

18 July 2022

*To the Independent Board Committee and the Independent Shareholders*

Dear Sirs or Madams,

**CONTINUING CONNECTED TRANSACTIONS  
RENEWAL OF THE TECHNOLOGY LICENCE AGREEMENT,  
THE MASTER SALES AGREEMENT,  
THE MASTER PURCHASE AGREEMENT AND  
THE PROPOSED ANNUAL CAPS**

**INTRODUCTION**

We refer to our appointment as the Independent Financial Adviser to the Independent Board Committee and the Independent Shareholders in relation to the renewal of the Existing Agreements and the proposed Annual Caps, details of which are set out in the letter from the Board (the “**Letter from the Board**”) contained in the circular issued by the Company to the Shareholders dated 18 July 2022 (the “**Circular**”), of which this letter forms part. Capitalised terms used in this letter shall have the same meanings as those defined in the Circular unless the context otherwise requires.

References are made to the announcement of the Company dated 27 June 2022, the circulars of the Company dated 11 March 2020 and 30 June 2021 in relation to, among other things, the Existing Agreements. On 4 September 2017, the Company and Tsugami Japan entered into the Existing Agreements for an initial term of three years commencing from 25 September 2017 to 31 March 2020, which was subsequently renewed for a successive period of three years commencing from 1 April 2020. As such, the Existing Agreements will expire on 31 March 2023, which will be automatically renewed for successive periods of three years thereafter unless terminated in accordance with the Existing Agreements. The Company and Tsugami Japan agreed to renew the Existing Agreements upon the expiry of their term on 31 March 2023 for a further term of three years, i.e. up to and including 31 March 2026. There has been no change in the terms of the Existing Agreements since they were entered into on 4 September 2017.

As at the Latest Practicable Date, Tsugami Japan is interested in approximately 70.9% of the issued share capital of the Company and is the controlling shareholder of the Company and therefore, members of the Tsugami Japan Group are connected persons of the Company. Accordingly, the renewal of the Existing Agreements and the transactions contemplated thereunder constitute continuing connected transactions of the Company under Chapter 14A of the Listing Rules. As one or more applicable percentage ratios (as defined under Rule 14.07 of the Listing Rules) in respect of each of the Technology Annual Caps, the Sales Annual Caps and the Purchase Annual Caps, respectively, is 5% or above, the renewal of the Existing Agreements and the proposed Annual Caps are subject to reporting, announcement and Independent Shareholders' approval requirements under Chapter 14A of the Listing Rules.

### **THE INDEPENDENT BOARD COMMITTEE**

The Independent Board Committee, comprising all three independent non-executive Directors, namely, Dr. Eiichi Koda, Dr. Huang Ping and Mr. Tam Kin Bor, has been established by the Company to advise the Independent Shareholders on, among other things, whether the renewal of the Existing Agreements are in the ordinary and usual course of business of the Company, fair and reasonable, on normal commercial terms, and in the interests of the Company and the Shareholders as a whole, and that the Annual Caps are fair and reasonable and in the interests of the Company and the Shareholders as a whole. We, Lego Corporate Finance Limited, have been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in this regard.

### **OUR INDEPENDENCE**

As at the Latest Practicable Date, we did not have any relationships or interests with the Company, Tsugami Japan or any other parties that could reasonably be regarded as relevant to our independence. In the last two years prior to the Latest Practicable Date, we had acted as an independent financial adviser to the Company in relation to the continuing connected transactions in respect of the ratification of the exceeding of the original 2021 technology annual cap and the adoption of the revised annual caps pursuant to the Existing Agreements, details of which were disclosed in the circular of the Company dated 30 June 2021. Apart from normal professional fees paid or payable to us in connection with the previous engagement and this appointment, no arrangement exists whereby we had received or will receive any fees or benefits from the Company. Accordingly, we consider that we are eligible to give independent advice in respect of renewal of the Existing Agreements and the proposed Annual Caps.

### **BASIS OF OUR OPINION**

In formulating our opinion and recommendations to the Independent Board Committee and the Independent Shareholders, we have relied on the information, facts and representations contained or referred to in the Circular and the information, opinions and representations provided or expressed to us by the Directors and/or the management of the Company (the "Management"). We have assumed that all the information, facts and representations contained or referred to in the Circular, and all the information, opinions and representations

provided or expressed by the Directors and/or the Management, for which they are solely responsible, were true, accurate and complete in all material respects at the time when they were provided and continue to be so as at the Latest Practicable Date and that they may be relied upon in formulating our opinion. We have also assumed that all such opinions and statements of intention or belief expressed by the Directors and/or the Management and those as set out or referred to in the Circular were reasonably made after due and careful enquiries.

The Directors have confirmed to us that no material facts have been withheld or omitted from the information provided, representations made or opinions expressed. We have no reason to suspect that any relevant information has been withheld or omitted, and we are not aware of any facts or circumstances which would render the information provided, representations made or opinions expressed to us untrue, inaccurate or misleading. We consider that we have been provided with, and have reviewed, sufficient information currently available, and that we have performed all the necessary steps to enable us to reach an informed view and to justify our reliance on the information provided so as to provide a reasonable basis for our opinion. We have not, however, carried out any independent verification of the information provided, representations made or opinion expressed by the Directors and/or the Management, and we have not conducted any form of in-depth investigation into the businesses, affairs, operations, financial position or future prospects of the Group. Our opinion is necessarily based on the financial, economic, market and other conditions in effect, and the information made available to us, as at the Latest Practicable Date.

