BUSINESS REVIEW

PRC Healthcare Products Market

Healthcare products in the PRC have a relatively recent history. Demand for healthcare products reached RMB40 billion in 2000 but dropped to around RMB20 billion in 2001 and 2002 due to concerns over the quality of healthcare food products and a change in the licensing of such products. The market rebounded in 2003 to RMB30 billion, on the strength of increased consumer awareness of personal healthcare.

Kam Ioi
Managing Director

Recent regulations have been a positive development for the industry. In 2004, the China Healthcare Association replaced the China Health Food Association as the industry's regulatory body, with a mission to strengthen product approval procedures and standardize rules and regulations. Old licenses have been revoked and new ones are issued only with approval from the State Drug Administration.

By the end of 2004, the PRC government is expected to lift the ban on direct selling in the PRC, which was instituted in 1998 in the wake of deceptive sales and consumer losses. The new regulations are expected to bolster sales of healthcare products.

The Group recognizes that the key success factors in the healthcare products industry are: quality products and technology; strong branding; and an extensive distribution network. To this end, the Group made further investments in its products, back-end systems, branding, and distribution network during the year. The investments have established a strong platform for growth.

Anion Water Producer

Sales of anion water producer maintained its growth momentum. Contribution to group turnover from this product line jumped from 28.1% to 49.2% this year. The Group further consolidated its dominant position in the anion water producer market by forming a joint venture with existing partner OSG Corporation Co., Ltd. ("OSG"), a listed company in Japan and pioneer of the anion water producer maker technology in Japan. In parallel, the Group gained control over its manufacturing partner 合肥美菱環保電子有限責任公司 (Hefei Meiling Electron Environment Protection Co., Ltd.*) ("Hefei Meiling"), a company established in the PRC, through its acquisition. The Group is now well-positioned to penetrate all price segments of the anion water producer market.

Healthy Sleeping System

Cross-pollination of customers between the Group's product lines has helped defend the Group's leading position in the highly competitive healthcare bedding market. The Group was granted the eligibility to use the "March 15" label of the China Consumers' Association on the Healthy Sleeping System signifying its premium quality. New bedding series for newly married couples and students were introduced. In addition, a series of bedding products with fibres developed from bamboo and containing BIOenergy® compound for the summer season was launched with a view to increasing sales of bedding products in the summer months.

Application of our flagship BIOenergy® and MBF® technology has been extended to a series of nano-grade medical functional dressing products, with good inroads made into hospital distribution.

BIOenergy® compound	A superfine microelemental biochemical mixture containing titanium oxide, zirconia, silica, yttrium oxide, cerium oxide, tin dioxide, silver phosphate and other microelements. The BIOenergy® compound has been proven to be able to improve blood microcirculation in the human body.
MBF®	microelemental bioactivity fibre, a processed fibre product of polyester chips blended with the BIOenergy® compound and woven into flax fibre. A China Healthcare Association certified clinical research conducted in seven grade-A hospitals shows that MBF® offers significant alleviation to the clinical symptoms of insomnia, exhaustion, tiredness, distraction, arthralgia, acrodynia, acrocyanosis, breathe difficulty and limbs anaesthesia resulted from or related to microcirculation dysfunction.

Back-end Systems

The Group increased its investments in back-end systems to facilitate integration among its franchisees, enhance customer service and streamline logistics:

— An ERP (enterprise resource planning) system consolidates and standardizes operational and financial management across the Group's distribution network.

— A CRM (customer relationship management) system is under pilot-testing in Shenzhen and will be rolled out to eight key cities initially. With support from a call center, the CRM system enables the provision of customized services to the Group's customers, particularly after-sales support.

— A supply chain management system gives the Group increased flexibility and efficiency in delivering to the Group's distributors and customers.

Branding

In a milestone development of its brand, the Group was granted eligibility to use the authoritative "March 15" label of the China Consumers' Association on its products. The label is an endorsement of the premium quality of the Group's healthcare products and the Group's commitment towards consumers' rights. It is believed that Vitop is the first in the healthcare sector eligible to use the "March 15" label.

Increased efforts were spent on corporate communication to raise consumer awareness and confidence in Vitop®'s positioning as a premium healthcare brand. The Group aligned the branding of its point of sales network with a new Vitop® corporate identity. Other initiatives included a co-operation with the State Sports General Administration of China to be the official provider of anion water producer and healthy sleeping system for China's Olympic athletes.

