NATURE

A) Business Review

During the financial year 2006, the Company achieved satisfactory performance in business and recorded a turnover of RMB541.3 million, representing an increase of 29.7% as compared to RMB417.3 million of the financial year 2005. We believe that the Company's diversified product structure is one of the essential factors contributing to its business growth.

Western pharmaceuticals remained the Company's major source of revenue, accounting for approximately 61.2% of the overall turnover, while the remaining 38.8% was generated from Chinese traditional medicine products. Among the numerous pharmaceutical products of the Company, the Xiangdan Injectible and Alginic Sodium Diester, which are used for the treatment of cerebrovascular and cardiovascular diseases, have achieved relative higher growth in sales. Their sales amount increased 46.3% and 59.5% respectively as compared to the financial year 2005. In addition, the sales amount of Pediatric Cough Syrup also recorded satisfactory growth.

According to the present classification system, a hospital will have departments specializing in cerebrovascular and cardiovascular, respiratory, gastrointestinal, antibacterial diseases and nutrition issues. Benefited from its wide-ranging pharmaceutical products which can be used for the treatment of five major types of diseases, as well as the broad application of its chemical medicine and the modern Chinese medicine, the Company managed to increase its turnover.

During the year under review, the Company continued to market its pharmaceuticals under the "3A" brand name, which is widely recognized for quality and reliability, and produce and market a diversified product mix comprising 19 western prescription drugs and five modern Chinese medicine products. The production line of Perilla Oil Capsule, our novel modern Chinese medicine product developed for hyperlipidemia-management, was ready for production during the year. It is expected that the product will be launched in the market after receiving sales approval from SFDA in the first half of 2007.

In the second half of 2006, the Company added five pharmaceutical products, including drugs used for the gastrointestinal system, flu and antibacterial treatment and pain management, and two of which were added subsequently in the fourth quarter. Therefore, these pharmaceutical products have not yet contributed any substantial profit to the Company. The aggregate turnover of these pharmaceutical products amounted to approximately RMB37.1 million, accounting for 6.9% of the overall turnover. The aggregate sales income of these five pharmaceutical products basically compensated the loss resulted from the suspension of production of Yuxingcao Injectibles.

The net profit recorded in 2006 amounted to RMB119.4 million. The non-cash and extraordinary impairment expenditure of RMB63.9 million made for adjusting the difference between the fair value of convertible bonds upon issuance and the fair value of the bonds upon conversion on 27 October 2006 was taken into account when calculating the profit for the year. Accordingly, if such impairment is not included the net profit for the year would be RMB183.3 million representing an increase of 56.4% over last year. The management considers that such expenditure arose only due to calculation under the requirement of the accounting standard. However, the Company's business fundamentals remain strong as far as growth and profitability is concerned.

The Company's products are capable of generating satisfactory gross profit margins. Among its numerous pharmaceutical products, the gross profit margins of Alginic Sodium Diester, Xiangdan Injectible and Netilmicin Sulfate and Glucose Injectible were relatively higher, exceeding approximately 50%, a level comparable to that of last year. Moreover, the gross profit margin of N(2)-L-Alanyl-L-Glutamine Injectible, which accounted for approximately 17.9% of the Company's overall turnover, also exceeded 50%, reflecting the sound profitability of the Company's pharmaceutical products.

(B) Outlooks and Future Development

(1) Corporate Development Objectives

Wuyi Pharmaceutical is a vertically-integrated company specialized in the production and sales of pharmaceuticals. Under its existing foundation, the Company plans to maintain the rapid growth of its sales income by increasing the resources allocated for the research and development of new pharmaceuticals, optimizing product structure, expanding sales network, promoting its brands, raising production capacity and expanding production scale, so as to ensure simultaneous surge in both its sales income and profits, and provide impetus for the Company's development into one of the leaders in the pharmaceutical industry of the PRC.

(2) Stepping up both Brand Promotion and Expansion of Marketing Network

The Company and its subsidiaries (collectively referred to the "Group") plans to increase its investment in sales network expansion and team building, adjust, optimize and increase its distributors, selectively expands into the Mid-western region and step up efforts in advertising and promoting its brands, so as to further enhance and increase public recognition of the Company's brands, and strengthen the influence of the Company's products by synergistic sales. The Company endeavours to maintain the rapid growth of its sales income and profits in 2007 and lay a solid foundation for the exponential growth of its sales in 2008 and beyond.

