

LJ INTERNATIONAL INC
Form 20-F
December 28, 2007

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U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g)
OF THE SECURITIES EXCHANGE ACT OF 1934
OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006
OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 0-29620

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report _____

LJ INTERNATIONAL INC.

(Exact name of Registrant as specified in its charter)

LJ INTERNATIONAL INC.

(Translation of Registrant's name into English)

British Virgin Islands

(Jurisdiction of incorporation or organization)

Unit #12, 12/F, Block A

Focal Industrial Centre

21 Man Lok Street

Hung Hom, Kowloon, Hong Kong

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each
class

Name of each exchange
on which registered

\$.01 Par Value Common Stock

NASDAQ

(Common Stock)

Securities registered or to be registered pursuant to Section 12(g) of the Act.

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

18,977,371 Shares of Common Stock as of December 31, 2006

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Not Applicable.

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**SPECIAL NOTE REGARDING
FORWARD-LOOKING STATEMENTS**

This annual report contains forward-looking statements that involve risks and uncertainties. These include statements about our expectations, plans, objectives, assumptions or future events. In some cases, you can identify forward-looking statements by terminology such as anticipate, estimate, plans, potential, projects, continuing, ongoing, expects, management believes, we believe, we intend and similar expressions. These statements involve estimates, assumptions and uncertainties that could cause actual results to differ materially from those expressed for the reasons described in this annual report. You should not place undue reliance on these forward-looking statements.

You should be aware that our actual results could differ materially from those contained in the forward-looking statements due to a number of factors, such as but not limited to:

dependence upon certain customers

dependence on key personnel

control by principal shareholder

competitive factors

the operation of our business

general economic conditions

You should also consider carefully the statements under Risk Factors and other sections of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

We may use data and industry forecasts in this annual report which we have obtained from internal surveys, market research, publicly available information and industry publications. Industry publications generally state that the information they provide has been obtained from sources believed to be reliable but that the accuracy and completeness of such information is not guaranteed. Similarly, we believe that the surveys and market research we or others have performed are reliable, but we have not independently verified this information.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA.

SELECTED CONSOLIDATED FINANCIAL DATA

(US Dollars in thousands, except per share amounts)

The following selected consolidated financial data with respect to eight months ended December 31, 2002 and the four-year period ended December 31, 2006 have been derived from our audited consolidated financial statements. The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes included elsewhere in this annual report.

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| | 2006 | Years ended December 31, | | 2003 | Eight-month period ended December 31, 2002 2001 (Unaudited) | | Year ended April 30, 2002 |
|------------------------------------------------------------------------------------------------------------------------------------|----------|-----------------------------|----------|----------|------------------------------------------------------------------------------|----------|------------------------------------|
| Statement of Operations Data: | | | | | | | |
| Revenues | 123,791 | 99,646 | 77,504 | 58,330 | 31,966 | 25,135 | 39,375 |
| Cost of Goods sold | (88,867) | (77,127) | (61,265) | (44,947) | (20,565) | (16,228) | (35,731) |
| Gross profit | 34,924 | 22,519 | 16,239 | 13,383 | 11,401 | 8,907 | 3,644 |
| Operating expenses | | | | | | | |
| Selling, general and administrative | (23,114) | (15,488) | (11,578) | (9,133) | (8,688) | (8,279) | (8,963) |
| Net gain (loss) on derivatives | (29) | 8 | 199 | 87 | (435) | (119) | (660) |
| Depreciation | (2,039) | (1,368) | (1,032) | (1,184) | (863) | (565) | (1,031) |
| Impairment on property, plant and equipment | - | - | - | (84) | (108) | - | (345) |
| Amortization and impairment loss on goodwill | - | - | (698) | (200) | (600) | (18) | (242) |
| Operating income (loss) | 9,742 | 5,671 | 3,130 | 2,869 | 707 | (74) | (7,597) |
| Other income and expenses | | | | | | | |
| Interest income | 282 | 139 | 38 | 41 | 48 | 172 | 217 |
| Interest expenses | (3,258) | (1,991) | (902) | (753) | (441) | (424) | (652) |
| Operating income (loss) before income taxes, minority interests, equity in results of investment securities and extraordinary item | 6,766 | 3,819 | 2,266 | 2,157 | 314 | (326) | (8,032) |
| Income taxes (expense) credit | (1,403) | (739) | (277) | (352) | (101) | (39) | 101 |
| Income (Loss) before minority interests, equity in results of investment securities and extraordinary item | 5,363 | 3,080 | 1,989 | 1,805 | 213 | (365) | (7,931) |

