

ALTUS CAPITAL LIMITED

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10 February 2022

To the Independent Board Committee and the Independent Shareholders

Lanzhou Zhuangyuan Pasture Co., Ltd.
26th Floor, Block B
Shanghai Building of Gansu Province
No. 601, Yanyuan Road
Chengguan District
Lanzhou City, Gansu Province
PRC

Dear Sirs,

CONTINUING CONNECTED TRANSACTIONS

INTRODUCTION

We refer to our appointment as the Independent Financial Adviser to advise the Independent Board Committee and the Independent Shareholders on the terms of and the proposed annual cap in relation to the continuing connected transactions under the Raw Milk Purchase Agreement. Details of which are set out in the “Letter from the Board” contained in the circular of the Company dated 10 February 2022 (the “**Circular**”). Terms used in this letter shall have the same meanings as those defined in the Circular unless the context requires otherwise.

As the Company and/or its subsidiaries expects to continue purchasing raw milk from certain connected persons and related parties of the Company, the Company has entered into the Raw Milk Purchase Agreement with Tianmu Dairy, respectively, on 18 January 2022, the continuing connected transactions contemplated thereunder for a term from 18 January 2022 to 31 December 2022, respectively.

LISTING RULES IMPLICATIONS

As at the date of this circular, Guansu Nongken Asset is interested 37,931,665 A Shares, representing approximately 19.2% of the total A Shares and 16.3% of (i) the total issued A Shares; and (ii) the total issued A Shares and H Shares, respectively. Tianmu Dairy is a fellow subsidiary of the holding company of Gansu Nongken Asset. Accordingly, Tianmu Dairy is an associate of a connected person of the Company under Chapter 14A of the Listing Rules. The transactions contemplated under the Raw Milk Purchase Agreement constitute continuing connected transactions of the Company under Chapter 14A of the Listing Rules.

As one or more of the applicable percentage ratios in respect of the annual cap under the Raw Milk Purchase Agreement exceeds 5%, the continuing connected transactions contemplated under the Raw Milk Purchase Agreement constitute non-exempt continuing connected transactions and are subject to the reporting, announcement, circular, annual review, annual cap, Independent Shareholders' approval and other requirements under Chapter 14A of the Listing Rules.

THE INDEPENDENT BOARD COMMITTEE

The Independent Board Committee comprising all the independent non-executive Directors, namely Mr. Wang Haipeng, Mr. Zhang Yubao, Mr. Sun Jian, has been established to advise the Independent Shareholders on (i) whether the terms of the continuing connected transactions under the Raw Milk Purchase Agreement are conducted on normal commercial terms and are fair and reasonable; (ii) whether the continuing connected transactions under the Raw Milk Purchase Agreement are in the interests of the Company and the Shareholders as a whole and are conducted in the ordinary and usual course of business of the Group; and (iii) how the Independent Shareholders should vote in respect of the resolutions to approve the continuing connected transactions under the Raw Milk Purchase Agreement at the EGM, taking into account the recommendation of the Independent Financial Adviser.

THE INDEPENDENT FINANCIAL ADVISER

As the Independent Financial Adviser to the Independent Board Committee and the Independent Shareholders, our role is to give an independent opinion to the Independent Board Committee and the Independent Shareholders on (i) whether the terms of the continuing connected transactions under the Raw Milk Purchase Agreement are conducted on normal commercial terms and are fair and reasonable; (ii) whether the continuing connected transactions under the Raw Milk Purchase Agreement are in the interests of the Company and the Shareholders as a whole and are conducted in the ordinary and usual course of business of the Group; and (iii) how the Independent Shareholders should vote in respect of the relevant resolutions to approve the Raw Milk Purchase Agreement at the EGM.

We have not acted as independent financial adviser in relation to any transactions of the Company in the last two years prior to the date of the Circular. Pursuant to Rule 13.84 of the Listing Rules, and given that remuneration for our engagement to opine on the continuing connected transactions under the Raw Milk Purchase Agreement is at market level and not conditional upon successful passing of the resolution to be proposed at the EGM, and that our engagement is on normal commercial terms, we are independent of and not associated with the Company, its controlling shareholder(s) or connected person(s).

