# MANAGEMENT DISCUSSION AND ANALYSIS

## INDUSTRY REVIEW

The Company is one of the PRC's leading high-speed, heavy-duty diesel engine manufacturers, supplying mainly to certain major domestic truck and construction machine makers. The Company's core products are its six-cylinder, 110–266kW output, 9.7 litre displacement WD615 diesel engines. The Company also launched the WD618 series in 2000, which have a higher power output of 265–323kW.

Over the past decade, emission and noise control regulations have become increasingly stringent, and against this background, the technologies for diesel engines in this respect have also been greatly improved.

China currently implements Euro I Standards. The State plans to implement Euro II Standards in September 2004. Demand for heavy-duty engines from the heavy-duty vehicles and construction machines industries has also increased in the past few years due to the economic growth of, the improvement of road systems of, and heavy infrastructure investment in, the PRC. The Directors believe that the development of environmental-friendly heavy-duty diesel engines will be a major trend of the PRC's diesel engine industry.

*Notes:*

1. Euro I Standards means the set of standards that limits the emission of carbon monoxide at 4.5g/kWh, hydrocarbons at 1.1g/kWh, nitrogen oxides at 8.0g/kWh, and particulate matters at 0.36g/kWh.

2. Euro II Standards means the set of standards that limits the emission of carbon monoxide at 4.0g/kWh, hydrocarbons at 1.1g/kWh, nitrogen oxides at 7.0g/kWh, and particulate matters at 0.15g/kWh.

### Heavy-duty vehicles industry

The development of road system, especially highway system, and the strong economic growth in the PRC have stimulated the sale of vehicles, especially heavy-duty vehicles in the PRC. Furthermore, highway transportation services, being more economical and efficient, has outgrown the production of heavy-duty vehicles in the PRC in recent years. Sales of heavy-duty vehicles have been rising very rapidly in recent few years, and the production of heavy-duty vehicles has surpassed that of medium-duty vehicles. A sizeable proportion of the unit sales of heavy-duty vehicle with a load capacity of 15 tonnes (and above) in the PRC is comparatively concentrated in a few manufacturers including: China Heavy Duty Truck Group Company Limited ("CHDTGL"), Chongqing Hongyan Heavy Duty Motor Company Limited ("Chongqing Hongyan"), Shaanxi Heavy-duty Company Limited ("Shaanxi Motor"), Beijing Futian Motor Company Limited ("Beijing Futian"), etc. and we believe that approximately 75% of the diesel engines used in their trucks had been sourced from the Company. Although in the six months ended 30th June, 2004, the PRC central government implemented a series of austerity measures, the sales growth of heavy-duty vehicles with a load capacity of 8 tonnes (and above) slowed very mildly. In the PRC, the total sales of heavy-duty vehicles with a load capacity of 8 tonnes (and above) for the six months ended 30th June, 2004 rose by 60.7% as compared with that of the same period of 2003. Although sales of trucks with load capacity of 8 to 10 tonnes remained sluggish, with the PRC's principal truck makers having recorded around below 5% in growth, major truck manufacturers with a load capacity of 15 tonnes (and above) recorded very impressive growth rates of around 50% to 200% on average.

An estimated 80% of the medium to heavy-duty trucks in the PRC are frequently overloaded. Lower toll charges for smaller trucks are the main attractions for overloading. The PRC central government is cracking down hard on the widespread practice of truck overloading. This has stimulated the demand for heavy-duty vehicles with a load capacity of 15 tonnes (and above) and also quickened the pace of truck-capacity upgrading in the PRC.

The said government crackdown on truck overloading also means that transportation companies that strive to remain in business and make a profit will be more inclined to upgrade their existing medium-duty trucks to heavy-duty vehicles. The Directors believe that rising port container throughput, highway cargo shipment as well as the property and infrastructure development will remain the main drivers for the growth of 15 tonnes (and above) trucks in the years ahead.

**Construction machines — wheel loaders**

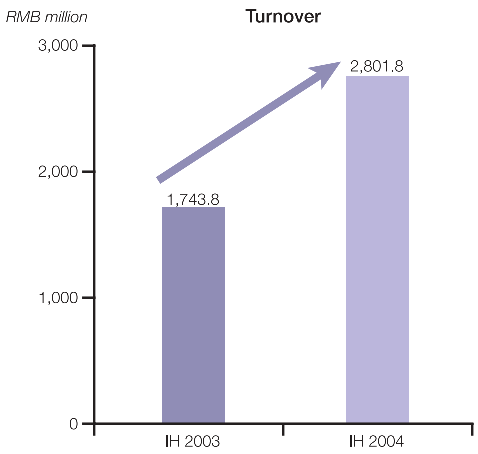
Wheel loaders with a load capacity of 5 tonnes (and above), being our the second-most important market, is also showing similarly strong growth during the Period.