The Circular, for which the Directors collectively and individually accept full responsibility, includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Group. The Directors, having made all reasonable enquiries, confirm that to the best of their knowledge and belief the information contained in the Circular is accurate and complete in all material respects and not misleading or deceptive, and there are no other matters the omission of which would make any statement therein or the Circular misleading.

This letter is issued for the information of the Independent Board Committee and the Independent Shareholders solely in connection with their consideration of the renewal of the Existing Agreements and the proposed Annual Caps. Except for its inclusion in the Circular, this letter is not to be quoted or referred to, in whole or in part, nor shall this letter be used for any other purposes without our prior written consent.

## PRINCIPAL FACTORS AND REASONS CONSIDERED

In formulating our opinion in respect of the renewal of the Existing Agreements and the proposed Annual Caps, we have considered the following principal factors and reasons:

### 1. Background information of the Group and Tsugami Japan

#### 1.1 The Group

The Company is an established foreign-owned CNC high precision machine tool manufacturer in the PRC. The principal activities of the Group are the manufacture and sales of a wide range of CNC high precision machine tools under the TSUGAMI brand based in the PRC.

#### 1.2 Tsugami Japan

Tsugami Japan, the controlling shareholder of the Company, is a long-established Japanese manufacturer of machine tools established in March 1937 and has been listed on the Tokyo Stock Exchange for over 60 years. The Tsugami Japan Group primarily engages in the design, research, development, manufacture and sales of machine tools.

### 2. Financial information of the Group

Set out below is a summary of the consolidated financial information of the Company as extracted from the annual report of the Company for the year ended 31 March 2021 (the “2020-2021 Annual Report”) and the annual results announcement for the year ended 31 March 2022 (the “2021-2022 Annual Results”).

	Year ended 31 March		
	2022	2021	2020
	RMB'000	RMB'000	RMB'000
	(audited)	(audited)	(audited)
Revenue	4,419,887	3,116,976	1,943,569
Gross profit	1,173,029	765,307	392,093
Profit attributable to Shareholders for the year	667,404	391,952	155,823

***For the year ended 31 March 2021***

Revenue of the Group amounted to approximately RMB3,117.0 million for the year ended 31 March 2021, representing an increase of approximately 60.4% as compared to that of approximately RMB1,943.6 million for the year ended 31 March 2020. According to the 2020-2021 Annual Report, such increase was primarily the results of (i) the comprehensive recovery of the domestic manufacturing industry starting from March and April 2020, coupled with the strong demand for high-end CNC machine tools in the automobile parts and components industry from the second half of the year; (ii) effective containment of the COVID-19 pandemic in the PRC; and (iii) the spread of the pandemic in other parts of the world, leading to a shift in demand towards manufacturing in the PRC. As a result of the foregoing, the Group's gross profit and profit attributable to Shareholders increased by approximately 95.2% and 151.5% for the year ended 31 March 2021, respectively, as compared to that for the year ended 31 March 2020.

***For the year ended 31 March 2022***

Revenue of the Group amounted to approximately RMB4,419.9 million for the year ended 31 March 2022, representing an increase of approximately 41.8% as compared to that of approximately RMB3,117.0 million for the year ended 31 March 2021. As disclosed in the 2021-2022 Annual Results, such increase in the total revenue was primarily due to (i) the continuation of the economic expansion during the year starting from the second half of 2020, coupled with the strong demand for high-end CNC machine tools in the automobile parts and components industry; (ii) the Group's early deployment of new factories, which enabled it to have sufficient production capacity to meet the strong domestic market demand and secure more orders; and (iii) the Group's ongoing efforts on cost reduction and efficiency enhancement, which have significantly improved the cost-effectiveness of the Group's products.

In particular, (i) precision lathes recorded sales of approximately RMB3,870.0 million during the financial year, representing a year-on-year increase of approximately 43.3%; (ii) the precision machining centres recorded sales of approximately RMB233.9 million during the financial year, representing a year-on-year increase of approximately 18.8%; and (iii) precision grinding machines and others (including sales of precision thread and form rolling machines, parts and components and after-sales service income) experienced increases in various sales activities, with sales of approximately RMB169.6 million and RMB146.3 million for the year ended 31 March 2022, respectively, representing increases of approximately 57.1% and 32.0%, as compared to last year.

As a result of the foregoing, the Group's gross profit and the profit attributable to Shareholders increased by approximately 53.3% and 70.3% for the year ended 31 March 2022, respectively, as compared to that for the year ended 31 March 2021.

### **3. Reasons for and benefits of the renewal of the Existing Agreements**

#### ***(i) Technology Licence Agreement***

Tsugami Japan, is a long-established renowned CNC high precision machine tool manufacturer with over 80 years of establishment and is recognised worldwide for its CNC high precision machine tools. According to the Letter from the Board, leveraging on the goodwill of the TSUGAMI brand, the Group has been widely recognised by manufacturing enterprises engaged in various industries including, automobile parts and components, IT communications and electronics and industrial automation. As advised by the Management, in order to strengthen the Group's leading position in the industry, the Group will continue to focus on deploying new technologies and applications, improvement of the production system, increase production capacity and efficiency, reduce production costs, improve product quality and enhance the distribution channels and sales network of the Group. The Directors are of the view, and we concur, that the renewal of the Technology Licence Agreement will allow the Group to continuously utilise the trademarks licensed by, and technical know-how and aftersales service supports provided by Tsugami Japan which enable the Group to leverage on the industry leading technology of Tsugami Japan in order to meet customers' increasing needs for the CNC high precision machine tools and to strengthen the market position of the Group, which we consider to be in line with the overall business strategy of the Group.

