Management Discussion and Analysis

BUSINESS REVIEW

On 10 December 2015, the shares of FSE Engineering Holdings Limited (the "Company", together with its subsidiaries, the "Group", "we" or "us") have been successfully listed on the Main Board of The Stock Exchange of Hong Kong Limited (the "Listing"), which marked a significant milestone for our Group. In view of the immense market development potential in Hong Kong, Mainland China and Macau, the Listing is expected to provide a more effective fund-raising platform to equip the Group with stronger financial capability and flexibility to timely capture greater opportunities for future expansion, especially on large-scale prospective projects in the regions in which the Group operates and complement our sustainable business development in the long term.

For the six months ended 31 December 2015 (the "period under review"), the Group has maintained its market position as one of the leading E&M (*electrical and mechanical*) engineering companies in Hong Kong, providing a comprehensive range of E&M engineering and environmental engineering services, and continued to have strong E&M engineering operations in Mainland China and Macau. Coupled with our full range of licenses and qualifications for E&M engineering projects, all of our operations are supported by an integrated management and control system, strong networks of well-established customers and suppliers and an experienced and well-trained workforce, which enable us to secure and undertake integrated E&M engineering projects of the largest scale in Hong Kong, Mainland China and Macau.

Besides, the Group has a strong commitment to creating a greener society. In addition to E&M engineering services, our environmental management service business has continued to provide the Group with a constant income stream through the provision of environmental assessment and improvement services and products to customers to achieve their environmental protection and energy-saving goals.

Leveraging on our competitive strengths described above, the Group has delivered a solid financial performance and recorded a revenue of approximately HK$1,609.3 million for the period under review, representing an increase of approximately HK$234.4 million or 17.1%, compared to approximately HK$1,374.9 million for the same period last year. Profit attributable to shareholders for the period under review was approximately HK$74.6 million (including one-off non-recurring listing expenses of approximately HK$16.8 million), representing an increase of approximately HK$0.5 million or 0.7% as compared to approximately HK$74.1 million for the same period last year. Without the impact of the listing expenses, the Group would have achieved a profit of approximately HK$91.4 million, representing a remarkable increase of HK$17.3 million or 23.3% as compared to approximately HK$74.1 million for the same period last year.

As at 31 December 2015, our projects have encompassed a wide range of buildings and facilities, including offices, shopping malls, convention and exhibition center, hotels, residential properties, universities, hospitals, and public transportation facility buildings with a total outstanding contract sum of approximately HK$6,400.0 million. For the period under review, the Group had been awarded 61 E&M engineering and environmental service projects (with a net contract sum equal to or exceeding HK$1.0 million for each project) with a total net contract sum of approximately HK$1,764.5 million. These projects included major projects (with net contract sum equal to or more than HK$100.0 million for each project) within (1) Hong Kong: a residential and commercial development in Tseung Kwan O, a public housing development in Sham Shui Po, a residential development in So Kwun Wat and a government office complex in Yau Ma Tei; and (2) the People's Republic of China (the "PRC"): a hotel development at Wuhan. The Group had also submitted tenders for 298 E&M and environmental service projects (with a contract sum equal to or exceeding HK$1.0 million for each project, if awarded) with a total tender sum of approximately HK$6,630.3 million.

Management Discussion and Analysis

FINANCIAL REVIEW

Revenue

During the period under review, the Group's revenue rose by approximately HK$234.4 million or around 17.1% from approximately HK$1,374.9 million to approximately HK$1,609.3 million compared to the same period last year which was mostly attributable to the higher revenue of HK$234.2 million derived from our E&M engineering segment.

The following table presents a breakdown of the Group's revenue by business segments:

	For the six months ended 31 December			
	2015 **HK$'000**	2014 HK$'000	Change HK$'000	% change
E&M engineering	**1,584,884**	1,350,694	234,190	17.3%
Environmental management services*	**24,433**	24,188	245	1.0%
Total	**1,609,317**	1,374,882	234,435	17.1%

* Revenue from environmental management services segment is arrived at after elimination of inter-segment sales within the Group.

