5. MANAGEMENT DISCUSSION AND ANALYSIS

(Unless otherwise stated, the financial data contained in this report is extracted from the financial statements prepared in accordance with PRC Accounting Standards and Systems.)

The Company and its subsidiaries (collectively the "Group") are 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.

5.1 ANALYSIS OF OPERATING RESULTS OF THE GROUP FOR THE REPORTING PERIOD

According to PRC Accounting Standards and Systems, the Group's turnover for the six months ended 30th June 2004 was approximately RMB3,990,694,000, representing an increase of 11.55% over that of the same period of 2003. Profit before taxation was approximately RMB91,053,000, representing a decrease of 44.07% over that of the same period of 2003. Net profit was approximately RMB31,809,000, representing a decrease of 66.02% over that of the same period of 2003.

According to HK GAAP, the Group's turnover for the six months ended 30th June 2004 was approximately RMB3,990,729,000, representing an increase of 11.55% over that of the same period of 2003. Profit before taxation was RMB88,570,000, representing a decrease of 45.24% over that of the same period of 2003. Profit attributable to shareholders was approximately RMB34,076,000, representing a decrease of 62.60% over that of the same period of 2003.

An analysis of the Group's turnover and gross profit from CPM manufacturing operations (the "Manufacturing Operations") and trading operations (the "Trading Operations") for the first six months of 2004 is set out as follows:

By segment	**Turnover**		**Cost of sales**		**Gross profit**	
	Under PRC Accounting Standards and Systems	**Under HK GAAP**	**Under PRC Accounting Standards and Systems**	**Under HK GAAP**	**Under PRC Accounting Standards and Systems**	**Under HK GAAP**
	RMB'000	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*
Manufacturing	982,389	982,424	457,111	457,305	525,278	525,119
Trading	3,008,305	3,008,305	2,815,155	2,815,155	193,150	193,150
Including:						
Wholesale	2,788,061	2,788,061	2,627,346	2,627,346	160,715	160,715
Retail	123,158	123,158	96,586	96,586	26,572	26,572
Import and export	97,086	97,086	91,223	91,223	5,863	5,863
Total	3,990,694	3,990,729	3,272,266	3,272,460	718,428	718,269

Geographical analyses of sales from manufacturing and trading operations are set out as follows:

	Manufacturing		**Trading**		**Total**	
Area	**Turnover**	**% to total turnover of manufacturing**	**Turnover**	**% to total turnover of trading**	**Turnover**	**% to total turnover**
	RMB'000		*RMB'000*		*RMB'000*	
Southern China	571,948	58.22	2,511,182	83.48	3,083,130	77.26
Eastern China	135,702	13.81	150,981	5.02	286,683	7.18
Northern China	94,220	9.59	70,709	2.35	164,929	4.13
North-Eastern China	67,277	6.85	68,233	2.27	135,509	3.40
South-Western China	60,488	6.16	107,686	3.58	168,174	4.21
North-Western China	38,359	3.90	54,248	1.80	92,607	2.32
Export	14,395	1.47	45,267	1.50	59,662	1.50
Total	982,389	100.00	3,008,305	100.00	3,990,694	100.00

5.1.1 CPM manufacturing operations

During the first half of 2004, the slowing down of growth in sales of certain products of the Manufacturing Operations and the decrease in operating results were caused by keen competition in the domestic pharmaceutical market, increase in production cost pursuant to Good Manufacturing Practice ("GMP") renovation in relation to quality of production management and the restrictions imposed through national advertising policies. To overcome the above difficulties and to sustain growth in sales, the Group has strengthened the promotion of key products and enhanced its marketing efforts at end-users such as hospitals, community and pharmacies.

According to PRC Accounting Standards and Systems, turnover of the Group attributable to the Manufacturing Operations for the first half of 2004 was approximately RMB982,389,000, representing an increase of 1.22% over that of the same period of 2003. Profit before taxation was approximately RMB102,184,000, representing a decrease of 16.28% over that of the same period of 2003. According to HK GAAP, turnover of the Group attributable to the Manufacturing Operations for the first half of 2004 was approximately RMB982,424,000, representing an increase of 1.23% over that of the same period of 2003. Profit before taxation was RMB99,359,000, representing a decrease of 18.49% over that of the same period of 2003.

