

**If you are in any doubt** as to any aspect of this circular or as to the action to be taken, you should consult a stockbroker or other registered dealer in securities, bank manager, solicitor, professional accountant or other professional adviser.

**If you have sold or transferred** all your shares in **CHINA MENGNIU DAIRY COMPANY LIMITED**, you should at once hand this circular, together with the enclosed form of proxy, to the purchaser or transferee or to the bank, licensed securities dealer or other agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.

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## **CHINA MENGNIU DAIRY COMPANY LIMITED**

*(Incorporated in the Cayman Islands with limited liability)*

**(Stock Code: 2319)**

### **CONTINUING CONNECTED TRANSACTIONS AND FINANCIAL ASSISTANCE**

*Independent Financial Adviser to the Independent Board Committee*

## **Watterson Asia Limited**

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A letter from the Independent Board Committee (as defined herein) containing its advice to the independent shareholders (as defined herein) is set out on pages 19 to 20 of this circular. A letter from Watterson Asia containing its advice to the Independent Board Committee is set out on pages 21 to 36 of this circular.

A notice dated 27 May 2005 convening an annual general meeting of China Mengniu Dairy Company Limited to be held at Hennessy Room, Level 7, Conrad Hong Kong, Pacific Place, 88 Queensway, Hong Kong on Tuesday, 28 June 2005 at 10:30 a.m. is set out at the end of another circular in relation to general mandates to repurchase shares and issue new shares and other matters issued on the same date as this circular. Whether or not you are able to attend the meeting, you are requested to complete and return the enclosed form of proxy in accordance with the instructions printed thereon to the Company's branch share registrar in Hong Kong, Computershare Hong Kong Investor Services Limited, as soon as practicable and in any event at least 48 hours before the time appointed for holding the meeting. Completion and return of the form of proxy will not preclude you from attending and voting in person at the meeting nor at any adjourned meeting should you so wish.

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## DEFINITIONS

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*In this circular, the following expressions shall have the meanings as set out below unless the context requires otherwise:*

- “AGM” means the annual general meeting of the Company to be held on Tuesday, 28 June 2005;
- “Agreements” means the Guarantee Agreements, Ice cream Products Inventory Adjustment Agreement, UHT Milk Beverage Products Centralised Sales Agreement, Yogurt Products Centralised Sales Agreement, Yogurt Products Inventory Adjustment Agreement and the inventory adjustment agreement for the transfer of raw materials and packaging materials;
- “Board” means the board of the Directors;
- “Company” means China Mengniu Dairy Company Limited (HKex code 2319), a company incorporated with limited liability in the Cayman Islands on 16 February 2004, the shares of which are listed on the main board of the Stock Exchange;
- “Continuing Connected Transactions” means the transactions contemplated under the Agreements;
- “Directors” means the directors of the Company;
- “Founding Individuals” means Niu Gensheng, Deng Jiuqiang, Hou Jiangbin, Sun Yubin, Qiu Lianjun, Yang Wenjun, Pang Kaitai, Lu Jun, Sun Xianhong and Xie Qiuxu, who are all PRC nationals. Niu Gensheng, Lu Jun, Sun Yubin and Yang Wenjun are Directors of the Company. The Founding Individuals have been acting as the controlling group of the Mengniu business since its inception in 1999 and as a result, they as a group are the controlling shareholders of the Company and they are connected persons of the Company;
- “Group” means the Company and its subsidiaries;
- “Guarantee Agreements” means the agreements entered into by Mengniu with each of Mengniu Luannan, Mengniu Tangshan, Mengniu Beijing, Mengniu Jiaozuo, Mengniu Taian, Mengniu Shenyang, Mengniu Shanxi and Mengniu Maanshan on 18 May 2005 to act as guarantor for future bank borrowings by each of the Mengniu Subsidiaries;
- “Hong Kong” means the Hong Kong Special administrative Region of the PRC;
- “Ice Cream Products Inventory Adjustment Agreement” means the agreement entered into among Mengniu, Mengniu Danyang, Mengniu Jiaozuo, Mengniu Jinhua, Mengniu Shenyang, Mengniu Taian, and Mengniu Maanshan on 18 May 2005 regarding the inventory adjustment of ice cream products;

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## DEFINITIONS

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| “Independent Board Committee” | means the independent board committee, comprising Mr Wang Huaibao, Mr Zhang Julin and Mr Li Jianxin, all being independent non-executive directors to advise the independent shareholders;                                       |
| “Latest Practicable Date”     | means 27 May 2005, being the latest practicable date prior to the printing of this circular for ascertaining certain information contained herein;   |
| “Listing Rules”               | means The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (as amended from time to time);   |
| “Mengniu”                     | means Inner Mongolia Mengniu Milk Industry (Group) Co., Ltd., (內蒙古蒙牛乳業(集團)股份有限公司) a sino-foreign joint stock limited company incorporated in the PRC with limited liability and the principal operating subsidiary of the Group; |
| “Mengniu Baotou”              | means 內蒙古蒙牛乳業包頭有限責任公司 (Inner Mongolia Mengniu Dairy Baotou Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;                                 |
| “Mengniu Beijing”             | means 蒙牛乳業(北京)有限責任公司 (Mengniu Dairy (Beijing) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “Mengniu Dangyang”            | means 蒙牛乳業(當陽)有限責任公司 (Mengniu Dairy (Dangyang) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;   |
| “Mengniu Dengkou”             | means 蒙牛乳業(磴口巴彥高勒)有限責任公司 (Mengniu Dairy (Dengkou Bayan Gaole) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;                              |
| “Mengniu Founding”            | means 內蒙古蒙牛方鼎產業管理有限責任公司 (Inner Mongolia Mengniu Founding Industry Management Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;               |
| “Mengniu Jiaozuo”             | means 蒙牛乳業(焦作)有限公司 (Mengniu Dairy (Jiaozuo) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “Mengniu Jinhua”              | means 金華蒙牛乳業有限公司 (Jinhua Mengniu Dairy Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;   |
| “Mengniu Keerqin”             | means 內蒙古蒙牛乳業科爾沁有限責任公司 (Inner Mongolia Mengniu Dairy Keerqin Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;                               |

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## DEFINITIONS

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|---|---|
| “Mengniu Luannan”                           | means 蒙牛乳業(瀋南)有限責任公司 (Mengniu Dairy (Luannan) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;   |
| “Mengniu Maanshan”                          | means 蒙牛乳業(馬鞍山)有限公司 (Mengniu Dairy Maanshan Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;   |
| “Mengniu Maanshan Intra-Group Transactions” | means the transactions contemplated under the UHT Milk and Milk Beverage Products Centralised Sales Agreement, UHT Milk and Milk Beverage Products Inventory Adjustment Agreement, Yogurt Products Centralised Sales Agreement, Yogurt Products Inventory Adjustment Agreement, Ice Cream Products Inventory Adjustment Agreement and the inventory adjustment agreement for the transfer of raw materials and packaging materials; |
| “Mengniu Maanshan JV Agreement”             | means the joint venture agreement entered into between Mengniu Founding and Mengniu governing the affairs of Mengniu Maanshan;  |
| “Mengniu Shanxi”                            | means 內蒙古蒙牛乳業(集團)山西乳業有限公司 (Inner Mongolia Mengniu Dairy (Group) Shanxi Dairy Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “Mengniu Shenyang”                          | means 蒙牛乳業(瀋陽)有限責任公司 (Mengniu Dairy (Shenyang) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “Mengniu Subsidiaries”                      | means the subsidiaries of Mengniu;  |
| “Mengniu Taian”                             | means 蒙牛乳業泰安有限責任公司 (Mengniu Dairy Taian Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;   |
| “Mengniu Tangshan”                          | means 蒙牛乳業(唐山)有限責任公司 (Mengniu Dairy (Tangshan) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “Mengniu Wulanhaote”                        | means 蒙牛乳業(烏蘭浩特)有限責任公司 (Mengniu Dairy (Wulanhaote) Co., Ltd.), a company incorporated in the PRC as a limited liability company, an indirect non-wholly owned subsidiary of the Company;  |
| “PRC”                                       | means the People’s Republic of China excluding Hong Kong, the Macau Special Administrative Region of the PRC and Taiwan;  |
| “Prospectus”                                | means the prospectus issued by the Company on 1 June 2004;  |
| “RMB”                                       | means Renminbi, the lawful currency of the PRC;   |
| “SFO”                                       | means the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong);  |

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## DEFINITIONS

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|   |   |
|---|---|
| “Stock Exchange”  | means The Stock Exchange of Hong Kong Limited;  |
| “UHT Milk and Milk Beverage Products Centralised Sales Agreement” | means the agreement entered into between Mengniu and Mengniu Maanshan on 18 May 2005 regarding the centralised sales arrangement of the UHT Milk and Milk Beverage Products;  |
| “Watterson Asia”  | means Watterson Asia Limited, a corporation licensed to carry out type 1 (dealing in securities) and type 6 (advising on corporate finance) regulated activities under the SFO, the independent financial adviser to the Independent Board Committee in relation to the Agreements;   |
| “Yogurt Products Centralised Sales Agreement”                     | means the agreement entered into between Mengniu Maanshan and Mengniu Beijing on 18 May 2005 regarding the centralised sales arrangement of the Yogurt Products;  |
| “Yogurt Products Inventory Adjustment Agreement”                  | means the agreement entered into among Mengniu, Mengniu Baotou, Mengniu Beijing, Mengniu Dengkou, Mengniu Jiaozuo, Mengniu Keerqin, Mengniu Luannan, Mengniu Shanxi, Mengniu Shenyang, Mengniu Tangshan, Mengniu Taian, Mengniu Wulanhaote and Mengniu Maanshan on 18 May 2005 regarding the inventory adjustment of Yogurt Products; and |
| “%”   | means per cent.   |



**CHINA MENGNIU DAIRY COMPANY LIMITED**

*(Incorporated in the Cayman Islands with limited liability)*

**(Stock Code: 2319)**

*Directors:*

Mr Niu Gensheng (*Chief Executive Officer*)  
Ms Lu Jun  
Mr Sun Yubin  
Mr Yang Wenjun  
Mr Jiao Shuge<sup>#</sup> (alias Jiao Zhen) (*Chairman*)  
Mr Liu Haifeng, David<sup>#</sup>  
Ms Jin Yujuan, Lily<sup>#</sup>  
Mr Wang Huaibao\*  
Mr Zhang Julin\*  
Mr Li Jianxin\*

*Company Secretary:*

Lo Ka Wai, Claudia

*Registered Office:*

M&C Corporate Service  
PO Box 309 GT  
Ugland House  
South Church Street  
George Town  
Grand Cayman  
Cayman Islands

*Principal place of business  
in Hong Kong:*

Unit 1001, 10th Floor  
Jubilee Centre  
18 Fenwick Street  
Wanchai  
Hong Kong

<sup>#</sup> *Non-executive Director*

\* *Independent Non-executive Director*

27 May 2005

*To the Shareholders*

Dear Sir or Madam,

**CONTINUING CONNECTED TRANSACTIONS  
AND FINANCIAL ASSISTANCE**

The purpose of this circular is to provide you with further information in relation to resolutions to be proposed at the AGM for the approval of the Agreements, the Continuing Connected Transactions, the respective caps in relation to the Continuing Connected Transactions and the restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of this letter (including recommendations from the Independent Board Committee and opinion rendered from Watterson Asia). A notice convening the AGM to be held at Hennessy Room, Level 7, Conrad Hong Kong, Pacific Place, 88 Queensway, Hong Kong on Tuesday, 28 June 2005 at 10:30 a.m. is set out at the end of another circular in relation to general mandates to repurchase shares and issue new shares and other matters issued on the same date as this circular.

