints. As at the Latest Practicable Date, none of the customers’ complaints were substantiated into claims or litigation against the Group. The Directors believe that this can make the Group’s hotel guests feel that the Group values their comments and cares about their needs.

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In order to increase awareness of the Group’s hotels, the Group launched a number of sales and marketing channels include launching its own websites, subscribing the website of an Independent Third Party, Baidu.com, and advertising at Huanggang border.

PROCUREMENT AND SUPPLIERS

The main suppliers of the Group comprise of suppliers of disposable amenities, cleansing products and laundry services. The Group has established business relationships with the major suppliers for about two years. For each of the two years ended 31 December 2010, the Group’s five largest suppliers in aggregate accounted for approximately 91.0% and approximately 98.3% of the Group’s total purchase respectively. For each of the two years ended 31 December 2010, the Group’s largest supplier accounted for approximately 39.8% and approximately 51.1% of the Group’s total purchase respectively. None of the Directors, their respective associates, or any Shareholder who, to the knowledge of the Directors, owns more than 5% of the issued share capital of the Company, has any interest in any of the Group’s five largest suppliers during the Track Record Period.

The Group has a centralised procurement team, which sources daily supplies such as disposable amenities for the Group’s hotels. The Group also keeps a centralised storage room at Welcome Inn Nanshan in order to control the inventory level and make replenishment. The Group procures daily supplies from local suppliers only.

The Group’s procurement team usually places orders for the disposable amenities, such as slippers, soap, shampoo and shaver, from a fixed supplier. The term of a procurement contract with the supplier is one year. The supplier will deliver the disposable amenities within 20 days upon orders being placed. The supplier offers the Group a payment term of two months after receipt of goods. The Group will assess the service quality of the supplier and renew the purchase contract annually. The Directors believe that, through this bulk-purchasing policy, the Group has bargaining power to secure purchase with favourable terms in terms of costs, payment term, delivery and after sales services, which in turn enables the Group to manage and control its operating costs efficiently. Sourcing from a fixed supplier enables the Group to ensure the standardised quality of the disposable amenities provided to the guests across hotels operated by the Group. As the suppliers are readily replaceable, the Group can easily secure daily supplies. Generally, the Group maintains an inventory level for one-month operation to maintain its flexibility in satisfying customers demand.

The Group believes that the established guidelines with respect to the procurement procedure can avoid the accumulation of excess inventory and wastage and thus ensure better quality control and compliance with ISO9001:2008.

MAINTENANCE AND REFURBISHMENT

The Group will carry out regular preventive maintenance, essential repairs and replacement of major equipment. All routine maintenance and repair work is carried out by the Group’s maintenance team. In addition to the ongoing routine maintenance on the interior decoration of the hotels, the Group plans to refurbish the leased-and-operated hotels in approximately every six to nine years depending on the then conditions to

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maintain a comfortable accommodation to guests. The Directors believe that the combination of attention to details of design and appropriate use of materials is the major factor for the improvement of the durability of the hotels and thus reduce the maintenance and depreciation expenses of the hotels.

QUALITY CONTROL

The Group was awarded ISO 9001:2008 by SGS for the Group’s compliance with the quality management systems standard for provision of hotel services (excluding restaurant services). The standards and operating procedures of the Group’s quality management system include, but not limited to, the following principles:

- **Management responsibilities**

To realise the commitment to continual improvement, the Group clearly defined the quality policy and objectives, implemented quality planning and established the requirements of its quality management system. It includes defining quality policy and measurable quality objectives, quality planning, reviewing system effectiveness, identifying opportunities for continual improvement, providing sufficient resources, strengthening internal communication to ensure all employees are aware of the importance of satisfying customer needs and expectation and to provide star-rated hotel services.

- **Resources management**

In order to establish, implement and improve the quality management system, the Group uses trained, qualified and competent staff. The Group does not only provide on-the-job training, but also review the effectiveness of training, and ensure that the staff is competent and in the progress of improvement in performance.

- **Service realisation**

To enhance guest confidence, the Group determines overall guest needs and expectation, and converts the same into quality system requirements. The Group complies with the quality system requirements to satisfy guest needs. The level of guest satisfaction will be measured and the outcome will be used to re-define the needs, expectations and requirements of the guests, thereby improving the quality of the hotel services.

- **Measurement, analysis and improvement**

The Group measures the performance of the quality system, which includes the level of guest satisfaction, as well as the performance of the hotel services. The Group analyses the results from time to time, so that corrective, preventive and remedial actions can be implemented.