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| | | | | | | | |
|---------------------------------------------------------------------------------|---------|---------|--------|--------|--------|--------|---------|
| Minority interests in consolidated subsidiaries | (38) | (20) | - | 8 | 120 | - | 30 |
| Income before equity in results of investment securities and extraordinary item | 5,325 | 3,060 | 1,989 | 1,813 | 333 | (365) | (7,901) |
| Equity in results of investment securities | - | - | 133 | (851) | 16 | 26 | 34 |
| Income before extraordinary item | 5,325 | 3,060 | 2,122 | 962 | 349 | (339) | (7,867) |
| Extraordinary gain on negative goodwill | - | 1,291 | - | - | - | - | - |
| Net income (loss) | 5,325 | 4,351 | 2,122 | 962 | 349 | (339) | (7,867) |
| Net income (loss) per share: | | | | | | | |
| Basic | 0.31 | 0.32 | 0.19 | 0.11 | 0.04 | (0.04) | (0.91) |
| Diluted | 0.29 | 0.30 | 0.18 | 0.10 | 0.04 | (0.04) | (0.90) |
| Weighted average number of shares | | | | | | | |
| Basic | 17,390 | 13,439 | 11,119 | 8,757 | 8,493 | 8,672 | 8,672 |
| Diluted | 18,303 | 14,322 | 12,107 | 9,706 | 8,493 | 8,832 | 8,779 |
| Balance Sheet Data: | | | | | | | |
| Working capital | 50,134 | 35,554 | 23,617 | 17,053 | 11,896 | 18,537 | 12,115 |
| Total assets | 124,522 | 108,230 | 73,673 | 59,885 | 48,938 | 51,088 | 43,557 |
| Long-term obligation | 1,640 | 43 | 58 | 77 | - | 12 | 8 |
| Total stockholders equity | 59,739 | 45,008 | 32,790 | 27,101 | 23,344 | 30,969 | 23,591 |

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Pursuant to the purchase agreement dated January 1, 2005, the Company paid \$2,827,500 for new issuance of 3,900 shares of common stock of Goldleaves International Limited (GIL), in which the Company had 20% equity interests and was classified as investment security as of December 31, 2004. The Company then became the major stockholder holding 98% equity interests in GIL, which became a subsidiary of the Company. As of December 31, 2004, this investment was accounted for using the cost method. As appropriate for a step-acquisition, in the 2005 financial statements, the investment has been restated to account for under the equity method.

B. CAPITALIZATION AND INDEBTEDNESS.

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS.

Not applicable.

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D. RISK FACTORS.

We depend upon one customer who accounts for at least 10% of our sales. We cannot be certain that these sales will continue; if they do not, our revenues will likely decline.

Although we sell to a large number of customers in a variety of markets, one of our customers accounts for at least 10% of our sales. For the fiscal years ended December 31, 2005 and 2006, this customer accounted for approximately 11% of our 2005 sales and 10% of our 2006 sales. This customer is a non-affiliated third party and is not a related party of the Company or any of its subsidiaries. Although we have maintained good and longstanding relationship with this customer, we do not have any long-term contract with it and it orders only on a purchase order basis. The loss of this customer or a significant reduction in its orders would have a materially adverse effect on our revenues.

We face significant competition from larger competitors in our wholesale and retail operations.

The making and distribution of jewelry is a highly competitive industry characterized by the diversity and sophistication of the product. We compete with major domestic and international companies with substantially greater financial, technical and marketing resources and personnel than us. There can be no assurance other jewelry makers will not similarly develop low-cost, high-volume production capability or an even better process, providing greater competition for us and materially affecting our business prospects.

There are numerous factors relating to the operations of our business that could adversely affect our success and results.

As a maker and merchandiser of low-cost, high-quality gem-set jewelry, our existing and future operations are and will be influenced by several factors, including:

technological developments in the mass production of jewelry;

our ability to meet the design and production requirements of our customers efficiently;

the market acceptance of our and our customers jewelry;

increases in expenses associated with continued sales growth;

our ability to control costs;

our management's ability to evaluate the public's taste and new orders to target satisfactory profit margins;

our capacity to develop and manage the introduction of new designed products; and

our ability to compete.

