

MANAGEMENT DISCUSSION AND ANALYSIS

Financial Review

In the first half of 2006, the Group's revenue increased by 58.7% to RMB7,546.4 million. Its continuous effort to launch popular value-adding new products has enabled the Group to flourish amid intense market competition. Net profit attributable to equity holders of the Company reached RMB343.4 million, an increase of 39.3% when compared with the RMB246.5 million for the same period of 2005. Basic and diluted earnings per share were both RMB0.25, representing an increase of 13.6% and 38.9% respectively from that of the first half of 2005.

Gross Profit

Gross profit of the Group totaled RMB1,757.7 million, representing an impressive increase of 64.8% over the same period last year. Despite the pressure from rising costs of raw materials and keen market competition, its gross profit margin improved from 22.4% to 23.3%, evidencing that the Group's product development and operation strategies during the review period have been effective.

Operating Expenses

For the first six months of 2006, selling and distribution costs amounted to RMB1,083.5 million (2005: RMB615.9 million), representing an increase from 13.0% of the Group's revenue in the last corresponding period to 14.4% this period. Expenses on advertising and promotion amounted to RMB532.3 million, representing 7.0% of the Group's revenue (2005: 5.2%). The increase was the result of strengthened advertising and marketing strategies to promote sales and facilitate market penetration of new products.

Administrative and other operating expenses amounted to RMB202.5 million for the first half of 2006 (2005: RMB112.1 million), representing a slight increase from 2.4% of the Group's revenue in the same period last year to 2.7% this period.

Profit from Operating Activities

EBITDA grew by 42.7% to RMB670.9 million during the period and EBITDA margin dropped to 8.9% from 9.9% in the first half of 2005. The drop in EBITDA margin was mainly due to the rise in selling and distribution costs as compared to the same period last year.

During the period under review, the Group enjoyed various tax exemptions and a relatively low effective tax rate of 10.5% (2005: 8.1%) in the first half of this year.

Capital Structure, Liquidity and Financial Resources

The Group had cash and bank balances totaled RMB1,461.5 million as at 30 June 2006. It maintained a strong net cash position and healthy cash flows during the period, with net cash from operating activities amounting to RMB627.7 million (2005: RMB703.5 million).

As at 30 June 2006, outstanding bank loans of the Group totaled RMB997.7 million (31 December 2005: RMB811.3 million), of which RMB288.6 million is repayable within one year and RMB709.1 million repayable beyond one year. Debt to equity ratio (total bank loans divided by total equity) of the Group was 31.7%, comparable with the 29.3% as at 31 December 2005.

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Finance costs for the review period were approximately RMB29.06 million (2005: RMB18.96 million), representing 0.4% of the Group's revenue, same level as the corresponding period last year.

Market Review

With the Government's forceful health education campaign, as well as the rising income level and purchasing power of people in China, milk drinking has become a habit of more Chinese consumers. Moreover, this habit has gradually spread from first and second-tier cities to third and fourth-tier cities. The expanding liquid milk market in China braced the robust growth of the dairy industry during the period under review. According to an ACNielsen survey conducted in June 2006, the moving annual total sales volume of China's liquid milk market, excluding milk beverages and yogurt, grew by approximately 20.6% when compared with that of prior period.

Although competition for traditional products remained intense during the review period, the Group saw consumers become more aware of the nutritional value and specialties of dairy products and thus demand for them is rising. As such, the Group believes that high value adding products such as functional milk, milk beverages, yogurt and premium milk products will be the growth drivers for the industry.

Business Review

Branding and Marketing

MENGNU continues to be the best liquid milk seller in China. According to an ACNielsen survey conducted in June 2006, the Group held a 31.7% share of the China liquid milk market by volume, excluding milk beverages and yogurt, against 28.6% in December 2005. The increased market share proved that the Group's strategies on product innovation, quality control, brand enhancement and market penetration have been effective. The top three players in the liquid milk market accounted for 62.4% share of the market in June 2006, against 61.3% in December 2005, indicating that the market is still going through consolidation.

The Group is dedicated to identifying what consumers in different market segments value, which serves as the basis for it to improve or develop new product varieties, and also to formulate marketing initiatives and operation objectives. During the period, the Group launched various innovative, unique marketing programs targeting consumers in specific market sub-segments.

