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12 December 2022

*To: The Independent Board Committee and the Independent Shareholders of
China Shengmu Organic Milk Limited*

Dear Sirs,

RENEWAL OF CONTINUING CONNECTED TRANSACTIONS RAW FRESH MILK SUPPLY FRAMEWORK AGREEMENT

INTRODUCTION

We refer to our appointment as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in relation to the entering into the Raw Fresh Milk Supply Framework Agreement. Details of the terms of the Raw Fresh Milk Supply Framework Agreement are contained in the circular issued by the Company to the Shareholders dated 12 December 2022 (“Circular”), of which this letter forms part. Unless the context otherwise requires, capitalised terms used in this letter shall have the same meanings as those defined in the Circular.

On 17 November 2022, Shengmu High-tech (for itself and on behalf of its subsidiaries) entered into the Raw Fresh Milk Supply Framework Agreement with Inner Mongolia Mengniu (for itself and on behalf of its subsidiaries) in relation to the sale of raw fresh milk by the Group to China Mengniu Group for a term of three years commencing from 1 January 2023 to 31 December 2025.

As at the Latest Practicable Date, Shengmu High-tech is an indirect wholly-owned subsidiary of the Company and Inner Mongolia Mengniu is a non-wholly owned subsidiary of China Mengniu. China Mengniu holds 100% equity interest in Start Great, which in turn directly holds approximately 29.99% equity interest in the Company. Accordingly, each of Start Great, China Mengniu and Inner Mongolia Mengniu is a connected person of the Company. As one or more applicable percentage ratios under the Listing Rules in respect of the highest proposed annual cap under the Raw Fresh Milk Supply Framework Agreement exceed 5%, the entering into the Raw Fresh Milk Supply Framework Agreement and the transactions contemplated thereunder are subject to the reporting, announcement and independent shareholders’ approval requirements under Chapter 14A of the Listing Rules.



The Independent Board Committee comprising all the independent non-executive Directors, namely Mr. Wang Liyan, Mr. Wu Liang and Mr. Sun Yansheng, has been established to advise the Independent Shareholders in respect of, among other things, the Raw Fresh Milk Supply Framework Agreement and to make recommendation as to voting. We, Somerley Capital Limited, have been appointed to advise the Independent Board Committee and the Independent Shareholders in the same regard.

We are not associated with the Company, Shengmu High-tech, Inner Mongolia Mengniu and their respective associates, close associates or core connected persons (all as defined under the Listing Rules) and accordingly are considered eligible to give independent advice on the above matters. Apart from normal professional fees payable to us in connection with this and similar appointments, no arrangement exists whereby we will receive any fees or benefits from the Company, Shengmu High-tech, Inner Mongolia Mengniu or their respective associates, close associates or core connected persons.

In formulating our opinion and recommendation, we have reviewed, among other things, the Raw Fresh Milk Supply Framework Agreement, the annual report of the Company for the year ended 31 December 2021 (“**2021 Annual Report**”), the interim report of the Company for the six months ended 30 June 2022 (“**2022 Interim Report**”) and the information as set out in the Circular. We have also discussed with the management of the Group (“**Management**”) regarding the business and prospects of the Group.

We have relied on the information and facts supplied, and the opinions expressed, by the Directors and the Management and have assumed that they are true, accurate and complete. We have also sought and received confirmation from the Directors that no material facts have been omitted from the information supplied and opinions expressed to us. We have no reason to believe that any material information has been withheld from us, or to doubt the truth or accuracy of the information provided. We have relied on such information and consider that the information we have received is sufficient for us to reach an informed view. We have not, however, conducted any independent investigation into the business and affairs of the Group.

