



# Management

## *Discussion and Analysis*



## BUSINESS REVIEW

For the year ended 31 December 2005, turnover of the Group increased by 18.2% to approximately RMB831,379,000. During the year, sales volume and market shares of the Group's injection, soft capsule and granule products continued to expand as a result of our high quality products, strong brand equity and effective marketing strategies. Along with optimization of sales mix and effective control of production and operation costs, net profit attributable to the equity holders of the Group surged to approximately RMB331,467,000, representing an increase of 27.1% over last year.





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## Sales by product format

	2005 Sales	2005 Sales mix	2005 Growth rate
Injections	RMB453,184,000	54.5%	25.3%
Soft Capsules	RMB259,883,000	31.3%	13.2%
Granules	RMB109,016,000	13.1%	6.8%

### Injection Products

During 2005, sales of injection products of the Group reached approximately RMB453,184,000, representing an increase of 25.3% from last year. The growth mainly came from a higher sales of Shen Mai injection and Qing Kai Ling injection which increased by 13.4% and 29.9% respectively during the year. The strong growth in sales was attributable to the strong market demand for Chinese medicine injections, the Group's strategies to focus on the business of injection products, careful selection of primary distributors, strengthened development of distribution network and thereby increasing market coverage.

Injection products accounted for approximately 54.5% of turnover in 2005 as compared to 51.4% in 2004. The Group believes that it is now the largest Chinese medicine injection manufacturer in PRC in terms of sales volume and production capacity.



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### Soft Capsule Products

Sales of the Group's soft capsule products in 2005 amounted to approximately RMB259,883,000, an increase of 13.2% as compared with last year. It was mainly attributable to the increase in sales volume of Wu Fu Xin Nao Qing soft capsule and Huo Xiang Zheng Qi soft capsule.

During the period under review, sales of Wu Fu Xin Nao Qing soft capsule and Huo Xiang Zheng Qi soft capsule reached RMB162,881,000 and RMB39,417,000 respectively, representing an increase of 4.2% and 92.6%, respectively over last year. Soft Capsule products accounted for approximately 31.3% of turnover in 2005 as compared to 32.6% in 2004. The Group believes that it is now the largest Chinese medicine soft capsule manufacturer in PRC in terms of sales volume and production capacity.

### Granule Products

Sales of granule products recorded an increase of 6.8% as compared with last year, amounting to approximately RMB109,016,000. The increase was due to strategic arrangement of the Group to maintain stable growth in granule products. Granule products accounted for approximately 13.1% of turnover in 2005 as compared to 14.5% in 2004.



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### Key Products

*Shen Mai injection – for treatment of coronary heart disease, viral myocarditis and cardiac pulmonary disease*

Sales of Shen Mai injection, one of the Group's core strategic products, increased by 13.4% from last year to reach approximately RMB203,443,000 in 2005. The growth in sales of Shen Mai injection was mainly attributable to the robust demand for the product in the market along with the product's strong brand name and superb quality. Leveraged on the strong and established brand equity, the Group strived to further expand its market share and penetration in the established markets in northern and central regions as well as the emerging markets in the eastern and southern regions of China. Shen Mai injection is a State Protected Chinese Medicine and is listed in the national catalogues of medical insurance and occupational injury insurance. Shen Mai injection is very popular and widely used by medical institutions and practitioners in clinical applications. The Group believes this product has enormous growth potential. During the year, Shen Mai injection was recommended by the Ministry of Health for treating human transmitted avian flu. The Group believes that it is the largest manufacturer and supplier of Shen Mai injection in China in terms of sales volume and enjoys competitive pricing advantage. According to an independent survey, Shen Mai injection ranked number one among Chinese medicines purchased by hospitals in the PRC.