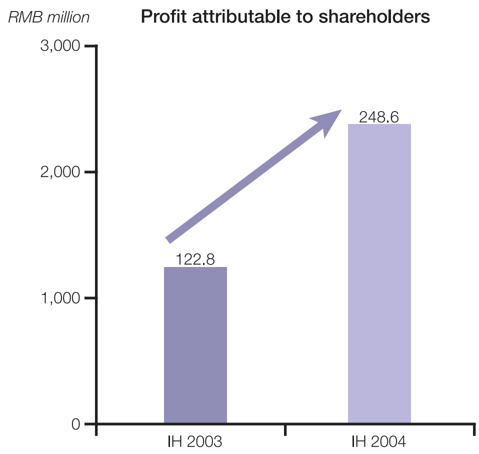
In recent years, the wheel loader market grew by over 30% year-on-year. During the Period, the central government of the PRC implemented a series of austerity measures with the credit-tightening policies hitting the sales of some categories of the construction machines such as excavators to a certain extent. But there is no clear sign of over supply of construction machines, especially in wheel loaders with a load capacity of 5 tonnes (and above). The sales growth of wheel loaders only slowed down mildly since the implementation of the said austerity measures. A sizeable proportion of the sales of construction machines with a load capacity of 5 tonnes (and above) in the PRC is concentrated in a few manufacturers including: Guangxi Liugong Machinery Co., Ltd. ("Guangxi Liugong Machinery"), Shanghai Longgong Machinery Company Limited ("Shanghai Longgong"), Fujian Longgong, etc. We believe that over approximately 73% of the diesel engines used in their construction machines had been sourced from the Company.

# MANAGEMENT DISCUSSION AND ANALYSIS

## BUSINESS REVIEW

During the Period, the Company recorded significant growth in both turnover and net profit attributable to shareholders.



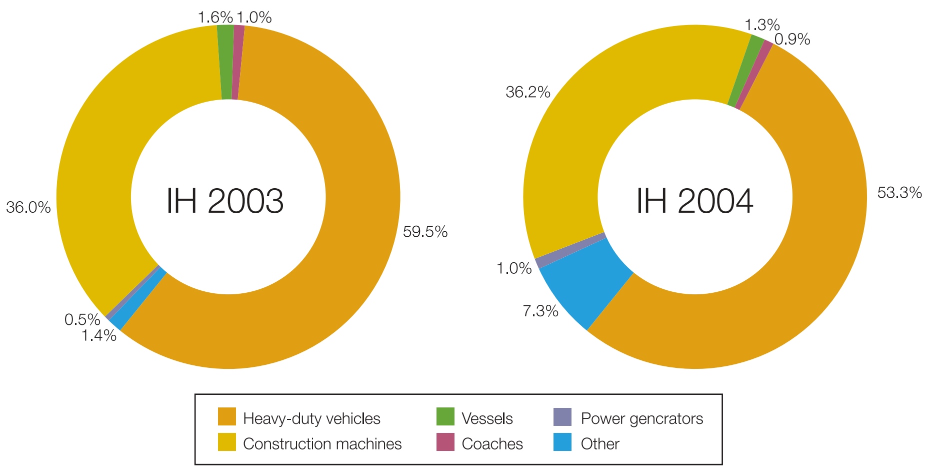

The significant increase in turnover and net profit attributable to shareholders were attributable to the significant increase in the demand for our products together with the increasing production capacity of diesel engines as a result of the improvement in our existing production lines. In addition, the expansion in scale that we achieved have enabled us to absorb fixed production costs more effectively and to enjoy greater bargaining power in purchasing raw materials, in particular the purchases of out-sourced parts for the manufacture of diesel engines. This in turn has enabled us to adopt a more flexible pricing strategy.

Turnover of the Company for the Period amounted to approximately RMB2,801.8 million, representing an increase of approximately RMB1,057.9 million or 60.7% over the same period in 2003. Turnover was derived mainly from the sale of diesel engines used in heavy-duty trucks and construction machines, which accounted for approximately 53.2% and 36.0% of the total turnover, respectively. The significant increase in turnover was mainly attributable to the robust market demand for our WD615 Engines. To meet increasing demand, the Company has further expanded its production capacity and improved its operational efficiency during the Period. The expansion in scale also enabled the Company to achieve economies of scale and adopt a more flexible and competitive pricing strategy for our products. As a result of the above factors, the Company's net profit for the Period increased to RMB248.6 million, representing a 102.4% increase as compared that for the same period in 2003.

## MANAGEMENT DISCUSSION AND ANALYSIS

The pie charts below set out the Company's turnover by key product categories in terms of value.

**Turnover by products in terms of value**




The Company has a very stable customer base which includes certain well-known market leaders in their industries including: CHDTGL, Chongqing Hongyan, Shaanxi Motor, Guangxi Liugong Machinery, Shanghai Longgong, etc. During the Period, sales to our top five customers accounted for 57% of our total turnover and top ten customers represented approximately 75% of our total turnover.

## FINANCIAL REVIEW

### Finance costs

Finance costs represent the interest paid on bank borrowings repayable within five years during the Period.

The Company maintained very low bank borrowings. Total bank loans decreased from RMB151.7 million in 2003 to only RMB51.7 million in 2004 due to sufficient operating cash being generated from the business during the Period. The increase in finance costs was mainly due to that certain bills receivables were discounted to banks and this led to the increase in finance costs from approximately RMB9.5 million in the six months ended 30th June, 2003 to approximately RMB31.3 million for the Period in 2004.

