LJ INTERNATIONAL INC
Form 20-F
March 31, 2009

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

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

OR

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

OR

o **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 __________

Commission file number 0-29620

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)

Hon Tak Ringo NG, CFO
011-852-2764-3622 (telephone)
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Unit #12, 12/F, Block A
Focal Industrial Centre
21 Man Lok Street
Hung Hom, Kowloon, Hong Kong
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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 (Common Stock)	NASDAQ

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:

22,911,172 Shares of Common Stock as of December 31, 2008

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

Yes o No þ

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 o No þ

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 þ No o

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 o Accelerated filer þ Non-accelerated filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

þ U.S. GAAP

o International Financial Reporting Standards as issued by the International Accounting Standards Board

o Other

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17

o 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 o No þ

(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 involv 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

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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 the five-year period ended December 31, 2008 have been derived from our audited consolidated financial statements. The following selected consolidated financial data should be read in conjunction with Operating and Financial Review and Prospects and the Consolidated Financial Statements and Notes included elsewhere in this annual report.

Selected Financial Data

	Year ended December 31,				
	2008	**2007**	**2006**	**2005**	**2004**
Statement of Operations Data:					
Revenues	136,268	152,037	123,791	99,646	77,504
Cost of goods sold	(97,031)	(112,508)	(88,867)	(77,127)	(61,265)
Gross profit	39,237	39,529	34,924	22,519	16,239
Operating expenses					
Selling, general and administrative	(34,815)	(30,399)	(23,114)	(15,488)	(11,578)
Net (loss) gain on derivatives	(86)	(4)	(29)	8	199
Depreciation	(3,373)	(3,095)	(2,039)	(1,368)	(1,032)
Amortization and impairment loss on goodwill					(698)
Operating income	963	6,031	9,742	5,671	3,130
Other income and expenses					
Interest income	199	273	282	139	38
Gain on currency translation	1,473				
Gain on sales of securities	49				
Gain on disposal of property held for lease	2,210				
Interest expenses	(1,789)	(3,103)	(3,258)	(1,991)	(902)
Operating income before income taxes, minority interests, equity in results of investment securities and extraordinary item	3,105	3,201	6,766	3,819	2,266
Income taxes expense	(569)	(1,711)	(1,403)	(739)	(277)
Income before minority interests, equity in results of investment securities and extraordinary item	2,536	1,490	5,363	3,080	1,989
Minority interests in consolidated subsidiaries	(6)	(1)	(38)	(20)	
Income before equity in results of investment securities and extraordinary item	2,530	1,489	5,325	3,060	1,989
Equity in results of investment securities					133
Income before extraordinary item	2,530	1,489	5,325	3,060	2,122

Extraordinary gain on negative goodwill				1,291	
Net income	2,530	1,489	5,325	4,351	2,122
Net income per share:					
Basic	0.11	0.07	0.31	0.32	0.19
Diluted	0.11	0.07	0.29	0.30	0.18
Weighted average number of shares					
Basic	22,246	21,064	17,390	13,439	11,119
Diluted	22,449	22,289	18,303	14,322	12,107
Balance Sheet Data:					
Working capital	72,059	62,786	50,134	35,554	23,617
Total assets	131,190	134,144	124,522	108,230	73,673
Long-term obligation	2,219	1,335	1,640	43	58
Total stockholders equity	78,329	72,668	59,739	45,008	32,790

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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.

D. RISK FACTORS.

We depend upon two customers who each 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, two of our customers each accounts for at least 10% of our sales. For the fiscal years ended December 31, 2007 and 2008, these customers accounted for approximately 10% and 8% of our 2007 sales and 11% and 11% of our 2008 sales. Each of these customers 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 relationships with these customers, we do not have any long-term contract with either of them and they order only on a purchase order basis. The loss of either of these customers or a significant reduction in their 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 that 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.

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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
- 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.

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 became 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. Existing companies are required to transition to the new EIT rate over a five-year period starting January 1, 2008.

Under the New EIT Law, an enterprise established outside of China with de facto management bodies within China is considered a resident enterprise , meaning that it can be treated in a manner similar to a Chinese enterprise for enterprise income tax purposes. The implementing rules of the New EIT Law define de facto management as substantial and overall management and control over the production and operations, personnel, accounting, and properties of the enterprise. Currently, no official interpretation or application of this new resident enterprise classification is available and, therefore, it is unclear how tax authorities will determine tax residency based on the facts of each case.

If the PRC tax authorities determine that our British Virgin Islands holding company is a resident enterprise for PRC enterprise income tax purposes, a number of unfavorable PRC tax consequences could follow. First, we may be subject to enterprise income tax at a rate of 25% on our worldwide taxable income as well as PRC enterprise income tax reporting obligations. In our case, this would mean that non-China source income would be subject to PRC enterprise income tax at a rate of 25%, in comparison to no taxation in the British Virgin Islands. Second, although under the New EIT Law and its implementing rules dividends paid to us from our PRC subsidiaries would qualify as tax-exempt income , we cannot guarantee that such dividends will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax, have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as resident enterprises for PRC enterprise income tax purposes. Finally, if our British Virgin Islands holding company is deemed to be a PRC tax resident enterprise, a 10% withholding tax shall be imposed on dividends we pay to our non-PRC shareholders and with respect to gains derived from our non-PRC shareholders transferring our shares.

