

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. Corporate information

The Company was incorporated in the Cayman Islands on 16 February 2004 as an exempted company with limited liability. The Company is an investment holding company and its subsidiaries are engaged in the manufacture and distribution of dairy products in the People's Republic of China (the "PRC").

2. Basis of preparation and accounting policies

Basis of preparation

The unaudited interim condensed consolidated financial statements for the six months ended 30 June 2006 have been prepared in accordance with International Accounting Standard ("IAS") 34 "Interim Financial Reporting".

The unaudited interim condensed consolidated financial statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with the Group's 2005 annual financial statements.

Significant accounting policies

The accounting policies adopted in the preparation of the interim condensed consolidated financial statements are consistent with those followed in the preparation of the Group's 2005 annual financial statements, except for the adoption of the following amendments to International Financial Reporting Standards ("IFRSs") mandatory for annual periods beginning on or after 1 January 2006 and relevant to the business of the Group:

- IAS 39 — "Financial Instruments: Recognition and Measurement ("IAS 39") - Amendment for Financial Guarantee Contracts" which amended the scope of IAS 39 to include financial guarantee contracts issued. The amendment addresses the treatment of financial guarantee contracts by the issuer. Under IAS 39 as amended, financial guarantee contracts are recognised initially at fair value and subsequently remeasured at the higher of the amount determined in accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 "Revenue"; and
- IFRIC 4 — "Determining whether an Arrangement contains a Lease" which provides further guidance for determining whether an arrangement is, or contains, leases that should be accounted for in accordance with IAS 17 "Leases".

The adoption of these amendments did not have significant impact on the Group's results of operations or financial position.

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3. Segment information

The Group is comprised of the following business segments:

- liquid milk products segment — manufacture and distribution of UHT milk, milk beverages and yogurt;
- ice cream products segment — manufacture and distribution of ice cream; and
- other dairy products segment — manufacture and distribution of milk powder and milk tablets.

As the Group mainly operates and generates its revenue and results in the PRC, no geographical segment analysis is presented.

The following tables present revenue, results and certain asset and liability information for the Group's business segments for the period ended 30 June 2006:

	Unaudited	
	For the six months ended 30 Jun	
	2006	2005
	RMB'000	RMB'000
Segment revenue		
Liquid milk	6,432,118	3,951,460
Ice cream	1,014,767	694,101
Other dairy products	99,470	108,481
	7,546,355	4,754,042
Segment results		
Liquid milk	426,583	306,639
Ice cream	79,055	49,723
Other dairy products	3,629	5,620
	509,267	361,982
Unallocated corporate expenses	(26,926)	(17,883)
Profit from operating activities	482,341	344,099
Interest income	8,075	6,063
Finance costs	(29,060)	(18,955)
Share of profits/(losses) of associates	1,825	(4,710)
Profit before tax	463,181	326,497
Income tax expense	(48,439)	(26,445)
Net profit for the period	414,742	300,052

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3. Segment information *(Continued)*

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Segment assets		
Liquid milk	5,670,880	4,274,241
Ice cream	1,267,397	886,902
Other dairy products	153,970	169,559
Unallocated corporate assets	1,148,031	1,226,247
Eliminations	(605,615)	(469,844)
Total assets	7,634,663	6,087,105
Segment liabilities		
Liquid milk	3,138,772	2,547,286
Ice cream	682,655	386,960
Other dairy products	49,117	67,239
Unallocated corporate liabilities	1,218,692	788,385
Eliminations	(605,615)	(469,844)
Total liabilities	4,483,621	3,320,026
	Unaudited For the six months ended 30 Jun	
	2006 RMB'000	2005 RMB'000
Capital expenditure		
Liquid milk	565,513	355,276
Ice cream	39,623	149,014
Other dairy products	495	14,074
Others	22,571	15,480
	628,202	533,844
Depreciation		
Liquid milk	142,446	94,468
Ice cream	33,910	22,976
Other dairy products	3,684	3,692
Others	7,621	4,465
	187,661	125,601

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4. Revenue

Revenue, being the turnover of the Group, represents the net invoiced value of goods sold, after allowances for goods returns and trade discounts, and after eliminations of all significant intra-group transactions.