## **CONTINUING CONNECTED TRANSACTIONS**

### **1. Introduction**

On 19 May 2005, the Company announced that (1) Mengniu, the operating subsidiary of the Company and Mengniu Subsidiaries; and (2) Mengniu Subsidiaries, amongst each other, have entered into a series of continuing connected transactions, namely the Mengniu Maanshan Intra-Group Transactions and the Guarantee Agreements for the purpose of satisfying intra-group transfers of different products and to aid in the expansion of various Mengniu Subsidiaries.

In respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purposes as disclosed in the Prospectus under category 16, the estimated caps for the year ended 2005 and 2006 will be revised due to adjustment in product portfolio and introduction of new products.

Details of the Mengniu Maanshan Intra-Group Transactions, the Guarantee Agreements and details of the connected transaction whereby the caps for the year 2005 and 2006 will be revised, subject to the independent shareholders' approval, are set out below under paragraph 2(A) to (G) of this letter.

Mengniu is a non wholly-owned subsidiary of the Company. Four executive directors of the Company, who are connected persons of the Company, namely, Niu Gensheng, Lu Jun, Sun Yubin and Yang Wenjun who are also Founding Individuals and another five Founding Individuals (who are connected persons of the Company) together are entitled to exercise more than 10% of the voting power of Mengniu. The Founding Individuals have been acting as the controlling group of the Mengniu business since its inception in 1999 and as a result, they as a group are the controlling shareholders of the Company and they are connected persons of the Company. Accordingly, pursuant to Rule 14A.11(5) of the Listing Rules, Mengniu is a connected person of the Company.

Due to Mengniu being a connected person of the Company, all of the Mengniu Subsidiaries are also connected persons of the Company pursuant to Rule 14A.11(6) of the Listing Rules. Accordingly, all transactions between Mengniu and the Mengniu Subsidiaries, or amongst the Mengniu Subsidiaries, are connected transactions under the Listing Rules.

In addition, as the applicable percentage ratios (as defined in Rule 14.07 of the Listing Rules) are more than 2.5%, the Continuing Connected Transactions and the connected transaction in relation to inventory adjustment as described under paragraph 2(G) of this letter constitute non-exempt continuing connected transaction of the Company under Rule 14A.35. These transactions are not only subject to the reporting and announcement requirements under Rule 14A.45 to 14A.47 but also require the approval of the independent shareholders of the Company under Rule 14A.48 of the Listing Rules.

### **2. The Transactions**

#### ***Background of Mengniu Maanshan JV Agreement***

Mengniu Maanshan Intra-group Transactions were entered into due to the establishment of a joint venture between Mengniu, the operating subsidiary of the Company and Mengniu Founding. Mengniu Maanshan is located in Maanshan, Anhui



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## LETTER FROM THE BOARD

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province. In order to better serve the demand in the eastern and southern part of China, Mengniu Maanshan has been established to expand the Group's production base in the Yangtze River Delta area. Mengniu Maanshan will conduct manufacturing of UHT milk and milk beverages, yogurt products and ice cream products.

### *Mengniu Maanshan Intra-Group Transactions*

#### (A) Centralised UHT milk and milk beverage products sales arrangements by Mengniu

##### (a) Background

As disclosed in page 111 of the Prospectus, the Group implements a centralised sales arrangement for its UHT milk and milk beverage products whereby such products are centralised for sale, billing and invoicing to distributors by Mengniu. As Mengniu Maanshan will manufacture UHT milk and milk beverage products it will sell its UHT milk and milk beverage products to Mengniu for further distribution.

These transactions occur as a result of the overall logistics management under the centralised sales arrangement which are conducted in the ordinary course of business on normal commercial terms and will benefit the Group as a whole as efficiency is increased.

##### (b) Agreement and Terms

The centralised sales arrangement is covered by the UHT Milk and Milk Beverage Products Centralised Sales Agreement entered into by Mengniu and Mengniu Maanshan on 18 May 2005. It is for an initial period commencing on the date of the agreement ending 31 December 2007.

Under the UHT Milk and Milk Beverage Products Centralised Sales Agreement, Mengniu will pay to Mengniu Maanshan on a monthly basis for all sales made that month.

##### (c) Pricing Standard

The UHT milk and milk beverage products will be sold to Mengniu at an intra-group rate as disclosed in the Prospectus. Such rate is determined by a formula, as follows:

$$\text{Intra-Group Rate} = \text{Wholesale price of the UHT milk and milk beverage products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to those manufacturing companies in the Group participating in the centralised sales arrangement. The general expenses consist of staff wages, marketing expenses, transport costs, storage costs and disbursements. As with other centralised sales transactions of the Group that are disclosed in the Prospectus, Y is expected to be capped at 3% going forward.

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## LETTER FROM THE BOARD

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The UHT milk and milk beverage products are transferred and booked at this intra-group rate for the purposes of the centralised sales arrangement. As these transactions are conducted for overall logistics management, there are no universal standards for comparison. There is therefore no market or comparison price for such centralised sales arrangements in China.

(d) Anticipated Annual Figures

There is no historical data for this transaction but it is anticipated that they will occur after the entering into of the UHT Milk and Milk Beverage Products Centralised Sales Agreement. It is anticipated that on an annual basis, the maximum aggregate amounts of the centralised sales, the caps for each of the three financial years ending 31 December 2007 will not exceed RMB70,000,000, RMB200,000,000 and RMB240,000,000 respectively. Since Mengniu Maanshan has not yet commenced production, these caps are mainly extrapolated from its planned production capacity and by making reference to factors such as the growth rate of turnover of the Group over the past year, expected increase in market share and expected increase in market demand and production capacity. In respect of the cap for the year ended 31 December 2005, it has been taken into account that Mengniu Maanshan will only commence operation in the second half of 2005. On the contrary, since the majority of the participating subsidiaries in respect of the continuing connected transaction as disclosed under category 11 on page 111 to 112 of the Prospectus have been in operation and that historical transaction data were available, hence, the approved caps were mainly extrapolated from factors such as historical production and sales data and expected growth in production and sales. Other factors taken into consideration were similar to those as for Mengniu Maanshan.

Based on the anticipated aggregate maximum amounts, each of the applicable percentage ratios (other than the profits ratio) for the centralised sales transactions is greater than 2.5%. In accordance with Rule 14A.35 of the Listing Rules, the centralised sales transactions are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

(B) Centralised yogurt products sales arrangement by Mengniu Beijing

(a) Background

As disclosed in page 114 of the Prospectus, the Group implements a centralised sales arrangement for its yogurt products whereby such products are centralized for sale, billing and invoicing to distributors by Mengniu Beijing. As Mengniu Maanshan will manufacture yogurt products, it will sell its yogurt products to Mengniu Beijing for onward sale to distributors. Mengniu Maanshan will execute physical delivery of yogurt products to distributors according to Mengniu Beijing's instructions. These sales do not involve delivery to Mengniu Beijing as these transactions are operational transactions only.

These transactions occur as a result of the overall logistics management under the centralised sales arrangement which are conducted in the ordinary course of business on normal commercial terms and will benefit the Group as a whole as efficiency is increased.

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## LETTER FROM THE BOARD

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### (b) Agreement and Terms

The centralised sales arrangement is covered by the Yogurt Products Centralised Sales Agreement entered into by Mengniu Beijing and Mengniu Maanshan on 18 May 2005. It is for an initial period commencing on the date of the agreement ending 31 December 2007.

Under the Yogurt Products Centralised Sales Agreement, Mengniu Beijing will pay Mengniu Maanshan on a monthly basis for all orders made that month.

### (c) Pricing Standard

The yogurt products will be sold to Mengniu Beijing at an intra-group rate as disclosed in the Prospectus. Such rate is determined by a formula, as follows:

$$\text{Intra-Group Rate} = \text{Wholesale price of the Yogurt Products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to those manufacturing companies in the Group participating in the centralised sales arrangement. The general expenses consist of staff wages, marketing expenses, transport costs, storage costs and disbursements. As with other centralised sales transactions of the Group that are disclosed in the Prospectus, Y is expected to be capped at 3% going forward.

The yogurt products are transferred and booked at this intra-group rate for the purposes of the centralised sales arrangement. As these transactions are conducted for overall logistics management, there are no universal standards for comparison. There is therefore no market or comparison price for such centralised sales arrangements in China.

### (d) Anticipated Annual Figures

There is no historical data for this transaction but it is anticipated that they will occur after the entering into of the Yogurt Products Centralised Sales Agreement. It is anticipated that the production lines for Mengniu Maanshan shall only commence in the second half of 2005, and on an annual basis, the maximum aggregate amounts of the centralised sales caps for each of the three financial years ending 31 December 2007 will not exceed RMB300,000,000, RMB720,000,000 and RMB1,068,000,000 respectively. Since Mengniu Maanshan has not yet commenced production, these caps are mainly extrapolated from its planned production capacity and by making reference to factors such as the growth rate of turnover of the Group over the past year, sales and expected increase in market share and expected increase in demand and production capacity. On the contrary, since the majority of the participating subsidiaries in respect of the continuing connected transaction as disclosed under category 14 on page 114 to 115 have been in operation and that historical transaction data were available, hence, the approved caps were mainly extrapolated from factors such as historical production and sales data and expected growth in production and sales. Other factors taken into consideration were similar to those as for Mengniu Maanshan.

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## LETTER FROM THE BOARD

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Based on the anticipated aggregate maximum amounts, each of the applicable percentage ratios (other than the profits ratio) for the centralised sales transactions is greater than 2.5%. These transactions constitute continuing connected transactions and in accordance with Rule 14A.35 of the Listing Rules, the centralised sales transactions are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

(C) Transfer of yogurt products amongst Mengniu, Mengniu Maanshan and other Mengniu Subsidiaries for inventory adjustment purposes

(a) Background

As disclosed in page 116 of the Prospectus, as part of the centralised sales system, delivery of the yogurt products to the distributors is made by those Mengniu Subsidiaries that manufacture the yogurt products. In meeting delivery orders there are occasionally shortfalls in the inventories of particular Mengniu Subsidiaries. Where this occurs the respective Mengniu Subsidiary purchases stock from Mengniu or other Mengniu Subsidiaries to make up for the shortfalls.

