

5. MANAGEMENT DISCUSSION AND ANALYSIS

(Unless otherwise stated, the financial data contained in this report is extracted from the Group's financial statements prepared in accordance with PRC Accounting Standards and Systems)

The Company and its subsidiaries (collectively the "Group") are principally engaged in (1) manufacture and sales of Chinese Patent Medicine; (2) wholesale, retail, import and export of Western and Chinese pharmaceutical products and medical apparatus; and (3) research and development of natural medicine and biological medicine.

5.1 ANALYSIS OF OPERATING RESULTS

During the Reporting Period, the operating results of the Company maintained a rapid and steady growth as the Group continued to strengthen the supervision and controls on its business operation, promote integration of internal resources, and actively expand the market for its principal operation.

According to PRC Accounting Standards and Systems, turnover of the Group for the Reporting Period was approximately RMB5,193,992,000, representing an increase of 13.01% over that of the same period of last year. Gross profit was approximately RMB191,808,000, representing an increase of 12.36% over that of the same period of last year. Net profit was approximately RMB120,049,000, representing an increase of 15.89% over that of the same period of last year.

According to the financial statements prepared in accordance with HK GAAP, turnover of the Group for the Reporting Period was approximately RMB5,193,992,000, representing an increase of 13.01% over that of the same period of last year. Profit before income tax was approximately RMB189,847,000, representing an increase of 2.28% over that of the same period of last year. Profit attributable to equity holders of the Company was approximately RMB128,848,000, representing an increase of 4.79% over that of the same period of last year. Excluding the gain of RMB19,819,000 arising from the purchase price premium from the additional investment of an external investor in Guangzhou Wang Lao Ji Pharmaceutical Co., Ltd ("Wang Lao Ji") in the first half of 2005, the Group's operating profit for the Reporting Period recorded an increase of 24.93% as compared with the corresponding period of 2005.

An analysis of the operating results of the manufacturing operations (the "Manufacturing Operations") and the trading operations (the "Trading Operations") of the Group for the first half of 2006 are set out as follows:

By segments	Revenue from principal operations		Costs from principal operations		Profit margin of principal operations	
	Amount RMB'000	Changes as compared with that of the same period of 2005 (%)	Amount RMB'000	Changes as compared with that of the same period of 2005 (%)	Profit margin of principal operations (%)	Changes as compared with that of the same period of 2005 (percentage point)
The Manufacturing Operations	1,260,519	10.55	593,844	11.50	52.02	(0.35)
The Trading Operations	3,933,473	13.82	3,681,379	13.22	6.31	0.40
Including:						
Wholesale	3,625,043	12.97	3,421,088	12.55	5.55	0.35
Retail	183,049	23.07	143,287	21.42	21.37	1.05
Import and Export	125,381	27.70	117,004	28.62	6.56	(0.77)
Total	<u>5,193,992</u>	<u>13.01</u>	<u>4,275,223</u>	<u>13.07</u>	<u>17.41</u>	<u>(0.03)</u>

Geographical analysis of turnover from the Manufacturing Operations and the Trading Operations is set out as follows:

Region	The Manufacturing Operations		The Trading Operations		Total	
	Turnover RMB'000	Percentage to total turnover of the Manufacturing Operations (%)	Turnover RMB'000	Percentage to total turnover of the Trading Operations (%)	Turnover RMB'000	Percentage to total turnover (%)
Southern China	767,674	60.90	3,409,903	86.69	4,177,577	80.43
Eastern China	185,020	14.68	183,783	4.67	368,803	7.10
Northern China	95,990	7.62	84,066	2.14	180,056	3.47
North-eastern China	72,175	5.73	41,291	1.05	113,466	2.18
South-western China	87,898	6.97	127,924	3.25	215,822	4.16
North-western China	40,739	3.23	36,120	0.92	76,859	1.48
Export	11,023	0.87	50,386	1.28	61,409	1.18
	<u>1,260,519</u>	<u>100</u>	<u>3,933,473</u>	<u>100</u>	<u>5,193,992</u>	<u>100</u>

5.1.1 Chinese Patent Medicine (The Manufacturing Operations)

According to PRC Accounting Standards and Systems, turnover of the Manufacturing Operations for the Reporting Period was approximately RMB1,260,519,000, representing an increase of 10.55% over that of the same period of last year. Gross profit was approximately RMB155,965,000, representing an increase of 14.47% over that of the same period of last year.

