ALTUS CAPITAL LIMITED
21 Wing Wo Street, Central, Hong Kong

Tel : (852) 2522 6122
Fax : (852) 2522 6992
E-mail Address:
mail@altus.com.hk

15 December 2021

To the IBC and the Independent Shareholders

Shandong Xinhua Pharmaceutical Company Limited
No. 1 Lutai Ave.
Hi-tech Industry Development Zone
Zibo City
Shandong Province
PRC

Dear Sirs,

RENEWAL OF CONTINUING CONNECTED TRANSACTIONS

INTRODUCTION

We refer to our appointment as the Independent Financial Adviser to advise the IBC and the Independent Shareholders on the terms of and the proposed annual caps in relation to the continuing connected transactions under the CCT Agreements. Details of which are set out in the "Letter from the Board" contained in the circular of the Company dated 15 December 2021 (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 procuring and supplying certain pharmaceutical related products and drugs from and to certain connected persons (including associates of HHC), the Company has entered into the CCT Agreements with Shandong Lukang, China Shandong Group and Hualu Hengsheng, respectively, on 23 November 2021, to renew the continuing connected transactions contemplated thereunder for a term from 1 January 2022 to 31 December 2024, respectively.

香港中環永和街21號

LISTING RULES IMPLICATIONS

Each of Shangdong Lukang (the board of which is controlled by HHC), China Shandong Group (the issued share capital of which is held as to 99.75% by HHC) and Hualu Hengsheng (the issued share capital of which is indirectly held as to approximately 32.19% by HHC) are associates of HHC, the controlling shareholder of the Company and are there connected persons of the Company. The CCT Agreements therefore constitute continuing connected transactions of the Company.

Given that the Shandong Lukang Agreement, the China Shandong Agreement and the Hualu Hengsheng Agreement are of a similar nature and have been entered into by the Company with the parties which are connected with each other within a 12-month period, the Directors consider that the transactions contemplated under these Agreements should be aggregated as if they were one transaction pursuant to Rule 14A.81 of the Listing Rules.

As the applicable percentage ratios (other than the profits ratio) under the Listing Rules for the transactions contemplated under the CCT Agreements calculated on an aggregated basis pursuant to Rule 14A.81 of the Listing Rules exceed 5% on an annual basis, the transactions contemplated under the CCT Agreements constitute non-exempt continuing connected transactions and are subject to the reporting, announcement, circular (including independent financial advice), annual review, annual caps, Independent Shareholders' approval and other requirements under Chapter 14A of the Listing Rules.

THE IBC

The IBC comprising all the independent non-executive Directors, namely Mr. Pan Guangcheng, Mr. Zhu Jianwei and Mr. Lo Wah Wai, has been established to advise the Independent Shareholders on (i) whether the terms of the continuing connected transactions under the CCT Agreements are on normal commercial terms and are fair and reasonable; (ii) whether the continuing connected transactions under the CCT Agreements 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 CCT Agreements at the EGM, taking into account the recommendation of the Independent Financial Adviser.

THE INDEPENDENT FINANCIAL ADVISER

As the Independent Financial Adviser to the IBC and the Independent Shareholders, our role is to give an independent opinion to the IBC and the Independent Shareholders on (i) whether the terms of the continuing connected transactions under the CCT Agreements are on normal commercial terms and are fair and reasonable; (ii) whether the continuing connected transactions under the CCT Agreements 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 CCT Agreements 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 CCT Agreements 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) announcement of the Company dated 22 October 2018, 30 March 2021 and 23 November 2021; (ii) the circular of the Company dated 12 December 2018; (iii) the annual reports of the Company for each of the years ended 31 December 2018, 2019 and 2020; (iv) the interim report of the Company for the six months ended 30 June 2021 (the "**2021 Interim Report**"); (v) full invoice list for transactions under the Hualu Hengsheng Agreement for the two years ended 31 December 2020 and the nine months ended 30 September 2021; (vi) full invoice list for transactions under the Shandong Lukang Agreement and the China Shandong Agreement for the nine months ended 30 September 2021; (vii) sample invoices and purchase orders under the CCT Agreements for the relevant periods; and (viii) Company's internal sales target for the year ending 31 December 2021.