Pushing on with its sales and marketing strategies, in the first half of 2006, the Group not only continued to join hand with Hunan TV (湖南衛視) to promote its trendy milk beverage series, *Suan Suan Ru* (酸酸乳), but also cooperated with CCTV (中央電視台) and organized the following nationwide programs:

- "Mengniu Yogurt — Family Let's Go" (蒙牛益生菌酸奶全家總動員), a talent contest for parents and children to show their talents and creativity and ultimately encourage tighter family bonding;
- "Mengniu Future Star Outstanding Teenagers" (蒙牛未來星非凡少年), the country's first nationwide interactive program to explore intrinsic potential of and provide all-round training to teenagers, echoes the Group's new children milk series — *Future Star* (未來星成長奶); and
- "Mengniu Breakfast Milk Anchor Challenges" (蒙牛早餐奶挑戰主持人), a TV program anchor selection campaign with healthy body and smart mind as the selection criteria.

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The marketing campaigns succeeded in reinforcing the special features and superior quality of the Group's products in the minds of consumers, thus in turn boosted the popularity of the **MENGNIU** brand.

Products

The Group offers a comprehensive array of products, with its product portfolio comprising over 220 varieties of liquid milk, ice cream and other dairy products. In this year, the Group has focused on optimizing its product mix by taking out products with low added-value and continued to develop well-received mid-end to high-end products to tap demand from different consumer segments.

Liquid milk

During the period, the liquid milk segment remained as the primary revenue driver of the Group and accounted for 85.2% of the Group's revenue. Revenue of this segment surged by 62.8% from RMB3,951.5 million the same period of 2005 to RMB6,432.1 million this period, thanks to the introduction of high value-adding products and strategic product differentiation by the Group.

Revenue from UHT milk increased by 48.7% to RMB4,307.7 million, accounting for 67.0% of the segmental revenue. The strong sales of value-added functional milk such as *Hi-calcium milk* provided the main thrust for growth. New functional milk products such as *Breakfast milk* (早餐奶) and *Good Night milk* (晚上好奶) and the premium milk series such as *Milk Supreme* (奶爵六特乳) and *Milk Deluxe* (特倫蘇奶) are well received by the market, mirroring rising demand for better quality and specialty milk products.

Revenue from milk beverage products recorded an impressive growth of 113.9% to RMB1,669.1 million, accounting for 25.9% of the segmental revenue. Riding on the effective marketing strategy, *Suan Suan Ru* achieved strong sales relative to other products and remained as the best selling milk beverage.

During the period under review, revenue from yogurt rose a remarkable 66.0% to RMB455.3 million, accounting for 7.1% of the segmental revenue. As consumers become more aware of the health benefits of yogurt, the Group's yogurt products have strong potential for growth.

Ice cream

Revenue from the ice cream segment surged by 46.2% to RMB1,014.8 million, accounting for 13.5% of the Group's revenue. This outstanding growth in sales evidenced the success of the Group's emphasis on adding value to its products including enhancing the taste, varieties and the image of new products to fit customers' needs.

Other dairy products

Revenue from other dairy products was RMB99.5 million, accounting for 1.3% of the Group's revenue. During the period, the other dairy product mix was restructured to prepare for the joint venture with Arla Foods amba ("Arla Foods"). The Group will continue to ride on the strategic partnership with Arla Foods to develop more value-adding milk powder products, thus paving the path for healthy growth of this segment.

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Production

As at 30 June 2006, the Group operated 19 production bases (31 December 2005: 14) with a total annual capacity of 3.57 million tons.

Venture and Alliance

The first half of 2006 saw the Group pursue many promising ventures and alliances. In January 2006, the Group set up a joint venture in Wuhan with the reputable local player, Wuhan Frealth Dairy Co., Ltd. The integration of both parties in terms of production, distribution and branding will not only enhance the Group's understanding and meeting of the needs of customers in central China, but will also help it gradually expand its market share.

In April 2006, the Group announced its corporate alliance with Hong Kong Disneyland. It is now the official milk sponsor and supplier for Hong Kong Disneyland Park, Hong Kong Disneyland Hotel and Disney's Hollywood Hotel. This alliance is a testament to the internationally recognized quality and healthy image of **MENGNU** products.

In May 2006, the Group entered into an agreement with Arla Foods, the largest European dairy product manufacturer in terms of turnover, to establish a 50-year sino-foreign equity joint venture to manufacture and distribute high-end milk powder and other solid milk products. Drawing from Arla Foods' strong technical expertise and management experience, the joint venture will further enhance the Group's product portfolio and boost its competitiveness in the dried dairy product area.