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 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.

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 33% of our wholesale sales during the fiscal year ended December 31, 2008 to our TV shopping channel customers was not seasonal in nature. It has been our management s experience that the remaining 67% of our total wholesale sales is seasonally sensitive and is greater during the quarter ending December 31 of each year.

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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 73% of our total revenue. Geographically, North America is a major market for our wholesale business and contributes 69% of our wholesale revenues. Accordingly, the revenue of our wholesale business in the US market accounts for 51% of our total revenue. Any substantial decline of the US economy may adversely affect the spending patterns of the US consumers which could, in turn, adversely affect our revenue and income from the region.

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.

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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 shares of common stock 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

- 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:

- 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 upon the securities laws of the United States or any state.

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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
- 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 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.

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Several lawsuits have been filed against us and certain 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.A. and in Part III, Item 18, Note 11 to our consolidated financial statements contained in this Form 20-F. Defending these lawsuits has and may continue to 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 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.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY.

LJ International Inc. (we or the Company) 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, 2008, 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.
- Lorenzo (Shenzhen) Co., Ltd.
- Wonderful (Shenzhen) Ltd.
- Goldleaves Gems (Shenzhen) Co., Ltd. (98% equity ownership)

Our principal place of business and our principal 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 spent $1,105,000 on capital expenditures, excluding inventory, for ENZO retail store openings during the fiscal year ended December 31, 2006
- we spent $1,977,000 on capital expenditures, excluding inventory, for ENZO retail store openings during the fiscal year ended December 31, 2007
- we spent $1,199,000 on capital expenditures, excluding inventory, for ENZO retail store openings during the fiscal year ended December 31, 2008

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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 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
- discount chain stores

For the years ended December 31, 2007 and 2008, approximately 53% and 51% 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 March 19, 2009, we currently operate 94 ENZO retail stores across Hong Kong, China and Macau.

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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, 2008 US$	2007 US$	2006 US$
US & Canada	69,232	80,572	76,889
Europe and other countries	27,455	32,597	24,452
Japan	989	2,206	2,454
PRC (including Hong Kong and Macau)	38,592	36,662	19,996
	136,268	152,037	123,791

Our Industry

The US jewelry industry is a highly fragmented $65 billion market, with no single entity having more than 5% market share. The industry consists primarily of three retail sectors:

- specialty retailers account for $33 billion in sales
- mass merchants and department stores account for $21 billion in sales
- direct avenues (television shopping, e-commerce, catalogs) account for $11 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
- 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.

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 have 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 second 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

- expand into new distribution channels, particularly in the United States, China, Western Europe, Japan, Russia, South Africa and Australia

We are 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

- 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 $732 billion annually, making China the third largest market in the world.

- large and growing jewelry market we estimate that China s jewelry sales totaled nearly $26 billion in 2007 and $32 billion in 2008.

- large pool of consumers   China has a population of more than 1.3 billion people. We estimate that roughly 173 million Chinese have enough income to purchase luxury goods.

- favorable regulatory changes   as a member of the World Trade Organization, China is eliminating many restrictions on foreign ownership and operation of retail stores. Tariffs on colored gemstones, gold, silver and pearls have been sharply reduced, and economic and trade relationships between China and Hong Kong have been liberalized.

- changing consumer preferences   Chinese consumers are no longer purchasing jewelry solely as an investment. More Chinese consumers are embracing a more Western view of jewelry as a fashion accessory and now demand more contemporary, colorful designs.

We are expanding into China by means of Company-owned and -operated retail stores and supplier relationships with leading retailers, such as Carrefour.

We intend to implement our business strategy by:

- expanding our retail jewelry market in China by planning to selectively open additional ENZO stores in China during 2009

- promoting visits with customers to coordinate and cater to their particular promotional sales needs and monitoring their on-hand inventory in order to promote more active sell-through

- expanding our distribution channels and further developing business with retail jewelry chains in the US

Our Production Capability

We have established a sophisticated facility in China that performs stone cutting and polishing and jewelry production. The facility is located in the city of Shenzhen in Guangdong Province, China. Our production facility in Shenzhen has been operating for ten years and has more than 14,000 square meters of production space. We currently employ approximately 2,000 skilled gemstone cutters and production personnel and turned out approximately 1.8 million pieces of finished fine jewelry during the fiscal year ended December 31, 2008.

We purchase imported choice gemstone material, which are from mines located in Africa, China and South America, especially those concentrated in Brazil. We source our diamonds mainly from suppliers in India and Africa. Gemstone craftsmen are trained to ensure that the highest levels of cutting and polishing quality are achieved. The professional skills possessed by our cutters are applied to a wide variety of shapes and sizes, maximizing the yield and value of the gemstone material that we purchase. By performing internally the value-added processes of cutting and polishing our colored gemstones, we maximize quality control and improve our profitability. We specialize in a wide range of popular and exotic colored gemstones ranging from amethyst, aquamarine and peridot to tanzanite and tourmaline.

