



Dad and Mum,
Let's Play
Together

MANAGEMENT DISCUSSION AND ANALYSIS

I can be
an Olympic
Winner!

Endowed with Talents,
Win the Future



Financial Review

Through the effective implementation of our strategies on product development and diversification, precise market segmentation and strengthening promotional efforts, the Group successfully increased its market share and market penetration, achieving satisfactory results and profit growth for the year. During the period under review, the Group's revenue increased by 50.1% to RMB16.2464 billion (2005: RMB10.8250 billion). Net profit attributable to equity holders of the Company reached RMB727.35 million (2005: RMB456.85 million). Basic earnings per share and diluted earnings per share both recorded RMB0.532 (2005: RMB0.365 and RMB0.334 respectively).

Gross Profit

During the year under review, the Group made a satisfactory gross profit of RMB3.7218 billion, a rise of 54.2% as compared with that of 2005 (2005: RMB2.4132 billion). Gross profit margin was stabilized at 22.9%, as a result of the continuous product mix enhancement by launching more high-end products. Through the ongoing enhancement of the production, logistics, warehousing, transportation and quality control systems, the Group has realized cost savings at every stage of the production chain, and has achieved a more precise and streamlined logistics, warehousing and transportation planning, thus the pressure of increased production costs was eased.

Operating Expenses

In 2006, the Group recorded operating expenses totaling RMB2.8170 billion (2005: RMB1.7867 billion), representing approximately 17.3% of the Group's revenue (2005: 16.5%). During the period under review, the Group continuously enhanced its operation management system and firmly adhered to its comprehensive budget control system in order to tighten operating expenses, thus improving its sale and management efficiency.

The Group's selling and distribution costs amounted to RMB2.3803 billion (2005: RMB1.4950 billion), representing approximately 14.6% of the Group's revenue (2005: 13.8%), of which expenses on advertising and promotion amounted to RMB1.1061 billion, accounting for 6.8% of the Group's revenue (2005: 6.1%). In order to cater for the needs of various market segments, the Group launched a greater variety of innovative and tailor-made advertising and promotion campaigns, resulting in an increase in such expenses. These campaigns were designed to increase the Group's market share through conveying specific and clear messages to targeted customer groups, thereby impressing on the public the distinctive image of each product series.

Administrative and other operating expenses amounted to RMB436.7 million (2005: RMB291.7 million), representing 2.7% of the Group's revenue, comparable to the level recorded in 2005.

Profit from Operating Activities

EBITDA for the period under review increased by 50.7% to RMB1.3961 billion. Despite the increase in the selling and distribution expenses to revenue ratio, the Group's improved gross profit margin allowed it to maintain the EBITDA margin at a healthy level of 8.6% as in 2005.



Management Discussion and Analysis

The Group's taxation expenses reached RMB76.032 million in 2006. Since the Group enjoyed various preferential tax treatment and exemptions, a relatively low tax rate was maintained.

Net Profit

Despite the pressure of intense market competition as well as rising production and operating costs, benefiting from various effective measures adopted during the year, net profit attributable to equity holders of the Company for the year reached RMB727.35 million (2005: RMB456.85 million).

Capital Structure, Liquidity and Financial Resources

The Group has a healthy consolidated balance sheet. As at 31 December 2006, the Group had cash and cash equivalents of RMB1.3301 billion (2005: RMB1.2478 billion), and net cash flow from operating activities of RMB1.4028 billion (2005: RMB1.3283 billion).

As at 31 December 2006, total outstanding bank loans of the Group were RMB875.16 million (2005: RMB811.3 million), of which RMB234.02 million was repayable within one year and RMB641.14 million was repayable beyond one year. The debt-to-equity ratio (total bank loans to total equity) of the Group was 24.1% as at 31 December 2006, 5.2 percentage points lower than the 29.3% recorded in the same period last year.

Total equity of the Group increased from RMB2.7671 billion as at 31 December 2005 to RMB3.6327 billion in 2006. Net finance costs for the period under review were approximately RMB47.25 million (2005: RMB31.06 million), representing 0.3% of the Group's revenue, which was comparable to that of 2005.