Prospects

The continuously growing per capita income and rising consumer demands for quality dairy products in China will continue to provide strong impetus for the country's dairy industry to prosper in the coming years. The Group will further enhance product quality controls, improve management capabilities, speed up its pace for internationalization, strengthen milk source management and development, thus enhancing its competitiveness for capturing opportunities in the growing market and enlarging its market share.

To enhance the advantage of product quality riding on an integrated quality control systems

To further enhance product quality control, the Group is dedicated to consolidate its quality management, control and monitoring systems. Through implementing the five quality assurance systems, including ISO9002, HACCP and GMP, and further unifying the quality control standards, the Group will ensure all its production bases adhere to uniform guidelines regarding standards for technology, examination, production formulae and control processes when they implement production and operation strategies. At the same time, the Group prepares to carry out a thorough diagnostic assessment of the operation of its various production lines according to the most advanced international manufacturing standards. It will also introduce systems to enhance the cost and effectiveness assessment of production and, through optimizing production flows and technical innovation, enhance automation level and operational efficiency.

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To improve operational quality and embark on precision management

To further enhance its operational competitiveness, the Group intends to implement a more precise and sophisticated operation management system. The Group will unify and optimize operational targets and impose stricter assessment and controls on resources input and output value at all divisions from product development, production to sales, to boost the added value of its products and improve efficiency of various fund and resources applications. The Group will continue to design effective procedures for its various business units and improve the existing operation mode with higher efficiency standard and more scientific work flows. The aims of these moves are to ensure different business units operate according to international standards, to effect more precise and sophisticated management, and lay a solid foundation for the Group's steady long-term development.

To enhance competitive edges by forging more international partnership

Cooperating with Arla Foods marks the beginning of the Group's efforts to pursue more international cooperations. To speed up the achievement of international standards in technology, products development, management and brand building, the Group will continue to strengthen its business cooperation with leading international dairy enterprises and seek to achieve synergy in areas such as technology, distribution and marketing. With its internationally advanced technology and experience, the Group will develop China's potential market for dairy products with its partners, to realize a win-win and mutually beneficial situation. In addition, the Group will expand cooperation with Disney to enhance consumer awareness of **MENGNIU** brand internationally and capture opportunities to speed up its pace for internationalization.

To ensure supply of quality raw milk by scaling up raw milk supply bases

Applying its extensive industry experience and the advanced technological knowledge gained from the Mengniu-Australia International Ranch, the Group continues to assist its raw milk suppliers in adopting state-of-art rearing techniques for better quality and yield of milk. The Group also, by taking reference from international models, strives to encourage raw milk suppliers to expand their herd size so as to enjoy better economies of scale. To accelerate the scaling up of raw milk supply bases and improve the quality and yield of raw milk, the Group will focus on about 2,000 ranches and provide them with development plan formulation as well as technological and equipment assistance. Building up a system of enhanced quality and pricing for raw milk will give much support to the Group's development of high-end premium products.

In addition, the Group has introduced internationally advanced cow breeding technologies and talents, as well as established a research and development institute with international institutions for the development of biotechnologies. Seeking registration for the cow breeding biotechnology institute will enable the Group to substantially promote its advanced breeding technologies and to provide impetus for development to its raw milk supply bases.

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To increase market share through marketing and promotional activities

To stand out in the keen competition, the Group will continue to launch unique marketing and promotional campaigns to raise consumers' receptiveness and awareness of its products. In order to further expand its sales and distribution network and strengthen its marketing competitiveness, the Group's sales personnel will maintain close contact with distributors and assist them in designing effective operational and marketing plans for different and fast-changing markets. The Group intends to step up promotion for its brand and new products by improving the service quality of its direct sales channel and distribution network.

Other than strengthening its marketing efforts, the Group also commits to contributing to the community, which is in line with its corporate culture of social commitment. The Group announced a one-year milk sponsorship program for 500 schools in poor areas of China in June this year. In the future, the Group will continue to honor its social responsibilities towards the community and the dairy industry.

Leveraging on its competitive advantages, the Group is determined to create an all-win situation for its customers, employees, business partners, shareholders and the community.

Human Resources and Remuneration of Employees

As at 30 June 2006, the Group had a total of 33,400 employees (30 June 2005: 26,000 employees) in China and Hong Kong. In addition to competitive remunerations, which include performance-based bonuses in line with industry practice, the Group has also established a share option scheme to provide incentive to employees. Committed to maintaining a strong corporate culture, the Group offers structured training and development programs to enhance employees' skills and understanding of its culture and strategies. Total staff costs for the first half of 2006 were approximately RMB328.8 million against the approximately RMB175.3 million for the same period in 2005.