These transactions occur as a result of the overall logistics management under the centralised sales arrangement which are conducted in the ordinary course of business on normal commercial terms and will benefit the Group as a whole as efficiency they represent an efficient use of excess inventory whilst allowing the respective Mengniu Subsidiary to meet delivery orders.

(b) Agreement and Terms

The inventory adjustment transactions are covered by the Yogurt Products Inventory Adjustment Agreement entered into by Mengniu Maanshan and all the Mengniu Subsidiaries which manufacture yogurt, Mengniu and Mengniu Beijing on 18 May 2005. It is for an initial period commencing on the date of this agreement ending 31 December 2007.

Under the inventory adjustment agreement, the transferee shall make payment on a monthly basis for all orders made that month.

(c) Pricing Standard

The yogurt products will be transferred at an intra-group rate as disclosed in the Prospectus. Such rate is determined by a formula, as follows:

$$\text{Intra-Group Rate} = \text{Wholesale price of the yogurt products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to those manufacturing companies in the Group participating in the inventory adjustment arrangement. The general expenses consist of staff wages, marketing expenses, transport costs, storage costs and disbursements. As with other inventory adjustment transactions of the Group that are disclosed in the Prospectus, Y is expected to be capped at 3% going forward.

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## LETTER FROM THE BOARD

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The yogurt products are transferred and booked at this intra-group rate for the purposes of the inventory adjustment arrangement. As these transactions are conducted for overall logistics management, there are no universal standards for comparison. There is therefore no market or comparison price for such inventory adjustment arrangements in China.

(d) Anticipated Annual Figures

There is no historical data for this transaction but it is anticipated that they will occur after the entering into of the inventory adjustment agreement. It is anticipated that on an annual basis, the maximum aggregate amounts of the centralised sales, the caps, for each of the three financial years ending 31 December 2007 will not exceed RMB12,000,000, RMB43,200,000 and RMB77,760,000 respectively. Since Mengniu Maanshan has not yet commenced production, these caps are mainly extrapolated from its planned production capacity and by making reference to factors such as the growth rate of turnover of the Group over the past year, sales and expected increase in market share and expected increase in demand and production capacity. In respect of the cap for the year ended 31 December 2005, it has been taken into account that Mengniu Maanshan will only be operation for the second half of 2005. On the contrary, since the majority of the participating subsidiaries in respect of the continuing connected transaction as disclosed under paragraph 2(G) to this letter have been in operation and that historical transaction data were available, hence, the proposed restated caps are mainly extrapolated from factors such as historical production and sales data and expected growth in production and sales. Other factors taken into consideration are similar to those as for Mengniu Maanshan.

Pursuant to Rule 14A.25 of the Listing Rules and as requested by the Stock Exchange, the current proposed caps in respect of these inventory adjustment transactions as mentioned in this paragraph 2(C) would have to be aggregated with the revised caps in respect of the continuing connected transaction as set out under paragraph 2(G) to this letter. Such aggregation would result in each of the applicable percentage ratios (other than the profits ratio) for the inventory adjustment transactions being greater than 2.5%. Hence, these transactions constitute continuing connected transactions under Rule 14A.35 of the Listing Rules and are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

(D) Sales of ice cream products amongst Mengniu, Mengniu Maanshan and other Mengniu Subsidiaries for inventory adjustment purposes

(a) Background

As disclosed in page 117 of the Prospectus, an inventory adjustment mechanism exists between those Mengniu Subsidiaries which manufacture ice cream products whereby they supply each other with finished ice cream products whenever shortages arise in another member. It is intended for Mengniu Maanshan to be a key manufacturer of ice cream products for the Mengniu Group. Since it is intended to produce the widest variety of ice cream products, it is expected that it may encounter the most frequent fluctuation in its inventory.

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## LETTER FROM THE BOARD

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These transactions occur as a result of the overall logistics management under the inventory adjustment arrangement which are conducted in the ordinary course of business on normal commercial terms and will benefit the Group as a whole as efficiency they represent an efficient use of excess inventory whilst allowing the respective Mengniu Subsidiary to meet delivery orders.

(b) Agreement and Terms

The inventory adjustment transactions are covered by the Ice Cream Products Inventory Adjustment Agreement entered into by Mengniu Maanshan and all the Mengniu Subsidiaries who manufacture ice cream products including Mengniu on 18 May 2005. It is for an initial period commencing on the date of this agreement ending 31 December 2007.

Under the Ice Cream Products Inventory Adjustment Agreement, the transferee shall make payment on a monthly basis for all orders made that month.

(c) Pricing Standard

The ice cream products will be transferred at an intra-group rate as disclosed in the Prospectus. Such rate is determined by a formula, as follows:

$$\text{Intra-Group Rate} = \text{Wholesale price of the ice cream products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to those manufacturing companies in the Group participating in the inventory adjustment arrangement. The general expenses consist of staff wages, marketing expenses, transport costs, storage costs and disbursements. As with other inventory adjustment transactions of the Group that are disclosed in the Prospectus, Y is expected to be capped at 3% going forward.

The ice cream products are transferred and booked at this intra-group rate for the purposes of the inventory adjustment arrangement. As these transactions are conducted for overall logistics management, there are no universal standards for comparison. There is therefore no market or comparison price for such inventory adjustment arrangements in China.

(d) Anticipated Annual Figures

There is no historical data for this transaction but it is anticipated that they will occur after the entering into of the inventory adjustment agreement. It is anticipated that on an annual basis, the maximum aggregate amounts of the centralised sales, the caps for each of the three financial years ending 31 December 2007 will not exceed RMB40,000,000, RMB80,000,000 and RMB96,000,000 respectively. Since Mengniu Maanshan has not yet commenced production, these caps are mainly extrapolated from its planned production capacity and by making reference to factors such as the growth rate of turnover of the Group over the past year, sales and expected increase in market share and expected increase in demand and production capacity. In respect of the cap for the year ended 31 December 2005, it has been taken into account that Mengniu Maanshan will only be in operation for

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## LETTER FROM THE BOARD

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the second half of 2005. On the contrary, since the majority of the participating subsidiaries in respect of the continuing connected transaction as disclosed under category 17 on page 117 to 118 have been in operation and that historical transaction data were available, hence, the approved caps were mainly extrapolated from factors such as historical production and sales data and expected growth in production and sales. Other factors taken into account were similar to those as for Mengniu Maanshan.

Pursuant to Rule 14A.25 of the Listing Rules and as requested by the Stock Exchange, the current proposed caps in respect of these inventory adjustment transactions as mentioned in this paragraph 2(D) would have to be aggregated with the approved caps in respect of the continuing connected transaction as set out under category 17 on page 117 to 118 of the Prospectus. Such aggregation would result in each of the applicable percentage ratios (other than the profits ratio) for the inventory adjustment transactions being greater than 2.5%. Hence, these transactions constitute continuing connected transactions under Rule 14A.35 of the Listing Rules and are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

(E) Ongoing inventory adjustment of raw materials and packaging materials amongst Mengniu, Mengniu Subsidiaries and Mengniu Maanshan

(a) Background

As disclosed in page 118 of the Prospectus, as part of an inventory adjustment mechanism, certain raw materials are centrally purchased by Mengniu in order to enjoy the advantage of bulk purchase and then transferred by Mengniu to other Mengniu Subsidiaries and excess raw materials and packaging materials are transferred to other members whenever shortages arise. Mengniu Maanshan will join such inventory adjustment mechanism.

This inventory adjustment mechanism is beneficial for all parties involved as it minimises wastage and increases the efficient use of resources.

(b) Agreement and Terms

The inventory adjustment transactions are covered by the inventory adjustment agreement for raw materials and packaging materials entered into by all the Mengniu Subsidiaries, Mengniu and Mengniu Maanshan on 18 May 2005. It is for an initial period commencing on the date of this agreement ending 31 December 2007.

Under the inventory adjustment agreement, the transferee makes payment on a monthly basis for all orders made that month.

(c) Pricing Standard

Inventory adjustment of such raw materials and packaging materials between the companies is at cost, which is the same as the pricing standard as disclosed in the Prospectus.

(d) Anticipated Annual Figures

There is no historical data for this transaction but it is anticipated that they will occur after the entering into of the inventory adjustment agreement. It is anticipated that on an annual basis, the maximum aggregate amounts of the inventory adjustment caps for each of the three financial years ending 31 December 2007 will not exceed RMB65,000,000, RMB195,000,000 and RMB254,000,000 respectively. Since Mengniu Maanshan has not yet commenced production, these caps are mainly extrapolated from its planned production capacity and by making reference to factors such as the growth rate of turnover of the Group over the past year, sales and expected increase in market share and expected increase in demand and production capacity. In respect of the cap for the year ended 31 December 2005, it has been taken into account that Mengniu Maanshan will only be in operation for the second half of 2005. Certain raw materials such as imported milk powder and white sugar are centrally purchased by Mengniu in order to enjoy the advantage of bulk purchase. Since the major products manufactured by Mengniu Maanshan are yogurt products which require the above raw materials, the amount of this transaction is significant. On the contrary, since the majority of the participating subsidiaries in respect of the continuing connected transaction as disclosed under category 18 on page 118 to 119 have been in operation and that historical transaction data were available, hence, the approved caps were mainly extrapolated from factors such as historical production and sales data and expected growth in production and sales. Other factors taken into consideration were similar to those as for Mengniu Maanshan.

Pursuant to Rule 14A.25 of the Listing Rules and as requested by the Stock Exchange, the current proposed caps in respect of the inventory adjustment transactions as mentioned in this paragraph 2(E) would have to be aggregated with the approved caps in respect of the continuing connected transaction as set out under category 18 on page 118 to 119 of the Prospectus. Such aggregation would result in each of the applicable percentage ratios (other than the profits ratio) for the inventory adjustment transactions being greater than 2.5%. Hence these transactions constitute continuing connected transactions under Rule 14A.35 of the Listing Rules and are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

*Guarantee Agreements*

(F) Provision of guarantees by Mengniu for loans to certain Mengniu Subsidiaries

(a) Background

To further aid in the expansion of Mengniu Luannan, Mengniu Tangshan, Mengniu Beijing, Mengniu Jiaozuo, Mengniu Taian, Mengniu Shenyang, Mengniu Shanxi and Mengniu Maanshan, Mengniu has agreed to act as guarantor for bank loans to be obtained by Mengniu Subsidiaries.



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## LETTER FROM THE BOARD

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(b) Agreement and Terms

The guarantees are covered by a Guarantee Agreement entered into with each of the Mengniu Subsidiaries as set out in paragraph (a) with Mengniu on 18 May 2005. Each agreement expires on 31 December 2007.