BASIS OF OUR ADVICE

In formulating our opinion, we have reviewed, amongst others, (i) the Raw Milk Purchase Agreement; (ii) the annual report of the Company for the year ended 31 December 2020 (the “**2020 Annual Report**”); (iii) the interim report of the Company for the six months ended 30 June 2021 (the “**2021 Interim Report**”); (iv) master purchase agreement entered into between the Group and Tianmu Dairy dated on the 10 February 2021 for the year ended 31 December 2021 (the “**2021 Master Purchase Agreement**”); (v) full list of transactions under the Master Purchase Agreement; (vi) sample invoices under the Master Purchase Agreement for the relevant periods; and (vii) other information set out in the Circular.

We have also relied on the statements, information, opinions and representations contained or referred to in the Circular and/or provided to us by the Company, the Directors and the management of the Group (the “**Management**”). We have assumed that all the statements, information, opinions and representations for matters relating to the Group contained or referred to in the Circular and/or provided to us by the Company, the Directors and the Management were reasonably made after due and careful enquiry and were true, accurate and complete at the time they were made and continued to be so as at the date of the Circular.

We have no reason to believe that any of such statements, information, opinions or representations are untrue, inaccurate or misleading, nor are we aware of any material facts the omission of which would render them untrue, inaccurate or misleading.

We consider that we have been provided with, and have reviewed, sufficient information to reach an informed view and provide a reasonable basis for our opinion. We have not, however, conducted an independent investigation into the business, financial conditions and affairs or future prospects of the Group.

PRINCIPAL FACTORS AND REASONS CONSIDERED

1. BACKGROUND INFORMATION

1.1 Principal business of the Group

The Group is one of the leading dairy companies in Gansu Province and Qinghai Province in the PRC where its operations and sales are primarily located. It operates on a vertically integrated business model which covers critical links of the dairy industry value chain, from dairy farming, to manufacturing, and marketing and sales of dairy products. Its dairy farming operations help ensure stable supply of high quality raw milk for its dairy product manufacturing.

1.2 Principal business of Tianmu Dairy

Tianmu Dairy is a fellow subsidiary of Gansu Nongken Asset, a substantial Shareholder, and is principally engaged in the processing and sales of dairy products, meat products and beverages. The Group has started to procure raw milk from Tianmu Dairy since September 2020. For the year ended 31 December 2021, the Group has purchased a total of approximately RMB133.6 million from Tianmu Dairy.

1.3 Financial performance of the Group

Set out below is a summary of (i) the audited consolidated financial information of the Group for the financial years ended 31 December (“FY”) 2019 and 2020 respectively, which has been extracted from the 2020 Annual Report; and (ii) the unaudited consolidated financial information of the Company for the six months ended 30 June (“1H”) 2020 and 2021 respectively, which has been extracted from the 2021 Interim Report.

	FY2020	FY2019	1H2021	1H2020
	<i>RMB'000</i>	<i>RMB'000</i>	<i>RMB'000</i>	<i>RMB'000</i>
	<i>(audited)</i>	<i>(audited)</i>	<i>(unaudited)</i>	<i>(unaudited)</i>
Revenue	739,821	813,554	480,820	324,987
Gross profit	206,877	253,899	149,560	93,634
Profit for the year/period attributable to equity shareholders of Company	10,453	51,321	22,854	(1,975)

Revenue

The Group’s revenue decreased by 9.1% from RMB813.6 million in FY2019 to RMB739.8 million in FY2020. Such decline was mainly due to the adverse impact of COVID-19 pandemic during 1H2020.

In 1H2021, operations were smooth and market demand for dairy products had fully recovered. From a low revenue base in 1H2020 for reasons of the COVID-19 pandemic, revenue in 1H2021 increased by 47.9% to RMB480.8 million from RMB325.0 million in 1H2020.