- *E&M (electrical and mechanical) engineering:* This segment has remained the key turnover driver and contributed approximately 98.5% of the total revenue of the Group (2014: 98.2%). Segmental revenue rose approximately 17.3% from approximately HK$1,350.7 million to approximately HK$1,584.9 million for the period under review. The increase was mainly attributable to the increase in revenue derived from our installation division as three major installation projects in Hong Kong achieved significant progress and started to contribute a sum of approximately HK$317.8 million turnover in the period under review. The increase was partially offset by the slight decline in revenue contribution from the PRC and the Macau regions.

- *Environmental management services:* During the period under review, revenue contribution of this business segment was stable at approximately HK$24.4 million (2014: HK$24.2 million), representing a mild growth of approximately 1.0% as compared to the same period last year. Segment revenue from environmental management services primarily consists of water treatment projects and bio-technology installation and maintenance services.

The following table presents a breakdown of our Group's revenue by geography:

	For the six months ended 31 December			
	2015 **HK$'000**	2014 HK$'000	Change HK$'000	% change
Hong Kong	**1,041,404**	716,613	324,791	45.3%
PRC	**167,020**	229,177	(62,157)	–27.1%
Macau	**400,893**	429,092	(28,199)	–6.6%
Total	**1,609,317**	1,374,882	234,435	17.1%

Hong Kong: Revenue from Hong Kong increased by HK$324.8 million or approximately 45.3% from HK$716.6 million to HK$1,041.4 million for the period under review as compared to the same period last year. The increase was mainly attributable to the substantial turnover contribution from a number of sizeable installation projects which had significant progress during the period under review, including a hotel, service apartments, an office and a shopping arcade complex at Tsim Sha Tsui, a catering facility of an airline company in Chek Lap Kok at Lantau and an university complex and dormitory at Fortress Hill that uplifted Hong Kong's contribution to the Group's total revenue from approximately 52.1% to approximately 64.7%.

PRC: Revenue from the PRC decreased by approximately 27.1% from approximately HK$229.2 million for the six months ended 31 December 2014 to approximately HK$167.0 million for the period under review with its geographical contribution declining from approximately 16.7% to approximately 10.4%. The decrease of approximately HK$62.2 million was the combined effect of the reduced revenue contribution from installation projects mitigated by the increase in project management income during the period under review. The decrease in revenue contribution from installation projects was mainly due to the fact that two major projects, namely a five-star hotel in Nanjing and a five-star hotel in Tangshan, were substantially completed in the corresponding period in last year. Moreover, the relatively sizeable contracts in the PRC awarded, including an office building development and a hotel development in Wuhan, were at an early stage and had yet to contribute revenue from the region for the period under review.

Macau: Revenue from Macau decreased by approximately 6.6% from approximately HK$429.1 million for the six months ended 31 December 2014 to approximately HK$400.9 million for the period under review with the geographical contribution of the region dropping from 31.2% to 24.9%. The slight decline was mostly related to the substantial completion of a five-star hotel and entertainment complex in Cotai (the "Project Cotai Complex"), the single largest revenue-contributing project in last year. The major revenue contributors for the period under review included a five-star hotel and resort development (the "Project Cotai Resort") and a well-known hotel in Cotai, Macau.

Gross profit

The Group's overall gross profit increased HK$24.6 million or 15.0% from approximately HK$164.5 million for the six months ended 31 December 2014 to approximately HK$189.1 million for the period under review, whereas the overall gross profit margin remained stable at approximately 11.8% (31 December 2014: 12.0%). The increase in gross profit was in line with the overall remarkable growth of the Group's revenue, of which a significant increase in gross profit derived from our E&M engineering business was recorded during the period under review with its segment gross profit margin maintained at approximately 11.5% (31 December 2014: 11.7%) . The gross profit margin of the environmental management services segment increased from approximately 25.0% to approximately 26.2%, which was mainly attributable to an increase in revenue from air quality and water treatment maintenance services with relatively higher profit margin.