(c) Pricing Standard

Mengniu will provide these guarantees to the Mengniu Subsidiaries at no consideration, which is the same as for the guarantees as disclosed in the Prospectus.

(d) Anticipated Annual Figures

Based on the past rate of growth and capital needs of each of the participating Mengniu Subsidiaries for the past year, it is anticipated that on an annual basis, the maximum bank loan borrowings, the caps, for the participating Mengniu Subsidiaries for each of the three financial years ending 31 December 2007 will not exceed RMB580,000,000, RMB696,000,000 and RMB765,600,000.

Based on the anticipated aggregate maximum amounts, each of the applicable percentage ratios (other than the profits ratio) are greater than 2.5%. The guarantees constitute continuing connected transactions and in accordance with Rule 14A.63 of the Listing Rules, the guarantees are subject to reporting and announcement requirements and independent shareholders' approval requirements.

The guarantees are also financial assistance provided by Mengniu. Pursuant to Rule 14A.65(4), such Mengniu Subsidiaries, being beneficiaries to the Guarantee Agreement and connected persons as recipients of the financial assistance are exempt from reporting and announcement requirements and independent shareholders' approval requirements of Chapter 14A. Mengniu, the provider of the financial assistance, which has been provided for the benefit of a connected person is subject to reporting and announcement requirements and independent shareholders' approval requirements under Rule 14A.63 of the Listing Rules.

*Transaction expected to exceed the cap estimated of 2005 and 2006*

(G) Transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purposes

(a) Background

As disclosed under category 16 on page 116 in the Prospectus, the estimated cap amount of this category of transaction for the year 2005 and 2006 was capped at RMB6,000,000 and RMB8,000,000 respectively. The Company confirms that the cap, as disclosed in the Prospectus, for the year 2004 had been complied with. The Company further confirms that the approved cap for the year 2005 will not be exceeded prior to obtaining the approval of the independent shareholders in relation to the revised caps for the particular connected transaction which will be sought at the upcoming AGM.

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## LETTER FROM THE BOARD

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Based on the current forecast, the above maximum aggregate amount for the year 2005 and 2006 will be RMB20,000,000 and RMB48,000,000 respectively. These caps are extrapolated, based on the estimated expansion in the sales network of the Group, adjustment in product portfolio and introduction of new products in the coming two years.

Prior to 2004, the amount of yogurt products transferred between Mengniu Subsidiaries for inventory adjustment purposes was not significant. This was mainly due to limited varieties of yogurt products manufactured by Mengniu and Mengniu Subsidiaries, which required insignificant inventory adjustments. In 2005, the Group strategically expanded its product portfolio, focusing on the high value-added yogurt products and will continue to develop new products.

From January to March 2005, the Company introduced 23 new yogurt products which are mainly manufactured by Mengniu Beijing while other Mengniu Subsidiaries will be focusing on the production of existing yogurt products.

In the first quarter of 2005, the amount of such transaction has already reached RMB3,000,000. The amount for each of the second and third quarter of 2005 is expected to double when compared with that of the first quarter, as these periods are the peak seasons of yogurt sales.

### (b) Estimated Annual Figures

Based on the estimated growth in sales for the new and existing yogurt products, the maximum aggregate annual amount for this category of transaction has been revised to for the years ended 31 December 2005 and 2006, respectively, RMB20,000,000 and RMB48,000,000.

Pursuant to Rule 14A.25 of the Listing Rules and as requested by the Stock Exchange, the proposed restated caps in respect of these inventory adjustment transactions as mentioned in this paragraph 2(G) would have to be aggregated with the proposed caps in respect of the inventory adjustment transactions as set out under paragraph 2(C) to this letter. Such aggregation would result in each of the applicable percentage ratios (other than the profits ratio) for the inventory adjustment transactions being greater than 2.5%. Hence, these transactions constitute continuing connected transactions under Rule 14A.35 of the Listing Rules and are subject to reporting and announcement requirements and will require independent shareholders' approval and must comply with requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

### **3. Independent shareholders' approval and independent financial advisor**

The Independent Board Committee comprising the independent non-executive Directors, namely, Mr Wang Huaibao, Mr Zhang Julin and Mr Li Jianxin has been established to consider whether the terms of the Agreements, the respective caps in respect of the Continuing Connected Transactions and the restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of this letter are fair and reasonable so far as the independent shareholders are concerned and are in the interests of the Company as a whole. Watterson Asia, the independent financial adviser, has been appointed to advise the

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## LETTER FROM THE BOARD

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Independent Board Committee with respect to the Continuing Connected Transactions, the respective caps related thereto and the restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of this letter.

#### **4. Procedures for demanding a poll**

Pursuant to Article 76 of the Company's articles of association, a resolution put to the vote of a general meeting of the Shareholders shall be decided on a show of hands unless a poll is (before or on the declaration of the result of the show of hands) demanded by:

- (i) the chairman;
- (ii) at least five Shareholders present in person or by proxy and entitled to vote at the meeting;
- (iii) any Shareholder or Shareholders present in person or and in the case of a corporation, by its duly authorised representative or by proxy and representing in aggregate not less than one-tenth of the total voting rights of all the Shareholders having the right to attend and vote at the meeting; or
- (iv) any Shareholder or Shareholders present in person (or in the case of a corporation, by its duly representative) or by proxy and holding shares conferring a right to attend and vote at the meeting on which there have been paid up sums in the aggregate equal to not less than one-tenth of the total sum paid up on all Shares conferring that right.

In accordance with Rule 13.39(4) and Rule 14A.52 of the Listing Rules, the chairman of the Annual General Meeting will demand a poll in relation to the ordinary resolution for approving the Continuing Connected Transactions, the associated caps and the Agreements at the Annual General Meeting.

#### **5. Recommendations**

Your attention is drawn to the letter from the Independent Board Committee set out on pages 19 to 20 of this circular which contains its recommendation to the independent shareholders as to the voting in favour of the resolutions regarding the Agreements, the Continuing Connected Transactions, the associated caps in respect of the Continuing Connected Transactions and the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of this letter at the AGM.

#### **6. Additional information**

The Group is a dairy product manufacturer in China and the principal product categories are liquid milk (such as UHT milk, milk beverages and yogurt), ice cream and other dairy products, such as milk powder and milk tablets, etc.

Your attention is also drawn to the letter from Watterson Asia set out on pages 21 to 36 of this circular, which contains, among others, its advice to the Independent Board Committee in relation to the Agreements, the Continuing Connected Transactions, the associated caps in

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## LETTER FROM THE BOARD

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respect of the Continuing Connected Transactions and the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of this letter and the principal factors and reasons considered by it in concluding its advice.

Your attention is also drawn to the additional information set out in the appendix to this circular.

Yours faithfully,  
On behalf of the Board of  
**China Mengniu Dairy Company Limited**  
**Niu Gensheng**  
*Chief Executive Officer*



## CHINA MENGNIU DAIRY COMPANY LIMITED

*(Incorporated in the Cayman Islands with limited liability)*

(Stock Code: 2319)

27 May 2005

*To the independent shareholders*

Dear Sir/Madam,

### **CONTINUING CONNECTED TRANSACTIONS AND FINANCIAL ASSISTANCE**

We refer to the letter from the Board set out on pages 5 to 18 of the circular which contains details of, amongst other matters, the Agreements, the Continuing Connected Transactions, the associated caps in respect of the Continuing Connected Transactions and the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board and in which this letter is to be included. Terms defined in the circular shall have the same meanings in this letter.

Under the Listing Rules, the the Agreements, the Continuing Connected Transactions, the associated caps in respect of the Continuing Connected Transactions and the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board are required to be approved by the independent shareholders at the AGM. We, as the independent non-executive Directors, have been appointed by the Board to constitute the Independent Board Committee to consider the terms of the Agreements, the Continuing Connected Transactions, the associated caps, the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board in this circular and to advise the independent shareholders in relation to them. The Independent Board Committee has appointed Watterson Asia as independent financial adviser to advise it as to whether the terms of the Agreements, the restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board in this circular are on normal commercial terms and fair and reasonable so far as the independent shareholders are concerned.

We wish to draw your attention to the letter from Watterson Asia containing its advice regarding the Agreement, as set out on pages 21 to 36 of the circular and in which this letter is to be included.

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## LETTER FROM THE INDEPENDENT BOARD COMMITTEE

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### RECOMMENDATION

Having considered the terms of the Agreements and the Continuing Connected Transactions, the proposed restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board in this circular and the advice given by Watterson Asia, the Independent Board Committee recommends the independent shareholders to vote in favour of the ordinary resolution in relation to the approval of the Agreements, the Continuing Connected Transactions, the respective caps and the restated caps in relation to the continuing connected transaction as mentioned in paragraph 2(G) of the letter from the Board in this circular set out in the notice of the Annual General Meeting at the end of the circular.

Yours faithfully,  
For and on behalf of  
*Independent Board Committee*  
**Mr Wang Huaibao,**  
**Mr Zhang Julin and Mr Li Jianxin**  
*Independent non-executive Directors*

## Watterson Asia Limited

5th Floor, 8 Queen's Road Central, Hong Kong  
Tel: (852) 2525 1990  
Fax: (852) 2526 1990

27 May 2005

The Independent Board Committee and  
the Independent Shareholders  
China Mengniu Dairy Co. Ltd.  
1001, 10th Floor  
Julibee Centre  
18 Fenwick Street  
Wanchai  
Hong Kong

Dear Sir/Madam,

### CONTINUING CONNECTED TRANSACTIONS

We refer to our appointment as independent financial adviser to the Independent Board Committee and the Independent Shareholders in relation to certain of the Mengniu Maanshan Intra-Group Transactions, the restating of caps in respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purposes and the provision of guarantees by Mengniu for loans to certain Mengniu Subsidiaries, all of which are regarded as continuing connected transactions and are described in the letter from the Board contained in the circular dated 27 May 2005 to Shareholders (the "Circular"). Our letter is made for incorporation into the Circular. Capitalised terms used in this letter have the same meanings as defined in the Circular unless the context otherwise requires.

Background and details for the above mentioned continuing connected transactions are set out in the letter from the Board in the Circular. Mengniu Maanshan, a newly established non wholly-owned subsidiary, will start production of UHT milk and milk beverages, yogurt products and ice cream products upon its commencement of operation in the second half of 2005. The purpose of the establishment of Mengniu Maanshan is to expand the Group's production base of the above products in the Yangtze River Delta region. Following the commencement of such production, all intra group transactions amongst Mengniu, Mengniu Subsidiaries and Mengniu Maanshan will constitute continuing connected transactions under the Listing Rules.