#### ***(ii) Master Sales Agreement and Master Purchase Agreement***

To the best knowledge of the Directors, the CNC high precision machine tools manufactured by the Group are varied from those manufactured by Tsugami Japan in terms of functionality and models, which certain specific products could only be produced exclusively by Tsugami Japan. In order to ensure there is a clear business delineation and not to create direct competition between the business of the Group and that of Tsugami Japan, and to ensure that the Group has full autonomy on its business operations, Tsugami Japan has undertaken to the Group in a deed of non-competition that it will not, and will use its best efforts to procure its close associates (other than the Group) not to participate in, or engage in or develop any business which is in direct competition with the Group. As such, the Directors are of the view that there is a clear delineation between the business of the Group and that of Tsugami Japan, taking into account the geographical location of sales and distribution, the business focus and customer groups. For example, when Tsugami Japan Group receives purchase orders for its CNC high precision machine tools in the PRC or Taiwan, instead of Tsugami Japan to confront the sales transactions, the Group will purchase such CNC high precision machine tools from Tsugami Japan Group to serve such purchase orders, and vice versa. In this regard, we concur with the Directors' view that the undertaking of non-competition would ensure the geographical delineation of customer groups and sales markets between the Group and Tsugami Japan Group, and therefore protect the interests of the Group.

Furthermore, the Group also procured parts and components (including the CNC systems panels) and production machinery and equipment from Tsugami Japan for manufacturing its CNC high precision machine tools in the PRC. As advised by the Management, owing to the long-term business relationship between Tsugami Japan and the suppliers of such products, the price offered by these third-party suppliers to Tsugami Japan would be more favourable than the price offered to the Group for the same products.

Having considered the above and, in addition, (i) the renewal of the Technology Licence Agreement, the Master Sales Agreement and the Master Purchase Agreement are a continuation of the Existing Agreements under the same agreement terms and pricing mechanism; (ii) the continuing connected transactions contemplated under the Existing Agreements are considered as the principal business activities of the Group; (iii) the Group has established and maintained long-term business relationship with Tsugami Japan Group; and (iv) through the renewal of the Existing Agreements, the Group can ensure stable income stream and steady supply of the parts and components, production machinery and equipment and CNC high precision machine tools for the Group, we are of the view that the proposed continuing connected transactions in relation to the renewal of the Existing Agreements are in ordinary and usual course of business of the Group, and are in the interests of the Company and the Shareholders as a whole.

#### 4. Principal terms of the Existing Agreements

##### (i) *Technology Licence Agreement*

The principal terms of the Technology Licence Agreement are summarised below:

- Date : 4 September 2017
- Parties : (a) the Company  
(b) Tsugami Japan
- Duration : The Technology Licence Agreement shall, upon renewal, continue to be effective up to and including 31 March 2026, which will be automatically renewed for successive periods of three years thereafter unless notified by the Company to Tsugami Japan by written notice of not less than 30 days before the expiry of the renewal term or any subsequent successive periods, or otherwise terminated earlier in accordance with the Technology Licence Agreement.
- Continuing transactions : Tsugami Japan agreed to irrevocably grant to the Company:
- (a) an exclusive licence to use the Technology necessary for the manufacture of the CNC high precision machine tools of the Company and to provide aftersales services in connection with these products; and
  - (b) as the sole licensee, the right to use the Trademarks in the PRC, Hong Kong and Taiwan, and a nonexclusive licence to use the Trademarks in any regions (excluding the PRC, Hong Kong and Taiwan).

*Pricing guideline*

Depending on the models of the Company's CNC high precision machine tools, the Trademarks and Technology licence fees payable to Tsugami Japan shall be calculated based on a royalty rate of 1.0% or 5.0% multiplied by the total sales of such models of CNC high precision machine tools (excluding tax and other miscellaneous costs and charges).

The aftersales services fee to be charged by Tsugami Japan will be determined based on the daily rate of approximately JPY46,000 multiplied by the total number of working days of the staff of Tsugami Japan.

As part of our due diligence works, we have shortlisted five continuing connected transactions in the period from 1 January 2020 up to the Latest Practicable Date, on non-exhaustive basis, in relation to the grant/use of trademark, patent and/or technology licence entered into by the relevant listed issuers on the Stock Exchange with their respective connected persons. Based on our review of the relevant announcements and/or circulars, we noted that the royalty rate in respect of grant/use of trademark, patent and/or technology licence under such five continuing connected transactions ranged from 0.8% to 12.0% of the relevant sales. Accordingly, the royalty rate of 1.0% or 5.0% payable to Tsugami Japan by the Group is within such range. Further as confirmed with the Management, the daily aftersales services fees of approximately JPY46,000 to be charged by Tsugami Japan is in general favourable to the Group as compared to the standard daily rate charged by Tsugami Japan for its staff in provision of the similar services in Japan. However, due to the continual COVID-19 pandemic and travel restrictions such as entry restrictions and quarantine measures imposed by the PRC government, there is neither any aftersales services provided nor any aftersales services fee charged by Tsugami Japan to the Group for the two years ended 31 March 2022, the Company expected that the aftersales services provided by Tsugami Japan may resume in or after 2023.