(3) Research and Development

Increasing investment in the research and development of new products is one of the crucial factors for the Group to maintain its rapid growth in the future. The Group planned to invest approximately RMB40 million in the research and development of new pharmaceuticals. Since the second half of 2006, 4 types of products with higher efficacy were selected among numerous new pharmaceutical projects. The four selected types of new pharmaceuticals comprise small-volume injectible, large-volume injectible, lyophilized powder of injection and drops pills. The Company is now negotiating for opportunities to engage in new research cooperations and will be introducing石家莊三普瑞醫藥科技開發公司as its new cooperation partner for research and development . The institute, is one of the cooperation partners of the renowned universities in the PRC. The successful commencement of cooperation will initiate the research and development of the new major pharmaceuticals in 2007. These pharmaceuticals will secure a large market share, will be well recognized by patients and will have high profit margins. The Company may have the exclusive rights to the production and sales of the products. We will continue to make effort in selecting new products which have huge market potential, high technology content and high profit margin in the second half of the year and 2008. We plan to have 3 to 5 new products put under research and development every year.

(4) Plans on Expanding Production Capacity

In order to cater to increasing sales, approximately RMB130 million will be invested as planned to expand the production capacity and increase the production lines of the Group's major profitable products and expand the production lines which operate in nearly full capacity at (Jianyang) 福建三愛藥業有限公司Fujian Sanai Pharmaceutical Co., Ltd. ("Fujian Sanai") The investment includes the establishment of facilities such as workshop for the production of large-volume injectibles in PVC soft packaging, workshop for the production of tablets, capsules, granules and oral solid medicine dosage form, workshop for extraction from Chinese traditional medicines and ancillary warehouses, all of which are expected to be completed by 2008. Upon completion of the construction of such facilities, the production scale of the relevant dosage form will be about 2 to 3 times of the current scale, guaranteeing the satisfaction of the increasing demand resulting from the sales growth of the above products in dosage form in the coming years and further enhancing the economies of scale of the Company. Furthermore, approximately RMB65 million will be invested as planned to establish the production line (second phase) of Perilla Oil Capsule at (Fuzhou) 福州三愛藥業有限公司Fuzhou Sanai Pharmaceutical Co., Ltd. ("Fuzhou Sanai") the construction of which is expected to be completed between 2008 and 2009. By then, the annual production capacity will be increased to 1 billion capsules and the annual production scale will be increased by approximately RMB400 million. This will ensure that the Group have adequate production capacity to cope with the market demand of Perilla Oil Capsule and will provide effective support to the generation of tremendous profit by Perilla Oil Capsule, the new pharmaceutical with high profit margin (in 2009 to 2010, RMB135 million will be invested as planned in the establishment of facilities at Fuzhou for the extraction of α-Linolenic of high purity from Perilla Oil. The facilities will have an annual production capacity of 1,000 tons).

(5) Merger and Acquisition Plan

The Company plans to identify from the chemical pharmaceutical, plant-made pharmaceutical and bio-pharmaceutical industries suitable enterprises with sound product structures that complements the product structure of the Company, extensive sales network, large production and sales scale, sufficient technical and management staff and good asset structure. After conducting due diligence investigation and analysis, the Company will acquire one or two of such manufacturing enterprises. The Company will use part of its proceeds to fund such mergers and acquisitions, which will strengthen the sales and profitability of the Company at steady pace.

(6) Future Prospects

The pharmaceutical industry of the PRC is an emerging industry. According to the information of National Bureau of Statistics of the PRC, the cumulative gross industrial output value of the PRC pharmaceutical industry amounted to RMB532.37 million in 2006, representing an year-on-year increase of 17.9%, and demonstrating a relatively steady growth trend. Due to the continuous and rapid growth of the PRC economy, the population's disposable income and individual medical expenditure, continue to rise, which in turn lead to the increase in the number of medical insurance policy holders. Under the support of government policies, bountiful resources will be allocated to the medical and hygienic area. The Company anticipates that it will maintain its rapid growth in the coming years.

