

## MANAGEMENT DISCUSSION AND ANALYSIS

(Unless otherwise stated, financial data contained herein is extracted from the accounts prepared by the Group in accordance with PRC accounting standards and systems)

### Scope of business

The Company and its subsidiaries ("the Group") are principally engaged in (1) the manufacture and sale of Chinese patent medicine ("CPM"); (2) the wholesales, retail, import and export of Western and Chinese pharmaceutical products and various medical apparatus and (3) research and development of natural medicine and biological medicine.

### 1. The Company's operation during the reporting period

According to the accounts prepared in accordance with PRC accounting standards and systems, the Group's consolidated turnover from principal activities for the six months ended 30th June 2002 was Rmb3,000,883,000, representing an increase of 13.46% over that of the same period of 2001. Profit before taxation amounted to Rmb184,745,000 representing an increase of 21.66% over that of the same period of 2001. Net profit amounted to Rmb106,973,000, representing an increase of 17.86% over that of the same period of 2001.

According to the accounts prepared in accordance with HK GAAP, the Group's consolidated turnover from principal activities for the six months ended 30th June 2002 was Rmb3,000,883,000, representing an increase of 13.46% over that of the same period of 2001. Profit before taxation amounted to Rmb174,010,000, representing an increase of 61.75% over that of the same period of 2001. Net profit amounted to Rmb96,727,000, representing an increase of 85.79% over that of the same period of 2001.

During the first half of 2002, the Group's CPM manufacturing business (the "manufacturing operations") contributed to 30.97% and 78.31% of the Group's turnover and profit before taxation respectively while its trading operations contributed to 69.03% and 21.69% of the Group's turnover and profit before taxation respectively.

An analysis of the Group's turnover and profit from principal activities for the reporting period is set out below: (under PRC accounting standards and systems and HK GAAP)

Area	Turnover		Cost of sales		Profit from principal activities	
	Six months ended 30th June 2002	Six months ended 30th June 2001	Six months ended 30th June 2002	Six months ended 30th June 2001	Six months ended 30th June 2002	Six months ended 30th June 2001
	Rmb'000	Rmb'000	Rmb'000	Rmb'000	Rmb'000	Rmb'000
Manufacturing	929,307	841,457	420,362	394,393	508,945	447,064
Trading:	2,071,576	1,803,514	1,896,560	1,639,612	175,016	163,902
Wholesale	1,852,312	1,588,581	1,720,821	1,468,931	131,491	119,650
Retail	161,940	173,503	122,438	132,203	39,502	41,300
Import and export	57,324	41,430	53,301	38,478	4,023	2,952
	<u>3,000,883</u>	<u>2,644,971</u>	<u>2,316,922</u>	<u>2,034,005</u>	<u>683,961</u>	<u>610,966</u>

## **(1) CPM manufacturing business (the “manufacturing operations”)**

According to the accounts prepared in accordance with PRC accounting standards and systems, turnover of the Group’s manufacturing operations in the first half of 2002 was Rmb929,307,000, representing an increase of 10.44% over that of the same period of 2001. Profit before taxation was Rmb144,675,000, representing an increase of 27.68% over that of the same period of 2001.

According to the accounts prepared in accordance with HK GAAP, turnover of the Group’s manufacturing operations in the first half of 2002 was Rmb929,307,000, representing an increase of 10.44% over that of the same period of 2001. Profit before taxation was Rmb140,980,000, representing an increase of 71.58% over that of the same period of 2001.

In order to be able to react rapidly to the national medical system reform and growing competitive pharmaceutical market, the manufacturing operations have implemented the following procedures. Firstly, the manufacturing operations conducted a number of product promotion campaigns in certain major cities with special focus on the hospital market. Secondly, the manufacturing operations continued expanding its sales network outside Guangdong Province as well as in certain rural areas to secure its market share. Thirdly, the manufacturing operations placed emphasis on the market coverage in its advertising campaigns. Furthermore, the manufacturing operations have carried out a series of marketing information collection and analysis in order to maintain its quality services provided to its customers.

In the first half of 2002, there was a prominent increase in the sales of major products such as Xiao Ke Wan, Hua Lao Ji, She Dan Chuan Bei Ye and Xu Han Ting. The increase in sales of the above products is 14.76%, 25.52%, 44.82% and 89.13%, respectively.

