



REPORT OF THE DIRECTORS

The Board of Directors (the “Directors”) takes pleasure in submitting their first annual report together with the audited financial statements of the Company and the Group for the year ended 31 December 2004.

PRINCIPAL ACTIVITIES AND GEOGRAPHICAL ANALYSIS OF OPERATIONS

The principal activity of the Company is investment holding. The principal activities of the operating subsidiary, Inner Mongolia Mengniu Milk Industry (Group) Co., Ltd. (“Mengniu”), and its subsidiaries are manufacturing and distributing dairy products including liquid milk (comprising ultra-high temperature milk (“UHT milk”), milk beverages and yogurt), ice cream and other dairy products (such as milk powder and milk tablets) in China.

Analyses of the Group’s revenue, net profit attributable to shareholders and segmental information for the year are set out in Notes 4 and 5 to the financial statements.

RESULTS AND APPROPRIATIONS

The results of the Group for the year ended 31 December 2004 are set out in the consolidated income statement on page 33.

The Directors recommend the payment of a final dividend of RMB0.0585 per share to shareholders, amounting to approximately RMB64,966,000. Holders of the Company’s convertible instruments are entitled to interest payment equivalent to the final dividend on an as if converted basis, amounting to approximately RMB15,087,000. The total dividend recorded in the financial statements amounted to RMB80,053,000.

PROPERTY, PLANT AND EQUIPMENT

During the year, the Group continued to expand its production bases and facilities. Details of movements in the property, plant and equipment of the Group and the Company are set out in Note 12 to the financial statements.

RESERVES

Details of the movements in the reserves of the Group and of the Company during the year are set out in the consolidated statement of changes in equity on page 36 and Note 31 to the financial statements.

DISTRIBUTABLE RESERVES

The Company’s reserves available for distribution comprise the share premium, contributed surplus and retained earnings. At 31 December 2004, the reserves of the Company available for distribution to shareholders amounted to approximately RMB1,429,270,000, subject to the restrictions stated in Note 31 to the financial statements.



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DONATIONS

Charitable and other donations made by the Group during the year amounted to approximately RMB1,500,000 (2003: RMB8,100,000).

SHARE CAPITAL

On 14 May and 18 May 2004, the Company issued an aggregate of 750,000,000 shares as part of the group reorganisation and preparation for the listing of shares in The Stock Exchange of Hong Kong Limited ("Stock Exchange"). The Company issued 250,000,000 shares at a total consideration of HK\$981,300,000 (equivalent to approximately RMB1,043,900,000) pursuant to the global offering on 10 June 2004. The Company also issued 110,500,000 shares at a total consideration of approximately HK\$81,800,000 (equivalent to approximately RMB87,000,000) pursuant to the conversion of convertible instrument on 20 December 2004.

Details of the movements in share capital of the Company are set out in Note 30 to the financial statements.

DIRECTORS

The Directors during the year and up to the date of this report were:

Executive Directors

Mr NIU Gensheng
Ms LU Jun
Mr SUN Yubin
Mr YANG Wenjun

Non-Executive Directors

Mr JIAO Shuge (alias JIAO Zhen)
Mr LIU Haifeng, David
Ms JIN Yujuan, Lily

Independent Non-Executive Directors

Mr WANG Huaibao
Mr ZHANG Julin
Mr LI Jianxin

In accordance with Article 112 of the Company's articles of association, Mr Niu Gensheng, Mr Sun Yubin and Mr Li Jianxin retire by rotation and, being eligible, offer themselves for re-election at the forthcoming annual general meeting.

The Company considers that Mr Wang Huaibao, Mr Zhang Julin and Mr Li Jianxin are independent pursuant to the criteria set out in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") and that confirmations of independence have been received from each of them.

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DIRECTORS' SERVICE CONTRACTS

Each of the Directors has entered into a service contract with the Company for an initial term of one year and continuing thereafter for further successive period of one year, for a maximum duration of three years.

BIOGRAPHICAL DETAILS OF DIRECTORS AND SENIOR MANAGEMENT

Brief biographical details of the Directors and senior management are set out on pages 13 to 16.