Gross profit

Gross profit decreased to RMB206.9 million in FY2020 from RMB253.9 million in FY2019 in line with the lower revenue, as well as lower gross profit margin which was affected by lower average selling price during the outbreak of COVID-19 pandemic in early 2020.

Gross profit improved by 59.8% from RMB93.6 million in 1H2020 to RMB149.6 million in 1H2021 due to higher revenue as well as gross profit margin. As described above, during the COVID-19 outbreak in 1H2020, selling prices were lower and in addition, the Group had to implement marketing policies to promote sales as products were slow moving. Consequently, gross profit margin was also lower.

Profit for the year/period attributable to equity shareholders of Company

In line with the reduction in gross profit, profit attributable to equity shareholders decreased by 79.5% from RMB51.3 million in FY2019 to RMB10.5 million in FY2020.

Due to the significant improvement in gross profit during 1H2021, the Group recorded profit attributable to equity shareholders of RMB22.9 million compared to a loss in 1H2020.

1.4 The Group's stated plan and strategy

We note from the 2020 Annual Report, for its future long-term planning and sustainable development, the Group had planned for the “reconstruction and expansion project with daily processing 600 ton of liquid milk” in 2018 and this project had been completed during FY2020, significantly increasing its production capacity.

It is also the Group's stated strategy to maintain approximately 60.0% of its raw milk requirement that could be sourced internally in the near future, which will enable it to achieve balanced, complementary yet diverse sources of raw milk supply for its dairy product manufacturing needs.

2. THE GROUP'S RATIONALE FOR THE CONTINUING CONNECTED TRANSACTIONS

The Group principally operates two business segments: (i) dairy farming business, under which the Group operates farms and produces raw milk; and (ii) dairy products business, under which the Group produces and sells dairy products. Raw milk is a major source of raw materials in the production of dairy products. The Group sources raw milk primarily from its self-operated farms and external suppliers.

According to the 2020 Annual Report, Chinese consumers have increasingly realised the benefits of dairy products. With the rising per capita disposable income and increasing regional nominal GDP of Gansu, Qinghai and Shaanxi Provinces, as well as consumers' rising health awareness, the consumption and the market share of pasteurised milk among liquid milk in China are expected to increase in the future.

As disclosed in the Letter from the Board, following completion of the expansion project in May 2020, the production capacity of the Group's milk products has increased and the demand for raw milk, as a raw material, has increased accordingly. We note that such expansion is part of the Group's stated long-term plan which it has been implementing since 2018 as described in the section above.

According to the Management, in light of the expansion, the Group's main source of raw milk from its self-operated farms has not provided sufficient supply. We note that this is consistent with its stated strategy of “maintaining approximately 60.0% of its raw milk requirement that could be sourced internally in the near future, which will enable it to achieve balanced, complementary yet diverse sources of raw milk supply for its dairy product manufacturing needs”.

To this end, the Management informed that Gansu Nongken Asset, being a substantial Shareholder, has accorded priority to fulfil the demand for raw milk from the Group through Tianmu Dairy. As disclosed in the Letter from the Board, Tianmu Dairy is a fellow subsidiary of Gansu Nongken Asset, and is principally engaged in the processing and sales of dairy products, meat products and beverages. According to the Management, the raw milk purchased from Tianmu Dairy has been of high quality. The Group had not encountered any material issues when dealing with Tianmu Dairy in the past.

Based on the above, we concur with the Directors that the entering into of the Raw Milk Purchase Agreement will allow the Group to secure a stable source of quality raw milk from a reliable supply who has accorded the Group priority. It is also in line with the aforesaid stated strategy of the Group where the Group will be sourcing raw milk externally in light of the increase in production capacity brought about by the recent expansion.