Sales and Marketing

Wholesale

Our merchandising strategy is to provide unique and differentiated products that are enhanced by the favorable pricing that results from our vertically integrated structure. We invest significant effort in design and model making to produce items which are distinctly different from those of our competitors. We continue to devote our efforts towards brand development and utilize marketing concepts to enhance the saleability of our products. We recognize that retailers favor certain price points. As part of our product development strategy, we strive to align our wholesale prices to match retailers target prices as a means of achieving these popular price targets.

Our sales and marketing team is located in our executive office in Shenzhen, China. Our marketing and distribution strategy is to identify the strongest retail customers in each distribution channel and to focus design and sales efforts towards the largest and fastest growing retailers. We maintain a broad base of customers and concentrate our efforts on five major jewelry market segments:

- fine jewelers
- national jewelry chains
- department stores
- TV shopping channels
- discount chain stores

Our sales promotion efforts include attendance by our representatives at US and international trade shows and conventions, including Las Vegas, Orlando, New York, Basel, Switzerland, Hong Kong and Japan. In addition, we advertise actively in trade journals and related industry publications.

Retail

Our retail brand, ENZO, focuses on brand building strategy that differentiates itself from the many mass market local competitors. This is the result of continuous marketing programs that built an unique image and identity for ENZO.

ENZO has combined its product, sales and marketing programs that align with the strategic direction of reinforcing the brand as one of the most recognized foreign jewelry brands in China.

With 94 retail points covering strategic locations in major cities as of March 19, 2009, ENZO is the foreign jewelry brand with the highest number of retail points in China. This perfect retail platform provides the most effective touch points for the consumers, in particular the fast growing middle class segment in China.

In 2008, total jewelry retail sales in China reached $32 billion and is expected to grow over the next few years.

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Design and Product Development

We have 20 internationally trained designers who work in our Shenzhen, China office. Our designers create styles that have been accepted by our various clients worldwide. Our design teams attend trade fairs worldwide to gather product ideas and monitor the latest product trends.

We provide our customers with a broad selection of high-quality 10, 14 and 18 karat gold, platinum and sterling silver jewelry products that incorporate traditional yet fashionable styles and designs. We currently offer more than 50,000 different styles of rings, bracelets, necklaces, earrings, pendants and matching sets that are contemporary and desired in the market.

We study product trends that are emerging in the international market and adapt these trends to the needs of our retail customers. The jewelry offered for sale considers colored, fabric and fashion trends, which are projected over a two-year period. We market our products as lifestyle inspired.

Production Process

We produce our jewelry at our facility in Shenzhen, China. Our production processes combine vertical integration, modern technology, mechanization and handcraftsmanship to turn out contemporary and fashionable jewelry. Our production operations basically involve:

- cutting and polishing colored gemstones
- combining pure gold, platinum or sterling silver with gemstones or diamonds to produce jewelry
- finishing operations such as cleaning and polishing, resulting in high quality finished jewelry

Supply

We cut our own colored stones. We purchase imported gemstones which are from South America, Africa and China. South America is the major source of ametrine, amethyst, aquamarine, imperial topaz, tourmaline and white topaz, and Africa is the main source of tanzanite, mandarine garnet, aquamarine and topaz. We also purchase imported aquamarine, peridot and topaz from China. We source our diamonds mainly from suppliers in India and Africa. We believe that we have good relationships with our suppliers, most of whom have supplied us for many years.

We maintain our supply of inventory at our warehouse. The amount of our inventory of a particular gemstone determines the extent and size of our marketing program for that product. We purchase our gemstones and diamonds in advance and in anticipation of orders resulting from our marketing programs.

We purchase our gold from banks, gold refiners and commodity dealers who supply substantially all of our gold needs, which we believe is sufficient to meet our requirements.

Gold acquired for production is at least .995 fine and is combined with other metals to produce 10, 14 and 18 karat gold. The term karat refers to the gold content of alloyed gold, measured from a maximum of 24 karats, which is 100% fine gold. Varying quantities of metals such as silver, copper, nickel and zinc are combined with fine gold to produce 14 karat gold of different colors. These alloys are in abundant supply and are readily available to us.

We purchase our gold requirements within a reasonable period after each significant purchase order is received.

We purchase supplies and raw materials from a variety of suppliers and we do not believe the loss of any of the suppliers would have a material adverse effect on our business. Alternative sources of supply for raw materials for production of jewelry are readily available.

Security

We have installed certain measures at our Shenzhen, China, production and our Hong Kong facilities to protect against loss, including multiple alarm systems, infrared motion detectors and a system of closed circuit television cameras, which provide surveillance of all critical areas of our premises.

We carefully inspect all materials sent and received from outside suppliers, monitor the location and status of all inventory, and have strict internal control procedures of all jewelry as it proceeds through the production process. A complete physical inventory of gold and gemstones is taken at our production and facilities on a quarterly basis.

Insurance

We maintain primary all-risk insurance, with limits which may be less than our current inventory levels, to cover thefts and damage to inventory located on our premises. We also maintain insurance covering thefts and damage to our owned inventory located off-site. The amount of coverage available under such policies is limited and may vary by location, but is generally in excess of the value of the gold, diamonds and gemstones supplied by us. We carry transit insurance, the coverage of which includes the transportation of jewelry outside of our office.