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The adoption of standardised management policies could enable the Group to form a unity of purpose and direction to enable the hotel staff to work towards the Group’s goals and objectives. Further, the standards and operating procedures can also ensure a consistent approach to improve the Group’s performance.

The Directors believe that the employment of the ISO 9001:2008 standard can provide a tried-and-tested framework for the Group in adopting a systematic approach to manage the hotel operations so that the Group can provide consistent quality services across its hotels. The Group also conducts regular quality assessment to ensure that the requirements under the quality management system are being met. The ISO 9001:2008 certification is subject to satisfactory surveillance audits to be carried out annually by SGS. The Group’s management team has continuously monitored the hotel operation to ensure that the Group complies with all applicable laws and regulations, ISO standard and the Group’s internal policies.

In addition, the Group has adopted measures to manage the risks of prohibited activities (such as illegal drug use, gambling, violence or prostitution by guests), accidents or injuries taking place in the Group’s hotels. The Group hires security guards at all of its hotels to conduct 24-hour surveillance. The Group also complies with the 廣東省旅館業治安管理規則 (The Public Security Management Regulations of the Guangdong Province*) including maintaining proper records of hotel guests and other visitors, reporting hotel guests information to the public security department and placing surveillance cameras at appropriate places of the hotels. Further, the Group takes into account the requirement of safety in the design of the hotels in order to minimise the risk of accidents and injuries, such as avoiding the use of glass in certain places and placing caution signs at prominent positions.

There was no past material incident of (i) delay or failure in the work of contractors; (ii) refurbishment resulting in cost overruns or disruption of hotel operations; (iii) failure to review leases; and (iv) failure to renew various licenses during the Track Record Period.

COMPETITION

According to the 2011 first quarter PRC chain budget hotel industry report issued by Inntie, the total number of budget hotels and budget hotel rooms in the PRC in the first quarter of 2011 amounted to 5,513 and 582,022 respectively. The top 10 budget hotel chains accounted for approximately 66.85% of the total number of budget hotel rooms in the PRC in the first quarter of 2011; while the largest budget hotel chain, Home Inns, accounted for about 16.58% of the total number of budget hotel rooms in the PRC. The top 10 budget hotel chains include Home Inns, Jin Jiang, Motel 168, 7 Days Inns, Hanting Inns, GreenTree Inn, Super 8, ibis, Vienna and Holiday Inn Express.

The hotel industry is highly competitive in the PRC. The competition to attract hotel guests is primarily based on the location of the hotel, price, property size, quality of rooms, amenities and facilities, hotel guest brand recognition and loyalty, geographic coverage, quality of services provided, and relationships with travel agents and third party wholesalers. The Group’s competitors include operators of single guesthouses and hotels located in the vicinity of the Group’s hotels, local hotel chains with multiple hotels,

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established property developers who have entered the hotel industry, and large international hotel chains operating multiple hotels under a variety of brand names. The Group also competes with one/two star-rated hotels. In addition, the Group faces rapid competition from new entrants in the budget hotel industry in the PRC since it does not require significant capital commitments or human resources to develop or convert budget hotel(s). This relatively low entry barrier potentially allows new and existing competitors to enter or expand in the hotel markets rapidly.

In addition to the leased-and-operated hotel operations, such budget hotel chain corporations provide hotel management services to hotel investors which include, but not limited to, hotel planning, hotel design, staff recruitment, training, management advisory, quality control, operational manual advisory, cost control advisory and information technology consultancy. The hotel planning, hotel design and operational manual advisory services provided by other budget hotel market players compete with the hotel consultancy services provided by the Group in terms of price, brand awareness, scope and quality of service.

The Group is positioned as a budget hip hotel service provider. As a relatively new market player in the budget hotel industry, in order to compete with other well-established competitors in the industry to attract new customers, the Group has maintained a low ARR compared with the ARR of the budget hotels in major cities in the PRC. For the year ended 31 December 2010, the ARR of Welcome Inn Caitian, Welcome Inn Nanshan, Welcome Inn Baoan and Welcome Inn Luohu were approximately RMB188.1, RMB194.3, RMB123.7 and RMB175.6 respectively. The table below shows the ARR of budget hotels in major cities in the PRC in the first quarter of 2011:

	Nanjing	Guangzhou	Hangzhou	Shenzhen	Beijing	Shanghai
ARR (RMB)	193.88	221.40	214.74	213.77	244.09	232.50

Source: Inntie

INSURANCE

As at the Latest Practicable Date, the Group maintained property insurance (which covers damage to building, furniture, fixture, neon sign, etc.), public liability insurance (which indemnifies the Group against any claims for which the Group is liable to pay for the Independent Third Party’s property damage and/or bodily injury occurred in connection with the business of the Group), money insurance (which covers the loss of cash in premises of hotels and cash in the custody) and also insurance for the Group’s vehicles. The Group does not maintain insurance policies covering losses relating to the information system of the Group and the Group does not have business interruption insurance.