DIRECTORS' INTERESTS IN CONTRACTS

Save as disclosed in "Connected Transactions" in this report, 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.

DIRECTORS' INTERESTS, LONG AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES

As at 31 December 2004, the interests of the Directors and chief executives of the Company in the shares of the Company and associated corporation as recorded in the register required to be kept under Section 352 of the Securities and Futures Ordinance ("SFO") or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies (the "Model Code") were as follows:

Name of Director	Company/Name of Associated Corporation	Nature of Interest	Total Number of Ordinary Shares	Percentage of the Company's Issued Share Capital
Niu Gensheng	The Company	Personal Interest	45,505,172(L)	4.10%
	The Company	Corporate Interest (Note 1)	335,937,391(L)	30.25%
Mengniu	Mengniu	Personal Interest (Note 2)	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%

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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 shares in Yinniu to Niu Gensheng. Therefore, Niu Gensheng controls 63.5% of the voting rights of Yinniu. Niu Gensheng also has equity rights which would convert to 17.8% of the enlarged issued share capital of Yinniu assuming all equity rights in Yinniu issued have been exercised. None of the equity rights have been exercised.
- (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.

Saved as disclosed above, as at 31 December 2004, none of the Directors or their associates had any interests and 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).

SUBSTANTIAL SHAREHOLDERS' INTERESTS

As at 31 December 2004, the interests or short positions of substantial shareholders, other than the Directors of the Company, in the shares and underlying shares of the Company as recorded in the register maintained under section 336 of the SFO were as follows:

Name	Number of Shares Issued	Percentage of Share Capital
Morgan Stanley Global Emerging Markets Inc	371,664,288(L) 87,295,726(S)	37.17(L) 8.73(S)
Niu Gensheng	381,442,563(L)	34.35(L)
Xie Qiuxu	335,937,391(L)	30.25(L)
Yinniu (<i>Note 1</i>)	335,937,391(L)	30.25(L)
Jinniu Milk Industry Limited ("Jinniu") (<i>Note 1</i>)	236,657,176(L) 78,313,169(S)	21.31(L) 7.05(S)

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Name	Number of Shares Issued	Percentage of Share Capital
Morgan Stanley	231,178,314(L)	20.82(L)
	58,160,988(S)	5.24(S)
Morgan Stanley Global Emerging Markets Private Investment Fund, L.P.	224,360,443(L)	20.20(L)
	52,260,988(S)	4.71(S)
MS Dairy Holdings	224,360,443(L)	20.20(L)
	52,260,988(S)	4.71(S)
MSGEM, LLC	224,360,443(L)	20.20(L)
	52,260,988(S)	4.71(S)
CDH China Fund, L.P.	71,188,759(L)	6.41(L)
	16,581,508(S)	1.49(S)
CDH China Holdings Company Limited	71,188,759(L)	6.41(L)
	16,581,508(S)	1.49(S)
China Diamond Holdings Company Limited	71,188,759(L)	6.41(L)
	16,581,508(S)	1.49(S)
China Diamond Holdings, L.P.	71,188,759(L)	6.41(L)
	16,581,508(S)	1.49(S)
Morgan Stanley Capital Management, LLC	54,847,000(L)	5.48(L)
	52,500,000(S)	5.25(S)
Morgan Stanley International Incorporated	54,847,000(L)	5.48(L)
	52,500,000(S)	5.25(S)
Morgan Stanley Domestic Capital Inc.	54,847,000(L)	5.29(L)
	52,500,000(S)	5.25(S)
Morgan Stanley & Co International Limited	52,865,000(L)	5.29(L)
	52,500,000(S)	5.25(S)
Morgan Stanley Group (Europe)	52,865,000(L)	5.29(L)
	52,500,000(S)	5.25(S)
Morgan Stanley International Limited	52,865,000(L)	5.29(L)
	52,500,000(S)	5.25(S)
Morgan Stanley UK Group	52,865,000(L)	5.29(L)
	52,500,000(S)	5.25(S)



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Notes:

- (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 44.5% of the voting power at the general meeting of the Company.