PRINCIPAL FACTORS AND REASONS CONSIDERED

In arriving at our opinion and recommendation, we have taken into account the following principal factors and reasons:

1. Information on the Group

(a) Business of the Group

The Company was incorporated in the Cayman Islands with limited liability and its issued shares have been listed on the Main Board of the Stock Exchange since July 2014. As set out in the 2022 Interim Report, the principal business of the Group is dairy farming, production and sales of high-end desert-based organic raw milk and quality non-organic raw milk. The Group has 33 farms with a stock of 130,000 cows and a daily production capacity of approximately 1,869 tonnes of fresh milk, of which 20 are certified organic farms and 3 are docosahexaenoic acid (commonly known as DHA) farms.



(b) *Financial results of the Group*

Set out below is a summary of the financial results of the Group for the years ended 31 December 2020 and 2021 and the six months ended 30 June 2021 and 2022.

	For the six months ended 30 June		For the year ended 31 December	
	2022 RMB (million)	2021 RMB (million)	2021 RMB (million)	2020 RMB (million)
Revenue	1,548.6	1,446.2	2,984.6	2,660.8
Cost of sales	<u>(1,035.8)</u>	<u>(898.9)</u>	<u>(1,920.2)</u>	<u>(1,635.7)</u>
Gross profit	512.8	547.3	1,064.4	1,025.1
Loss arising from changes in fair value				
less costs to sell of biological assets	(197.2)	(154.9)	(248.8)	(224.2)
Selling and distribution expenses	(23.5)	(25.3)	(53.8)	(32.1)
Administrative expenses	(66.6)	(47.6)	(111.7)	(111.7)
Finance costs	(10.0)	(31.1)	(71.2)	(116.8)
Others	<u>27.7</u>	<u>(16.7)</u>	<u>(68.5)</u>	<u>(79.3)</u>
Profit before tax	243.2	271.7	510.4	461.0
Income tax expense	<u>—</u>	<u>(0.2)</u>	<u>(0.8)</u>	<u>—</u>
Profit for the period/year	<u>243.2</u>	<u>271.5</u>	<u>509.6</u>	<u>461.0</u>
Profit for the period/year attributable to:				
- the Shareholders	228.8	259.3	471.7	406.7
- non-controlling interests	14.4	12.2	37.9	54.3

The Group derives revenue from the production and distribution of raw milk in the PRC. For the year ended 31 December 2021, the Group's revenue enhanced by approximately 12.2% as compared to that for the prior year, which was mainly attributable to increases in both the sales volume and average selling price of organic raw milk. The gross profit margin of the Group for the year ended 31 December 2021 was down by approximately 2.8% to approximately 35.7% due to, among other things, the increase in bulk feed prices. The net profit of the Group for the year ended 31 December 2021 attributable to the Shareholders was approximately RMB471.7 million, representing an improvement of approximately RMB65.0 million or approximately 16.0% as compared to that for the prior year. The enhanced net profit was largely driven by the increase in the revenue and the control of various expenses of the Group.



For the six months ended 30 June 2022, the Group recorded a revenue of approximately RMB1,548.6 million, representing a year-on-year increase of approximately 7.1%, primarily due to the increase in sales volume of raw milk. The gross profit margin of the Group for the six months ended 30 June 2022 continued to decline to approximately 33.1% as a result of, among other things, the increase in bulk feed prices. The net profit of the Group attributable to the Shareholders for the period was approximately RMB228.8 million, representing a year-on-year decrease of approximately RMB30.5 million or approximately 11.8%. This was mainly due to a significant increase in feed prices and a slight fall in raw milk prices as compared with those for the corresponding period in the previous year.

(c) Financial position of the Group

Set out below is a summary of the financial position of the Group as at 30 June 2022 and 31 December 2021.