*Qing Kai Ling injection – a widely used anti-virus medicine for treatment of a wide spectrum viral diseases including respiratory tract infection, viral hepatitis, cerebral hemorrhage and cerebral thrombosis*

Sales of Qing Kai Ling injection, one of the Group's core strategic products, increased by 29.9% to RMB194,550,000, accounting for 23.4% of the Group's turnover. Qing Kai Ling injection is listed in the national catalogues of medical insurance and occupational injury insurance, and designated by the State Administration of Traditional Chinese Medicine as an indispensable Chinese medicine for the emergency wards of Chinese hospitals. During the year, it was also recommended by the Ministry of Health for treating human transmitted avian flu. The product has broad clinical applications. As Qing Kai Ling injection is the





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longest in the history of the Group's manufacturing of injection products, the Group possesses strong production knowhow and production cost advantage. The Group believes it is the largest manufacturer of Qing Kai Ling injection in the PRC in terms of sales volume. Sales increase of this product was mainly attributable to the increase in demand from the established markets of the northern and central regions and emerging markets in the eastern and southern regions of China. With further expansion and alliance with strategic national distributors, improved distribution channels and strengthened marketing and promotion efforts at point of sales, the Group believes that sales of this product will continue to increase.

*Wu Fu Xin Nao Qing soft capsule – for prevention and treatment of coronary heart disease and cerebral arteriosclerosis*

Sales of Wu Fu Xin Nao Qing soft capsule increased by approximately 4.2% to RMB162,881,000, as compared to last year and accounted for 19.6% of the Group's turnover. At the beginning of the year, the Group rationalized the distribution network of this product by way of careful selection of primary distributors, consolidation of distribution channels and rationalization of its pricing management to ensure the long term profit margin of this product and to protect the interest of all distributors. Wu Fu Xin Nao Qing soft capsule is one of the lowest in cost of average daily dosage among similar cardiovascular medicines and the product has been very popular. Leveraging on the strong brand equity of "Wu Fu", the Group will continue to strengthen its management and support on points of sales, and increase its promotion effort. The Group believes that the rationalization of distribution network of Wu Fu Xin Nao Qing soft capsule has demonstrated good results and this product will have high growth momentum in the coming years.





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## Emerging Products

*Huo Xiang Zheng Qi soft capsule – for prevention and treatment of heat stroke, stomach ache, nausea and diarrhoea*

During the year, the Group recorded an increase of 92.6% in sales of Huo Xiang Zheng Qi soft capsule with a revenue of RMB39,417,000, which accounted for 4.7% of the Group's turnover. Huo Xiang Zheng Qi soft capsule is a very popular non-prescription Chinese medicine due to its effective efficacy and the relatively high absorption rate of soft capsule. It was recommended by the Ministry of Health for treating human transmitted avian flu during the year. The product is a State Protected Chinese Medicine and is listed in the national catalogues of medical insurance and occupational injury insurance. The dramatic increase in sales of Huo Xiang Zheng Qi soft capsule was mainly attributable to the Group's strong brand equity, effective implementation of pinpointed first mover channel strategy and point of sales pulling strategy. The Group will continue to increase its marketing efforts, and growth of this product is expected to increase significantly again next year.

*Huang Qi injection – medicine for cardiovascular disease and anti-virus – for treatment of viral myocarditis, heart malfunction and hepatitis*

Sales of Huang Qi injection increased by 55.5% to RMB29,819,000, accounting for 3.6% of the Group's turnover. The product is a State Protected Chinese Medicine and is listed in the national catalogues of medical insurance and occupational injury insurance. It is also one of the strategic growth products of the Company. With the rising trend of viral myocarditis in recent years, Huang Qi injection, with a proven efficacy on such illness, has solid foundation for future market development.

*Qing Kai Ling soft capsule – for treatment of high fever, viral influenza and respiratory tract infection*

Qing Kai Ling soft capsule is a State Protected Chinese Medicine. It is both a prescription and non-prescription medicine, and is included in the national catalogues of medical insurance and occupational injury insurance. During the year, it was also recommended by the Ministry of Health for treating Human transmitted avian flu. Sales of Qing Kai Ling soft capsule amounted to approximately RMB13,406,000, an increase of 40.1% as compared to last year, accounting for



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1.6% of the Group's turnover. With strong brand name, effective implementation of channel strategy and point of sales pulling strategy and the synergy in branding Qing Kai Ling injection, the Group believes that the product will maintain strong sales growth next year. Since the beginning of the year, the Group increased its marketing and promotion efforts for Qing Kai Ling soft capsule. With superior product quality, sales of this product will increase considerably.