According to the financial statements prepared in accordance with HK GAAP, turnover of the Manufacturing Operations for the Reporting Period was approximately RMB1,260,519,000, representing an increase of 10.55% over that of the same period of last year. Profit before income tax was approximately RMB153,551,000, representing an increase of 0.83% over that of the same period of last year.

During the Reporting Period, the Group took the following measures in the Manufacturing Operations: (i) centralized resources and kept improving its marketing for major products such as medicine for diabetes, cardio-cerebral, cough and phlegm clearing, heat clearing and anti-toxic medicine and rheumatism curing medicine, while exerted full effort in exploring markets for key nurturing products such as Wanglaoji herbal tea etc. The Group also endeavored to enhance the influence of its enterprises' professional brand names and the competitive advantage of products; (ii) integrated its network resources and strengthened marketing efforts in end-markets. Based upon the secured stable growth of the mature Southern China market, the Group aggressively expanded distribution channels and end-market network, and endeavored to increase market shares of its major products; (iii) improved client relationship management, conducted proper supervision over the market prices and sales flow, and endeavored to stabilize the market price of its major products, ensuring the healthy development of the principal operations; (iv) strengthened the research, development and industrialization of new products. During the Reporting Period, the approvals for the production of Kun Xian Capsule (formerly known as Feng Shi Ping Capsule), Nateglinide tablets, and Metformin Hydrochloride Tablets were obtained; and (v) strengthened the control of production and costs, established and improved the supervision system for receivables, and endeavored to enhance its operational efficiency.

After the implementation of the aforesaid measures, there were 39 products whose sales income exceeded RMB5 million for the first half of 2006. For the first half of 2006, sales of certain major products, including Xia Sang Ju Ke Li, Wang Lao Ji Qing Liang Cha, Xiao Er Qi Xing Cha Ke Li, She Dan Chuan Bei Ye and Mi Lian Chuan Bei Pi Pa Gao etc., have significantly increased by 18.92%, 138.19%, 61.24%, 17.43% and 34.12% respectively as compared with the corresponding period of last year.

Analysis of major products of the Manufacturing Operations for the Reporting Period is as follows:

Products	Revenue from principal operations		Costs from principal operations		Profit margin from principal operations	
	Amount RMB'000	Change (%)	Amount RMB'000	Change (%)	Profit margin (%)	Change (%)
Heat clearing and anti-toxic medicine	338,406	18.04	171,997	17.39	48.30	0.34
Including: herb tea series	86,111	111.18	47,912	102.63	43.49	2.40
Diabetic medicine	228,315	6.88	72,380	0.22	67.43	2.16
Cough and phlegm clearing medicine	149,950	2.14	64,271	3.99	56.27	(0.71)
Arthritic medicine	147,096	23.85	59,993	38.26	58.34	(4.19)
Gastric medicine	48,740	(13.49)	25,924	(16.08)	45.94	1.70
Other products	348,012	9.42	199,279	12.12	41.78	(1.32)

Note: Herb tea series includes Wang Lao Ji herb tea and Xing Qun Sang Ju drinks, and the sales of the products of Wang Lao Ji is calculated by the percentage of shareholding in that company by the Company (i.e. 48.0465%).

During the Reporting Period, the rate of expenses of the Manufacturing Operations increased by 0.83 percentage point over that of the corresponding period of last year, mainly due to a greater marketing effort for the sales for the year and the substantial increase in advertising expenses and POS expenses.