**(ii) Master Sales Agreement**

The principal terms of the Master Sales Agreement are summarised below:

Date	:	4 September 2017
Parties	:	(a) the Company (b) Tsugami Japan
Duration	:	The Master Sales Agreement shall, upon renewal, continue to be effective up to and including 31 March 2026, which will be automatically renewed for successive periods of three years thereafter unless terminated, among other matters, by either party with not less than 30 business days' prior written notice, subject to the compliance of the Listing Rules.
Continuing transactions	:	The Group agreed to sell its CNC high precision machine tools to the Tsugami Japan Group.



### *Pricing guideline*

The transactions contemplated under the Master Sales Agreement will be conducted in the ordinary and usual course of business of the Group and that of the Tsugami Japan Group, on normal commercial terms or better and on terms which are fair and reasonable and in the interests of the Group and the Shareholders as a whole. The selling price in respect of each definitive agreement under the Master Sales Agreement will be determined in line with similar products provided to the Independent Third Parties. Before entering into the separate sales contract with Tsugami Japan, among other things, the Company will analyse and compare the prevailing market prices for similar products in the market with the selling prices offered to Tsugami Japan Group and taking into account factors including the level of customisations, time and effort required for making various specifications and/or customisations to the CNC high precision machine tools, purchase quantity, the delivery schedule, whether sales and marketing, aftersales services and technical support services are needed, etc., and provide a quotation which is comparable to at least two transactions with independent third party customers of similar products for the same period. We are of the view that such arrangements are justifiable for the Company to ensure the selling price for Tsugami Japan Group is fair and reasonable.

### ***(iii) Master Purchase Agreement***

The principal terms of the Master Purchase Agreement are summarised below:

- Date : 4 September 2017
- Parties : (a) the Company  
(b) Tsugami Japan
- Duration : The Master Purchase Agreement shall, upon renewal, continue to be effective up to and including 31 March 2026, which will be automatically renewed for successive periods of three years thereafter unless terminated, among other matters, by either party with not less than 30 business days' prior written notice, subject to the compliance of the Listing Rules.
- Continuing transactions : The Group may procure parts and components (including the relevant warranty costs in relation to the CNC system panels procured through Tsugami Japan), production machinery and equipment, and CNC high precision machine tools manufactured by the Tsugami Japan Group.

### *Pricing guideline*

The transactions contemplated under the Master Purchase Agreement will be conducted in the ordinary and usual course of business of the Group and that of the Tsugami Japan Group, on normal commercial terms or better and on terms which are fair and reasonable and in the interests of the Group and its Shareholders as a whole. In respect of purchase of parts and components which are manufactured by independent third party suppliers but procured from the Tsugami Japan Group, before making the purchase orders, the Company will obtain at least two quotations from the independent third party suppliers and/or review two comparable transactions with independent third party suppliers for the same period. In respect of the parts and components, production machinery and equipment and CNC high precision machine tools which are manufactured and uniquely designed for the Group's needs by the Tsugami Japan Group and are not available from independent third party suppliers, the Company will compare the time and costs incurred by the Group if the Group directly develops and manufactures such products with the purchase prices offered by the Tsugami Japan Group. The Group will only procure from Tsugami Japan Group when the purchase price offered to the Group is at a relatively competitive level. Having considered the above, we are of the view that such arrangements are justifiable for the Company to ensure the purchase price for Tsugami Japan Group is fair and reasonable.

### **5. Historical transaction amounts**

The actual transaction amounts and respective annual caps for transactions under the Existing Agreements for the two years ended 31 March 2022 and for the three months ended 30 June 2022 are set out as below:

	<b>For the year ended 31 March</b>		<b>For the three months ended</b>
	<b>2021</b>	<b>2022</b>	<b>30 June</b>
	<i>RMB million</i>	<i>RMB million</i>	<i>RMB million</i>
<b>Technology Licence Agreement:</b>			
Actual transaction amounts	144.3	203.4	55.5
Annual caps	129.0	231.0 <sup>(Note 1)</sup>	276.0 <sup>(Note 1)</sup>
Utilisation rates (%)	111.9%	88.1%	80.4% <sup>(Note 2)</sup>
<b>Master Sales Agreement:</b>			
Actual transaction amounts	384.6	739.7	246.5
Annual caps	840.0	1,380.0 <sup>(Note 1)</sup>	1,650.0 <sup>(Note 1)</sup>
Utilisation rates (%)	45.8%	53.6%	59.8% <sup>(Note 2)</sup>

	For the year ended 31 March		For the three months ended
	2021	2022	30 June 2022
	RMB million	RMB million	RMB million
<b>Master Purchase Agreement:</b>			
Actual transaction amounts	152.4	339.1	58.6
Annual caps	358.0	607.0 <sup>(Note 1)</sup>	726.0 <sup>(Note 1)</sup>
Utilisation rates (%)	42.6%	55.9%	32.3% <sup>(Note 2)</sup>

*Notes:*

1. The original annual caps for the Existing Agreements for the two years ended 31 March 2023 have been revised, for more details, please refer to the circular of the Company dated 30 June 2021.
2. For illustrative purpose only, the utilisation rates of the annual caps for the year ending 31 March 2023 were calculated by annualising the actual transaction amounts for the three months ended 30 June 2022 without taking into account any other factors such as the potential price fluctuation of the CNC high precision machine tools and part and components, and thus the actual utilisation rates for the year ending 31 March 2023 may vary.

