MANAGEMENT DISCUSSION AND ANALYSIS

Intense competition is a fact of life throughout pharmaceutical industry and it is particularly true for the present situation in the PRC. To meet competition, products' prices are under tremendous pressure and thus profitability. The Group has so far maintained its growth in turnover but had to suppress prices and boost advertising expenses and sales forces in the year under review. The Group's turnover grew 34% but net profit attributable to shareholders fell 39%; partly due to the phenomenon mentioned and partly due to higher expenses spent on developing new products.

Operating Results

Turnover of the Group for the year ended 31 May 2001 was approximately HK$235 million, representing an increase of approximately 34% as compared to the HK$176 million of the previous year. The increase was led by increased sales of anti-rheumatoid pharmaceutical products to hospitals and over-the-counter drug markets in the PRC.

Gross profit of the Group for the year ended 31 May 2001 was approximately HK$112 million, representing an increase of approximately 25% as compared to the HK$89 million of the previous year. The gross profit margin fell 3% to approximately 48% due to intense price competition.

The other revenue of HK$1 million recorded for the year ended 31 May 2001 represented interest income on cash at banks.

Selling and distribution costs for the year ended 31 May 2001 were approximately HK$35 million comprising expenses for extensive advertising programs on televisions, radios and presses, sales staff salaries and commissions, traveling and entertainment expenses and office and rental expenses for regional sales offices. The current year's expenses were two times over the HK$12 million of the previous year. Additional expenses were mainly incurred for promoting the Group's products, introducing the Group's anti-rheumatoid pharmaceutical products to the over-the-counter drug markets in rural areas of the PRC, developing new sales network and opportunities and paying remunerations for newly recruited sales forces.

Administrative expenses rose from approximately HK$6 million in the previous year to approximately HK$11 million for the year ended 31 May 2001. After the Company became a listed company in Hong Kong, it had to incur additional professional fees, directors' salaries and rental expenses for its Hong Kong office.

The other operating expenses of HK$18 million for the year ended 31 May 2001 were mainly development costs for new products. For pharmaceutical business, long-term financial growth sources from new products. To lay the foundation for future, the Group, during the year, paid approximately HK$16 million to medical and research institutes in the PRC that had conducted efficacy, toxicity, pathological and clinical tests for five new Chinese pharmaceutical products., namely, Chan Feng Qian Lie Kang Pian 蟾蜂前列康片, Yan Yan Ning Zhusheye 咽炎寧注射液, Rencanguo Huangtongfen Zhenji 人參果黃酮粉針劑, A Jiao Bu Xie Ruan Jiaonang 阿膠補血軟膠囊 and Huangqi Tuyi Ruan Jiaonang 黃芪菟胰軟膠囊. The Group has commenced

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the process for applying production permit for these products. The Group's management believes that the above costs will be fully recovered when the Group produces and markets these products. However, as it is not certain when production permits are granted, on prudent basis, the Group charged the entire amount of these expenses to the current year's profit and loss account. During the year, the Group has also commenced the amortization on the deferred development costs relating to the thirteen types of traditional Chinese medicines that the Group developed earlier. The total amortization so charged in the year was approximately HK$2 million.

The Group's major profit-making entity, Shanxi Zhengzhong Pharmaceutical Co., Ltd, was entitled to a 50% reduction in corporate income tax in the year ended 31 May 2001 while it was fully exempted from corporate income tax until 31 December 1999 in the previous financial year. Hence, despite the profit before tax was lower this year, the Group's tax was 70% higher than that of the previous year.

Manufacturing of Chinese pharmaceutical products

The development, manufacturing and provision of medicinal preparations and anti-rheumatoid capsules for the treatment of rheumatoid and/or arthritis remain to be the key drivers of the Group's growth. For the year ended 31 May 2001, this part of business contributed approximately 83% and 98%, respectively, of the Group's turnover and profit before tax. The turnover from manufacturing of Chinese pharmaceutical products rose approximately HK$54 million, representing 38% over that of last year. The increase had two sources: the organic growth of revenue from its present network with hospitals and new revenue income from OTC in certain rural areas in the PRC that commenced in the year under review. The increase in revenue from hospital network was caused by the Group's increased presence in certain provinces such as Hubei and Hebei. During the year, the Group has set up regional offices in the provinces of Sichuan, Zhejiang and Jiangsu. These offices have been successfully penetrating the OTC markets in these areas. The Group will continue to expand its hospital networks and OTC markets in the year ahead to secure the Group's growth.

Trading business

The Group's wholesale and retail business remain focused on the Beijing region. In response to intense competition in the pharmaceutical wholesaling business in 2000, the Group had altered product mix and profitability. Hence, even though this sector of business sustained its market share and its turnover had a 14% growth to HK$33 million, its contribution to profit before tax was down to HK$1 million. The Group expected that the profitability of the Group's wholesale business may further be affected after China's entry into the WTO as competition in pharmaceutical industry will intensify.

Operation of Taiyuan Hospital

The financial results from operation of Taiyuan Hospital were essentially level with the previous year.

Employees

As at 31 May 2001, the Group has a workforce of approximately 950 in both the PRC and Hong Kong. Remuneration policies are reviewed annually and certain staffs are entitled to commission. During the year, there was no significant change in the Company's employees and remuneration policies.

Liquidity and Financial Resources

As at 31 May 2001, the Group has no bank borrowing or debt. The Group finances its operations with internally generated cashflow. The Group's cash balances at 31 May 2001, which accounted for approximately 71% of the total current assets, amounted to HK$135,321,000.

Use of Proceeds

During the year ended 31 May 2001, the net proceeds of approximately HK$48 million raised in the Company's initial public offering in July 2000 have been applied as follows:

- approximately HK$7 million for upgrading the existing production plant and acquisition of additional machinery;

- approximately HK$3 million for marketing and advertising campaigns in the PRC; and

- the remaining balance was either used for general working capital purposes or placed on short term deposits with banks if no requirement for immediate use.

Prospects

The high curative effects of its anti-rheumatoid pharmaceutical products and strong sales channel through hospitals across the PRC have laid solid foundation to growth for the Group. In the past year, the Group has also successfully launched its anti-rheumatoid capsules to the OTC markets in numerous cities and towns in the PRC.

In respect of market development, the Group will continue to proliferate the number of hospitals alliances for the sale of anti-rheumatoid pharmaceutical products and to extend its OTC market coverage to greater part of the PRC. Discussions with several hospitals are now under way and alliances are expected to form in the year ahead. Sales forces are also being recruited for the new sales regional offices in the provinces of Anhui, Henan and Shenyang for penetration to OTC markets. Moreover, the Group also believes that may the pace of the track record growth be kept, it needs to diversify its products ranges. The Group will commence in the coming year marketing the traditional Chinese medicines that it developed earlier. These medicines are used for nourishing liver and kidney, preventing cold and flu and etc. In addition to these medicines, the Group will continue to develop the five products that were in clinical stages. The Group is also looking into merger and acquisition opportunities with other pharmaceutical manufacturers where they have products with high curative effects and other conditions are proper.