

Management Discussion and Analysis

BUSINESS PERFORMANCE CONDITIONS

Business Review

Affected by the rationalisation of the health care products market by the State and the emergence of direct sales as a popular mode of medicine distribution, sales of health care products under traditional channels were still in decline, and the health care products market as a whole was in the doldrums. Under such circumstances, the Group recorded a sales turnover of health care products of HK\$100,583,000 for the year 2005, representing a decrease of 26.36% over the previous year, and sales of pharmaceutical products amounted to HK\$30,088,000, increasing by 49.19% over the previous year, while the sales of Electronic Cigarettes Components, a new product, rose 182.25% to HK\$46,092,000 from the previous year. The Group's overall sales turnover was HK\$176,763,000, which was largely the same as the previous year.

Due to the intense competition in the PRC's health care products and pharmaceutical products market, distribution cost, advertising and marketing expenses remained to be substantial, the business of these products was unable to generate satisfactory profit growth for the Group. Therefore, the Group has been actively developing the market for our new products with health concept such as Electronic Cigarettes Component, a tobacco substitute health care product, and satisfactory results were achieved in this area.

As such, the Group continued to seek for opportunities in the market of other non-traditional health care products for diversification, aiming to enhance our business performance and strengthen the foundation for the Group's further development.

In late 2005, at the request of the investor of the preferred shares issued by a subsidiary, the Group restructured such investment and confirmed to repurchase such convertible preferred shares. The Group's shareholding structure will not be affected following the restructuring.

Product Development

The Group increased its investment in the development of pharmaceutical products. A number of new products developed on its own and two new projects acquired will commence production and sales in the second half of 2006 and in 2007 respectively, which will serve as new sources of growth for the Group. Two production lines have been established for the Electronic Cigarettes Component, our new product, increasing its production to 500,000 pieces per day which will support the Group in attaining higher growth of revenue.

The Group has been engaging in the research and development of various pharmaceutical products, two of which belong to category 5 of PRC chemicals, including Amlodipine Besylate which is used for the treatment of hypertension and patients with stabilised angina pectoris, and Pidotimod capsule which has the therapeutic effect of an immunostimulant and is suitable for patients with weak cellular immunity function, it may also be used as a supplementary drug for anti-bacteria treatment in acute infections. These products have a wide prospect, the application for clinical testing has just completed and will be launched after application for their production is made. The applications for other Chinese traditional medicines under development are actively under way.

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REGIONAL DEVELOPMENT

Since the advertising cost for promotion in the health care products market is increasing and the Group is attempting to invite franchised chain stores for the marketing of its health care products in larger cities in the PRC, thus besides the original markets, the Group does not plan to explore into other PRC markets in regions and cities with lower spending power, the main consideration for this is that sales revenues generated from these markets may not be enough to cover the advertising cost incurred. For pharmaceutical products, the Group shall develop its market at a stable pace, strengthening its existing markets first and subsequently exploring other potential markets gradually.

PROSPECTS FOR THE YEAR 2006 AND DEVELOPMENT PLAN

In an effort to revert the declining trend in the sales of its health care products, the Group has introduced new packings of varied contents to cater for the different needs of consumers. By the end of 2005, new additions include the 200 gram packing of single Baoling Ginseng grown for over 10 years which targets for the high-end market, and also smaller packs of ginseng extracts each containing 10 grams of ginseng, available in 3 different sizes which is easier for intake and matches with the rapid pace of modern living. Moreover, the Group is attempting to sell its health care products through franchised chain stores in the Beijing district, which will be extended to the rest of the country if the result is satisfactory. We believe that with the above two measures, the sales of health care products will turn around in the year 2006.

The Group will also focus more on the pharmaceutical products market. The marketing of "Azithromycin Granules" has set a sound foundation for other pharmaceutical products. Making use of the existing sales network of "Azithromycin Granules", our new product "Piglyketone" has good market potential. The Group will be able to generate more stable revenue following the launching of various new products on to the market.

As for our new product, the Electronic Cigarettes Component, the prospects of development is particularly promising as more and more people becoming conscious about health, the electronic cigarette will gradually replace traditional cigarettes. We have already set up two production lines for the product which is expected to contribute more significantly to our revenue growth.

In early 2006, we established a new company, Shenyang Jinlong Health Tobacco Control Co., Ltd., with the hope of further expanding the cigarette substitution market and create a healthier living environment for our customers.

LIQUIDITY AND FINANCIAL ANALYSIS

As at 31 December 2005, bank loans of the Group at fixed interest rate amounted to HK\$36,493,000, representing a decrease of HK\$38,167,000 as compared to the total outstanding loans at 31 December 2004, all of which were short-term loans due within one year and partial in Renminbi loans. Since movements of Renminbi against other currencies, in particular the Hong Kong dollar were more stable, the Directors do not anticipate to face any major currency exposures, therefore the Group has not arranged any currency hedge.

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During the year, an amount of HK\$3,285,000 was paid as aggregate interest of bank loans (2004: HK\$6,049,000). The Group did not use property as securities for such bank facilities, nor the use of any financial instruments for hedging purposes.

Gearing ratio of the Group reduced from approximately 34.5% at 31 December 2004 to approximately 16.13% at 31 December 2005. This calculation is based on net borrowings of approximately HK\$36,651,000 (2004: HK\$75,008,000) and shareholders fund of approximately HK\$227,168,000 (2004: HK\$217,179,000).

As at 31 December 2005, the balance of the inventories amounted to HK\$87,056,000, representing a decrease of HK\$1,578,000 when compared with the corresponding period of the previous year.

ACQUISITION

There was no material acquisitions and disposals of subsidiaries and associated companies during the year ended 31 December 2005.

CHARGE OF ASSETS

As at 31 December 2005, the Group had no bank deposits pledged to banks to secure banking facilities granted to its subsidiaries (2004: HK\$10,198,000).

CONTINGENT LIABILITIES

As at 31 December 2005, the Group did not provide any form of guarantees for any outside companies and was not liable to any material legal proceedings of which provision for contingent liabilities was required.

EMPLOYEE POLICY

The Group employs a total of about one thousand employees in the PRC and Hong Kong (remains at the same level of the corresponding period last year).

In addition to maintaining a stable employee policy, the Group also set down minimum sales quotas for various pharmaceutical products for the sales staff working in pharmaceutical products sales division: those achieved only the minimum sales quota could just receive the basic salary, the portion exceeding the minimum sales quota will be taken in calculating bonus at different proportion corresponding to the extra sales amount achieved, the more the sales amount, the higher proportion of bonus will be rewarded. Such a performance-based salary system aims to encourage the employees to excel in their sales performance.