

# Business Environment Analysis and Outlook



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In 2006, the cement industry is expected to pick up gradually. The Group will continue to expand its export market, waiting for an opportunity to develop domestic trade. The Group will also expand its deepwater jetty and cement storage with a view to strengthening its production operating basis and improving profitability.

In 2005, as the PRC government continued to enforce and refine its austerity control measures, GDP grew at a steady but faster pace and fixed asset investment overall continued to grow at a faster speed amidst the consolidation process. However, fixed asset investment in the eastern region experienced a larger decline than the national average in growth. Energy prices were also at steady but high level, but the imbalance between supply and demand has improved. For the cement industry, supply continued to increase and demand slightly decreased, putting downward pressure on pricing. In this downturn, the industry hastened its pace of consolidation and structural adjustment. Exports volumes increased and became the new focus.

decreased in part provinces of the eastern region, with Shanghai and Zhejiang declining by 11% and 5.1% respectively.

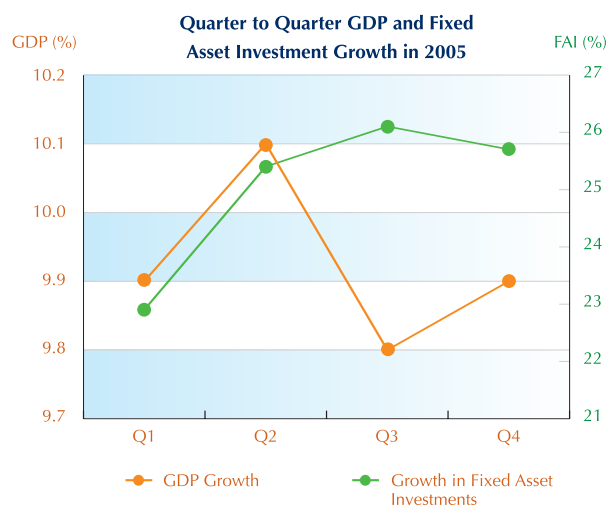
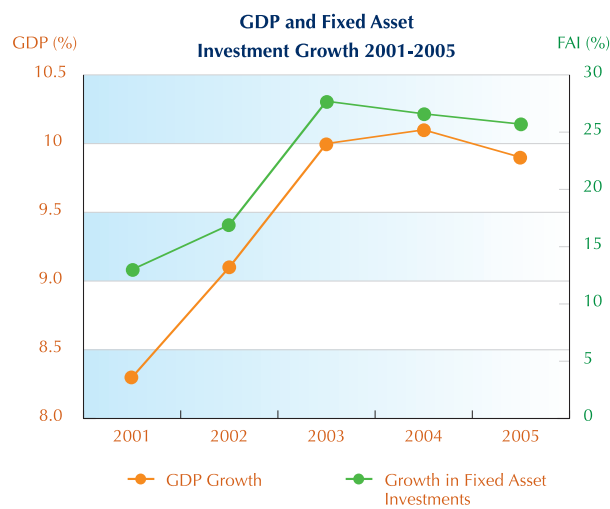
## I. 2005 OPERATING ENVIRONMENT ANALYSIS

### 1. Stable economic growth

In 2005, under the efforts of “Bi-Stable” macro-economic policy, China’s economy experienced faster growth amidst industry restructuring. Overall conditions were favorable. GDP totaled RMB 18,232.1 billion, up 9.9% from the previous year. By quarters, GDP for the four quarters were 9.9%, 10.1%, 9.8%, and 9.9% respectively. This provided a solid foundation as we enter the “Eleventh Five-Year Plan”.