	As at 30 June 2022	As at 31 December 2021
	<i>RMB (million)</i>	<i>RMB (million)</i>
Non-current assets		
Property, plant and equipment	1,680.4	1,699.6
Biological assets	2,790.8	2,698.6
Other non-current assets	<u>665.7</u>	<u>683.6</u>
	5,136.9	5,081.8
Current assets		
Inventories	437.4	768.1
Trade receivables	272.1	248.1
Restricted bank deposits	209.3	256.5
Cash and bank balances	802.9	531.8
Other current assets	<u>254.0</u>	<u>245.3</u>
	1,975.7	2,049.8
Current liabilities		
Trade and bills payables	811.1	1,253.4
Interest-bearing bank borrowings	1,653.4	1,299.5
Other current liabilities	<u>229.7</u>	<u>309.9</u>
	2,694.2	2,862.8
Net current liabilities	<u>(718.5)</u>	<u>(813.0)</u>



	As at 30 June 2022 <i>RMB (million)</i>	As at 31 December 2021 <i>RMB (million)</i>
Non-current liabilities		
Interest-bearing bank borrowings	300.0	379.6
Lease liabilities	<u>10.5</u>	<u>—</u>
	310.5	379.6
Equity		
Equity attributable to the Shareholders	3,884.2	3,679.8
Non-controlling interests	<u>223.7</u>	<u>209.4</u>
	<u><u>4,107.9</u></u>	<u><u>3,889.2</u></u>

The majority of the Group's assets as at 30 June 2022 were (i) biological assets consisting of dairy cows held to produce raw milk and cows held for sale; and (ii) property, plant and equipment primarily comprising buildings and machinery and equipment. Current assets as at 30 June 2022 mainly consisted of inventories, trade receivables and cash and bank balances.

The Group's operations were chiefly financed by Shareholders' equity and bank borrowings. As at 30 June 2022, the Group had interest-bearing bank borrowings of approximately RMB1,953.4 million. The gearing ratio, being total interest-bearing bank borrowings less cash and bank balances divided by the total equity, was approximately 28.0% as at 30 June 2022. As the majority of the interest-bearing bank borrowings were due within one year, the Group was in net current liability position of approximately RMB718.5 million as at 30 June 2022.

2. Information on Inner Mongolia Mengniu and China Mengniu Group

Inner Mongolia Mengniu is a non-wholly owned subsidiary of China Mengniu and is principally engaged in the business of manufacturing and sale of dairy products.

China Mengniu (stock code: 2319) has listed on the Main Board of the Stock Exchange since 2004. China Mengniu Group is one of the leading dairy product manufacturers in the PRC, principally engaged in manufacturing and distribution of quality dairy products including liquid milk products, ice-cream, milk formula and other dairy products. Based on its latest financial reports, China Mengniu recorded revenue and net profit after tax of approximately RMB88.1 billion and approximately RMB5.0 billion respectively in 2021 and had net asset value and cash and bank balances of approximately RMB44.0 billion and approximately RMB9.8 billion, respectively, as at 30 June 2022. In addition, China Mengniu had a market capitalisation of approximately HK\$133.3 billion as at the Latest Practicable Date.



3. Reasons for and benefits of entering into the Raw Fresh Milk Supply Framework Agreement

As discussed in the letter from the Board contained in the Circular, there are a number of benefits of entering into the Raw Fresh Milk Supply Framework Agreement for the Group, which include:

- (a) As one of the leading dairy product manufacturers in the PRC, China Mengniu Group is equipped with a strong management team and a solid dairy product distribution network, offering diversified products including liquid milk products, ice cream, milk formula and cheese. The Company believes that a raw fresh milk supply relationship with China Mengniu Group (taking into account, among other things, the Group's commitment to supply on average more than 80% of the raw fresh milk it produces in each year to China Mengniu Group) will help to stabilise the price and sales volume of raw fresh milk and generate stable income and cash flow for the Group.
- (b) The dairy farms of the Group are mainly located in the regions of Hohhot and Bayannur, and China Mengniu Group has sufficient raw fresh milk processing capacity in these regions. The short transportation distance ensures the freshness of raw fresh milk supplied by the Group, which in turn contributes to the high quality of milk products manufactured by China Mengniu Group. It also lowers the Group's costs of transportation and preservation, which makes the price of raw fresh milk supplied by the Group more competitive as compared to other suppliers of raw fresh milk.
- (c) Whilst focusing on the production and sale of desert-based organic milk, the Group also endeavors to satisfy customers' diversified needs for quality raw milk and continues to develop a variety of functional raw milk to enhance the Group's product mix and profitability.
- (d) The collaboration between the Group and China Mengniu Group, which eventually leads to the growth of demand for desert-based organic milk through channels such as marketing and distribution, would enhance the awareness of the Group's milk products and in turn promote the Group's sales growth, thereby achieving a win-win outcome for both groups.