As a result of strengthened cost controls, the unit cost of certain major products has decreased by 3.23%. Operating expenses were also decreased by 1.3% in comparison with last year. This led to the improvement on the manufacturing operation’s operating profit.

During the reporting period, accounts receivable turnover days and inventory turnover days were increased by 18.74% and 12.76% respectively in comparison to last year.

To sustain the Group’s future development, the Group has been upgrading its technology and developing new products. During the reporting period, the manufacturing operations have commenced commercial production of Wei Ren Qing and Fu Yan Xiao Tablet, and have obtained approval for production of 3 newly developed products. There are 14 new products under development.

The Company has accelerated the establishment of Guangzhou Hanfang Modern Chinese Medicine Research and Development Company Limited (“GZ Hanfang”) and Guangzhou Baidi Biological Pharmaceutical Company Limited (“GZ Baidi”) for the purpose of increasing the Group’s technological level on the CPM manufacture and development of biological medicine.

GZ Hanfang’s paid in capital was increased to Rmb50 million on 25th April 2002. The Company holds 90% of its equity. Guangzhou Chen Liji Chinese Medicine Factory holds 4%, the Guangzhou Pharmaceutical Industrial Research Department holds 2.3%, Guangzhou First Chinese Medicine Company Limited holds 2% and Guangzhou Jing Xiu Tang Pharmaceutical Company Limited holds 1.7%. GZ Hanfang has established a modernised laboratory, which is used as a testing and industrialisation base for the research and development of Chinese medicine and study of extraction and purification technology and has taken up the responsibility for some projects such as “Demonstration of the State’s Contemporary Chinese Medicine Technology”. GZ Hanfang is currently conducting research on one Type 1 new medicine, Mao Dong Qing Fu Zhi Na, and five Type 2 new medicines including Si Ni Huan Xi Pian and medicine for compound hypertension.

GZ Baidi’s paid in capital was increased to Rmb50 million on 10th July 2002. The Company holds 92.8% of its equity, Guangzhou Pharmaceutical Industrial Research Department holds 4% and therest of 3.2% is held by its inner staff. GZ Baidi is currently working on certain biological medicine projects such as DNA hepatitis vaccine and reborn impiedent anaemia PHA project.

In order to complete all the GMP certification for the manufacturing operations before 2003, the Company has expedited the technological reform process during the reporting period. The technological reform included construction of new factory plants for GZ First Chinese Medicine and GZ Xing Qun and also some GMP technology upgrade projects undertaken by other manufacturing operations.

At present, the ERP management system is operating in six manufacturing subsidiaries and there is one under the implementation stage.

**(2) Pharmaceutical trading business, including wholesaling, retailing, import and export (the “trading operations”)**

According to the accounts prepared in accordance with PRC accounting standards and systems, turnover of the Group's trading operations in the first half of 2002 was Rmb2,071,576,000, representing an increase of 14.86% over that of the same period of 2001. Profit before taxation of the trading operations was Rmb40,070,000, representing an increase of 3.97% over that of the same period of 2001.

According to the accounts prepared in accordance with HK GAAP, turnover of the Group's trading operations in the first half of 2002 was Rmb2,071,576,000, representing an increase of 14.86% over that of the same period of 2001. Profit before taxation of the trading operations was Rmb33,030,000, representing an increase of 29.98% over that of the same period of 2001.

In the recent years, the State has implemented certain reforms which created severe competition in the pharmaceutical market. They included reform on the employee medicare, pharmaceutical retail market and the tendering system of hospitals. Accordingly, gross profit margin of the trading operations has been decreased by 0.64% as compared with the same period of 2001. The trading operations' inventory turnover days decreased by 21.60%, while accounts receivable turnover days increased by 15.03% in comparison with the same period of 2001.

During the reporting period, the trading operations focused on sourcing and selling new medicines to secure the sales increase of brand-named and core products. In additions, the trading operations have reassessed their penetration into different markets so that sales personnel can provide better after-sales services for those chain store customers. Furthermore, they continued to emphasize on expanding their wholesales and distribution operations. The trading operations have obtained distribution rights for 822 new products, 2 of which the trading operations have exclusive distribution rights. The trading operations have also secured more than 129 new customers. Such measures contributed to the increase in turnover of the trading operations.

