

MANAGEMENT DISCUSSION AND ANALYSIS

SALES

As at 31 December 2005, the sales of the Company and its subsidiaries ("Group") amounted to approximately RMB884,709,000, representing a decrease of 2.0% as compared with RMB903,006,000 in last year.

	2004			2005		
	First Half RMB'000	Second Half RMB'000	Full Year RMB'000	First Half RMB'000	Second Half RMB'000	Full Year RMB'000
Group's total sales	457,531	445,475	903,006	433,092	451,617	884,709

The No. 289 Document issued by the SFDA has become effective on 1 July 2004. Pursuant to the No. 289 Document, antibacterial agents (including antibiotics, sulfonamides, quinolones, drugs acting on tuberculosis and antifungal agents) not listed on the over-the-counter medicines catalogues can only be sold by retail drug stores in the PRC with the prescriptions of practising physicians. This policy has affected the overall sales of antibiotics. The sales of antibiotics, which accounted for 75.4% (2004: 77.7%) of the Group's total sales, has been the Group's major source of income. Therefore, the implementation of No.289 Document has led to the decline in the Group's total sales starting from the second half of 2004, and a further slowdown was seen during the first half of 2005. After the implementation of No. 289 Document, the Group has adopted various measures targeting to reduce its impact on the Group, including consolidating the relations with the distributors and pushing up the sales of other products, which began to bring fruits in the second half of 2005 when the Group's total sales started to rebound. However, there was still a slight decrease in the Group's total sales in 2005 as compared with that of last year.

	2004		2005	
	RMB'000	%	RMB'000	%
Antibiotics				
— Lijunsha	489,825	54.2	422,341	47.7
— Paqi	72,224	8.0	89,083	10.1
— Erythromycin tablets	52,761	5.8	54,002	6.1
— Cephalosporin	53,663	5.9	52,927	6.0
— Limaixian	12,688	1.4	16,119	1.8
— Other antibiotics	21,365	2.4	32,692	3.7
Total sales of antibiotics	702,526	77.7	667,164	75.4
Other finished medicines	126,061	14.0	130,222	14.7
Sales of bulk pharmaceuticals	60,842	6.8	72,825	8.2
Sales of Chinese medicines	7,600	0.8	10,241	1.2
Others	5,977	0.7	4,257	0.5
Group's total sales	903,006	100	884,709	100

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ANTIBIOTICS

The sales of antibiotics for the year amounted to RMB667,164,000 (2004: RMB702,526,000), of which “Lijunsha” accounted for 63.3% or RMB422,341,000 (2004: RMB489,825,000). Since Lijunsha, the major product of the Group, accounted for 47.7% of the Group’s total sales and enjoyed a greater market share among similar products in the major cities, its sales received the heaviest blow caused by the No. 289 Document. Sales of Lijunsha started to slow down since the second half of 2004 and suffered from a year-on-year decrease of 13.8%. Nevertheless, its sales has been recovering and amounted to RMB218,989,000 during the second half of 2005. This represented an increase of 7.7% as compared with RMB203,352,000 recorded in the first half of 2005.

Due to the increasing market demand for azithromycin, a third-generation of macrolide antibiotics, the Group’s “Paiqi” has become the key product of the Group in terms of sales. During 2005, sales of Paiqi was RMB89,083,000, representing a year-on-year growth of 23.3%. It accounted for 10.1% of the Group’s total sales, representing an increase as compared with 8.0% of last year.

OTHER FINISHED MEDICINES

As for the sales of the Group’s other products not affected by the No. 289 Document, an overall increase was recorded. Sales of other finished medicines amounted to RMB130,222,000 (2004: RMB126,061,000) in 2005, representing an increase of 3.3% as compared to that of last year. “Dobesilate”, a kind of Calcium dobessilate product effective for preventing and treating various illnesses caused by obstruction in the microcirculation, was another key product of the Group which has achieved rapid growth among others. “Dobesilate” was, among the same kind of products, the first one to be listed by the related authority as an over-the-counter medicine in September 2005 and this has greatly increased its sales. In 2005, the sales of Dobesilate amounted to RMB29,934,000, representing a year-on-year growth of 46.1%.

BULK PHARMACEUTICALS AND CHINESE MEDICINES

Sales of bulk pharmaceuticals and Chinese medicines amounted to RMB72,825,000 (2004: RMB60,842,000) and RMB10,241,000 (2004: RMB7,600,000) respectively, representing an increase of 19.7% and 34.8% respectively.

COST OF GOODS SOLD

The cost of goods sold decreased 2.8% from RMB449,318,000 for the year ended 31 December 2004 to RMB436,842,000 for the year ended 31 December 2005. The cost of direct materials, direct labour and overhead represented approximately 70.8%, 9.0% and 20.2% of the total cost of goods sold respectively for the year ended 31 December 2005 while their comparative percentage for 2004 were 68.8%, 8.9% and 22.3% respectively.

GROSS PROFIT

Total gross profit of the Group in 2005 amounted to RMB447,867,000 (2004: RMB453,688,000), while the gross profit margin was 50.6%, which was similar to that recorded in last year (50.2%).

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SELLING AND MARKETING EXPENSES

For the year ended 31 December 2005, selling and marketing expenses amounted to approximately RMB202,793,000 (2004: RMB220,599,000), which mainly comprised of advertising expenses of approximately RMB37,781,000 (2004: RMB79,854,000), sales commission of approximately RMB97,331,000 (2004: RMB83,646,000), salaries expenses of sales and marketing staff of approximately RMB17,182,000 (2004: RMB23,156,000) and office and rental expense of approximately RMB14,046,000 (2004: RMB11,242,000).