5.1.2 Pharmaceutical trading operations (including wholesale, retail, import and export)

Turnover of the Trading Operations for the Reporting Period prepared under PRC Accounting Standards and Systems was approximately RMB3,933,473,000, representing an increase of 13.82% over that of the same period of last year. Gross profit was approximately RMB35,843,000, representing a growth of 4.02% as compared with the same period of last year.

According to the financial statements prepared in accordance with HK GAAP, turnover of the Trading Operations for the Reporting Period was approximately RMB3,933,473,000, representing an increase of 13.82% over that of the same period of last year. Profit before income tax was approximately RMB36,296,000, representing an increase of 8.93% over that of the same period of last year.

During the Reporting Period, active adjustments to operating strategies was made for the Trading Operations following the deepening of health care reform, medicine circulation system reform by the State and changes in the pharmaceutical market. The Group (i) strengthened the communication and cooperation with the suppliers and actively assisted the suppliers to expand sales market, develop and nurture normal domestic brand pharmaceutical products, while carried out proper marketing plan for imported major products with famous brand from joint ventures, ensured the sustained growth of sales operations; (ii) strengthened network building and endeavored to develop market outside Guangdong Province and the end market of hospitals, retail drugstores so as to enlarge the coverage and effectiveness of the network; (iii) improved the system of client credit management and supervision over receivables for the purpose of controlling operating risks; and (iv) continued to focus on retail operations, adhered to diversified operating with more types of agency products, and explored new operating methods audaciously, enhancing its market presence and that for its products continuously.

As at 30 June 2006, the Group has 148 chained pharmacies, including 82 "Cai Zhi Lin" chained pharmacies which specialize in Chinese medicine and 65 "Jian Min" chained pharmacies which specialise in western medicine and 1 named Ying Bang Pharmacy.

5.2 THE OPERATING RESULTS OF THE COMPANY AND ITS FELLOW ENTERPRISES DURING THE REPORTING PERIOD

Name of enterprises	Equity directly held by the Company (%)	Sales RMB'000	Profit RMB'000	Net profit RMB'000
Guangzhou Xing Qun Pharmaceutical Co., Ltd	88.99	188,494	23,886	16,004
Guangzhou Zhong Yi Pharmaceutical Co., Ltd	90.36	333,167	69,147	47,009
Guangzhou Chen Li Ji Pharmaceutical Factory	100	120,945	22,615	15,040
Guangzhou Qi Xing Pharmaceutical Co., Ltd	75	196,999	29,472	22,040
Guangzhou Jing Xiu Tang Pharmaceutical Co., Ltd	88.40	112,394	10,578	10,578
Guangzhou Pan Gao Shou Pharmaceutical Co., Ltd	87.77	151,130	13,175	9,028
Wang Lao Ji	48.05	331,167	40,001	40,001
Guangzhou Huan Ye Pharmaceutical Co., Ltd	59.70	17,474	207	120
Guangxi Ying Kang Pharmaceutical Co., Ltd	51	11,984	(185)	(185)
Guangzhou Bai Di Bio-technology Co., Ltd	95.69	—	(4,747)	(4,747)
Guangzhou Han Fang Contemporary Medicine Research & Development Co., Ltd	70.04	2,122	(10,188)	(10,188)
Guangzhou Pharmaceutical Co., Ltd	90.09	3,715,908	39,573	25,813
Guangzhou Chinese Medicine Corporation	100	511,168	1,560	1,553
Guangzhou Pharmaceutical Import & Export Corporation	100	164,346	1,332	720
Ying Bang Branch Company of Guangzhou Pharmaceutical Company Limited	—	151,855	656	656

5.3 DURING THE REPORTING PERIOD, THE COMPANY DID NOT CARRY OUT ANY OTHER BUSINESS OPERATION WHICH HAS SIGNIFICANT IMPACT ON THE GROUP'S NET PROFIT.

