

The Directors have pleasure in submitting their report together with the audited accounts of Vital BioTech Holdings Limited ("the Company") and its subsidiaries (collectively "the Group") for the year ended 31 December 2003.

LISTING OF SHARES

The Company's shares had been listed on The Growth Enterprise Market (the "GEM") of The Stock Exchange of Hong Kong Limited (the "Stock Exchange") on 7 February 2002. On 4 August 2003, the Company withdrew the listing of its shares on GEM and on the same date, the Company's shares were listed on the main board of the Stock Exchange by way of introduction.

PRINCIPAL ACTIVITIES AND GEOGRAPHICAL ANALYSIS OF OPERATIONS

The Company is an investment holding company. Its subsidiaries are principally engaged in research and development, selling and manufacturing of pharmaceutical products.

An analysis of the Group's performance for the year by business and geographical segments is set out in note 2 to the accounts.

RESULTS AND APPROPRIATIONS

The results of the Group for the year are set out in the consolidated profit and loss account on page 28.

The Directors have declared an interim dividend of HK1 cent per share, with option of 1 scrip share for every 45 shares or in cash. On 28 October 2003, the interim dividend was settled by cash of HK\$1,878,000 and by scrip share amounting to HK\$10,896,000.

The Directors proposed to pay a final dividend of HK1.5 cent per share to the shareholders whose names appear on the register of members on 1 April 2004. The dividend will be payable on 6 May 2004. In addition, shareholders may elect to receive the proposed final dividend in the form of fully paid shares of the Company, in cash or partly in shares and partly in cash. The holder of every 55 shares will be entitled to one fully paid share of the Company as final dividend.

Should all eligible shareholders elect to receive the dividend in cash or in the form of fully paid shares of the Company, the effect of the final dividend herein would be payment of HK\$22,382,342 or an additional issue of 27,130,111 fully paid shares of the Company.

The register of members of the Company will be closed from 26 March 2004 (Friday) to 1 April 2004 (Thursday), both days inclusive, during which period no transfer of shares will be effected. In order to be qualified for the above-mentioned dividend, all transfers accompanied with relevant share certificates must be lodged with the Company's share registrar, Computershare Hong Kong Investor Services Limited at Rooms 1712-1716, Hopewell Centre, 183 Queen's Road East, Hong Kong not later than 4:00 p.m. on 25 March 2004 (Thursday).

FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the years ended 31 December 2000, 2001, 2002 and 2003 is set out on page 2 of the annual report.

RESERVES

Movements in the reserves of the Group and the Company during the year are set out in note 23 to the accounts.

INTANGIBLE ASSETS AND FIXED ASSETS

Details of the movements in intangible assets and fixed assets of the Group are set out in notes 11 and 12 to the accounts respectively.

SUBSIDIARIES

Details of the principal subsidiaries of the Company are set out in note 30 to the accounts.

SHARE CAPITAL

Details of the movements in share capital of the Company are set out in note 22 to the accounts.

DIRECTORS

The directors during the year and up to the date of this report were:

Executive directors

Mr. Ko Sai Ying, Thomas (<i>Chairman</i>)	("Mr. Ko")
Mr. Au Yeung Terence Ping Yuen (<i>Deputy Chairman</i>)	("Mr. Au Yeung")
Mr. Liu Jin, James	("Mr. Liu")
Mr. Tao Lung	("Mr. Tao")

Independent non-executive directors

Mr. Lee Kwong Yiu
Mr. Lui Tin Nang

In accordance with article 108 of the articles of association of the Company, Mr. Liu will retire from office by rotation at the forthcoming Annual General Meeting and, being eligible, will offer himself for re-election.

