

5. MANAGEMENT DISCUSSION AND ANALYSIS

(Unless otherwise stated, the financial data contained in this report is extracted from the accounts 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

During the Reporting Period, the Group has, firstly, adjusted and enhanced its management team and strengthened the assessment on business target management of the subordinated enterprises. Secondly, it has strengthened supervision on and management of the business operations of the subordinated enterprises. Designated directors were appointed to the subordinated enterprises and participated in the decision-making process regarding significant business policies of the subordinated enterprises, to standardize and strengthen their internal management. Analysis of the operation conditions were carried out regularly and the application of the finance monitoring system has been promoted. The Company’s supervision and control over these subordinated enterprises were reinforced thus enhancing the quality of operations and economies of scale of these subordinate enterprises. Thirdly, the Group worked aggressively to speed up the progress of internal resources integration and amalgamation. The Group strived for the best on the uniform procurement of traditional Chinese medicine, raw materials in bulk, packing materials and imported materials, enhanced the cooperation between the Group’s manufacturing enterprises and trading enterprises and made full use of the wholesale and retail networks of trading business with a view of expanding the Group’s market share. Meanwhile, the Group’s internal fund management was enhanced endeavoring to lower finance costs of its subordinated enterprises. The Group continued its efforts on brand-name establishment and integration of our sales network and resources for sales fleet, increased its efforts on advertisement and publicity and promotion on technology, and has actively developed the end market of key hospitals, retail drugstores and communities so as to increase the market share of its products. Besides, the Group paced up the reform of its subsidiary, Guangzhou Chinese Medicine Corporation (“Chinese Medicine Corporation”) and put all its efforts in developing the core traditional Chinese medicine business of Chinese Medicine Corporation. The implementation of the series of measures above has achieved a good result. During the Reporting Period, the operating results of the Group have been significantly improved compared with the corresponding period of the previous year.

According to PRC Accounting Standards and Systems, turnover of the Group for the Reporting Period was approximately RMB4,596,172,000, representing an increase of 15.17% over that of the same period of last year. Gross profit was approximately RMB170,705,000, representing an increase of 87.48% over that of the same period of last year. Net profit was approximately RMB103,590,000, representing an increase of 225.67% over that of the same period of last year.

According to HKFRS, turnover of the Group for the Reporting Period was approximately RMB4,596,172,000, representing an increase of 15.17% over that of the same period of last year. Profit before income tax was approximately RMB185,607,000, representing an increase of 109.56% over that of the same period of last year. Profit attributable to equity holders of the Company was approximately RMB122,956,000, representing an increase of 260.83% over that of the same period of last year.

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 half of 2005 is set out as follows:

By segment	Turnover		Cost of sales		Gross profit	
	Under PRC Accounting Standards and Systems RMB'000	Under HKFRS RMB'000	Under PRC Accounting Standards and System RMB'000	Under HKFRS RMB'000	Under PRC Accounting Standards and System RMB'000	Under HKFRS RMB'000
Manufacturing	1,140,259	1,140,259	532,579	532,579	607,680	607,680
Trading	3,455,913	3,455,913	3,248,533	3,248,533	207,380	207,380
Including: Wholesale	3,208,996	3,208,996	3,039,557	3,039,557	169,439	169,439
Retail	148,735	148,735	118,009	118,009	30,726	30,726
Import and export	98,182	98,182	90,967	90,967	7,215	7,215
Total	<u>4,596,172</u>	<u>4,596,172</u>	<u>3,781,112</u>	<u>3,781,112</u>	<u>815,060</u>	<u>815,060</u>

Geographical analyses of sales from the Manufacturing Operations and Trading Operations are set out as follows:

Region	Manufacturing Operations		Trading Operations		Total	
	Sales RMB'000	% to total turnover of Manufacturing Operations	Sales RMB'000	% to total turnover of Trading Operations	Sales RMB'000	% to total turnover
Southern China	687,955	60.33	3,024,235	87.51	3,712,190	80.77
Eastern China	175,047	15.35	146,684	4.25	321,731	7.00
Northern China	100,243	8.79	60,619	1.75	160,862	3.50
North-eastern China	68,592	6.02	31,458	0.91	100,050	2.18
South-western China	62,205	5.46	112,980	3.27	175,185	3.81
North-western China	36,887	3.23	34,582	1.00	71,469	1.55
Export	9,330	0.82	45,355	1.31	54,685	1.19
	<u>1,140,259</u>	<u>100</u>	<u>3,455,913</u>	<u>100</u>	<u>4,596,172</u>	<u>100</u>

5.1.1 CPM manufacturing operations

According to PRC Accounting Standards and Systems, turnover of the Group's Manufacturing Operations for the Reporting Period was approximately RMB1,140,259,000, representing an increase of 16.07% over that of the same period of 2004. Gross profit was approximately RMB136,247,000, representing an increase of 33.33% over that of the same period of 2004.

According to HKFRS, turnover of the Group's Manufacturing Operations for the Reporting Period was approximately RMB1,140,259,000, representing an increase of 16.07% over that of the same period of 2004. Profit before income tax was approximately RMB152,286,000, representing an increase of 53.27% over that of the same period of 2004.

During the Reporting Period, the Group has taken the following measures in its Manufacturing Operations: (i) it has endeavored to further strengthen the promotion and marketing in its major products such as Xiao Ke Wan, Hua Tuo Zai Zao Wan, Xia Sang Ju and the series of Wang Lao Ji Liang Cha to ensure that market sales of the major products continue to increase. Meanwhile, it has also facilitated aggressively the market planning of our key nurturing products such as Wu Ji Bai Feng Wan, An Shen Bu Nao Ye and cough and phlegm clearing medicines and promoted the introduction of products to major hospitals and the construction of sales network and teams, strengthening the marketing and promotion of products so as to expand the market share of its products; (ii) it has endeavored to further enhance the marketing and promotion in the end market of retails and further expand rural markets and markets outside the Guangdong Province to improve the market share. Since this year, the Company and its subordinated enterprises have held large-scale business sodalities and products introduction meetings in major cities of the country on a monthly basis, strengthening the connections and communications between its enterprises and distributors and improving the corporate identity and the brand popularity; and (iii) it has strengthened the business cooperation between the manufacturing enterprises and trading enterprises of the Group and endeavored to expand the market share of the Group's products by taking full advantage of the wholesale and retail networks of the Trading Operations.

After the implementation of the aforesaid measures, there were 38 products whose sales income exceeded RMB5 million for the first half of 2005, and the total sales revenue of which accounted for 87.87% of the turnover of the Manufacturing Operations for the Reporting Period. During the Reporting Period, sales income of certain main products, including Xiao Ke Wan, Xia Sang Ju Ke Li, Wang Lao Ji Qing Liang Cha, She Dan Chuan Bei Pi Pa Gao, Chuan Bei Pi Pa Lu, She Dan Chuan Bei Pi Pa Ye, Mi Lian Chuan Bei Pi Pa Gao and Wu Ji Bai Feng Wan, have significantly increased by 17.69%, 40.13%, 153.13%, 71.17%, 37.85%, 48.47%, 84.27% and 15.16% respectively as compared with the corresponding period of 2004.

Analysis of sales of major products of the Manufacturing Operations for the Reporting Period is as follows:

Products	Sales Income <i>RMB'000</i>	Gross profit <i>RMB'000</i>
Heat clearing and anti-toxic medicine	286,677	140,154
Diabetic medicine	213,625	141,401
Cough and phlegm clearing medicine	146,810	85,005
Arthritic medicine	113,074	72,121
Gastric medicine	56,338	25,447
Other products	323,735	143,552

During the Reporting Period, the rate of expenses of the Manufacturing Operations fell by 1.61 percentage points over that of the same period of 2004. The profit of the Company in the first half improved mainly due to an increase in the sales income and a decrease in the rate of expenses in respect of the Manufacturing Operations.