(L) Indicates a long position.

(S) Indicates a short position.

Saved as disclosed above, as at 31 December 2004, no other interests or short positions in the shares or underlying shares of the Company were recorded in the register maintained under section 336 of the SFO.

CONNECTED TRANSACTIONS

Intra-group connected transactions and/or non-exempt connected transactions

Mengniu is a non wholly-owned subsidiary of the Company. Currently, four executive directors of the Company (who are connected persons as defined under the Listing Rules) and another five Founding Individuals (who are connected persons of the Company as all the Founding Individuals as a group are the controlling shareholders of the Company) together are entitled to exercise more than 10% of the voting power of Mengniu. As a result, Mengniu is a connected person of the Company as defined under Rule 14A.11(5) the Listing Rules. Accordingly, each of Mengniu's subsidiaries ("Mengniu Subsidiaries") is also a connected person of the Company pursuant to Rule 14A.11(6) of the Listing Rules. Therefore, all intra group transactions between Mengniu and Mengniu Subsidiaries which would otherwise be common and in the ordinary course of group operations for any group of companies, constitute continuing connected transactions under the Listing Rules. Owing to the complexities involved in the Group's transaction flow starting from the manufacturing of various products to when they are received by the Group's distributors, the process involves many intra-group transfers (mainly for accounting and administrative purposes) which constitute non-exempt continuing connected transactions ("Non-Exempt Connected Transactions").

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Summary of the Group's Non-Exempt Connected Transactions

During the year, the Group has entered into the following discloseable continuing connected transactions:

Type of transaction	Amount (RMB'000)
1. Centralised UHT milk and milk beverages products sales arrangement by Mengniu for the Group	1,960,660
2. Sales of UHT milk and milk beverages products by Mengniu to the distributors within the Group for distribution	568,103
3. Transfer of UHT milk and milk beverages products between Mengniu and certain Mengniu Subsidiaries for inventory adjustment purposes	4,006
4. Centralised yogurt product sales arrangement by Mengniu Dairy (Beijing) Co., Ltd. ("Mengniu Beijing") for the Group	77,461
5. Sales of yogurt products by Mengniu Beijing to the distributors within the Group for further distribution	18,461
6. Transfer of yogurt products between Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purposes	67
7. Sales of ice cream products between Mengniu and certain Mengniu Subsidiaries for inventory adjustment purposes	74,320
8. Ongoing inventory adjustment of raw materials and production and packaging materials between Mengniu and Mengniu Subsidiaries	303,252
9. Purchase of packaging materials from Chaozhou Yangtian Printing Co., Ltd. ("Chaozhou Yangtian") by Mengniu and certain Mengniu Subsidiaries for their ice cream products (<i>Note</i>)	14,450
10. Provision of guarantees by Mengniu to banking organisations for loans and credit facilities drawn by Mengniu Subsidiaries	390,000
11. Centralised dairy products (except UHT milk, milk beverages, yogurt and ice cream products) sales arrangement by Mengniu for the Group	239
12. Sales of other dairy products by Mengniu to Mengniu Subsidiaries for inventory adjustment purposes	13,123



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Note: Chaozhou Yangtian is owned by Xie Qiuxu, a substantial shareholder of the Company, and his brother. This transaction is also a related party transaction under accounting standard. Except for this transaction, connected transactions disclosed above are not related party transactions. Significant related party transactions entered into by the Group during the year are disclosed in Note 37 to the financial statements.

