

The board of directors (the "Directors") has the pleasure in presenting its report together with the audited financial statements of the Company and the Group for the year ended 31 December 2006.

Principal Activities and Analysis of Operations

The principal activity of the Company is investment holding. The principal activities of the main operating subsidiary, Inner Mongolia Mengniu Dairy (Group) Company Limited ("Mengniu"), and its subsidiaries are manufacturing and distribution of dairy products including liquid milk (comprising UHT milk, milk beverages and yogurt), ice cream and other dairy products (such as milk powder) in China, including Hong Kong and Macau.

Particulars of the Company's subsidiaries are set out in Note 15 to the financial statements.

The Group's revenue is derived principally from business activities in China. An analysis of the Group's performance for the year ended 31 December 2006 by business segments is set out in Note 3 to the financial statements.

Results and Appropriations

The results of the Group for the year ended 31 December 2006 are set out in the consolidated income statement on page 52.

The Directors have recommended the payment of a final dividend of RMB0.1094 (2005: RMB0.0686) per share, amounting to approximately RMB149,718,000 (2005: RMB93,873,000) in total, to shareholders whose names appear on the register of members on 22 June 2007.

Property, Plant and Equipment

Details of the movements in the property, plant and equipment of the Group and the Company during the year are set out in Note 11 to the financial statements.

Reserves

Details of the movements in the reserves of the Group and of the Company during the year are set out in the consolidated statement of changes in equity on page 55 and Note 33 to the financial statements. The Company's distributable reserves, calculated in accordance with statutory provisions applicable in the Company's place of incorporation, amounted to approximately RMB1,566,649,000 as at 31 December 2006 (2005: RMB1,516,046,000).

Report of the Directors

Donations

Charitable and other donations made by the Group during the year amounted to approximately RMB2,841,000 (2005: RMB3,085,000).

Share Capital

There was no movements in the share capital of the Company during the year.

Directors

The Directors during the year and up to the date of this report were:

Executive Directors

Mr NIU Gensheng

Ms LU Jun (re-designated on 1 January 2007 as non-executive director)

Mr YANG Wenjun

Mr SUN Yubin

Non-Executive Directors

Mr JIAO Shuge (alias JIAO Zhen)

Ms LU Jun (commencing from 1 January 2007)

Mr LIU Haifeng, David (resigned on 26 January 2006)

Ms JIN Yujuan, Lily (resigned on 7 March 2006)

Mr Julian Juul WOLHARDT (appointed on 26 January 2006)

Independent Non-Executive Directors

Mr WANG Huaibao

Mr ZHANG Julin

Mr LI Jianxin

In accordance with Article 112 of the Company's articles of association, Mr Jiao Shuge (alias Jiao Zhen), Ms Lu Jun and Mr Wang Huaibao, will retire by rotation and, being eligible, offer themselves for re-election at the forthcoming annual general meeting.

The Company considers that Mr Wang Huaibao, Mr Zhang Julin and Mr Li Jianxin are independent pursuant to the criteria set out in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") and that a confirmation of independence has been received from each of them.

Biographical Details of Directors and Senior Management

Brief biographical details of the Directors and the senior management are set out on pages 23 to 27.

Directors' Interests in Contracts

Save as disclosed in the section headed "Connected Transactions" in this report, no contracts of significance in relation to the Group's business to which the Company or any of its subsidiaries was a party and in which a Director had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

Directors' Interests, Long and Short Positions in Shares, Underlying Shares and Debentures

As at 31 December 2006, the interests, long and short positions of the Directors and chief executives of the Company in the shares of the Company and associated corporation as recorded in the register required to be kept under Section 352 of the Securities and Futures Ordinance ("SFO") or as otherwise notified to the Company and the Stock Exchange of Hong Kong Limited (the "Stock Exchange") pursuant to the Model Code for Securities Transactions by Directors of Listed Companies (the "Model Code") were as follows:

Name of Director	Company/Name of Associated Corporation	Nature of Interest	Total Number of Ordinary Shares	Percentage of the Company's Issued Share Capital
Niu Gensheng	The Company	Personal Interest	45,505,172(L)	3.33%
	The Company	Corporate Interest (Note 1)	216,730,130(L)	15.84%
Mengniu	Mengniu	Personal Interest (Note 2)	16,514,220(L)	6.18%
	Mengniu	Personal Interest (Note 3)	7,325,670(S)	2.74%
Lu Jun	Mengniu	Personal Interest	804,646(L)	0.30%
Yang Wenjun	Mengniu	Personal Interest	1,068,646(L)	0.40%
Sun Yubin	Mengniu	Personal Interest	1,772,646(L)	0.66%

Report of the Directors

Directors' Interests, Long and Short Positions in Shares, Underlying Shares and Debentures *(continued)*

Notes:

- (1) These shares are held by Yinniu Milk Industry Limited ("Yinniu"), a substantial shareholder of the Company, and Niu Gensheng, by virtue of the Xie Trust, has been delegated voting rights to the shares in Yinniu held in the Xie Trust. The Xie Trust has been in effect since September 2002 and is a trust declared by Xie Qiuxu in respect of the shares in Yinniu held on trust by him for a selected group of individuals comprising employees and business associates of Mengniu. Xie Qiuxu has similarly delegated the voting rights of his own shares in Yinniu to Niu Gensheng. Together with his personal interest in Yinniu, Niu Gensheng controlled 81.3% of the voting rights of Yinniu as at 31 December 2006.
- (2) During the year, Niu Gensheng donated 2% of his equity interest in Mengniu to an unconnected social organization in China. Details of the donation were disclosed in the Company's announcement dated 7 February 2006.
- (3) Out of his shareholdings in Mengniu, Niu Gensheng granted an option of 7,325,670 shares in total, representing approximately 2.7% of the issued capital of Mengniu, to CDH China Fund. L.P., Actis China Investment Company Limited and MS Dairy Holdings ("Financial Investors") on 23 March 2004. Such options can be exercised in one or more tranches by each Financial Investor and are exercisable within 10 years. As at the date of this report, none of the options have been exercised.

(L) Indicates a long position.

(S) Indicates a short position.

Save as disclosed above, as at 31 December 2006, none of the Directors and the chief executives of the Company had any interests and short positions in the shares, underlying shares and debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO).



Substantial Shareholders' Interests

As at 31 December 2006, the interests or short positions of substantial shareholders, other than the Directors or the chief executives of the Company whose interests, long and short positions in the shares of the Company are set out above, in the shares and underlying shares of the Company in the register maintained under section 336 of the SFO were as follows:

Name of Substantial Shareholder	Number of Ordinary Shares	Percentage of Issued Share Capital
Xie Qiuxu (<i>Note 1</i>)	216,730,130(L)	15.84%
Jinniu Milk Industry Limited ("Jinniu") (<i>Note 2</i>)	152,191,836(L)	11.12%
AllianceBernstein L.P. (formerly known as Alliance Capital Management L.P.)	94,900,000(L)	6.94%

Notes:

- (1) Xie Qiuxu legally owned 59.1% of the issued share capital of Yinniu, which directly owned 15.8% of the issued shares of the Company. Accordingly, the 216,730,130 shares attributable to Xie Qiuxu above represent his indirect effective interest in the Company via his legal shareholding interest in Yinniu.
- (2) 10 founding individuals, namely Niu Gensheng, Deng Jiuqiang, Hou Jiangbin, Sun Yubin, Qiu Lianjun, Yang Wenjun, Pang Kaitai, Lu Jun, Sun Xianhong and Xie Qiuxu, have been acting as a controlling group over the business since its inception in 1999. Therefore, they as a group are controlling shareholders of the Company. As at 31 December 2006, Niu Gensheng, Deng Jiuqiang, Lu Jun, Sun Yubin, Yang Wenjun, Sun Xianhong and Qiu Lianjun who are shareholders of Jinniu together controlled approximately 83.4% of Jinniu. Niu Gensheng, Xie Qiuxu, Pang Kaitai, Hou Jiangbin and Deng Jiuqiang who are shareholders of Yinniu together controlled approximately 87.2% of Yinniu. As at 31 December 2006, Jinniu and Yinniu in aggregate controlled approximately 26.96% of the voting power at the general meeting of the Company.

