

Management Discussion & Analysis

Financial Review

The Group recorded impressive sustainable growth in the first half of 2005. Revenue for the six months ended 30 June 2005 was RMB4,754.0 million, an increase of 36.9% over that of the same period last year. Net profit attributable to the equity holders of the Company for the period reached RMB246.5 million, up 33.9%. Basic earnings per share were RMB0.22, against RMB0.24 in the first half of 2004; diluted earnings per share were RMB0.18, against RMB0.16 in the first half of 2004.

Gross Profit

Remarkable sales growth pushed gross profit up by 28.9% to RMB1,066.3 million. The introduction of new high value-added products and the gradual rebound of the lower average selling price of UHT milk due to the severe competition last year has resulted in an improved overall gross margin of 22.4% in the first half of 2005 over that of the second half of 2004. The 22.4% gross margin is 1.4 percentage points lower when compared with the first half of 2004.

Operating Expenses

The Group's stringent cost control measures proved to be successful. Attributable to greater economies of scale, total operating expenses as a percentage of revenue during the period decreased to 15.3%, from 16.6% in the same period last year.

Profit from Operating Activities

EBITDA during the period increased by 46.1% to RMB470.2 million and EBITDA margin rose to 9.9% from 9.3% in the corresponding period in 2004. This indicated that the cost control measures enforced during the period had been effective.

Net Profit

Net profit attributable to the equity holders of the Company grew 33.9% to RMB246.5 million in the first half of 2005 from RMB184.1 million in the same period in 2004.

The two-year tax holiday enjoyed by a subsidiary of the Group, which is a sino-foreign joint venture, expired during the period. Nevertheless, the Group still enjoyed a relatively low effective tax rate of 8.1%, only 3.8 percentage points higher than that in the corresponding period last year.

Capital Structure, Liquidity and Financial Resources

The Group's cash and cash equivalents amounted to RMB1,191.2 million as at 30 June 2005. Net cash from operating activities amounted to RMB703.5 million, representing a surge of 309.0% as compared with the same period in 2004.

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As at 30 June 2005, the Group had outstanding bank loans amounting to RMB720.5 million, a slight increase from RMB710.0 million as at 31 December 2004. Of the outstanding bank loans, RMB650.5 million is repayable within one year and RMB70 million is repayable beyond one year. The total debt to equity ratio (total debts divided by total equity) of the Group was reduced to 30.3% as at 30 June 2005 from 32.6% as at 31 December 2004.

Total equity of the Group increased from RMB2,303.1 million as at 31 December 2004 to RMB2,508.0 million as at 30 June 2005.

Net finance cost for the period decreased by 5.4% to RMB12.9 million when compared with the same period in 2004 as the Group effectively consolidated the use of capital and reduced the amount of interest bearing loans.

Market Review

Despite the negative effects caused by the outbreak of contagious disease among milk cows in some localities and media reports of questionable milk quality in parts of the country, benefiting from the improving living standards of the country and the increasing awareness among consumers of the nutritional value of liquid milk, the dairy industry experienced strong growth in the first half of 2005. According to a survey conducted by ACNielsen in June 2005, the annualized growth rate of the liquid milk market in China, excluding milk beverages and yogurt, by volume was approximately 20%. As the per capita consumption of liquid milk in China is still relatively low when compared to other Asian countries, the Chinese dairy industry has room for further sustainable growth.

Business Review

Branding and Marketing

According to ACNielsen, the Group had 25.6% share of the liquid milk market by volume, excluding milk beverages and yogurt, in June 2005, as compared with 22.0% in December 2004. Brand equity and strong consumer loyalty have been the key success drivers for the Group. The liquid milk market in China continued to be dominated by key local dairy players, with the top three accounting for 59.8% market share in June 2005, as compared with 55.5% in December 2004.

The Group has built and maintained a nationwide sales and distribution network comprising predominantly of over 1,000 exclusive distributors across China. It will continue to enhance cooperation and communication with these distributors.

The advertising and promotions budget was expended more effectively during the first half of 2005, mostly on advertising campaigns on national television. Leveraging greater economies of scale, the advertising and promotion expenses during the period amounted to RMB248.7 million, which accounted for 5.2% of the Group's total revenue, against 6.9% in the same period of 2004.