All these insurance policies are valid for 365 days and renewable annually. The Directors believe that the insurance coverage is consistent with the industry practice and the Group will continue to assess its risk and make necessary modifications to its current insurance policies.

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ENVIRONMENTAL MATTERS

The operation of the Group’s hotels is subject to various environmental laws. The Group has been in compliance with applicable environmental laws and regulations, including those relating to water pollution control, drainage control and noise control. The Group has not been required to pay any annual cost for compliance with applicable rules and regulations regarding environmental matters during the Track Record Period and is not expected to incur any amount for compliance going forward under the current laws and regulations. There was no penalty or fine in connection with the breach of any environmental laws or regulations imposed to the Group since its incorporation and up to the Latest Practicable Date. The Company’s PRC legal advisers confirmed that the Group complied with all relevant rules and regulations during the Track Record Period and up to the Latest Practicable Date.

The hotel managers and the administrative manager of the Group are experienced personnel responsible for implementing and ensuring compliance with the environmental laws and regulations imposed on the hotels of the Group.

For further information in relation to the environmental laws applicable to the Group, please refer to the paragraph headed “Principal laws and regulations related to environmental protection” under the section headed “The PRC regulatory framework” of this document.

PROPERTIES

As at the Latest Practicable Date, the Group had leased four sites of part of various commercial buildings as leased-and-operated hotels, one commercial building floor as office, and six sites as staff quarters in the Louhu District, Baoan District, Nanshan District and Futian District, Shenzhen in the PRC. The details of the properties leased by the Group in the PRC are set out below:

Location	Use	GFA (sq.m.) (approximate)	Lease term
1. 中華人民共和國深圳市 福田區彩田路3030號 橄欖鵬苑裙樓二、三層 (2-3/F, Ganlan Peng Garden Podium Building, No. 3030 Caitian Road, Futian District, Shenzhen, the PRC*)	Hotel	2,116	20 November 2005 to 19 November 2015
2. 中華人民共和國深圳市 羅湖區深南路南嘉賓花園裙樓三樓 (3/F, Jiabin Garden Podium Building, Shennan Road South, Luohu District, Shenzhen, the PRC*)	Hotel	2,277.14	1 February 2008 to 31 January 2018 with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises

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Location	Use	GFA (sq.m.) (approximate)	Lease term
<p>3. 中華人民共和國深圳市 南山區南山大道2009號 億利達精英綜合樓 (Yilida Jingying Complex Building, No. 2009 Nanshan Main Road, Nanshan District, Shenzhen, the PRC*)</p>	Hotel	7,079	<p>1 January 2007 to 31 December 2014</p> <p>with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises</p>
<p>4. 中華人民共和國深圳市 寶安五區新安二路二十三號商業樓 (Building 23, Xinan Second Road, Baoan District 5, Shenzhen, the PRC*)</p>	Hotel	1,700	<p>1 January 2011 to 30 December 2017</p> <p>with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises</p>
<p>5. 中華人民共和國深圳市 南山區商業文化中心 區海岸大廈西座1309 (Room 1309, West Building, Hai'an Towers, Commercial and Cultural Centre, Nanshan District, Shenzhen, the PRC*)</p>	Office	130.55	<p>1 October 2010 to 30 September 2012</p> <p>with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises</p>
<p>6. 中華人民共和國深圳市 羅湖區和平路1191號 海關三院2棟402房 (Room 402, Block 2, Haiguan San Court, No. 1191 Heping Road, Luohu District, Shenzhen, the PRC*)</p>	Staff quarter	132	<p>1 September 2010 to 31 August 2011</p> <p>with right of first refusal to enter into a new tenancy upon expiry of the existing lease</p>
<p>7. 中華人民共和國深圳市 南山區常興路怡苑閣36棟2單元701室 (Room 701, Unit 2, Block 36, Yiyuange, Changxing Road, Nanshan District, Shenzhen, the PRC*)</p>	Staff quarter	120	<p>1 November 2010 to 31 October 2011</p> <p>with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises</p>