An analysis of the Group's revenue and other income is as follows:

	Notes	Unaudited For the six months ended 30 Jun	
		2006 RMB'000	2005 RMB'000
Revenue		7,546,355	4,754,042
Other income			
Government grants	(a)	2,529	1,775
Amortisation of deferred income	(b)	2,072	2,072
Foreign exchange gains, net		5,443	—
Others		687	1,989
		10,731	5,836
		7,557,086	4,759,878

Notes:

- (a) The government grants have been received for the Group's contribution to the local economy with respect to the establishment of infrastructure relating to the dairy products industry. There are no unfulfilled conditions or contingences attaching to these grants.
- (b) The Group has received certain government grants in the form of property, plant and equipment donations or cash donations to purchase property, plant and equipment. The grants are initially recorded as deferred income and amortised to match the depreciation charge of the underlying property, plant and equipment in accordance with the assets' useful lives.

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5. Profit from operating activities

The Group's profit from operating activities is arrived at after charging:

	Unaudited	
	For the six months ended 30 Jun	
	2006	2005
	RMB'000	RMB'000
Employee benefits expenses (excluding directors' fees as disclosed in Note 22)	328,796	175,272
Depreciation on property, plant and equipment	187,661	125,601
Amortisation of land use rights	888	527
Cost of inventories sold	5,788,670	3,687,747

6. Finance costs

	Unaudited	
	For the six months ended 30 Jun	
	2006	2005
	RMB'000	RMB'000
Interest on bank loans and long term payables wholly repayable within 5 years	29,060	20,461
Less: Amounts capitalised	—	(1,506)
	29,060	18,955

The amounts capitalised are borrowing costs related to funds borrowed specifically for the purpose of obtaining qualifying assets. The interest rates on capitalised borrowings during the six months ended 30 June 2005 varied from 2.9% to 5.0% per annum.

7. Income tax expense

- (a) No provision for Hong Kong profits tax has been made as the Group has no assessable profits arising in Hong Kong during the period.
- (b) The tax charge represents the provision for PRC corporate income tax ("CIT") for the period at the prevailing tax rates applicable thereto.

During the period, certain PRC subsidiaries were subject to tax exemption in accordance with the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" under which these subsidiaries would be exempted from CIT for the first two profitable years, followed by a 50% reduction for the next three profitable years, and "The Notice of Income Tax Exemption for the Country's Key Enterprises in Agricultural Industries".



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8. Earnings per share

Basic earnings per share amount is calculated by dividing the net profit for the period attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during the period.

There was no dilutive potential ordinary shares outstanding during the period. Diluted earnings per share amount for the six months ended 30 June 2005 was calculated by dividing the net profit for the period attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during that period adjusted for the effects of dilutive potential ordinary shares.

The following reflects the net profit and the number of shares used in the basic and diluted earnings per share calculations:

	Unaudited	
	For the six months ended 30 Jun	
	2006	2005
	RMB'000	RMB'000
Net profit attributable to equity holders of the Company	343,425	246,527
	Number of shares (in thousand)	Number of shares (in thousand)
Weighted average number of ordinary shares for the purpose of basic earnings per share calculation	1,368,416	1,131,897
Weighted average number of ordinary shares, assuming issued on the conversion of convertible instrument during the period	—	236,519
Weighted average number of ordinary shares for the purpose of diluted earnings per share calculation	1,368,416	1,368,416

9. Dividend

The Directors do not recommend the payment of an interim dividend for the six months ended 30 June 2006 (six months ended 30 June 2005: nil).

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10. Property, plant and equipment

	Unaudited 2006 RMB'000	Unaudited 2005 RMB'000
Carrying amount at 1 January	3,140,433	2,227,528
Additions	247,846	135,449
Contributions from minority shareholders	74,578	—
Transfers from construction in progress (Note 11)	625,839	500,338
Disposals	(7,144)	(374)
Depreciation charge for the period	(187,661)	(125,601)
Carrying amount at 30 June	3,893,891	2,737,340

Certain property, plant and equipment of the Group with a net book value of approximately RMB553,484,000 (31 December 2005: RMB467,667,000) have been pledged to secure the long term payables of the Group, as set out in Note 18 "Long term payables".

