HUAZHANG TECHNOLOGY HOLDING LIMITED

華章科技控股有限公司

(incorporated in the Cayman Islands with limited liability)
(**Stock Code: 1673**)

SUPPLEMENTAL ANNOUNCEMENT TO THE ANNUAL REPORT FOR THE YEAR ENDED 30 JUNE 2019

References are made to the annual report of Huazhang Technology Holding Limited (the "**Company**", together with its subsidiaries, the "**Group**") dated 25 September 2019 (the "**Annual Report**") and the circular of the Company dated 10 October 2017 (the "**Circular**") in relation to the acquisition of 100.0% of the entire issued share capital of Fu An 777 Logistics Limited (the "**Target**", together with its subsidiaries, the "**Target Group**") and the shareholders loans due from the 777 Logistics Group (the "**Acquisition**"). Capitalised terms used herein shall have the same meanings as those defined in the Annual Report unless otherwise specified.

In addition to the information provided in the Annual Report, the Board wishes to provide further information in relation to the Acquisition and the impairment loss on goodwill amounting to approximately RMB108.2 million for the year ended 30 June 2019 (the "**Impairment**").

THE ACQUISITION OF 777 LOGISTIC GROUP

The Company entered into the sales and purchase agreement with Swift Fortune Holdings Limited and 777 Logistics Warehouse Holdings Limited (together referred to the "**Vendors**") on 23 May 2017 pursuant to the Company agreed to acquire the entire issued share capital of the Target at an aggregate consideration of HK$205,140,000, which was settled in full by the Company's issuance of 80,447,059 shares upon the completion of the Acquisition at a pre-determined price of HK$2.55 per Share for consideration shares (the "**Consideration Price**"). The acquisition was completed on 15 November 2017 (the "**Completion Date**"). This transaction constituted a major transaction of the Company.

At the Completion Date, the Target Group has not commenced its business and was constructing a logistics and warehouse centre which was to be the Target Group's main assets and was planned to be utilised to provide logistics services of raw materials, equipment and supplies for papermaking enterprises and raw materials suppliers for papermaking enterprises in the southern part of PRC.

Prior to the completion of the Acquisition, the Board performed various due diligence work and believes it made an informed decision on the Acquisition. The due diligence work performed prior to the Acquisition included, but not limited to:

(i) meeting between the Company's chairman and chief executive officer and the governmental officials from Yangjiang Hitech Development Zone (陽江高新技術產業開發區) and Yangjiang City Government in April and May 2017 to discuss the relevant local development plans and policies that the government entities were considering to implement at that time, in particularly on the development of the local logistic infrastructure;
(ii) requested and reviewed the feasibility study of the logistic business in Yangjiang City provided by the Vendors;
(iii) engaged Colliers International (Hong Kong) Ltd. to produce a valuation report on the Acquisition;
(iv) reviewed the audit report of the Target Group prepared by Ernst & Young; and
(v) conducted own researches on the economic and industrial development of Yangjiang City.

Considering the market condition of the paper industry in Guangdong Province of the PRC at the Completion Date and the satisfactory results of the due diligence works, the Board was of the view that having a logistic and warehouse centre in the Guangdong Province would support and complement the Group's one-stop project contracting services to the papermaking enterprises in the Guangdong Province by providing logistic and storage services for the raw materials imported for the papermaking enterprises. As a result, the Directors considered that the Acquisition was in the interests of the Company and the Shareholders as a whole and was for the benefits of the Shareholders.

CHANGE OF BUSINESS OPERATIONS OF THE TARGET GROUP

The construction of logistics and warehouse center was completed in June 2018, and the Target started to operate the planned logistics services. In December 2018, the Company evaluated the Target's performance in the six months since the inception of its operation, and believed the Target had significantly underperformed compared with the Company's expectation during the Acquisition. The Company believes the underperformance was due to a combination of a number of factors, including but not limited to:

- delay in development of infrastructure by the local government of Yangjiang City, Guangdong Province where the logistics and warehouse center was located, which was initially expected to significantly benefit the local logistics industry;

- uncertainties due to the Sino-US trade war and general slowdown of the economy of the PRC which may put a general downward pressure on profit forecast; and
- a slowdown in the paper industry in the second half of 2018 following a significant growth period in 2017 which may affect the profit forecast of the cash generating unit (the "**CGU**").