### 2. Slower fixed asset investment in the Huadong Area

During the year, the government focused its efforts on improving various industry structure. Annual aggregate fixed asset investments reached RMB 8,860.4 billion or a growth of 25.7%. This was a decrease of 0.9% from the previous year. Compared to last year, the growth of fixed asset investments in the central and western regions increased by 2.5% and 4.0% respectively, while it



Source: National Bureau of Statistics of China

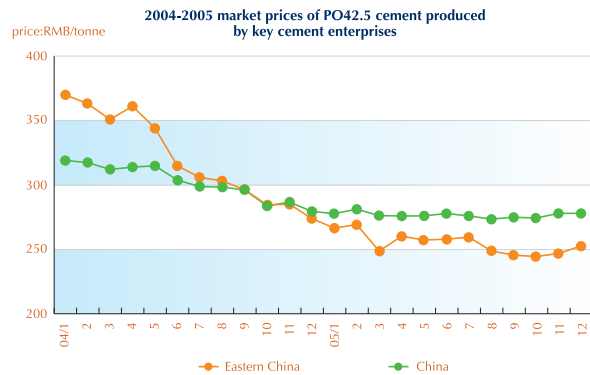
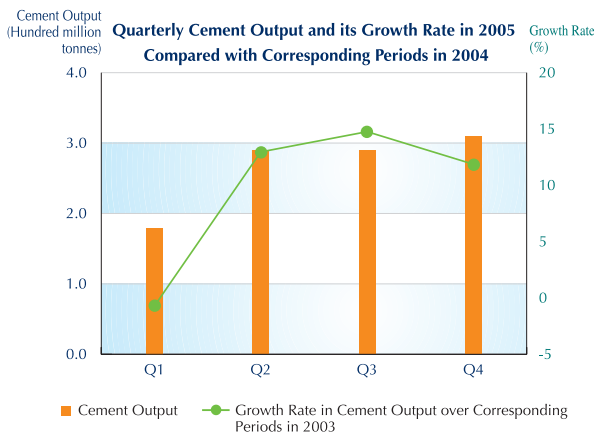
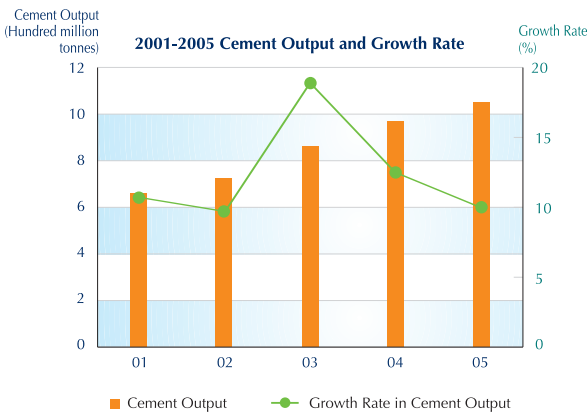
**3. High energy prices, but improving supply and demand**

Coal prices remained rather stable at the high end during the year with a slight increase in the first quarter and then some fluctuations after the second quarter. As the international coal prices declined and the supply tension in China eased, coal prices have become more stable. In 2005, power prices in many provinces increased and the supply of power was still tight. But with the demand on electricity easing and additional supply coming on line, power shortages was alleviated compared with the last year.

**4. Pricing pressure due to excess supply in the market**

Due to the austerity control measures, demand for cement decreased in 2005. Total production was 1.06 billion tonnes, representing a year-on-year increase of 9.7%. However, the pace of growth decreased by 2.8%.

As the capacity from previous years' investments came on line in 2005, 111 new dry process production lines were added, with a production capacity of 101.74 million tonnes, of which eastern China accounted for 34 newly added production lines with a production capacity of 37.01 million tonnes. The excess supply caused downward pricing pressure. At the same time, costs remained high, causing profit margins to deteriorate. The cement industry reached a periodical trough.



Source: China Building Materials Information's website

**5. More consolidation, greater participation from foreign players**

The downturn in the China cement industry has accelerated consolidation in the industry. According to the National Development and Reform Commission, the cement industry should strive to eliminate the capacity of vertical kilns by 50 million tonnes a year while steadily increasing the dry process cement output. Total dry process cement output for 2005 was 40% of total output, an increase of 7% from 2004. The eastern region accounted for 62% of the dry process cement output. The industry became more concentrated and the percentage output of the top 10 cement groups reached 13.3%. Mergers and acquisitions also increased in activity. The joining of large groups is now an important strategic move. Foreign players were also very active in 2005, helping speed up the consolidation process, while the elimination of smaller players also accelerated.