The decrease of 8.1% in selling and marketing expenses in 2005 as compared with that of 2004 was mainly attributable to the Group's reduction in advertising expenses in the mass media and the reinforcement of its marketing efforts directly on the distributors and ultimate customers such as hospitals and clinics after the implementation of No. 289 Document. Consequently, the advertising expense enjoyed a year-on-year decrease of 52.7% while sales commission suffered from a year-on-year increment of 16.4%.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses amounted to approximately RMB108,414,000 (2004: RMB96,686,000) for the year ended 31 December 2005 which mainly comprised of salaries of approximately RMB33,877,000 (2004: RMB34,071,000), depreciation of approximately RMB10,663,000 (2004: RMB10,063,000), office and rental expenses of approximately RMB11,195,000 (2004: RMB7,793,000), sharing of administrative costs of Shaanxi Xi'an Pharmaceutical Factory of approximately RMB12,063,000 (2004: RMB13,105,000) and research and development expenses of approximately RMB7,429,000 (2004: RMB6,166,000).

The increase of 12.1% in general and administrative expenses in 2005 as compared with that of 2004 was mainly attributable to the increase in office and rental expenses and research and development expenses, as well as the accrued staff welfare fund and the expenses for the establishment of the offices in Hong Kong.

OPERATING PROFIT

In 2005, despite the decrease in the Group's sales and gross profit and the increase in general and administrative expenses as compared with that of last year, these impacts were eliminated by the decrease in selling and marketing expenses. As a result, the Group's operating profit in 2005 remained at similar level as compared with that of last year, amounted to RMB138,737,000 (2004: 138,503,000) with its operating profit margin (defined as operating profit divided by total sales) increased from 15.3% to 15.7%.

FINANCE COSTS

As the Group has repaid certain bank borrowings during the year, the finance cost for the year has decreased slightly to RMB7,069,000 (2004: RMB7,111,000) as compared with that of last year.

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INCOME TAX EXPENSE

The income tax expenses decreased from approximately RMB22,331,000 for the year ended 2004 to approximately RMB15,122,000 for the year ended 2005 while the effective tax rate reduced from 17.0% to 11.5%. Pursuant to the "Reply on Enjoying Statutory Reduction and Exemption of Enterprise Income Tax" (享受企業所得稅法定減免的覆函) issued by the Foreign-related branch of Xi'an State Tax Bureau (西安市國家稅務局涉外分局) on 13 May 2005, Xi'an Lijun Pharmaceutical Co., Ltd ("Xi'an Lijun") is entitled to an exemption from the enterprise income tax for the first two years and a 50% reduction in the enterprise income tax for the subsequent three years for the years 2005 to 2009.

PROFIT ATTRIBUTABLE TO EQUITY HOLDERS FOR THE YEAR

Although the Group's operating profits for 2005 remained at a similar level as compared with that of last year, the profit attributable to equity holders for the year increased by 5.3% to RMB93,311,000 (2004: RMB88,632,000) while net profit margin (profit attributable to equity holders for the year divided by total sales) increased from 9.8% in 2004 to 10.5%.

LIQUIDITY AND FINANCIAL RESOURCES

The Group primarily finances its working capital and other capital requirements by net cash generated from operating activities and resorts to external financing including both long-term and short-term loans from time to time in case the operating cashflow is insufficient to meet the capital requirements.

As the Group was listed on The Stock Exchange of Hong Kong Limited ("Stock Exchange") on 20 December 2005 and raised a net amount of HK\$145,557,000, the Group's capital structure was remarkably improved. As at 31 December 2005, the cash and bank balance aggregated to RMB275,122,000 (2004: RMB138,674,000) while bank loans amounted to RMB113,000,000 (2004: RMB137,000,000). On the other hand, the gearing ratio (defined as total liabilities divided by total assets) decreased from 56.1% as at 31 December 2004 to 36.6% as at 31 December 2005. Current ratio (defined as current assets divided by current liabilities) increased from 1.11 as at 31 December 2004 to 1.79 as at 31 December 2005.

INTEREST RATE AND FOREIGN EXCHANGE RISK

Substantially all of the Group's businesses are operated in the PRC and are denominated in RMB while a small portion of which is denominated in US dollar or HK dollar. Therefore, interest rate and foreign exchange risk is insignificant.

CONTINGENT LIABILITIES

As at 31 December 2005, the Group did not have any contingent liabilities.

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PROCEEDS FROM INITIAL PUBLIC OFFERING

Proceeds from initial public offering amounted to approximately HK\$145,557,000, net of relevant expenses. As the Group was listed on the Stock Exchange on 20 December 2005, most of the proceeds from initial public offering have not been utilized as at 31 December 2005 and such proceeds were mainly deposited in the bank account of the Group and the bank account of the placing underwriters in Hong Kong.

Proceeds from initial public offering will be applied as follows:

	HK\$'000
Setting up of the new production line of spray form products	3,800
Setting up of the new production line of oral solution products	43,300
Setting up of the new production line of soft capsule form products	21,200
Expansion of production capacities of lyophilized powder for injection	17,300
Improvement of existing products and production technology of Chinese medicines, improvement and expansion of the Group's existing production facilities of Chinese medicines, development of new forms of Chinese medicines, and promotion of the brand name of the Group's Chinese medicines	19,200
Enhancement and expansion of the Group's distribution network	9,200
Setting up of centralised information and management systems for sales networks	5,800
Enhancement of the research and development capability to improve existing and develop new pharmaceutical technology	21,400
Group's Working capital	4,357
Total	145,557