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 in accordance with Rule 13.80 of the Listing Rules. 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 Company

The Company is a joint stock limited company incorporated in the PRC with its H shares and A shares listed on the Stock Exchange and Shenzhen Stock Exchange respectively. The Company is principally engaged in the development, manufacture and sale of bulk pharmaceuticals, preparations and chemical products. The ultimate beneficial owner of the Company is the State-owned Assets Supervision and Administration Commission of the State Council of Shandong province.

1.2 Principal business of HHC

HHC is a state-owned enterprise principally engaged in investment holding of various companies listed or not listed on the stock exchanges of the Mainland China and Hong Kong, and is the controlling shareholder of the Company.

1.3 Principal business of Shandong Lukang

Shandong Lukang is a company incorporated in the PRC with limited liability and its principal business include, among others, manufacturing, processing and sales of chemical raw materials and preparations products for pharmaceutical production, auxiliary materials and intermediates, veterinary drugs, pharmaceutical packaging products and feed additives.

1.4 Principal business of China Shandong

China Shandong is a company incorporated in Hong Kong with limited liability and its principal business include project investment and import and export trade.

1.5 Principal business of Hualu Hengsheng

Hualu Hengsheng is a company incorporated in the PRC with limited liability and its principal businesses include, the production and sales of chemical products. Its main businesses include the production and sale of chemicals and chemical fertilizers, as well as the electricity generation and heating supply business.

1.6 Financial performance of the Group

The Group is mainly engaged in the development, manufacturing and sale of chemical bulk drugs, including active pharmaceutical ingredients ("**APIs**"), preparations and medical intermediates and other products.

The table below sets out the financial performance of the Group during the financial year ended 31 December ("**FY**") 2020 and 2019, as well as the 6-month ended ("**1H**") 2021 and 2020.

	FY2020 *RMB million*	**FY2019** *RMB million*	**1H2021** *RMB million*	**1H2020** *RMB million*
Operating income	6,005.6	5,606.0	3,551.0	3,285.8
Net profits attributable to shareholders after deduction of non-recurring profit and loss	290.8	258.6	185.9	154.3

The Group's operating income increased by 7.1% to approximately RMB6,005.6 million in FY2020 due mainly to increased sales of chemical bulk drugs, and in particular, the 33.4% growth in sales of medical intermediate and other products. Due to continued control on sales expenses and market development and terminal sales costs, the Group's selling expenses decreased by 20.0%. In line with improvement in operating income and lower selling expenses, the Group's net profits attributable to shareholders after deduction of non-recurring profit and loss increased by 12.5% from approximately RMB258.6 million in FY2019 to approximately RMB290.8 million in FY2020.

Comparing 1H2021 and 1H2020, the Group recorded increases in operating income of 8.1% to approximately RMB3,551.0 million, underpinned by income growth of preparations and, in particular, medical intermediate and other products. In line with the higher operating income, the Group's net profits attributable to shareholders after deduction of non-recurring profit and loss increased by 20.5% from approximately RMB154.3 million in 1H2020 to approximately RMB185.9 million in 1H2021.

1.7 Prospects of the Group

As set out in the Company's annual report for the year ended 31 December 2020, the Management believes that the domestic big circulation in the PRC and dual circulations of domestic and international complementing each other are becoming the new development pattern, which creates more development opportunities for enterprises. The introduction of various preferential policies and acceleration of population aging and urbanisation, coupled with the enhancement of public health awareness and national health insurance coverage and payment capabilities, the Management expected that the demand for medicine will continue to grow rapidly. As such, the bio-pharmaceutical industry is strategically poised to maintain a rapid development.

However, the Management also noted that the global landscape is facing more instabilities and uncertainties. The Company is facing challenges such as the COVID-19 pandemic, rising of de-globalisation, RMB appreciation and skyrocketing prices for international transportation. The intensified competition in the pharmaceutical market as well as the rising price of basic chemical raw materials are also impacting the Group's profitability.

