

MANAGEMENT DISCUSSION AND ANALYSIS

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

Scope of business

The Group is principally engaged in (1) manufacture and sales of Chinese Patent Medicine ("CPM"); (2) wholesale, retail, import and export of western and Chinese pharmaceutical products and medical apparatus and (3) research and development of natural medicine and biological medicine.

1 Analysis of operating results

According to the interim financial report prepared in accordance with PRC accounting standards and systems, the Group's turnover for the six months ended 30th June 2003 was Rmb3,577,432,000, representing an increase of 19.21% over that of the same period of 2002. Profit before taxation was Rmb162,799,000, representing a decrease of 11.88% over that of the same period of 2002. Net profit was Rmb93,613,000, representing a decrease of 12.49% over that of the same period of 2002.

According to the interim financial report prepared in accordance with HKGAAP, the Group's turnover for the six months ended 30th June 2003 was Rmb3,577,432,000, representing an increase of 19.21% over that of the same period of 2002. Profit before taxation was Rmb161,734,000, representing a decrease of 7.05% over that of the same period of 2002. Net profit was Rmb91,102,000, representing a decrease of 9.58% over that of the same period of 2002.

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

Segment	Turnover		Cost of sales		Gross profit	
	For the six months ended 30th June 2003 <i>Rmb'000</i>	For the six months ended 30th June 2002 <i>Rmb'000</i>	For the six months ended 30th June 2003 <i>Rmb'000</i>	For the six months ended 30th June 2002 <i>Rmb'000</i>	For the six months ended 30th June 2003 <i>Rmb'000</i>	For the six months ended 30th June 2002 <i>Rmb'000</i>
Manufacturing:	970,509	929,307	451,384	420,362	519,125	508,945
Trading:	2,606,923	2,071,576	2,409,410	1,896,560	197,513	175,016
Wholesale	2,315,062	1,852,312	2,169,597	1,720,821	145,465	131,491
Retail	190,793	161,940	144,714	122,438	46,079	39,502
Import and export	101,068	57,324	95,099	53,301	5,969	4,023
Total	3,577,432	3,000,883	2,860,794	2,316,922	716,638	683,961

Geographical analysis of sales arising from manufacturing and trading operations of the Group is as follows:

Area	Manufacturing		Trading		Total	
	Turnover Rmb'000	%	Turnover Rmb'000	%	Turnover Rmb'000	%
Southern China	612,793	63.14%	2,183,379	83.76%	2,796,172	78.16%
Eastern China	126,080	12.99%	123,805	4.75%	249,885	6.99%
Northern China	85,119	8.77%	71,645	2.75%	156,764	4.38%
North-eastern China	54,835	5.65%	55,337	2.12%	110,172	3.08%
South-western China	46,995	4.84%	96,302	3.69%	143,297	4.01%
North-western China	29,406	3.03%	38,930	1.49%	68,336	1.91%
Export	15,281	1.57%	37,525	1.44%	52,806	1.48%
Total	<u>970,509</u>	<u>100.00%</u>	<u>2,606,923</u>	<u>100.00%</u>	<u>3,577,432</u>	<u>100.00%</u>

During the reporting period, the outbreak of Severe Acute Respiratory Syndrome (the "SARS") in the Guangdong province and other regions of China carried a series of impact on domestic pharmaceutical market: (1) demand for certain pharmaceutical products changed significantly; (2) purchases from medical institutions dropped tremendously in some areas due to the decrease in the number of inpatients; (3) gross profit margin of manufacturing operations decreased as a result of the increase in cost of certain raw materials. All of these factors adversely affected on the operating results of the Group.

(1) CPM manufacturing business (the "manufacturing operations")

According to the interim financial report prepared in accordance with PRC accounting standards and systems, turnover of the Group's manufacturing operations in the first half of 2003 was Rmb970,509,000, representing an increase of 4.43% over that of the same period of 2002. Profit before taxation was Rmb122,055,000, representing a decrease of 15.63% over that of the same period of 2002;

According to the interim financial report prepared in accordance with HKGAAP, turnover of the Group's manufacturing operations was Rmb970,509,000, representing an increase of 4.43% over that of the same period of 2002. Profit before taxation was Rmb121,898,000, representing a decrease of 13.54% over that of the same period of 2002.