Competition

The jewelry production industry is highly competitive, and our competitors include domestic and foreign jewelry manufacturers, wholesalers, and importers who may operate on a national, regional and local scale. Our competitive strategy is to provide competitively priced, high-quality products to the high-volume retail jewelry market. According to our management, competition is based on pricing, quality, service and established customer relationships. We believe that we have positioned ourselves as a low-cost producer without compromising our

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quality. Our ability to conceive, design and develop products consistent with the requirements of each retail distribution channel represents a competitive advantage.

We believe that few competitors have the capacity and production skills to be effective competitors. We believe that our vertically integrated production capabilities distinguish us from most of our competitors and enable us to produce very competitively priced, high quality and consistent products.

The North American market is highly fragmented but does contain a number of major competitors, many of whom import much of their product from the Far East and many of whom sell higher priced items. The key United States competitor is E.E.A.C. Inc. International competitors include Pranda International and Beauty Gems Limited. Most of these manufacturers/wholesalers have been successful vendors for many years and enjoy good relations with their clients. Although it may be difficult for a newcomer to break into established relationships, we have already made substantial inroads in the North American jewelry market and we believe we can remain competitive, based on our vertically integrated, low-cost, high-volume and high-quality production process.

Regarding the China retail jewelry market, there are many Hong Kong, local and foreign competitors. Those competitors may have product type, price range, market segment, target customer, size, history, strategy and background similar to or different from ENZO. Hong Kong competitors include Hong Kong-listed chain store operators such as Chow Sang Sang, Tse Sui Luen and Luk Fook; the local Chinese retail competitor is Laofengxiang; and foreign competitors include Tiffany, Cartier and Bvlgari.

C. ORGANIZATIONAL STRUCTURE AS OF DECEMBER 31, 2008.

The following chart provides a listing of our significant subsidiaries. The respective country of organization/incorporation is shown in brackets.

LJ INTERNATIONAL INC.
(British Virgin Islands)

100%

Lorenzo Jewelry Limited (Hong Kong)

Lorenzo Jewellery (Shenzhen) Co., Ltd. (PRC)

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

Wonderful (Shenzhen) Ltd. (PRC)

98%

Goldleaves Gems (Shenzhen) Co., Ltd. (PRC)

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D. PROPERTY, PLANTS AND EQUIPMENT.

Our principal executive office is located at Unit #12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong. We own and lease approximately 11,100 square feet of office and showroom at this location.

Our jewelry production facility in Shenzhen, China consists of 14,080 square meters of building space located inside of and close to the Shatoujiao Free Trade Zone, Shenzhen. We own approximately 6,893 square meters of this space. We also currently lease:

1,751 square meters for a term of five years expiring June 30, 2011 from an unaffiliated third party at a rental rate of $3,817 per month;

1,751 square meters for a term of two years expiring August 31, 2010 from an unaffiliated third party at a rental rate of $5,868 per month;

1,799 square meters for a term of three years expiring March 31, 2009 from an unaffiliated third party at a rental rate of $4,978 per month, renewal of lease is under negotiation; and

1,886 square meters for a term of three years expiring September 30, 2009 from an unaffiliated third party at a rental rate of $5,219 per month.

We own two warehouse facilities in Hung Hom and Aberdeen consisting of 5,432 square feet and 5,200 square feet. We also own an additional property in Hung Hom. We lease all three of these properties to non-affiliated third parties. We have pledged all of our land and buildings to collateralize general banking facilities granted to us.

Our production facilities are currently utilized for one shift per day but are capable of being expanded to accommodate three shifts per day as necessary.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion and analysis should be read in conjunction with our financial statements and notes to the financial statements appearing elsewhere in this Form 20-F. See Special Note Regarding Forward-looking Statements.

LJ International Inc., through its operating subsidiaries, designs, manufactures, distributes and markets a full range of fine jewelry through both wholesale and retail channels

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under the tradenames of LORENZO and ENZO, respectively. In terms of sales revenue, geographically the United States and China are the two major contributors.

Our product types include ring, bracelet, necklace, earring and pendant, and we are one of the prominent companies in colored gemstones that employ the mine-to-market strategy for cost minimization and ease of quality and production lead time control. Our colored gemstones are mainly imported from Brazil and Africa which supply, in terms of color, size and quality, the best colored gemstones in the world, the choices of which to customers are many and diversified and include, among others, ametrine, amethyst, aquamarine, imperial topaz, tourmaline, white topaz, tanzanite, mandarine garnet, topaz, ruby, sapphire and emerald.