The following table presents the breakdown of the Group's gross profit by business segments:

	For the six months ended 31 December			
	2015		2014	
	Gross profit HK$'000	**Gross profit margin %**	Gross profit HK$'000	Gross profit margin %
E&M engineering	**182,716**	**11.5%**	158,442	11.7%
Environmental management services	**6,393**	**26.2%**	6,037	25.0%
Total	**189,109**	**11.8%**	164,479	12.0%

The following table presents the breakdown of the Group's gross profit by geography:

	For the six months ended 31 December			
	2015		2014	
	Gross profit HK$'000	**Gross profit margin %**	Gross profit HK$'000	Gross profit margin %
Hong Kong	**111,659**	**10.7%**	80,595	11.2%
PRC	**34,746**	**20.8%**	36,813	16.1%
Macau	**42,704**	**10.7%**	47,071	11.0%
Total	**189,109**	**11.8%**	164,479	12.0%

Hong Kong: The gross profit of this region for the period under review increased by approximately HK$31.1 million or approximately 38.6% as compared to the same previous period last year. The gross profit margin remained stable at approximately 10.7% which was mainly contributed by key installation projects including the E&M engineering projects for a design-build-operate project for a district cooling system at Kai Tak, a hotel, service apartments, an office and shopping arcade complex at Tsim Sha Tsui, a catering facility of an airline company in Chek Lap Kok at Lantau, a university complex and dormitory at Fortress Hill, a police station in Yau Ma Tei, Kowloon, and a public housing development at Sau Mau Ping, Kowloon coupled with the relatively higher gross profit from trading of building equipment and materials.

PRC: Despite revenue from the PRC region decreased by approximately 27.1% for the period under review, the gross profit of region decreased only slightly by approximately HK$2.1 million, or approximately 5.6% as compared to the previous period. This was attributable to the relatively high gross profit margin contributed by our project management services for the newly-awarded contracts of two high-rise building complexes in Tianjin and Guangzhou and the ongoing project management services contract in Shenyang as well as the cost savings from our completed projects in Shanghai upon contract closeout.

Macau: The gross profit of the Macau region remained at approximately 10.7% with major gross profit contributed from three major E&M installation projects from the Project Cotai Complex, the Project Cotai Resort and a well-known hotel in Cotai.

Management Discussion and Analysis

Other income/gains, net

For the period under review, other income and net gains of approximately HK$0.2 million (2014: approximately HK$0.5 million) included the net exchange gain recognized mainly from settlement of trade payables and partially set off by loss on disposal of property, plant and equipment.

Finance income

The Group recorded finance income of approximately HK$5.1 million and approximately HK$8.7 million for the six months ended 31 December in 2015 and 2014 respectively. The decrease was mainly due to the decrease in the market interest rate and the average principal sum on the bank deposit placed in Mainland China.

General and administrative expenses

General and administrative expenses of the Group for the six months ended 31 December 2015 increased 24.5% to approximately HK$110.4 million, compared to approximately HK$88.7 million for the same period last year. The increase of approximately HK$21.7 million was mainly attributable to the one-off non-recurring listing expenses of approximately HK$16.8 million incurred during the six months ended 31 December 2015.

Taxation

The effective tax rate of the Group decreased from approximately 12.8% to approximately 11.2% as compared to the same period last year resulting from the recognition of deferred tax assets of a joint operation project during the period under review.

Profit attributable to shareholders

As a result of the foregoing, our profit for the period under review increased by around 0.7% or approximately HK$0.5 million from approximately HK$74.1 million for the six months ended 31 December 2014 to approximately HK$74.6 million for the period under review. The increase was the combined result of higher contracting revenue mostly from our core business segment, which was partially offset by the increase in general and administrative expenses due to the one-off non-recurring listing expenses.

The net profit margin decreased from approximately 5.4% for the six months ended 31 December 2014 to approximately 4.6% for the period under review. If the one-off non-recurring listing expenses of HK$16.8 million was excluded from the general and administrative expenses, the Group would have achieved a profit of approximately HK$91.4 million, representing a remarkable increase of approximately HK$17.3 million or approximately 23.3% as compared to approximately HK$74.1 million for the same period last year.

Other comprehensive loss

The Group recorded other comprehensive loss of approximately HK$21.9 million for the period under review, comprising mainly the decrease in exchange reserve of approximately HK$16.4 million resulting from the devaluation of the Renminbi ("RMB") for conversion of the net investments in our PRC operations and the decrease in the asset revaluation reserve of approximately HK$5.5 million in relation to the decrease in the estimated market price for the Group's properties, especially in the Hong Kong region.