Market Review

Mirroring China's robust economic growth in 2006, the population of dairy product consumers in the country likewise grew. The industry has been developing well benefiting from a rise in consumption power, and the increased market demand for dairy products resulted from consumers' higher recognition of the nutrition and health benefits associated with dairy products. The government's efforts on health education have also helped raising awareness among the people, and that in turn has driven demand for nutritious food products, particularly dairy products.

The dairy industry also has strong support from the supply side. In early 2006, the government announced new policies to aid the development of the "Three Agricultures" (三農), comprising of peasant farmers (農民), farming villages (農村) and the farming industry (農業). Those policies have encouraged dairy farmers to pursue technical advancements in stock raising and the optimization of production processes to ensure better quality and yield of raw milk. As a result, dairy farmers are able to improve their living standards.

Management Discussion and Analysis

All of these incentives have been beneficial to the growth of the country's dairy market. According to the industry estimates, the annual average consumption rate of liquid milk in China for 2006 was approximately 25 kg per capita. An ACNielsen survey conducted in December 2006 also found that the moving annual total sales revenue of the country's liquid dairy market grew more than 20% when compared with that of 2005.

The burgeoning dairy market has attracted keen competition, not just among local players, but also from foreign enterprises drawn to the market by its tremendous potential. Still other challenges include the fast changing tastes and needs of customers. This means that dairy industry players with well-recognized brands, as well as solid research and development ("R&D") and marketing capabilities will be able to survive in this competitive market.

In 2006, Mengniu continued its efforts to spearhead the industry. Accordingly, as a major market player, its core products earned top rankings and captured outstanding market share while at the same time achieved favorable results from various segments of the business.

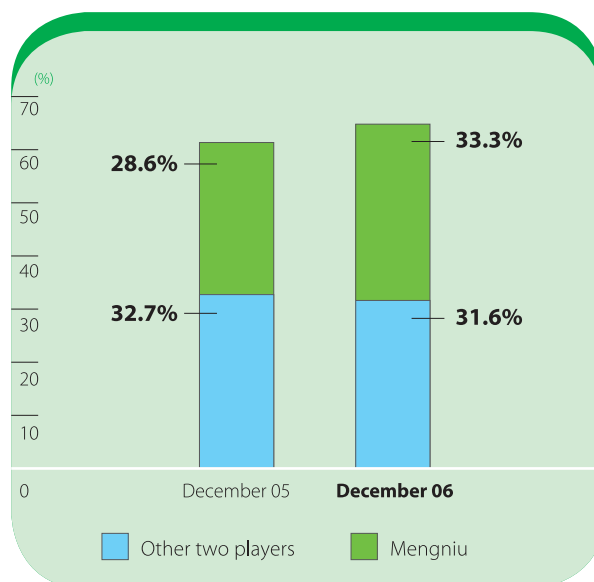
Business Review

With enlarging market share and ensuring sustainable profitability as key targets for the year, Mengniu integrated its resources and optimized its production, operation, quality control and management systems to enhance the operational efficiency and competitiveness. In addition, the Group diversified its product mix to better meet the specific needs of different customer segments and formulated marketing programs tailored for each product to ensure more effective market penetration.

The Group's strategies have been successful in fortifying its position as a key player in the industry. According to an ACNielsen survey conducted in December 2006, the Group has secured a 33.3% share of the liquid milk market in terms of sales volume, excluding milk beverages and yogurt, as compared to 28.6% in December 2005. The top three players in the China liquid milk market accounted for 64.9% share of the market in December 2006.

Top Leader in Liquid Milk Market in China

(Excluding milk beverages and yogurt)



Source: ACNielsen

Branding and Marketing

During the period under review, the Group continued to develop unique and innovative marketing and promotion campaigns to enhance the image of the **MENGNIU** brand while strengthening customer loyalty.



Management Discussion and Analysis

Branding

Other than the primary **MENGIU** brand, the Group has been actively developing secondary brands in each product category. By implementing specific marketing plans for the secondary brands, the Group not only managed to appeal to targeted customer groups, but also boosted the overall market presence of the **MENGIU** brand.