Products

The Group offers a comprehensive array of choices to consumers with a product portfolio comprising over 250 varieties of liquid milk, ice cream and other dairy products.

Liquid milk

The liquid milk segment remained as the Group's primary revenue contributor. Accounting for 83.1% of the Group's revenue, revenue from liquid milk grew to RMB3,951.5 million, up 44.3% from the corresponding period last year. The increase was attributable to the Group's continuous efforts to build its brands and develop new products of higher value to cater to different consumer preferences.

UHT milk, being the core product of the Group, accounted for 73.3% of the revenue from the liquid milk segment. Apart from offering traditional UHT milk, the Group also offered a variety of functional UHT milk products such as fortified milk with calcium and low fat and low lactose milk. The newly launched breakfast milk targeting busy city dwellers contributed to the Group's profit growth during the period.

A variety of milk beverages and yogurt products, targeting consumers who go for healthy and flavoursome products, were launched in the first half of 2005. These products accounted for 19.8% and 6.9% of the segmental revenue respectively, and their revenue grew 88.7% and 58.4% over that of the same period in 2004 respectively, pointing to ample room for market development for milk beverages and yogurt products.

Ice cream

Revenue from the ice cream segment rose by 42.4% to RMB694.1 million, accounting for 14.6% of the Group's total revenue, despite that the peak season for sales of ice cream did not fall fully within the period.

In light of the seasonal characteristics of ice cream products, the Group has striven to set consumption trend by rolling out quickly products of various flavours to capture different seasonal demands across the nation.

Other dairy products

Revenue from other dairy products decreased by 56.1% to RMB108.5 million in the first half of 2005, contributing 2.3% of the Group's total revenue. The decrease in sales revenue was mainly attributable to the fact that milk tablets were exceptionally well-accepted by the market when they were first launched last year, and its sales retreated in the first half of 2005. The continuous efforts invested to develop the baby milk powder market brought encouraging results, indicating promising prospects for the segment.

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Raw Milk Supply

The Group established exclusive supply contracts with over 2,000 milk collection centers and raw milk suppliers. A stable supply of quality and safe raw milk is maintained to support the growth of the Group.

Production

The Group operated 14 production bases with a combined annual production capacity of 2.54 million tons in the first half of 2005.

Prospects

The continuous market competition in the dairy industry and a series of unfavourable reports on milk quality or the industry itself in the first half of 2005 has brought about challenges to industry players. Nevertheless, healthy development of the dairy industry is still expected in the long run. To capture greater market share, the Group will continue to optimize its product mix, as well as enhance its investment portfolio, financial management processes and operational management structure so as to boost its operational capability in accordance with its market strategies.

Product Quality

Applying stringent measures on milk source management to ensure the quality of raw milk supply is a priority to the Group. Mengniu-Australia International Model Ranch was established as a role model to promote the application of scientific technology. Besides, the Group's state-of-the-art milk inspection facilities boasting sophistication also help to deliver a stable supply of raw milk and enhance product quality.

Meanwhile, the Group will further strengthen the management systems in the quality control process to ensure all production procedures meet high standards.

New Product Introduction

The Group will invest more resources to further enhance the product portfolio and provide quality, nutritious and delicious products that meet the sophisticated tastes and needs of consumers, thereby enables the Group to capture opportunities for further growth.

By evaluating market receptiveness of the newly launched products, the Group is able to identify and re-launch some of the popular new products in a larger scale to gain better economies of scale.

In the second half of 2005, the Group will ride on the supply of quality raw milk from the Mengniu-Australia International Model Ranch to introduce a range of premium milk products.

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Penetration of New Markets

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

Capacity Expansion

The Group added 54 new production lines in its factory premises in the first half of 2005. To keep up with projected sales growth, the Group will expand its production capacity to 2.75 million tons by the end of 2005.

Partnership

Aiming at securing stable and safe supply of raw milk to support business growth, the Group is committed to fostering closer relationship with milk collection centers and raw milk suppliers by providing them advice and assistance.

Management Incentives

To encourage successful implementation of its growth strategies, the Group will continue to build employee excellence by strengthening its management system. In addition to offering promotion and compensation systems to boost employee initiatives and work place excellence, the Group adopted a share option scheme in June 2005 to acknowledge and reward employees' loyalty and contributions.