The manufacturing operations have taken certain remedial actions for this dynamic domestic pharmaceutical market. Firstly, the manufacturing operations have taken full advantage of and reacted positively to the changing market, and have done their best to emphasise on the production and promotion of the SARS related products to satisfy the increasing market demand. Secondly, the manufacturing operations have conducted a series of promotional campaigns related to pharmaceutical technology to the end-user markets, and have emphasised on maintaining good customer relationship to mitigate the side-effects brought by the SARS. Thirdly, the manufacturing operations have been keen to explore and develop products with high market potential and to improve their marketing and promotional campaign so as to sharpen their competitive edge.

In the first half of 2003, the sales of certain products, such as Wang Lao Ji Liang Cha, Xu Han Ting Ke Li, Xia Sang Ju, She Dan Chuan Bei Pipa Gao and Qing Re An Chang Pian, significantly increased by 33.62%, 58.70%, 22.55%, 113.68% and 40.71%, respectively.

During the reporting period, sales of diabetic medicine decreased by 18.43% due to the SARS. Due to price fluctuation of certain raw materials and package materials, gross profit margin of the manufacturing operations in the first half of 2003 also decreased by 1.28% over the same period of 2002.

Sales analysis of major products is as follows:

Product	Six months ended 30th June 2003	
	Turnover Rmb'000	Gross profit Rmb'000
Heat clearing and anti-toxic	275,670	138,150
Diabetic medicine	150,710	96,320
Cough and phlegm clearing	133,160	62,190
Arthritic medicine	101,290	61,370
Gastric medicine	55,270	26,010

During the reporting period, the Group continuously strengthened the development of new products, especially those already in the 2nd phase process. Four new products have commenced production and three new products passed the development stage. 12 projects are under research and development stage, such as “Feng Shi Ping Jiao Nang” and “Fan Xi Luo Wei Ruan Jiao Nang”. Besides, “Feng Shi Ping Jiao Nang” is undergoing the 3rd clinic testing phase.

The Group concentrated on accelerating the process of the technology upgrades. During the reporting period, Guangzhou Huanye Medicine Manufacturing Co., Ltd. has been granted the GMP certification for its completed renovation for its raw medicine workshop. Guangzhou Jin Xiu Tang has also completed the construction projects for adhesive plaster workshop, distilling workshop, pre-processing workshop and warehouse. Guangzhou Qi Xing Pharmaceutical Co., Ltd.’s (“Guangzhou Qi Xing”) pill and keli syrup workshop upgrade and Guangzhou Qing Qun’s automation of granules upgrade have already commenced operations. Gaolu workshop and technology upgrade of syrup production of Guangzhou Pan Gao Shou, tablets and syrup workshop of Guangzhou Yang Cheng and the new factory plants of Guangzhou Xing Qun and Guangzhou First Chinese Medicine Company Limited (“First Medicine”) are still under construction.

During the reporting period, the ERP system has been implemented in 7 manufacturing subsidiaries. At present, the Group is in the process of implementing the ERP system and decision-making supporting system for the trading operations.

(2) Pharmaceutical trading business (including wholesale, retail, import and export) (the “trading operations”)

According to the interim financial report prepared in accordance with PRC accounting standards and systems, turnover of the Group’s trading operations in the first half of 2003 was Rmb2,606,923,000, representing an increase of 25.84% over that of the same period of 2002. Profit before taxation was Rmb40,744,000, representing an increase of 1.68% over that of the same period of 2002;

According to the interim financial report prepared in accordance with HKGAAP, turnover of the Group’s trading operations was Rmb2,606,923,000, representing an increase of 25.84% over that of the same period of 2002. Profit before taxation was Rmb39,836,000, representing an increase of 20.61% over that of the same period of 2002.

Due to the impact of the tendering system adopted by hospitals and the changes in the State pricing policy for pharmaceutical products, gross profit margin of the trading operations in the first half of 2003 decreased by 0.87% over the same period of 2002 and accounts receivable balances increased significantly by 39.52% as well.