Management Discussion and Analysis

Liquidity and financial resources

The Group's finance and treasury functions have been centrally managed and controlled at the headquarters in Hong Kong. As at 31 December 2015, the Group had total cash and bank balances of approximately HK$1,074.8 million, of which approximately 58%, 39% and 3% were denominated in Hong Kong dollars, RMB and other currencies respectively (30 June 2015: approximately 29%, 70% and 1% respectively). As compared to 30 June 2015, the Group's cash and bank balances increased by approximately HK$462.3 million from approximately HK$612.5 million which was primarily due to the receipt of net proceeds of approximately HK$273.5 million (after deduction of underwriting commission and all related expenses paid during the six months ended 31 December 2015) (the "Net Proceeds Received during the Period") from the Listing and the increase in net cash flow from operating activities. Taking into account of the Net Proceeds Received during the Period and the listing related expenses (i) prepaid prior to 30 June 2015 of approximately HK$3.8 million and (ii) to be settled after 31 December 2015 of approximately HK$5.2 million, we recorded an aggregate net proceeds of approximately HK$264.5 million from the Listing.

The Group has adopted a prudent financial management approach towards its treasury policies and thus maintained a healthy liquidity position throughout the reporting period and did not have any bank borrowings and outstanding borrowings as at 31 December 2015 (30 June 2015: Nil) and hence the Group's gearing ratio (being our total borrowings divided by our total equity) maintained at zero as at 31 December 2015. As at 31 December 2015, the Group had total banking facilities in respect of bank overdrafts, bank loans, bank guarantees and/or trade financing of approximately HK$1,122.8 million (30 June 2015: HK$1,601.3 million), of which approximately HK$356.8 million (30 June 2015: HK$356.4 million) had been utilized for bank guarantees and trade finance. The Group believes it has sufficient committed and unutilized banking facilities to meet its current business operation and capital expenditures.

Foreign currency exposure

The Group operates primarily in Hong Kong, Macau and the PRC and is not exposed to significant exchange risk. Our Company does not have a foreign currency hedging policy and we manage our foreign currency risk by closely monitoring the movement of the foreign currency rates and will consider to enter into forward foreign exchange contracts to reduce the exposure should the need arise.

As part of our business was carried in the PRC, part of our assets and liabilities were also denominated in RMB. Majority of these assets and liabilities were arisen from the net investments in the PRC operations with net assets of HK$295.9 million as at 31 December 2015. The foreign currency translation arising from translation of these PRC operations' financial statements from RMB (functional currency of these PRC operations) into Hong Kong dollars (the group's presentation currency) will not affect our profit before and after tax, and will be recognized in our other comprehensive income.

During the period under review, the fluctuation of RMB against Hong Kong dollars was approximately 5.0% (by comparing the highest exchange rate of RMB against Hong Kong dollars with the lowest exchange rate of RMB against Hong Kong dollars during the period under review).

As at 31 December 2015, if Hong Kong dollars had strengthened/weakened by another 5.0% against RMB with all other variables unchanged, the Group's other comprehensive income would have been approximately HK$14.8 million lower/higher.

Management Discussion and Analysis

Use of net proceeds from listing

The aggregate net proceeds raised by the Company from the Listing through the issue of an aggregate of 112,500,000 new shares (the "Offer Shares") of HK$0.10 each in the Company at the final offer price of HK$2.75 per Offer Share pursuant to the Global Offering referred to in the prospectus issued by the Company on 26 November 2015 (the "Prospectus") were approximately HK$264.5 million. Based on the net proceeds derived from the Global Offering, proposed application of net proceeds as stated in the Prospectus had been adjusted according to the principles as specified in the section headed "Future Plans and Use of Proceeds" of the Prospectus.

During the period from the date of the Listing (that is, 10 December 2015 (the "Listing Date")) to 31 December 2015, the net proceeds from the Global Offering had not been utilized and are placed in bank accounts maintained with licensed banks and authorised financial institutions in Hong Kong.

Capital commitments

The Group had capital commitments of approximately HK$3.9 million as at 31 December 2015 in relation to the purchase of property, plant and equipment (as at 30 June 2015: HK$5.0 million).

Contingent liabilities

The Group has no material contingent liabilities as at 31 December 2015.