The Company is also optimistic about its development prospect in the next few years. Upon the approval for the production of its new Chinese traditional medicine Perilla Oil Capsule, the proportion of Chinese traditional medicine will surely outweigh the western pharmaceuticals. The Chinese traditional medicine sector will be one of the key sectors within the pharmaceutical industry that will be promoted during the Eleventh Five-Year Plan period. In 2006, the income generated by the modern Chinese medicine manufacturing industry reached RMB114.01 million, representing an year-on-year increase of 13.8%. On 21 March 2007, 16 ministries and committees, including Ministry of Science and Technology, the Ministry of Health, State Administration of Traditional Chinese Medicine and SFDA, jointly issued the "中醫藥創新發展規劃綱要 (2006-2020)", which is another programmatic document in respect of the overall innovative development of the Chinese traditional medicines after the re-issuance of "中藥現代化發展綱要" by the General Office of the State Council in 2002. The development of the Chinese traditional medicine industry will be placed in higher priority by the state.

With the PRC government's implementing more in-depth reforms in the pharmaceutical market and increasing its effort in regulating the pharmaceutical industry, pharmaceutical manufacturing enterprise will have to comply with more stringent requirements and restrictions. This will create excellent opportunities for pharmaceutical manufacturing enterprises with capital, technology , brand and scale advantages. Evidenced from our remarkable performance in the past, the Company possesses the fundamental conditions for rapid development. With optimistic development prospects, we believe that the Company will develop into one of the leading enterprises in the PRC pharmaceutical industry.

(C) Financial Review

1. Turnover

Turnover increased by 29.7% to RMB541.3 for the year ended 2006 from RMB417.3 million for the year ended 2005. The increase was primarily attributable to increased sales volumes resulting from the introduction of five new products starting in the second half of 2006, which contributed RMB37.1 million, and increased sales volumes of our best selling products, including N(2)-L-Alanyl-L-Glutamine, Xiangdan Injectible, Lincomycin Hydrochloride, and Alginic Sodium Diester and Sodium Chloride, as a result of increased market demand and expansion of our rural sales network, particularly in Henan, Hebei, Hubei and Jiangxi Provinces in the year ended 2006.

Increased turnover during the year ended 2006 was also due to increases in the sales prices of our major western pharmaceutical products, including Famotidine and Glucose Injectible, and Fluconazole and Glucose Injectible, and of our modern Chinese medicine products, including Manshan White Syrup and Manshan White Granule, as a result of increased demand for and brand awareness of these products. However, SFDA's suspension of Yuxingcao Injectible on 1 June 2006 also impacted our sales volume of modern Chinese medicine for the second half of the year.

2. Cost of Goods Sold

Cost of goods sold increased by 24.9% to RMB272.8 million for the year ended 2006 from RMB218.5 million for the year ended 2005. This increase was mainly due to an increase in production and sales volume of products, thereby increasing raw material costs, packaging material costs, energy and fuel costs, manufacturing overhead costs and direct labor costs.

Raw material costs as a percentage of cost of goods sold increased to 54.3% for the year ended 2006 from 53.1% for the year ended 2005. The amount of raw material costs increased to RMB148.3 million for the year ended 2006 from RMB116.0 million for the year ended 2005 as a result of increased raw material requirements to satisfy our increased production needs. The suspension of Yuxingcao Injectible changed the cost of sale scale component in which shifted from modern Chinese medicine to western pharmaceuticals.

Packaging raw material costs as a percentage of cost of goods sold slightly decreased to 34.7% for the year ended 2006 from 34.8% for the year ended 2005, reflecting that the Group has maintained the packaging raw material costs at substantially the same level and the production and sales volume has increased in line with the packaging raw material costs.

While energy and fuel costs as a percentage of cost of goods sold decreased to 8.5% for the year ended 2006 from 9.4% for the year ended 2005, the amount of energy and fuel costs increased to RMB23.2 million for the year ended 2006 from RMB20.0 million for the year ended 2005.