During the reporting period, the trading operations made all efforts to react to the severe market competition. Firstly the trading operations adjusted their sales policies for the dynamic market changes. They focused on the logistic management for the SARS related medicines and tried to maintain the stability of their market share. The trading operations have also strengthened the promotional activities on the SARS related medicines to ensure continual sales growth in the first half of 2003. Secondly, the trading operations has kept on exploring new products and certain famous pharmaceutical products and to secure their distribution rights in order to maintain the market share. Thirdly, the trading operations have proactively explored potential markets. During the reporting period, the trading operations have set up representative offices in Shenzhen City and Shantou City. At the same time, they paid attention to the development of OTC medicines and expansion of sales network outside Guangdong province. All these have helped to improve the reputation and strengthen competitiveness of the trading operations. Fourthly, the trading operations have done their best to secure the share in the end-user market, surrounding by favourable factors of its chained pharmacies of Cai Zhi Lin and Jian Min and excellent sales services. As at 30th June 2003, the Group has 267 chained pharmacies, including 162 Cai Zhi Lin pharmacies, which mainly carry CPM, and 105 Jian Min pharmacies, which mainly carry western pharmaceutical products. Finally, the trading operations have accelerated the progress of upgrading logistic centre. The major part of this project has been completed and parts of the warehouse have been in use.

During the reporting period, sales of wholesaling and retailing operations were respectively increased by 24.98% and 17.82% over the same period of 2002.

2 During the reporting period, the Group did not carry out any other business which has significant impact on the Group’s net profit.

3 During the reporting period, the Group has no investment which derived income equal to 10% or more of the Group’s net profit.

4 The Company's investment

(1) Use of net proceeds from issuing A shares

At the end of the reporting period, the use of proceeds from the issue of A shares was in line with the prospectus for issuing of A shares:

Category	Projects	Proposed injection Rmb'000	Funds injected Rmb'000	Status of completion %
Project for the technology upgrade and industrialisation of new products				
Pills	Xiao Ke Wan upgrade	29,800	29,800	100
	Bao Ji Wan upgrade	11,000	11,000	100
	Commercialisation of Wei Re Qing	29,000	7,990	80
	Automation of pill production	11,000	10,260	100
	Technology upgrade of Hua Tuo Pills	17,000	16,850	100
	Throat, spleen and intestine pills technology upgrade	29,100	15,050	60
Syrup	Technology upgrade of syrup production	29,500	13,710	60
	Commercialisation of Ke Gan Li Yan syrup	19,600	10,750	70
Granules	Anti-perspiration granules upgrade	12,000	11,350	100
	Automation of granules upgrade	29,900	29,900	100
	Flu granules for children upgrade	23,000	23,000	100
Tablets	Commercialisation of Xiao Yin tablets	29,500	8,640	45
	Spleen, intestine and pimples tablets upgrade	17,800	13,260	70
	Gaolu upgrade	29,500	29,500	60
	Tablets workshop upgrade	12,000	12,000	100
Industrialisation foundation				
	Modernisation of extraction and purification technology	29,900	16,030	40
	Critical purification of CO2 technology foundation	29,900	-	-
Trading				
	Expanding of retail chain pharmacies			
	Jian Min	89,300	62,910	65
	Cai Zhi Lin	59,500	20,160	60
	Logistic centre upgrade	20,000	20,000	50
	ERP for trading section upgrade	20,000	10,840	50
	Bio-medical research centre	80,000	45,930	50
	Additional working capital	50,000	79,690(Note)	-
Total		<u>708,300</u>	<u>498,620</u>	<u>-</u>

Note: The net proceeds from issuing of A shares were Rmb737,990,000. The portion exceeded the budgeted proceeds amounting to Rmb29,690,000 was used as additional working capital.

Explanatory note on returns on projects and delay in completion of certain projects

During the reporting period, additional sales and gross profit from the completed projects amounted to Rmb250,430,000 and Rmb130,500,000 respectively. Due to plant relocation, technology upgrade for syrup production was delayed. Expansion of chained pharmacies also slowed down because of the severe competition in the retailing sector. The traffic re-construction in the Guangzhou City led to the delay in the construction of the logistic centre project, the construction of which is still in progress.

(2) Other investment

With the approval from the Investment Management Committee of the Company on 26th May 2003, the Company entered into a joint venture agreement with Guangdong New Greenery Life Technology Co., Ltd. to establish an enterprise, Guangzhou Jin Shen Pharmaceutical Technology Co., Ltd. ("Jin Shen"). The purpose of establishing Jin Shen is to develop and to sell health-care food and natural-ingredient products. The Company is the major shareholder and its investment in Jin Shen amounted to Rmb675,000, representing 45% of total equity thereof. The establishment of Jin Shen is still in process.