3. PRINCIPAL TERMS OF THE RAW MILK PURCHASE AGREEMENT

Raw Milk Purchase Agreement

Pursuant to the Raw Milk Purchase Agreement, the Group shall purchase raw milk from Tianmu Dairy. The term of the Raw Milk Purchase Agreement is from 18 January 2022 to 31 December 2022 (both dates inclusive). We note that this approximate one-year period is shorter than the period of three financial years allowed for continuing connected transactions under the Listing Rules. This means the Raw Milk Purchase Agreement will be reviewed more frequently. Previously, the Group had entered into the 2021 Master Purchase Agreement with Tianmu Dairy under which the Group purchased raw milk from Tianmu Dairy during the period from 10 February 2021 to 31 December 2021. The Raw Milk Purchase Agreement is a general continuation of such purchase arrangement.

The Group regularly purchases raw milk from a number of suppliers. We have reviewed the Raw Milk Purchase Agreement and noted that the transactions contemplated thereunder shall be conducted on normal commercial terms and on terms no less favourable to the Group than those offered to the Group by other Independent Third Party suppliers of same or similar products. We also noted that the Raw Milk Purchase Agreement does not restrict the Group from conducting similar transactions with any other suppliers.

Based on the above, we are of the view that the entering into of the Raw Milk Purchase Agreement is in the ordinary course of business. For details of other terms of the Raw Milk Purchase Agreement, please refer to the “Letter from the Board” in the Circular.

4. PRICING POLICY

Pursuant to the Raw Milk Purchase Agreement, the price of raw milk shall be based on the prevailing market price determined by (i) comparing the price obtained from at least three Independent Third Party suppliers of same or similar products during the same period; and (ii) regularly conducting market review on the market price of long term raw milk supply charged by other industry participants in Gansu province and Ningxia region taking into account the supply of raw milk in the industry. In any event, the price shall not be less favourable than those offered to the Group by the Independent Third Party suppliers of same or similar products.

We noted the above pricing policy is the same as those previously under the 2021 Master Purchase Agreement and the Group has already established internal control procedures to monitor the implementation of pricing mechanism of the transactions contemplated under the Raw Milk Purchase Agreement including, amongst others, (i) making reference to relevant market information; and (ii) comparing quotations from Independent Third Party suppliers.

To review the Group's practices and procedures, we have obtained the full list of transactions under the 2021 Master Purchase Agreement which according to the Management was entered into to fix the purchase price of raw milk to avoid market fluctuations during the year ended 31 December 2021. Based on the transaction list, we randomly selected eight transactions conducted under the Master Purchase Agreement and have obtained and reviewed their respective transaction invoices. To compare the reasonableness of this purchase price, we also obtained a full list of Third Party Independent suppliers from whom the Group purchased raw milk for the year ended 31 December 2021. Based on this list, we have randomly selected three Independent Third Party suppliers, obtained and reviewed their respective purchase contracts entered into with the Group. The review shows that the purchase price under the 2021 Master Purchase Agreement had been lower than those contracted with Independent Third Party suppliers.

Under the payment terms of the Raw Milk Purchase Agreement, the final purchase amount for each month shall be calculated on or before the 15th day of the following months and Tianmu Dairy shall issue the invoice containing the final amount to the Group five days before the payment date. If the invoice is not provided in time, the invoice amount provided is incorrect or not confirmed, the payment time will be postponed, and the resulting loss shall be borne by Tianmu Dairy. If the payment date is a holiday, the payment date will be postponed accordingly. We have reviewed three prevailing purchase contracts entered into between the Group and its Independent Third Party suppliers. While detailed payment terms vary, we note that they generally stipulate payments within 30 days for purchases made in the previous month. On this basis, we concur with the Management that the payment terms under the Raw Milk Purchase Agreement are in line with prevailing market practice. We have also compared other terms such as quality requirements, termination, penalties and delivery methods of the Raw Milk Purchase Agreement with those purchase contracts with Independent Third Party suppliers and noted that they are comparable.