As set out in the 2021 Interim Report, the Management expects that the COVID-19 pandemic is expected to continue to affect the world for some time in the future. The international freight rates will continue to run high and the exchange rates will be fluctuating, putting greater pressure on the export of Company's products. As it is difficult for the Company to pass on the cost by increasing the price of its products, the Management expects the high price of bulk commodities will slow down the improvement of the Company's profitability. Nevertheless, given the development of the Group's characteristic chemical APIs maintains a rapid pace, the market share of strategic formulations continues to increase, international cooperation projects for formulations and commercial production are rapidly advancing. The Management believes that the Group will be able to overcome numerous difficulties and maintain a strong momentum for development.

In response to the challenging environment, the Group will continue to capture market opportunities and strive for market initiative by implementing a proactive price strategy to ensure the stability of the bulk API market, as well as promoting multiple series of speciality products. The Group will also fully leverage its leading role in the market and continue to capture more market share, in particular in areas such as featured bulk drugs such as EPA and carbidopa.

We note that the continuing connected transactions under the CCT Agreements which involve purchase and sales of chemical products and APIs, forms part of the strategy above and is in line with the overall plan of the Group. We also note that the increasing trend of the proposed annual caps is consistent with the operating income growth recorded by the Group since FY2019.

2. RATIONALE FOR THE CONTINUING CONNECTED TRANSACTIONS

With reference to the "Letter from the Board", the Directors believe that it is in the best interest of the Group to enter into transactions under the CCT Agreements with Shandong Lukang, China Shandong and Hualu Hengsheng, respectively.

As set out in the "Letter from the Board", the Directors are of the view that, by entering into the Shandong Lukang Agreement, the Group will sell its pharmaceutical intermediates and APIs to Shandong Lukang and/or its subsidiaries, which allows the Group to expand its sales channels. The Company also will purchase pharmaceutical preparation products and APIs from Shandong Lukang and/or its subsidiaries, which enables the Group to increase its scale of distribution to medical institutions in Luzhong region (the surrounding areas of the Company) as well as to meet its own production needs. Furthermore, the Company will provide engineering design service to Shandong Lukang and/or its subsidiaries, and therefore the Company can utilise its pharmaceutical engineering capabilities and its product and solution innovation experience in the pharmaceutical industry.

As set out in the "Letter from the Board", the Directors are of the view that, by entering into the China Shandong Agreement, the Group will sell chemical raw materials and products to China Shandong and/or its subsidiaries. Such transactions between the Group and China Shandong and/or its subsidiaries enable the Group to increase its international sales so as to expand its business into international markets. Other than that, it also allows the Group to secure a stable source of income from selling those materials and products.

As set out in the "Letter from the Board", the Directors are of the view that, by entering into the Hualu Hengsheng Agreement, the Company will purchase chemical products from Hualu Hengsheng. Purchasing chemical products from Hualu Hengsheng helps the Company minimise procurement costs by reducing intermediate layers and secure a steady supply without additional costs which might be incurred by buying from other third parties.

Furthermore, we understand from the Management that the Group also sells chemical raw materials and products, pharmaceutical intermediates and APIs to, as well as purchase pharmaceutical preparation products and APIs from independent third parties. As such, the transactions contemplated under the CCT Agreements are in the ordinary and usual course of business of the Group.

Based on the abovementioned rationale for entering the CCT Agreements, we concur with the Directors that the transactions contemplated under the CCT Agreements 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.

3. PRINCIPAL TERMS OF THE CCT AGREEMENTS

(i) The Shandong Lukang Agreement

Pursuant to the Shandong Lukang Agreement, the Group shall purchase pharmaceutical preparation products and active pharmaceutical ingredients from Shandong Lukang and/or its subsidiaries, while the Group shall sell pharmaceutical intermediaries, active pharmaceutical ingredients as well as provide engineering design services to Shandong Lukang and/or its subsidiaries.

The term of the Shandong Lukang Agreement is from 1 January 2022 to 31 December 2024 (both dates inclusive), subject to early termination by either party giving the other party at least three months' prior written notice.

We have reviewed the Shandong Lukang Agreement and noted that the transactions contemplated thereunder shall be conducted on normal commercial terms and on terms no less favourable to the Company than those available to or from other independent third parties. We also noted that the Shandong Lukang Agreement does not restrict the Group from conducting similar transactions with any other independent third parties. As such, we are of the view that the terms of the Shandong Lukang Agreement are fair and reasonable. For details of other terms of the Shandong Lukang Agreement, please refer to the "Letter from the Board" in the Circular.