EMPLOYEES AND REMUNERATION POLICY

As at 31 December 2015, the Group had a total of 1,609 employees (31 December 2014: 1,498). Staff costs for the period under review, including salaries and benefits, were approximately HK$258 million (six months ended 31 December 2014: approximately HK$228 million). The addition to the total headcount is mainly for the E&M engineering segment in Hong Kong which had been awarded an increased number of projects during the past 12 months ended 31 December 2015.

The Group offers attractive remuneration packages, including competitive fixed salaries plus performance-based annual bonuses, and continuously provides tailored training to its employees with the aim of promoting upward mobility within its organization and fostering employee loyalty. Our employees are subject to regular job performance reviews which determine their promotion prospects and compensation.

The Company adopted a share option scheme during the period under review, which is to provide incentives to the eligible participants (including the employees of the Group) to contribute to the Group and to enable us to recruit high-calibre employees and attract human resources that are valuable to the Group. Details of the share option scheme are set out in the Prospectus.

OUTLOOK

The successful Listing last year has marked a key milestone for the Group. Our leading market position, proven track record, well-established customer connections and ample financial reserve continue to serve as the valuable assets to the Group. As stated in the Prospectus, from time to time we evaluate acquisition opportunities and engage competent professional talent to explore new markets and expand the Group's market presence in Hong Kong, Macau and the PRC.

Our board of directors believes that, through unwavering efforts, the Group is able to maximize our shareholders' value and enhance its corporate image as well as its position in the E&M engineering industry. In addition, our E&M engineering segment in Hong Kong, which contributes more than 50% of the Group's total revenue and gross profit, remains the core business of the Group. Nonetheless, the Company is striving to continue its presence in the PRC and expand its business in the environmental engineering segment.

Management Discussion and Analysis

E&M engineering segment

Hong Kong — In Hong Kong, the Government has unveiled a raft of new policy initiatives that is expected to add to the already-full order books of the construction and E&M engineering industries. With major infrastructure projects entering their construction peaks starting from 2013, capital works expenditure has increased to more than HK$70 billion for each of the next few years. These large infrastructure projects have created a large number of jobs, which are particularly crucial in times of uncertain economic outlook.

According to the Chief Executive's 2016 Policy Address delivered in January 2016, the Hong Kong Government will continue to make vigorous efforts to increase land supply. In line with the Long Term Housing Strategy, the Hong Kong Housing Authority and the Hong Kong Housing Society will produce 76,700 public rental housing units and 20,400 subsidized sale units over the next five years. Based on the preliminary assessment of private residential developments known to have or to be started on disposed sites, it is projected that the private sector will supply a historically high record of about 87,000 flats since the first release in September 2004 of the quarterly statistics on supply in the coming three-to-four years.

In addition, the Hong Kong Government is proceeding full stream ahead with the new development areas and the extension of new towns, including Kwu Tung North, Fanling North, Tung Chung, Hung Shui Kiu and Yuen Long South, and will examine the development of Tseung Kwan O Area 137 for residential, commercial and other purposes.

To prepare for the challenge of the aging population, the Hong Kong Government has worked with the Hospital Authority to invest HK$200 billion and devise an overall hospital development plan by providing 5,000 additional public hospital beds and 94 new operating theatres in the next ten years.

Apart from the above, the construction of the Shatin-Central Link, the investment in the West Kowloon Cultural District, the Mass Transit Railway Corporation Limited's railway property development, the Kai Tak redevelopment, the expansion of the airport, the Lantau development associated with the Hong Kong-Zhuhai-Macao Bridge, and the Energizing Kowloon East Initiative (including Kwun Tong redevelopment and revitalized industrial buildings) will definitely help boost the construction industry in Hong Kong in the coming decade.

Regarding the maintenance section of our E&M engineering services, the Group foresees a steady growth in the term maintenance contracts in view of growing demands from different prestigious commercial buildings, public sectors and education institutions. We anticipate an increase in revenue in respect of the fit-out works, system upgrading works and replacement works. Large scale alteration and addition and system retrofit works are also set to provide a favorable return to the maintenance section.

Currently, the construction and engineering sectors in Hong Kong face a multitude of immense problems and challenges. The severe labour shortage coupled with the aging workforce and the resultant escalated labour costs result in keen competition for labour and raise the construction cost. The awarding of new public works contracts is experiencing a serious delay. The Group is striving to maintain a stable labour workforce and retain our loyal staff members so as to uphold its competitive strength.