Quality control is also essential to our operations since customers demand compliance with design and product specifications and consistency of production. We cannot assure that revenue growth will occur on a quarterly or annual basis.

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Our production facilities are located in China. Our results of operations and financial condition may, therefore, be influenced by the economic, political, legal and social conditions in China.

Since 1978, the Chinese government has been reforming, and is expected to continue to reform, China's economic and political systems. Such reforms have resulted in significant social progress. Other political, economic and social factors could also lead to further readjustment of the reform measures. This refinement and readjustment process may not always have a positive effect on our operations in China. At times, we may also be adversely affected by changes in policies of the Chinese government such as changes in laws and regulations or their interpretation, the introduction of additional measures to control inflation, changes in the rate or method of taxation and imposition of additional restrictions on currency conversion and remittances abroad.

Changes to PRC tax laws may adversely affect our financial condition and results of operations in the future.

The National People's Congress, the Chinese legislature, on March 16, 2007 passed a new enterprise income tax law, which will become effective on January 1, 2008. The new law applies a uniform 25% enterprise income tax rate (EIT) to both foreign invested enterprises and domestic enterprises, except that enterprises that were approved to be established prior to March 16, 2007 may continue to enjoy the existing preferential tax treatments until December 31, 2012. An enterprise registered under the laws of a jurisdiction outside China may be deemed a Chinese tax resident if its place of effective management is in China and it will consequently be subject to the EIT upon its worldwide income. Existing companies are required to transition to the new EIT rate over a five-year period starting January 1, 2008. The new Enterprise Income Tax Law empowers the PRC State Council to promulgate detailed implementation rules. Since the implementation rules are not yet promulgated, there is uncertainty as to how the new law will be interpreted or implemented. Although we are carefully monitoring these legal developments and will timely adjust our effective income tax rate when necessary, we cannot assure that the new Enterprise Income Tax Law will not cause increases in the EIT rates applicable to our PRC subsidiaries, which could have a material adverse effect on our financial condition and results of operations.

Our products are currently made at our production facility located in Shenzhen, China. However, our insurance may not adequately cover any losses due to fire, casualty or theft.

We have obtained fire, casualty and theft insurance aggregating approximately \$42 million, covering several of our stock in trade, goods and merchandise, furniture and equipment and production facility in China. The proceeds of such insurance may not be sufficient to cover material damage to, or the loss of, our production facility due to fire, severe weather, flood or other cause, and such damage or loss would have a material adverse effect on our financial condition, business and prospects. Consistent with the customary practice among enterprises in China and due to the cost in relation to the benefit, we do not carry any business interruption insurance in China.

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Sales of our jewelry to retailers are generally stronger during the quarter ending December 31 of each year due to the importance of the holiday selling season.

The approximately 28% of our wholesale sales during the fiscal year ended December 31, 2006 to our TV shopping channel customers was not seasonal in nature. It has been our management's experience that the remaining 72% of our total wholesale sales is seasonally sensitive and is greater during the quarter ending December 31 of each year.

The success of our retail store expansion program in China is dependent upon numerous factors over which we have limited control.

The future success of our ENZO retail stores in China is partially dependent upon general economic conditions in China, competitive developments within the retail jewelry sector in China and consumer attitudes, including changes in consumer preferences for certain jewelry styles and materials. In addition, our retail expansion program is also dependent upon a number of factors relating to our stores, including the availability of property, the location of the mall or shopping centre, the availability of desirable locations within a mall, the terms of leases, our relationship with major landlords, and the design and maintenance of our stores.

We rely on short-term financing from banks for our daily operation.

We rely on short-term borrowings as part of our financing needs. If we fail to achieve timely rollover, extension or refinancing of our short-term debt, we may be unable to meet our obligations in connection with debt service, accounts payable and/or other liabilities when they become due and payable. In addition, we may be exposed to changes in interest rates. If interest rates increase substantially, our results of operations could be adversely affected.

Certain of our banking facilities that offer short-term borrowings are collateralized by properties owned by Yu Chuan Yih and by his personal guarantee. If Mr. Yih withdraws the properties or his personal guarantee, the banking facilities may no longer remain available for use by us. In that event, our daily operations may be adversely affected.