DIRECTORS' SERVICE CONTRACTS

Each of Mr. Ko, Mr. Au Yeung, Mr. Liu and Mr. Tao, being the executive directors, has entered into a service contract with the Company for an initial term of two years commencing on 1 December 2001 and will continue thereafter until terminated by not less than three months' notice in writing served by either party to the other. Each of these executive directors is entitled to a basic salary of HK\$720,000 (subject to an annual increment at the discretion of the Directors). In addition, the executive directors are also entitled to a discretionary management bonus provided that the aggregate amount of the bonuses payable to all the executive directors for any financial year of the Company after 31 December 2001 may not exceed 10% of the audited profit attributable to the shareholders of the Group in respect of that financial year. An executive director may not vote on any resolution of the Directors regarding the amount of the management bonus payable to him. The independent non-executive directors, Mr. Lui Tin Nang and Mr. Lee Kwong Yiu have been appointed for a term of two years expiring on 31 December 2005. Save for a director fee of HK\$132,000 per annum for each of them, the independent non-executive directors are not entitled to any other remuneration.

Save as disclosed herein, there are no existing or proposed service contracts with the Company which is not determinable within one year without payment of compensation, other than statutory compensation.

DIRECTORS' INTERESTS IN CONTRACTS

No contracts of significance in relation to the Group's business to which the Company or its subsidiaries were a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

BIOGRAPHICAL DETAILS OF DIRECTORS AND SENIOR MANAGEMENT

Brief biographical details of Directors and senior management are set out on pages 13 to 15 of the annual report.

DISTRIBUTABLE RESERVES

Distributable reserves of the Company as at 31 December 2003 amounted to HK\$186,975,000.

PRE-EMPTIVE RIGHTS

There is no provision for pre-emptive rights under the Company's articles of association and there was no restriction against such rights under the laws of the Cayman Islands.

PURCHASE, SALE OR REDEMPTION OF SHARES

The Company has not redeemed any of its shares during the year. Neither the Company nor any of its subsidiaries has purchased or sold any of the Company's shares during the year.

SHARE OPTIONS

The share option scheme effective on 26 January 2002 was replaced by a new share option scheme adopted by the shareholders on 23 July 2003 (the "Scheme").

The purpose of the Scheme is to grant share options to selected participants satisfying the criteria according to the Scheme as incentives or rewards for their contribution to the Group.

The maximum number of securities to be issued upon the exercise of all outstanding options granted and yet to be exercised under the Scheme and any other share option scheme must not in aggregate exceed 30% of the relevant shares capital of the Company in issue from time to time.

The total number of shares which may be issued upon exercise of all options to be granted under the Scheme must not in aggregate exceed 127,746,216 shares representing 10% of the share in issue at the date of the Scheme.

The total number of shares issued and which may fall to be issued upon exercise of the options granted under the Scheme to each participant in any 12-month period shall not exceed 1% of the issued share capital of the Company for the time being.

An option may be accepted by a participant within 21 days from the date of the offer of grant of the options. The subscription price for shares under the Scheme will be a price determined by the Directors but shall not be less than the highest of (i) the closing price of shares as stated in the Stock Exchange's daily quotation sheet for trades in one or more board lot of shares on the date of the offer of grant, or (ii) the average closing price of the shares as stated in the Stock Exchange's daily quotation sheets for trades in one or more board lot of shares for the five trading days immediately preceding the date of the offer of grant, and (iii) the nominal value of shares. A nominal consideration of HK\$1 is payable on acceptance of the grant of option.

An option may be exercised in accordance with the terms of the Scheme at any time during a period to be determined and notified by the Directors to each grantee, which period may commence from the date of acceptance of the offer but shall and in any event be not later than ten years from the date on which the offer is made subject to the provisions of early termination thereof.

The Scheme will remain in force for a period of ten years commencing on 23 July 2003.

First phase:

On 21 June 2002, the Directors granted options to subscribe for an aggregate of 30,000,000 shares of the Company, with an exercise price at HK\$0.39 per share. Those who were granted with the options can exercise their rights in multiple periods starting from 16 August 2002 to 6 February 2012 as below:

- From 16 August 2002 to 6 February 2012 – approximately 6,850,000 shares
- From 1 January 2003 to 6 February 2012 – approximately 8,280,000 shares
- From 1 January 2004 to 6 February 2012 – approximately 6,510,000 shares
- From 1 January 2005 to 6 February 2012 – approximately 8,360,000 shares

Among the grantees in this grant of share options, 108 of them are full-time employees of the Company and an aggregate of 21,100,000 options were granted to them; 29 of them are staff of major customers of the Company and an aggregate of 8,900,000 options are granted to them. During the year ended 31 December 2003, no grantees had exercised any of the options and no option was forfeited or cancelled.