Marketing

Aware of the fact that the market has become more segmented as customers' tastes become more varied and sophisticated, in addition to the mass advertising programs, the Group came up with segment-based marketing and innovative promotion campaigns designed to capture the attention of specific customer groups.



The Group collaborated with the Hong Kong Disneyland on the "Drink Future Star — Win a Fantasy Trip to Hong Kong Disneyland" program which aimed at highlighting the goodness that *Future Star* (未來星成長奶) can bring to children; in essence, the same happiness and fantastic experience that a trip to Hong Kong Disneyland promises.

During the period under review, the Group continued to cooperate with national and regional television channels to conduct effective marketing campaigns during prime time, including themed programs to highlight the special features and advantages of its different products to the public. These programs included:

- "Mengniu's Inter-city All People Sports Game" (蒙牛《城市之間》全民運動會), the Olympic Games participated by common people and aimed at arousing public attention to the importance of consuming nutritious foods as well as exercising regularly for better health;
- "Mengniu Probiotics 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 creativity as a team, the ultimate aim of which is to tighten family bond;
- "Mengniu Future Star Outstanding Teenagers" (蒙牛未來星非凡少年), China's first nationwide interactive program for unleashing the potential of teenagers by providing these "future stars" with all-round training; and
- "Mengniu Breakfast Milk Anchor Challenges" (蒙牛早餐奶挑戰主持人), a TV program anchor selection campaign where a healthy body and smart mind are key selection criteria.

The Group also created its own spokesperson — "Milk Man More More" (奶人多多), a symbol of nutrition, energy and good health. Aimed at capturing and maintaining attention to its brand and products, Milk Man More More has been created to attract customers of all ages.

Products

To further appeal to specific market segments, targeted new product series were introduced during the period under review. The Group also strived to enhance existing products and develop premium high-end products with high added-value so as to assure the Group's all round growth.

Liquid milk

The liquid milk segment continued to be the major revenue contributor of the Group, accounting for 87.8% of revenue. The timely introduction of high added-value products and deployment of successful marketing strategies helped increase liquid milk revenue for the year to RMB14.2609 billion, representing an increase of 53.1% against last year.



UHT milk

Revenue from UHT milk products grew by 46.1% to RMB9.5762 billion when compared with last year, accounting for 67.2% of revenue of the liquid milk segment. In addition to the organic growth of plain milk,

the launch of high added-value products to cater for different customers' needs also led to the strong growth. Favorable results from marketing strategies implemented by the Group have made customers become more aware of their nutritional needs and helped build a solid customer base for the Group's functional milk products, such as *Hi-calcium*, *Low Fat Milk* (高钙低脂奶) as well as *Breakfast Milk* (早餐奶) and *Good Night Milk* (晚上好奶) series.

The Group's ongoing efforts on research and product development were well recognized around the world during the period under review. Its self-developed premium milk product series, *Milk Deluxe* (特侖蘇), won the "2006 IDF Marketing Awards — New Product Development" presented by the International Dairy Federation ("IDF"). The Group is the first PRC dairy enterprise to receive the honor in the 104 years' history of the IDF. Constantly striving to offer highest quality products, the Group also continued to enhance *Milk Deluxe* by fortifying it with osteoblast milk protein ("OMP"), which can facilitate the retention and absorption of calcium by the body for repairing bones and building stronger bones. As OMP function is certified by the Center for Public Nutrition and Development of China, the *Milk Deluxe* series duly enjoys strong consumer confidence and support.

Milk beverages

Revenue from the milk beverages segment increased by 71.9% to RMB3.6412 billion, accounting for 25.5% of liquid milk revenue. In particular, effective targeted marketing efforts helped *Suan Suan Ru* (酸酸乳) generate positive momentum and stable revenue to the milk beverage segment.



Management Discussion and Analysis

During the year, the Group launched the *Future Star* children milk series, products that contain various essential nutrients for promoting children's growth. The new product series reported satisfactory results while the inventive, target-specific marketing programs have laid down a solid foundation that will open the fast-growing children's milk market for the Group. Still more innovative products will be developed by the Group allowing it to lead the consumption trend and tap the tremendous market potential of this segment.