### *Shu Xie Ning injection – cardio-cerebrovascular disease medicine*

Sales of Shu Xie Ning injection reached RMB12,519,000 during 2005. This product was put into mass production after the Group expanded its extraction capacity in early 2005. According to an independent survey, Shu Xie Ning injection, being a major type of clinical medicine for treating cardio-cerebrovascular diseases, is the third most purchased Chinese medicine by hospitals in China. The Group successfully obtained Certificate of State Protected Chinese Medicine for Shu Xie Ning injection in early December 2005. The Group believes that by leveraging the Group's advantage in production technology and economies of scale in Chinese medicine injections, this product will become a core product of the Group. With its business experience in Chinese medicine injection products, established brand name, the Group successfully introduced the product to the market during the year. This product is expected to achieve a substantial growth in the coming years.

## RESEARCH AND DEVELOPMENT

### **Achievements**

During the year, the Group obtained Certificates of New Medicine for Xue Sai Tong dropping pill and Shu Jin Tong Luo granule, and the certificates offer a protection period of 3 years.

Furthermore, the Company has obtained certificates of State Protected Chinese Medicine for two medicines, namely Guan Xin Ning injection and Shu Xie Ning injection and renewed certificates of State Protected Chinese Medicine for two medicines, namely Paediatric Qingfei Huatan granule and Jingwu granule, with a protection period from 2005 to 2012.

Jiangzhi Tongluo soft capsule was named as one of the 2005 State Key New Products by the Ministry of Science and Technology.





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Zhikeping Jiangzhi Tongluo soft capsule was honored as one of the National Model Projects of High-Tech Industrialization and was awarded RMB5,000,000 by National Development and Reform Commission. Moreover, certain products under development were awarded a total of RMB950,000 from national and provincial science and technology authorities.

### **In Progress**

Currently, there are 17 potential new product research projects which are either undergoing pharmaceutical research and clinical trial or have completed clinical trial. Among these projects are 5 products for treatment of cardiovascular diseases, 2 products for treatment of digestive system, 1 product for anti-viral treatment. All of these research projects are progressing as scheduled.

The Group had increased its focus in protecting intellectual properties. During the year, the Group filed three patent applications including two formulations and production processes for a medicine treating constipation and a medicine for treating cardiovascular illness, as well as one formulation of a medicine for treating cardio-cerebrovascular disease.

### **EXPANSION OF DISTRIBUTION NETWORK**

During 2005, the Group established strategic alliance with key national distributors which have controlled over half of market share of the medicine wholesale market in China. Through this alliance, the Group will be able to accelerate its expansion and expand its coverage in the PRC.

### **EXPANDING PRODUCTION AND STORAGE CAPACITY**

Earlier this year, the Group completed the expansion of its Chinese medicine extraction capacity from 1,800 tonnes to 5,400 tonnes per annum. In light of expected strong demand of injection products, the Company is now constructing a new injection workshop to double its existing injection production capacity from 1.2 billion units to 2 billion units of injection products per annum. The new injection workshop is expected to be completed in early 2007.

To cope with the constant growth of the Group's business, the Group also commenced the construction of a large-scale logistic centre in the second half of the year, which will effectively increase the automation and capacity of storage and delivery to cater for the increasing business volume. The new logistic centre is expected to be completed by mid-2006. Upon completion, storage capacity will increase by approximately 1.5 times while efficiency in storage and delivery will be enhanced.



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## CHANGES IN REGULATORY ENVIRONMENT

During the year, price caps of 22 western anti-biotic medicines listed in the national insurance catalogue were adjusted downward. Currently, the Group is not aware of any formal notifications from PRC regulatory bodies of any downward adjustment of price caps of Chinese medicines. The Group believes that even if such downward adjustment occurs, it will not have material impact on its earnings as average retail prices of most of the Group's products are considerably lower than the current price caps.

During the year, PRC regulatory authorities delegated the authority of regulating retail price cap of OTC products to provincial pricing departments. The Group believes that this change will increase the efficiency of the approval process of medicine prices and facilitate reasonable medicine prices, thereby establish a healthy market. The Group believes that such delegation of authority would not have any material impact on its earnings.