1. Centralised UHT milk and milk beverages products sales arrangement by Mengniu for the Group

The Group has implemented a centralised sales system for its 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, those Mengniu Subsidiaries that manufacture UHT milk and milk beverages products sell their UHT milk and milk beverages products to Mengniu and Mengniu then deals with the distributors centrally. These sales do not involve physical delivery to Mengniu as these transactions are merely the Group's operational mechanism to centralise administration. Each of the Mengniu Subsidiaries will execute physical delivery on Mengniu's instructions. The companies in the Group which take part (or will take part) in this arrangement include Mengniu and Mengniu Subsidiaries that are currently (or will in the future be) producing UHT milk and milk beverages products, including Mengniu Beijing, Inner Mongolia Mengniu Dairy Baotou Co., Ltd. ("Mengniu Baotou"), Inner Mongolia Mengniu Dairy Keerqin Co., Ltd. ("Mengniu Keerqin"), Mengniu Dairy Wulanhate Co., Ltd. ("Mengniu Wulanhate"), Inner Mongolia Mengniu Dairy (Group) Shanxi Dairy Co., Ltd. ("Mengniu Shanxi"), Mengniu Dairy Taian Co., Ltd. ("Mengniu Taian"), Mengniu Dairy (Jiaozuo) Co., Ltd. ("Mengniu Jiaozuo"), Mengniu Dairy (Shenyang) Co., Ltd. ("Mengniu Shenyang"), Mengniu Dairy (Dengkou Bayan Gaole) Co., Ltd. ("Mengniu Dengkou"), Mengniu Dairy (Tangshan) Co., Ltd. ("Mengniu Tangshan") and Mengniu Dairy (Luannan) Co., Ltd. ("Mengniu Luannan"), each of the above companies is a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company. Mengniu and relevant subsidiaries have entered into a centralised sales agreement dated 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

2. Sales of UHT milk and milk beverages products by Mengniu to the distributor within the Group for distribution

As described above, Mengniu is responsible for dealing and liaising with the distributors of UHT milk and milk beverages products, which include Beijing Mengniu Hongda Dairy Product Co. Ltd. ("Mengniu Hongda") (a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company). Mengniu sells its UHT milk and milk beverages products to the distributor for further distribution. Delivery is usually handled by the relevant Mengniu Subsidiaries which manufacture the UHT milk and milk beverages products. Mengniu and Mengniu Hongda have on 13 May 2004 entered into a distribution agreement for the Beijing area for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

3. Transfer of UHT milk and milk beverages products between Mengniu and certain Mengniu Subsidiaries for inventory adjustment purposes

As part of the centralised sales system described above, delivery of the UHT milk and milk beverages products to the distributors is made by those Mengniu Subsidiaries that manufacture the UHT milk and milk beverages products. In meeting delivery orders there are occasionally shortfalls in the inventories of particular Mengniu Subsidiaries. Where this occurs the respective Mengniu Subsidiary purchases from Mengniu inventory to make up for the shortfalls. The products will be physically delivered to the particular Mengniu Subsidiary. These intra-group sales are part of the overall centralised sales system, and are booked for accounting and administrative purposes at the intra-group rate for UHT milk and milk beverages products.

An inventory adjustment agreement for an initial period of three years commencing 1 January 2004 ending 31 December 2006 has been entered into on 13 May 2004 by Mengniu and the Mengniu Subsidiaries that are or will be UHT milk and milk beverages products manufacturers. Companies in the Group involved are Mengniu, Mengniu Beijing, Mengniu Baotou, Mengniu Keerqin, Mengniu Wulanhaote, Mengniu Shanxi, Mengniu Taian, Mengniu Jiaozuo, Mengniu Shenyang, Mengniu Dengkou, Mengniu Tangshan and Mengniu Luannan.

4. Centralised yogurt product sales arrangement by Mengniu Beijing for the Group

The Group has implemented a centralised sales system for its yogurt products whereby all its yogurt products are centralised for sale and distribution to distributors by Mengniu Beijing. Pursuant to this system Mengniu and those Mengniu Subsidiaries which manufacture yogurt products sell their yogurt products to Mengniu Beijing who will, in turn, sell and invoice to distributors. These sales do not involve delivery to Mengniu Beijing as these transactions are operational transactions for the centralised sales system. The companies in its Group which take part or will take part in this arrangement are Mengniu and the Mengniu Subsidiaries which are currently or will in the future be producing yogurt products including Mengniu, Mengniu Beijing, Mengniu Taian, Mengniu Jiaozuo, Mengniu Shenyang, Mengniu Tangshan and Mengniu Luannan.