As illustrated in the table above, we noted that the historical transaction amount under the Technology Licence Agreement for the year ended 31 March 2021 amounted to approximately RMB144.3 million, which exceeded its original annual cap of RMB129.0 million. Accordingly, the original annual caps for the Technology Licence Agreement for the two years ending 31 March 2023 have been revised. We noted that the existing annual cap of the Technology Licence Agreement was close to full utilisation for the year ended 31 March 2022, which implied that the Company had taken a prudent approach in estimating the transaction amount for the Technology Licence Agreement during the revising process. On an annualised basis, the annual cap of the Technology Licence Agreement for the year ending 31 March 2023 is also expected to be substantially utilised based on the actual transaction amount for the three months ended 30 June 2022.

On the contrary, we noted that the Group recorded comparatively lower utilisation rates for the Master Sales Agreement and the Master Purchase Agreement for the two years ended 31 March 2022. We have discussed with the Management in such regard and reviewed the 2020-2021 Annual Report and 2021-2022 Annual Results, from which we understood that the comparatively low utilisation rates of the annual caps were mainly attributable to the continual spread and negative impact of the COVID-19 pandemic in the Other Markets, which brought down the sales of the CNC high precision machine tools in such markets for the year ended 31 March 2021. Notwithstanding, we noted that the actual transaction amounts under the Master Sales Agreement and Master Purchase Agreement for the year ended 31 March 2022 amounted to approximately RMB739.7 million and RMB339.1 million, representing a year-on-year growth of approximately 92.3% and 122.5%, respectively, which have demonstrated significant growth in the transaction amounts for the year ended 31 March 2022.

## 6. The proposed Annual Caps

The proposed Annual Caps for the transactions contemplated under the renewed Technology Licence Agreement, Master Sales Agreement and Master Purchase Agreement, respectively, for the three years ending 31 March 2026 are set out as below:

	For the year ending 31 March		
	2024	2025	2026
	<i>RMB million</i>	<i>RMB million</i>	<i>RMB million</i>
Proposed Annual Caps:			
Technology Licence Agreement	332.0	398.0	438.0
Master Sales Agreement	1,980.0	2,376.0	2,613.0
Master Purchase Agreement	898.0	1,077.0	1,185.0

As disclosed in the Letter from the Board, the proposed Technology Annual Caps were determined with reference to (i) the historical Trademarks and Technology licence fees paid to Tsugami Japan for the two years ended 31 March 2022 and the three months ended 30 June 2022; (ii) the royalty rate of 1.0% or 5.0% and the aftersales services fee payable to Tsugami Japan pursuant to the Technology Licence Agreement; (iii) the projected growth for the sales of the CNC high precision machine tools of the Group for the three years ending 31 March 2026; and (iv) a buffer of approximately 3% to 5% for potential increase in market price of or demand for the CNC high precision machine tools of the Company for the three years ending 31 March 2026 .

The proposed Sales Annual Caps were determined with reference to (i) the historical sales amounts for the CNC high precision machine tools of the Group to the Tsugami Japan Group for the two years ended 31 March 2022 and the three months ended 30 June 2022; (ii) the expected demand for the CNC high precision machine tools of the Group from the Tsugami Japan Group for the three years ending 31 March 2026 taking into account the expected recovery of the overseas economies; and (iii) a buffer of approximately 3% to 5% for potential increase in market price of the CNC high precision machine tools of the Group for the three years ending 31 March 2026 in view of potential increase in material costs and/or labour cost.

The proposed Purchase Annual Caps were determined with reference to (i) the historical purchase costs paid to Tsugami Japan for the two years ended 31 March 2022 and the three months ended 30 June 2022; (ii) the projected growth for the sales of the CNC high precision machine tools of the Group for the three years ending 31 March 2026; (iii) the expected demand for parts and components (including the relevant warranty costs in relation to the CNC system panels procured through Tsugami Japan), production machinery and equipment and CNC high precision machine tools to cope with the Group's projected growth for the sales of its CNC high precision machine tools; and (iv) the estimated increase in production costs of parts and components and production machinery and equipment and CNC high precision machine tools.

Furthermore, from analysing the historical transaction amounts, we were given to understand that the Trademarks and Technology licence fees and procurement costs payable to Tsugami Japan Group were, to certain extent, driven by the overall sales performance of the Group. Hence, in determining the proposed Technology Annual Caps and the proposed Purchase Annual Caps for the three years ending 31 March 2026, the Company made reference to the proportion of respective historical transaction amounts over the total revenue of the Group for the five years ended 31 March 2022 in order to eliminate the effect of the COVID-19 pandemic.