Distribution Networks

As of the end of June 2004, the Group has 355 franchisees (June 2003: 222) in 355 cities (June 2003: 240) with 647 exclusive points of sales outlets (June 2003: 387) carrying the Group's products. The Group continued to invest resources into strengthening the existing franchisee network, penetrating untapped markets with new recruits, and providing professional consultation and services to franchisees. The Group is also looking into penetrating new distribution networks through alliances and acquisitions.

FINANCIAL REVIEW

Retail sales	Sales to consumers through franchisees
Group turnover	Group revenue derived from wholesale revenue and royalties for goods sold to franchisees

Retail Sales and Group Turnover

The Group delivered a strong financial year 2004 performance, with retail sales and group turnover rising by 32.7% and 35.2% over 2003 to approximately HK$349.5 million and approximately HK$140.0 million respectively. The increase in group turnover was broad-based with growth, ranging from 18.0% in the second quarter to 57.0% in the last quarter, in each and every quarter of financial year 2004.

The anion water producer recorded the strongest growth of 136.8% to approximately HK$68.9 million and accounted for 49.2% of group turnover in the year. Turnover of the healthy sleeping system was approximately HK$55.6 million representing a decrease of about 4.8% from 2003. The Group has launched several new product series targeting the newly married couples and students as well as healthy sleeping system for the summer season with fibres developed from bamboo and containing BIOenergy® compound. It is expected that the new products will improve the sales performance in the summer season. The turnover of non-bedding MBF® products decreased by 8.2% to approximately HK$9.7 million as a result of inventory clearance program aiming to reduce the number of stock keeping units to focus sales effort on core products. Polypeptide products, driven by the albumin powder launched during the year, achieved an increase of 7.0% in turnover to approximately HK$5.8 million.

Gross Profit

Gross margin decreased by 5.5 percentage points to 55.0% as compared to 60.5% in 2003. The decrease in gross margin is due to a change in sales mix, the lower margin anion water producer amounted to nearly half of group turnover. Segment-wise, the anion water producer recorded a drop in gross margin to 46.3% from 48.0% last year as new models were introduced to complement the current product range. Bedding products recorded a gross margin of 67.9% and was in line with the gross margin of 70.0% last year. The gross margin of non-bedding MBF® products decreased from 45.9% recorded last year to 35.4% this year as a result of inventory clearance program aiming to reduce the number of stock keeping units to focus sales effort on the core products. Polypeptide products, driven by the recently launched albumin powder, achieved an increase in gross margin to 66.4% as compared to 54.6% recorded last year.

Net Profit

Gross profit increased by 22.8% to approximately HK$77.0 million from approximately HK$62.7 million in 2003. Other income, comprised of tax refund, investment and interest income increased by approximately HK$1.4 million to approximately HK$2.9 million in 2004. The marketing initiatives in brand building and network development as well as the investments in back-end systems attributed to the increase of 5.1% in operating expenses to approximately HK$56.8 million in 2004 as compared to total operating expenses of approximately HK$54.0 million last year.

Though expenses were higher in 2004, they lagged the growth in turnover and gross profit. Consequently, operating profit increased by 126.5% to approximately HK$23.1 million and operating profit margin expanded by 6.6 percentage points to 16.5%. The tax exemption period of the Group's operating subsidiary in the PRC ended in 2003 and the Group is subject to profit tax in the PRC which led to the increase of approximately HK$1.8 million tax charge from approximately HK$0.5 million to approximately HK$2.3 million in 2004. After deducting minority interest of approximately HK$0.6 million, group net profit increased by 2.6 times to approximately HK$20.2 million from approximately HK$5.6 million recorded in 2003.

LIQUIDITY AND FINANCIAL RESOURCES

During the year, the Group recorded an inflow of approximately HK$17.9 million from the operating activities, after the payments of approximately HK$10.1 million for capital expenditures and intangible assets, and the final dividend of financial year 2003 of approximately HK$4.8 million partly financed by the inflow of approximately HK$3.6 million on exercise of share options, cash on hand increased by approximately HK$6.6 million to approximately HK$48.8 million as at 30 June 2004. The Group had no outstanding bank borrowing and no banking facilities available.

