

## Market Review

The dairy industry is generally enjoying strong growth in China as a result of rising GDP. The increasing awareness of the nutritional value of liquid milk, along with improved transportation and cold chain systems has facilitated the growth of liquid milk consumption. The per capita consumption of liquid milk in China was comparatively lower than that in other Asian countries. Such trends indicate tremendous growth potential for the dairy industry in China.

## Business Review

### Branding & Marketing

According to ACNielsen, Mengniu captured 19.5% share in the liquid milk market by volume in June 2004, as compared with 12.6% share in June 2003. Brand equity and strong consumer loyalty are key success drivers for the Group. Liquid milk market in China remains dominated by key local dairy product players, with top three players capturing 50.8% market share in June 2004, as compared with 40.7% in June 2003.

Mengniu has been actively building a nationwide sales and distribution network predominantly through over 1,000 exclusive third party distributors located across China. The Group deployed sales personnel in key markets to assist distributors in serving retailers and to gain first hand information about the latest developments in the market.

In the first half of 2004, advertising and promotion expenses reached RMB238 million, which accounted for 6.9% of the total turnover against 7.7% of the same period in 2003.

### Products

Mengniu offers a comprehensive choice to consumers and produces over 200 varieties of liquid milk, ice cream and other dairy products.

#### *Liquid Milk*

The liquid milk segment remained as the primary revenue contributor and accounted for 78.9% of the Group's total turnover. Its revenue rose to RMB2,737.8 million, an increase of 96.8% over the same period in 2003. Growth was attributable to the extended exclusive distribution network established to meet increasing market demand.

UHT milk accounted for 78.6% within the segment and its revenue increased by 91.2% during the period as a result of strong brand building efforts. In order to meet different nutritional requirements of different consumer segments, the Group also offered a variety of functional UHT milk products such as milk fortified with vitamins and minerals, and milk with lower fat or lower lactose content.

Milk beverages and yogurt during the period accounted for 21.4% of the liquid milk sales. Within this segment, yogurt revenues grew 178.3% compared to the same period in 2003.

#### *Ice Cream*

Turnover from ice cream rose by 84.2% to reach RMB487.6 million despite the fact that the majority of this period did not coincide with the peak season for sales of ice cream and accounted for 14.0% of the Group's total turnover. The introduction of new products also contributed to the sales growth.

#### *Other Dairy Products*

Turnover from other dairy products accelerated by 565.8% to reach RMB247.3 million in the first half of 2004, with contribution to the total turnover increasing from 2.2% in the first half of 2003 to 7.1% in 2004. The rapid growth was due to successful promotion of the Group's milk tablets in the first half of 2004.

### **Raw Milk Supply**

Established exclusive supply contracts with over 1,000 milk collection centers and individual dairy farmers ensures that Mengniu's growth is supported by a secure supply of quality raw milk.

### **Production**

Equipped with world-class production and packaging technologies, Mengniu operated nine production bases with a combined production capacity of 1.66 million tons in the first half of 2004.

## **Prospects**

The Directors believe that China's growing GDP will increase the purchasing power of individuals and encourage further growth of the dairy industry. To capture greater market share, Mengniu will continue to improve its brand equity, introduce new products, deepen its market penetration, expand its production capacity, forge closer business partnerships, and at the same time manage the risk of over-expansion. The Group is confident of its ability to capitalize on the growth trend of the dairy industry in China.

### **New Products Introduction**

With liquid milk as its key segment, the Group will invest additional resources to strengthen its market position, expand distribution channels and to diverge into different product lines such as flavored and functional milk products, premium yogurt and other dairy products to broaden its product portfolio and to seize additional opportunities.

More medium and high-end ice cream products will be launched to capture broader market segments. The Group will increase its in-house production of ice cream products which to date are partly manufactured through external arrangements.

The Group also intends to develop secondary brand names to better differentiate its dairy products to different segments of consumers.

### **New Markets Penetration**

Mengniu will deepen its market penetration through targeted sales channels to consolidate its leading position in the first-tier markets, while prudently expanding into second and third-tier markets. The Group intends to enhance its brand and product awareness by effective promotions, advertising campaigns on nationwide television channels in prime time slots and by broadening its sales network.

### **Capacity Expansion**

Mengniu ultimately targets to build over 100 new production lines for liquid milk products, over 30 for ice cream products and over 50 for other dairy products, achieving total annual production capacity of 2.75 million tons by the end of 2005. By investing the proceeds raised from the global offering in expanding production capacity, Mengniu is set to fulfill the increasing demands for its products.

### **Partnership Cooperation**

In view of the vast but fragmented raw milk supply base, Mengniu will continue to enhance its cooperation with dairy farmers and milk collection centers to expand its milk sources and to ensure the supply of high quality raw milk. It will continue to encourage its existing and new suppliers to develop mid and larger scale milk collection centers, which will allow Mengniu to meet the growing demands for its products.

### **Management Incentives**

To encourage successful implementation of its growth strategies, Mengniu will continue to build employee excellence by strengthening its management system. The management will encourage employee initiatives and work place excellence through established promotion and compensation systems.