Source: China Cement Association

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## 6. Export: a new focus in the industry

Cement export volume started to increase in the first half of 2005 and intensified in the second half of 2005. In 2005, total export volume amounted to 22.16 million tonnes, up 215% from the previous year, with the second half of 2005 realizing 14.38 million tonnes. The main countries for export included the United States, Spain, and Korea. Expanding exports at the proper time has become an important tool to balance the domestic market and a drive towards technological improvement in the industry.

## II. 2006 OPERATING ENVIRONMENT OUTLOOK

Looking forward to 2006, we believe that, under the “Eleventh Five-Year Plan”, the overall macro-economic environment for China will be positive. The supply over demand situation will gradually improve and it is expected that we will see the recovery in the second half of 2006.

### 1. “Eleventh Five-Year Plan”

2006 will be the first year of the “Eleventh Five-Year Plan”. According to the spirit of the “Eleventh Five-Year Plan”, systematic economic development, improvement of industry structure and efficiency, lowering wasteful consumption, and conservation will be the focus. According to the forecasts stated in the blue book by the Chinese Academy of Social Sciences, the GDP growth in 2006 will be 8.9%.

### 2. Fixed asset investment remains strong

Total fixed asset investment is expected to remain strong in 2006. The directives of the “Eleventh Five-Year Plan” will push the development of cities and villages, road construction and repairs, new water systems, railways, and power plants, benefiting the sustainable development of the cement industry.

### 3. Overall balance in energy supply, reduced pressure for price hike

In 2006, coal prices will be affected by the production of the smaller quarries and be at a stable but high level. In the short term, the supply and demand imbalance will increase the pricing sensitivity. Furthermore, movement of domestic coal prices will be more and more subject to the fluctuations in the international coal prices. Analysts forecast international coal prices to be stable. Thus, we expect domestic coal prices to continue to be rather stable going forward. Electricity shortages will be

decreased with the fast-growing power generation. The stability of coal used for electricity will also allow a more steady production environment and electricity prices.

### 4. A more rational cement industry: rebound in 2H2006

The government’s austerity control measures have curbed new capacity investment in 2005. Thus, we will see a decreasing amount of new capacity coming on line in 2006. We expect new capacity investments to further decrease in 2006. The industry is expected to start recovering from the second half of 2006, with the possibility of improvements in margins as well.

### 5. Acceleration of consolidation

Under the guidance of the “Eleventh Five-Year Plan”, industry consolidation will accelerate and the competitive advantages of a low cost, environmentally friendly dry process plant will become more evident. Moreover, companies fulfilling government standards will be supported via tax subsidies in constructing waste-heat recovery power generation systems, utilization of waste products such as slag and fly ash, and increase the producing efficiency of the industry. The government will also continue to tighten on environmental control, causing the smaller inefficient plants to be obsolete. With the government’s initiatives and the participation of the foreign investors, industry consolidation accelerate should be expedited.

### 6. Exports: strong with uncertainties

In 2006, we believe that there will be uncertainties associated with cement exports. They are reflected in various aspects. Cement is traditionally an energy intensive product. Under China’s conservation initiatives, it is uncertain whether the government will continue to grant export tax rebates. The appreciation of the Renminbi will also put pressure on China’s cement export. In addition, the increase in oil and transportation costs will also reduce the margins of export. However, so as long as China’s cement industry remains low and margins suppressed, companies who have the capabilities such as jetties, strategic location, and sales channels will continue to export in order to expand its sales market and sustain profitability.

Based on the above, we believe that we should see a recovery of the industry in the second half of 2006 and the year will provide the Group with many business opportunities.