

# MANAGEMENT DISCUSSION AND ANALYSIS

## Financial Review

During the year, the Group achieved significant growth in revenue from RMB7,213.8 million in 2004 to RMB10,825.0 million in 2005, representing an increase of 50.1%. Net profit attributable to equity holders of the Company increased by 43.0% to reach RMB456.8 million. Basic earnings per share were RMB0.365 (2004: RMB0.357), and the diluted earnings per share were RMB0.334 (2004: RMB0.285), representing an increase of 2.2% and 17.2% respectively as compared with 2004.

## Gross Profit

In 2005, the Group's gross profit reached RMB2,413.2 million, representing a surge of 50.2% over that of 2004. Gross profit margin was sustained at 22.3%. The introduction of new high value-added products and the change in product mix offset the effect of keen competition in the market and increase in production costs during the year.

## Operating Expenses

The Group's operating expenses mainly consisted of selling and distribution costs, administrative expenses and other operating expenses. Its total operating expenses for the year was RMB1,786.7 million (2004: RMB1,180.0 million).

Benefiting from greater economies of scale and stringent cost control, the Group's total operating expenses as a percentage of revenue in 2005 was 16.5%, similar to that of 2004.

## Profit from Operating Activities

In 2005, at its effective cost control measures including streamlining and automating operating procedures and centralizing procurement control, the Group's EBITDA improved by 51.9% to RMB926.5 million (2004: RMB610.0 million) and EBITDA margin was 8.6%.

## Net Profit

The Group's net profit attributable to equity holders of the Company reached RMB456.8 million for the year ended 31 December 2005, representing a surge of 43.0% from RMB319.4 million in the previous year.

During the year, one of the Group's subsidiaries, a sino-foreign joint venture, ceased to be eligible for the two-year tax holiday granted by the PRC government and was taxed at preferential rate. Nevertheless, the Group still enjoyed a relatively low effective tax rate of 10.0%, 5.5 percentage points higher than last year's.

## Capital Structure, Liquidity and Financial Resources

The Group's cash and cash equivalents amounted to RMB1,247.8 million as at 31 December 2005 (2004: RMB1,018.9 million). During the reviewing period, the Group effectively centralized cash flow which contributed to a surge of 132.1% in net cash from operating activities to RMB1,328.3 million.

As at 31 December 2005, the Group had outstanding bank loans amounted to RMB811.3 million, representing a slight increase of RMB26.98 million from RMB784.3 million as at 31 December 2004. Of the outstanding bank loans, RMB365.6 million was repayable within one year and RMB445.7 million was repayable beyond one year. The total debt to equity ratio (total bank loans divided by total equity) of the Group was 29.3% as at 31 December 2005, representing a drop of 4.8 percentage points over the same period in 2004.

Total equity of the Group increased from RMB2,303.1 million as at 31 December 2004 to RMB2,767.1 million in 2005.

Net finance cost slightly increased by 6.7% to RMB31.06 million in 2005 (2004: RMB29.10 million).



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## Market Review

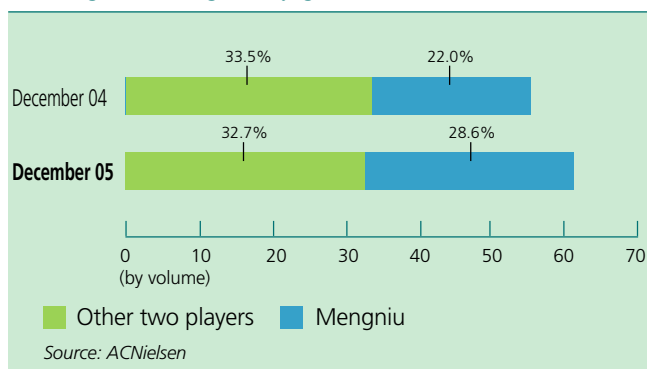
Riding on the economic prosperity of the country, the dairy industry in China sustained strong growth in 2005. According to a survey conducted by ACNielsen in 2005, by sales volume, the liquid milk market in China, excluding milk beverages and yogurt, grew an average 29% in 2005.

Competition for traditional products continued to be keen in the review period, leading inevitably to market consolidation. In the highly consolidated industry, it is the major dairy players of massive operating scale, who enjoy strong brand recognition supported by well-developed distribution networks who stand favorable, while small players with only weak brand and distribution back up are likely to be gradually ousted.