(L) Indicates a long position

Saved as disclosed above, as at 31 December 2006, no other interests or short position in the shares or underlying shares of the Company were recorded in the register maintained under section 336 of the SFO.



Connected Transactions

Intra-group connected transactions and/or non-exempt connected transactions

Mengniu is a non wholly-owned subsidiary of the Company. As at 1 January 2006, four executive directors of the Company (who are connected persons as defined under the Listing Rules) and another five founding individuals together were entitled to exercise more than 10% of the voting power of Mengniu. As a result, Mengniu was a connected person of the Company as defined under Rule 14A.11(5) of the Listing Rules. Accordingly, each of Mengniu's subsidiaries ("Mengniu Subsidiaries") was also a connected person of the Company pursuant to Rule 14A.11(6) of the Listing Rules. Therefore, all intra group transactions between Mengniu and Mengniu Subsidiaries, which would otherwise be common and in the ordinary course of group operations for any group of companies, constituted continuing connected transactions under the Listing Rules. Owing to the complexities involved in the Group's transaction flow starting from the manufacturing of various products to when they are received by the Group's distributors, the process involves many intra-group transfers (mainly for accounting and administrative purposes), which constitute non-exempt continuing connected transactions ("Non-Exempt Connected Transactions").

Cessation of Mengniu and subsidiaries as connected persons

During the year, Mengniu and Mengniu Subsidiaries have ceased to be the Company's connected persons as a result of Niu Gensheng's donation of part of his equity interest in Mengniu to an unconnected, social organization in China, thereby reducing the collective voting power of the executive directors and the founding individuals to less than 10%. Rule 14A.11(5) of the Listing Rules has accordingly become inapplicable and Mengniu and Mengniu Subsidiaries were no longer connected persons of the Company. Details of Niu Gensheng's donation have been disclosed in the Company's announcement dated 7 February 2006.



Connected Transactions *(continued)*

Summary of the Group's Non-Exempt Connected Transactions

The Group had entered into the following non-exempt continuing connected transactions during the year and prior to Mengniu and Mengniu Subsidiaries ceasing to be connected persons of the Company as mentioned above, and such continuing connected transactions, which amounts exceeded the thresholds for disclosure, are required to be disclosed in accordance with the requirements of the Listing Rules as follows:

Type of transaction	Amount <i>(RMB'000)</i>
1. Centralised UHT milk and milk beverage products sales arrangement by Mengniu for the Group	514,509
2. Sales of UHT milk and milk beverages products by Mengniu to the distributors within the Group for distribution	70,405
3. Centralised yogurt product sales arrangement by Mengniu Dairy (Beijing) Co., Ltd. ("Mengniu Beijing") for the Group	18,856
4. Ongoing inventory adjustment of raw materials and production and packaging material between Mengniu and certain Mengniu Subsidiaries	14,364
5. Provision of guarantees by Mengniu to banking organizations for loans and credit facilities drawn by Mengniu Subsidiaries	395,000

Connected Transactions *(continued)*

Summary of the Group's Non-Exempt Connected Transactions *(continued)*

1. *Centralised UHT milk and milk beverages products sales arrangement by Mengniu for the Group*