In the first half of 2004, sales of certain products, including Wang Lao Ji Liang Cha, Ru He San Jie Pian, Xin Yi Bi Yan Wan, Hua Zhi Quan, An Shen Bu Nao Ye and Zhuang Yao Jian Shen Xiao Wan, have significantly increased by 47.66%, 43.11%, 41.04%, 55.77%, 86.36% and 31.89% respectively as compared with the corresponding period of 2003. Sales of other products, including She Dan Chuan Bei Ye and Mi Lian Chuan Bei Pi Pa Gao, has significantly decreased by 42.22% and 33.26% respectively over that of the same period of 2003.

Analysis of sales of major products of the Manufacturing Operations for the six months ended 30th June 2004 is as follows:

Products	**Turnover** *RMB'000*	**Gross profit** *RMB'000*
Heat clearing and anti-toxic medicine	240,651	116,008
Diabetic medicine	181,508	124,474
Cough and phlegm clearing medicine	96,073	40,823
Arthritic medicine	107,756	68,618
Gastric medicine	50,880	22,870

During the reporting period, inventory turnover days of the Manufacturing Operations were 101.78 days, representing an increase of 1.78 days over the corresponding period in 2003. Accounts receivable turnover days were 35.12 days, representing an increase of 5.14 days as compared with the corresponding period of 2003.

During the reporting period, the Group continued accelerating the process of research and development of new products and further development of certain existing key products. During the reporting period, research for 3 products has been completed and they are currently in the process of applications for new drug certifications, while 2 products are under research. Besides, "Feng Shi Ping Jiao Nang" has successfully passed the third clinic testing phase and is now in the process of applying for production certification.

During the reporting period, 7 out of 9 manufacturing subsidiaries have been granted with GMP certification. Manufacturing subsidiaries namely Guangzhou Zhong Yi Pharmaceutical Co., Ltd. and Guangxi Ying Kang Pharmaceutical Co., Ltd. have speeded up the process of GMP renovation and are trying their best to pass the GMP certification before the stipulated deadline.

During the reporting period, the enterprise resources planning system (ERP system) has been fully implemented and is operating in 7 manufacturing subsidiaries.

5.1.2 Pharmaceutical products trading operations (including wholesale, retail, import and export)

The implementation of Good Supply Practice ("GSP") in relation to quality of trading management, the changes in the national pricing policy on pharmaceutical products and fierce competition in the domestic pharmaceutical market resulting from the market entry of large number of pharmacies offering lower selling price have brought about direct impact on the domestic pharmaceutical industry. The above factors have also caused certain impact on the Group's Trading Operations.

During the reporting period, the Trading Operations made efforts as follows: Firstly, the continued active development of agency, distribution and wholesale business for popular, new and specially good effect medicines. Meanwhile, the development of markets outside Guangdong Province through the advantage of agency distribution network of various brandnamed products. Secondly, the active improvement in the tender for hospital projects, with a view to increasing sales of the Group's products to hospitals. Thirdly, the adoption to changes in the pharmaceutical retail network in response to market changes and taking advantage of brandnamed "Jian Min" and "Cai Zhi Lin" to develop flagship shops and community center shops to compete with the pharmacies offering lower selling price.

The implementation of the above measures have attained favorable results. Turnover of the Trading Operations has maintained steady growth. Turnover of the Trading Operations prepared under PRC Accounting Standards and Systems for the first half of 2004 was approximately RMB3,008,305,000, representing 15.40% increase over that of the same period of 2003. Turnover of the Trading Operations prepared under HK GAAP for the first half of 2004 was approximately RMB3,008,305,000, representing 15.40% increase over that of the same period of 2003.

Loss before taxation of the Trading Operations prepared under PRC Accounting Standards and Systems amounted to approximately RMB11,130,000, representing a significant decrease of 127.32% over that of the same period of 2003. Loss before taxation of the Trading Operations prepared under HK GAAP was RMB10,789,000, representing a significant decrease of 127.08% over that of the same period of 2003. Main reasons for the significant decrease in operating results are:

1) As affected by the market entry of large number of pharmacies offering lower selling price and national pricing policy on pharmaceutical products, the Group's gross margin ratio continued to drop to 6.42%, representing a decrease of 1.61% over that of the same period of 2003.