In assessing the fairness and reasonableness of the proposed Sales Annual Caps, we have considered the following factors:

- (i) We have reviewed the computation table of the proposed Annual Caps and noted that the proposed Sales Annual Caps were calculated with reference to the actual transaction amounts for the five years ended 31 March 2022. During the pre-pandemic years (i.e. the two years ended 31 March 2019), the sales of the Group's CNC high precision machine tools to the Tsugami Japan Group contributed approximately 27.4% and 28.9% of the total revenue of the Group for the respective year. Accordingly, the Company has adopted a percentage of 30.0% of the estimated revenue for computing the proposed Sales Annual Caps for the three years ending 31 March 2026, which is at a similar level under the pre-pandemic market environment.
- (ii) We have also reviewed the computation of the Group's target sales for the three years ending 31 March 2026. We noted that an estimated year-on-year growth of approximately 20% of the target sales of the Group was applied by the Company for the two years ending 31 March 2025 which is at the same level to that for the year ending 31 March 2023 and approximately 10% estimated year-on-year growth was applied for the year ending 31 March 2026. Provided that the Group experienced revenue growth of approximately 60.4% and 41.8% for the two years ended 31 March 2022 as compared to that of the respective previous year, we consider that the applied estimated growth rate of 20% and 10% of the target sales of the Group for the two years ending 31 March 2025 and the year ending 31 March 2026, respectively, are justifiable.
- (iii) For illustrative purpose, the annualised sales transaction amount for the year ending 31 March 2023 (based on the actual sales transaction amount for the three months ended 30 June 2022) amounted to approximately RMB986.0 million. The Directors are of the view, and we concur, that (i) the actual transaction amount for the year ending 31 March 2023 is expected to be higher than the annualised transaction amount of approximately RMB986.0 million; and (ii) the sales of the Group's CNC high precision machine tool to Tsugami Japan Group are expected to continue to increase for the three years ending 31 March 2026 for the following reasons: We have reviewed the monthly sales revenue from Tsugami Japan Group to the Group for the year ended 31 March 2022, and we noted that the sales revenue of the

second-half year outperformed the first-half year by approximately 65.1% and the actual sales amount from April to June 2022 only accounted for approximately 20% of the total sales amount for the year ended 31 March 2022. As advised by the Directors, the sales pattern for the year ending 31 March 2023 is expected to be similar to that for the year ended 31 March 2022. For illustrative purpose, if we assume that the actual sales amount from April to June 2023 accounts for 20% of the annual sales amount, the annualised sales amount for the year ending 31 March 2023 would be approximately RMB1,232.5 million, which represents an utilisation rate of the existing annual cap of approximately 74.7%. We have also reviewed the annual results announcement of Tsugami Japan for the year ended 31 March 2022 and noted that the revenue of the Tsugami Japan Group recorded an increase of approximately 51.1%, from approximately JPY61,662 million for the year ended 31 March 2021 to approximately JPY93,174 million for the year ended 31 March 2022. We have discussed with the Management and understood that, the sales of the high precision machine tools contributed to the majority of the revenue of Tsugami Japan for prolonged years and due to the high vaccination rate and various measures imposed against the COVID-19 pandemic, the spread of the COVID-19 pandemic is gradually under control in the Other Markets. Concurrently, a significant portion of the CNC high precision machine tools sold in the Other Markets by Tsugami Japan Group were supplied by the Group. Therefore, the demand of high precision machine tools from the Other Markets and Tsugami Japan was recovering for the year ended 31 March 2022. In fact, the actual transaction amounts of the Master Sales Agreement for the year ended 31 March 2022 amounted to approximately RMB739.7 million, representing a year-on-year growth of approximately 92.3% as compared to that of approximately RMB384.6 million for the year ended 31 March 2021.

Based on the factors as discussed above and the other reasons as discussed below (including the strategic expansion plan implemented by the Group and the expected increasing selling price of the CNC high precision machine tools), we are of the view that the proposed Sales Annual Caps are fair and reasonable so far as the Independent Shareholders are concerned.

In order to further assess the fairness and reasonableness of the proposed Annual Caps, we have discussed with the Management on the bases and assumptions underlying the determination of the proposed Annual Caps as below:

- (i) We were given to understand that the Company estimated the target sales of the Group to form the basis of determining the proposed Annual Caps for the three years ending 31 March 2026. In such, we have obtained and reviewed the computation of the target sales of the Group for the three years ending 31 March 2026, which were determined based on the historical and estimated sales of the Group for the nine years ending 31 March 2026. We noted that the estimated year-on-year growth of approximately 20% of the target sales of the Group applied by the Company for the two years ending 31 March 2025 is at the same level to that for the year ending 31

March 2023 while the Company estimated a year-on-year growth of approximately 10% on the target sales of the Group for the year ending 31 March 2026. As discussed in the sub-section headed “2. Financial information of the Group” above, the revenue of the Group for the year ended 31 March 2022 increased by approximately 41.8% as compared to that of the previous year. Therefore, we are of the view that the target sales of the Group with year-on-year growth of approximately 20% and 10% for the two years ending 31 March 2025 and the year ending 31 March 2026, respectively, are justifiable.