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

Turnover of the Group's Trading Operations for the Reporting Period prepared under PRC Accounting Standards and Systems was approximately RMB3,455,913,000, representing an increase of 14.88% over that of the same period of 2004. Gross profit was approximately RMB34,458,000, an increase of RMB45,589,000 representing a growth of 409.59% as compared with the same period of 2004.

Turnover of the Group's Trading Operations for the Reporting Period prepared under HKFRS was approximately RMB3,455,913,000, representing an increase of 14.88% over that of the same period of 2004. Profit before income tax was approximately RMB33,321,000, an increase of RMB44,110,000 representing an increase of 408.84% over that of the same period of 2004.

During the Reporting Period, the Group's Trading Operations mainly focused on the following aspects: (i) they continued active development as agent and distributor for prestigious pharmaceutical products, actively seeking and developing characteristic products with promising market prospect, and endeavoured to expand sales in the wholesale market. Meanwhile, they tried to exploit new lines of products for sales as agent, and enhance new economic growths. (ii) additional efforts were made to expand the sales market of hospitals by enhancing the capability of the hospital marketing teams. In addition, they also made an earnest effort in improving the bidding and supplying for hospitals with a wider range of medicines to increase the sales volume through hospital channels. (iii) they expedited the process of resources integration within the Group, and facilitated the purchases, supplies and services of traditional Chinese medicine, raw materials in bulk and imported materials. Meanwhile, they strengthened the cooperation with the Group's manufacturing enterprises and took full advantage of the huge distribution network established to expand the proportion of sales of the Group's products.

In the first half of 2005, as affected by the market entry of large number of pharmacies offering lower selling price, the gross margin ratio of the Group's Trading Operations continued to drop. In the first half of 2005, the gross margin ratio of the Group's Trading Operations was 6%, a decrease of 0.42 percentage point as compared with the gross margin ratio of 6.42% in the first half of 2004, which adversely affected the profit growth of the Group's Trading Operations.

As at 30 June 2005, the Group has 160 chain pharmacies, including 86 "Cai Zhi Lin" chain pharmacies which specialize in traditional Chinese medicine 73 "Jian Min" chain pharmacies which specialize in western medicine and 1 Ying Bang Pharmacy.

During the Reporting Period, the growth in the Group's Trading Operations profit was primarily contributed by the significant improvement of the operating results of the Company's subsidiary, Chinese Medicine Corporation.

5.2 THE OPERATING RESULTS OF THE COMPANY'S MAIN ENTERPRISES FOR THE REPORTING PERIOD

Name	Equity interest directly held by the Company (%)	Sales revenue RMB'000	Total profit RMB'000	Net profit RMB'000
Guangzhou Xing Qun Pharmaceutical Co., Ltd	88.99	154,105	24,807	16,621
Guangzhou Zhong Yi Pharmaceutical Co., Ltd	90.36	299,351	66,066	44,264
Guangzhou Chen Li Ji Pharmaceutical Factory	100	120,905	21,172	14,239
Guangzhou Qi Xing Pharmaceutical Co., Ltd	75	179,840	24,236	18,397
Guangzhou Jing Xiu Tang Pharmaceutical Co., Ltd	88.4	80,093	(1,188)	(1,188)
Guangzhou Pan Gao Shou Pharmaceutical Co., Ltd	87.77	136,124	12,633	8,830
Guangzhou Wang Lao Ji Pharmaceutical Co., Ltd	48.0465	213,186	34,871	32,201
Guangzhou Huan Ye Pharmaceutical Co., Ltd	59.7	15,699	172	115
Guangxi Ying Kang Pharmaceutical Co., Ltd	51	10,745	(4,527)	(4,527)
Guangzhou Bai Di Bio-technology Co., Ltd	94.87	659	(3,552)	(3,552)
Guangzhou Han Fang Contemporary Medicine Research & Development Co., Ltd	70.04	365	(4,100)	(4,100)
Guangzhou Pharmaceutical Corporation	90.09	3,266,514	36,732	26,815
Chinese Medicine Corporation	100	341,767	(163)	(185)
Guangzhou Pharmaceutical Import & Export Corporation	100	128,883	113	(458)
Guangzhou Guangyao Ying Bang Marketing Co., Ltd	51	100,300	960	408
Total		<u>5,048,536</u>	<u>208,232</u>	<u>147,880</u>

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

5.4 DURING THE REPORTING PERIOD, THE COMPANY HAD NO INVESTMENT WHICH DERIVED INVESTMENT INCOME EQUAL TO 10% OR MORE OF THE COMPANY'S NET PROFIT.