Our role as independent financial adviser is to give our opinion as to whether the terms of the following categories of continuing connected transactions are fair and reasonable so far as the Independent Shareholders are concerned:

- A. certain Mengniu Maanshan Intra-Group Transactions; namely, transactions contemplated under (1) the UHT Milk and Milk Beverage Products Centralised Sales Agreement, (2) the Yogurt Products Centralised Sales Agreement; (3) the Yogurt Products Inventory Adjustment Agreement; (4) the Ice Cream Products Inventory Adjustment Agreement; and (5) the ongoing inventory adjustment arrangement of raw materials and packaging materials amongst Mengniu, Mengniu Subsidiaries and Mengniu Maanshan;

- B. the increase in cap amounts in respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purpose for 2005 and 2006; and
- C. the provision of guarantees by Mengniu for loans to certain Mengniu Subsidiaries.

In putting forth our recommendations in respect of the above continuing connected transactions, we have relied on the Company to provide us with all relevant information relating to such transactions, production plans for Mengniu Maanshan and the other Mengniu Subsidiaries and their respective projections up to the three years to 31 December 2007. We have reviewed the basis of such projections and are of the view they are fair and reasonable under the circumstances. We consider that we have sufficient information to reach an informed view and to provide a reasonable basis for our recommendation.

The Directors have also confirmed to us that no material facts have been omitted from the information supplied and we have no reason to suspect that any material information has been withheld by the Company or is misleading. We have not, however, for the purpose of this exercise, conducted any form of detailed investigation or audit into the businesses or affairs of the Group.

#### **PRINCIPAL FACTORS AND REASONS CONSIDERED IN RELATION TO THE CONTINUING CONNECTED TRANSACTIONS**

In arriving at our opinion on the terms of the continuing connected transactions as mentioned above, we have taken into consideration the following factors and reasons:

##### **A. Certain Mengniu Maanshan intra-group transactions**

###### **1. UHT Milk and Milk Beverage Products Centralised Sales Agreement**

###### *Background*

The Group has implemented a centralised sales system for UHT milk and milk beverages products whereby all such products are centralised for sale, billing and invoicing to distributors by Mengniu. Pursuant to this system, all Mengniu Subsidiaries that manufacture UHT milk and milk beverage products sell their products to Mengniu and Mengniu then deals with the distributors centrally. These sales do not involve the transfer of physical inventory within the Group as these transactions are only Mengniu's operational mechanism to centralise sales administration. Each of the Mengniu Subsidiaries executes physical delivery on Mengniu's instructions, and Mengniu will pay the Mengniu Subsidiaries on a monthly basis for the intra-Group sales conducted during that month.

Upon its commencement of production in the second half of 2005, Mengniu Maanshan will join Mengniu's centralised sales system.

The purpose of the establishment of a centralised sales system is to facilitate the Group's overall sales, marketing and administration of UHT milk and milk beverages within its Mengniu Subsidiaries. Compared to each of the Mengniu Subsidiaries handling its own sales and marketing individually, the above system is more cost effective and efficient so far as the Group is concerned as each Mengniu's subsidiary does not have to be responsible for sales and marketing activities



individually. Consequently, we are of the view the entering into the UHT Milk and Milk Beverage Products Centralised Sales Agreement by Mengniu Maanshan is beneficial to the Group's operations.

*Pricing formula*

Similar to existing arrangement with other Mengniu Subsidiaries, Mengniu will buy UHT milk and milk beverages products from Mengniu Maanshan at an intra-group price determined by the following formula:

$$\text{Intra-Group Pricing} = \text{Wholesale price of the UHT milk and milk beverage products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to Mengniu Maanshan participating in the centralised sales system and takes into account the amount of sales involved, but subject to a cap of 3%. The above general expenses consist of staff wages as well as sales and marketing and warehousing expenses associated with the sales of UHT milk and milk beverages products. As with other centralised sales transactions of the Group relating to UHT milk and milk beverage products, Y is expected to be capped at 3% going forward.

The UHT Milk and Milk Beverage Products Centralised Sales Agreement with respect to Mengniu Maanshan has the same pricing formula as other Mengniu Subsidiaries with regard to intra-Group sales of UHT milk and milk beverage products.

We noted from the Company's record that sales and marketing expenses as well as warehousing and salary expenses associated with the centralised sales system incurred by Mengniu accounted for approximately 3% of the Group's UHT milk and milk beverage products' wholesale amounts in both 2003 and 2004. As the pricing formula under the UHT Milk and Milk Beverage Products Centralised Sales Agreement with respect to Mengniu Maanshan is the same as those between Mengniu and other Mengniu Subsidiaries, that general expenses charged by Mengniu to Mengniu Maanshan in respect of the above centralized sales is on an costs incurred basis and that the above centralized sales arrangement enables the Group to market and sell UHT milk and milk beverage products more cost effectively, we are of the view that the terms of the UHT Milk and Milk Beverage Products Centralised Sales Agreement are fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected the cap amounts for the above annual intra-Group sales with Mengniu Maanshan will be approximately RMB70 million, RMB200 million and RMB240 million for the three years to 2007. We understand from the Company that the bases for the above projections are as follows:

2005:

Upon completion of the production facilities of Mengniu Maanshan in the second half of 2005, it will have two production lines for UHT milk and milk beverage products with each having an initial daily production capacity between 70 and 80 tonnes (depending on the type of UHT milk and milk beverage products). Presently, sales of UHT milk and milk beverage are expected to commence in September 2005. Based on an initial daily production capacity of 70 tonnes per production line, average sales price of UHT milk and milk beverage of around RMB4,200 per tonne for the first quarter of 2005 and on four 30-day months' production from September to December 2005, total intra-Group sales for 2005 is expected to be around RMB68 million. The above projected sales amount approximates the cap amount of RMB70 million for 2005. As such, we are of the view that the above cap amount is fair and reasonable.

2006:

Projection for 2006 is based on the same calculating factors in 2005, except that sales will be on a 12 months' basis (instead of on four months in 2005). Based on the above projection, intra-Group sales for 2006 will amount to approximately RMB205 million, which approximates the cap amount of RMB200 million for 2006.

2007:

The cap amount of RMB240 million for 2007 is calculated based on the 2006 cap amount of RMB200 million and assuming a growth rate of 20% per annum in 2007. We understand the above projected growth rate is catered for circumstances arising from the following:

- (1) increase in Mengniu Maanshan's UHT milk and milk beverage products production capacity; and
- (2) price differentials arising from the change in the types of UHT milk and milk beverage products sold.

As Mengniu Maanshan is a new company, it does not have a track record. Consequently, we have to make reference to the cap amount growth rate of centralized UHT milk and milk beverage products for the Mengniu Subsidiaries. As set out in the Prospectus, the above cap amount growth rate for Mengniu Subsidiaries amounted to an average of approximately 72% per year for the three

years to 2006. Given that the expected growth rate for 2007 in respect of Mengniu Maanshan is 20% only, we are of the view that the cap amount so determined is fair and reasonable so far as the Independent Shareholders are concerned.

Given the above intra-Group sales with Mengniu Maanshan are beneficial to the Group as it facilitates centralised sales, marketing and administration of UHT milk and milk beverage products within the Group, that the price formula for such sales is fair and reasonable and that the above cap amounts are determined based on Mengniu Maanshan's planned production capacity of UHT milk and milk beverage products, we are of the opinion that the above cap amounts so derived are fair and reasonable so far as the Independent Shareholders are concerned.

## 2. *Yogurt Products Centralised Sales Agreement*

### *Background*

Presently, all yogurt products manufactured by Mengniu and the Mengniu Subsidiaries are centralised for sale and distribution to distributors by Mengniu Beijing. Under this system, all yogurt products are sold to Mengniu Beijing at a pricing formula (see below) for further sale and invoicing to distributors. These sales, which are intra-Group operational transactions only, do not involve physical delivery of yogurt products to Mengniu Beijing. Mengniu Beijing will pay Mengniu and the Mengniu Subsidiaries on a monthly basis for the intra-Group sales conducted during that month.

Upon its commencement of production in the second half of 2005, Mengniu Maanshan will join Mengniu Beijing's centralised yogurt sales system.

Similar to the UHT milk and milk beverage products centralised sales system, this centralised sales system of yogurt products facilitates the Group's control of sales, marketing and administration of yogurt products within Mengniu and the Mengniu Subsidiaries (including Mengniu Maanshan), and is thus more cost effective and efficient so far as the Group is concerned given that each Mengniu's subsidiary does not have to be responsible for sales and marketing activities individually. Consequently, we are of the view that the entering by Mengniu Maanshan of the Yogurt Products Centralised Sales Arrangement with Mengniu Beijing is beneficial to the Group.

### *Pricing formula*

Similar to existing arrangement with Mengniu and other Mengniu Subsidiaries, Mengniu Beijing will buy yogurt products from Mengniu Maanshan at an intra-group price determined by the following formula:

$$\text{Intra-Group Pricing} = \text{Wholesale price of yogurt products} \times (1 - Y\%*)$$

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to Mengniu Maanshan participating in the centralised sales system and takes into account the amount of sales involved, but subject to a cap of 3%. The above general expenses consist of staff wages as well as sales and marketing and warehousing expenses

associated with the sales of yogurt products. As with other centralised sales transactions of the Group relating to yogurt products, Y is expected to be capped at 3% going forward.

The Yogurt Products Centralised Sales Agreement with respect to Mengniu Maanshan has the same pricing formula as Mengniu and other Mengniu Subsidiaries so far as intra-Group yogurt products sales are concerned. As the pricing formula under this agreement with respect to Mengniu Maanshan is the same as those applicable to other Mengniu Subsidiaries, that general expenses charged by Mengniu Beijing to Mengniu Maanshan in respect of the above centralized sales is on an costs incurred basis and that the above centralized sales arrangement enables the Group to market and sell yogurt products more cost effectively, we are of the view that the terms of the Yogurt Products Centralised Sales Agreement is fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected that the annual cap amounts for this category of intra-Group transactions with Mengniu Maanshan for the three years to 2007 will be approximately RMB300 million, RMB720 million and RMB1,068 million respectively. We understand from the Company that the bases for the above projections are as follows:

2005:

Upon completion of the production facility, Mengniu Maanshan will have eight yogurt products production lines with each having an initial daily production capacity of approximately 35 tonnes. Presently, yogurt products sales are expected to commence in July 2005. Based on an average sales price of yogurt products of around RMB5,600 per tonne for the first quarter of 2005 and on a six months' production period from July to December 2005, total intra-Group sales for 2005 is expected to be around RMB274 million. We note that the 2005 cap amount has incorporated an approximately 10% buffer to the projected sales amount. The above buffer was incorporated due to the fact that Mengniu Maanshan is a new factory and, as such, unforeseen circumstances such as increased production capacity and sales price may change. On that basis, we are of the view that the cap amount so determined is fair and reasonable.