Second phase:

On 28 February 2003, the Directors granted options to three directors of certain subsidiaries of the Group to subscribe for 19,800,000 shares of the Company, with an exercise price at HK\$0.24 per share. The grantees are entitled to exercise the subscription rights on or before 6 February 2012.

On 24 October 2003, 13,200,000 options granted were exercised. The closing price per share on the date when the options were exercised was HK\$0.70. During the year, no option was forfeited or cancelled.

Third phase:

On 29 September 2003, the Directors granted options to subscribe for an aggregate of 30,000,000 shares of the Company, with an exercise price at HK\$0.51 per share. Those who were granted with the options can exercise their rights in two periods starting from 16 August 2002 to 6 February 2012 as below:

From 2 January 2004 to 6 February 2012 – approximately 8,990,000 shares

From 2 July 2004 to 6 February 2012 – approximately 21,010,000 shares

Among the grantees in this grant of share options, 14 of them are full-time employees of the Company and an aggregate of 16,595,000 options were granted to them; 5 of them are directors of certain subsidiaries of the Group and an aggregate of 12,405,000 options are granted to them; and one of them is a consultant of a wholly owned subsidiary and 1,000,000 options are granted. During the year ended 31 December 2003, 1,500,000 options were waived by a grantee and no grantees had exercised any of the options and no option was cancelled during the year. Any share options forfeited before expiry will be cancelled.

Valuation of the options granted under the Scheme:

The Company adopted Black-Scholes Options Pricing Model to calculate the value of share options.

First phase

For share options to subscribe for 30,000,000 shares granted on 21 June 2002 with an exercise price of HK\$0.39 each, the fair value of the options was HK\$0.25 at the date of grant with assumptions as follows:

1. Using the annual exchange fund notes interest rate of 1.57% as the risk-free interest rate;
2. The expected life is 9.5 years;
3. The expected volatility is 60.16% during the period from 7 February 2002, being the listing day on GEM of the Company's shares, to 20 June 2002; and
4. No expected dividend as the Company is newly listed on GEM.

Second phase

For share options to subscribe for 19,800,000 shares granted on 28 February 2003 with an exercise price of HK\$0.24 each, the fair value of the share options was HK\$0.15 at the date of grant with assumptions as follows:

1. Using the annual exchange fund notes interest rate of 1.9% as the risk-free interest rate;
2. The expected life is 9 years;
3. The expected volatility is 54.66% during the period from 7 February 2002, being the date of the listing of the Company's shares on GEM, to 28 February 2003; and
4. No expected dividend as the Company has a track record of dividends for only 1 year.

Third phase

For share options to subscribe for 30,000,000 shares granted on 29 September 2003 with an exercise price of HK\$0.51 each, the fair value of the share options was HK\$0.17 at the date of grant with assumptions as follows:

1. Using the annual exchange fund notes interest rate of 1.68% as the risk-free interest rate;
2. The expected life is 8.5 years;
3. The expected volatility is 48.16% during the period from 30 September 2002 to 29 September 2003; and
4. Expected annual dividend yield of the Company is 3.9%.

Note: The value of the share options is subject to a number of assumptions and with regard to the limitation of the model. Therefore the value may be subjective and difficult to determine.

Other share options

On 22 September 2003, the Group entered into an agreement to acquire the remaining 15% minority interest of the subsidiary, Vital Pharmaceuticals (Sichuan) Co Ltd. The remaining monetary considerations of the acquisition amounting to approximately HK\$28.3 million representing 60% of the total considerations will be settled at the sole option of the Company, either in cash or in new ordinary share of the Company. On or before the following dates, the Company may opt to pay cash or to issue new ordinary shares by serving a notice to the seller (the "Notice"):

- 22 March 2004: HK\$9,433,962;
- 22 September 2004: HK\$9,433,962; and
- 22 March 2005: HK\$9,433,962.