The Group has implemented a centralised sales system for its UHT milk and milk beverages products whereby all such products are centralised for sale, billing and invoicing to distributors by Mengniu. Pursuant to this system, those Mengniu Subsidiaries that manufacture UHT milk and milk beverages products sell their UHT milk and milk beverages products to Mengniu and Mengniu then deals with the distributors centrally. These sales do not involve physical delivery to Mengniu as these transactions are merely the Group's operational mechanism to centralise administration. Each of the Mengniu Subsidiaries will execute physical delivery on Mengniu's instructions. The companies in the Group which take part in this arrangement include Mengniu and Mengniu Subsidiaries that produce UHT milk and milk beverages products, including Mengniu Beijing, Inner Mongolia Mengniu Dairy Baotou Co., Ltd. ("Mengniu Baotou"), Inner Mongolia Mengniu Dairy Keerqin Co., Ltd. ("Mengniu Keerqin"), Mengniu Dairy (Wulanhaote) Co., Ltd. ("Mengniu Wulanhaote"), Inner Mongolia Mengniu Dairy (Group) Shanxi Dairy Co., Ltd. ("Mengniu Shanxi"), Mengniu Dairy Taian Co., Ltd. ("Mengniu Taian"), Mengniu Dairy (Jiaozuo) Co., Ltd. ("Mengniu Jiaozuo"), Mengniu Dairy (Shenyang) Co., Ltd. ("Mengniu Shenyang"), Mengniu Dairy (Dengkou Bayan Gaole) Co., Ltd. ("Mengniu Dengkou"), Mengniu Dairy (Tangshan) Co., Ltd. ("Mengniu Tangshan"), Mengniu Dairy (Luannan) Co., Ltd. ("Mengniu Luannan") and Mengniu Dairy (Maanshan) Co., Ltd. ("Mengniu Maanshan"), each of the above companies is a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company. Mengniu and relevant subsidiaries, except Mengniu Maanshan, have entered into a centralised sales agreement dated 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006. Mengniu and Mengniu Maanshan have entered into a centralised sales agreement dated 18 May 2005 for an initial period of three years.

2. *Sales of UHT milk and milk beverages products by Mengniu to the distributor within the Group for distribution*

As described above, Mengniu is responsible for dealing and liaising with the distributors of UHT milk and milk beverages products, which include Beijing Mengniu Hongda Dairy Product Co. Ltd. ("Mengniu Hongda") (a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company). Mengniu sells its UHT milk and milk beverages products to the distributor for further distribution. Delivery is usually handled by the relevant Mengniu Subsidiaries which manufacture the UHT milk and milk beverages products. Mengniu and Mengniu Hongda have on 13 May 2004 entered into a distribution agreement for the Beijing area for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

Connected Transactions *(continued)*

Summary of the Group's Non-Exempt Connected Transactions *(continued)*

3. *Centralised yogurt product sales arrangement by Mengniu Beijing for the Group*

The Group has implemented a centralised sales system for its yogurt products whereby all its yogurt products are centralised for sale and distribution to distributors by Mengniu Beijing. Pursuant to this system Mengniu and those Mengniu Subsidiaries which manufacture yogurt products sell their yogurt products to Mengniu Beijing who will, in turn, sell and invoice to distributors. These sales do not involve delivery to Mengniu Beijing as these transactions are operational transactions for the centralised sales system. All subsidiaries which produce yogurt products take part in this arrangement.

Mengniu, Mengniu Beijing, Mengniu Taian, Mengniu Jiaozuo, Mengniu Shenyang, Mengniu Luannan and Mengniu Tangshan have entered into a centralised sales agreement on 13 May 2004 for an initial period for three years commencing 1 January 2004 ending 31 December 2006. Mengniu Beijing and Mengniu Maanshan have entered into a centralised sales agreement dated 18 May 2005 for an initial period of three years.

4. *Ongoing inventory adjustment of raw materials and production and packaging materials between Mengniu and Mengniu Subsidiaries*

As an inventory adjustment mechanism, members of its Group transfer any excess raw materials (including, inter alia, sugar, oil etc.) and packaging materials to other members whenever shortages arise. Mengniu and all Mengniu Subsidiaries take part in this arrangement. This inventory adjustment mechanism is beneficial for all parties involved as it minimises wastage, and efficiently uses resources permitting companies to meet their respective market's fluctuating demand.

Mengniu and all Mengniu Subsidiaries (except for Inner Mongolia Mengniu Founding Industry Management Co., Ltd. ("Mengniu Founding"), a company incorporated in the PRC and an indirect non-wholly owned subsidiary of the Company), have each entered into an inventory adjustment agreement on 13 May 2004 for an initial period of three years commencing 1 January 2004 ending 31 December 2006.