2) During the reporting period, Guangzhou Chinese Medicine Corporation, a subsidiary of the Company, has made a provision for inventories amounting to approximately RMB24,494,000 and redundancy payments to laid-off workers as compensation amounting to approximately RMB7,921,000. The above factors have significant impact on the overall operating results of the Group during the reporting period.

As at 30th June 2004, the Group has 215 chain pharmacies, including 121 "Cai Zhi Lin" which specializes in traditional Chinese medicine ("TCM") chain pharmacies and 94 "Jian Min" which specializes in western medicine chain pharmacies.

During the reporting period, "Huang Jin Wei", a modernised pharmaceutical logistics centre invested by the Company, has been put into use. It is the largest pharmaceutical logistics centre in Southern China in terms of area with the highest handling capacity, indicating that the distribution capability of the Group has been further improved.

GSP certification of the trading subsidiaries of the Company had been completed as planned. At present, the Company is in the process of implementating the ERP system in the Trading Operations.

5.2 DURING THE REPORTING PERIOD, THE GROUP DID NOT CARRY OUT ANY OTHER BUSINESS OPERATION WHICH HAS SIGNIFICANT IMPACT ON THE GROUP'S NET PROFIT.

5.3 DURING THE REPORTING PERIOD, THE GROUP HAS NO INVESTMENT WHICH DERIVED INVESTMENT INCOME EQUAL TO 10% OR MORE OF THE GROUP'S NET PROFIT.

5.4 THE COMPANY'S INVESTMENTS

5.4.1 Use of net proceeds from the issue of A shares

As at 30th June 2004, the use of the proceeds from the issue of A shares was in line with the undertakings made in the prospectus for the issue of A shares.

Category	Projects	Budgeted injection *RMB'000*	Amount injected *RMB'000*	Status of completion *(%)*
Projects for the technology upgrade and industrialization of new products				
Pills	Xiao Ke Wan upgrade	29,800	29,800	100
	Bao Ji Wan upgrade	11,000	11,000	100
	Industrilisation of Wei Re Qing	29,000	20,970	82
	Automation of pill production	11,000	11,000	100
	Technology upgrade of Hua Tuo Zai Zao Wan	17,000	17,000	100
	Technology upgrade of throat, spleen and intestine pills	29,100	17,580	70
Syrup	Technology upgrade for syrup production	29,500	29,500	100
	Industrialisation of Ke Gan Li Yan Syrup	19,600	19,600	100
Granules	Technology upgrade of Xu Han Ting Granules	12,000	12,000	100
	Automation of granules upgrade	29,900	29,900	100
	Technology upgrade of flu granules for children	23,000	23,000	100
Tablets	Industrilisation of Fu Yan Xiao Solutable Tablets	29,500	19,840	68
	Technology upgrade of spleen, intestine and pimples tablets	17,800	17,800	100
	Technology upgrade of syrup workshops	29,500	29,500	100
	Technology upgrade of suppository workshops	12,000	12,000	100
Industrialization foundations				
Modernisation of extraction and purification technology		29,900	21,570	90
Critical purification of CO_2 technology foundation		29,900	19,950	90
Trading				
Expansion of chain pharmacies				
Jian Min		89,300	85,400	95
Cai Zhi Lin		59,500	21,750	63
Logistics centre upgrade		20,000	20,000	100
ERP upgrade for the Trading Operations		20,000	15,620	80
Bio-tech research centre		80,000	55,490	68
Additional working capital		50,000	79,690 (Note)	—
Total		708,300	619,960	

Note: The net proceeds from the issue of A shares were approximately RMB 737,990,000. The portion exceeding the budgeted proceeds (amounting to approximately RMB29,690,000) was used as additional working capital.

Explanatory note on return on projects and delay in completion of certain projects:

During the reporting period, additional sales and gross profit from the completed projects amounted to approximately RMB587,820,000 and RMB162,570,000, respectively. Due to plant relocation, industrialization of Fu Yan Xiao Solutable Tablets and industrialization of Wei Re Qing are expected to be completed by the end of 2004. Expansion of chain pharmacies also slowed down because of the severe competition in the retail sector.