Mengniu, Mengniu Beijing, Mengniu Taian, Mengniu Jiaozuo, Mengniu Shenyang, Mengniu Luannan and Mengniu Tangshan have entered into a centralised sales agreement on 13 May 2004 for an initial period for three years commencing 1 January 2004 ending 31 December 2006.

5. Sales of yogurt products by Mengniu Beijing to the distributors within the Group for further distribution

As described above Mengniu Beijing is the company in its Group responsible for dealing and liaising with external sales and distributors of its yogurt products. Yogurt products are sold by Mengniu Beijing to either independent third party distributors or Mengniu Hongda, a distributor within its Group for the Beijing area. Mengniu Hongda predominantly handles sales administration and occasionally actual delivery of the yogurt products. Delivery is predominantly handled by Mengniu or the relevant Mengniu Subsidiaries which manufacture the yogurt products. Mengniu Beijing and Mengniu Hongda have entered into a distribution agreement on 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

6. Transfer of yogurt products between Mengniu Beijing and certain Mengniu Subsidiaries for inventory adjustment purposes

As part of the centralised sales system described above, delivery of the yogurt products to the distributors is made by those companies in its Group which manufacture the yogurt products. In meeting delivery orders it is anticipated there will be occasional shortfalls in the inventories of either Mengniu or the relevant Mengniu Subsidiaries. Where this occurs the respective company will purchase inventory from each other to make up for the shortfalls. These products will be physically delivered to the particular Mengniu Subsidiary. These intra-group sales are part of the overall centralised sales system and are booked for accounting and administrative purposes at an intra-group rate for yogurt products.

An inventory adjustment agreement has been entered into on 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006 by Mengniu, Mengniu Beijing, Mengniu Baotou, Mengniu Keerqin, Mengniu Wulanhaote, Mengniu Shanxi, Mengniu Taian, Mengniu Jiaozuo, Mengniu Shenyang, Mengniu Dengkou, Mengniu Tangshan and Mengniu Luannan.

7. Sales of ice cream products between Mengniu and certain Mengniu Subsidiaries for inventory adjustment purposes

As an inventory adjustment mechanism Mengniu Dairy (Dangyang) Co., Ltd. ("Mengniu Dangyang"), Jinhua Mengniu Dairy Co., Ltd. ("Mengniu Jinhua"), Mengniu Jiaozuo, Mengniu Taian and Mengniu (each of the above companies is a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company) which currently manufacture ice cream products supply each other with finished ice cream products whenever shortages arise in another member. The Group intend for Mengniu Shenyang to participate in this mechanism when it commences the manufacture of ice cream in the near future. This inventory adjustment mechanism is beneficial for all parties involved as it minimises wastage, is an efficient use of its resources whilst permitting such companies to meet their respective market's fluctuating demand for ice cream products.

An inventory adjustment agreement for an initial period ending 31 December 2006 has been entered into on 13 May 2004 by Mengniu Danyang, Mengniu Jinhua, Mengniu, Mengniu Shenyang, Mengniu Jiaozuo and Mengniu Taian which are currently, or will be, ice cream products manufacturers. Under the agreement, payment in full will be made by the transferee on a monthly basis for inventory adjustments that month.

8. Ongoing inventory adjustment of raw materials and production and packaging materials between Mengniu and Mengniu Subsidiaries

As an inventory adjustment mechanism, members of its Group transfer any excess raw materials (including, inter alia, sugar, oil etc.) and packaging materials to other members whenever shortages arise. Mengniu and all Mengniu Subsidiaries take part in this arrangement. This inventory adjustment mechanism is beneficial for all parties involved as it minimises wastage, is an efficient use of its resources permitting companies to meet their respective market's fluctuating demand.