The business activities of the Group is dairy farming, production and sales of high-end desert-based organic raw milk and quality non-organic raw milk. We note that the revenue generated from the sales of raw fresh milk by the Group to China Mengniu Group has been substantial and has accounted for a significant majority of the revenue of the Group in the past few years. The entering into the Raw Fresh Milk Supply Framework Agreement, particularly the term that on average at least 80% of the raw fresh milk the Group produces in each year will be sold to China Mengniu Group, secures a continuing demand for the raw fresh milk produced by the Group and provides a regular revenue stream to the Group. Furthermore, the price of raw fresh milk to be sold to China Mengniu Group will be no less favourable to the Group than the price offered from independent third party customers. Having considered the above, we are of the view that the entering into the Raw Fresh Milk Supply Framework Agreement is beneficial to the Group and in the ordinary and usual course of the business of the Group.



4. Principal terms of the Raw Fresh Milk Supply Framework Agreement

Date

17 November 2022

Parties

- (i) Shengmu High-tech (for itself and on behalf of its subsidiaries); and
- (ii) Inner Mongolia Mengniu (for itself and on behalf of its subsidiaries)

Term

From 1 January 2023 to 31 December 2025

Principal terms

The Group shall sell raw fresh milk which meets China Mengniu Group's purchasing standard and quality requirements to China Mengniu Group on a daily basis in accordance with the monthly milk supply plan to be agreed between the Group and China Mengniu Group, and the Group shall ensure that on average more than 80% of the raw fresh milk it produces in each year will be sold to China Mengniu Group. The specific amount to be purchased shall be the amount as confirmed by the Group and China Mengniu Group. The daily delivery amount is determined by the amount as weighted by China Mengniu Group.

Purchase price and pricing mechanism

The purchase price of raw fresh milk to be sold by the Group to China Mengniu Group under the Raw Fresh Milk Supply Framework Agreement shall be determined and adjusted in accordance with the following pricing mechanism:

- (a) the base price ("**Base Price**") shall be determined based on market conditions (taking into account (i) the latest average price of raw fresh milk for 10 selected regions (including Inner Mongolia and Hebei) published on the website of the Ministry of Agriculture and Rural Affairs of the PRC, and (ii) prices charged by other suppliers to China Mengniu Group), together with seasonal factors and sales price of raw fresh milk in the region, as agreed between Shengmu High-tech and Inner Mongolia Mengniu;
- (b) the logistics subsidy as agreed between Shengmu High-tech and Inner Mongolia Mengniu based on the prevailing logistics costs incurred by the dairy farming industry (taking into account (i) vehicle depreciation and maintenance, (ii) wages, (iii) fuel costs, based on refined oil prices announced by the National Development and Reform Commission of the PRC from time to time, (iv) toll rates, (v) insurance premium, and (vi) cargo-loading rate) and the distance between the customer's location and Shengmu High-tech's dairy farm(s); and



- (c) adjustments as agreed between Shengmu High-tech and Inner Mongolia Mengniu based on the quality and rating of raw fresh milk, taking into account various milk quality indicators, such as level of protein, fat content, somatic cell count, microorganism count and freezing point etc. (together with the logistics subsidy referred to in paragraph (b) above, “Adjustments”).