We rely geographically on the US market for the majority of our revenue.

Our wholesale business is our major revenue contributor and accounts for 88% of our total revenue. Geographically, North America is a major market for our wholesale business and contributes 71% of our revenues. Accordingly, the revenue of our wholesale business in the US market accounts for 62% of our total revenue. Any substantial decline of the economy may adversely affect the spending patterns of the US consumers which could in turn adversely affect our revenue and the income from the region.

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Our holding company structure creates restrictions on the payment of dividends.

We have no direct business operations, other than the ownership of our subsidiaries, of which we have control over their operation policies including, among others, payment of dividend. While we have no current intention of paying dividends, should we, as a holding company, decide in the future to do so, our ability to pay dividends and meet other obligations depends upon the receipt of dividends or other payments from our operating subsidiaries and other holdings and investments. In addition, our operating subsidiaries are subject to restrictions on their ability to make distributions to us, including as a result of restrictive covenants and minimum net worth requirements in loan agreements, restrictions on the conversion of local currency into US dollars or other hard currency and other regulatory restrictions.

As a foreign private issuer, we are not subject to certain rules promulgated by Nasdaq that other Nasdaq-listed issuers are required to comply with.

Our common shares are currently listed on the Nasdaq Global Market and, for so long as our securities continue to be listed, we will remain subject to the rules and regulations established by Nasdaq applicable to listed companies. As permitted under Nasdaq rules applicable to foreign private issuers, we have determined not to comply with the following Nasdaq rules:

our independent directors do not hold regularly scheduled meetings in executive session;

the compensation of our executive officers is not determined by an independent committee of the board or by the independent members of the board of directors, and our CEO may be present and participate in the deliberations concerning his compensation;

related party transactions are not required to be reviewed or approved by our audit committee or other independent body of the board of directors; and

we are not required to solicit shareholder approval of stock plans, including those in which our officers or directors may participate; stock issuances that will result in a change in control; the issuance of our stock in related party transactions or other transactions in which we may issue 20% or more of our outstanding shares; or, below market issuances of 20% or more of our outstanding shares to any person.

We may in the future determine to voluntarily comply with one or more of the foregoing provisions.

It may be difficult to serve us with legal process or enforce judgments against us or our management.

We are a British Virgin Islands holding company, and substantially all of our assets are located in China and Hong Kong. In addition, all but one of our directors and officers are non-residents of the United States, and all or substantial portions of the assets of such non-residents are located outside the United States. As a result, it may not be possible to effect service of process within the United States upon such persons. Moreover, there is doubt as to whether the courts of the British Virgin Islands, China or Hong Kong would enforce:

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judgments of United States courts against us, our directors or our officers based on the civil liability provisions of the securities laws of the United States or any state; or

in original actions brought in the British Virgin Islands, China or Hong Kong, liabilities against us or non-residents based on the securities laws of the United States or any state.

Some information about us may be unavailable due to exemptions under the Exchange Act for a foreign private issuer.

We are a foreign private issuer within the meaning of the rules under the Exchange Act. As such, we are exempt from certain provisions applicable to United States domestic public companies, including:

the rules under the Exchange Act requiring the filing with the Securities and Exchange Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;

the provisions of Regulation FD aimed at preventing issuers from making selective disclosures of material information;

the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations applicable to a security registered under the Exchange Act; and

the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction.

Because of these exemptions, investors are not provided with the same information which is generally available about domestic public companies organized in the United States.

Since we are a British Virgin Islands company, the rights of our shareholders may be more limited than those of shareholders of a company organized in the United States.

Under the laws of most jurisdictions in the United States, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders. Shareholder action must be taken in good faith, and actions by controlling shareholders which are obviously unreasonable may be declared null and void. British Virgin Islands law protecting the interests of minority shareholders may not be as protective in all circumstances as the law protecting minority shareholders in US jurisdictions. In addition, the circumstances in which a shareholder of a BVI company may sue the company derivatively, and the procedures and defenses that may be available to the company, may result in the rights of shareholders of a BVI company being more limited than those of shareholders of a company organized in the US.