Mengniu and all Mengniu Subsidiaries (except for Inner Mongolia Mengniu Founding Industry Management Co., Ltd. ("Mengniu Founding"), a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company), have entered into an inventory adjustment agreement on 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

9. Purchase of packaging materials from Chaozhou Yangtian by Mengniu and certain Mengniu Subsidiaries for their ice cream products

Chaozhou Yangtian sells packaging materials to Mengniu and certain Mengniu Subsidiaries which currently manufacture ice cream products. A packaging materials supply agreement has been entered into by Chaozhou Yangtian, Mengniu, Mengniu Danyang, Mengniu Jinhua, Mengniu Shenyang, Mengniu Jiaozuo, Mengniu Taian, Mengniu Luannan and Mengniu Tangshan on 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

10. Provision of guarantees by Mengniu to banking organisations for loans and credit facilities drawn by certain Mengniu Subsidiaries (provision of financial assistance to a connected person of the Company)

For the benefit of the Group as a whole, Mengniu, as the main operating subsidiary, provides guarantees to Mengniu Subsidiaries at nil consideration. These loans were required for the expansion of the Group over the past two years, and out of necessity, Mengniu was required by the relevant banks to act as guarantor for its subsidiaries. From Mengniu Subsidiaries' perspective, this continuing connected transaction represents financial assistance provided by Mengniu to the benefit of the Mengniu Subsidiaries, which are connected persons of the Company.

11. Centralised dairy products (except UHT milk, milk beverages, yogurt and ice cream products) sales arrangement by Mengniu for the Group

The Group has implemented a centralised sales system for its dairy products (except UHT milk, milk beverages, yogurt and ice cream products) whereby all such products produced by the Group are centralised for billing and invoicing to distributors by Mengniu. Pursuant to this system, those Mengniu Subsidiaries that manufacture dairy products (except UHT milk, milk beverages, yogurt and ice cream products) sell their dairy products (except UHT milk, milk beverages, yogurt and ice cream products) to Mengniu and Mengniu then deals with the distributors. Delivery is not made as these transactions are the Group's operational mechanism to centralise administration. Instead, each of the Mengniu Subsidiaries will execute delivery on Mengniu's instructions. The companies which take part (or will take part) in this arrangement include Mengniu and Mengniu Subsidiaries that are currently (or will in the future be) producing dairy products (except UHT milk, milk beverages, yogurt and ice cream products) including Mengniu Taian and Mengniu Jiaozuo.

This arrangement is covered by a centralised sales agreement dated 13 May 2004 and is for an initial period of three years commencing 1 January 2004 ending 31 December 2006. Under the agreement, Mengniu will pay the relevant Mengniu Subsidiary on a monthly basis in accordance with centralised sales that month.

12. Sales of other dairy products by Mengniu to Mengniu Subsidiaries for inventory adjustment purposes

As disclosed above as part of the centralised sales system of the Other Dairy Products (including dairy products such as milk powder, milk tea powder and milk tablets), delivery of the Other Dairy Products to the distributors is made by those Mengniu Subsidiaries that manufacture the Other Dairy Products for logistical efficiency. In meeting delivery orders there are occasionally shortfalls in the inventories of particular Mengniu Subsidiaries. Where this occurs the respective Mengniu Subsidiary will purchase inventory from Mengniu to make up for the shortfalls. The products will be physically delivered to the particular Mengniu Subsidiary. These intra-group sales are part of the overall centralised sales system, and are booked for accounting and administrative purposes at an intra-group rate for Other Dairy Products.

This inventory adjustment arrangement is covered by the Inventory Adjustment Agreement entered into by Mengniu and Mengniu Subsidiaries that are manufacturers of Other Dairy Products on 25 November 2004. It is for an initial period commencing on the date of this agreement ending 31 December 2006. The companies in the Group involved are Mengniu, Mengniu Baotou, Mengniu Beijing, Mengniu Danyang, Mengniu Dengkou, Mengniu Jiaozuo, Mengniu Wulanhaote, Mengniu Jinhua, Mengniu Keerqin, Mengniu Luannan, Mengniu Shanxi, Mengniu Taian, Mengniu Shenyang and Mengniu Tangshan.



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In addition to the above Non-Exempt Connected Transactions, certain equipment was transferred between Mengniu and certain Mengniu Subsidiaries at net book value amounting to approximately RMB65,865,000 as at 31 October 2004 pursuant to the Intra-group Equipment Transfer Agreements entered into on 25 November 2004. As these were intra-group transfers of equipment currently owned by Mengniu or the relevant Mengniu Subsidiaries and there was no market for these used office, dairy production and manufacturing equipment, the net book value of the equipment was used as the basis of determining the consideration. This transfer was a one-off connected transaction.