The number of option share is calculated at a price that is equal to the higher of the average 30 day closing price of the Company's share on the Stock Exchange immediate prior to the date of the Notice and HK\$0.46 per share. The maximum number of option share to be issued if based on HK\$0.46 per share will be 61,525,839. A conditional approval has been obtained from the Stock Exchange for the listing of the option shares.

RETIREMENT BENEFIT SCHEMES

Details of the retirement benefit schemes are set out in notes 1(m) and 9 to the accounts.

DIRECTORS' AND CHIEF EXECUTIVES' INTERESTS AND SHORT POSITIONS IN THE SHARES, UNDERLYING SHARES AND DEBENTURE'S OF THE COMPANY OR ANY ASSOCIATED CORPORATION

As at 31 December 2003, the interests and short positions of the Directors in the share capital of the Company and its associated corporations (within the meaning of the Securities and Futures Ordinance ("SFO")) which will have to be notified to the Company and the Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short positions which they are taken or deemed to have under such provisions of the SFO), or which will be required pursuant to section 352 of the SFO to be entered in the register referred to therein, or which will be required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies in the Listing Rules, are as follows:

Ordinary shares of HK\$0.01 each in the Company:

Name of Director	Company/name of associated corporation	Capacity	Number and class of securities (Note 1)	Percentage shareholding in the same class of securities
Mr. Ko Sai Ying, Thomas	Company	Beneficial owner	52,103,991 (L)	3.96%
Mr. Au Yeung Ping Yuen, Terence	Company	Beneficial owner	8,516,248 (L)	0.65%
Mr. Liu Jin, James	Company	Beneficial owner	16,201,813 (L)	1.23%
Mr. Tao Lung	Company	Beneficial owner	110,891,648 (L)	8.43%
	Company	Interest of a controlled corporation (Note 2)	645,406,489 (L)	49.09%
	Perfect Develop Holding Inc. ("Perfect Develop")	Beneficial owner	49 ordinary shares of US\$1 each (L)	49%

Notes:

- The letter "L" stands for the Director's long position in such securities.
- The interests in the shares are held by Perfect Develop. The entire issued share capital of Perfect Develop is beneficially owned as to 33% by Mr. Ko, 6% by Mr. Au Yeung, 12% by Mr. Liu and 49% by Mr. Tao. Accordingly, Mr. Tao is deemed to be interested in all the Shares which Perfect Develop is interested by virtue of the SFO.

SUBSTANTIAL SHAREHOLDERS' INTEREST AND SHORT POSITIONS IN THE SHARES, UNDERLYING SHARES OF THE COMPANY

As at 31 December 2003, according to the register of members kept by the Company pursuant to section 336 of the SFO and so far as is known to, or can be ascertained after reasonable enquiry by the Directors, the following persons/entities had an interest or short position in the Shares and underlying Shares which would fall to be disclosed to the Company under the provisions of Divisions 2 and 3 of Part XV of the SFO, or, directly, or indirectly, interested in 5% or more of the nominal value of any class of share capital carrying rights to vote on all circumstances at general meetings of the Company:

Name	Company/ Name of Group member	Capacity	Number of shares (Note 1)	Approximate percentage of shareholding
Perfect Develop (Note 2)	Company	Beneficial owner	645,406,489 (L)	49.09%
Mr. Tao (Note 3)	Company	Beneficial owner	110,891,648 (L)	8.43%
		Interest of a controlled corporation	645,406,489 (L)	49.09%
Ms. Li Chun Yi (Note 4)	Company	Interest of spouse	756,298,137 (L)	57.52%

Notes:

- The letter "L" denotes the person's/entity's long position in the shares.
- The entire issued share capital of Perfect Develop is owned as to 49% by Mr. Tao, 33% by Mr. Ko, 6% by Mr. Au Yeung and 12% by Mr. Liu respectively. All of Mr. Tao, Mr. Ko, Mr. Au Yeung and Mr. Liu are founders of the Group.
- Mr. Tao owns in aggregate 49 shares in, representing approximately 49% of the issued share capital of Perfect Develop. Accordingly, Mr. Tao is deemed, by virtue of the SFO, to be interested in all the Shares in which Perfect Develop is interested, amounting to 645,406,489 shares. Together with 110,891,648 shares registered in his own name, Mr. Tao is deemed, by virtue of the SFO, to be interested in, 756,298,137 shares in aggregate, amounting to approximately 57.52% of the issued share capital of the Company as at 31 December 2003.
- Ms. Li Chun Yi is the wife of Mr. Tao and is taken to be interested in the shares in which Mr. Tao is interested by virtue of the SFO.

