

MANAGEMENT DISCUSSION & ANALYSIS

FINANCIAL REVIEW



The Company was listed on the Main Board of the Hong Kong Stock Exchange on 10 June 2004, representing a significant milestone in the Company's corporate development. The response to its global offering was encouraging. The international offering was significantly over-subscribed whilst the Hong Kong public offering was 205 times over-subscribed.

The Group achieved remarkable growth in 2004. For the year ended 31 December 2004, the Group recorded a revenue of RMB7,213.8 million, representing an increase of 77.2% over that of the previous year. Net profit attributable to shareholders increased by 94.3% to RMB319.4 million. Basic earnings per share were RMB0.357, representing an increase of 85.9% over that of 2003 and the diluted earnings per share were RMB0.285.

Gross Profit

Robust sales growth brought about an increase in gross profit by 57.0% to RMB1,606.5 million. The primary reason for the gross margin decrease was due to the Group's aggressive expansion strategy and intense competition that resulted in lower average selling price for both liquid milk and ice cream products. Overall gross profit margin decreased from 25.1% in 2003 to 22.3% in 2004.

Operating Expenses

In 2004, the Group continued its stringent cost control measures. Although total operating expenses rose by 62.4% in 2004, the growth rate in operating expenses was lower than that of revenue. The Group leveraged greater economies of scale to deliver further operating efficiency. Total operating expenses as a percentage of total revenue in 2004 decreased to 16.4%, against 17.8% in 2003.

Profit from Operating Activities

EBITDA in 2004 amounted to RMB610 million and EBITDA margin slightly decreased to 8.5%. The decrease in EBITDA margin was less than the decrease in gross profit margin, indicating that better cost control was enforced during the year.

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Net Profit

Despite the intensifying market competition, the Group's net profit attributable to shareholders reached RMB319.4 million, a surge of 94.3% from 2003, and exceeded 2004 full year forecast of RMB300 million as disclosed in the prospectus by 6.5%.

Capital Structure, Liquidity and Financial Resources

The Group's cash and cash equivalents amounted to RMB1,018.9 million as at 31 December 2004. Net cash from operating activities amounted to RMB572.3 million, representing an increase of 61.5% over that of 2003.

Non-current assets increased by RMB1,344.2 million to RMB2,693 million in 2004, attributable to the increase in investment in fixed assets and construction in progress and the goodwill arising on the acquisition of additional interest in a subsidiary.

As at 31 December 2004, the Group had outstanding bank loans amounting to RMB710.0 million, representing an increase of RMB322.5 million from RMB387.5 million as at 31 December 2003. Out of the outstanding bank loans, RMB470.5 million was repayable within one year and RMB239.5 million was repayable beyond one year.

The shareholders' fund increased from RMB689.2 million as at 31 December 2003 to RMB1,954.5 million as at 31 December 2004, attributable to the listing proceeds of RMB981.5 million and the profit for the year.

Net finance cost increased from RMB12.9 million in 2003 to RMB29.1 million in 2004 as a result of an increase in interest-bearing loans for supporting the Group's expanded operation scale.

The total debt to capital ratio of the Group was 27.8% as at 31 December 2004, as compared with 38.6% as at 31 December 2003.

MARKET REVIEW



The dairy industry in China experienced strong growth in 2004 as a result of rising GDP and awareness of the nutritional value of liquid milk. The liquid milk industry by volume recorded an average annual increase of 20.0% over that of 2003, according to ACNielsen. However, the per capita consumption of liquid milk in China was still relatively low when compared to other Asian countries, pointing to tremendous growth potential for China's dairy industry.

BUSINESS REVIEW

Branding and Marketing

According to ACNielsen, the Group captured 22.0% share of the liquid milk market by volume in December 2004, as compared with 17.0% in December 2003. Brand equity and strong customer loyalty are key growth drivers for the Group. The competition in the liquid milk market favored key local dairy players, enabling them to expand their market shares, and accelerated industry consolidation. The top three players captured 55.5% market share in December 2004, as compared with 45.9% in December 2003.



The Group has built and maintained a nationwide sales and distribution network predominantly through over 1,000 exclusive third party distributors located across China. To ensure close communication with distributors and gain thorough understanding of market situations, the Group employed sales personnel in key markets to assist distributors in serving retailers and gather first hand market information. Flexible logistics arrangement was in place to meet market demands.

The Group also rolled out effective promotions and advertising campaigns on national television channels in prime time slots to further enhance its brand and product awareness. The advertising and promotion expenses amounted to RMB450.4 million in 2004, which accounted for 6.3% of the total revenue. The Group achieved its spending target disclosed at the time of its Listing, demonstrating the Group's ability in achieving better scale of economy in its branding and marketing efforts.



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Products

The Group offers a comprehensive array of choices to consumers with a product portfolio comprising over 200 varieties of liquid milk, ice cream and other dairy products.

Liquid milk

The liquid milk segment remained the primary revenue contributor and accounted for 84.5% of the Group's revenue. Its revenue rose to RMB6,097.2 million, an increase of 74.2% as compared with 2003. The increase was attributable to the Group's success in tapping the growth of China liquid milk market through its new product offerings, to cater to the preference of different consumers. In order to



attain the goal of delivering healthy, nutritious and high quality products to consumers, UHT milk, the core product of the Group, accounted for 79.2% of the revenue from our liquid milk segment. Apart from its ongoing efforts in consolidating the market share of our traditional UHT milk and sustaining its rapid growth, the Group also offered a variety of functional UHT milk products such as fortified milk with calcium and milk with low fat and low lactose content, in order to meet the nutritional needs of different consumer groups. Our new offering of breakfast milk, which has been well received by the public since its first launch into the market, has ample room for market development.