Yogurt

During the period under review, revenue from the yogurt segment increased by 62.8% to RMB1.0435 billion, accounting for 7.3% of liquid milk revenue. Committed to adding value to its products, the Group, in addition to enhancing product varieties and tastes, has adopted probiotics specifically suited for absorption by Chinese consumers. The new product series, *Champion* (冠益乳), is one of the many examples. In cooperation with strategic partner Danone, the Group expects to achieve synergies conducive to product development and technological enhancements, hence allowing for long-term growth in this market segment.



Ice cream

Accounting for 11.2% of the Group's revenue, the ice cream segment generated revenues totaling RMB1.8180 billion, representing an increase of 40.3% over that of last year. During the period under review, being fully aware of the emergence of more defined market segments with specific preferences of different consumer groups, the Group created more secondary brands and adopted state-of-art approaches in addressing flavors, tastes, packaging and image as well as distinctive marketing campaigns to uphold its leading position in the market.

During the year, the Group continued to improve its existing product series, such as *Sui Bian* (隨變) and *Mood for Green* (綠色心情), by enhancing their added-value, thus the competitiveness in the conventional market. On the other hand, the Group also aggressively developed secondary brands to capture demand from the high-end market. *Rachel* (瑞趣), made with premium quality ingredients and elegantly packaged, is a secondary brand targeted at customers with higher purchasing power. Another premium product, *Deluxe* (特侖聖雪), is scheduled for rolling out in 2007. The Group will continue to explore the needs of various customer segments and will enhance the competitive edge of its product mix by introducing more pioneering products.



Other dairy products

Revenue from other dairy products amounted to RMB167.4 million, accounting for 1.0% of the Group's revenue. During the period under review, the Group established a joint venture with Arla Foods of Denmark for the production of solid form dairy products, such as milk powder.

The joint venture has realigned the Group's product mix by shifting emphasis toward high added-value milk powder products. From the joint efforts of Mengniu and Arla Foods, the Group has enhanced its product mix for this segment during the year. A medium-end formula milk powder product targeted at the elderly and women for their special nutritional needs, namely, *Mengniu Arla* (蒙牛阿拉) was launched. Also, *Millex* (美蕾兹), a premium baby milk powder formula was launched at the end of the year. Due to the enhancement of Chinese's living standards, the demand for premium baby formula milk powder has been keen in the PRC. As Mengniu and Arla Foods continue to complement each other on marketing and technological expertise on production and R&D, the Group expects to launch even more dairy products that offer promising growth potential.

Raw Milk Supply

The Group continued to actively correspond with raw milk suppliers, encouraging them to enhance the scale and efficiency of their ranches in order to ensure high quality raw milk supplies. During the period under review, the Group introduced internationally advanced cow breeding technologies and expertise to its operation. With the support of a biotechnology R&D institute set up during the year, the Group has been able to help its suppliers to control the quantity and quality of raw milk, and even achieving more effective yield by applying gender selection techniques and choosing better breeds.

Mengniu-Australia International Ranch ("International Ranch"), a ranch in which the Group owns a stake, provides an ideal model for raw milk suppliers to emulate. Through visits to the modernized rearing and production processes, raw milk suppliers are able to take a closer look at and adopt advanced rearing techniques, exchange experiences and advanced technologies, as well as learning more about the benefits of upgrading their rearing scale.



Management Discussion and Analysis

Production and Operation

In December 2006, the Group operated a total of 19 production bases with a combined annual production capacity reaching 3.93 million tons (2005: 2.78 million tons). The Group has adhered to the principle of effective product quality control. In addition to adopting five major internationally recognized quality assurance systems, during the year, the Group consolidated its product quality control and monitoring systems. Moreover, the Group further refined and unified quality standards to ensure that all production bases adhere to the same precise technology, examination, production formulae and quality control standards.