11. Construction in progress

Movements of the Group's construction in progress, all of which is located in the PRC, are as follows:

	Unaudited 2006 RMB'000	Unaudited 2005 RMB'000
Carrying amount at 1 January	235,373	292,013
Additions	527,031	406,095
Transfers to property, plant and equipment (Note 10)	(625,839)	(500,338)
Carrying amount at 30 June	136,565	197,770

12. Inventories

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Raw materials	738,622	488,937
Finished goods	493,181	292,064
	1,231,803	781,001

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13. Bills receivable

An ageing analysis of the bills receivable of the Group is as follows:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Within 3 months	115,948	81,167
4 – 6 months	868	361
	116,816	81,528

As at 30 June 2006, bills receivable amounting to approximately RMB106,800,000 (31 December 2005: RMB80,590,000) were factored with recourse to financial institutions. The corresponding amounts were recorded as short term bank loans (Note 17).

14. Trade receivables

The Group normally allows a credit period of not more than 30 days to its customers. The Group closely monitors overdue balances. In view of the aforementioned and that the Group's trade receivables relate to a large number of diversified customers, there is no significant concentration of credit risk. Trade receivables are non-interest-bearing.

An ageing analysis of the trade receivables of the Group, net of provision for doubtful debts, is as follows:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Within 3 months	209,996	160,485
4 – 6 months	14,870	7,580
7 – 12 months	5,897	6,592
	230,763	174,657

Amounts due from associates of approximately RMB51,522,000 (31 December 2005: RMB30,748,000) are included in the above balance. These balances are unsecured, non-interest-bearing and are repayable on credit terms similar to those offered to other major customers of the Group.

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15. Trade and bills payables

An ageing analysis of the trade and bills payables of the Group is as follows:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Within 3 months	1,453,070	896,018
4 – 6 months	124,588	198,911
7 – 12 months	6,308	15,438
Over 1 year	5,750	6,638
	1,589,716	1,117,005

An amount due to an associate of approximately RMB3,790,000 (31 December 2005: RMB3,224,000) is included in the above balance. The balance is unsecured, non-interest-bearing and is repayable on demand.

The Group's bills payable are secured by the pledge of certain of the Group's deposits amounting to approximately RMB48,414,000 (31 December 2005: RMB36,475,000). The Group's trade payables are unsecured, non-interest-bearing and are repayable on demand.

16. Accruals and other payables

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Advances from customers	322,161	227,484
Salary and welfare payables	95,072	79,699
Other payables	695,646	498,195
Current portion of long term payables (Note 18)	209,266	146,766
Other accruals	53,206	24,430
	1,375,351	976,574

Amounts due to associates of approximately RMB82,070,000 (31 December 2005: RMB32,374,000) are included in the above balance. The balances are unsecured, non-interest-bearing and are repayable on demand.

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17. Interest-bearing bank loans

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Short term bank loans, secured	106,800	80,590
Short term bank loans, unsecured	181,785	285,000
Long term bank loans, unsecured	709,107	445,702
	997,692	811,292

As at 30 June 2006, short term bank loans of approximately RMB106,800,000 (31 December 2005: RMB80,590,000) were secured by certain bills receivable of the Group (Note 13).

During the period, the Group obtained new bank loans amounting to approximately RMB421,990,000 and repaid bank loans of approximately RMB235,590,000.

During the period, the annual interest rates of the short term bank loans and the long term bank loans varied from 3.0% to 5.9% and from 3.0% to 5.9% (six months ended 30 June 2005: varied from 4.8% to 5.8% and from 2.9% to 5.5%), respectively. As at 30 June 2006, the Group's interest-bearing bank loans were denominated in Renminbi, except for loans of approximately US\$27,000,000 (equivalent to approximately RMB215,881,000) (31 December 2005: US\$10,000,000) denominated in United States dollars.

The repayment schedule of the bank loans is as follows:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Within 1 year	288,585	365,590
1 – 2 years	268,981	190,000
2 – 5 years	440,126	255,702
Total interest-bearing bank loans	997,692	811,292
Less: Amount due within 1 year included in current liabilities	(288,585)	(365,590)
	709,107	445,702

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18. Long term payables

The Group's long term payables represent outstanding instalments payable for the purchase of plant, machinery and equipment. The balances are interest-free and are repayable as follows:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Within 1 year	209,266	146,766
1 – 2 years	104,618	165,881
2 – 5 years	184,680	145,640
Total long term payables	498,564	458,287
Less: Amount due within 1 year included in current liabilities (Note 16)	(209,266)	(146,766)
	289,298	311,521

Certain long term payables are secured by the Group's property, plant and equipment (Note 10).