5.4.2 Other investments

During the reporting period, other investments are as follows:

(1) As approved at the meeting of the Investment Management Committee of the Company held on 12th January 2004, the Company injected RMB 90,000 to Guangzhou Jin Shen Pharmaceutical Co., Ltd. ("GZ Jin Shen"). After that, the Company has invested a total of RMB 765,000 in GZ Jin Shen, representing 38% of the equity interest.

(2) As approved at the meeting of the Investment Management Committee of the Company held on 18th February 2004, the Company injected an investment of RMB21,717,000 in cash into Guangxi Ying Kang Pharmaceutical Co., Ltd, representing 51% of total equity interest thereof.

(3) As approved at the meeting of the Investment Management Committee of the Company held on 18th May 2004, Guangzhou Pharmaceutical Corporation, a subsidiary of the Company, has invested RMB 250,000 to Guangzhou Lian Jie Computer Technology Co., Ltd., representing 50% of the equity interest thereof.

(4) As approved at the meeting of the Investment Management Committee of the Company held on 21st June 2004, the Company has additionally injected RMB1,200,000 to the associated company, Jihua Medical Appliance Company Limited, on a pro rota basis based on the 24% of the equity interest.

5.5 FINANCIAL CONDITIONS (PREPARED IN ACCORDANCE WITH PRC ACCOUNTING STANDARDS AND SYSTEMS)

5.5.1 Change of major accounting items:

	For the six months ended 30th June 2004	For the six months ended 30th June 2003	**Changes**	
	RMB	*RMB*	Amount *RMB*	*(%)*
Revenues from main operations	**3,990,694,132.12**	3,577,432,478.96	413,261,653.16	11.55
Profit from main operations	**704,733,704.92**	704,017,563.16	716,141.76	0.10
Financial expenses	**17,684,980.77**	9,745,954.57	7,939,026.20	81.46
Income tax	**52,938,643.69**	60,757,080.64	(7,818,436.95)	(12.87)
Net profit	**31,808,644.71**	93,613,387.19	(61,804,742.48)	(66.02)
Net increase in cash and cash equivalents	**44,574,144.24**	(127,760,262.46)	172,334,406.70	134.89

	As at 30th June 2004	As at 31st December 2003	**Changes**	
	RMB	*RMB*	Amount *RMB*	*(%)*
Total assets	**4,887,994,454.22**	4,707,039,445.98	180,955,008.24	3.84
Accounts receivable	**1,152,103,215.38**	878,361,678.85	273,741,536.53	31.17
Other receivables	**180,942,926.43**	130,980,738.37	49,962,188.06	38.14
Inventories	**846,378,572.62**	1,067,439,529.10	(221,060,956.48)	(20.71)
Long-term investments	**78,184,066.12**	74,867,192.97	3,316,873.15	4.43
Net fixed assets	**1,108,119,724.86**	981,069,314.32	127,050,410.54	12.95
Accrued expenses	**7,396,467.46**	4,456,292.55	2,940,174.91	65.98
Other payables	**243,663,221.19**	199,619,096.28	44,044,124.91	22.06
Taxes payable	**28,524,842.79**	21,605,390.47	6,919,452.32	32.03
Long-term loans	**127,180,000.00**	107,180,000.00	20,000,000.00	18.66
Share capital	**810,900,000.00**	810,900,000.00	—	—
Shareholders' equity	**2,413,697,962.22**	2,429,476,382.41	(15,778,420.19)	(0.65)

5.5.2 Explanatory notes on the items with changes of 30% or more (as compared with the comparative figures in 2003)

(a) Financial expenses: During the reporting period, financial expenses increased by 81.46% in comparison with the same period of 2003 due to the significant increase in long-term borrowings and discount interest.

(b) Net profit: During the reporting period, net profit decreased by 66.02% in comparison with the same period of 2003 due to the significant increase of stock provision of RMB24,494,000 and redundancy payments for laid-off staff accrued by Guangzhou Chinese Medicine Corporation, a subsidiary of the Company.

(c) Cash and cash equivalents: Cash and cash equivalents increased by 134.89% in comparison with 2003. The major reason was that the cash inflows from operating activities increased as compared with the same period of 2003.