The average consumption of liquid milk in China is 18kg per capita per annum for the year, which is relatively low when compared with other Asian countries and developed areas. This points to promising business opportunities for the Chinese dairy industry and Mengniu as a major player in the industry.

## Top Leader in Liquid Milk Market in China

(Excluding milk beverages and yogurt)



## Business Review

### Branding and Marketing

According to a ACNielsen survey, the Group had 28.6% share of the liquid milk market by volume in December 2005, and 22.0% in the previous year. The increase was the result of strong brand equity, growing customer loyalty, aggressive marketing campaign and effective product differentiation strategy, all of which are our advantages as a key incumbent player in the industry. The top three players in China together had 61.3% share of the market in December 2005, as compared with 55.5% in December 2004. It showed that the China dairy industry had continued to consolidate.

The Group's effective nationwide sales and distribution network is made up of over 2,500 predominantly exclusive third party distributors located across the country. The Group employs sales personnel in key markets to ensure close communication with distributors and gain fine understanding of market situations and dynamics to help it map out effective operational plans for the different markets. Flexible logistics arrangement and using the latest enterprise resources planning (ERP) system have enabled the Group to effect timely meeting of market demands.

The Group's advertising and promotion expenses in 2005 amounted to RMB655.0 million, comparable to 6.1% of the revenue against 6.3% in 2004. This showed that the Group has been successful in realizing better economies of scale from its branding and marketing efforts.

The Group's positive image and superior quality products won for it the certificates of "Exclusive Dairy Products for Chinese Cosmonauts" and "Exclusive Dairy Products for National Athletes of the Training Bureau of the State Administration of Sports". The continuous active involvement of the Group in these sponsorship programs has greatly strengthened its brand image.

2005 was an important year to the Group in terms of business development as it rolled out effective promotion and advertising campaigns, which enhanced consumers' awareness of its brand and products. Apart from buying prime time slots

on national television channels, the Group also mounted several innovative and unique marketing campaigns, such as title sponsorship – the “Mengniu Suan Suan Ru Super Girl Singing Contest” (蒙牛酸酸乳超級女聲), a nationwide singing competition organized by Hunan TV (湖南衛視). The campaign was a huge success, boosting significantly the popularity of the Group as well as the Suan Suan Ru series among consumers.



### Products

The Group boasted a comprehensive product portfolio comprising over 210 varieties of liquid milk, ice cream and other dairy products.

#### Liquid milk

The liquid milk segment continued to be the major revenue contributor and accounted for 86.0% of the Group's revenue. Revenue of this segment was RMB9,314.7 million in 2005, or an increase of 52.8% as compared with 2004. The growth was mainly due to our successful market differentiation strategy, which enabled us to introduce products with appeals to different consumer segments.

UHT milk accounted for 70.4% of the liquid milk segment's revenue. Its revenue increased by 35.8% to RMB6,555.3 million, thanks to the Group's strong brand building efforts. To meet different nutritional requirements of different

consumer segments, the Group offered a variety of functional UHT milk products such as milk with high calcium and low fat, milk enriched with iron and zinc, nutritious milk for students and milk with low lactose content.

During the year, the Group launched a series of new functional milk products namely Breakfast milk (早餐奶) and Good Night milk (晚上好奶), with added nutrients such as malt essence, whey protein and vitamins, to cater for the daily needs of busy city dwellers. In addition, the Group launched the premium nutrition milk series, Milk Supreme (奶爵六特乳) and Milk Deluxe (特倫蘇), demonstrating its capability to satisfy market demand for high-end milk products.



For the milk beverages segment, the Group promoted Suan Suan Ru (酸酸乳), riding on the hit Super Girl Program. As a result, Suan Suan Ru was very well received and stood out among similar products in popularity. Revenue of the segment surged 134.7% to RMB2,118.2 million, and accounted for 22.7% of the liquid milk segment's revenue.

During the year under review, revenue from yogurt was RMB641.2 million, representing an increase of 74.7% over that of 2004. In early 2005, the Group launched new products using the proprietary probiotics it has jointly developed with Chr Hansen, a world-renowned probiotics manufacturer, and the market returned encouraging responses.