PRC — In the midst of a global economic slowdown, China's economic growth is likely facing further downward pressure this year. In line with corporate strategy, the Group will continue to take a disciplined approach in its business development towards this market. Our business target remains focused on E&M services for major property developments initiated by both Hong Kong and foreign investors. Apart from playing an active role in Beijing and Shanghai, the Group has also established its presence in other first-tier and second-tier cities in the PRC such as Tianjin, Dalian, Shenyang, Chengdu, Wuhan, Changsha, Nanjing, etc.

Management Discussion and Analysis

With the advent of China's "One Belt, One Road (一帶一路)" initiative and the rapid development of the three Guangdong Pilot Free Trade Zone regions, being Hengqin (橫琴), Qianhai (前海) and Nansha (南沙), the Company will actively seek to participate in related projects in order to seize new business opportunities and achieve higher market penetration.

During recent years, the Company has been actively engaged in project management services in the PRC for an international exhibition centre development in Shenyang, and subsequently two high-rise building complexes in Tianjin and Guangzhou, and has gained market recognition in this field. We firmly believe that our strong value-added E&M project management expertise in the areas of integrated services coordination, coordinated services drawing production, building information modeling techniques, project planning, quality assurance, system testing and commissioning, etc pose strong attractions for foreign and Hong Kong-based developers of high-end projects in the PRC.

With our accumulated E&M installation experience in the PRC sector, we plan to extend our E&M project management services to high-end projects developed in the PRC. We believe such project management services can generate an additional stable source of income for the Group.

Macau — The construction and E&M engineering sectors in Macau performed very well in the past few years. Yet, following the anticipated completion of several casino projects in 2016 and the slowdown of the tourism and gaming industry, the construction engineering sectors in Macau are expected to undergo a stage of consolidation.

Nevertheless, the robust demand for housing, the development of the Light Rapid Transit System, the expansion of the Macao International Airport, and the investment in Islands District Medical Complex are expected to create emerging business opportunities in Macau in the coming few years.

According to the Policy Address for the fiscal year of 2016 of Macau, the Macau SAR Government has initiated the reclamation project for New Urban Zone Area A and the Zhuhai-Macao artificial islands of Hong Kong-Zhuhai-Macao Bridge, which plan to build 28,000 public housing units and 4,000 private housing units. To enhance the tourism industry, it is projected that the number of guestrooms will progressively increase from the current 29,000 units to 44,100 units during 2017 to 2019.

The positioning of Macau as a world exemplary tourism and leisure center addresses its need for adequate economic diversification and sustainable development. The Macau SAR Government continues to monitor the pace of development of the gaming industry while actively fostering the development of integrated tourism and reinforcing non-gaming elements.

As the PRC has designated Hengqin, an island next to Macau, as a tourism, business and cultural zone, it was reported in the media that certain casino and/or listed companies are vigorously considering procuring land in Hengqin to build a hotel-to-office complex, resort and theme park.

Environmental engineering segment

The increasing awareness of the importance of a good environment further raises the demand for environmental engineering services and products. As mentioned in the Hong Kong 2016 Policy Address, promotion of energy efficiency and renewable energy for buildings are being highlighted. Thus, the Group recognizes that "*going green*" is an important growing trend and aims at providing our customers a total solution pertinent to energy saving, renewable energy and environmentally friendly technologies.

The recently implemented Buildings Energy Efficiency Ordinance (Chapter 610 of the Laws of Hong Kong) has immense potential for further development in our environmental consultancy services. Strict control of water pollution helps increase the market demand for the services of our environmental testing laboratory to run tests to ensure potable water quality. The increasing demand for our water treatment and odour abatement products such as electro-chlorination system and biotech deodorization system also support the growth of our environmental engineering segment. The Group currently has a laboratory accredited under the Hong Kong Laboratory Accreditation Scheme (HOKLAS) in operation and is investing in a web-based building energy management system, an advanced lighting solution product and waste water treatment technology involving microalgae, to better capture business opportunities in the potential environmental assessment and improvement services market in the environmental engineering sector.

As the Group provides a comprehensive range of E&M engineering and environmental engineering services and has a well-established E&M engineering operations in Hong Kong, the Mainland and Macau, the above infrastructure, large scale and/or high-end projects or potential projects are expected to bring ample business opportunities to the Group.