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Location	Use	GFA (sq.m.) (approximate)	Lease term
8. 中華人民共和國深圳福田區 蓮花一村9棟503單位 (Unit 503, Block 9, Lianhua Yi Cun, Futian District, Shenzhen, the PRC*)	Staff quarter	86	1 September 2010 to 31 August 2011 with right of first refusal to enter into a new tenancy upon expiry of the existing lease and to purchase the premises
9. 中華人民共和國深圳市 寶安區西部開發區 翠湖花園七棟602 (Unit 602, Block 7, Cuihu Garden, Xibu Development Zone, Baoan District, Shenzhen the PRC*)	Staff quarter	50.2	10 March 2011 to 11 March 2012 with right of first refusal to enter into a new tenancy upon expiry of the existing lease
10. 中華人民共和國深圳市 南山區海德二道和南山大道 交界處南光花園5棟706室 (Room 706, Block 5, Nanguang Garden, located at the intersection of Haide Second Road and Nanshan Main Road, Nanshan District, Shenzhen, the PRC*)	Staff quarter	96.28	16 March 2011 to 15 March 2012
11. 中華人民共和國深圳市 福田區華富街道辦彩田路3028號 春暉苑乙棟5層01房 (Room 1, 5/F, Yi Block, Chunhui Garden, No. 3028 Caitian Road, Huafu Jiedao Ban, Futian District, Shenzhen, the PRC*)	Staff quarter	42.24	25 March 2010 to 24 March 2011 under the original lease and 26 March 2011 to 18 October 2011 under the supplementary lease

As at the Latest Practicable Date, the Group had leased one commercial building unit as office in Hong Kong from an Independent Third Party with details set out below:

Location	Use	GFA (sq.ft.) (approximately)	Lease term
1. Unit 1303, 13th Floor, Tai Tung Building, 8 Fleming Road, Wanchai, Hong Kong	Office	1,218	15 April 2011 to 14 April 2013 with the tenant's option to renew for a further term of 24 months at the then prevailing market rent

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On 18 March 2011, Yuelai Inn Tourists entered into a lease (the “**Welcome Inn Caitian Lease**”) with 深圳市億民興物業管理有限公司 (Shenzhen Yi Min Xing Property Management Co., Ltd.*) (the “**Caitian Lessor**”) in respect of premises located at 2nd and 3rd Podium Floors, Gan Lan Peng Yuan, No. 3030 Caitian Road, Futian District, Shenzhen, the PRC of an aggregate GFA of 2,116 sq.m. (the “**Caitian Property**”). The Welcome Inn Caitian Lease has a term from 20 November 2005 to 19 November 2015. The Company is advised by its PRC legal advisers that the retrospective effect from 20 November 2005 is legal, valid and enforceable under the PRC laws.

The land use right of the parcel of land on which the Caitian Property is located belongs to 中國人民武裝警察部隊 (the People’s Armed Police Force of China*) (the “**PAPF**”) and 中國人民武裝警察部隊後勤部基建營房部 (Logistic Department and Infrastructure and Housing Department of People’s Armed Police Force of China*) issued 中國人民武裝警察部隊房地產租賃許可證((武后)營字房租證字第001179號) (Real Estate Title Certificate issued by the People’s Armed Police Force of China*) on 25 December 2008 confirming that the Caitian Lessor has the right to use the Caitian Property. Such permit had expired on 31 December 2009. To the best knowledge of the Directors, the application for a new permit is under progress. Up to the Latest Practicable Date, no objections have been made by any party against the use of the Caitian Property by the Group.

The legal advisers of the Company as to PRC laws have advised as follows:

- (i) the land use right of the parcel of land on which the Caitian Property is located belongs to PAPF;
- (ii) the Welcome Inn Caitian Lease is legally binding and enforceable against the parties thereto;
- (iii) Welcome Inn Caitian Hotel has been occupying the Caitian Property for operating hotel business for five years and during the period, no objections have been made by any third party, including the relevant PRC authorities, against the parties to the Welcome Inn Caitian Lease; and
- (iv) in conclusion, there is no evidence to prove that the Caitian Lessor does not have the right to sub-lease the Caitian Property to the Group and the Group cannot use the Caitian Property in accordance with the Welcome Inn Caitian Lease and under the laws of the PRC.