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## *Ice cream*

Revenue from ice cream increased by 60.9% to RMB1,295.9 million in 2005, contributing 12.0% of the Group's revenue. The increase was attributable to the tasty favors, trendy packaging, fresh image, quality raw materials and broad mix of Group's products. To sustain its market leadership and capture different seasonal and regional demands across the nation, the Group continued to invest in research and development ("R&D") and apply stringent quality control.



To stay close to the markets and speed up market penetration, in mid 2005, the Group strategically set up a new production plant in Shenyang to produce ice cream products for consumers in northeastern China who like to have ice cream even in wintertime.

In 2005, the Group streamlined its layered distribution system, with the aim of speeding up response to market and bringing the Group closer to the end markets.

## *Other dairy products*

Revenue from other dairy products contributed 2.0% of the Group's revenue. The operating environment of the milk tablets market changed during the year, leading to a 31.2% decrease in revenue for other dairy products to RMB214.4 million in 2005. The decrease was mainly due to the retreat in sales during the year relative to the initial tremendous response bolstering sales when the milk tablets were first launched in 2004. During the year, seeing strong potential

in the high value-added baby milk powder products, the Group invested continuous efforts to develop the market.

## **Raw Milk Supply**

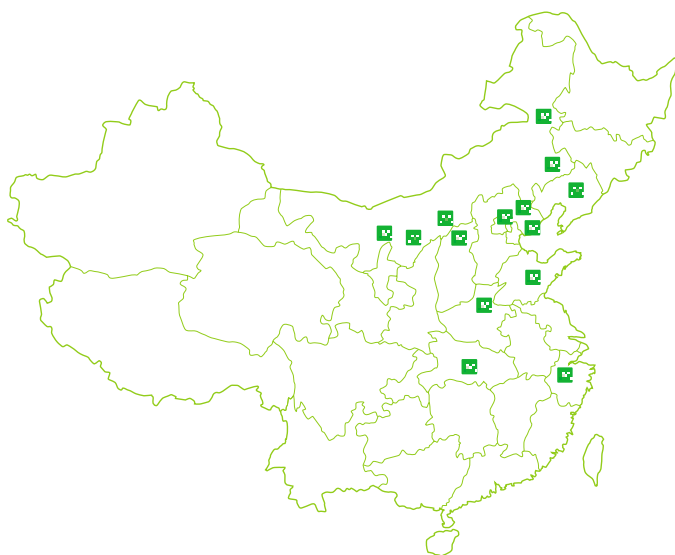
The Group's key focus has been to strengthen milk source management. The first Mengniu-Australia International Model Ranch ("Model Ranch") started operation in 2005. Equipped with high-end imported equipment and adopting advanced western management practices, the Model Ranch is currently the biggest model farm in China. It is the first model farm in the country to introduce advanced milking robot and also an excellent demonstration ground for milk farmers to learn the latest knowledge in raising, feeding and milking cows to enhance the quality and quantity of raw milk supply. The superior quality of Milk Supreme and Milk Deluxe are proof of the success of the Model Ranch.



The Group has exclusive supply contracts with over 3,000 milk collection centers and raw milk suppliers. To maintain a stable supply of quality and safe raw milk that meets consumers' requirements, the Group has in place a comprehensive quality control mechanism that keeps track of quality throughout the collection, transporting and production processes.

## Production

In 2005, the Group operated 14 production bases that are equipped with world-class production and packaging technologies and had a combined annual production capacity of 2.78 million tons. To have production bases in different parts of the nation is a strategic direction of the Group in its bid to shorten transportation distance thus save production cost, and also to make logistic arrangements more flexible.



## Prospects

According to the China Dairy Industry Association, the dairy industry of China is expected to grow at an annual rate of more than 20% between 2006 and 2008, driven by the continuous growth in per capita income and rising consumer demands for quality dairy products. Building on its strong brand name, well-developed distribution network, and, most importantly, its supreme quality products, the Group is confident of outperforming the industry in growth.

By improving product quality and production capacity, introducing new products, penetrating new markets, optimizing managerial capability and fostering closer business partnership with both distributors and raw milk suppliers, the Group will seize market opportunities to enlarge its market share.

