

MANAGEMENT DISCUSSION AND ANALYSIS

SALES

As at 31 December 2006, the sales of the Group amounted to approximately RMB860,641,000, representing a decrease of 2.7% as compared with RMB884,709,000 in last year. A breakdown of the sales of the Group for the year ended 31 December 2006 is set out as follows:

	2006		2005		Change
	RMB'000	%	RMB'000	%	%
Antibiotics					
— Lijunsha	413,338	48.0	422,341	47.7	-2.1
— Paiqi	80,996	9.4	89,083	10.1	-9.1
— Erythromycin tablets	62,080	7.2	54,002	6.1	15.0
— Cephalosporin	28,914	3.4	52,927	6.0	-45.4
— Other antibiotics	35,194	4.1	48,811	5.5	-27.9
Total sales of antibiotics finished products	620,522	72.1	667,164	75.4	-7.0
Non-antibiotic					
Dobesilate	32,847	3.8	29,934	3.4	9.7
Other non-antibiotic medicines	127,042	14.8	100,288	11.3	26.7
Total sales of non-antibiotic finished products	159,889	18.6	130,222	14.7	22.8
Sales of bulk pharmaceuticals	75,189	8.7	72,825	8.2	3.3
Others	5,041	0.6	14,498	1.7	-65.2
Group's total revenue	860,641	100	884,709	100	-2.7

MANAGEMENT DISCUSSION AND ANALYSIS

ANTIBIOTICS

Owing to mandatory order of the retail prices cut in antibiotics products by the National Development and Reform Commission and the government's strengthen regulation in distribution and purchase system of pharmaceuticals products to hospital, the overall sale of pharmaceutical industry, especially the prescription drugs such as antibiotics, in the PRC has been greatly affected. The sales of antibiotics, which accounted for more than 70% of the Group's revenue, dropped 7% from RMB 667,164,000 in 2005 to RMB620,522,000 in 2006.

Lijunsha, the Group's most important antibiotic-product, accounted for 48% or RMB413,338,000 (2005: RMB422,341,000) of the Group's total sales. Thanks to the expansion of distribution network in clinic and drugs stores located in rural areas, impact of the two above mentioned policies had been partly off-set. Overall sales of Lijunsha for the year resulted a drop of 2.1% with compared to that of last year.

With the hospital being the main customer, Paiqi and other antibiotic products generally experienced a decrease in turnover comparing to that of last year.

NON-ANTIBIOTIC PRODUCTS

With the expansion of the distribution network in medium and small cities and rural area, sales of non-antibiotic products recorded satisfactory growth in 2006. Total sales of non-antibiotic finished medicines amounted to RMB159,889,000 (2005: RMB130,222,000) in 2006, representing an increase of 22.8% as compared to that of last year. Sales of Dobesilate reached RMB32,847,000 (2005: RMB29,934,000), representing a year-on-year growth of 9.7%.

BULK PHARMACEUTICALS

Sales of bulk pharmaceuticals amounted to RMB75,189,000 (2005: RMB72,825,000), representing an increase of 3.3%.

COST OF GOODS SOLD

While sales of the group dropped by 2.7%, the cost of goods sold decreased by 4.8% from RMB436,842,000 for the year ended 31 December 2005 to RMB415,806,000 for the year ended 31 December 2006. The cost of direct materials, direct labour and overhead represented approximately 70.3%, 8.8% and 20.9% of the total cost of goods sold respectively for the year ended 31 December 2006 while their comparative percentage for 2005 were 70.8%, 9.0% and 20.2% respectively.

GROSS PROFIT MARGIN

Thanks to the improved efficiency in the production procedures, gross profit of the Group in 2006 amounted to RMB444,835,000, representing a gross profit margin of 51.7%, which was increased by 1.1 percentage point comparing to that of last year (50.6%).

MANAGEMENT DISCUSSION AND ANALYSIS

SELLING AND MARKETING EXPENSES

For the year ended 31 December 2006, selling and marketing expenses amounted to approximately RMB223,726,000 (2005: RMB202,793,000), which mainly comprised of advertising expenses of approximately RMB52,999,000 (2005: RMB37,781,000), sales commission of approximately RMB105,865,000 (2005: RMB97,331,000), salaries expenses of sales and marketing staff of approximately RMB16,783,000 (2005: RMB17,182,000) and office and rental expense of approximately RMB11,208,000 (2005: RMB14,046,000).