Furthermore, our directors have the power to take certain actions without shareholder approval which would require shareholder approval under the laws of most US jurisdictions. The directors of a BVI corporation, subject in certain cases to court approval but without shareholder approval, may implement a reorganization, merger or consolidation, the sale of any assets, property, part of the business, or securities of the corporation. Our ability to amend our

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Memorandum of Association and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in our control without any further action by the shareholders, including a tender offer to purchase our common stock at a premium over then current market prices.

Legal proceedings related to our historical reporting of financial results and other issues may significantly harm our business.

Several lawsuits have been filed against us and current officers and members of the Board of Directors, alleging false representations and material omissions in connection with press releases, SEC filings and other statements that purportedly overstated the Company's business prospects and financial results. These lawsuits are described more fully in Part I, Item 8 and in Part III, Item 18, Note 12 to our consolidated financial statements contained in this Form 20-F. Defending these lawsuits will result in significant expenditures and the diversion of our management's time and attention from the operation of our business, which could have a negative effect on our business operations. From time to time, we may become involved in other litigation or other proceedings. Matters arising out of or related to the delayed filing of our audited financial statements, the outcome of our delisting proceedings and the outcome of litigation could possibly harm our future results of operations or financial condition due to expenses we may incur to defend ourselves or the ramifications of an adverse decision.

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ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY.

LJ International Inc. (we) was incorporated as an international business company under the International Business Companies Act of the British Virgin Islands on January 30, 1997. As of December 31, 2006, we owned all of the issued share capital in the following significant subsidiaries except Goldleaves Gems (Shenzhen) Co., Ltd.:

Lorenzo Jewelry Limited (Lorenzo Jewelry), a company incorporated in Hong Kong on February 20, 1987

Lorenzo Jewellery (Shenzhen) Co., Ltd.

Shenzhen PGS Jewelry Mfg.

Lorenzo (Shenzhen) Co., Ltd. (LSC)

Lorenzo Crystal Ltd.

Enzo (Shenzhen) Co., Ltd. (ESC)

Enzo Ltd.

Goldleaves Gems (Shenzhen) Co., Ltd. (98% equity ownership)

Due to the restrictions on foreign ownership on the retail business of jewelry, the Company, through loans to the agents, established ESC to carry out the retail business of jewelry in the PRC. Pursuant to various agreements entered into between the Company, its agents and ESC on July 14, 2005, the Company has control of ESC, absorbs the majority of any expected losses and receives the majority of residual return of ESC. The Company is, therefore, considered the primary beneficiary of ESC. Accordingly, ESC is consolidated in the financial statements of the Company since July 14, 2005.

Our principal place of business and our executive office is located at Unit #12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong, telephone: (011) 852-2764-3622. We have designated CT Corporation, 111 Eighth Avenue, New York, New York 10011 as our agent for service of process in the United States.

During our last three fiscal years, we have made the following significant capital expenditures:

we invested \$670,000 for the purchase of 1,639 square meters of production space in our Shenzhen, China facility during the fiscal year ended December 31, 2005

we acquired an additional 78% of the equity of Goldleaves International Limited for \$2,827,500 during the fiscal year ended December 31, 2005

we spent \$1,105,000 on capital expenditures, excluding inventory, for ENZO retail store openings during the fiscal year ended December 31, 2006

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B. BUSINESS OVERVIEW.

We are a vertically integrated company that designs, brands, markets, distributes and retails a complete range of fine jewelry. While we specialize in the colored jewelry segment, we also offer high-end pieces set in yellow gold, white gold, platinum or sterling silver and adorned with colored stones, diamonds, pearls and precious stones. We distribute to fine jewelers, department stores, national jewelry chains and electronic and specialty retailers throughout North America and Western Europe; and we conduct our jewelry retail business through the ENZO brand in the Asia Pacific region, with the primary focus in the PRC market, which we regard as having one of the largest and fastest growing consumer demands for luxury items. Our product lines incorporate all major categories sought by major retailers, including earrings, necklaces, pendants, rings and bracelets.

We believe that our vertically integrated structure provides significant advantages over our competitors. All profits from value added processes are captured internally, rather than shared with third party manufacturers. This results in very competitive pricing for the retailer and enhanced profits for us. Innovative processes in stone cutting and production further enhance our competitive position.

We employ an international design team and all of our designs and merchandising strategies are proprietary. The exclusive and innovative concepts that we create offer brand potential. Our primary marketing focus has been in North America where we have sold directly to certain high volume customers that need specialized product development services, and through a marketing relationship with International Jewelry Connection (IJC) for those customers that need higher levels of service and training.