Our wholesale customers comprise fine jewellers, national jewelry chain stores, department stores and television shopping networks in North America, Western Europe, Japan and China. To keep in touch with our customers and to ensure that they are updated with our latest designs and products, we exhibited at the following international jewelry shows in 2008:

Show Name	**Show Date**
Vicenza Winter	Jan 13 - 20
HKJJMA Jewelry Trade Show	Jan 26 - 28
Hong Kong Int l Jewellery Show March 2008	Mar 4 - 8
JA Winter Show	Mar 9 - 11
Basel 2008	Apr 3 - 10
Vicenza Spring	May 17 - 21
JCK Las Vegas 08	May 30 - Jun 3
JA Summer Show	Jul 27 - 30
Vicenza Autumn	Sept 6 - 10
Hong Kong Jewellery & Watch Fair September 2008	Sept 15 - 21
JANY Special Show	Oct 26 - 28

Our retail operation is mainly concentrated in China where we serve individual consumers throughout 30 cities. For 2008, we temporarily suspended our ENZO Signature line, which contributed approximately $13 million sales for 2007, because of the economic downturn and market situation as the Signature line is a luxury premium line of jewelry. In our ENZO retail shops, we offer fashionable and affordable jewelry items. Excluding the Signature line sales of $13 million in 2007, our 2008 sales at retail shop level increased by 70% as compared to our 2007 retail shop sales. As at December 31, 2008, there were 97 ENZO stores throughout PRC, Hong Kong and Macau compared to the same number of stores as at December 31, 2007.

During 2008, we concentrated on improving our individual ENZO store performance by finding better locations for some of our stores and by continuing to expand our product lines. Besides introducing new colored gemstone jewelry, we were also successful in introducing various types of diamond jewelry which contributed to 46% of total retail revenue for 2008 compared to 38% of total retail revenue for 2007.

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The revenue mix of the two streams of business of LORENZO (wholesale) and ENZO (retail) were roughly in the ratio of 73% to 27% for the year ended December 31, 2008.

The wholesale business focuses on the US market with sales made to those $100 Million Supersellers such as Sterling Jewelers Inc, ShopNBC, Zale Corporation, QVC and Wal-Mart. The turnover of our sales to those Supersellers in the US and Canada amounted to $69.2 million for 2008 compared to $80.6 million in 2007, a decrease of 14%.

Employing the ENZO brand name, the retail business focuses on the PRC market. ENZO has stores in Macau, Hong Kong, Shanghai, Beijing, Harbin, Qingdao, Shenyang, Ningbo, Chengdu, Changsha, Wuxi, Tianjin, Dalian, Shenzhen, Changchun, Tangshan, Guiyang, Xian, Anshan, Changzhou, Hefei, Shijiazhuang, Zhengzhou, Nanchang, Chongqing, Kunming, Jinan, Suzhou, Wuhan and Hengyang. Our ENZO stores in the PRC operate in department stores and shopping malls.

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of our assets, liabilities, revenue and expenses. These estimates are based on our historical experience and on various other assumptions that we believe to be reasonable. Estimates are evaluated on an ongoing basis, but actual results may differ from these estimates.

Critical accounting policies are those that, in management s view, are most important in the portrayal of our financial condition and results of operations. Those that require significant judgments and estimates include:

Collectibility of Accounts Receivable. Our management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. Credit evaluations are performed on all customers requiring credit over a certain amount. Our international sales are settled via letter of credit or open account. For export sales on open account, we purchased trade credit insurance to cover the risk of collectibility, the insured percentage is 85% on the invoiced amount to customers. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility.

We make specific allowance for doubtful accounts based on our best estimate of the amount of losses that could result from the inability or intention of our existing customers not to make the required payments. We generally review the allowance by taking into account factors such as historical experience, age of the accounts receivable balances and economic conditions that may affect a customer s ability to pay.

Stock-based Compensation. We account for share-based compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS No. 123R), *Share-*

Based Payment. SFAS No. 123R requires us to use a fair-value based method to account for share-based compensation. Accordingly, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. Our option plans are described more fully in Note 14 to our consolidated financial statements included elsewhere in this annual report.

Goodwill Impairment. Goodwill is tested for impairment at least annually based on a two-step approach. The first step is conducted by comparing the fair value of each reporting unit to its carrying amount. If the fair value of a reporting unit is less than its carrying amount, the second step requires a comparison of the implied fair value of goodwill to its carrying value. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. This allocation process is only performed for purposes of evaluating goodwill impairment and does not result in an entry to adjust the value of any assets or liabilities. An impairment loss is recognized for any excess in the carrying value of goodwill over its implied fair value.

We have determined that iBBC Inc., a subsidiary of the Company in the US, is the reporting unit for goodwill impairment testing. The fair value of iBBC Inc. is determined based on the discounted expected cash flow method. The discount rate was based on the subsidiary s weighted average cost of capital. The use of discounted cash flow methodology requires significant judgments including estimation of future revenues and costs, industry economic factors, future profitability, determination of iBBC Inc. s weighted average cost of capital and other variables. Although we believe that the assumptions adopted in our discounted cash flow model are reasonable, those assumptions are inherently unpredictable and uncertain.

We had goodwill of US$1,521,000 as of December 31, 2007 and 2008. The estimated fair value of the reporting unit exceeded its carrying value at December 31, 2008. Consequently, no goodwill impairment has been recognized.

Allowance for Obsolete Inventories. We established inventory allowance for unmarketable inventory in an amount equal to the difference between the cost of inventory and its estimated net realizable value based upon assumptions about future demand and market conditions. Management records a write-down against inventory based on several factors, including expected sales price of the item and the length of time the item has been in inventory. If actual demand and market conditions are less favorable than those projected by management, additional inventory allowance could be required. In that event, our gross margin would be reduced.