5.5 THE COMPANY'S INVESTMENTS

5.5.1 Use of net proceeds from the issue of A shares

As at the end of the Reporting Period, 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	Name of Projects	Budgeted injection under the offering plan RMB'000	Accumulated amount injected as at the end of the Reporting Period 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
	Industrialisation of Wei Re Qing	29,000	24,550	85
	Introduction of speedy automation technology for 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	19,300	80
	Syrup	Technology upgrade for syrup production	29,500	29,500
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
	Introduction of speedy automation of granules upgrade	29,900	29,900	100
	Technology upgrade of flu granules for children	23,000	23,000	100
Tablets	Industrialisation of Fu Yan Xiao Soluble Tablets	29,500	23,540	80
	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 foundation	29,900	29,900	99
	Critical purification of CO ₂ technology foundation	29,900	29,900	99
Trading				
Expansion of chain pharmacies				
	“Jian Min”	89,300	88,760	100
	“Cai Zhi Lin”	59,500	29,110	65
	Logistics centre upgrade	20,000	20,000	100
	ERP upgrade for the Trading Operations	20,000	16,220	81
	Bio-tech research centre	80,000	72,250	78
	Additional working capital	79,690	79,690	
Total		737,990	675,320	

Note: The net proceeds from the issue of A shares were approximately RMB73,990,000. The portion exceeding the budgeted proceeds (amounting to approximately RMB29,690,000) was used as additional working capital.

5.5.2 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 RMB1,692,830,000 and RMB269,590,000 respectively.

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

5.6.1 Change of major accounting items

Items	For the six	For the six	Changes	
	months ended June 2005 RMB'000	months ended June 2004 RMB'000	Amount RMB'000	Increase/ decrease (%)
Revenues from principal operations	4,596,172	3,990,694	605,478	15.17
Profit from principal operations	801,459	704,734	96,725	13.73
Financial expenses	24,823	17,685	7,138	40.36
Income tax	60,005	52,939	7,066	13.35
Net profit	103,590	31,809	71,782	225.67
Net increase in cash and cash equivalents	(89,448)	44,574	(134,022)	(300.67)

Items	As at	As at 31	Changes	
	30 June 2005 RMB'000	December 2004 RMB'000	Amount RMB'000	Increase/ decrease (%)
Total assets	5,352,579	5,182,878	169,701	3.27
Accounts receivable	1,258,719	967,659	291,060	30.08
Notes receivables	304,437	185,210	119,228	64.37
Inventories	1,048,905	1,077,925	(29,020)	(2.69)
Net fixed assets	1,290,812	1,371,795	(80,983)	(5.90)
Accrued expenses	30,889	9,231	21,658	234.62
Other payables	208,130	265,572	(57,443)	(21.63)
Long-term loans	30,000	109,500	(79,500)	(72.60)
Share capital	810,900	810,900	—	—
Shareholders' equity	2,545,001	2,440,230	104,771	4.29

5.6.2 Explanatory notes on the accounting items with changes of 30% or more as compared with the comparative figures at the beginning of the year (or a comparison between the Reporting Period and the same period of last year):