We have obtained and reviewed four recent raw fresh milk long-term supply agreements entered into between the Group as the supplier and each of two independent third parties and two associate companies of the Group as the purchaser. We note that the purchase price in the four supply agreements was either a fixed rate or determined based on the market conditions and seasonal factors. For the logistics service costs, except for one purchaser which does not require such service, all the remaining three purchasers agreed to either bear the costs or provide a subsidy for such service to the Group. In respect of the adjustments for milk quality to the base price, save for one of the supply agreements provides downward adjustment when milk quality factors are not met, there is no similar adjustment in all other three supply agreements. We have also obtained the supply listings of one farm of the Group, which supplied raw fresh milk to both China Mengniu Group and an independent third party during the period from 1 January 2022 to 30 September 2022, and we randomly selected two transactions between the Group as the supplier and China Mengniu Group and the independent third party as the purchasers. We have obtained and reviewed the selected raw fresh milk supply transaction documents and we note that the selling prices of raw fresh milk to China Mengniu Group were not lower than those of the independent third party.

Quality of milk

The quality of raw fresh milk supplied by the Group shall comply with the standards set by the government and the requirements of China Mengniu Group. We have reviewed the aforesaid recent raw fresh milk supply agreements and note that similar milk quality requirements were in place in the agreements.

Punctual delivery

The Group shall be responsible for delivering raw fresh milk to the locations designated by China Mengniu Group. If the Group is unable to deliver milk in a timely manner, the Group shall notify China Mengniu Group at least 24 hours prior to the scheduled delivery and the Group shall bear related losses suffered by China Mengniu Group (“Late Delivery Charge”).

As stated in the letter from the Board contained in the Circular, the Group has established an internal control mechanism to ensure the timely delivery of raw fresh milk. The Group maintains a three-month rolling plan for the herd and milk production to ensure that the Group has sufficient milk production capacity to meet the monthly supply plans for raw fresh milk. In addition, the dairy farms of the Group and the dairy products manufacturing facilities of China Mengniu Group are located in the same region. The maximum transportation distance for the supply of raw fresh milk from the dairy farms of the Group to the manufacturing facilities of China Mengniu Group is less than 110 kilometers and the transportation time is generally less than two hours. Given the close proximity, the Group is able to coordinate additional resources to meet the monthly supply plans if there is an emergency situation.



Moreover, the Late Delivery Charge is a common term in similar agreements between China Mengniu Group and its suppliers of raw fresh milk which are independent from China Mengniu Group. Therefore, the Board considers that such term is on normal commercial terms and in the interest of the Company. Having considered the existence of such term in similar agreements entered into between China Mengniu Group and their other suppliers of raw fresh milk, we concur with the view of the Board that the Late Delivery Charge is on normal commercial terms.

Payment terms

China Mengniu Group shall pay monthly in accordance with the purchase amount of raw fresh milk, and payment for raw fresh milk purchased in any month shall be settled by the end of the following month. The monthly payment date shall be before the 30th calendar day of each month (or the 28th calendar day for February).

Based on our review of the aforesaid four recent raw fresh milk long-term supply agreements, we note that the purchaser shall pay raw fresh milk purchased in any month by the end of that month or a few days before the end of the following month. Accordingly, it is considered that the payment terms of the aforesaid raw fresh milk supply agreements are generally in line with that of the Raw Fresh Milk Supply Framework Agreement.

5. Internal control procedures in determining the purchase price

As set out in the letter from the Board contained in the Circular, the Group formulates an annual supply plan for raw fresh milk, which is then divided into monthly supply plans taking into account the volume required by China Mengniu Group. The unit price of raw fresh milk, which comprises the Base Price and the Adjustments, is determined on a monthly basis. The Sales Team will review on a monthly basis the actual volume of raw fresh milk supplied. The Sales Team will also evaluate the fairness of the unit price by examining and considering the quantitative data from the test results of the milk quality indicators and checking whether the unit price has correctly reflected the test results of the raw fresh milk.