The change in pharmaceutical market has driven the trading operations to adjust their marketing strategies on a timely basis. As at 30th June 2002, the Group's retail chain stores increased from 273 as at 31st December 2001 to 294 stores, which included 190 Caizhilin chain stores, which mainly deal with CPM retailing, and 104 Jian Min chain stores, which mainly deal with Western pharmaceutical products retailing.

During the reporting period, the trading operations have fully implemented ERP management system.

## 2. The Company's investment

### Use of net proceeds from issue of A shares

Proceeds from issuing A share have been utilised according to their proposed use as disclosed in the prospectus for issue of A share. During the reporting period, details of the use of proceeds from A share issue are as follows:

Category	Projects	Proposed injection <i>Rmb'000</i>	Funds injected <i>Rmb'000</i>	Status of completion
<b>Project for the technology upgrade and industrialisation of new products</b>				
Pills	Xiaokewan upgrade	29,800	29,800	100%
	Baojiwan upgrade	11,000	11,000	100%
	Commercialisation of Weierqian	29,000	3,700	40%
	Automation of pill production	11,000	5,760	60%
	Technology upgrade of Wahtao pills	17,000	10,440	70%
	Throat, spleen and intestine pills technology upgrade	29,100	13,280	50%
Syrup	Import of the technology for syrup production	29,500	710	25%
	Commercialisation of Keli syrup	19,600	3,240	50%
Granules	Anti-presipriation granules upgrade	12,000	5,610	50%
	Automation of granules upgrade	29,900	29,900	100%
	Flu granules for children upgrade	23,000	23,000	100%
Tablets	Commercialisation of Xiaoyian tablets	29,500	4,980	40%
	Spleen, intestine and pimples tablets upgrade	17,800	2,790	40%
	Gaolu upgrade	29,500	11,750	45%
	Tablets workshop upgrade	12,000	10,720	70%
<b>New Technology Base</b>				
	Modernisation of extraction and purification technology (includes Critical purification of CO2 technology foundation)	59,800	6,000	30%
<b>Trading</b>				
Expanding of retail chain stores				
	Jian Min	89,300	62,910	65%
	Cai Zhi Lin	59,500	16,210	55%
	Logistic centre upgrade	20,000	2,200	30%
	ERP for trading section upgrade	20,000	8,200	35%
	Bio-medicine research centre	80,000	28,920	30%
	Additional working capital	50,000	79,690	100%
Total		<u>708,300</u>	<u>370,810</u>	<u>—</u>

*Note:* The net amount received from issuing A shares totalled Rmb737,990,000. The amount exceeded the budgeted injections amounted to Rmb29,690,000 was used as additional working capital.

Projects completed during the reporting period have contributed economic benefit of Rmb18 million to the Company.

The balance of the proceeds is temporarily placed in banks as working capital. The Company will gradually utilise the fund according to their proposed use.

### Other investment

During the reporting period, the Company has no other investment.

### 3. Financial status (prepared in accordance with PRC accounting standards and systems)

(1) Change of major accounting items:

Items	<b>30th June 2002</b> <i>Rmb</i>	<b>31st December 2001</b> <i>Rmb</i>	<b>Change</b> <i>Rmb</i>	%
Total assets	3,899,072,530.83	3,697,238,505.79	201,834,025.04	5.46%
Cash and cash equivalents	865,150,772.53	867,407,649.48	-2,256,876.95	-0.26%
Accounts receivable	806,581,214.37	547,182,576.57	259,398,637.80	47.41%
Other account receivable	119,535,894.55	134,310,382.41	-14,774,487.86	-11.00%
Inventories	665,446,196.37	833,327,684.61	-167,881,488.24	-20.15%
Long-term investment	173,234,830.98	107,467,122.39	65,767,708.59	61.20%
Net fixed assets	729,965,135.53	707,982,777.15	21,982,358.38	3.10%
Accrued expenses	12,954,759.15	4,553,878.05	8,400,881.10	184.48%
Other account payable	147,637,004.14	151,264,229.61	-3,627,225.47	-2.40%
Tax payable	52,788,031.36	28,911,407.61	23,876,623.75	82.59%
Long-term borrowings	42,000,000.00	10,000,000.00	32,000,000.00	320.00%
Share capital	810,900,000.00	810,900,000.00	0.00	0.00%
Shareholders' equity	2,285,144,274.50	2,172,909,782.86	112,234,491.64	5.17%