Based on our review above and considering (i) the price of raw milk under the Raw Milk Purchase Agreement shall be determined based on prevailing market price by comparing with prices offered by other Independent Third Party suppliers; (ii) the payment terms under the Raw Milk Purchase Agreement are in line with prevailing market practice; and (iii) other terms of the Raw Milk Purchase Agreement are comparable to those purchase contracts with Independent Third Party suppliers, we consider that the terms of the Raw Milk Purchase Agreement are on normal commercial terms and are fair and reasonable.

In light of the above and considering the monitoring measures undertaken as set out under the section headed "6. Internal control measures" below, we are of the view that the Group's internal control measures to ensure fair pricing of the transactions contemplated under the Raw Milk Purchase Agreement can be adhered to. As such, we are of the view that there exist internal control mechanisms to protect the interests of the Company and the Shareholders as a whole in respect of the continuing connected transactions contemplated under the Raw Milk Purchase Agreement.

5. PROPOSED ANNUAL CAP

Under the Raw Milk Purchase Agreement, the proposed annual cap for the price payable by the Group to Tianmu Dairy for the purchase of raw milk for the year ending 31 December 2022 is RMB 200.0 million.

As stated in the Letter from the Board, the proposed annual cap for the year ending 31 December 2022 under the Raw Milk Purchase Agreement has been determined with reference to (i) the historical amount of the purchase of raw milk; (ii) the prevailing market price of raw milk which is expected to increase due to the rising costs of raw materials (i.e. feeds for dairy cows such as silage and alfalfa) due to increasing petroleum and delivery costs; and (iii) the anticipated market demand of the Group on raw milk during the term of the Raw Milk Purchase Agreement for the year ending 31 December 2022, taking into account the increased demand of the Group due to the additional orders for the Group's processing service received by the Group's new production site which commenced in 2021.

Historical amount of purchase of raw milk

For the year ended 31 December 2021, the amounts of purchase of raw milk paid by the Group to Tianmu Dairy was RMB133.6 million. We note that this historical amount represents approximately 66.8% of the annual cap under the 2021 Master Purchase Agreement. According to the Management, the utilisation of the aforesaid annual cap had been affected by availability of raw milk from Tianmu Dairy at the time when the Group had purchase demand, as well as fluctuations in the Group's own raw milk production which would affect the amount of raw milk the Group purchased externally.

Prevailing market price of raw milk

As mentioned above, the proposed annual cap for the year ending 31 December 2022 under the Raw Milk Purchase Agreement has been determined with reference to the prevailing market price of raw milk, which is expected to increase due to the rising costs of raw materials (ie. feeds for dairy cows such as silage and alfalfa) due to increasing petroleum and delivery costs. We have reviewed the internal report of the Company on the price of silage and alfalfa and we noted that the market price of silage and alfalfa had increased by approximately 16.0% between the year ended 31 December 2020 and the year ended 31 December 2021. The Management expects this trend may continue during the year ending 31 December 2022. Taking into account the rising costs of raw materials, we concur that it is reasonable to expect increase in market price of raw milk for the year ending 31 December 2022.

Anticipated market demand of the Group on raw milk

As stated in the Letter from the Board, there has been additional orders for the Group's processing service received by the Group's new production site which commenced in 2021, necessitating the Group purchasing more raw milk. We have obtained and reviewed the signed processing service contracts entered into by the Group and noted that the Group has indeed secured several new customers towards the end of 2021 and the Group will be providing processing service to them for one-year term. Taking into account such increased demand for processing service, we concur with the Management's assumption of higher anticipated market demand of the Group on raw milk for the year ending 31 December 2022.

The Management informed that with reference to the aforesaid historical purchases for 2021 and the factors above, the Group has prepared an internal budget for its transactions with Tianmu Dairy for the year ending 31 December 2022. We have obtained and reviewed the Group's internal budget in relation to the transactions with Tianmu Dairy for the year ending 31 December 2022 and noted that the transaction volume has been determined in accordance with the agreed transaction volume estimated between the Group and Tianmu Dairy taking into account anticipated market demand elaborated above, as set out in the Raw Milk Purchase Agreement which we have reviewed. We also noted that prices stated in the internal budget for the raw milk purchases are in line with the historical prices of raw milk purchased from Tianmu Dairy and other suppliers, taking into account the expected increase explained above.