5. *Provision of guarantees by Mengniu to banking organisations for loans and credit facilities drawn by certain Mengniu Subsidiaries (provision of financial assistance to a connected person of the Company)*

For the benefit of the Group as a whole, Mengniu, as the main operating subsidiary, provides guarantees to Mengniu Subsidiaries at nil consideration. These loans are required for the expansion of the Group, and out of necessity, Mengniu is required by the relevant banks to act as guarantor for its subsidiaries. From Mengniu Subsidiaries' perspective, this continuing connected transaction represents financial assistance provided by Mengniu to the benefit of the Mengniu Subsidiaries, which are connected persons of the Company.

Report of the Directors

Connected Transactions *(continued)*

Summary of the Group's Non-Exempt Connected Transactions *(continued)*

The Directors (including the independent non-executive Directors) are of the opinion that the connected transactions had been entered into and were carried out in the ordinary and usual course of business of the members of the Group and on normal commercial terms which are fair and reasonable so far as the interests of the shareholders of the Company are concerned, and the aggregate amount of the connected transactions did not exceed the caps set out in the prospectus dated 1 June 2004 or in the announcements dated 25 November 2004 and 18 May 2005.

The Company has received from the auditors a letter reporting, on a sample test basis, that the connected transactions (i) have been approved by the board of directors of the Company, (ii) were entered into in accordance with the pricing policies of the Company; (iii) have been entered into in accordance with the relevant agreements governing the transactions; and (iv) have not exceeded the relevant caps as set out in the prospectus dated 1 June 2004 or in the announcements dated 25 November 2004 and 18 May 2005.

Saved as disclosed above, there were no other transactions which need to be disclosed as connected transactions in accordance with the requirements of the Listing Rules.

Share Option Scheme

The Company has adopted a share option scheme to provide incentives to the employees of the Group. As at 31 December 2006, 6,803,000 options to apply for ordinary shares of the Company have been granted, each at an exercise price of HK\$13.4. The exercise period of the share options granted commences after a certain vesting period and the fulfilment of certain performance targets, and ends on a date which is not later than six years from the date of grant of such options. None of such share options granted have been exercised so far. Further details of the share option scheme are set out in Note 35 to the financial statements.

Pre-emptive Rights

There is no provision for pre-emptive rights under the Company's articles of association or the laws of the Cayman Islands which would oblige the Company to offer new shares on a pro rata basis to its existing shareholders.

Purchase, Sale or Redemption of the Company's Listed Shares

During the year, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.



Public Float

As at the date of this report, the Company has maintained the prescribed public float under the Listing Rules, based on the information that is publicly available to the Company and within the knowledge of the Directors.

Management Contracts

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

Major Customers and Suppliers

The percentage of purchases attributable to the five largest suppliers of the Group combined was less than 30% of the total purchases of the Group.

The percentage of revenue attributable to the five largest customers of the Group combined was less than 30% of the total revenue of the Group.

Pledge of Assets

As at 31 December 2006, the Group pledged certain bank deposits, bills receivable and certain property, plant and equipment aggregating to approximately RMB774,400,000 (2005: RMB601,930,000). Details are set out in respective notes to the financial statements.

Contingent Liabilities and Commitments

Details of contingent liabilities and commitments are set out in Notes 37 and 36 to the financial statements.

Subsequent Events

Details of subsequent events are set out in Note 41 to the financial statements.

Financial Summary

A summary of the results for the year and of the assets and liabilities of the Group as at 31 December 2006 and for the previous four financial periods are set out on page 128.

Report of the Directors

Corporate Governance

The Company's corporate governance principles and practices are set out in the Corporate Governance Report on pages 28 to 36.

Auditors

The financial statements have been audited by Ernst & Young. A resolution for the re-appointment of Ernst & Young as auditors of the Company will be proposed at the forthcoming annual general meeting.

By order of the Board of Directors

Niu Gensheng

Chief Executive Officer

Hong Kong, 12 April 2007