Milk beverages and yogurt accounted for 20.8% of the segment and delivered solid increase of 118.1% during the year. These products, which serve to keep one's health, state of relaxation and vigour, are particularly sought after by ladies and teenagers. After several years of research and development, the Group has developed its competitive advantage in these products and has forged cooperation with Chr Hansen, the world-renowned probiotics manufacturer, to develop the Group's proprietary probiotics products. This significantly contributes to the control of the high content quality in products and has laid a good foundation for the future expansion of this product.



Ice cream

During the year, the ice cream segment generated revenue of RMB805.2 million, representing an increase of 69.4% from 2003. A traditional forte of the Group, ice cream products feature wide varieties, quick roll out of new products and seasonality in market demand. As such, the Group emphasizes research and development and strives to lead the market trend by introducing ice cream products that are suitable for sale in retail outlets.

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In light of the seasonality of ice cream products, the Group also emphasizes the development of premium products that are consumed during wintertime in north-eastern China, eastern China and southern China regions. These strategies have fuelled the continuous increase in the Group's share in the ice cream market.

Other dairy products

Owing to the launch of new product "milk tablets" and successful promotion campaigns in 2004, revenue from other dairy products soared by 217.6% to RMB311.4 million in 2004. Its contribution to revenue increased from 2.4% in 2003 to 4.3% in 2004.

Raw milk supply

The Group established exclusive supply contracts with over 1,000 milk collection centers and raw milk suppliers to ensure a stable supply of quality raw milk to support the growth of the Group.

To help dairy farmers improve productivity and thus ensure stable and quality supply of raw milk in the long run, the Group's indirectly controlled subsidiary, Inner Mongolia Mengniu Founding Industry Management Co., Ltd., invested jointly with foreign enterprises in the establishment of the single largest dairy farm in China — Mengniu-Australia International Model Ranch — in late 2004. Located near the Group's production base in Helin Geer, the ranch will be constructed in three phases spanning three years. When the ranch is fully completed, it can raise up to 10,000 dairy cows. The ranch adopts a combination of technologies in grass planting, cattle breeding and milking from Australia, Europe, the U.S. and Asia. Advanced milking robot has also been installed on the ranch. The establishment of the ranch will help to promote the application of scientific knowledge and techniques, improvement of quality and quantity of milk supply, the establishment of scalable operations and in turn the modernization of dairy cow breeding in China.



Production

Equipped with world-class production and packaging technologies, the Group operated 11 production bases with a combined production capacity of 2 million tons in 2004.

PROSPECTS

Looking ahead, despite the intensifying market competition, the Group has full confidence in its ability in delivering better financial results and managing the rapid development by launching high quality products and improving the profitability of products.



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In addition to its ongoing efforts in optimizing product mix in light of market demand, the Group will continue to enhance its investment portfolio, financial management processes and operational management structure in order to boost its operational capability and live up to its market strategies.

Product quality

In line with our primary focus of strengthening milk source management, Mengniu-Australia International Model Ranch has been established as a role model for future formation and enhancement of a fine pool of raw milk supply. This would serve not only to enhance the quality of raw milk but also regulate and guide the development of the raw milk market. In respect of the quality control process, the GMP and QACP management systems are put in place, targeting at the establishment of standard operation procedures for every single stage of our production process. In addition, we will further invest in state-of-the-art milk inspection facilities boasting high technology and sophistication in pursuit of stability and further enhancement of our product quality.

New products introduction

With liquid milk remaining as its key revenue contributor, the Group will invest more resources in introducing a more diversified portfolio of products such as flavored and functional milk products, premium yogurt and other dairy beverages to fulfill the sophisticated tastes of consumers, as well as to capture opportunities for further growth.

The Group is dedicated to improve yogurt products to cater to Chinese consumers to meet their increasing demand for yogurt products. At the same time, the Group will increase the proportion of in-house production of ice cream products, which to date are partly manufactured through OEM arrangements.

According to the market demand, the Group plans to expand the production capacity of milk powder and is dedicated to develop premium milk powder products. To ensure sustained consumer loyalty, the Group has been applying secondary brand names on certain products to differentiate its dairy product offerings for different market segments.

New markets penetration

The Group will seek to achieve better economies of scale of its sales and distribution network by consolidating its leading position in the first-tier markets while expanding prudently into the second and third-tier markets. The Group is also set to further lift its brand position through effective budgeting for its nationwide promotion and advertising campaigns.

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Capacity expansion

141 new production lines were added to our factory premises as scheduled during the year. To stay in line with the projected sales growth, the Group will endeavour to expand its capacity so as to achieve an annual aggregate production capacity of approximately 2.75 million tons by the end of 2005.

Partnership cooperation

In view of the vast but relatively fragmented raw milk supply base, the Group will work on enhancing its cooperation with raw milk suppliers and milk collection centers to expand its milk sources and ensure a quality supply of raw milk. The Group will encourage its suppliers to develop mid and larger scale milk collection centers so as to take advantage of economies of scale and meet the needs of the fast growing business.

Management incentives

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

HUMAN RESOURCES AND REMUNERATION OF EMPLOYEES

As at 31 December 2004, the Group employed a total of approximately 21,000 employees (2003: 9,973) in China and Hong Kong. Total staff costs for the year amounted to approximately RMB254 million, including those for the Directors, as compared with approximately RMB117 million in 2003.

The Group invests in continuing education and training programs for its management staff and other employees to constantly improve their skills and knowledge. An internal vocational training center, Mengniu Commercial College, has been set up to develop and implement training programs for the Group's personnel.

Remuneration is maintained at competitive levels with incentive bonuses payable on a merit basis for innovations and improvements which is in line with industry practice. Other staff benefits provided by the Group include a pension contribution plan and insurance schemes.