- (ii) The “Made in China 2025” strategy, a roadmap released by the State Council of the PRC in July 2015 to guide the country’s advanced industrial manufacturing, has pictured a steady progress in industrial capability, smart manufacturing, innovation, as well as product quality and branding. Sectors that boost manufacturing innovation, including the Internet of Things, smart appliances and high-end consumer electronics, are the major priority for funding, according to the Ministry of Industry and Information Technology of the PRC. It is specifically stated that in high-end digital control machine tools sector, the PRC government will focus and provide support on (a) developing precision machine tools which are capable of high speed, high efficiency and functional flexibility, and developing manufacturing equipment and integrated manufacturing systems; (b) accelerating research of frontier technologies and equipment like high-end digital control machine tools and additive manufacturing; (c) reliability, stability and precision of major parts like high-end numerical systems, servomotors, bearings and grating to realize industrialisation; and (d) improving user process certification.
- (iii) According to the National Bureau of Statistics of China, the gross domestic product of China reached approximately RMB114.4 trillion in 2021, representing a year-on-year growth of approximately 8.1% as compared to that of 2020. Furthermore, the manufacturing Purchasing Managers’ Index (the “PMI”), an indication of each month of economic activities in the PRC manufacturing sector, was only 35.7% in February 2020. After recording the lowest manufacturing PMI in 2020, save for the manufacturing PMI recorded at 49.6% in September 2021 and 49.2% in October 2021, the manufacturing PMI had surpassed the threshold of 50% for consecutive 24 months, being the period from March 2020 to February 2022. The manufacturing PMI trend indicates the PRC manufacturers’ operations are resuming gradually. In light of the foregoing, the Directors are of the view, and we concur that, both economic parameters demonstrated that the PRC’s overall economy and manufacturing industry has restored to pre-pandemic levels and there is potential increasing demand of high-end manufacturing equipment in the PRC.
- (iv) According to the 2021-2022 Annual Results and our discussion with the Management, in order to further expand the production capacities of the Group to meet the enormous demand for CNC machine tools in the PRC market, the Group has invested in the establishment of a new company in Pinghu, namely Precision Nakatsu (China) Corporation Limited (中津精密機床(浙江)有限公司) in October

2021. The Company planned to purchase 50,000 square meters of land and approximately 25,800 square meters of plant and ancillary buildings in the preliminary stage of the investment project. The new company is expanding the existing plant, the expanded plant will cover an area of approximately 13,000 square meters and is expected to commence operation in 2024 with an estimated production capacity of 4,000-4,500 units of CNC precision machine tools and an annual production value of approximately RMB1.0 billion, representing an increase of the overall production capacity of the Group by approximately 30%.

We further noted that, given the gradually increasing market demand and sales of the Group, and having adjusted its sales projections upward to better reflect the growth potential of the Group's business and sales performance, the Group has planned to implement strategies such as (i) increasing the number of production staff, especially for assembling and precision adjustment and testing; (ii) extending the operating hours per day and number of working days per month; (iii) adding additional production machineries and equipment to further expand its production capacity; and (iv) engaging additional subcontracting partners for machining and metal processing and focus more internal resources on key production processes, for example, assembling and precision adjustment and testing. As and when circumstances require, the Group will also consider and implement additional means to further increase its production capacity. Having considered the newly established company and the additional measures to further increase the Group's production capacity, the Directors are of the view, and we concur that, the Group will have sufficient production capability to fulfil the increasing demand for the Group's CNC high precision machine tools by 2026.

- (v) We have discussed with the Management and were given to understand that the Company reserved a buffer of approximately 3% to 5% for potential upward adjustments to the selling prices of its CNC high precision machine tools in view of the general increasing cost of production (including but not limited to labour and raw material costs). For our due diligence purpose, we have obtained and reviewed the salary expense records of the Group for the two years ended 31 March 2022 and noted that the salary expenses was growing steadily and recorded an annual growth rate of approximately 29.9%. We have also obtained and reviewed five sample notices of increase in the selling price of the major raw materials issued by the suppliers of the Group and noted that the average selling price of major raw materials has increased by approximately 8.6% in 2022. In view of the above, we consider that it is fair and reasonable for the Group to adopt a buffer of approximately 3% to 5% in computing the proposed Annual Caps to correspond to the potential increase in the production costs and the selling prices of its CNC high precision machine tools.
- (vi) We have reviewed the 2020-2021 Annual Report and the 2021-2022 Annual Results and noted that, in recent years, the growth in production capacity of the Chinese manufacturing industry has transformed from quantitative to qualitative. From being



labor-intensive to technology-intensive, transformation and upgrading have gradually become the mainstream phenomenon across the industry, and the standard required for automation, numerical control and precision of manufacturing equipment are getting higher. The Directors are of the view, and we concur that, there is potential for the demand for high-end manufacturing equipment to grow.

Having considered the foregoing, in particular, (i) the reasons for and benefits of renewal of the Existing Agreements; (ii) the anticipated industry growth and demand of the Group's products; (iii) the expected growth of the selling prices of the Group's CNC high precision machine tools; and (iv) the existing scale of operation and development plans of the Group, we concur with the Directors' view that the proposed Annual Caps and the major factors considered as the bases of determining the proposed Annual Caps are fair and reasonable so far as the Independent Shareholders are concerned and in the interests of the Company and the Shareholders as a whole.

However, the Shareholders should note that as the proposed Annual Caps are determined based on various factors relating to future events and assumptions which may or may not remain valid for the entire period up to 31 March 2026, they do not represent any forecasts or estimations of the Group's financial performance. Consequently, we express no opinion as to how closely the actual future transaction amounts of the continuing connected transactions will correspond with the relevant proposed Annual Caps.