The increase of 10.3% in selling and marketing expenses in 2006 as compared with that of 2005 was mainly attributable to the Group's boost up in advertising expenses to promote the brand name of the Company and its products.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses amounted to approximately RMB123,992,000 (2005: RMB108,414,000) for the year ended 31 December 2006 which mainly comprised of salaries for the administrative staff of approximately RMB40,591,000 (2005: RMB33,877,000), depreciation of approximately RMB10,160,000 (2005: RMB10,663,000), office and rental expenses of approximately RMB9,853,000 (2005: RMB11,195,000), sharing of administrative costs of Shaanxi Xi'an Pharmaceutical Factory of approximately RMB13,000,000 (2005: RMB12,063,000), research and development expenses of approximately RMB7,833,000 (2005: RMB7,429,000) and impairments of trade receivables of approximately RMB3,658,000 (2005: written back of RMB3,784,000).

The increase of 14.4% in general and administrative expenses in 2006 as compared with that of 2005 was mainly attributable to the increase in salaries expenses and impairment provision for trade receivables.

OPERATING PROFIT

Due to the increase in the Group's selling and marketing costs and general and administrative expenses, the Group's operating profit in 2006 was decreased by approximately RMB39,875,000 or 29.1%, amounted to RMB97,293,000 (2005: RMB137,168,000) with its operating profit margin (defined as operating profit divided by total sales) dropped from 15.5% to 11.3%.

FINANCE COSTS

As the Group has drawn certain bank borrowings during the year to finance the acquisition in its subsidiary's interests and for general working capital, the finance cost for the year has increased from RMB7,069,000 in 2005 to RMB10,232,000.

MANAGEMENT DISCUSSION AND ANALYSIS

INCOME TAX EXPENSE

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 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.

Income tax expenses for the year ended 2005 was approximately RMB15,122,000 which was mainly represented by written off of deferred income tax assets in the income statement. For the year ended 2006, the overall result in income tax expenses is an recognition of deferred income tax assets of RMB966,000.

PROFIT ATTRIBUTABLE TO EQUITY HOLDERS FOR THE YEAR

Profit attributable to equity holders for the year decreased by 9.4% to RMB84,575,000 (2005: RMB93,311,000) while net profit margin (profit attributable to equity holders for the year divided by total sales) decreased to 9.8% from 10.5% in 2005.

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 bank borrowings from time to time in case the operating cashflow is insufficient to meet the capital requirements.

As at 31 December 2006, the cash and cash equivalents aggregated to RMB167,387,000 (2005: RMB275,122,000), comprising RMB46,469,000 (2005: RMB129,745,000) of cash and cash equivalents denominated in Hong Kong dollars, RMB116,068,000 (2005: RMB145,106,000) in RMB and RMB4,850,000 (2005: RMB271,000) in other currencies.

As at 31 December 2006, the Group has restricted deposits amounted to RMB16,248,000. (2005: nil) as guarantee of the bank borrowings.

Bank borrowings amounted to RMB209,376,000 (2005: RMB113,000,000) as at 31 December 2006, comprising RMB80,376,000 (2005: Nil) of bank borrowings denominated in Hong Kong dollars and RMB129,000,000 (2005: RMB113,000,000) in RMB. The increase was mainly due to bank borrowings obtained for acquisition of 20% interest in Xi'an Lijun in June 2006 and for general working capital of the Group.

Gearing ratio (defined as total liabilities divided by total assets) increased from 36.6% as at 31 December 2005 to 45.1% as at 31 December 2006.

Current ratio (defined as current assets divided by current liabilities) decreased from 1.79 as at 31 December 2005 to 1.43 as at 31 December 2006.

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.

MANAGEMENT DISCUSSION AND ANALYSIS

PLEDGE OF ASSETS

As at 31 December 2006, bank deposits of HK\$16,077,000 and the Group's land use rights with the net bank amount of approximately RMB4,000,000 was pledged as collateral for the Group's bank borrowings.

CONTINGENT LIABILITIES

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

PROCEEDS FROM INITIAL PUBLIC OFFERING

Proceeds from initial public offering amounted to approximately HK\$145,557,000, net of relevant expenses. The proceeds not yet utilized as at 31 December 2006 were mainly deposited in the bank accounts of the Group.

Application of proceeds from initial public offering was as follows:

	Planned Use HK\$'000	Actual used as at 31 December 2006 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	18,919
Setting up of the new production line of soft capsule form products	21,200	7,785
Expansion of production capacities of lyophilized powder for injection	17,300	9,605
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	7,795
Group's Working capital	4,357	4,357
Total	145,557	48,461