Approximately 26% and 17% of the Group’s total revenue during the Track Record Period were contributed by Welcome Inn Caitian. Welcome Inn Caitian recorded approximately HK\$0.5 million of operating profit compared to the Group’s total operating loss of approximately HK\$3.3 million for the year ended 31 December 2009. Approximately 11% of the Group’s total operating profit for the year ended 31 December 2010 was contributed by Welcome Inn Caitian. It is noted that the contribution of Welcome Inn Caitian to the Group’s revenue and profit has decreased in 2010 mainly due to the commencement of the hotel consultancy business in December 2009 which offers a new revenue source. As discussed in the section headed “Strategies and business objectives” in

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this section, the Group plans to continue to expand its leased-and-operated hotel portfolio. The Fujian Hotel is expected to commence operation in early 2012 and the Heyuan Hotel is expected to commence operation in the second half of 2012. In addition, the Group plans to continue to expand the hotel consultancy business and commence the hotel management services business in the second half of 2011 which is expected to further diversify the Group's sources of revenue. In view of the above, it is expected that the contribution of Welcome Inn Caitian to the Group's revenue and profit will further decrease in the future.

In the event that the Group is requested to vacate the Caitian Property, it is expected that the Group will incur a loss of approximately HK\$3.6 million, being the carrying amount of Welcome Inn Caitian (including all immovable assets such as leasehold improvements) as at 31 December 2010. The PRC legal advisers of the Company advised that the Group may choose to claim against the lessor who will be liable to compensate the Group for the carrying value of Welcome Inn Caitian under applicable laws. Based on the Group's experience and available information and after consultation with the Company's PRC legal advisers, the Directors are of the view that the defective title of the Caitian Property is unlikely to cause any interruption to or termination of the lease or to have a material effect on the carrying amount of the related leasehold improvements. Moreover, the Controlling Shareholder has agreed to keep the Group indemnified for any losses that the Group may suffer from any failure of the Group's subsidiary in obtaining licence or permit to use the Caitian Property. Accordingly, no impairment for such leasehold improvement is considered necessary to be made according to the Group's accounting policies.

In the event that the Group is requested by the PAPF to vacate the Caitian Property, the Group will transfer the hotel bookings and relocate the hotel guests to other hotels of the Group in Shenzhen where there are rooms available subject to the consent of the concerned hotel guests. The Group will return the deposit received from hotel guests who do not wish to be relocated. As at 31 December 2009 and 2010, the amount of deposit received from hotel guests was approximately HK\$78,896 and HK\$121,536 respectively. Further, the fixtures and supplies of Welcome Inn Caitian shall be transferred to other hotels of the Group for use or stored for use at future hotels of the Group.

Further, the landlord of a staff quarter (property number 11 in the above table) is unable to produce evidence of ownership in the property, and such lease agreement may be challenged as to its validity. If the lease agreement is found to be invalid by the competent authorities or if the landlord turn out does not process valid title, the Group may have to relocate the staff quarter and in such circumstance, the Group would have to incur additional relocation costs.

In addition, the lease agreements of Caitian Property and Welcome Inn Nanshan and all the six lease agreements of staff quarters have not been registered according to the relevant PRC rules and regulations. The Company's PRC legal advisers have advised that the relevant members of the Group as the lessee may be liable for a fine but non-registration of the said leases will not affect their respective legality.

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To ensure the smooth renewal of the lease agreements of the Group’s hotels, the Group will negotiate with the landlords in relation to the renewal around one year prior to the expiry of each lease agreement with reference to the then prevailing market rates. Also, all the lease agreements of the Group’s hotels, save for the lease agreement of the Caitian Property, offer first priority to the Group to renew the respective lease agreements. Since the Group will negotiate to renew the lease agreements in advance, there will be sufficient time for the Group to arrange for the closing of a hotel, vacating the property and to plan for the starting up of new hotels in other locations in the event that the Group is unable to renew any of the lease agreements.

Indemnity


The Controlling Shareholder has agreed to keep the Group indemnified for any losses that the Group may suffer from any failure of any member of the Group in leasing or obtaining licence or permit to use any property interests owned or leased or otherwise used or occupied by the Group, or to obtain any property certificate in respect of such properties.