5 Financial status (prepared in accordance with PRC accounting standards and systems)

(1) Change of major accounting items:

	For the six months ended 30th June 2003 <i>Rmb</i>	For the six months ended 30th June 2002 <i>Rmb</i>	Change <i>Rmb</i>	%
Turnover from principal activities	3,577,432,478.96	3,000,882,903.37	576,549,575.59	19.21
Profit from principal activities	704,017,563.16	670,377,619.25	33,639,943.91	5.02
Financial expenses	9,745,954.57	7,534,799.14	2,211,155.43	29.35
Income tax	60,757,080.64	69,144,132.64	(8,387,052.00)	(12.13)
Net profit	93,613,387.19	106,973,391.95	(13,360,004.76)	(12.49)
Decrease in cash and cash equivalents	127,760,262.46	(2,256,876.95)	(125,503,385.51)	(5,560.93)
	At 30th June 2003 <i>Rmb</i>	At 31st December 2002 <i>Rmb</i>	Change <i>Rmb</i>	%
Total assets	4,460,610,581.03	4,173,194,491.19	287,416,089.84	6.89
Accounts receivable	1,009,479,818.74	716,482,532.62	292,997,286.12	40.89
Other receivables	167,803,876.13	122,975,499.77	44,828,376.36	36.45
Inventories	862,206,587.39	848,519,074.31	13,687,513.08	1.61
Long-term investment	86,016,292.53	86,789,969.55	(773,677.02)	(0.89)
Net fixed assets	927,461,719.21	775,707,985.29	151,753,733.92	19.56
Accrued expenses	14,935,569.23	4,625,106.82	10,310,462.41	222.92
Other payables	136,336,249.99	124,069,695.90	12,266,554.09	9.89
Tax payable	37,383,884.41	48,773,628.89	(11,389,744.48)	(23.35)
Long-term borrowings	107,180,000.00	89,680,000.00	17,500,000.00	19.51
Share capital	810,900,000.00	810,900,000.00	—	—
Shareholders' equity	2,384,160,418.04	2,286,928,678.67	97,231,739.37	4.25

(2) Explanatory notes on the items with changes of 30% or above (as compared with the corresponding figures 2002)

- (a) Financial expenses: During the reporting period, financial expenses increased by 29.35% in comparison with the same period of 2002 due to the significant increase in bank borrowings.
- (b) Cash and cash equivalents: Cash and cash equivalents decreased by 5,560.93% in comparison with 2002. The major reason was that the cash inflows from operating activities and financing activities decreased.
- (c) Accounts receivable: As at 30th June 2003, accounts receivable of the Group increased by 40.98% in comparison with 2002. The major reasons for the increase were : 1) significant increase in credit sales; 2) credit terms extended to those medical institutions were increased as a result of implementing the tendering system; 3) delay repayment by customers due to SARS.
- (d) Other receivable: As at 30th June 2003, other receivable of the Group increased by 36.45% in comparison with 2002. The reason was due to large amount of prepayments for machineries and constructions in progress.
- (e) Accrued expenses: As at 30th June 2003, accrued expenses increased by 222.92% in comparison with 2002. The reason was due to the accrual of advertising expenses, repair and maintenance expenses and research and development expenses.

(3) Liquidity, financial resources and capital structure

As at 30th June 2003, long-term borrowings of the Group amounted to Rmb117,180,000 (of which Rmb10,000,000 are repayable within one year). These borrowings are fixed interest loans denominated in Rmb, of which Rmb20,000,000 are repayable in 2004, Rmb27,680,000 repayable in 2005 and Rmb59,500,000 repayable in 2006. As at 30th June 2003, cash and cash equivalents of the Group amounted to Rmb892,140,000, of which 89.40% is denominated in Rmb and 10.60% is denominated in Hong Kong dollars.

(4) Capital expenditure

The Group expected that capital expenditure for the year 2003 will be approximately Rmb291 million and actual expenditure in the first half of 2003 amounted to Rmb136 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 2003, the Group has no significant contingent liabilities.

(7) Charge on the Group assets

As at 30th June 2003, the net book value of fixed assets pledged as security for bank borrowings granted to the Group amounted to Rmb97,260,000.