Management Discussion and Analysis

FINANCIAL REVIEW

During the year, Harbin Brewery posted a turnover of approximately HK$1,119 million, an increase of 34% from 2001. The growth in turnover was a result of the increase in sales volumes and an improved product mix, as well as enhanced efficiencies in the newly acquired breweries.

In 2002, output volumes of the Group's products reached 912,946 tonnes (approximately 9.0 million hl), achieving a growth of 30% over 2001. The average price per tonne (average price per hl) rose 3% to HK$1,225 per tonne (approximately HK$124.0 per hl) during the year.

The Group's overall gross margin for the year was 42.4%, down from 45.6% in 2001. The slight decrease was due to a change of product mix and the lag time effect in the early stage of integration in the newly acquired breweries during the year.

As a result of strenuous operating costs control, profit from operating activities reached approximately HK$210 million for the year, accounting for a 38% increase over 2001. Net profit attributable to shareholders in 2002 was approximately HK$109 million, representing an increment of 34% from that of 2001. Basic earnings per share were HK13.8 cents.

The Board does not recommend the payment of any dividend for the year ended 31 December 2002 (2001: Nil).

BUSINESS REVIEW

With a centrally co-ordinated, process-based management model in place, the Group has been successful in integrating the operations and enhancing the overall efficiencies in existing and newly acquired breweries, achieving scalable operations.

(i) Turnover by product mix

A strategically oriented product mix is the key to a business' success. Harbin Brewery's products are divided into three categories: Original, Classic and Premium, targeting at the provision of quality beer products for the mass, middle-income and premium markets respectively.

The major income source of the Group came from the sales of Original products, accounting for 78% of the total turnover for the year. Turnover of Original products increased by 29% from approximately HK$675 million in 2001 to approximately HK$869 million in 2002.

During the year, the Group recorded a high growth in the sales of Classic products, reaching 15% of the total turnover. Turnover from Classic products increased from approximately HK$88 million in 2001 to approximately HK$171 million, representing a surge of 94%. The Group expects that the middle-income market will continue to offer the greatest room for growth.

The sales of Premium products accounted for 7% of the total turnover for the year. Turnover slightly increased 7% from approximately HK$74 million in 2001 to approximately HK$79 million.

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(ii) Turnover by geographical location

In 2002, the Group's products were mainly sold to the Northeast Region, accounting for 95% of the total turnover. Turnover from the Northeast Region amounted to approximately HK$1,058 million, an increase of 32% from approximately HK$802 million over 2001.

The single largest market of the Group - Heilongjiang Province - contributed 66% of the total turnover. Turnover from the rest of the Northeast Region, which includes Jilin and Liaoning Provinces, recorded substantial growth of 66% compared with 2001, contributing 29% of the total turnover in 2002.

Sales from the Non-Northeast Region contributed to 5% of the Group's total turnover, an increase of 74% as compared to 2001.

(iii) Overall production operations

Apart from facilitating organic growth, the Group adopts the strategy of acquisition to expand its aggregate production capacity for deeper market penetration. Adding the three breweries acquired in 2002 (mentioned in (iv) below) to the portfolio, the number of breweries the Group operates in the PRC increased from eight in 2001 to eleven in 2002. The aggregate designed production capacity thus increased from 1,044,000 tonnes (approximately 10.3 million hl) to 1,264,000 tonnes (approximately 12.5 million hl) in 2002. The utilization rate of all breweries during the year reached 88%.

(iv) 2002 Acquired Breweries

To capture favourable expansion opportunities, Harbin Brewery acquired a 100% equity interest in Ballantine Management Limited ("Ballantine") in August 2002 for an aggregate cash consideration of HK$70 million. Ballantine owned a 100%, 63.02% and 60% equity interest in three breweries in Liaoning, Hebei and Heilongjiang Provinces respectively ("2002 Acquired Breweries").

This acquisition was a significant corporate move for the Group in 2002. It was the first time for the Group to extend its production bases to the west of Heilongjiang Province, and to the Liaoning and Hebei Provinces. The location of these brewery operations enable the Group to tap into their corresponding markets more effectively, further strengthening its dominant market position in the Northeast Region of China.

The combined designed production capacity of the 2002 Acquired Breweries reached 220,000 tonnes (approximately 2.2 million hl), increasing the Group's aggregate designed production capacity by 21% to 1,264,000 tonnes (approximately 12.5 million hl) per annum. Besides the HK$70 million spent on the acquisition, the Group has thus far invested another HK$20 million as capital expenses into these breweries for enhancing efficiency. The operating performance of the 2002 Acquired Breweries is expected to be fully reflected in 2003, as the integration process was only commenced in late 2002.

(v) Single-megabrand marketing strategy

In the belief of a "Single-megabrand Strategy", the Group is promoting "Harbin" as the brand of "the oldest brewery in China" providing high quality products. The Group's marketing objective is to build up its brand as a nation-wide brand in the PRC beer market. An integrated marketing strategy has been put in place, which covers brand building strategy, product mix management, pricing policy and distribution network establishment.

PROSPECTS

For the benefit of continuous business growth, Harbin Brewery will continue to capture favorable acquisition opportunities in the Northeast Region of China to deepen market penetration of the "Harbin" brand. Moreover, the Tangshan/Tianjin Region and the southern part of the Northeast Region are target markets that the Group will explore further for acquisition opportunities to extend its distribution network.

For those newly acquired breweries, the Group is committed to enforce stringent measures to increase their production capacity and to maximize their utilization rates, generating stronger sales for the Group. With its solid track record in turning around loss operations and improving profitability of the acquired breweries, the Group is confident in successfully integrating acquired brewery operations into existing ones.