Rental expense

Rental expense is one of the Group’s major costs in its business operations. For the two years ended 31 December 2010, total operating lease expenses of the Group’s leased properties amounted to approximately HK\$8.4 million and approximately HK\$7.5 million respectively, representing approximately 36.8% and 31.6% of the operating expenses of the Group, respectively.

For further details of the Group’s property interest, please refer to the valuation report prepared by Norton Appraisals Limited, an independent property valuer, as set out in Appendix III to this document.

INTELLECTUAL PROPERTIES

As at the Latest Practicable Date, the Group had registered one trademark in Hong Kong, namely . The Group also has registered the domain names of **welcomeinn.com.cn** and **legendstrategy.com**. The Group has not been notified that it has infringed any patents, copyrights or other intellectual property rights owned by other parties during the Track Record Period.

The Company considers its brand names being critical to the Group’s success in the long term but less critical in the short to medium term since the Group has a limited operating history of four years and has yet to develop a sizeable hotel chain operation under an established brand name. The Company considers that brand recognition among its hotel customers is currently weak. Customer loyalty is built up from the quality of services of the Group’s hotels rather than its brand name. The Company considers that a significant portion of its hotel guests are corporate customers who pays more attention on the hotel’s quality of services rather than its brand name.

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The Group has made applications for the registration of word marks and logo marks containing “悦來客棧”, “悦來”, and “Welcome Inn” as trademarks in the PRC in February and March 2011 which are accepted and being processed by 國家工商行政管理總局商標局 (Trademark Department of the State Administration of Industry and Commerce*) as at the Latest Practicable Date. It is expected that the registrations will be completed within two years from the respective dates of applications. Certain trademarks containing “悦來客棧” or “悦來” have already been registered by others in the PRC. However, the specific services in respect of which such trademarks were registered for do not include providing accommodation and operation of hotel business. As such, the Company’s PRC legal advisers advised that it is not expected that there would be any infringement from the use of “悦來客棧” or “悦來” by the Group for the operation of hotel business in the PRC prior to registration. The Trademark Department of the State Administration of Industry and Commerce may reject an application for registration of the trademarks in any of the following circumstances: (i) if an application has been made to register a trademark that is not in conformity with the trademark law of the PRC or that is identical with or similar to another person’s trademark which has already been registered or given preliminary examination and approval for use on the same kind of commodities or similar commodities; (ii) when two or more trademark registration applications apply for registration of identical or similar trademarks for the same kind of commodities or similar commodities, the trademark whose registration was first applied for shall be given preliminary examination and approval; if the applications are filed on the same day, the trademark which was first used shall be given preliminary examination and approval, and the applications of the others shall be rejected; (iii) any person may file an opposition to a trademark which has been given preliminary examination and approval within three months from the day it was publicly announced; and (iv) if the trademark registration applicant or the registrant has found that there are obvious mistakes in the trademark application documents or registration documents. The Company’s PRC legal advisers advised that they are not aware of any legal impediments for the Group to register the relevant trademarks. The Group’s applications for registration of the trademarks may be rejected by the Trademark Department of the State Administration of Industry and Commerce if it considers the applications conform to any of the above circumstances.

Further details of the Group’s intellectual property rights are set out in the sub-section headed “The Group may not be able to register the existing band names” under the section headed “Risk factors” of this document and the sub-paragraph headed “Intellectual property rights of the Group” under the section headed “Further information about the business of the Group” in Appendix V to this document.

LITIGATION AND LEGAL COMPLIANCE

As at the Latest Practicable Date, there were no litigation or arbitration proceedings pending or threatened against the Group which could have a material adverse effect on the Group’s financial condition or results of operations.

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Compliance with PRC laws and regulations

The Directors, as advised by the Company’s PRC legal advisers, confirm that as at the Latest Practicable Date, save as disclosed otherwise, the Group had complied with all relevant PRC laws and regulations in all material respects in relation to the operations of the Group in the PRC, the conversion of existing commercial buildings into hotel accommodation, and fire prevention, public security and public area hygiene, including obtaining all required permits and licences.