The Group's pricing mechanism with its customers (including China Mengniu Group and other independent third party customers) is generally the same and therefore the selling price of raw fresh milk to be sold by the Group to China Mengniu Group under the Raw Fresh Milk Supply Framework Agreement would be comparable to that of the other independent third party customers. The Group has established the following internal control measures to ensure that the purchase price and other terms of the sale of raw fresh milk by the Group to China Mengniu Group contemplated under the Raw Fresh Milk Supply Framework Agreement are no less favourable to the Group than the terms offered to independent third party customers, where the Sales Team has been tasked with:

- (a) considering and comparing prices and terms of similar products offered by the Group to other purchasers every month;
- (b) conducting market research every month and comparing the selling price of similar products offered by three other raw fresh milk producers when determining the Base Price for each month;



- (c) reviewing other terms of orders received from China Mengniu Group and other independent third party customers to ensure that the other terms offered by the Group to China Mengniu Group are no less favourable to the Group than those offered to independent third party customers; and
- (d) ensuring that each sale is executed at a purchase price determined in accordance with the relevant pricing mechanism as set out above.

Based on our review of the Group's internal controls policies in relation to connected transactions, in particular the pricing policies of raw fresh milk, we note that the responsible officer of the Group (who is independent to the purchasers and responsible for comparison of the quotations and negotiation with the purchasers) will determine the pricing of the raw fresh milk delivered to the relevant purchasers with supply agreements in that month at the beginning of each month. The responsible officer of the Group will review all the quotations and negotiate with the various purchasers to ensure the final unit price, before taking into account the Adjustments, is consistent among the purchasers. We have obtained the supply listings of one farm of the Group, which supplied raw fresh milk to both China Mengniu Group and an independent third party, during the period from 1 January 2022 to 30 September 2022 and we randomly selected two transactions between the Group as the supplier and China Mengniu Group and the independent third party as the purchasers. We have obtained and reviewed the selected raw fresh milk supply transaction documents and we note that the selling prices of raw fresh milk to China Mengniu Group were not lower than those of the independent third party.

Based on the above, we concur with the view of the Board that the aforesaid pricing procedures can result in the transactions contemplated under the Raw Fresh Milk Supply Framework Agreement to be conducted on normal commercial terms.

6. The Annual Caps

The proposed total annual sale amount by the Group to China Mengniu Group under the Raw Fresh Milk Supply Framework Agreement shall not exceed RMB3,400 million, RMB4,300 million and RMB5,000 million (“**Annual Caps**”) for the years ending 31 December 2023, 2024 and 2025 (“**Cap Period**”), respectively.

As stated in the letter from the Board contained in the Circular, the Annual Caps were determined with reference to a number of factors, particularly (i) the expected number of milkable cows of the Group (taking into account anticipated purchases and improvement in dairy cow breeding capacity, etc.); (ii) the expected increase in the overall sales volume of raw fresh milk by the Group for the years ending 31 December 2023, 2024 and 2025; (iii) the expected increase in sales volume of raw fresh milk to China Mengniu Group taking into account, among other things, the Group's commitment to supply on average at least 80% of the raw fresh milk it produces in each year to China Mengniu Group; (iv) the potential increase in price of dairy products in China; (v) the historical and prevailing purchase price of raw fresh milk paid by China Mengniu Group; and (vi) the historical transaction amounts of raw fresh milk sold by the Group to China Mengniu Group for the years ended 31 December 2019, 2020 and 2021 and the nine months ended 30 September 2022.



We have reviewed the following factors to assess the fairness and reasonableness of the Annual Caps:

(a) The expected number of milkable cows of the Group

On average for 2020, 2021 and the nine months ended 30 September 2022, the Group had 51,230, 51,314, and 53,408 heads of milkable cows for the production of raw fresh milk, respectively, representing growths of approximately 0.2% from 2020 to 2021 and approximately 4% from 2021 to September 2022. Among these milkable cows, 24,414, 33,979, and 38,099 heads of milkable cows were used for the production of organic raw fresh milk (“**Organic Milkable Cow(s)**”) for 2020, 2021 and the nine months ended 30 September 2022, respectively, representing growths of approximately 39% from 2020 to 2021 and approximately 12% from 2021 to September 2022. The remaining 26,816, 17,335, and 15,309 heads of milkable cows were used for the production of non-organic raw fresh milk (“**Non-organic Milkable Cow(s)**”) for 2020, 2021 and the nine months ended 30 September 2022, respectively, representing decreases of approximately 35% from 2020 to 2021 and approximately 12% from 2021 to September 2022. Such fluctuations of the numbers of the Organic Milkable Cows and the Non-organic Milkable Cows, as stated in the 2021 Annual Report, were mainly due to the conversion of regular farms to organic farms.