Fair value of financial instruments. The Company follows Statement of Financial Accounting Standards No. 107 (SFAS No. 107), *Disclosures about Fair Value of Financial Instruments*, for its financial instruments. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties. The carrying amounts of financial assets and liabilities, such as cash and cash equivalents, accounts

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receivable, prepayments and other current assets, notes payable, capital lease obligations, accounts payable, refundable customer deposits, income taxes payable, and accrued expenses and other current liabilities, approximate their fair values because of the short maturity of these instruments and market rates of interest.

A. OPERATING RESULTS.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Revenues

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2008	2007	2006	2008-2007	2007-2006
Revenues					
Wholesale	$ 99,840	$ 117,689	$ 108,679	-15%	8%
Retail	$ 36,428	$ 34,348	$ 15,112	6%	127%
	$ 136,268	$ 152,037	$ 123,791	-10%	23%

The decrease in revenue of jewelry product for wholesale of $17,849,000 or 15% to $99,840,000 for the year ended December 31, 2008, compared to the year ended December 31, 2007, was primarily attributable to the decrease in order quantity of 12%,

The increase in revenue of jewelry product for wholesale of $9,010,000 or 8% to $117,689,000 for the year ended December 31, 2007, compared to the year ended December 31, 2006, was primarily attributable to the increase in average selling price of 4% and the increase in order quantity of 8%.

The Company s retail business increased by $2,080,000, or 6% to $36,428,000 for the year ended December 31, 2008, compared to the year ended December 31, 2007. Considering the fact of suspension of the Signature line operation in 2008, retail revenue at retail store level actually increased by $15,031,000 or 70% for the year ended December 31, 2008 as compared to the year ended December 31, 2007. This increase was primarily due to the implementation of the Company s strategy of consolidation of its ENZO retail stores. The Company opened 22 new stores, which are in better locations with better quality customers, and closed 20 of its less profitable stores. In effect, that was a total of 97 ENZO retail stores in full operation for the year ended December 31, 2008 compared to the same number of retail stores at December 31, 2007, but some of which did not operate for the full year.

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The Company s retail business increased by $19,236,000, or 127% to $34,348,000 for the year ended December 31, 2007, compared to the year ended December 31, 2006. This increase was primarily due to the successful launch of the ENZO Signature line of high-end jewelry which accounted for $12,951,000 of the Company s retail business. The remaining increase was due to the Company s new ENZO retail store openings and the continued operation of its existing 51 ENZO retail stores, that is, a total of 95 ENZO retail stores in full operation compared to a total of 44 ENZO retail stores at December 31, 2006.

Cost of Sales and Gross Profit

				% Change	
	Year ended December 31,			**Years ended December 31,**	**Years ended December 31,**
(in thousands)	**2008**	**2007**	**2006**	**2008-2007**	**2007-2006**
Cost of sales and gross profit					
Cost of sales					
Wholesale	$ 79,729	$ 95,528	$ 83,387	-17%	15%
% of revenues	80%	81%	77%		
Retail	$ 17,302	$ 16,980	$ 5,480	2%	210%
% of revenues	47%	49%	36%		
Total	$ 97,031	$ 112,508	$ 88,867	-14%	27%
% of revenues	71%	74%	72%		
Gross profit					
Wholesale	$ 20,111	$ 22,161	$ 25,292	-9%	-12%
% of revenues	20%	19%	23%		
Retail	$ 19,126	$ 17,368	$ 9,632	10%	80%
% of revenues	53%	51%	64%		
Total	$ 39,237	$ 39,529	$ 34,924	-1%	13%
% of revenues	29%	26%	28%		

The gross profit margin of wholesale increased to 20% for the year ended December 31, 2008 from 19% for the year ended December 31, 2007. This was attributable to more effective procurement of sourced raw materials at lower costs and consumption of inventory whose original costs were lower than market.

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The gross profit margin of wholesale decreased to 19% for the year ended December 31, 2007 from 23% for the year ended December 31, 2006 and was attributable to the sales of product which had a lower gross profit margin.

The gross profit margin of ENZO retail operation increased to 53% for the year ended December 31, 2008 compared to 51% for the year ended December 31, 2007 and was attributable to more effective procurement of sourced raw materials and finished products at lower costs.

The gross profit margin of ENZO retail operation decreased to 51% for the year ended December 31, 2007 compared to 64% for the year ended December 31, 2006. The gross profit margin of 64% in 2006 was attributable to the service income from launch of the ENZO Signature line of jewelry products which substantially increased the retail division s gross profit margins. Excluding the contribution from service income, the gross profit margin of retail operation remained at 51% for the years ended December 31, 2007 and 2006.