## GROWTH STRATEGIES

The Group will continue to implement its established strategies and strive to achieve better growth and results for next year and beyond. The details of the growth strategies are as follows:

1. Product mix enhancement – while increasing the revenue contribution from its core products, (namely Shen Mai, Wu Fu Xin Nao Qing and Qing Kai Ling) the Group will nurture emerging products (including Huang Qi, Shu Xie Ning, Huo Xiang and Qing Kai Ling soft capsule) to broaden its strategic growth product portfolio.
2. Rationalization of distribution channels – The Group will foster closer strategic cooperation with cross-regional distributors which have strong distribution capabilities and strong financial position to establish a distribution network backbone and further increase the efficiency of distribution channels.
3. Strengthening support at point of sales – The Group will continue to enhance the development of a professional team to support the point of sales of prescription medicines of hospitals and OTC, as well as the “Third Point of Sale Zones” (hospitals of factories and mining fields, public clinics and rural healthcare centres).



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4. Implementation of regional expansion strategies – While utilizing its advantageous position in northern, northeastern and northwestern China markets, the Group will also explore opportunities in southern, central and eastern China emerging markets which have strong demand for Chinese medicines to broaden the growth of the Group. Key strategic development regions include economically developed regions such as the Pearl River Delta, the Yangtze River Delta, Huanbo Bay costal areas, Yangtze River costal areas and cities and regions along the Beijing and Guangzhou railway.
5. The Group will continue to execute its research and development strategies with increased investments in the development of products for the treatment of chronic diseases that commonly affect the middle and old aged, anti-viral diseases and diseases that mostly affect children.
6. The Group will continue to evaluate acquisition opportunities in a prudent manner.

### FUTURE OUTLOOK

In view of continuous growth of China's GDP, increase in average income per capita, rising health awareness among the general public, an aging population that results in increased demand for medicines for treatment of chronic diseases, the pharmaceutical market of the PRC has been growing rapidly. In addition, the continuous support of the Chinese government also facilitates further growth of the industry.

The State Council have recently promulgated the National Guideline on Medium and Long-Term Program for Science and Technology Development (2006-2020) which set out a number of emphasis and priorities, including strengthening the succession and innovation of Chinese medicines, promoting modernization and internationalization of Chinese medicines, developing modern Chinese medicines and production techniques, as well as reinforcing patent protection and international cooperation.

The Group expected that during the period of the Eleventh Five-Year Plan, the PRC government would commit more resources to develop the medical and healthcare industry, intensify the development of rural health care system so as to provide high quality medical service to the people, and will also strengthen health education to promote public health awareness.

Being one of the leading enterprises of the Chinese medicine industry, the Group will benefit from the growth trend of the industry.



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## FINANCIAL ANALYSIS

### Turnover

In 2005, the Group continued to focus its business on Chinese medicine injection and, soft capsule products of good efficacy and high quality. Turnover of injection, soft capsule and granule products increased by 25.3%, 13.2% and 6.8% from 2004 to approximately RMB453,184,000, RMB259,883,000 and RMB109,016,000, respectively, each of which accounted for 54.5%, 31.3% and 13.1% of the Group's turnover. The Group had also sold RMB9,296,000 of medicines in other formats which accounted for 1.1% of total turnover.

Turnover of the three key products of the Group, namely Shen Mai injection, Qing Kai Ling injection and Wu Fu Xin Nao Qing soft capsule increased by 13.4%, 29.9% and 4.2% from 2004 to approximately RMB203,443,000, RMB194,550,000 and RMB162,881,000, respectively.

During the year, turnover of medicines for treating cardiovascular illness, anti-virus medicines and medicines for treating other illness accounted for 55.8% (2004: 58.3%), 27.9% (2004: 25.6%) and 16.3% (2004: 16.1%) of the Group's total turnover, respectively.

Turnover of prescription and non-prescription medicines of the Group of 2005 were approximately RMB684,732,000 and RMB146,647,000, accounting for approximately 82.4% and 17.6% of the total turnover, respectively.