DIRECTORS' AND CHIEF EXECUTIVES' RIGHT TO SUBSCRIBE FOR SHARES

As at 31 December 2003, none of the Directors and chief executive (including their spouse and children under 18 years of age) had any interest in, or had been granted, or exercised, any rights to subscribe for shares, warrants or debentures (if applicable) of the Company and its associated corporations (within the meaning of the SFO).

MANAGEMENT CONTRACTS

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

MAJOR CUSTOMERS AND SUPPLIERS

The percentages of purchases and sales for the year attributable to the Group's major suppliers and customers are as follows:

Purchases

– the largest supplier	45%
– five largest suppliers combined	74%

Sales

– the largest customer	25%
– five largest customers combined	56%

None of the Directors, their associates or any shareholder (which to the knowledge of the Directors owns more than 5% of the Company's share capital) had an interest in the major suppliers or customers noted above.

CONNECTED TRANSACTIONS

During the year, the Group purchased raw materials from Pharmco International, Inc., the beneficial shareholder of the minority shareholder of a subsidiary of the Company and a connected person. The Stock Exchange has, subject to certain conditions, granted waivers to the Company from compliance with certain requirements of the Listing Rules. The independent non-executive Directors of the Company reviewed the above transactions and opined that the transaction are:

- (a) entered into by the Group in the ordinary and usual course of its business;
- (b) conducted on normal commercial terms or on terms that are fair and reasonable as far as the shareholders are conducted;
- (c) entered into either in accordance with the terms of the agreements governing the transactions or where there are no such agreements, on terms no less favorable than those available to or from independent third parties; and
- (d) where there is a limit on the amount of such transactions, the aggregate value of such transactions did not exceed the maximum imposed by the Stock Exchange.

On an extraordinary general meeting of the Company held on 31 October 2003, the shareholders of the Company has approved the Group to acquire the remaining 15% minority interests of a subsidiary of the Group, Vital Pharmaceuticals (Sichuan) Co Ltd, at a total monetary considerations of approximately HK\$47.2 million.

COMPLIANCE WITH THE CODE OF BEST PRACTICE OF THE LISTING RULES

Throughout the year, the Company was in compliance with the Code of Best Practice as set out in the Listing Rules.

AUDIT COMMITTEE

The written terms of reference which describe the authority and duties of the Audit Committee were prepared and adopted with reference to "A Guide for The Formation of An Audit Committee" published by the Hong Kong Society of Accountants.

The Audit Committee provides an important link between the Board and the Company's auditors in matters coming within the scope of the group audit. It also reviews the effectiveness of both the external and internal audit and of internal controls and risk evaluation. The Committee comprises two independent non-executive directors, namely Messrs. Lui Tin Nang and Lee Kwong Yiu. Four meetings were held during the current financial year.

DIRECTORS' INTERESTS IN COMPETING BUSINESS

None of the Directors, the management shareholders of the Company and their respective associates (as defined in the Listing Rules) had an interest in a business which causes or may cause any significant competition with the business of the Group and any other conflicts of interest which any such person has or may have with the Group.

SUBSEQUENT EVENT

The Company placed 170 million new ordinary shares of the Company to institutional investors on 26 February 2004 at HK\$0.72 each. The net proceeds received from the placing of approximately HK\$119 million is to finance pharmaceuticals and health supplements projects, and working capital of the Group.

Saved as disclose above, the Directors are not aware of other material subsequent event.

AUDITORS

The accounts have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for re-appointment.

By Order of the Board

KO Sai Ying, Thomas

Chairman

Hong Kong, 2 March 2004