Selling, General and Administrative Expenses

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2008	2007	2006	2008-2007	2007-2006
Selling, general and administrative expenses					
Wholesale	$ 14,087	$ 13,072	$ 13,324	8%	-2%
Retail	$ 17,820	$ 15,251	$ 7,562	17%	102%
Corporate	$ 2,908	$ 2,076	$ 2,228	40%	-7%
	$ 34,815	$ 30,399	$ 23,114	15%	32%
% of revenues	26%	20%	19%		

Selling, general and administrative expenses increased by 15% for the year ended December 31, 2008, compared to the year ended December 31, 2007. For the wholesale business, the selling, general and administrative expenses increased by 8% for the year ended December 31, 2008, compared to the year ended December 31, 2007. The increase was mainly attributable to the allowance for doubtful accounts of $1,223,000 because the debtors filed for bankruptcy protection. Excluding the allowance for doubtful accounts, the selling, general and administrative expenses of the wholesale business was $12,864,000, a decrease of 2% for the year ended December 31, 2008, compared to the year ended December 31, 2007. The expenses incurred by the retail business of $17,820,000, or 17% increase of the same for the year ended December 31, 2007, comprised advertising cost of $686,000, rental cost of $8,361,000, staff cost of $4,920,000 and other expenses of $3,853,000. The increase was mainly in the rental cost area which was a result of higher sales. The rental costs of more than 90% in number of retail stores were based on percentage of sales of which 44% in number of stores did not have any minimum rentals. The corporate expenses included items of corporate overheads, such as charges for legal and professional advisory services, and non-recurring litigation expenses of $1,311,000.

Selling, general and administrative expenses increased by 32% for the year ended December 31, 2007, compared to the year ended December 31, 2006. For the wholesale business, the selling, general and administrative expenses decreased by 2% for the year ended December 31, 2007, compared to the same of year 2006. The decrease was mainly attributable to a decrease in development cost of new products, designs and markets. The expenses incurred by the retail business of $15,251,000, or 102% increase of the same for the year ended December 31, 2006, comprised advertising cost of $2,058,000, rental cost of $5,367,000, staff cost of $4,933,000 and other expenses of $2,893,000 as a result of higher sales and increased store counts. The corporate expenses included items of corporate overheads, such as charges for legal and professional advisory services.

Net gain (loss) on derivatives

(in thousands)	Year ended December 31, 2008	2007	2006	% Change Years ended December 31, 2008-2007	Years ended December 31, 2007-2006
Unrealized (loss) gain on derivatives	$ (483)	$ (349)	$ 190	38%	-284%
% of revenues	0%	0%	0%		
(With the hedging mechanism in place, we have the realized gain on hedging activities)					
Realized gain (loss) on hedging activities	$ 397	$ 345	$ (219)	15%	-258%
% of revenues	0%	0%	0%		
Net loss on derivatives and hedging activities	$ (86)	$ (4)	$ (29)	2050%	-86%
% of revenues	0%	0%	0%		

We have secured gold loan facilities with various banks in Hong Kong, which typically bear a below-market interest rate. Under the gold loan arrangements, we may defer the purchase until such time as we decide appropriate, the price to be paid being the current market price at time of payment. The gold loan, however, does expose us to certain market risks associated with potential future increases in the price of gold. In the past, we did not hedge against such risks and at the close of each reporting period, the gold loan was valued at fair value with changes reflected on the income statement.

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Since 2003, we have commenced hedging the fluctuations in the price of gold related to the gold loans by entering into contracts with financial institutions for the future purchase of gold. With the hedging mechanism in place, we have incurred realized loss of $483,000 and $349,000 for each of the years ended December 31, 2008 and 2007, respectively, and an unrealized gain of $190,000 for the year ended December 31, 2006; and a realized gain of $397,000 and $345,000 for each of the years ended December 31, 2008 and 2007, and a realized loss of $219,000 on derivatives for the year ended December 31, 2006.

The hedging mechanism has been in place since 2003. We secured position of a net loss of $86,000, $4,000 and $29,000 for each of the years ended December 31, 2008, 2007 and 2006, respectively, on derivative hedging activities.

Depreciation

(in thousands)	Year ended December 31, 2008	2007	2006	% Change Years ended December 31, 2008-2007	% Change Years ended December 31, 2007-2006
Depreciation					
Wholesale	$ 1,877	$ 1,995	$ 1,425	-6%	40%
% of revenues	2%	2%	1%		
Retail	$ 1,496	$ 1,100	$ 614	36%	79%
% of revenues	4%	3%	4%		
Total	$ 3,373	$ 3,095	$ 2,039	9%	52%
% of revenues	2%	2%	2%		

Depreciation of wholesale business decreased by 6% to $1,877,000 for the year ended December 31, 2008 from $1,995,000 for the year ended December 31, 2007, which reflected part of the on-going capital expenditures which were fully amortized during the year. Depreciation of retail business increased by 36% to $1,496,000 for the year ended December 31, 2008 from $1,100,000 for the year ended December 31, 2007, which reflected the amortization of the capital expenditures of renovation on the increased number of retail stores during the year.

Depreciation of wholesale business increased by 40% to $1,995,000 for the year ended December 31, 2007 from $1,425,000 for the year ended December 31, 2006, which reflected the amortization on the on-going capital expenditures, and a full year s amortization on cost of renovation and motor vehicles incurred in 2006. Depreciation of retail business increased by 79% to $1,100,000 for the year ended December 31, 2007 from $614,000 for the year ended December 31, 2006, which reflected the amortization of the capital expenditures of renovation on the increased number of retail stores during the year.