Set out below are the key licences and permits obtained by the Group as a hotel operator required under the relevant PRC laws and regulations:

Hotel	Licence/Permit	Expiry date
Welcome Inn Caitian	Business Licence	11 December 2026
	特種行業許可證 (Licence of Special Trade*)	No expiry
	排污許可證 (Licence of Pollution Discharge*)	24 January 2012
	城市排水許可證 (Urban Wastewater Discharge Permit*)	27 July 2014
	衛生許可證 (Public Area Hygiene Licence*)	21 December 2012
Welcome Inn Nanshan	Business Licence	30 May 2028
	特種行業許可證 (Licence of Special Trade*)	No expiry
	城市排水許可證 (Urban Wastewater Discharge Permit*)	3 March 2016
	衛生許可證 (Public Area Hygiene Licence*)	30 July 2011 (<i>Note</i>)
Welcome Inn Baoan	Business Licence	25 April 2028
	特種行業許可證 (Licence of Special Trade*)	No expiry
	城市排水許可證 (Urban Wastewater Discharge Permit*)	17 March 2012
	衛生許可證 (Public Area Hygiene Licence*)	20 May 2012
Welcome Inn Luohu	Business Licence	26 November 2028
	特種行業許可證 (Licence of Special Trade*)	No expiry
	排污許可證 (Licence of Pollution Discharge*)	25 May 2015
	城市排水許可證 (Urban Wastewater Discharge Permit*)	24 September 2013
	衛生許可證 (Public Area Hygiene Licence*)	16 January 2013

Note: According to the relevant PRC requirement, 衛生許可證 (Public Area Hygiene Licence*) should be renewed within three months following its expiry date.

Non-compliance with the relevant PRC social insurance laws and regulations

Pursuant to the relevant PRC laws and regulations, the Group is required to contribute to the employees’ statutory pension fund, medical insurance, unemployment insurance, maternity insurance, work-related injury insurance (together, “social insurance”)

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contributions. The Group has contributed social insurance of approximately HK\$199,000 and HK\$230,000 respectively during the Track Record Period. The basis of the contribution paid was deviated from the contribution calculated based on the PRC laws and regulations. The Group has therefore not fully paid and has not been required by the relevant local authorities to fully pay the social insurance contribution for some of the Group’s employees. Pursuant to the advice of the Company’s PRC legal advisers, the Group has updated its internal system for calculating social insurance contributions according to the PRC laws and regulations. In addition, as part of its initiative to strengthen its internal control following the [●], the Company intends to set up an internal audit department after [●], which shall be responsible for monitoring compliance by the Group, including the compliance of social insurance contribution requirements.

The Group has received confirmation from 深圳市社會保險基金管理局 (The Shenzhen Social Insurance Fund Management Bureau*), the competent authority, confirming each of the subsidiaries in the PRC has complied with relevant labour protection laws and regulations, and is not subject to any late payment or fine or penalties since its establishment. To ensure strict compliance with the relevant PRC social insurance laws and regulations, the Group has entered into labour contracts with the employees in the PRC and paid for their social insurance contribution. As advised by the Company’s PRC legal advisers, if the above arrangements are subsequently overruled by the relevant authorities, according to current applicable PRC social insurance laws, the Group may be ordered to rectify the problem and pay the outstanding social insurance contribution together with a daily surcharge of 0.2% of the total outstanding contribution before a set deadline and the Group’s management and other persons with direct responsibilities of the Group may be fined to a maximum of RMB30,000. The maximum amount of overdue penalty that the Group would have to pay would be approximately HK\$2,800 per day, being 0.2% of HK\$1.4 million, which is the total unpaid social insurance contribution as at 31 December 2010. The Group did not provide for such penalty since the Group has obtained a confirmation from the relevant authorities confirming that the Group’s subsidiaries in the PRC have not breached the regulations for the years ended 31 December 2009 and 2010. The PRC Government has announced that effective on 1 July 2011, the relevant regulation will be amended such that The Shenzhen Social Insurance Fund Management Bureau may order any entity who has not fully paid social insurance contribution to pay the outstanding social insurance contribution together with a daily surcharge of 0.05% of the total outstanding contribution by a stipulated deadline. If payment is not made by the deadline, the entity will be subject to a penalty in a sum ranging from the total outstanding social insurance contribution to three times thereof.

As at the Latest Practicable Date, the Group had not received any order which overrules the above arrangements or notice on payment of social insurance contribution or surcharge from the government authorities. The Group will pay the contribution by the stipulated deadline in case it is ordered to do so. Since the Group has not received any notices from or has not been ordered by the relevant government authorities to pay any outstanding social insurance contribution, the Group was not being held liable for any late payment of social insurance as at the Latest Practicable Date. The Group has made provisions in the amount of approximately HK\$0.8 million and approximately HK\$1.4 million as at 31 December 2009 and 2010 respectively, for the maximum potential

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underpayment of social insurance contribution. This amount does not take into account any delinquency payments or fines. Subsequent to the year ended 31 December 2010, the Group has made monthly social insurance contribution in accordance with the PRC laws and regulations.