(d) Accounts receivable: As at 30th June 2004, accounts receivable increased by 31.71% in comparison with 2003 due to the longer credit term offered to hospitals.

(e) Other receivables: As at 30th June 2004, other receivables of the Group increased by 38.14% in comparison with 2003. The reason was due to the balance due from third parties increased.

(f) Accrued expenses: As at 30th June 2004, accrued expenses increased by 65.98% in comparison with 2003 due to the accrual of advertising.

(g) Taxes payable: As at 30th June 2004, taxes payable increased by 32.03% in comparison with 2003 due to the increase of VAT payable.

5.5.3 Liquidity, financial resources and capital structure

As at 30th June 2004, the current ratio of the Group was 1.59 and quick ratio was 1.18. Accounts receivable turnover rate was 8.66, and inventory turnover rate was 6.75, representing a decrease of 6.12% and 3.62% respectively as compared with the same period of 2003.

As at 30th June 2004, long-term borrowings of the Group amounted to RMB127,180,000 (as at 31st December 2003: RMB107,180,000). These borrowings are fixed interest loans denominated in RMB, out of which RMB47,680,000 are repayable in 2005 and RMB79,500,000 repayable in 2006. As at 30th June 2004, cash and cash equivalents of the Group amounted to RMB861,010,000, of which 97.49% is denominated in RMB and 2.51% is denominated in Hong Kong dollars.

5.5.4 Capital expenditure

The Group expected that capital expenditure for the year 2004 will be approximately RMB367 million (2003: RMB363 million) and actual expenditure in the first half of 2004 amounted to RMB120 million (the same period in 2003: RMB136 million). The Group has sufficient financial resources to meet the demand for capital expenditure and daily working capital requirements.

5.5.5 Exposure to fluctuations in exchange rate

As the majority of revenues, expenses, assets and liabilities of the Group are denominated in RMB, the Group does not have significant exposure to fluctuations in exchange rate.

5.5.6 Contingent liabilities

Up to 30th June 2004, the Group has no significant contingent liabilities.

5.5.7 Charge on Group assets

As at 30th June 2004, the net book value of fixed assets pledged as security for bank loans granted to the Group amounted to RMB105,440,000.

5.6 THE ISSUES AND DIFFICULTIES ENCOUNTERED IN OPERATIONS AND OPERATION PLANS FOR THE SECOND HALF OF 2004

The following factors had certain impact on the Group operations, including (i) the implementation of the national regulations on pharmaceutical products, which led to the reduction in the price of certain pharmaceutical products; (ii) production cost of the Manufacturing Operations increased as a result of the implementation of GMP renovation; (iii) significant number of pharmacies offering lower selling price led to the increasingly fierce competition in the domestic pharmaceutical market.

Due to severe competition in the domestic pharmaceutical market, the operating result of Guangzhou Chinese Medicine Corporation, a subsidiary of the Company, decreased significantly and it made provision for part of inventory. The factors resulted in net profit of the Group decreasing 66.02% comparing with the amount in the same period of 2003 and are forecasted to have significant impact on the operating results of the Group in the next reporting period.

The Company took certain actions in view of the severe market conditions and problems encountered in operations. The measures include strengthening the marketing and promotion of certain key products, accelerating the process of the technology upgrade and seeking opportunities for co-operations with other pharmaceutical enterprises. At the same time, the Company set up a working group to implement reformation of Guangzhou Chinese Medicine Corporation. The above implementations have achieved certain positive effects.

In the second half of 2004, the Company will actively react to the problems and difficulties in order to reverse the adverse conditions in the first half year through the following:

1. To further strengthen the marketing and promotion of certain key products and certain products with high market potential, seeking to increase the Group's turnover and profit to a higher level;

2. To strengthen the financial budgeting management, management of accounts receivable and inventories, seeking to reduce the operation costs and risks;

3. To accelerate the reformation of Guangzhou Chinese Medicine Corporation, optimize internal resources, strengthen the core business operations, exploit Chinese medicine or CPM wholesale market and seek more distribution rights and develop hospital sales channels, retail and wholesale market outside Guangdong; and

4. To continue seeking opportunities for co-operation with quality overseas and domestic pharmaceutical enterprises.