2006:

The eight yogurt production lines at Mengniu Maanshan are expected to be fully utilized in 2006. As such, assuming the wholesale price of yogurt products remains unchanged, intra-Group sales for these eight production lines in 2006 will amount to approximately RMB548 million.

The Company is currently planning to install another five new yogurt production lines with the same daily production capacity as existing production lines in phases during the course of 2006. Assuming all five new production lines will become operational in the second half of 2006, total intra-Group sales of the above five new lines for 2006 will amount to approximately

RMB171 million. The above sales, together with intra-Group sales of the original eight production lines, will total approximately RMB719 million, which approximates the cap amount of RMB720 million for 2006.

2007:

It is currently expected that the 13 yogurt products production lines are fully operational in 2007. As such, total sales amount for 2007 is expected to be around RMB890 million. We note that the cap amount of RMB1,068 million for 2007 is calculated based on the above projected sales amount and assuming a growth rate of 20% per annum in 2007. We understand the above growth is expected to derive from an expected increase in Mengniu Maanshan's production capacity as well as price differentials arising from the change in the types of yogurt products sold.

As Mengniu Maanshan is a new company, we have to make reference to the cap amount growth rate of centralized yogurt products sales for the Mengniu Subsidiaries. As set out in the Prospectus, the above cap amount growth rate for Mengniu Subsidiaries amounted to an average of approximately 201% per year for the three years to 2006. Given that the expected growth rate for 2007 in respect of Mengniu Maanshan is 20% only, we are of the view that the cap amount so determined is fair and reasonable so far as the Independent Shareholders are concerned.

As the above intra-Group sales with Mengniu Maanshan facilitates centralised sales, marketing and administration yogurt products within the Group, the price formula for such sales is fair and reasonable and the above cap amounts are determined based on Mengniu Maanshan's planned production capacity of yogurt products, we are of the opinion that the above cap amounts so derived are fair and reasonable so far as the Independent Shareholders are concerned.

### **3. *Yogurt Products Inventory Adjustment Agreement***

#### *Background*

As part of the Group's centralised sales system, delivery of yogurt products to the distributors is made by those companies within the Group that manufactures the yogurt products. In meeting delivery orders, it is anticipated that there will be occasional shortfalls in the inventories of either Mengniu or the relevant Mengniu Subsidiaries. Where this occurs, the respective Mengniu Subsidiary purchases stock from Mengniu or other Mengniu Subsidiaries to make up for such shortfall. Upon the commencement of production in the second half of 2005, Mengniu Maanshan will join the Group's existing yogurt products inventory adjustment system.

These transactions occur as a result of the overall logistics management under the centralised sales arrangement and are conducted in the ordinary course of business on normal commercial terms. The above inventory adjustment arrangement benefits the Group as a whole as it allows an efficient use of inventory amongst companies within the Group.

*Pricing formula*

Under the Yogurt Products Inventory Adjustment Agreement, yogurt products will be transferred among Mengniu, Mengniu Maanshan and other Mengniu Subsidiaries for inventory adjustment purposes based on the same pricing formula as in the Yogurt Products Centralised Sales Agreement. As the pricing formula under this agreement with respect to Mengniu Maanshan is the same as those applicable to Mengniu Beijing, Mengniu and other Mengniu Subsidiaries, that such expenses are charged on an costs incurred basis and that the above inventory adjustment arrangement enables the Group to allocate its yogurt products more efficiently, we are of the view that the terms of the Yogurt Products Inventory Adjustment Agreement is fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected that the annual cap amounts for this category of intra-Group transactions with Mengniu Maanshan for the three years to 2007 will be approximately RMB12.0 million, RMB43.2 million and RMB77.76 million respectively. We understand from the Company that the above cap amounts are calculated based on the cap amounts as set out under the Yogurt Products Centralised Sales Agreement for the three years to 2007:

2005:

It is currently expected the cap amount in respect of centralised yogurt products sales for Mengniu Maanshan is RMB300 million. The Directors estimated that the cap amount in respect of yogurt products inventory adjustment for 2005 will be RMB12.0 million, which is calculated based on 4% of the 2005 cap amount of RMB300 million for centralised yogurt products sales of Mengniu Maanshan. We understand from the Company that the above percentage has made reference to the percentage of inventory adjustment ratio for ice cream products within the Group. This is because the Group's yogurt products production capacity will only be increased significantly following the establishment of Mengniu Maanshan. As such, references to historical yogurt products inventory adjustment percentage may not be appropriate. Since yogurt products are similar to ice cream products as both have significant amount of varieties and flavours, the Company uses the percentage of inventory adjustment ratio for ice cream products with the Group as guidance. At present, the percentage inventory adjustment ratio for ice cream products is approximately 10% of the Group's sales. And given the number of variety of the Group's yogurt products is presently about 40% of that for ice cream products, it is currently estimated that the inventory adjustment percentage in respect of yogurt products should be 4%. Based on the above, we are of the view that the cap amount for 2005 so determined is fair and reasonable.

2006:

The cap amount for 2006 will be RMB43.2 million, which is calculated based on 6% of the 2006 cap amount of RMB720 million for centralised yogurt sales. The increase from 4% in 2005 to 6% in 2006 is due to the planned 50%

increase in yogurt products sales derived from an increase in the number of variety of yogurt products available as well as the planned increase in production capacity during the year following full production of Mengniu Maanshan's 13 yogurt products production lines.

2007:

The cap amount for 2007 will be RMB77.76 million, which is calculated based on approximately 7.3% of the 2007 cap amount of RMB1,068 million for centralised yogurt products sales. The increase from 6% to 7.3% in 2007 is due to the expected further increase in the number of variety of yogurt products available as well as increase in production capacity during the year. On that basis, we are of the view that the cap amount for 2007 is fair and reasonable so far as the Independent Shareholders are concerned.

#### **4. *Ice Cream Products Inventory Adjustment Agreement***

##### *Background*

Similar to yogurt products, Mengniu and Mengniu Subsidiaries implement an existing inventory adjustment mechanism whereby finished ice cream products are transferred amongst themselves to meet deliveries. Upon its establishment, Mengniu Maanshan will become a key manufacturer of ice cream products within the Group.

These transactions occur as a result of the overall logistics management under the inventory adjustment arrangement and are conducted in the ordinary course of business on normal commercial terms. The above inventory adjustment arrangement benefits the Group as a whole as it allows an efficient use of inventory amongst companies within the Group.

##### *Pricing formula*

Similar to other intra-Group inventory adjustment arrangement, ice cream products produced by Mengniu Maanshan are transferred within the Group based on the following formula:

Intra-Group Pricing = Wholesale price of the ice cream products x (1 - Y%\*)

\*Y = a variable percentage calculated based on the expected amount of general expenses to be allocated to Mengniu Maanshan participating in the inventory adjustment arrangement and takes into account the amount of sales involved, but subject to a cap of 3%. The above general expenses consist of staff wages as well as sales and marketing, transportation and storage expenses associated with the sales of ice cream products. As with other centralised sales transactions of the Group in relation to ice cream products, Y is expected to be capped at 3% going forward.

The Ice Cream Products Inventory Adjustment Agreement with regard to Mengniu Maanshan has the same pricing formula as Mengniu and other Mengniu Subsidiaries with respect to ice cream products. As the pricing formula for Mengniu Maanshan under this agreement is the same as that applicable to Mengniu and other

Mengniu Subsidiaries, that general expenses charged by Mengniu to Mengniu Maanshan in respect of the above inventory adjustment arrangement is on an costs incurred basis and that such inventory adjustment allows an efficient use of inventory amongst Mengniu Maanshan, Mengniu and Mengniu Subsidiaries, we are of the view that the terms of the Ice Cream Products Inventory Adjustment Agreement is fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected that the cap amounts for the three years to 2007 will be approximately RMB40 million, RMB80 million and RMB96 million respectively.

2005:

Mengniu Maanshan will have upon its completion 26 ice cream products production lines with each having a daily production capacity of 20 tonnes. Due to seasonality of ice cream products, average production days per year for such products are approximately 280 days. As full production at Mengniu Maanshan is only expected to commence in July 2005, the total estimated number of production days for 2005 will be approximately 140 days. Based on the average wholesale price of approximately RMB5,600 per tonne for ice cream products, total ice cream sales of Mengniu Maanshan is expected to be around RMB400 million. Given the inventory adjustment ratio for ice cream products was approximately 10% of the Group's ice cream products sales in 2004, it is currently projected that the amount of adjustments for Mengniu Maanshan in respect of ice cream products for 2005 will be approximately RMB40 million.

2006:

With full year production in 2006 as compared to half-year's in 2005, it is currently expected that the amount of adjustments in respect of ice cream products for 2006 will be approximately RMB80 million.

2007:

The cap amount of RMB96 million in 2007 is calculated based on the projected 20% growth in ice cream products sales, compared to that in 2006. We understand the above growth is expected to derive from the Group's expected increases in ice cream production capacity, wholesale prices as well as in the number of varieties of ice cream products being offered.

As Mengniu Maanshan is a new company, it does not have a track record. Consequently, we have to make reference to the ice cream inventory adjustment cap amount growth rate in respect of Mengniu and other Mengniu Subsidiaries. As set out in the Prospectus, the above cap amount growth rate for Mengniu Subsidiaries amounted to an average of approximately 57.5% per year for the three years to 2006. Given that the expected growth rate for 2007 in respect of Mengniu Maanshan is 20% only, we are of the view that the cap amount so determined is fair and reasonable so far as the Independent Shareholders are concerned.



As the above intra-Group sales with Mengniu Maanshan is beneficial to the Group since it minimizes wastage and allows an efficient use of inventory amongst companies within the Group, and that the price formula of such sales is fair and reasonable, we are of the opinion that the above cap amounts are fair and reasonable so far as the Independent Shareholders are concerned.

**5. *Ongoing inventory adjustment of raw materials and packaging materials amongst Mengniu, Mengniu Maanshan and other Mengniu Subsidiaries***

*Background*

As an inventory adjustment mechanism, members of the Group presently transfer any excess raw materials, such as milk powder and sugar as well as packaging materials to other members whenever shortages arise. The above inventory adjustment mechanism is beneficial for all parties involved as it minimizes wastage and allows the Group to put its raw materials to more effective use within the Group. More importantly, this mechanism facilitates centralised bulk purchases of certain raw materials such as milk powder and packaging materials by Mengniu for the production use of the Mengniu Subsidiaries. It is currently planned that Mengniu Maanshan will join this programme upon its commencement of production. We agree with the Directors that the participation of this programme by Mengniu Maanshan is beneficial to the Group as it reduces purchasing costs through centralised purchases of raw materials and increases the efficient use of resources within the Group.