In light of the above, we are of the view that the proposed annual cap for the year ending 31 December 2022 under the Raw Milk Purchase Agreement was estimated based on reasonable ground, and are fair and reasonable so far as the Company and the Independent Shareholders are concerned.

6. INTERNAL CONTROL MEASURES

According to the "Letter from the Board" in the Circular, we understand that the Group has adopted a set of internal control measures in connection with the transactions contemplated under the Raw Milk Purchase Agreement.

The management of the Company will discuss and consider the terms and conditions as well as the pricing mechanism of each transaction contemplated under the Raw Milk Purchase Agreement before entering into those transactions in order to ensure that they are on normal commercial terms.

The procurement department and finance department of the Company will supervise the continuing connected transactions and shall compare the price of raw milk with the price of the same or similar products obtained from at least three Independent Third Party suppliers when making purchases under the Raw Milk Purchase Agreement.

In addition, we noted that the finance department of the Company will review the relevant transactions on a quarterly basis and submit the relevant information, including but not limited to, the historical and actual transaction amounts, to the Board for review in order to ensure that (i) the relevant transactions are conducted in accordance with the terms of the Raw Milk Purchase Agreement; and (ii) the annual cap (as applicable) has not been exceeded.

Furthermore, we also noted that the independent non-executive Directors and the auditors of the Company will conduct annual review on the continuing connected transactions contemplated under the Raw Milk Purchase Agreement to confirm that the pricing mechanisms and annual cap remain fair and reasonable, and provide confirmation of the same annually in the annual report of the Company in accordance with the Listing Rules.

Having reviewed (i) price quotations obtained from at least three Independent Third Party suppliers from same or similar products as to the transactions under the Raw Milk Purchase Agreement; and (ii) sample quarterly reports issued by the finance department of the Company regarding the actual transaction amounts between the Group and Tianmu Dairy including the remaining transaction amounts under the approved annual cap for transactions under the Raw Milk Purchase Agreement; and after taking into account the fact that the annual cap for the Raw Milk Purchase Agreement had not been exceeded, we are of the view that such internal control measure for monitoring the transactions contemplated under the Raw Milk Purchase Agreement have been effectively implemented.

In view of the procedures and arrangements set out above, we consider that there exists the appropriate procedures and arrangements to ensure the transactions contemplated under the Raw Milk Purchase Agreement will be conducted on terms that are fair and reasonable and in the interests of the Company and the Shareholders as a whole.

RECOMMENDATION

Having considered the factors and reasons as stated above, we are of the view that (i) the terms of the continuing connected transactions under the Raw Milk Purchase Agreement are on normal commercial terms and are fair and reasonable; (ii) the continuing connected transactions under the Raw Milk Purchase Agreement are conducted in the ordinary and usual course of business of the Group and in the interests of the Company and the Shareholders as a whole. Accordingly, we recommend the Independent Board Committee to advise the Independent Shareholders, to vote in favour of the resolutions to be proposed at the EGM to approve the continuing connected transactions under Raw Milk Purchase Agreement (including the respective proposed annual cap thereof) and we commend the Independent Shareholders to vote in favour of the resolutions in this regard.

Yours faithfully
For and on behalf of
Altus Capital Limited



Chang Sean Pey
Executive Director

Mr. Chang Sean Pey ("Mr. Chang") is a Responsible Officer of Altus Capital Limited licensed to carry on Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activities under the SFO and permitted to undertake work as a sponsor. He is also a Responsible Officer of Altus Investments Limited licensed to carry on Type 1 (dealing in securities) regulated activity under the SFO. Mr. Chang has over 25 years of experience in banking, corporate finance advisory and investment management. In particular, he has participated in sponsorship work for initial public offerings and acted as financial adviser or independent financial adviser in various corporate finance advisory transactions.