### Taxation

PRC income tax for the Company was calculated at the statutory income tax rate of 33% (six months ended 30th June, 2003: 33%) of the assessable profit except that the Company's Chongqing branch is taxed at a preferential rate of 15% pursuant to the relevant laws and regulations in the PRC. The tax charges during the Period were approximately RMB108.3 million in aggregate, representing an effective

# MANAGEMENT DISCUSSION AND ANALYSIS

tax rate of 30.3% (six months ended 30th June, 2003: 39.8%). The difference in the effective tax rate of 30.3% compared to the statutory rate of 33% was due to that the Company was granted a tax credit of approximately RMB29,386,000 relating to its acquisition of certain PRC produced plant and equipment. The amount of tax credit is calculated at 40% of the current year's additions of PRC produced plant and equipment for production use.

**Net profit margin**

The net profit margin increased substantially from approximately 7.0% for the six months ended 30th June, 2003 to approximately 8.9% for the Period, which was primarily due to the improvement in operational efficiency, benefit from the economy of scale enjoyed by the Company and the tax credit granted to the Company as mentioned above.

**Liquidity and financial resources**

Our day-to-day funding requirements and capital expenditures were met by our internal cash flow from our business operation. The Company has uncommitted bank loan facilities provided by its local principal bankers.

The Company had a very solid financial position and maintained a strong and steady cash inflow from its operating activities. As at 30th June, 2004, the cash and cash equivalents of the Company amounted to approximately RMB1,544.2 million, representing an increase of 487.6% from RMB262.8 million as at 30th June, 2003. Such increase was primarily due to the cash inflow from operations and the net IPO proceeds of approximately RMB1,226.9 million received by the Company in March 2004.

The Company has sufficient financial resources to fund its operations, as well as its current investment needs and development plans disclosed in the Prospectus.

**Earnings per share — basic**

The calculation of basic earnings per share is based on the net profit attributable to shareholders for the Period of approximately RMB248.6 million and on the weighted averaged number of 285,769,231 ordinary shares. The basic earnings per share for the Period was RMB0.87 in 2004 , which represented an increase of 52.7% compared with the same period in 2003. The significant increase in earnings per share was due to the increase in net profit attributable to shareholders for the Period by 102.4% compared to that of the same period in 2003. It also represented approximately 89.6% of the net profit attributable to shareholders for the full year of 2003.

# MANAGEMENT DISCUSSION AND ANALYSIS

### Use of IPO proceeds

In 2004, the Company raised approximately HK$1,328.3 million by issuing H shares. After deduction of issue expenses, the net proceeds from the issue were approximately RMB1,226.9 million. The use of proceeds during the Period was as follows:

| | | Investment amount committed *RMB'million* | Amount paid *RMB'million* |
|---|---|---|---|
| 1. | Establishment of an additional production line and modification of existing production line | 500 | 348 |
| 2. | Research and development of WD615 and WD618 Euro III engines | 80 | 25 |
| 3. | Expansion of existing sales and service network | 80 | 9.5 |
| 4. | Establishment of ERP and PDM systems | 54 | 5 |
| | Total: | 714 | 387.5 |

### Capital structure

During the Period, the Company's bank borrowings were primarily denominated in RMB while its cash and cash equivalents were held in RMB and Hong Kong dollars.

It is the intention of the Company to maintain an appropriate mix of equity and debt to ensure an efficient capital structure from time to time. As at 30th June, 2004, the Company had debts of approximately RMB51.7 million and the gearing ratio was only a mere 1.04% (total debt/total asset).

### Segment information

The Company was principally engaged in the manufacture and sale of WD615 and Wd618 diesel engines and its related parts. As substantially all of the Company's turnover and operating results were derived from the PRC, no analysis of business and geographical segment is prepared for the Period.

### Pledge of assets

At 30th June, 2004, bank deposits and bills receivables of approximately RMB629.4 million and RMB110.5 million, respectively were pledged to secure banking facilities granted to the Company.

# MANAGEMENT DISCUSSION AND ANALYSIS

**Foreign exchange risk exposure**

As almost all of the income and expenditure of the Company were denominated in RMB and Hong Kong dollars for the Period, the Company did not experience any material difficulties or effects on its operations or liquidity as a result of fluctuations in currency exchange during the Period. The Directors believe that the Company will have sufficient foreign exchange to meet its foreign exchange requirements.

**Contingent liabilities**

The Company had no material contingent liabilities as at 30th June, 2004.

**Human resources practice**

As at 30th June, 2004, the Company had a total of over 5,400 employees. Employee are remunerated based on their performance, experience and the prevailing industry practices, with compensation policies and packages being reviewed on a yearly basis. Bonus and commission may also be awarded to employees based on internal performance evaluation.

The Company has established an incentive scheme for its senior management. Under this scheme, up to 5% of the audited annual profit after tax of the Company will be paid as bonus to the Directors and senior management staff each year.