While optimizing the production process, the Group applied a more precise and sophisticated operation management system, and enforced an innovative operation management mechanism so as to integrate and streamline the Group's resources and monitor the product performance over its entire lifecycle. For realizing the synergies generated from resource integration, all marketing, procurement, logistics and distribution activities implemented by each business segment were collectively organized by the Group. The Group will also timely assessed and monitored the

market performance and efficiency of each product at every stage from development, marketing to mass-scale sales, for which its input and output value is based. In accordance with the assessment results, the Group will be able to identify the direction for improvement and thus, the Group can eliminate products with poor market potential and low efficiency. This, in turn allows a better allocation of resources to a product mix that generates maximum market advantages. As such, operational efficiency and core competitiveness can thus be reinforced.

Ventures and Alliances

2006 saw the Group realize several fruitful ventures and alliances. Powerful partnerships were formed with a number of international enterprises that are leaders in their respective fields. Leveraging on their complementary attributes, the Group's competitiveness has been further strengthened.

In April 2006, the Group announced its corporate alliance with the Hong Kong Disneyland and became the Official Milk Sponsor and supplier for the Theme Park and its two hotels, Disneyland Hotel and Disney Hollywood Hotel. The alliance has enabled foreign visitors to enjoy the premium, healthy dairy products from China — a true testament to the internationally recognized quality of **MENGNIU** products.

In August 2006, Mengniu Arla (Inner Mongolia) Dairy Products Co. Ltd., a joint venture between the Group and the premier European dairy product manufacturer Arla Foods, was established to manufacture and distribute high-end milk powder and other solid milk products. The strong technical expertise and



Management Discussion and Analysis



management experience of Arla Foods has helped boost Mengniu's competitiveness in the solid dairy product sector, and to gain a foothold in the fast growing baby milk powder market.

In December 2006, the Group announced the establishment of joint ventures with Danone, the world's largest yogurt manufacturer (in terms of sales volume), to manufacture, develop and distribute yogurt products, thereby expanding its yogurt business in Greater China. Capitalizing on Danone's and the Group's respective merits and expertise, Mengniu is confident in its ability to elevate its yogurt products business to new heights.

Social Responsibilities

Apart from expanding the business and creating greater value for shareholders, Mengniu has never forgotten to honor its responsibilities and has made every effort to support the communities in which it operates. To aid in the building of China into a healthy nation and to realize the dream of China's Premier, Mr. Wen Jiabao, to have every Chinese, with children as the start, to drink a catty of milk a day, the Group supported the government's slogan of "A catty of milk a day keeps the Chinese people invigorated always" by introducing a one-year milk sponsorship program for 500 schools in impoverished areas of China in June 2006.

Mengniu is delighted to be able to provide our future pillar of the community, especially children living in poverty, with premium dairy products that can enhance their health and help them realize their dreams. Mengniu will continue to honor its responsibilities to the community as a good corporate citizen and contribute to the development of the dairy industry in China in the years to come.

Prospects

The China dairy industry is looking at a future filled with opportunities and challenges. As per capita income rises and consumers become more health conscious, the Group believes that domestic demand for dairy products will deliver a rapid growth. However, the immense potential of the market will also trigger competition for market share among the players, hence the industry will remain highly competitive in the future. Customers' increasingly sophisticated tastes and demand for product function and quality have also triggered the drive for product innovations and quality assurance.



Management Discussion and Analysis

Seeing the opportunities and challenges ahead, Mengniu has devised coherent strategies with the aim of securing its leading position while developing competitive edges at the same time. Measures will be implemented to consolidate the Group's resources and ensure its efficient and effective application. As well, continuous efforts will be made to enhance the product mix in order to penetrate different market segments. Perfecting product quality and increasing productivity will also be among the Group's key objectives.

We understand that the key to success rests on the quality of our products. Accordingly, we have stringent mechanisms and measures in place to ensure that the quality of raw milk supplied, the technical R&D employed and the quality of products are all of the highest standards.



We understand that premium raw milk supply is critical to ensuring the quality of our products and we are committed to provide the best to our valuable customers. As such, our passion for advancement is ongoing, and this is the conviction we share with our over 3,000 raw milk ranches. To aid our raw milk suppliers to expand the scale of their farms and in turn

elevate the yield of dairy cattle as well as the quality of raw milk, we will keep in step with the advanced cattle breeding and gender control assistance. The Group will also continue to use the International Ranch as a lively education facility for sharing its extensive industry experience, which includes promulgating the latest stock raising techniques and efficiency as well as offering assistance on planning and equipment acquisitions. Such measures not only ensure that the stable supply of quality raw milk for the development of premium high-end products, but also effectively improve the living standards of our raw milk suppliers, hence, achieving a win-win situation for all.