The Directors (including the independent non-executive Directors) are of the opinion that the connected transactions had been entered into and were carried out in the ordinary and usual course of business of the members of the Group and on normal commercial terms which are fair and reasonable so far as the interests of the shareholders of the Company are concerned.

Saved as disclosed above, there were no other transactions which needed to be disclosed as connected transactions in accordance with the requirements of the Listing Rules.

SHARE OPTION SCHEME

As at 31 December 2004, the Company had not adopted a share option scheme and no option had been granted or agreed to be granted. Subsequent to the year ended 31 December 2004, the Directors proposed to adopt a share option scheme to provide incentives to the employees of the Company. Terms of the proposal are set out in the circular to be circulated.

PRE-EMPTIVE RIGHTS

There is no provision for pre-emptive rights under the Company's Articles of Association and there is no restriction against such rights under the laws of the Cayman Islands.

PURCHASE, SALE OR REDEMPTION OF THE COMPANY'S LISTED SHARES

During the year, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.

PUBLIC FLOAT

As at the date of this report, the Company has maintained the prescribed public float under the Listing Rules, based on the information that is publicly available to the Company and to the knowledge of the Directors.

MANAGEMENT CONTRACTS

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.



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MAJOR CUSTOMERS AND SUPPLIERS

During the year, the largest customer accounted for approximately 6% of the Group's revenue, and the five largest customers accounted in aggregate for approximately 18% of the Group's revenue.

The purchases for the year attributable to the Group's largest supplier and five largest suppliers were approximately 9% and 19% of the Group's total purchases respectively.

None of the Directors, their respective associates or the existing shareholders who, to the knowledge of the Directors, own more than 5% of the Company's share capital, has any interest in any of the five largest customers and suppliers.

USE OF PROCEEDS

During 2004, the Group was dedicated to the development and expansion of the production capacity in order to capture the anticipated growth in the consumption of dairy products in China. The Group has injected all of the net proceeds into its operating subsidiary, Mengniu, which then applied the proceeds as follows:

- approximately RMB480,000,000, RMB140,000,000 and RMB80,000,000 were used to expand the production facilities of liquid milk, ice cream and other dairy product respectively, majority of which were spent on the purchase of equipment;
- approximately RMB40,000,000 was spent on the public facilities of new production bases;
- approximately RMB60,000,000 was used for general working capital; and
- the remaining amount of approximately RMB180,000,000 has been deposited into interest bearing accounts and retained for future expansion plans.

CONTINGENT LIABILITIES AND COMMITMENTS

Details of contingent liabilities and commitments are set out in Notes 33 to 35 to the financial statements.

SUBSEQUENT EVENTS

Details of subsequent events are set out in Note 39 to the financial statements.

FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the last three periods is set out on page 87.



REPORT OF THE DIRECTORS

INVESTOR RELATIONS AND COMMUNICATIONS

The Company adopts a proactive policy in promoting investor relations and communications. Regular meetings are held with institutional investors and financial analysts to ensure two-way communications on the Company's performance and development.

COMPLIANCE WITH THE CODE OF BEST PRACTICE

None of the Directors of the Company is aware of any information that would reasonably indicate that the Company was not at any time during the year in compliance with the Code of Best Practice as set out by the Stock Exchange in Appendix 14 to the Listing Rules.

COMPLIANCE WITH MODEL CODE

The Company has adopted the Model Code set out in Appendix 10 of the Listing Rules as the Company's code of conduct and rules governing dealings by all Directors in the securities of the Company. Having made specific enquiry of all Directors of the Company, during the year, the Directors of the Company had strictly complied with the Model Code.

AUDITORS

The financial statements have been audited by Ernst & Young. A resolution for their reappointment as auditors of the Company will be proposed at the forthcoming annual general meeting.

By order of the Board of Directors

NIU Gensheng

Chief Executive Officer

PRC, 6 April 2005