Management Discussion and Analysis

BUSINESS REVIEW

During the year under review, the Group continued to move towards product diversification. In addition to promoting its own products, the Group stepped up the marketing of overseas products in the capacity as an agent.

Last year, a series of severe quality issues dealt a heavy blow to the pharmaceutical industry. The PRC Government therefore strengthened the regulation and rectification of the industry, resulting in a more stringent adjustment to the industry landscape and changes and intensified competitions in the pharmaceutical market. The Group took the initiatives to conduct self-examination on its products and submitted the results of such examination to the SFDA. While enhancing its public relationship, the move also strengthened quality control over its products so as to reduce market and product risk.

In addition, in order to implement risk management and prepare for the new challenges ahead, the Group established a plant that complies with GMP specifications in Hong Kong to fully capture the advantages brought by CEPA. While the effect of policy reform on the Group's products is mitigated, the future business performance is also guaranteed. Furthermore, the Group will continue to uphold the strategy of attaching equal importance to the introduction and distribution of quality overseas products and the development of the Group's own products.

Due to certain severe quality issues that hit the pharmaceutical industry of the PRC, 2006 was a year marked by tremendous reform and surviving pressure for the industry. With the view to solving the problem of excessive applications for drug registration, SFDA has stepped up the amendment to the "Administrative Measures on Drug Registration" and related technical criterion, so as to raise the technical entry barrier and implement more stringent review and approval policies.

Meanwhile, SFDA commenced the nationwide re-registration of the approval numbers of pharmaceuticals in the second half of 2006, so as to further sort and count the number of drug types and establish and improve the drug elimination mechanism to initiate the re-registration of drugs by different stages, focuses and types. Hence, the cycle from the research of a new drug to the launch of the drug will lengthen, including procedures such as the stringent checking of information and data, the compilation of extremely reliable experimental data, the conduct of pharmacological and toxicological researches before clinical trials and the formulation of clinical research standards. All of these reforms extend the time for research and approval, which in turn increase the cost for developing new drugs.

In view of the current new drugs policies in the PRC, Vital has terminated projects that involved high risks in a timely manner and ceased on its own initiative the application of projects of minimal benefit. Hence, research and development of and application for some 20 new drugs projects have been ceased or suspended during the year. As such, the Group made a provision of approximately HK$18 million for the impairment of relevant assets.

Sales of Product

During the year, our consolidated turnover amounted to approximately HK$487 million, an increase of around 9% over approximately HK$446 million of last year.

Flagship product

"Osteoform" , a compound calcium amino acid chelate capsule for the treatment of osteoporosis and calcium deficiency

Sale of "Osteoform", our flagship product, had seen a steady increase with a turnover of approximately HK$451 million, compared with approximately HK$397 million of last year, an increase of over 13% was recorded. In 2007, the Company anticipates that sale of "Osteoform" will continue to enjoy a steady increase. In 2006, turnover of the 60-capsule package recorded approximately HK$44 million compared with approximately HK$22 million of last year, an increase of around 100% was recorded.

Other Product

"Legalon" (Silymarin), a drug that protecting liver

"Legalon" , a product imported from Madaus, Germany brought in a turnover of approximately HK$15 million (2005: approximately HK$15 million).

"Depile Capsules" , an oral herbal drug that relieves symptoms of haemorrhoids

Turnover for 2006 amounted to approximately HK$5.1 million, an increase of approximately 39% over last year.

"Opin" , an interferon suppository for the treatment of chronic viral cervicitis and vaginitis

"Opin" was launched into the market in the third quarter of 2005. However, the effect of our market promotion and sales turnover are fall behind of our expectation. Its turnover in 2006 only recorded amounted to approximately HK$1.1 million, a decrease of approximately 36% when compare to year 2005.

"Aceclofenac Tablets" , a drug that relieve soft tissue pain and inflammation

"Aceclofenac Tablets" a drug that has been beyond the pre-marketing lead period, and it had been launched into the market in 2006, and claimed a sales turnover of approximately HK$2.8 million, an increase of around 65% when compare with last year.

"Clarithromycin Capsules" , a new generation of broad-spectrum marolide antibiotic drug

Turnover for 2006 amounted to approximately HK$2.3 million, an increase of approximately 43% over last year.

"Aotianping" (Miglitol Tablets), a third generation alpha-glucosidase inhibitor, a drug for the treatment of diabetes in conjunction with dietary management

"Aotianping" has been conducted trial sale in 2005. Turnover for 2006 recorded of approximately HK$0.26 million, an increase of approximately 7% over last year.