We will continuously improve our product development and quality control systems to deliver the Group's promise of only offering the best value to customers. The Group will consolidate and bolster resources for R&D so as to facilitate knowledge and experience sharing among different product segments. This will duly strengthen our technical and R&D capabilities, thus preserving our position as an innovator. By promoting the dairy market's development while at the same time developing products that deliver optimum nutritional value and taste, the Group will also



Management Discussion and Analysis



further raise its competitiveness. Consistent with the Group's drive for excellence, a new R&D center that is equipped with the most advanced technologies will be put into operation in the first half of 2007. The facility will be used for developing the highest quality products that combine premium raw milk with unique product formulae. The Group will also continuously strive to optimize the production technology and process, and to ensure its product quality control system in line with the most advanced international standards.

We are committed to serving our customers, and our efforts to lead and address market development trends fully reflect such commitment. With strong R&D capabilities and good product quality, we have achieved a positive start for delivering value to our customers. However, a thorough understanding of customers' needs and the ability to continuously employ innovative and refine marketing strategies are crucial for the Group's ongoing success. Accordingly, we will fortify its nationwide distribution network by providing better services and support to our distributors as well as promoting two-way communications for obtaining first-hand market information. The timely feedback

from distributors and the results of extensive marketing surveys will help the Group better understand customers' needs and behaviors thereby delivering more unique, segment-focused products and secondary brands. Moreover, the Group will continue to implement innovative, eye-catching marketing programs to draw customers' attention to the outstanding features of the Group's products, as well as raising public awareness of the health benefits of drinking milk.

We understand that our future hinges on having an efficient management and operation system as well as a global management vision, which is why we continue to improve internal management effectiveness and efficiency, while at the same time, focus on business opportunities in the global market keeping abreast of the latest trends.

We strive to achieve operational excellence by encouraging different divisions to realize endeavors through concerted efforts. During the year, we established the foundation for a more precise and sophisticated operation management system. In the days to come, the Group will seek to ensure effective implementation of the new system at all levels. It will further improve work flows and, achieve higher efficiency, while stricter performance assessment systems will be implemented. Operational targets will be clearly defined and communicated to all divisions in order to enhance the accountability of different business units. The Group will extend its improved system to also cover its distributors and retailers so as to ensure effective communications and consistent controls. With a micro-management system to enhance efficiency, the Group is duly prepared for the potential challenges in the market.



Management Discussion and Analysis



We forge international alliances at all levels, bolster relations constantly. To ensure continuous, robust growth of its businesses, the Group will continue to forge strategic alliance with leading international enterprises and institutions thereby generating synergies and mutual benefits in different areas, such as product quality, R&D capabilities, marketing and promotion. In addition, the Group will further enhance its cooperative efforts with current partners, namely, Hong Kong Disneyland, Arla Foods and Danone, by drawing from their strengths and combining forces on different business aspects to promote Mengniu's long-term growth as well as that of the China dairy industry.

Looking forward, the Group will continue to honor its responsibilities to the community by being a good corporate citizen and contributing to charitable activities. It will also seek to advance the development of China's dairy industry.

Human Resources and Remuneration of Employees

As at 31 December 2006, the Group had a total of approximately 29,000 employees (2005: 29,000) in China and Hong Kong. Staff costs, excluding remuneration for the directors, totaled approximately RMB673.9 million for the year (2005: RMB390.3 million).

Committed to continuous enhancement of staff quality, the Group offers structured pre-job and on-the-job training to ensure employees are kept up to date with the latest technologies and industry knowledge. In addition, to ensure adherence to corporate culture and to maintain high staff morale, the Group organized various staff activities to educate them about Mengniu's beliefs and objectives. To reward employees and provide work incentives, the Group offers competitive remuneration packages with performance-based bonuses and a share option plan.