5.4 DURING THE REPORTING PERIOD, THE COMPANY HAD NO INVESTMENT WHICH DERIVED INVESTMENT INCOME EQUAL TO 10% OR MORE OF THE COMPANY'S NET PROFIT.

5.5 THE COMPANY'S INVESTMENTS

5.5.1 Use of proceeds from the issuance of A shares

As at the end of the Reporting Period, the actual applications of the proceeds from the issuance of A shares in the Company were in line with the undertakings made in the prospectus for the issuance of A shares.

The net proceeds from the issuance of A shares in the Company were approximately RMB737,990,000. The portion exceeding the budgeted proceeds (amounting to approximately RMB29,690,000) was used as supplemental working capital of the enterprise. As at 30 June 2006, the actual capital applied was RMB690,660,000, leaving the unapplied capital of RMB47,330,000. Save as the projects set out in the following table, other projects were completed for investment as scheduled.

Category	Name of Projects	Budgeted injection under the offering plan RMB'000	Accumulated amount injected as at the end of the Reporting Period RMB'000	Stages of completion (%)
Pills	Industrialization of Wei Re Qing	29,000	25,630	90
	Technology upgrade of throat, spleen and intestine pills	29,100	24,660	90
Tablets	Industrialization of Fu Yan Xiao Soluble Tablets	29,500	24,030	88
Sales network expansion project	Expansion of "Cai Zhi Lin" chained pharmacies	59,500	29,190	68

5.5.2 Explanatory note on the return from projects and off-target projects

Among projects financed by proceeds from the issuance of A shares, additional sales and gross profit from projects amounted to RMB2,242,960,000 and RMB329,070,000 respectively. Projects on Fu Yan Xiao Pao Teng Pian and Wei Re Qing capsule are delayed due to the relocation of plant, and sales network expansion projects are slowed down due to keen market competition.

5.6 FINANCIAL POSITION OF THE COMPANY (PREPARED IN ACCORDANCE WITH PRC ACCOUNTING STANDARDS AND SYSTEMS)

5.6.1 Changes in major accounting items

<i>Items</i>	For the six months ended 30 June 2006	For the six months ended 30 June 2005	Amount RMB'000	Changes (%)
	RMB'000	RMB'000		
Income from principal operations	5,193,992	4,596,172	597,820	13.01
Profit from principal operations	904,093	801,459	102,634	12.81
Operating expenses	404,627	301,493	103,188	34.23
Income tax	63,435	60,005	3,430	5.72
Net profit	120,048	103,590	16,458	15.89
Net increase in cash and cash equivalents	(4,043)	(89,448)	85,405	95.48

<i>Items</i>	As at 30 June 2006	As at 30 June 2005	Amount RMB'000	Changes (%)
	RMB'000	RMB'000		
Total assets	5,466,565	5,098,095	368,470	7.23
Accounts receivable	1,469,008	959,777	509,231	53.06
Notes receivable	371,034	331,754	39,280	11.84
Advance to suppliers	112,695	196,549	(83,854)	(42.66)
Inventories	1,088,650	1,148,569	(59,919)	(5.22)
Net fixed assets	1,260,917	1,297,576	(36,659)	(2.83)
Accrued expenses	43,489	14,220	29,269	205.83
Other payables	212,893	191,144	21,749	11.38
Share capital	810,900	810,900	—	—
Shareholders' equity	2,685,045	2,621,437	63,608	2.43

5.6.2 Explanatory notes on the accounting items with changes of 30% or more as compared with the comparative figures at the beginning of the year (or compared with the Reporting Period and the corresponding period of last year):