*Pricing standard*

Inventory adjustment of raw materials and packaging materials between the companies is at cost. As such, we are of the view that the consideration for such ongoing inventory adjustment is fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected that the annual cap amounts for the three years to 2007 are RMB65 million, RMB195 million and RMB254 million respectively. We understand from the Company that the bases for the above projections are as follows:

2005:

We understand 2005 projections are calculated primarily based on the expected centralised purchases of milk powder by Mengniu for the production of yogurt products in Mengniu Maanshan. Based on existing yogurt products production needs, each yogurt product production line consumes approximately 70 tonnes of milk powder. Based on the latest price of milk powder of approximately RMB18,000 per tonne, total purchases by Mengniu Maanshan for its eight yogurt products production lines are expected to amount to approximately RMB60 million from July (the month that production of yogurt

products starts) to December 2005. The remaining RMB5 million are expected purchases of sugar and other packaging materials by Mengniu Maanshan during the above period.

Based on the above projections, we are of the view that the 2005 cap amount of RMB65 million so determined is fair and reasonable.

2006:

Mengniu Maanshan is currently planning to install another five yogurt production lines in phases during the course of 2006. Assuming all five new production lines will become operational in the second half of 2006, total intra-Group purchases of milk powder for the five additional lines for 2006 will amount to approximately RMB38 million. The above purchases, together with expected purchases from the original eight production lines, will amount to approximately RMB158 million. Apart from the above, purchases of other raw materials such as sugar and packaging material in 2006 is expected to amount to approximately RMB13 million. Consequently, total purchases are expected to amount to approximately RMB171 million. We note the 2006 cap amount of RMB195 million carries a buffer of approximately RMB24 million. As both prices for milk powder and other raw materials may increase and the fact that the above centralised purchasing and inventory adjustment of raw materials are carried out at cost which is to the benefit of the Group, we are of the view that the cap amount so determined is fair and reasonable.

2007:

Assuming full production of the 13 yogurt production lines in 2007, total intra-Group purchases of milk powder, sugar and packaging materials by Mengniu Maanshan is expected to amount to approximately RMB212 million. We note the cap amount of RMB254 million for 2007 carries a buffer of approximately 20% from the expected amount calculated above to cater for unforeseen circumstances such as possible increases in prices of milk powder and other raw material as well as further increase in production capacity in 2007. On that basis and the fact that the above centralised purchasing and inventory adjustment of raw materials is to the benefit of the Group, we are of the opinion that the above cap amount is fair and reasonable.

**B. Relating to the increase in 2005 and 2006 cap amounts in respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu subsidiaries for inventory adjustment purpose**

***Background***

At the time of the Company's listing on the Stock Exchange in June 2004, the Company had estimated the cap amounts in respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purpose for 2005 and 2006 was to be RMB6 million and RMB8 million respectively. Based on latest estimates by the Company, it is projected that the above cap amounts for 2005 and 2006 will be increased to RMB20 million and RMB48 million respectively.

*2005:*

Prior to 2004, the amount of yogurt products transferred between Mengniu Subsidiaries for inventory adjustment purpose was insignificant. This was mainly due to the limited varieties of yogurt products manufactured by Mengniu and Mengniu Subsidiaries, which did not require significant inventory adjustments. In 2005, the Group strategically expanded its product portfolio, focusing on the high value-added yogurt products and will continue to develop new products. We understand Mengniu Beijing introduced 23 new yogurt products from January to March 2005 while the other Mengniu Subsidiaries focused on the production of existing yogurt products. As a result of increased yogurt products production at Mengniu Beijing, the amount of transactions under this category reached RMB3 million in the first quarter of 2005. The Directors currently expect the intra-Group transfer amount for the second and third quarters of 2005 will double when compared with that of the first quarter, as these periods are peak seasons for yogurt sales. On that basis, it is currently expected that the total amount in respect of this category for 2005 will be around RMB20 million, being the aggregate of RMB3 million, RMB6 million, RMB6 million and RMB5 million for the four quarters of 2005 respectively. Consequently, the above amount will be the new cap for 2005.

*2006:*

It is currently expected that cap amount for 2006 will be RMB48 million. The cap amount is calculated based on a planned 100% increase in yogurt sales by Mengniu Beijing in 2006, compared to 2005, based on Mengniu Beijing's planned increase in yogurt production capacity in 2006 as well as the increase in the number of varieties of yogurt products to be offered. The above cap amount has also incorporated a 20% buffer to cater for unforeseen circumstances such as further increases in production capacity during 2006 to cater for increased market demand for yogurt products as well as price differentials arising from the change in the type of yogurt products transferred within the Group. We note that the Group's yogurt sales registered a growth rate of 109% in 2004. Given such historical growth rate, we are of the view that the above buffer is fair and reasonable so far as the Independent Shareholders are concerned. In addition, as the above intra-Group sales is beneficial to the Group since it facilitates centralised sales, marketing and

administration of yogurt products within the Group, we are of the opinion that the above cap amount so determined are fair and reasonable so far as the Independent Shareholders are concerned.

**C. Relating to the provision of guarantees by Mengniu for loans to certain Mengniu Subsidiaries**

***Background***

For the benefit of the Group as a whole, Mengniu acts a guarantor to banks of in respect of loans and credit facilities drawn by certain Mengniu Subsidiaries in their normal course of business and business expansion needs. These guarantees are provided by Mengniu under request by banks of the Mengniu Subsidiaries for no consideration.

As disclosed in the “Letter from the Board” in the Circular, Mengniu and certain Mengniu Subsidiaries, namely, Mengniu Luannan, Mengniu Tangshan, Mengniu Beijing, Mengniu Jiaozuo, Mengniu Taian, Mengniu Shenyang, Mengniu Shanxi, and Mengniu Maanshan (together the “Participating Mengniu Subsidiaries”), have entered into Guarantee Agreements, pursuant to which to Mengniu agreed to act as guarantor for bank borrowings by each of the Participating Mengniu Subsidiaries.

As disclosed in the Company’s prospectus dated 1 June 2004, from Mengniu Subsidiaries’ perspective, the guarantee is treated as financial assistance provided by Mengniu (a connected person) to Mengniu Subsidiaries (as recipients of the guarantees). Pursuant to Rule 14A.65(4) of the Listing Rules, these transactions are exempt from the requirements of reporting, announcement and Independent Shareholders’ approval. However, we are given the understanding that the same transactions, from Mengniu’s perspective, are regarded as financial assistance provided by Mengniu to the benefit of the Participating Mengniu Subsidiaries, which are also treated as connected persons of the Company. Such financial assistance is subject to the reporting and announcement requirements and Independent Shareholders’ approval requirements under Rule 14A.63 of the Listing Rules.

***Consideration***

Pursuant to the Guarantee Agreements, Mengniu will provide these guarantees to the Participating Mengniu Subsidiaries for no consideration. The above guarantees are provided to the Participating Mengniu Subsidiaries, all of which are essentially wholly-owned by Mengniu with more than 99.0% interest with the exception of Mengniu Shanxi which is 90% owned, for no consideration. We note that the 10% minority shareholder of Mengniu Shanxi is an independent third party other than a substantial shareholder of Mengniu Shanxi who does not have board representation on such company. Given the above and the guarantee amount provided to Mengniu Shanxi for the three years to 2007 represents only approximately 2.6% of the total guarantee amounts provided by Mengniu during the above period, we are of the view that the above guarantees provision arrangement is fair and reasonable so far as the Independent Shareholders are concerned.

*Annual cap amounts*

It is currently expected that the annual cap amounts in respect of bank guarantees to be provided by Mengniu under the Guarantee Agreements for the three years to 2007 will be approximately RMB580 million, RMB696 million and RMB766 million respectively. We understand from the Company that the bases for the above annual caps are as follows:

*2005:*

The annual cap of RMB580 million for 2005 is calculated based on the expected total working capital as well as capital investment needs of all Participating Mengniu Subsidiaries in 2005. Particularly, a number of the Participating Mengniu Subsidiaries, such as Mengniu Luannan, Mengniu Tangshan, Mengniu Jiaozuo, Mengniu Taian, Mengniu Shenyang and Mengniu Maanshan, only commenced production in the second half of 2004 or early 2005. As such, the working capital requirement, and thus the guarantee amount needed, is expected to be higher commencing 2005.

*2006:*

The annual cap of RMB696 million for 2006 is calculated based on the expected working capital needs of the Participating Mengniu Subsidiaries brought on by an expected business expansion growth rate of approximately 20% from 2005. In view of the expansion plans of certain Mengniu Subsidiaries to install additional production lines in 2006 and expected increases in their working capital as turnover increases, we are of the view that the 20% growth rate of the annual caps from 2005 is fair and reasonable.

*2007:*

The annual cap of RMB766 million for 2007 is calculated based on the expected working capital needs of the Participating Mengniu Subsidiaries brought on by their respective business expansion growth rate of approximately 10% from 2006. We understand from the Company that it plans to further increase the Group's production capacity by installing additional production lines in certain Participating Mengniu Subsidiaries in 2007, resulting in increases in working capital as turnover increases. Consequently, we are of the view that the expected 10% growth rate of the annual cap from 2006 is fair and reasonable.

Having considered that the above guarantees are provided by Mengniu to the Participating Mengniu Subsidiaries for no consideration and such guarantee arrangements are necessary for the Participating Mengniu Subsidiaries' business expansion needs, we are of the view that the provision of guarantees by Mengniu for the benefits of the Participating Mengniu Subsidiaries are in the interest of the Group and are fair and reasonable so far as the Independent Shareholders are concerned.

**ADVICE**

Having considered the above principal factors and reasons, we are of the opinion that certain Mengniu Maanshan Intra-Group Transactions (being the transactions contemplated under the UHT Milk and Milk Beverage Products Centralised Sales Agreement, the Yogurt Products Centralised Sales Agreement, the Yogurt Products Inventory Adjustment Agreement, the Ice Cream Products Inventory Adjustment Agreement) and the ongoing inventory adjustment arrangement of raw materials and packaging materials amongst Mengniu, Mengniu Subsidiaries and Mengniu Maanshan are beneficial to the Group and that the terms for these transactions are fair and reasonable so far as the Independent Shareholders are concerned. In addition, we are of the view that the relevant annual cap amounts governing the above continuing connected transactions and the increase in cap amounts in respect of the transfer of yogurt products amongst Mengniu, Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purpose for 2005 and 2006 are fair and reasonable so far as the Independent Shareholders are concerned.

Apart from the above, we are also of the opinion that the provision of additional guarantees by Mengniu for loans to certain Mengniu Subsidiaries are beneficial to the Group and that their terms are fair and reasonable so far as the Independent Shareholders are concerned. Accordingly, we would recommend the Independent Board Committee to advise the Independent Shareholders as well as the Independent Shareholders to vote in favour of the ordinary resolution to approve the above continuing connected transactions at the upcoming AGM.