### Cost of Sales

Cost of sales of the Group in 2005 was approximately RMB274,772,000. Direct materials, direct wages and other production costs accounted for approximately 79.6%, 4.4% and 16.0% of the total cost of sales.

### Gross Profit Margin

During 2005, the overall gross profit margin increased slightly by 2.7% to 66.9% as compared to the 64.2% over the corresponding period last year. The average gross profit margins of injection products, soft capsule products and granule products were 72.1%, 62.9% and 48.4%, respectively. The improvement in gross profit margin is mainly attributable to the economies of scale, effective internal control, and advanced production technology to achieve high extraction rate and production yield rate. The higher sales mix of injection products, as compared with the corresponding period of last year, also led to the increase in the gross profit margin of the Group during the year.



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### Distribution costs

The overall distribution costs of the Group increased by 38.1% when compared with the corresponding period of last year, representing 19.4% of the Group's turnover (2004: 16.6%). This was primarily attributable to the increase of distributor promotion expenses and advertising fees by approximately 44.2% and approximately 33.0% respectively. Distributor promotion expenses which accounted for 8.1% of turnover (2004: 6.6%), mainly included the promotion cost subsidies to distributors with reference to the growth of turnover in the year. Advertising fees represented 6.2% of turnover (2004: 5.5%). The Group had been strengthening its effort in the establishment of the Group's brand image and the nation-wide recognition of its products through active participation in exhibitions and media promotions, and thus resulting to an increase in advertising fees.

### Administrative expenses

The administrative expenses of the Group increased by 29.6% when compared with last year, representing 8.6% of turnover (2004: 7.8%). The increase of administrative expenses was primarily attributable to the increase of salaries and benefits and research and development expenses from last year. Salaries and benefits accounted for 2.9% (2004: 1.6%) of turnover and the increase was due to the recruitment of additional high caliber employees by the Group during the year to facilitate business growth. Research and development expenses was approximately RMB10,083,000 in 2005. During the year, the Group increased its effort in product development, which led to a moderate rise in the overall research and development expenses to 1.2% (2004: 1.1%) of turnover. Administrative expenses also comprised of non-productive depreciation expenses which accounted for 5.2% (2004: 4.5%) of total administrative expenses.

### Income tax

Pursuant to Qiong Hai National Tax Document 2004 No.151 (瓊海國稅發2004 151號), Shineway Pharmaceutical Sales Co., Ltd. ("Shineway Sales") was exempted from PRC Enterprise Income Tax for the year ended 31 December 2003. Pursuant to National Tax Document 1988 No. 26 (國發1988 26號), the PRC Enterprise Income Tax rate applicable to Shineway Sales was 15% of its assessable profit.

The PRC Enterprise Income Tax and Local Income Tax rates applicable to Shineway Pharmaceutical and Hebei Shineway is 33% of their assessable profits. Pursuant to the relevant law and regulations of the PRC, Shineway Pharmaceutical and Hebei Shineway are exempted from PRC Enterprise Income Tax for two years commencing from their first profitable year of operation and are entitled to a 50% relief from PRC Enterprise Income Tax for the following three years. In addition, these two companies are also exempted from Local Income Tax for five years from the first profitable year. The first profitable period of Shineway Pharmaceutical and Hebei Shineway commenced on 1 January 2004.



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Hence, the overall effective income tax rate of the Group from 2006 to 2008 is estimated to be approximately 15%.

The Group believes that Shineway Pharmaceutical and Hebei Shineway are able to continue to enjoy 50% relief of PRC Enterprise Income Tax according to the current tax concession for high-tech enterprises of PRC, and therefore its overall effective income tax rate will most likely remain at approximately 15% after 2008.

### Capital Expenditures

Capital expenditures of the Group in 2005 were as follows:

- 1) Approximately RMB51,000,000 was utilised for the acquisition of a newly constructed Chinese medicine extraction workshop in January 2005, leading to an increase of the Group's Chinese medicine extraction capacity to 5,400 tonnes per annum. The Group believes that it is now the enterprise with the highest Chinese medicine extraction capacity in the country.
- 2) Approximately RMB80,846,000 was utilised for the acquisition of the remaining 20% of equity of Shineway Pharmaceutical Sales Co., Ltd. ("Shineway Sales"). After the acquisition, the Group held 100% of equity of Shineway Sales and eliminated the related minority interests and increased its net profit.