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Interest cost

(in thousands)	Year ended December 31, 2008	2007	2006	% Change Years ended December 31, 2008-2007	Years ended December 31, 2007-2006
Interest expenses	$ 1,789	$ 3,103	$ 3,258	-42%	-5%
% of revenues	1%	2%	3%		

Interest expenses decreased by $1,314,000 or 42% to $1,789,000 for the year ended December 31, 2008, compared to the year ended December 31, 2007, and was primarily attributable to the decrease in interest rates and the decrease in utilization level of credit lines of letters of credit and gold loans due to the suspension or cancellation imposed by the banking facilities.

Interest expenses decreased by $155,000 or 5% to $3,103,000 for the year ended December 31, 2007, compared to the year ended December 31, 2006, and was primarily attributable to the decrease in interest rates and the decrease in utilization level of credit lines of letters of credit.

Income taxes

(in thousands)	Year ended December 31, 2008	2007	2006	% Change Years ended December 31, 2008-2007	Years ended December 31, 2007-2006
Income taxes expense					
Wholesales	$ 569	$ 1,015	$ 682	-44%	49%
% of revenues	1%	1%	1%		
Retail	$ 0	$ 696	$ 721	-100%	-3%
% of revenues	0%	2%	5%		
Total	$ 569	$ 1,711	$ 1,403	-67%	22%
% of revenues	0%	1%	1%		

We are incorporated in the British Virgin Islands and, under current laws of the British Virgin Islands, are not subject to tax on income or on capital gains.

For our subsidiaries in Hong Kong, the prevailing corporate income tax rate is 16.5%.

Three of our subsidiaries in China are registered to be qualified as Foreign Investment Enterprises in China and are eligible for certain tax holidays and concessions. Accordingly, certain of our Chinese subsidiaries are exempt from Chinese income tax for two years starting from their first profit-making year, followed by a 50% reduction of tax for the next three years.

One of our subsidiaries in China is enjoying the tax holiday as its first profit-making year in 2004 and another subsidiary in China is enjoying the tax holiday as its first profit-making year in 2005. PRC income tax is calculated at the applicable rates relevant to these subsidiaries which currently are 18%.

For other subsidiaries in China, the prevailing corporate income tax rate is 25%. The prevailing corporate income rate is 18% for companies operating in special economic zones of China.

Income taxes included tax under provision adjustment of $1,000, $195,000 and $72,000 for the years ended December 31, 2008, 2007 and 2006, respectively, after the finalization of tax assessment for prior years.

Inflation

We do not consider inflation to have had a material impact on our results of operations over the last three years.

Foreign Exchange

Approximately 72% of our sales are denominated in US Dollars whereas the other sales are basically denominated in Hong Kong Dollars and Renminbi. The largest portion of our expenses are denominated in Hong Kong Dollars, followed by US Dollars and Renminbi. The exchange rate of the Hong Kong Dollar is currently pegged to the US Dollar, but during the past several years the market exchange rate has fluctuated within a narrow range. The Chinese government principally sets the exchange rate between the Renminbi and all other currencies. As a result, the exchange rates between the Renminbi and the US Dollar and the Hong Kong Dollar have fluctuated in the past and may fluctuate in the future. If the value of the Renminbi or the Hong Kong Dollar depreciates relative to the US Dollar, such fluctuation may have a positive effect on the results of our operations. If the value of the Renminbi or the Hong Kong Dollar appreciates relative to the US Dollar, such fluctuation may have a negative effect on the results of our operations. We do not currently hedge our foreign exchange positions.

Governmental economic and political policies and factors

For information regarding governmental economic, fiscal, monetary and political policies that could materially affect our operations, directly or indirectly, please refer to the Risk Factors section on pages 4 to 10.

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B. LIQUIDITY AND CAPITAL RESOURCES.

We have no direct business operations other than the ownership of our subsidiaries and investment securities. Our ability to pay dividends and meet other obligations depends upon our receipt of dividends or other payments from our operating subsidiaries and investment securities. 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.

Cash Flows

	Years ended December 31,		
(in thousands)	**2008**	**2007**	**2006**
Net cash provided by (used in) operating activities	$8,746	$ 2,203	$ (6,200)
Net cash used in investing activities	(801)	(1,806)	(3,829)
Net cash (used in) provided by financing activities	(533)	(1,309)	11,096
Effect of foreign exchange rate change	985		
Net increase (decrease) in cash and cash equivalents	8,397	(912)	1,067

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Operating Activities:

(in thousands)	Years ended December 31, 2008	2007	2006
Cash flows from operating activities:			
Net income	$ 2,530	$ 1,489	$ 5,325
Adjustments to reconcile income to net cash provided by (used in) operating activities:			
Depreciation of property, plant and equipment and properties held for lease	3,373	3,095	2,039
Unrealized (gain) loss on derivatives			(48)
Gain on sales of securities	(49)		
Gain on disposal of property held for lease	(2,210)		
Loss on disposal and write-off of property, plant and equipment	45	45	3
Gain on currency translation	(1,473)		
Allowance for (Reversal of) doubtful debts	1,223	(2)	(40)
Minority interests	6	1	