In particular, a significant portion of the originally planned logistic business of the Target Group was the import and trading of pulp, a key ingredient of papermaking, through the warehouse being constructed by the Target Group in Yangjiang. To conduct such business, the Target Group needs to transfer pulps to and from the warehouse in large quantity on a regularly basis. Yangjiang Port (陽江港) at the time of Acquisition was not able to handle the transfer in its planned quantity and frequency, as a result, the logistic business of the Target Group depended on the timely completion of the renovation project of Yangjiang Port (陽江港), which will turn the port into a deep-water high-capacity port. In October 2018, the renovation project of the Yangjiang Port(陽江港) was suspended and the Company was informed that the local logistic infrastructure development would not proceed as planned and there is no clear indication when the renovation project will resume, if at all. Consequently, the Company decided to reassess the situation and the operations of the Target Group in light of the change of circumstances.

The above factors were not reasonably foreseeable by the Company at the time of the Acquisition and will not likely to improve in the foreseeable future. As such, in December 2018 the Company decided to shift the main business operations of the Target from logistic services to one-stop supply chain services to selected customers. For the supply chain business, the Group entered an agency service agreement with a selected customer pursuant to which the Company will provide the selected customer the following services: (i) purchase of raw materials and spare parts from suppliers on behalf of the customer, where the Company will make payment on behalf of the selected customer and the raw materials and spare parts purchased will be delivered by the suppliers to the selected customer directly and (ii) sales of the products produced by the selected customer to their customers. The Group will charge the selected customer (i) service fees that equal to 5% of the purchase amounts with a credit period of 90 days and (ii) an interest at 14.6% per annum for the outstanding balance of the purchase of raw materials, the payable to the selected customers is settled by proceeds received from sales of the products.

The Board considered that the supply chain business is a value-added service to the papermaking and trading business, which is a part of the ordinary business of the Group. In order to implement the shift of the operational focus of the Target Group, the Company performed the following due diligence works:

- planned the procedural details of the supply chain business;
- feasibility studies of the supply chain business;
- visited certain companies that provide similar services; and
- marketing the supply chain business to potential customers, most of which are existing customers of the Group.

As part of the feasibility studies of the Supply Chain Business, the Directors assessed the associated risks set out below:

- the business success of the Target Group depends on its ability to recruit and retain members of senior management, and their willingness and capability to adapt to the new business model;
- the business and prospects of the Target Group could be materially and adversely affected if it is not able to conduct its business successfully; and
- changes in relevant governmental regulations and policies.

The Directors were satisfied with the results of the above due diligence works and considered the above risks are manageable in the foreseeable future at the time of assessment.

As the Company's management has solid experience in the papermaking industry in the PRC and the Company has well-developed networks and business relationship with enterprises in the papermaking industry, also the supply chain business is a value-added service to the papermaking business, the Group can readily apply its expertise in the papermaking industry and leverage its existing networks in the papermaking industry to quickly identify and procure customers.

In addition, there were no significant costs incurred by the Company for such change, as the change involved mainly the discontinuity of the operations of the import and trading of pulp. The Group shifted the Target Group's focus to the supply chain business and leveraged the industry know-how it accumulated and its existing customer base to ramp up the operations. The Directors believe the change to the supply chain business for the Target Group was in the best interest of the Company and its shareholders as a whole because:

- at the time the decision was made, it was amply clear that the logistic business the Target Group was conducting had been significantly underperforming due to unforeseeable changes of circumstances, and it was imperative to make timely changes in business strategies to prevent further loss of shareholder value;
- the supply chain business was not a completely new business operation model as it involves the trading of raw materials and products on behalf of customers and trading is part of the logistic business of which the Group has significant experience and industrial know-how; and
- although the one-stop supply chain business combining trading and financing services is a relatively new model in papermaking industry, similar services are already offered to customers in many other industries.

IMPAIRMENT ASSESSMENTS

In connection with the change of business operations of the Target Group, for the year ended 30 June 2019, the Group made a one-off impairment provision for the goodwill, which was generated from the Acquisition, amounting to RMB108.2 million.

In determining the value-in-use of the CGU of the logistic and warehouse business, the Directors applied the generally accepted business enterprise appraisal approach, namely the income approach, which estimated future cash flows expected to be derived from the CGU, discounted to its present value that reflected the current market assessments of the time value of money and the risks specific to the CGU and taken into consideration of the financial forecasts approved by the Directors. The valuation approach has been consistently applied as at 30 June 2018 and 2019, and the difference in results was mainly due to the respective financial forecasts periods covered, which was in turn a result of the change of business operations of the Target.