The Controlling Shareholder has entered into a deed of indemnity with and in favour of the Company in which the Controlling Shareholder has agreed with each member of the Group that he will indemnify and at all times keep all and each of the members of the Group fully indemnified on demand against all losses, costs (including all legal costs), expenses, penalties or other liabilities which any of the members of the Group may incur in connection with or sustain from the under-provision of social insurance to any members of the Group by the relevant shareholders.

Non-compliance with Companies Ordinance

Pursuant to sections 122(1) and 122(2) of the Companies Ordinance, the directors of every Hong Kong company must cause the profit and loss account and balance sheet of the company to be made out and laid before the company at each of its annual general meetings, failing which, each director shall be liable to a fine of HK\$300,000 and an imprisonment of 12 months.

Certain subsidiaries of the Group namely Moon Ko, Triple Leaf, Lai Ying and Legend Strategy had failed to prepare the financial statements for the years 2007, 2008 and 2009, which had therefore not been laid before their respective annual general meetings, as required under the Companies Ordinance. The non-compliance with the Companies Ordinance of the subsidiaries of the Group was due to the reasons that the directors of these subsidiaries lacked training regarding legal and compliance matters and they had entrusted the companies' secretaries to deal with and handle the compliance matters, but the company secretaries of these subsidiaries did not inform the directors of the statutory requirements under the Companies Ordinance. In response to this, the directors of Moon Ko, Triple Leaf, Lai Ying and Legend Strategy immediately took steps to appoint Solarmark (HK) C.P.A. Co. Ltd. and PricewaterhouseCoopers to audit the financial statements of the above companies. The audited financial statements for 31 December 2007 and 2008 of these companies were issued on 28 February 2011 while the audited financial statements for 31 December 2009 were issued on 15 March 2011. These audited financial statements were adopted by all the members of relevant companies by way of written resolutions on 12 April 2011.

On 22 June 2011, the Court of First Instance of the High Court has granted orders to each of Moon Ko, Triple Leaf, Lai Ying and Legend Strategy, pursuant to which the requirements under sections 122(1) and 122(2) of the Companies Ordinance for laying of the financial statements for the years 2007, 2008 and 2009 before the companies' respective general meetings be extended to 12 April 2011 and the shareholders' written resolutions dated 12 April 2011 of each company do satisfy the requirements of the Companies Ordinance. Upon the grant of such orders, Moon Ko, Triple Leaf, Lai Ying and Legend Strategy will no longer be in breach of sections 122(1) and 122(2) of the Companies Ordinance.

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Internal control and corporate governance

In order to prevent the recurrence of non-compliance of rules and regulations, the Company has taken measures to enhance its internal control and corporate governance. The Company has engaged a consulting firm to review the internal control system of the Group. The Company has rectified the material deficiencies identified from the review according to the recommendation of the consulting firm. In particular, the review has identified that no audited financial statements were prepared for certain subsidiaries of the Group for the three years ended 31 December 2007, 2008 and 2009. The Group has now appointed the company secretary to closely monitor and schedule annual audit to ensure audited financial statement is available before every annual general meeting. It was also identified that the basis of calculation of the social insurance contribution paid previously has deviated from the contribution calculated based on the PRC laws and regulations. The Group has therefore not fully paid the social insurance contribution for some of the Group’s employees. The Company has now updated its system for calculating social insurance contribution according to the PRC laws and regulations. The finance manager will also review and approve the calculation of monthly social benefit contribution. Further, the Group previously has no proper documentation on monthly approved financial statements to monitor the financial position and performance of the Group and there was no financial statement disclosure guideline to ensure information presented in the financial statements is accurate, complete and consistent. The Group has put in place financial statement guidelines to ensure the accuracy, completeness and consistency of financial disclosure and since January 2011, the finance department has properly filed all approved monthly management accounts. In addition, the Company has established an audit committee to oversee the financial reporting system and internal control procedures of the Company. The Company has appointed Mr. Kam Tik Lun, a certified public accountant of the Hong Kong Institute of Certified Public Accountants, as the company secretary of the Company. Mr. Kam oversees the company secretarial functions of the Group and monitors compliance with relevant rules and regulations such as the Companies Ordinance. The Company will procure annual review of the effectiveness of its internal control system.