As advised by the Management and for the purpose of determining the Annual Caps, it was anticipated that the total number of milkable cows during the Cap Period would grow by approximately 10% to 22% per annum, consisting of (i) the expected growths in the number of the Organic Milkable Cows of approximately 17% to 27% per annum; and (ii) the expected changes in the number of the Non-organic Milkable Cows between a decline of approximately 9% per annum and a growth of approximately 8% per annum. The expected higher growth in the total number of milkable cows during the Cap Period is driven by, among others, the reducing culling rate of milkable cows. As stated in the 2021 Annual Report and the 2022 Interim Report, the annualised culling rate of milkable cows continued to decline from 35.9% to 32.9% for the year ended 31 December 2021 and further down to 31.1% for the first half of 2022. We concur with the Management’s expected growths of the total number of milkable cows are reasonable taking into account the historical decreasing culling rate of milkable cows.

As advised by the Management, additional expected growths of the number of the Organic Milkable Cows would be contributed by the potential acquisition of milkable cows from other parties during the Cap Period for a new dairy farm and an organic demonstration farm in the demonstration zone, which was expected to produce additional approximately 100,000 tonnes of organic raw fresh milk per year. We have obtained and reviewed the calculation of expected growth of the number of the Organic Milkable Cows and we note that the potential acquisition of the Organic Milkable Cows in 2023 and 2024 will produce additional approximately 100,000 tonnes or more of organic raw fresh milk for 2024 and 2025, respectively. We consider the projected numbers of the Organic Milkable Cows and the Non-organic Milkable Cows are reasonable having taken into account the historical movement of the numbers of the Organic Milkable Cows and the Non-organic Milkable Cows and the potential acquisition of milkable cows.



(b) The expected production volume of raw fresh milk of the Group

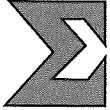
We have obtained and reviewed calculation of expected production volume of raw fresh milk of the Group provided by the Management, and we note that the production volume of organic raw fresh milk per day by each Organic Milkable Cow for the Cap Period would grow by approximately 1% to 3% per annum. For the production of non-organic raw fresh milk per day by each Non-organic Milkable Cow for the Cap Period, it was anticipated to grow by approximately 1% to 5% per annum. As stated in the 2022 Interim Report, the Group hired cow feeding experts during the first half of 2022 to develop better feeding practices for different farms and cows and as a result, the raw fresh milk production levels improved with average annualised production volume per milkable cow increased by approximately 0.24 tonnes to 10.53 tonnes, representing a growth of approximately 2% compared with that for the corresponding period in the prior year. Based on our discussion with the Management, the Group would continued to implement a series of measures to gradually improve the yield of the milkable cows of the Group during the Cap Period. Multiplying the expected number of milkable cows by the expected production volume of raw fresh milk per day per milkable cow as discussed above, the Management has arrived at the expected production volume of organic raw fresh milk and non-organic raw fresh milk of the Group for the years ending 31 December 2023, 2024 and 2025. Based on the historical growth in production volume of the milkable cows and the continuing implementation of measures to improve the yield of the milkable cows, we are of the view that the expected production volumes of raw fresh milk of the Group during the Cap Period are reasonable.

(c) The potential increase in the price of dairy products in China

Based on the annual reports published by the Company and as advised by the Management, we note that the average selling price of the organic raw fresh milk of the Group increased from approximately RMB4.8 per kg in 2019 to approximately RMB5.3 per kg in 2021 and slightly decreased to approximately RMB5.2 per kg for the nine months ended 30 September 2022, representing an overall increase of approximately 8%. Based on our review of calculation of the Annual Caps, it was projected that the average selling price of the organic raw fresh milk during the Cap Period would increase by approximately 2% to 3% per annum.