For impairment assessments at 30 June 2018, the value-in-use of the CGU were determined based on a value in use calculation using cash flow projections based on financial forecasts period of 40 years. The Directors considered that the cash flow projection period of 40 years to be reasonable after considering land use right period of the warehouse is 50 years, which is an indication of the expected operational period of the Target Group.

The pre-tax discount rate applied to the cash flow projections was 14% and cash flows beyond the 40-year period were extrapolated using a growth rate of 3% which was less than the long-term average growth rate of logistics and warehousing services industry.

For the year ended 30 June 2019, the calculation uses a cash flow projection based on financial forecasts period of 5 years. After due analysis the Directors believe the 5-year period is reasonable given that:

- one-stop supply chain services to selected customer is a relatively new business model and there are not yet abundant market data available;
- the Target has not engaged in one-stop supply chain services before; and
- giving the business model's focus on individual customers, the customer base of this new business model is difficult to predict on a long-term basis.

Cash flows beyond the 5-year period have been extrapolated using a 3% long-term growth rate. There is a material change in financial forecasts period from a 40 year-period in 2018 to a 5-year period in 2019. The forecasts prepared by the senior management in 2018 were based on the trading business (such as raw materials and spares parts for the paper manufacturers), which is a traditional business, the senior management referenced to the land use right period of 50 years. As the forecasts prepared by the senior management in 2019 were based on provision for the supply chain services, which is a new business model, the senior management considered the cash flow projection periods of 5 years is reasonable.

The goodwill allocated to the CGU under the business segment of supporting services for impairment test. The following table sets out the key assumptions for the CGUs that have significant goodwill allocated to them:

	30 June 2018	30 June 2019
Annual growth rate of sales revenue	15%-33%	8%-94%
Budgeted gross margin	8%	51%-85%
Long term growth rate	3%	3%
Pre-tax discount rate	14%	16%

Set out below is an analysis of the changes in key parameters and assumptions adopted for impairment test of logistic and warehouse business CGU as at 30 June 2019:

1. Annual growth rate of sales revenue/estimated gross margin

   The logistic and warehouse business started from 1 June 2018, the management of logistic and warehouse business (the "**Logistic Management**") determined the estimated sales based on the anticipated market development and demands from the customers as at 30 July 2018. In January 2019, the Logistic Management revisited the estimated sales at 1 June 2018 and the actual sales amount after the 7 months of the operations, and the Logistic Management proposed to shift the main business operations of the Target from logistic services to one-stop supply chain services to selected customers. Such services include the procurement of raw materials for the customers and the provision of financing for the purchase of the raw materials. For the year ended 30 June 2019, the CGU generated an income of approximately RMB13.1 million from the leasing of the warehouse and the supply service to a customer.

   The proposed shift in business model results in changes in both the annual growth rate of sales revenue and the estimated gross margin. The annual growth rate of sales revenue was changed from 15%-33% as at 30 June 2018 to 8%-94% as at 30 June 2019 primarily as a result of the change of the assumption of revenue from the trading volume basis to the individual customer basis. The estimated gross profit margin was also changed from 8% for 30 June 2018 to 51%-85% for 30 June 2019 as the expected gross profit margin of provision for supply chain service is higher than that of the trading business.

2. Long-term growth rate and pre-tax discount rate

   The long-term growth rate was referenced to the long-term inflation rate of the markets in the PRC. We use the pre-tax cash flows and pre-tax discount rate to calculate a pre-tax value in use, which is the same amount to a post-tax value in use calculated by post-tax cash flows and the post-tax discount rate. Post-tax discount rate is determined based on the weighted average cost of capital ("**WACC**"). WACC represents investors' expectations and for any given investment is a combination of three basic factors, namely the risk-free rate, the expected return and a premium for risk. The pre-tax discount rate for 30 June 2018 and 2019 were at 14% and 16%, respectively. Both long-term growth rate and pre-tax discount rate are unaffected by the shift of business operations.

The above additional information does not affect the financial information (including consolidated statement of profit or loss and other comprehensive income and consolidated statement of financial position) and other information contained in the Annual Report. Save as disclosed in this announcement, the remaining contents of the Annual Report remain unchanged.

By order of the Board
Huazhang Technology Holding Limited
ZHU GEN RONG
Chairman

Hong Kong, 8 December 2019

As at the date of this announcement, the executive directors are Mr. Zhu Gen Rong, Mr. Wang Ai Yan, Mr. Liu Chuan Jiang and Mr. Jin Hao, and the independent non-executive directors are Mr. Dai Tian Zhu, Mr. Kong Chi Mo and Mr. Heng, Keith Kai Neng.