Yours faithfully,  
For and on behalf of  
**Watterson Asia Limited**  
**David Tsang**  
*Managing Director*

## 1. RESPONSIBILITY STATEMENT

This circular includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Company. The Directors collectively and individually accept full responsibility for the accuracy of the information contained in this circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts the omission of which would make any statement herein misleading.

## 2. DIRECTORS' INTERESTS

As at the Latest Practicable Date, the interests and short positions of the Directors or the chief executives of the Company in the Shares, underlying shares and debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) as recorded in the register kept under section 352 of the SFO were as follows:

| Name of Directors | Company/<br>Name of Associated<br>Corporation | Nature of Interests                  | Total Number<br>of Ordinary<br>Shares | Percentage of<br>the Company's<br>Issued Share<br>Capital |
|-------------------|---|--------------------------------------|---------------------------------------|---|
| Niu Gensheng      | The Company                                   | Personal Interest                    | 45,505,172(L)                         | 4.10%   |
|                   | The Company                                   | Corporate Interest ( <i>Note 1</i> ) | 335,937,391(L)                        | 30.25%  |
|                   | Mengniu                                       | Personal Interest ( <i>Note 2</i> )  | 21,862,810(L)                         | 8.18%   |
|                   | Mengniu                                       | Personal Interest                    | 7,325,670(S)                          | 2.74%   |
| Lu Jun            | Mengniu                                       | Personal Interest                    | 804,646(L)                            | 0.30%   |
| Sun Yubin         | Mengniu                                       | Personal Interest                    | 1,772,646(L)                          | 0.66%   |
| Yang Wenjun       | Mengniu                                       | Personal Interest                    | 1,068,646(L)                          | 0.40%   |

*Notes:*

- (1) These shares are held by Yinniu Milk Industry Limited (“Yinniu”), a substantial shareholder of the Company, and Niu Gensheng by virtue of the Xie Trust has been delegated voting rights to the shares in Yinniu in the Xie Trust. The Xie Trust has been in effect since September 2002 and is a trust declared by Xie Qiuxu in respect of Shares in Yinniu held on trust by him for a selected group of individuals comprising employees and business associates of Mengniu. Xie Qiuxu has similarly delegated the voting rights of his own share in Yinniu to Niu Gensheng. Therefore, Niu Gensheng controls 70.02% of the voting rights of Yinniu.
  - (2) Out of his share interests in Mengniu, Niu Gensheng granted an option of over 7,325,670 shares in total representing approximately 2.7% of the issued capital of Mengniu to CDH China Fund, L.P., Actis China Investment Company Limited and MS Dairy Holdings (“Financial Investors”) on 23 March 2004. Such options can be exercised in one or more tranches by each Financial Investor and are exercisable within 10 years. None of the options have been exercised.
- (L) Indicates a long position.
- (S) Indicates a short position.

Save as disclosed herein, as at the Latest Practicable Date, none of the Directors had or was deemed to have any interests or short positions in the Shares, underlying shares and debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) which would be required to be notified to the Company and the Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short position which they are deemed or taken to have under such provisions of the SFO); or which would be required, pursuant to section 352 of the SFO, to be entered in the register referred to therein; or which would be required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies.

## 3. SUBSTANTIAL SHAREHOLDERS

As at the Latest Practicable Date, so far as is known to, or can be ascertained after reasonable enquiry by, the Directors, the following persons (other than a Director or chief executive of the Company) had, or were deemed or taken to have interests or short positions in the shares or underlying shares of the Company which would fall to be disclosed to the Company and the Stock Exchange under the provisions of Divisions 2 and 3 of Part XV of the SFO or, who were directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any other member of the Group were as follows:

| Name   | Number of<br>Shares<br>Interests | Percentage of<br>Existing<br>Shareholding | Percentage of<br>Shareholding if<br>the Repurchase<br>Mandate is<br>exercised in full |
|--|----------------------------------|---|---|
| Morgan Stanley Global Emerging Markets Inc                           | 371,664,288(L)<br>87,295,726(S)  | 33.47(L)<br>7.86(S)                       | 35.23<br>8.27   |
| Niu Gensheng   | 381,442,563(L)                   | 34.35(L)                                  | 36.16   |
| Xie Qiuxu  | 335,937,391(L)                   | 30.25(L)                                  | 31.84   |
| Yinniu Milk Industry Limited (“Yinniu”)<br>(Note)                    | 335,937,391(L)                   | 30.25(L)                                  | 31.84   |
| Jinniu Milk Industry Limited (“Jinniu”)<br>(Note)                    | 220,952,775(L)                   | 19.90(L)                                  | 20.94   |
| Morgan Stanley   | 133,658,361(L)<br>4,696,000(S)   | 12.04(L)<br>0.42(S)                       | 12.67<br>0.45   |
| Morgan Stanley Global Emerging Markets Private Investment Fund, L.P. | 130,321,990(L)                   | 11.74(L)                                  | 12.35   |
| MS Dairy Holdings  | 130,321,990(L)                   | 11.74(L)                                  | 12.35   |
| MSGEM, LLC   | 130,321,990(L)                   | 11.74(L)                                  | 12.35   |
| CDH China Fund, L.P.   | 106,813,544(L)<br>16,581,508(S)  | 9.62(L)<br>1.49(S)                        | 10.12<br>1.57   |
| CDH China Holdings Company Limited                                   | 106,813,544(L)<br>16,581,508(S)  | 9.62(L)<br>1.49(S)                        | 10.12<br>1.57   |
| Morgan Stanley Capital Management, LLC                               | 54,847,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley International Incorporated                            | 54,847,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley Domestic Capital Inc.                                 | 54,847,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley & Co International Limited                            | 52,865,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley Group (Europe)  | 52,865,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley International Limited                                 | 52,865,000(L)<br>52,500,000(S)   | 4.94(L)<br>4.73(S)                        | 5.20<br>4.98  |
| Morgan Stanley UK Group  | 52,865,000(L)                    | 4.94(L)                                   | 5.20  |



*Note:*

- (1) 10 founding individuals, namely Niu Gensheng, Deng Jiuqiang, Hou Jiangbin, Sun Yunbin, Qiu Lianjun, Yang Wenjun, Pang Kaitai, Lu Jun, Sun Xianhong and Xie Qiuxu, have been acting as a controlling group over the business since its inception in 1999. Therefore, they as a group are controlling shareholders of the Company. As at 31 December 2004, Niu Gensheng, Deng Jiuqiang, Lu Jun, Sun Yubin, Yang Wenjun, Sun Xianhong and Qiu Lianjun who are shareholders of Jinniu together control approximately 87.4% of Jinniu. Xie Qiuxu, Pang Kaitai, Hou Jiangbin and Deng Jiuqiang who are shareholders of Yinniu together control approximately 70.8% of Yinniu. Jinniu and Yinniu in aggregate control approximately 50.15% and 52.78% of the voting power at the general meeting of the Company before and after the exercise of the repurchase mandate (if exercised in full) respectively.
- (L) Indicates a long position.
- (S) Indicates a short position.

Save as disclosed above, so far as is known to the Directors or chief executives of the Company, no other person (not being a Director or chief executive of the Company) who had any interests or short positions in shares or underlying shares of the Company which would fall to be disclosed to the Company and the Stock Exchange, under the provisions of Divisions 2 and 3 of Part XV of the SFO, or who was, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any other member of the Group.

#### **4. DIRECTORS' INTERESTS IN CONTRACTS**

Save as disclosed in the Letter from the Board in this circular, no contracts of significance in relation to the Group's business to which the Company or any of its subsidiaries was a party and in which a Director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

#### **5. OTHER INTERESTS OF THE DIRECTORS**

As at the Latest Practicable Date:

- (i) none of the Directors had any interest or indirect interest in any assets which have been, since the date to which the latest published audited accounts of the Group were made up, acquired or disposed of by, or leased to any member of the Group, or are proposed to be acquired or disposed of by, or leased to, any member of the Group;
- (ii) save as disclosed in this circular, none of the Directors was materially interested in any contract or arrangement entered into by any member of the Group which contract or arrangement is subsisting as at the date of this circular and which is significant in relation to the business of the Group; and
- (iii) save as disclosed in this circular, none of the Directors had any competing interests that would be required to be disclosed under Rule 8.10 of the Listing Rules if he was a controlling shareholder.

## 6. CONSENT AND QUALIFICATION OF EXPERT

Watterson Asia is a corporation licensed to carry out type 1 (dealing in securities) and type 6 (advising on corporate finance) regulated activities under the SFO. As at the Latest Practicable Date, Watterson Asia has given and has not withdrawn its written consent to the issue of this circular with the inclusion of its letter and reference to its name in the form and context in which they appear.

As at the Latest Practicable Date, Watterson Asia was not beneficially interested in the share capital of any member of the Group and it did not have any right, whether legally enforceable or not, to subscribe for or to nominate persons to subscribe for securities in any member of the Group.

## 7. MATERIAL ADVERSE CHANGE

The Directors are not aware of any material adverse change in the financial or trading position of the Group since 31 December 2004, the date of the latest published audited financial statements of the Group.

## 8. SERVICE CONTRACTS

As at the Latest Practicable Date, none of the Directors had entered into any service contracts with the Company or any member of the Group (excluding contracts expiring or determinable by the employer within one year without payment of compensation (other than statutory compensation)).

## 9. GENERAL

- (a) The secretary and qualified accountant of the Company is Lo Ka Wai, Claudia, *CPA*.
- (b) As at the Latest Practicable Date, none of the members of the Group was engaged in any litigation or arbitration of material importance and no litigation or claim of material importance was known to the Directors to be pending or threatened against any member of the Group.
- (c) The registered office of the Company is situated at M&C Corporate Services, P.O. Box 309 GT, Uglan House, South Church Street, George Town, Grand Cayman, Cayman Islands. The principal office of the Company in Hong Kong is situated at Unit 1001, 10th Floor, Jubilee Centre, 18 Fenwick Street, Wanchai, Hong Kong.
- (d) The Hong Kong branch share registrar of the Company is Computershare Hong Kong Investor Services Limited at Shops 1712–16, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong.
- (e) The English text of this circular shall prevail over the Chinese text for the purpose of interpretation.

**10. DOCUMENTS AVAILABLE FOR INSPECTION**

Copies of the following documents are available for inspection during normal business hours at Unit 1001, 10th Floor, Jubilee Centre, 18 Fenwick Street, Wanchai, Hong Kong, up to and including 28 June 2005.

- (a) the Agreements;
- (b) the letter of recommendation from the Independent Board Committee, the text of which is set out on pages 19 to 20 of this circular;
- (c) the written consent of Watterson Asia, referred to in paragraph 6 of this appendix; and
- (d) the advice letter from Watterson Asia dated 27 May 2005, the text of which is set out on pages 21 to 36 of this circular.