SIGNIFICANT INVESTMENT

During the year, there was no significant investment held by the Group.

MATERIAL ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES AND ASSOCIATED COMPANIES/JOINTLY CONTROLLED ENTITIES

During the year, the Group entered into an acquisition agreement with 合肥美菱集團控股有限公司 (Hefei Meiling Group Holdings Company Limited*) for the acquisition of 80% interests in Hefei Meiling for a consideration of RMB3.57 million (equivalent to approximately HK$3.37 million). The acquisition was completed in April 2004, after which Hefei Meiling had been converted into a sino-foreign joint venture and renamed as 合肥天年美菱環保科技有限責任公司 (Hefei Vitop Meiling Environmental Technologies Co. Ltd.*) ("Vitop Meiling"). Vitop Meiling is principally engaged in the manufacturing of anion water producer.

During the year, the Company entered into an agreement with OSG to form a joint venture named Vitop OSG Environmental Technology (Suzhou) Co., Ltd 天年三愛環保科技(蘇州)有限公司 ("Vitop OSG") in the PRC and is owned as to 40% by the Company with an investment of 60,000,000 yen (equivalent to approximately HK$4.3 million). The joint venture was formed in May 2004, after which Vitop OSG became a jointly controlled entity of the Group and is principally engaged in the manufacturing of anion water producer.

Save as disclosed above, there were no material acquisitions or disposals of subsidiaries and associated companies/jointly controlled entities during the year.

EMPLOYEES AND REMUNERATION POLICIES

As at 30 June 2004, the Group employed a total of 334 employees, of which 327 are based in the PRC and 7 are based in Hong Kong. The total salaries and other remuneration (excluding directors' emoluments) of approximately HK$12.22 million were incurred for the year. Remuneration packages comprised salary, mandatory provident fund, bonus, medical coverage and share options.

MAJOR EVENTS

During the year, on 5 January 2004, Mr. Lee Kwok Ming ("Mr. Lee") was appointed as an executive director of the Company and entered into with the Company (i) a director's service agreement for a term of two years and (ii) a subscription agreement in relation to the subscription of an aggregate of 7,752,000 new shares by Mr. Lee at the subscription price of HK$0.31 per share. On the same day, Mr. Lee was also granted options to subscribe for up to 20,000,000 shares at the exercise price of HK$0.495 per share exercisable during the period of five years from the date of grant, subject to approval of the grant by the independent shareholders of the Company. At the extraordinary general meeting of the Company held on 9 February 2004, the subscription agreement and the grant of the options were approved by the independent shareholders of the Company. Details of these transactions have been disclosed in the Company's announcement dated 5 January 2004 and the Company's circular dated 21 January 2004.

SECURITIES IN ISSUE

During the year, a total of 13,028,400 shares were issued pursuant to the exercise of the subscription rights attaching to the options by the option holders of the Company at an exercise price of HK$0.25 per share as to 5,695,000 shares and HK$0.30 per share as to 7,333,400 shares, respectively.

Subsequent to the year end, a total of 1,938,000 shares were issued pursuant to the subscription of the first tranche of the subscription shares by Mr. Lee at the subscription price of HK$0.31 per share as referred to in the subscription agreement dated 5 January 2004 and made between Mr. Lee and the Company.

As a result of the new issue of 14,966,400 shares upon the exercise of share options and the subscription of shares as referred to above, the total number of issued shares of the Company as at the date of this annual report is 680,136,400.

OUTLOOK AND FUTURE PROSPECTS

The coming five years will be an exciting next-stage development for the Group. It will be a period of change and expansion. Reinventing our sales models to maximize opportunities in direct sales will be a priority. Another is to step up merger and acquisition activities and other strategic initiatives. The Group will introduce new products and multi-brands to increase domestic market share, while also looking abroad for opportunities in the international markets. Distribution complementary to the Group's existing franchisee network will be developed. The investments in branding, product development, distribution network, and back-end systems fortified the Group's leading position in the non-food healthcare sector and paved a solid foundation to achieve the long term growth rate of 30% per annum.

The ongoing priority for the Group will be to focus on better execution in all parts of its value chain. While much has already been achieved, further improvements can still be made in operating efficiency, information systems and customer service. This will ensure that the Group can manage change and expansion with success.

* *For identification purpose only*