1. Accounts receivable recorded an increase of 53.06% as compared with the amounts at the beginning of the Reporting Period and an increase of 16.71% as compared with the amounts at the end of corresponding period of 2005. The increase in accounts receivable is mainly because of the fact that the tender policies for clinical pharmaceuticals resulted in the settlement period of loans extended to more than three months, and the credit periods of clients in other segments are properly extended in order to capture more market shares;
2. Advance to suppliers as at the end of the Reporting Period decreased by 42.66% as compared with those at the beginning of the Reporting Period, due to the stronger bargaining power of the Group's pharmaceutical trading companies and a decrease of the Group's prepayments on medicine at the end of the Reporting Period;
3. Accumulated operating expenses for the period increased 34.23% as compared with those for the corresponding period in the previous year, mainly due to a greater marketing effort for sales for the Reporting Period and a substantial increase in advertising expenses and POS expenses;
4. Accrued expenses as at the end of the Reporting Period increased by 205.83% as compared with those at the beginning of the Reporting Period, due to the increase in advertising and promotional fee which was incurred but not yet settled at the end of the Reporting Period.

5.6.3 Liquidity, financial resource and capital structure

As at 30 June 2006, the current ratio of the Group was 1.52 and the quick ratio was 1.04. During the Reporting Period, annual turnover rate for accounts receivable was 10.01, and annual inventory turnover rate was 7.64, representing an increase of 3.61% and 7.36% respectively as compared with the same period of last year.

As at 30 June 2006, cash and cash equivalents of the Group amounted to RMB612,940,000 (as at 31 December 2005: RMB616,983,000), of which approximately 95.16% is denominated in RMB and 4.84% is denominated in foreign currencies such as Hong Kong dollars.



5.6.4 Capital expenditure

The Group expected that capital expenditure for the year 2006 will be approximately RMB245 million (2005: RMB137 million) and actual expenditure in the first half of 2006 amounted to RMB55,840,000 (the corresponding period in 2005: RMB68,700,000). The Group has sufficient financial resources to meet the demand for capital expenditure and daily working capital requirements.

5.6.5 Exposure to fluctuations in exchange rate

As the majority of revenues, expenses, assets and liabilities of the Group are denominated in RMB, the Group does not have significant exposure to fluctuations in exchange rate.

5.6.6 Contingent liabilities

As at 30 June 2006, the Group has no significant contingent liabilities.

5.6.7 Charge on Group assets

As at 30 June 2006, the net book value of fixed assets pledged as security for bank loans granted to the Group amounted to RMB56,100,000.

5.7 THE ISSUES AND DIFFICULTIES ENCOUNTERED IN OPERATIONS AND OPERATION PLANS FOR THE SECOND HALF OF 2006

The adjustment of medicine prices and the increasingly fierce competition in the domestic pharmaceutical industry had certain impact on the Group's operations.

In the second half of 2006, the Company will develop and strengthen its principal business and cultivate new growth area with profitability, while keep on improving the corporate governance structure and strengthening internal controls and supervision, so as to achieve the operation goal of 2006.

The business plans for the second half of 2006 mainly include:

- (1) To continuously enhance the market segmenting and management of our key products such as Xiao Ke Wan and Hua Tuo Zai Zao Wan, so as to increase their respective market share, focus on the industrialization of and make a sound market planning and promotion of our new products such as Feng Shi Ping capsule, Artemisinin, Ganoderma Lucidum Spore Oil and Rabies Bacterin, and endeavored to nurture and develop new tier II and tier III products.
- (2) To continuously expedite the progress of internal resource integration through enhancing the integrated purchase and supply of Chinese medicine, raw materials in bulk, packaging materials and import stuffs, and strengthening the cooperation between the inter-group industrial and commercial enterprises, so as to enlarge the market share of products of the Group.
- (3) With the focus on the professional development and brand building, to aggressively explore specialized sales markets, improve the brand awareness and social influence of the products with a view to increase the targeted market share.
- (4) To strengthen the supervision and management over the receivables with a view to decrease operating risks.
- (5) To strengthen fund attraction and aggressively seek opportunities for cooperation with outstanding and high-tech pharmaceutical enterprises at home and abroad.