- Financial expenses increased by 40.36% as compared with the same period of last year. This was mainly due to: (i) increase of interest expenses on account of increase in the amounts of borrowings for the Reporting Period; and (ii) increase of handling expenses charged by financial institutions during the Reporting Period as the Group was mainly financed by way of discounting of notes receivable and transfer of accounts receivable.
- Net profit increased by 225.67% as compared with the same period of last year, as a result of substantial increase of income from principal operations and decrease of rate of expenses for the Group during the Reporting Period; at the same time, the operating results of the Company's subsidiary, Chinese Medicine Corporation, improved significantly during the Reporting Period.
- The amount of accounts receivable at the end of period increased by 30.08% as compared with the beginning of the year, as a result of increase in income of the main operations of the Group and the extension of the repayment period of the goods to hospitals, because of the further expansion of the tender scope of hospital pharmaceutical purchase.
- The amount of notes receivable at the end of period increased by 64.37% as compared with the beginning of the year, mainly as a result of more frequent use of bills for settlement by customers of the Group in the Reporting Period.
- The amount of accrued expenses at the end of period increased by 234.62% as compared with the beginning of the year, as a result of increase of incurred but not settled relevant expenses, such as advertising expenses and POS expenses.
- The amount of long-term loans at the end of period decreased by 72.6% as compared with the beginning of the year, mainly as a result of the transfer of long-term loans due within one year as at the end of the Reporting Period to "long-term liabilities due within one year".

5.6.3 Liquidity, financial resources and capital structure

As at 30 June 2005, the current ratio of the Group was 1.46 and the quick ratio was 1.01. Accounts receivable turnover rate was 9.66, and annual inventory turnover rate was 7.12, representing an increase of 5.04% and 3.98% respectively as compared with the same period of 2004.

As at 30 June 2005, long-term borrowings of the Group amounted to RMB129,500,000 (as at 31 December 2004: RMB157,180,000). These borrowings are fixed interest loans denominated in RMB, out of which RMB99,500,000 will be repayable in 2006 and RMB30,000,000 will be repayable in 2007. As at 30 June 2005, cash and cash equivalents of the Group amounted to RMB791,377,000 (as at 31 December 2004: RMB880,825,000), of which approximately 97.07% is denominated in RMB and 2.93% is denominated in foreign currencies such as Hong Kong dollars.

5.6.4 Capital expenditure

The Group expected that capital expenditure for the year 2005 will be approximately RMB258 million (2004: RMB329 million) and actual expenditure in the first half of 2005 amounted to RMB68,700,000 (the corresponding period in 2004: RMB127 million). The Group has sufficient financial resources to meet the demand for capital expenditure and daily working capital requirements.

5.6.5 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.

5.6.6 Contingent liabilities

Up to 30 June 2005, the Group has no significant contingent liabilities.

5.6.7 Charge on Group assets

As at 30 June 2005, the net book value of fixed assets pledged as security for bank loans granted to the Group amounted to RMB124,913,000.

5.7 THE ISSUES AND DIFFICULTIES ENCOUNTERED IN OPERATIONS AND OPERATION PLANS FOR THE SECOND HALF OF 2005

The following factors had certain impact on the Group's operations, including the implementation of the national restriction on the prices of pharmaceutical products, production cost of the Manufacturing Operations increased as a result of the implementation of GMP renovation, and continuous decrease of the gross profit margin of the Trading Operations.

In the second half of 2005, the Company will develop the principal business and cultivate new growth in profit, while keep on improving the management structure and strengthening the management and regulation, to reach the goal of operations of 2005. The business plans for the second half of 2005 include:

- (1) Continuous strengthening of the market planning and regulation of Xiao Ke Wan, Hua Tuo Zai Zao Wan and other main products, focusing on the market planning for the development of key products, and prompt setting up of a group of new main products.
- (2) Continuous expediting of the progress of internal resource integration, focusing on the integrated purchase and supply of Chinese medicine, raw materials in bulk, packaging materials and import stuffs while taking full advantage of the wholesale and retail network of the Trading Operations to enlarge the market share of products of the Group.
- (3) Strengthening of fundamental management, reasonably minimising of operating costs and expenses, improving of the utilization rate of capital, further strengthening of the management of receivables and reduction of operating risks.
- (4) Continuous strengthening of the core business of Chinese Medicine Corporation, and focusing on a turnaround for such company.
- (5) Additional efforts in soliciting more business and investment and active identification of opportunities for cooperation with top pharmaceutical companies, both domestic and abroad, and merger and acquisition of suitable domestic pharmaceutical companies.