China is one of the largest beer consuming nations in the world with beer consumption reaching 24 million tonnes (per capita consumption of 18 litres) in 2002. Concurrently, with an annual growth of gross domestic product at 7.7% in the PRC, increased disposable income, especially from the middle-income market, is spearheading the upward demand for high quality beer products. The Group will thus continue to expand in this high growth market segment in the coming years, further adjusting its product mix for higher profitability.

The Group is open to explore possible co-operation opportunities with world renowned brewery groups for the benefit of the Group's long-term development.

As one of the leading brewery groups in the PRC, the Group will closely leverage opportunities arising from industry consolidation underway in China's beer market to grow further. The implementation of the centrally co-ordinated, process-based management model will also be sustained to reengineer brewery operations for optimal efficiencies.

Given the strong market demand and its competitive advantages, Harbin Brewery is optimistic about its future performance, and is confident in bringing satisfactory returns to shareholders.

Management Discussion and Analysis

FINANCIAL RESOURCES AND LIQUIDITY

The Group's total assets increased by 28% from approximately HK$1,775 million as at 31 December 2001 to approximately HK$2,277 million as at 31 December 2002. Net assets increased by 138% from approximately HK$340 million as at 31 December 2001 to approximately HK$808 million as at 31 December 2002. The increase in net assets was attributable to the net proceeds raised from the share offer of the Group's listing on the Stock Exchange on 27 June 2002 and the over-allotment option exercised on 15 July 2002, together with the net cash inflow from the Group's operating activities. Cash and bank balances amounted to approximately HK$168 million as at 31 December 2002.

The debt to equity ratio of the Group was 97% as at 31 December 2002, greatly improved from 226% as at 31 December 2001 after repaying part of the Group's debts from its operating income and the proceeds raised from its share offer in June 2002. The net debt to equity ratio of the Group was 77% as at 31 December 2002.

USE OF NET PROCEEDS FROM NEW ISSUES

The net proceeds from the share offer of the Group's listing on the Stock Exchange on 27 June 2002 and the over-allotment option exercised on 15 July 2002 were approximately HK$345 million. Of that amount, the Group utilized approximately HK$130 million for the repayment of shareholders' and bank loans. A further HK$90 million was used for the acquisition of the 2002 Acquired Breweries (HK$70 million used for the acquisition and HK$20 million used for capital expenses of the acquired breweries). Approximately HK$87 million of the proceeds were used for the Group's working capital requirements, of which approximately HK$70 million was used for the purchase and downpayment of raw materials, such as barley. Approximately HK$38 million of the net proceeds of the Group's IPO remains available, which is placed on short-term deposits with licensed banks in Hong Kong.

HUMAN RESOURCES AND REMUNERATION OF EMPLOYEES

The Group employs a total of 5,956 full time employees in Hong Kong and the PRC. The Group recognizes the importance of its human resources to its success. Remuneration is maintained at competitive levels with discretionary bonuses payable on a merit basis and in line with industry practice. Other staff benefits provided by the Group include mandatory provident fund, insurance schemes and performance related commissions.

SIGNIFICANT EVENTS

The Group was listed on the Main Board of the Stock Exchange on 27 June 2002, raising net proceeds amounted to approximately HK$296 million by issuing a total of 220,000,000 shares, which is equivalent to 25% of the enlarged issued share capital of the Group as at the same day.

Upon exercising the over-allotment option, the Group raised additional net proceeds of approximately HK$49 million on 15 July 2002 by issuing 33,000,000 shares, which is equivalent to 3.6% of the enlarged issued share capital of the Group as at the same day.

On 28 August 2002, the Group completed the acquisition of the 2002 Acquired Breweries.

Management Discussion and Analysis

CONTINGENT LIABILITIES

At 31 December 2002, the Group had given guarantees of approximately HK$8,047,000 (2001: HK$3,770,000) to a bank in connection with credit facilities granted to certain employees of a subsidiary for financing the construction of employees' quarters. Upon the issuance of building ownership certificate, the employees' quarters will be mortgaged to secure the credit facilities and replace the guarantees.

PLEDGE OF ASSETS

Certain of the Group's bank loans are secured by the Group's land and building and plant and machinery, which had an aggregate net book value at the balance sheet date of approximately HK$609,624,000 (2001: HK$616,628,000).

In addition, the Group's syndicated bank loan at the balance sheet date of approximately US$11.4 million (2001: US$22 million) is secured by the following:

(i) Floating charge over the assets of all of the Company's subsidiaries; and

(ii) Share mortgage/assignment of the ownership rights of the Group's interests in subsidiaries.

EXPOSURE TO FOREIGN EXCHANGE RISKS

The Group conducts most of its business transactions in currencies of Hong Kong dollars and Renminbi. In view of the stability of the exchange rate of these currencies during the year under review, the Group has not been subject to exchange rate fluctuation exposure and thus no financial instrument has been adopted for hedging purposes.

PURCHASE, REDEMPTION OR SALE OF THE COMPANY'S LISTED SECURITIES

The Company's shares were listed on the Stock Exchange on 27 June 2002. Neither the Company, nor any of its subsidiaries purchased, redeemed or sold any of the Company's listed securities during the period ended 31 December 2002.

COMPLIANCE WITH THE CODE OF BEST PRACTICE

In the opinion of the directors, the Company complied with the Code of Best Practice (the "Code") as set out in Appendix 14 of the Listing Rules of the Stock Exchange, since the listing of the Company's shares on the Stock Exchange on 27 June 2002, except that the non-executive directors of the Company are not appointed for specific terms as required by paragraph 7 of the Code, but are subject to retirement and re-election at the general meeting of the Company in accordance with the Company's articles of association.