"Vital Fast", a slow release flu medication formulated with loratadine, psuedophedrine sulphate and paracetamol

"Vital Fast" has been granted a new drug certificate and approval for production by the State Food and Drug Administration Authority ("SFDA") in 2005, and had been launched into the market in 2006. Turnover during the year 2006 was approximately HK$0.5 million.

Management Discussion and Analysis

"Agiolax" (Plantain and Senna Granules), a drug to restore the functions of the intestines

With the keen competition of the market for similar products, it has not achieved any sales during the year 2006. The Group will carry out adjustment on the market strategy and re-appoint product agent in 2007, it is expected the product will re-launch into the market and breakthrough "zero achievement" in year 2007. Due to the reason that Agiolax had not been sold in year 2006, the Group had recognized an impairment of inventory of approximately HK$3.8 million.

The production base in Chengdu, Sichuan Province, the PRC

Equipped with advanced production facilities and staffed with outstanding domestic experts, the highly effective drug manufacturing plant adopts innovative technology of drug manufacture and manufactures drugs in accordance with the international GMP standards. The plant produces principally the Group's flagship products such as "Osteoform", "Depile Capsule", "Clarithromycin Capsules", "Azithromycin Capsules" and "Aceclofenac Tablets".

The newly constructed No. 2 compound workshop, which is GMP certified to produce the drug substance "Aotianping" ("Miglitol Tablets"), had been commenced production in mid 2006.

The production base in Wuhan, Hubei Province, the PRC

At present, the factory has five GMP pharmaceutical workshops, including the suppository workshop for "Opin"; and the workshops which process and package products in dosage forms of granules, capsules, gel and tablets. All 5 GMP pharmaceutical workshops had passed the review and examination of the SFDA and obtained the certificate which is valid for "five years".

In addition to producing "Vital Fast" tablets and "Opin" suppositories, the factory commenced the processing of "Osteoform" capsules as well as the processing and packaging of "Reparil-Gel N" gel and "Uralyt U" granules, products from Madaus AG, Germany, in 2006.

Weiao (Chengdu) Pharmaceutical Co., Ltd. (維奥(成都)製藥有限公司)

Sichuan Vital San Jiang Pharmaceutical Co., Ltd. was renamed as Weiao (Chengdu) Pharmaceutical Co., Ltd. in 2006. Weiao (Chengdu) Pharmaceutical Co., Ltd. is the new pharmaceutical factory of the Group, and the construction of its new workshops has basically been completed with production permit on relevant dosage forms obtained. Currently, the factory is mainly preparing for the GMP certification of the wokshop of freeze-dried powder for injection and the workshop of solution for injection.

Sichuan Chengdu Export Supervised Warehouse Co., Ltd.

The main business of the Supervised Warehouse is to consolidate the Group's import and export resources. This lays a solid foundation for internal control, strengthens risk management and further reduces the logistics cost of the Group. On the other hand, being an international and professional trade logistics company, the Supervised Warehouse not only helps to save the Group's logistics cost, but also aims at becoming a profit center by providing trading and logistics services to Sichuan's sub-contracting and trading enterprises, so as to capture more business opportunities for the Group.

Vital Pharmaceuticals Company Limited

In mid 2006, the Group established a new pharmaceutical factory in Hong Kong that complies with GMP standards, in order to proactively cope with the changes in the pharmaceutical management policy in the PRC. As at the date of this Report, the construction of the factory was basically completed and the relevant GMP and pharmaceutical manufacturer licence is expected to be obtained in the middle of year 2007.

BUSINESS PROSPECT

In the coming year, the Group will continue to pursue its existing marketing strategy of being an agent and distributor and moving towards product diversification. Other than importing and trading products, the Group is also engaged in the logistics services, processing and re-packaging business, so as to increase the return of the Company and its shareholders.

Moreover, the Group will adopt a prudent expansion and budget strategy. Sophisticated and effective logistics management and inventory management systems will be put in place to enhance the operational efficiency and reduce costs, and ultimately consolidate its leading business. Regarding the quality management effort, the Group will improve the quality assurance and packaging procedures to boost the confidence of the international market in Vital's products, and enable the Group to strengthen risk management while capturing business opportunities brought by the reform of pharmaceutical policies.

The operating environment of the pharmaceutical industry will still be challenging in 2007. Research and development, production and market sales will be subject to changes due to the continuous adjustments of the PRC policies. Therefore, the Group will continue to step up its effort in capturing opportunities brought by the pharmaceutical policies and will examine and improve every segment to avoid suffering from enormous loss due to minor mistakes.