(ii) The China Shandong Agreement

Pursuant to the China Shandong Agreement, the Group shall sell chemical drug products and chemical products to China Shandong and/or its subsidiaries.

The term of the China Shandong Agreement is from 1 January 2022 to 31 December 2024 (both dates inclusive), subject to early termination by either party giving the other party at least three months' prior written notice.

We have reviewed the China Shandong Agreement and noted that the transactions contemplated thereunder shall be conducted on normal commercial terms and on terms no less favourable to the Company than those available to other independent third parties. We also noted that the China Shandong Agreement does not restrict the Group from conducting similar transactions with any other independent third parties. As such, we are of the view that the terms of the China Shandong Agreement are fair and reasonable. For details of other terms of the China Shandong Agreement, please refer to the "Letter from the Board" in the Circular.

(iii) The Hualu Hengsheng Agreement

Pursuant to the Hualu Hengsheng Agreement, the Group shall purchase chemical raw materials from Hualu Hengsheng and/or its subsidiaries.

The term of the Hualu Hengsheng Agreement is from 1 January 2022 to 31 December 2024 (both dates inclusive), subject to early termination by either party giving the other party at least three months' prior written notice.

We have reviewed the Hualu Hengsheng Agreement and noted that the transactions contemplated thereunder shall be conducted on normal commercial terms and on terms no less favourable to the Company than those available from other independent third parties. We also noted that the Hualu Hengsheng Agreement does not restrict the Group from conducting similar transactions with any other independent third parties. As such, we are of the view that the terms of the Hualu Hengsheng Agreement are fair and reasonable. For details of other terms of the Hualu Hengsheng Agreement, please refer to the "Letter from the Board" in the Circular.

4. PRICING POLICY

Pursuant to the CCT Agreements, the price will be determined through arm's length negotiations with reference to (i) the respective Pricing Policy; and (ii) the prevailing market price charged by independent third parties for comparable products and/or services. In any event, the price shall not be less favourable to the Company than those entered into by the Company with independent third parties.

The Pricing Policy for the transactions contemplated under each of the CCT Agreements is summarised in the table below:

Relevant transactions in relation to purchase of products	*Pricing policy*
• purchase of pharmaceutical preparation products and APIs by the Company from Shandong Lukang under the Shandong Lukang Agreement • purchase of chemical raw materials by the Company from Hualu Hengsheng under the Hualu Hengsheng Agreement	The prices and terms in respect of any purchase of products by the Group shall be negotiated on an arm's length basis with relevant counterparties taking into account the prevailing market price of the same or substantially similar products announced by at least two independent third parties in the same period which offer the same or substantially similar products in the same or nearby areas through inquiries via websites.

Relevant transactions in relation to sale of products	*Pricing policy*
• sale of pharmaceutical intermediaries, APIs and by the Company to Shandong Lukang under the Shandong Lukang Agreement • sale of chemical drug products and chemical products by the Company to China Shandong Group under the China Shandong Agreement	The prices and terms for any sale of products, chemical materials and/or provision of utility from the Group will be negotiated on arm's length basis with relevant counterparties taking into account and/or with reference to the following: (i) the actual costs incurred plus a reasonable profit margin (with reference to the general range of profit in the industry). The Company will refer to the historical average price for the relevant products and profit margins of comparable products and services disclosed by at least two other PRC listed companies to determine whether the profit margin charged is in line with the industry. In this regard, some PRC listed companies publish profit margins of their principal goods and services on the Shanghai Stock Exchange, the Shenzhen Stock Exchange or domestic bond markets (including but not limited to the inter-bank market of the PRC operated by the National Association of Financial Market Institutional Investors), from which the Company is able to draw references. As information are categorised by the industry and the region in the PRC, the Company will select and refer to profit margins of comparable products and services in the same or nearby areas or in the PRC (to the extent available) to determine whether the profit margin charged is in line with the industry.

Relevant transactions in relation to sale of products	*Pricing policy*
	(ii) the demand and supply in the market for the relevant products and the urgency of the orders from counterparties at the relevant time will be considered in determining the final transaction price.