The Group expected to utilise approximately RMB50,000,000 for the construction of a new logistic centre commencing in the second half of the year in order to cope with business growth. The Group is also building a new injection workshop with investment of approximately RMB110 million. The new injection workshop is expected to be completed in early 2007. Accordingly annual output of injection products will be increased by approximately twofold to reach 2 billion vials when compared with the current level.

### Dividends

Details of dividends and dividend policy are set out in the director's report on page 31 of this annual report.

### Loans and Bank Borrowings

The Group did not have any loans or bank borrowings as at 31 December 2005 (2004: Nil). Accordingly the gearing ratio based on interest bearing debt for the year is Nil (2004: Nil).

### Liquidity and Financial Resources

As at 31 December 2005, bank deposits of the Group amounted to RMB1,347,605,000 which comprised of RMB713,742,000 and HK\$615,401,000 (which is equivalent to RMB633,863,000). Except for trade and operating payables, the Group did not have any other liabilities.



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The Directors believe that the financial position of the Group is healthy, with sufficient financial resources to meet the requirement for future development.

## Capital structure

For the year ended 31 December 2005, except for the repurchase of 3,000,000 ordinary shares, there was no change in the capital structure and issued share capital of the Group.

## Inventories

Inventories balance at the end of 2005 increased approximately 95.2% as compared with last year due to an expected increase in demand of sales in the beginning of 2006 and the Group purchased more raw materials for production in the end of 2005 accordingly. Raw materials, work in progress and finished goods accounted for approximately 48.8%, 14.7% and 36.5% (2004: 48.8%, 12.9% and 38.3%) of inventories respectively.

Finished goods inventories turnover days of 2005 was 13.2 days (2004: 29.8 days).

## Property, plant and equipment

Property, plant and equipment grew by 33.6% as compared with last year. This was mainly due to the purchase of a new Chinese medicine extraction workshop of approximately RMB51,000,000 and the construction of a large logistics centre in the year.

## Trade and bills receivables

Bills receivables dropped by 28.2% from last year since the Group encouraged customers to settle payment by cash instead of bills. Turnover days of trade and bills receivables was 73 days (2004: 65 days).

## Trade payables

During the period under review, turnover days of trade payables was 61 days (2004: 53 days).

## Minority interests

In 2005, the Group acquired the remaining 20% interests of Shineway Sales. Upon the acquisition, the Group now holds the entire interests of Shineway Sales and effectively eliminated the related minority interests.

## Goodwill

Goodwill is related to the Group's acquisition of the remaining 20% ownership interests of Shineway Sales for approximately RMB80,846,000 in 2005.



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### **Government grants**

The amount is related to the grants from relevant government authorities in China for supporting the research of Jiangzhi Tongluo soft capsule.

### **Pledge of Assets**

The Group did not have any pledged assets as at 31 December 2005 (2004: Nil).

### **Contingent Liabilities**

The Group did not have any contingent liabilities as at 31 December 2005 (2004: Nil).

### **Exposure to Fluctuations in Exchange Rates**

Substantially all of the business transactions and liabilities of the Group are denominated in Renminbi and Hong Kong dollars. The Group adopts a conservative financial policy and all of its bank deposits are in Renminbi and Hong Kong dollars. As at 31 December 2005, the Group did not have any bank liabilities, foreign exchange contracts, interest or currency swaps or other financial derivatives for hedging purpose. Therefore, the Group is not exposed to any material interest and exchange risks.

### **Substantial Investment and Acquisition**

During 2005, the Group did not have any substantial investment and acquisition other than the acquisition of a Chinese medicine extraction workshop and the 20% equity interest in Shineway Sales, and the construction of a new injection workshop and a new logistic centre.

### **Employees**

As at 31 December 2005, the Group has 1,748 (2004: 1,607) employees. Remuneration was determined and reviewed based on fair principles with reference to market conditions and individual performance. The Group also provided other benefits to its employees, including medical insurance and retirement benefits. The Group's employees in Hong Kong were also enrolled in the mandatory provident fund scheme.