While manufacturing overhead costs as a percentage of cost of goods sold slightly decreased to 1.3% for the year ended 2006 from 1.4% for the year ended 2005, the amount of manufacturing overhead costs increased to RMB3.5 million for the year ended 2006 from RMB3.1 million for the year ended 2005, as a result of increased depreciation expense arising from the addition of an in-house raw material production line for our western pharmaceutical, N(2)-L-Alanyl-L-Glutamine.

Direct labor costs as a percentage of cost of goods sold slightly decreased to 1.2% for the year ended 2006 from 1.3% for the year ended 2005.

Cost of goods sold as a percentage of turnover decreased to 50.4% for the year ended 2006 from 52.3% for the year ended 2005 primarily due to increased economies of scale arising from the increase in production volume. In addition, raw material costs as a percentage of cost of goods sold declined because the raw material costs required for the production of N(2)-L-Alanyl-L-Glutamine decreased as a result of volume discounts the Group received for bulk purchases from suppliers and the quality of raw materials required for the production of Fluconazole and Glucose Injectible stabilized during the year ended 2006.

3. Gross Profit

Gross profit increased by 35.0% to RMB268.5 million for the year ended 2006 from RMB198.9 million in the year ended 2005. Gross margin was 49.6% in the year ended 2006 compared to 47.7% for the year ended 2005. This increase in gross margin was principally due to the introduction of five new products in the second half of 2006, the increased economies of scale arising from the increase in sales and production volume of the products and the turnover contributed from the increased sales prices of major western pharmaceutical products and of our modern Chinese medicine products.

4. Distribution Expenses

Distribution expenses decreased by 12.7% to RMB11.7 million for the year ended 2006 from RMB13.4 million for the year ended 2005. The decrease was attributable to the exemption from Urban Construction tax and the reduction of the rate of Education Surtax from 4% for the year ended 2005 to 1% for the year ended 2006 we received upon conversion of Fujian Sanai to a wholly foreign owned enterprise on 15 June 2006. The decrease was partially offset by the increase in transportation costs due to increased sales of our products for the year ended 2006 compared to the year ended 2005. Our distribution expenses as a percentage of our turnover in the year ended 2006 was 2.2%, compared to 3.2% for the year ended 2005.

5. Administrative Expenses

Administrative expenses increased by 357.1% to RMB38.4 million for the year ended 2006 from RMB8.4 million for the year ended 2005. The increase was primarily attributable to expenses incurred for the Hong Kong and International offer shares (collectively "Global Offering") amounting to approximately RMB11.2 million. In addition, payment of insurance increased to RMB4.6 million for the year ended 2006 from RMB1.6 million for the year ended 2005 as a result of our enrollment in work injury, medical and maternity insurance programs in June 2006, together with retroactive payment of premium for this insurance since our inception. Moreover, the Group accounted for a housing allowance in staff welfare of RMB1.2 million for the year ended 2006.

6. Fair Value on Convertible Bonds

The change of fair value on convertible bonds amounting to RMB63.9 million represents a non-recurring charge to adjust for the difference between the fair value of the convertible bonds at the time of issue and the fair value of the convertible bonds at conversion date on 27 October 2006.

7. Taxation

Income tax decreased by 39.8% to RMB34.6 million for the year ended 2006 from RMB57.5 million for the year ended 2005. The decrease was primarily attributable to a decrease in profit before tax by 11.8% to RMB154.0 million for the year 2006 from RMB174.7 million for the year ended 2005. Our effective tax rate was 22.5% for the year ended 2006, compared with 32.9% for the year ended 2005. The decrease in effective tax rate was attributable to the non-deductible tax expenses of fair value change of convertible bonds and tax exemption resulting from conversion of Fujian Sanai to a wholly foreign owned enterprise on 15 June 2006.

8. Profit for the Year

Profit for the year increased slightly by 1.9% to RMB119.4 million for the year ended 2006 from RMB117.2 million for the year ended 2005. Net profit margin was 22.1% for the year ended 2006 compared to 28.1% in the year ended 2005. The slightly increase in profit was preliminary attributable to a non-recurring charge to adjust for the difference between the fair value of the convertible bonds at the time of issue and the fair value of the convertible bonds at the conversion date on 27 October 2006.