	<b>Six months ended 30th June 2002</b> <i>Rmb</i>	<b>Six months ended 30th June 2001</b> <i>Rmb</i>	<b>Change</b> <i>Rmb</i>	%
Sales	3,000,882,903.37	2,644,970,813.82	355,912,089.55	13.46%
Profit from principal operations	670,377,619.25	599,040,209.80	71,337,409.45	11.91%
Financial expenses	7,534,799.14	4,525,182.18	3,009,616.96	66.51%
Income tax	69,144,132.64	54,116,860.58	15,027,272.06	27.77%
Net profit	106,973,391.95	90,763,780.34	16,209,611.60	17.86%

(2) Explanatory notes to the accounts regarding the items involving changes of 30% or above as compared with the corresponding items at the beginning of the year (or the same period of previous year)

- (a) Total assets: During the reporting period, the total assets of the Company increased by 5.46% in comparison to last year. The major reason was due to the current year profit and new borrowings.
- (b) Cash and cash equivalents: Cash and cash equivalents decreased by 0.26% in comparison to last year. The major reason was that the cash outflows for the investments exceeded the cash inflows from operating activities and borrowings.
- (c) Shareholders' equity: Shareholders' equity increased by 5.17% in comparison with last year. The major reason was due to the current year profit.
- (d) Accounts receivable: During the reporting period, accounts receivable of the Company increased by 47.41% in comparison to last year. The major reason was that credit terms extended to those medical institutions were increased from one month to two and three months.
- (e) Accrued expenses: During the reporting period, accrued expenses of the Company increased by 184.48% in comparison with last year. The major reason was mainly due to an increase in repairs and maintenance expenses and advertising expenses accrued for the period.



- (f) Long-term investments: As at 30th June 2002, long-term investment increased by 61.20% in comparison with last year. The reason was due to additional capital injection in GZ Hanfang and GZ Baidi. These two companies were not included in the company's consolidation.
  - (g) Tax payable: During the reporting period, tax payable increased by 82.59% in comparison with last year. The major reason was that the Company had not paid off the income tax and VAT for the period.
  - (h) Long-term bank loans: Long-term bank loans increased by 320% in comparison with last year. The reason was that an addition of Rmb32,000,000 loan was borrowed for financing new technology base.
  - (i) Finance expenses: During the reporting period, financial expenses increased by 66.51% in comparison with last year due to the significant decrease in interest income on bank deposits.
  - (j) Turnover: During the reporting period, turnover increased by 13.46% in comparison with last year. The major reason of the increase was that the Company strengthened promotion effect to improve their product marketability.
  - (k) Profit from principal activities: During the reporting period, profit from principal activities increased by 11.91% in comparison with last year. The increase was due to significant growth in turnover.
  - (l) Net profit: During the reporting period, net profit increased by 17.86% in comparison with last year. The reasons were due to growth in sales and drop in operating expenses.
- (3) Liquidity, financial resources and capital structure
- As at 30th June 2002, the long-term borrowings of the Group amounted to Rmb42 million. These borrowings are fixed interest loans denominated in Rmb, of which Rmb10 million loans are repayable in 2003 and the Rmb32 million loans are repayable in 2005. As at 30th June 2002, the cash and cash equivalents of the Group amounted to Rmb865.15 million, 87% of which is denominated in Rmb and 13% is denominated in Hong Kong dollars.
- (4) Capital expenditure
- The Group expected that the capital expenditure during 2002 would be approximately Rmb340 million. The Group has sufficient financial resources to meet the demand for capital expenditure and daily working capital.
- (5) Exposure to fluctuations in exchange rate
- As the majority of the revenue, expenses, assets and liabilities of the Group are denominated in Rmb, the Group does not have significant risk in exposure to fluctuations in exchange rate.
- (6) Contingent liabilities
- Up to 30th June 2002, the Group has no significant contingent liabilities.
- (7) Charge on the Group assets
- As at 30th June 2002, the net book value of fixed assets pledged as security for the Group's bank borrowings amounted to Rmb207.21 million.

#### **4. Prospects for the 2nd half of 2002**

In the second half of 2002, the Group plans 1) to increase marketing activities with a view to maintaining the sales growth of major products, 2) to give priority to those technology upgrade projects by utilizing the proceeds from issuing the A share for sustaining growth on its market share, 3) to accelerate its research and development capabilities especially on the CPM manufacturing and biology medicine products, and 4) to try its utmost to achieve a full scale ERP management system implementation by the end of 2002.