## **7. Internal control measures**

We were given to understand by the Management, that the Group has adopted internal control measures when conducting the continuing connected transactions contemplated under the Existing Agreements. The Company has assigned specific responsibilities to the senior management, finance department and procurement department of the Company in performing regular checks on the continuing connected transactions, monitoring the amounts of transactions and conducting assessment and evaluation on the fairness of the transaction terms and pricing terms to ensure the continuing connected transactions with Tsugami Japan Group are in accordance with respective Existing Agreements.

In particular, we noted that the Company shall pay the Trademark and Technology licence fees to Tsugami Japan pursuant to the Technology Licence Agreement, and the licence fees payable to Tsugami Japan shall be calculated based on a royalty rate of 1.0% or 5.0% multiplied by the total sales of CNC high precision machine tools (excluding tax and other miscellaneous costs and charges), while the adopted royalty rates were determined based on the model of the CNC high precision machine tools. For our due diligence purpose, we have reviewed eight sample invoices issued by Tsugami Japan to the Group during the period from 1 April 2020 to 31 March 2022 and noted that the royalty rates of the Trademark and Technology licence fees charged by Tsugami Japan were in line with the pricing guideline.

In addition, we noted that to ensure the transactions conducted pursuant to the Master Sales Agreement are priced fairly and reasonably and in the interests of the Company and its Shareholders as a whole, the Company will consider at least two comparable transactions with the independent third-party customers of similar products for the same period to ensure no better terms are offered to the Tsugami Japan Group. For our due diligence purpose, we have reviewed eight sample transactions entered into between the Group and Tsugami Japan Group during the period from 1 April 2020 to 31 March 2022 and compared each of the sample transactions with two randomly-selected transactions with independent third-party customers of the Group conducted at or around the same period. Based on our review, we noted that the selling prices charged by the Group to Tsugami Japan Group were no less favourable than those charged by the Group to the relevant independent third-party customers for the similar type of products.

Moreover, we noted that, to ensure the transactions conducted pursuant to the Master Purchase Agreement are priced fairly and reasonably and in the interests of the Company and its Shareholders as a whole, before marking the purchase orders for the parts and components from the Tsugami Japan Group, the Company will obtain at least two quotations from the independent third-party suppliers and/or review two comparable transactions with independent third-party suppliers for the same period. For our due diligence purpose, we have reviewed eight sample transactions entered into between the Group and Tsugami Japan Group during the period from 1 April 2020 to 31 March 2022 and compared each of the sample transactions with two randomly-selected transactions with independent third-party suppliers of the Group conducted at or around the same period. Based on our review, we noted that the selling prices charged by Tsugami Japan Group to the Group were no more favourable than those charged by relevant independent third-party suppliers to the Group for the similar type of products.

Furthermore, we noted from the annual report of the Company for each of the two years ended 31 March 2020 and 2021, that the independent non-executive Directors of the Company had reviewed the historical continuing connected transactions in relation to the Existing Agreements and confirmed such continuing connected transactions were (i) entered into in the ordinary and usual course of business of the Company; (ii) conducted on normal commercial terms; and (iii) conducted pursuant to the Existing Agreements governing the relevant transactions on terms which are fair and reasonable and in the interests of the Company and the Shareholders as a whole. In determining the prices and terms of the said continuing connected transactions conducted during respective financial year, the Company has complied with the pricing guidelines and adopted internal control measures. We also noted that auditor of the Company had confirmed, in accordance to Rule 14A.56 of the Listing Rules, to the Board that the historical continuing connected transactions were, in all material respects, in accordance with the Existing Agreements.

As confirmed by the Company, the Company will continue to comply with the relevant annual review requirements under the Listing Rules on an on-going basis.

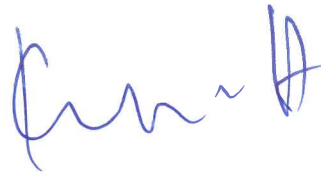
Given the above, we concur with the Directors' view that the Group has implemented effective internal control measures to ensure that the continuing connected transactions with Tsugami Japan Group will be conducted on normal commercial terms and in accordance with the Existing Agreements.

## **RECOMMENDATION**

Having considered the above principal factors and reasons, we are of the opinion that the continuing connected transactions to be conducted in relation to the renewal of the Existing Agreements are in the ordinary and usual course of business of the Group and on normal commercial terms, and the terms of the Technology Licence Agreement, the Master Sales Agreement and the Master Purchase Agreement (including the proposed Annual Caps) are fair and reasonable so far as the Independent Shareholders are concerned and in the interests of the Company and the Shareholders as a whole.

Accordingly, we recommend the Independent Shareholders, as well as the Independent Board Committee to advise the Independent Shareholders, to vote in favour of the ordinary resolutions to be proposed at the EGM to approve the renewal of the Technology Licence Agreement, the Master Sales Agreement and the Master Purchase Agreement and the transactions thereunder (including the proposed Annual Caps).

Yours faithfully,  
For and on behalf of  
**Lego Corporate Finance Limited**



**Kristie Ho**  
*Managing Director*

*Ms. Kristie Ho is a licensed person registered with the Securities and Futures Commission and a responsible officer of Lego Corporate Finance Limited to carry out Type 6 (advising on corporate finance) regulated activity under the Securities and Futures Ordinance (Chapter 571 of the laws of Hong Kong). She has over 15 years of experience in the securities and investment banking industries.*