9. Loss Attributable to Minority Interests

Loss attributable to minority interests increased to RMB0.4 million for the year ended 2006 from RMB0.1 million for the year ended 2005, reflecting increased loss attributable to minority interest resulting from increased start-up costs of Fuzhou Sanai before its commencement of operation.

10. Liquidity and Financial Resources

As at 31 December 2006, the Group had net current assets and total assets less current liabilities of approximately RMB30.4 million (2005: RMB110.5 million) and RMB198.8 million (2005: RMB233.4 million), respectively. The decrease was primarily represented Put Option 2 exercisable by the Investors to require the Company to repurchase the Share in the event that the Global Offering does occur within six months from the conversion of the convertible bonds on 27 October 2006, detail explanation on Put Option 2 is included in the note 22 to the Financial Statements, and liabilities from the shareholders' loan from our Chairman, Chief Executive Officer and Executive Director, Mr. Lin Ou Wen, for funds required for acquisition of 40% interest in Fuzhou Sanai.

The Group has bank balances and cash of approximately RMB199.8 million (2005: RMB108.2 million) with a short-term bank loans of approximately RMB43.0 million (2005: RMB43.0 million).

Taking into account the net proceeds from Global Offering on 1 February 2007, available banking facilities and cash flow from the operations, the management believe that the financial position of the Group is healthy, with a sufficient financial resources to meet the requirements for future development.

11. Materials Acquisitions and Disposals of Investments

On 8 August 2006, the Group entered into an equity agreement with our Chairman, Chief Executive Officer and Executive Director, Mr. Lin Ou Wen, in relation to the acquisition of 40% equity interest in Fuzhou Sanai for the consideration of USD8 million (equivalent to approximately RMB62.4 million) on an arm's length based on a valuation report as at 30 June 2006 prepared by an independent third party. Upon approval of such acquisition on 14 November 2006, the Group's equity interest in Fuzhou Sanai increased from 60% to 100% and Fuzhou Sanai became an indirect wholly-owned subsidiary of the Group.

For the year ended 31 December 2006, the Group had no disposal of investment.

Besides, details of future plans for materials investments and capital expenditures have been disclosed in the Prospectus of the Company dated 22 January 2007.

12. The Number and Remuneration of Employees

The Group determines staff remuneration in accordance with prevailing market salary scales, individual qualifications and performance. Staff recruitment and promotion is based on individual merit and their development potential for the positions offered. Remuneration packages including performance bonuses and entitlements to share options are reviewed on regular basis. As at 31 December 2006, the Group employed approximately 311 employees.

Subsequent to the year ended 31 December 2006, the Company has established share option scheme conditionally approved by resolutions of shareholders of the Company dated 8 January 2007 ("Share Option Scheme"). The purpose of this Share Option Scheme is to enable the Company to grant options to selected candidates as incentives or rewards for their contribution to the Group. Since establishment of Scheme to the report date, no share option was granted to the employees.

13. Charges on Group Assets

As at 31 December 2006, the Group had no charges on Group assets.

14. Gearing Ratio

The gearing ratio representing the ratio of bank borrowings to total equity of the Group was 22.1% as at 31 December 2006 (2005: 18.6%).

15. Foreign Exchange and Interest Rate Exposure

Foreign currency risk refers to risk that movement in foreign currency exchange rate which will affect the Group's financial results and its cash flow.

For the year ended 31 December 2006, the Group had convertible bonds denominated in United States Dollars and exposed to foreign currency risk. Apart from this, the management considers the Group does not expose to significant foreign currency risk as majority of its transactions of the Group were denominated in RMB.

All bank borrowings of the Group were denominated in RMB and at the prevailing market interest. The management is of the opinion that the Group is not subject to any significant interest rate risk.

Further discussion on financial risk management is included in the "Financial Risk Management Objectives and Policies" section of note 6 to the Financial Statements.

16. Contingent Liabilities

As at 31 December 2006, the Group did not have any significant contingent liabilities.

17. Capital Expenditure

For the year ended 31 December 2006, capital expenditures of the Group for property, plant and equipment and intangible assets amounted to approximately RMB50.0 million.

18. Capital Commitments

As at 31 December 2006, the Group had capital expenditure contracted for but not provided amounted to approximately RMB8.1 million.