We organize our marketing and distribution strategies by retail distribution channels. Concepts are developed for the specific needs of different market segments. We have identified the following as prime retail targets:

fine jewelers;

national jewelry chains;

department stores;

TV shopping channels; and

discount chain stores.

For the years ended December 31, 2005 and 2006, approximately 72% and 62% of our sales were in North America.

In addition to our wholesale line of business involving direct sales to retailers, we have expanded into the retail sales line of business involving direct sales to consumers in China through company-owned retail stores under the brand name ENZO. In March 2004, we opened our first retail store in Hong Kong and opened our flagship store in Shanghai in November 2004. As of December 10, 2007, we currently operate 88 ENZO retail stores across Hong Kong, China and Macau, and we expect to open and operate a total of at least 100 stores by the beginning of 2008.

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The following is a breakdown of our total revenues by geographic market for each of our past three financial years:

| (in thousands) | Year ended December 31, | | |
|-------------------------------------|-------------------------|--------|--------|
| | 2006 | 2005 | 2004 |
| | US\$ | US\$ | US\$ |
| US & Canada | 76,889 | 67,780 | 56,186 |
| Europe and other countries | 24,452 | 20,527 | 13,062 |
| Japan | 2,454 | 3,686 | 4,158 |
| PRC (including Hong Kong and Macau) | 19,996 | 7,653 | 4,098 |
| | 123,791 | 99,646 | 77,504 |

Our Industry

The US jewelry industry is a highly fragmented \$45 billion market, with no single entity having more than 6% market share. The industry consists primarily of three retail sectors:

specialty retailers account for \$27 billion in sales

mass merchants and department stores account for \$12 billion in sales

direct avenues (television shopping, e-commerce, catalogs) account for \$6 billion

The US jewelry industry is comprised of two major groups that distribute finished jewelry to retailers in the United States:

a small number of producers that make and distribute their own jewelry directly to retailers; and

a large number of wholesalers and distributors who purchase products or portions of products from third parties and resell those items to retailers.

We believe that vertically integrated companies that control costs by performing all value added processes enjoy a distinct competitive advantage over wholesalers and distributors who pay premium acquisition prices for items that they intend to resell. We further believe that large retailers want to rely upon prime producers because they believe that prime producers are reliable and low cost producers who can accommodate the large quantities of production that large retailers commonly purchase.

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The Chinese jewelry industry has experienced rapid development due to a series of major reforms, including the liberalization of China's gold market, the lowering of tariff rates, and the decision of the Chinese Government to open up the retail sector to international companies.

In addition, rising income levels coupled with the growing urban population in China has helped the jewelry market record double-digit growth annually. The continuing acceleration of the urbanization trend in China will likely result in improved income levels, thereby increasing private consumption. The Chinese Government has also encouraged consumer spending by instituting longer national holidays and increasing the salary of civil servants.

Management believes that China is the largest consumer of platinum and jade in the world for the past three years, the largest consumer of diamonds in Asia, and the fourth largest consumer of gold in the world.

Our Business Strategy

Our business strategy is to:

increase our market share of moderately priced high-quality gem-set colored and precious jewelry by capitalizing on our vertically integrated production processes to produce diamond and high-end precious stone jewelry in addition to high volume, high-quality colored products;

further develop our existing customer relationships with our specialized services; and

expand aggressively into new distribution channels, particularly in the United States, China, Western Europe, Japan and Australia.

We are aggressively developing new product lines in exotic stones, which have high perceived values among colored stones. We continue to expand into new product categories by:

marketing a line of sterling silver jewelry. These are typically merchandised with a retail price range of \$30 to \$150;

adding more lines into our LORENZO branded products with a retail price range of \$199 to \$999; and

offering diamond jewelry and expanding this business to our current client base by adding diamonds to some of our settings, as well as offering newly designed jewelry.

Our China Retail Sales Strategy

In 2004, we initiated a retail sales strategy aimed at gaining market share in the rapidly growing consumer market in China. We opened three ENZO stores, two in China (including a flagship store in Shanghai) and one in Hong Kong. We believe that China represents an excellent retail sales opportunity for several reasons:

significant retail market - China's retail sales exceed \$600 billion annually, making China the third largest market in the world.

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