## Product Quality and Production Capacity Improvement

The Group will further strengthen its management systems, particularly in optimizing the quality control process by improving the existing quality control system. Taking reference from international models, we will ensure all production procedures meet high standards. The Group will build new plants in strategic regions or expand production capacity through merger and acquisition, which will allow it to seize growth opportunities from rising demand for dairy products. To effectively expand its production capacity, the Group will pay close attention to the latest development in equipment and technology and continually improve its production techniques and product quality.

## New Product Introduction

To consolidate its leading position in the dairy market, the Group will enrich its product portfolio by introducing more high-value added functional milk products and products that match consumers' needs. The Group's persistent R&D efforts, innovation and introduction of new products will ensure the continual supply of nutritious and delicious products that can meet consumers' increasing sophisticated tastes and needs. These moves will enable the Group to capture opportunities for growth.

To further sharpen the competitiveness of fast moving products, such as Breakfast milk and Suan Suan Ru, efforts will be put on developing second or third generation of new products with enhanced taste and functions. Furthermore, the Group will introduce more highly nutritious products, such as the Future Star (未來星成長奶), tailored for fostering children's health and growth.



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To establish a strong hold throughout the country, the Group built a scalable ice cream production base in Maanshan in 2005 to satisfy the needs of markets in southeastern China. The plant has had new facilities installed and will commence full production in 2006. By increasing the proportion of in-house production and with production facilities located close to the market, the Group can save on long-haul transportation cost and promptly respond to changes in the market in particular of low temperature products, and in turn enhance efficiency and flexibility of its operations. The plant will also allow the Group to allocate more resources into developing secondary ice cream brands and adding to the more premium product series, such as the Super Sui Bian (超級隨變) series, thus expand the ice cream market share.

To optimize its capability to capture business opportunities in the other dairy products segment, the Group has signed a framework agreement with a Danish company, Arla Foods amba ("Arla Foods"), for a proposed joint venture to engage in the production, sales and distribution of high-quality milk powder and other dried dairy products in China. The proposed joint venture with Arla Foods will not only optimize the Group's product mix, but will also equip the Group to compete with international dairy enterprises which are currently major players in the high-end imported milk powder market.

## Penetration of New Markets

By consolidating its leading position in first-tier markets and expanding into second and third-tier markets, the Group is confident of further boosting economies of scale for its sales and distribution network.

In addition to heightening consumer awareness of its primary brand **MENGNU** through effective nationwide promotion and advertising campaigns, the Group's growth strategies also include developing secondary brands. By establishing joint ventures with sizeable local firms and integrating their proven sales channels with its own, the Group can quickly expand market share.



## Enhancement of Management Strength

To further reduce production costs and expenses, the Group will seek to enhance its management strengths and operational efficiency. It will improve its management model by integrating enterprise management, formulating a centralized logistics supply chain distribution system, optimizing its inventory management system and further quantifying the accountability of different departments.

The Group believes that its employees are its important asset. To gain the most from this important asset, incentives are incorporated in our promotion and remuneration mechanisms to encourage outstanding performance and loyalty.

## Partnership

The Group sees the need to constantly align its interests with those of its partners so as to create a win-win situation conducive to the healthy growth of the industry.

Dairy farmers and milk collection centers are the Group's important partners for it is only with the cooperation of milk suppliers that it can ensure it has a stable supply of quality raw



milk and can expand milk sources. Apart from providing these partners with training and support in the form of loan guarantee, the Group also encourages and assists them in expanding their ranches and milk collection centers to enjoy better economies of scale while meeting the needs of the fast growing China dairy market.

The Group will introduce to its operation world-class technology and management systems, and work with international companies to enhance development, production and quality control of products. These moves will enable us to achieve our goal of quickly assuming a share of the high-end market and in turn accelerate internationalization of the Group.

### Human Resources and Remuneration of Employees

As at 31 December 2005, the Group had a total of approximately 29,000 employees (2004: 21,000) in China and Hong Kong. Total staff costs for the year was approximately RMB390.3 million, excluding remuneration for the Directors. The expenses totaled approximately RMB252.3 million in 2004.

The Group invests in continuing education and training programs that can help its management staff and employees improve their professional skills and knowledge. An internal vocational training center, Mengniu Commercial Study College, has been set up to develop and render training programs for staff.

Our employees receive competitive remunerations with performance-based bonuses in line with industry practice. Other staff benefits provided by the Group include a pension contribution plan and insurance schemes.