FINANCIAL REVIEW

Capital structure

As of 31 December 2006, the Company had in issue 1,541,706,993 ordinary shares (31 December 2005: 1,541,706,993 shares). During the year 2006, no new shares had been issued (2005: total 20,508,613 new ordinary shares were issued).

The market capitalization of the Company as of 31 December 2006 was approximately HK$213 million (31 December 2005: approximately HK$266 million).

Liquidity and financial resources

As of 31 December 2006, the Group has bank loans of approximately HK$154 million (31 December 2005: approximately HK$151 million), comprising long-term portion of approximately HK$54 million (31 December 2005: approximately HK$51 million), short-term portion of approximately HK$100 million (31 December 2005: approximately HK$100 million). Bank balances and cash amounted to approximately HK$136 million (31 December 2005: approximately HK$60 million), including pledged bank deposits of approximately HK$8.7 million (2005: approximately HK$8.1 million).

As of 31 December 2006, the Group has obtained banking facilities of approximately HK$241 million from banks in HK and China. Unutilised banking facilities amounted to approximately HK$88 million. The cost of financing was around 6% per annum. The Group has maintained sufficient financial resources for business operation purpose.

Currency policy

The sales receipts of the Group were mainly denominated in RMB. Purchases were denominated as to approximately 67% in USD, 4% in EURO and 29% in RMB. Operating expenditures including selling and distribution expenses and administrative expenses were denominated as to approximately 85% in RMB, others are in HKD, AUD, USD and Macau Pataca. For the year 2006, the Group was not required to settle a large portion of purchase in EURO and therefore, was not entered into any forward contracts to hedge against foreign currency fluctuation.

Management Discussion and Analysis

Key financial figures and ratios

Profit and loss item:

In the year 2006 several profit and loss items and ratios were enhanced by a lowering level of selling and distribution, and general and administrative expenses. Compared with last year, the Group was tightening its budget control and expenses, which leads to maintain a steady gross profit margin. Furthermore, both of the gross profit margin after selling and distribution expenses and profit attributable to equity holders of the Company margin were climbed by 3%.

	Year 2006	Year 2005
Profit and loss item:		
Turnover (HK$' million)	**487.1**	446.4
Gross profit margin	**66%**	66%
Selling and distribution expenses (HK$' million)	**173.6**	174.6
Gross profit margin after selling and distribution expenses	**30%**	27%
Profit attributable to equity holders/turnover	**8%**	5%
EBITDA (HK$'million)	**81.4**	56.2
EBITDA/Turnover	**16.7%**	12.6%

Balance sheet item:

Taken into account of a significant increase of cash and bank balances as at 2006 year end over 2005 year end, with a comparable bank borrowing level to last year. The gross debt equity ratio (total bank borrowings / equity attributable to equity holders of the Company, net of intangible assets and goodwill) was decreased to 38% and net debt equity ratio was decreased to 4.6%. Average trade receivable turnover day was maintained at around 4 months. However, inventory (excluding goods in transit) average turnover day was climbed up to about 4 months.

	As at 31 December 2006 HK$'million	As at 31 December 2005 HK$'million
Balance sheet item:		
Short-term bank loans	**100.5**	100.2
Long-term bank loans	**53.9**	50.6
Bank balances and cash	**135.7**	60.2
Bank loans net of cash on hand	**18.7**	90.6
Net tangible assets	**406.5**	357.1
Debt equity ratio (gross)	**38.0%**	42.7%
Debt equity ratio (net)	**4.6%**	25.3%
Average trade receivable turnover day	**123 days**	119 days
Average inventory turnover day	**126 days**	101 days

As at 31 December 2006, the Group had HK$8.7 million in bank balances and cash, HK$3.8 million in available-for-sale investments, HK$47.6 million in property, plant and equipment and HK$13.0 million in prepaid lease payments on land use rights pledged as collateral to banks.

For year 2006, return on equity was on average 8%.

EMPLOYEE INFORMATION

As at 31 December 2006, the Group had 515 employees, comprising 26 in research and development, 312 in production, 21 in sales and marketing, and 156 in general administration and finance. 487 of these employees were located in China and 28 in Hong Kong and Macau.

The policy of employee remuneration, bonus, share option scheme and training are commensurate with performance and comparable to market rate. The Group encourages employees to participate in external training programmes to develop themselves on a continuous basis, so as to improve staff quality to meet future challenges and gain a competitive edge. Total staff costs for the year 2006 amounted to approximately HK$35 million.