19. Other reserves

Movements in other reserves of the Group during the period are as follows:

	Share premium	Contributed surplus	Statutory reserves	Currency translation differences	Total
	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000
At 1 January 2006	1,127,581	204,677	286,099	(2,616)	1,615,741
Additional equity contributed by a minority shareholder (Note a)	—	16,918	—	—	16,918
Currency translation differences	—	—	—	126	126
At 30 June 2006	1,127,581	221,595	286,099	(2,490)	1,632,785

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19. Other reserves (Continued)

	Share premium	Contributed surplus	Statutory reserves	Currency translation differences	Total
	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000	Unaudited RMB'000
At 1 January 2005	950,380	214,677	149,962	(1,969)	1,313,050
Shares issued upon conversion of convertible instrument (Note b)	177,201	—	—	—	177,201
Currency translation differences	—	—	—	4	4
Transfer to dividend payable	—	(10,000)	—	—	(10,000)
At 30 June 2005	1,127,581	204,677	149,962	(1,965)	1,480,255

- (a) The beginning balance of contributed surplus of the Group represents the difference between the nominal value of the share capital of the subsidiaries acquired pursuant to the group reorganisation over the nominal value of the shares of the Company issued in exchange therefor.

During the period, a minority shareholder injected additional capital to a subsidiary of the Group in the form of property, plant and equipment. The excess of the amount of capital injected by the minority shareholder over its additional interest in the subsidiary's net asset attributable to the Company's equity holders amounting to approximately RMB16,918,000 is recorded as contributed surplus of the Group.

- (b) On 16 June 2005, convertible instrument of US\$24,663,679 (equivalent to approximately RMB204,636,000) was converted into 257,891,532 ordinary shares of HK\$0.10 each, giving rise to a share premium of RMB177,201,000, being the excess of the value of the convertible instrument of RMB204,636,000 over the par value of the new shares issued of RMB27,435,000.

20. Contingent liabilities

The Group is contingently liable in respect of loan guarantees granted to certain banks in favour of certain suppliers of raw milk (the "Suppliers"). Guarantees granted as at 30 June 2006 amounted to RMB165,976,000 (31 December 2005: RMB140,976,000), of which RMB140,976,000 (31 December 2005: RMB140,976,000) are counter-guaranteed by these Suppliers who are independent third parties. Security under these counter-guarantees included property, dairy cattle and other assets owned by these Suppliers.

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21. Commitments

(a) Capital commitments

The Group had the following outstanding capital commitments in respect of the purchase and construction of property, plant and equipment:

	Unaudited At 30 Jun 2006 RMB'000	Audited At 31 Dec 2005 RMB'000
Contracted, but not provided for	250,067	343,232
Authorised, but not contracted for	485,055	—
	735,122	343,232

(b) Investment commitment

On 18 May 2006, Inner Mongolia Mengniu Dairy (Group) Company Limited, a subsidiary of the Company, entered into an equity joint venture contract with several independent third parties to set up an equity joint venture, Arla Mengniu (Inner Mongolia) Dairy Products Co., Ltd. ("Arla Mengniu").

As at 30 June 2006, the Group had an investment commitment to contribute 50% of Arla Mengniu's registered capital, amounting to RMB90,000,000, in the form of certain property, plant and equipment and intangible assets. The Group also agreed to provide a guarantee in proportion to its equity interest in Arla Mengniu to secure the joint venture's proposed financing of RMB110,000,000.

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22. Related party transactions

The Group had the following material transactions with related parties. In the opinion of the Directors, the transactions were conducted in the ordinary course of business.

	Notes	Unaudited For the six months ended 30 Jun	
		2006 RMB'000	2005 RMB'000
Sale of liquid milk to associates	(a)	954,859	404,564
Sale of ice cream and other dairy products to associates	(a)	82,389	49,942
Purchase of raw material from an associate	(a)	24,257	2,873
Key management compensation	(b)		
— directors' fees		135	30
— salaries and allowances		2,326	1,309
— retirement benefits contributions		69	21

Notes:

- (a) The price of the above transactions was determined with reference to the then prevailing market price/rates and the price charged to third parties.
- (b) Key management compensation represented remuneration paid or payable to the directors and senior management of the Company.

23. Subsequent event

The establishment of Arla Mengniu and the related capital injections were completed in August 2006.

24. Comparative amounts

Certain comparative amounts have been reclassified to conform with the presentation of the 2005 annual consolidated financial statements.

25. Approval of the interim financial statements

The unaudited condensed consolidated interim financial statements were approved and authorised for issue by the Board of Directors on 5 September 2006.