The non-organic raw fresh milk price followed a similar trend as that of organic raw fresh milk. The average selling price surged from approximately RMB3.7 per kg in 2019 to approximately RMB4.5 per kg in 2021 and slightly decreased to approximately RMB4.3 per kg for the nine months ended 30 September 2022, representing an overall increase of approximately 16%. Based on our review of calculation of the Annual Caps, it was projected that the average selling price of the non-organic raw fresh milk during the Cap Period would be at the same level or increase by approximately 2% to 4% per annum.

We consider the projected average selling prices of the organic raw fresh milk and the non-organic raw fresh milk during the Cap Period are reasonable taking into account the historical growths of the average selling prices from 2019.



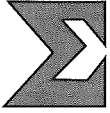
(d) The expected sales of substantial proportion of raw fresh milk to China Mengniu Group

In determining the Annual Caps, the Management estimated that up to approximately 89% of the raw fresh milk to be produced by the Group would be sold to China Mengniu Group, which would be equivalent to approximately RMB3,400 million, RMB4,300 million and RMB5,000 million for the years ending 31 December 2023, 2024 and 2025, respectively. As set out in the letter from the Board contained in the Circular, the historical transaction amounts of raw fresh milk (including both organic raw fresh milk and non-organic raw fresh milk) sold by the Group to China Mengniu Group for the years ended 31 December 2019, 2020 and 2021 and the nine months ended 30 September 2022 amounted to approximately RMB2,462.1 million, RMB2,505.1 million, approximately RMB2,621.6 million and approximately RMB2,171.4 million, respectively, representing approximately 89%, approximately 94%, approximately 88% and approximately 92% of the total revenue of the Group for the corresponding year or period, respectively. Based on our discussion with the Management, the significant majority of sales of raw fresh milk to China Mengniu Group was mainly due to the deepened collaboration between the Group and China Mengniu Group, in particular after completion of the disposal of the downstream dairy product business to China Mengniu Group in May 2019. Accordingly, it was anticipated that China Mengniu Group would continue to be the largest customer of the Group in the Cap Period.

Having considered that (i) the percentages of raw fresh milk sold to China Mengniu Group by the Group were up to 94% in recent years; (ii) the requirement of at least 80% of the raw fresh milk produced by the Group have to be sold to the China Mengniu Group pursuant to the Raw Fresh Milk Supply Framework Agreement; and (iii) the raw fresh milk supply relationship between the Company and China Mengniu Group and the expected synergistic benefits as stated in the letter from the Board contained in the Circular, we are of the view that it is acceptable to have the aforesaid percentages (i.e., up to approximately 89%) of the projected production of raw fresh milk to be sold to China Mengniu Group for the purpose of determining the Annual Caps.

OPINION AND RECOMMENDATION

Having taken into account the above principal factors and reasons, we consider that, the entering into the Raw Fresh Milk Supply Framework Agreement are in the ordinary and usual course of business of the Group and in the interests of the Company and the Shareholders as a whole. We are also of view that the terms of the Raw Fresh Milk Supply Framework Agreement (including the Annual Caps) are on normal commercial terms and fair and reasonable so far as the Independent Shareholders are concerned.



We therefore advise the Independent Board Committee to recommend, and we ourselves recommend, the Independent Shareholders to vote in favour of the resolution in relation to the Raw Fresh Milk Supply Framework Agreement (including the Annual Caps) at the EGM.

Yours faithfully,
for and on behalf of
SOMERLEY CAPITAL LIMITED

Danny Cheng
Director

Mr. Danny Cheng is a licensed person registered with the Securities and Futures Commission and a responsible officer of Somerley Capital Limited, who is licensed under the Securities and Futures Ordinance to carry out Type 1 (dealing in securities) and Type 6 (advising on corporate finance) regulated activities. He has over 15 years of experience in the corporate finance industry.