Relevant transactions in relation to provision of engineering design services	*Pricing policy*
• provision of engineering design services by the Company to Shandong Lukang under the Shandong Lukang Agreement	The determination of the service fees chargeable by the Group on relevant counterparties will be negotiated on arm's length basis with the counterparties taking into account and/or with reference to the following: (i) the urgency of the requested services to be provided; (ii) the estimated man-hours and/or man-days of the human resources required to provide the relevant services; (iii) the materiality and complexity of the proposed services to be provided; and (iv) the fees charged for historical transactions of similar nature.

We understand that the Group has established internal control procedure to monitor the implementation of pricing mechanism of the transactions contemplated under the CCT Agreements including, amongst others, (i) making reference to relevant market information; and (ii) comparing quotation from independent third parties.

In this respect, we have obtained (i) the full invoice list for transactions under the Hualu Hengsheng Agreement for the two years ended 31 December 2020 and the nine months ended 30 September 2021; (ii) the full invoice list for transactions under the Shandong Lukang Agreement for the nine months ended 30 September 2021; and (iii) the full invoice list for transactions under the China Shandong Agreement for the nine months ended 30 September 2021. Based on the full invoice lists, we randomly selected 5 sample walkthroughs for each of the year ended 31 December 2019, 2020 and the nine months ended 30 September 2021 (where applicable) for each CCT Agreement's transaction type, namely:

- purchase of pharmaceutical preparation products and APIs by the Company from Shandong Lukang under the Shandong Lukang Agreement;

- purchase of chemical raw materials by the Company from Hualu Hengsheng under the Hualu Hengsheng Agreement;

- sale of pharmaceutical intermediaries, APIs and by the Company to Shandong Lukang under the Shandong Lukang Agreement;

- sale of chemical drug products and chemical products by the Company to China Shandong Group under the China Shandong Agreement; and

- provision of engineering design services by the Company to Shandong Lukang under the Shandong Lukang Agreement.

Each set of sample walkthrough includes (i) the transaction invoice (including the unit prices of products and/or services) between the Group and its connected persons (i.e. Shandong Lukang, China Shandong, Hualu Hengsheng and their respective subsidiaries); and (ii) the corresponding comparison quotations of unit prices of products/services provided by independent third parties or obtained through online trading platforms. In view of the large transaction volume and the relatively small transaction value for each invoice, and given the samples were randomly selected from the full invoice list, we believe the approach is practical and the selected walk-through documents are sufficient for this purpose.

Based on review of the 35 randomly selected samples, it is noted that the price for the transactions entered into between the Group and the connected persons (i.e. Shandong Lukang, China Shandong, Hualu Hengsheng and their respective subsidiaries) for each category of the products and/or services are no less favourable than those in the market.

In light of the above and considering the monitoring measures undertaken as set out under the section headed "6. Internal control measures" in this letter below, we are of the view that the Group's internal control measures to ensure fair pricing of the transactions contemplated under the CCT Agreements have been 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 CCT Agreements.

5. PROPOSED ANNUAL CAPS

(i) The Shandong Lukang Agreement

2021 approved annual cap and historical transaction amount

The table below sets out the 2021 approved annual cap and the historical transaction amount for the nine months ended 30 September 2021.

	For the year ending 31 December 2021 *RMB'000*
Purchase of pharmaceutical preparation products and APIs by the Group from Shandong Lukang and/or its subsidiaries:	
Approved annual cap	14,000
Historical transaction amount *(Note 1)*	4,624
Utilisation percentage *(Note 2)*	33.0%
Sale of pharmaceutical intermediaries, APIs and provisions of engineering design services by the Group to Shandong Lukang and/or its subsidiaries:	
Approved annual cap	14,000
Historical transaction amount *(Note 3)*	2,899
Utilisation percentage *(Note 4)*	20.7%

Notes:

1. Such amount represents the transaction amount for the purchase of pharmaceutical preparation products and APIs by the Group from Shandong Lukang and/or its subsidiaries for the nine months ended 30 September 2021.

2. The utilisation rate was calculated by dividing the transaction amount for the purchase of pharmaceutical preparation products and APIs by the Group from Shandong Lukang and/or its subsidiaries for the nine months ended 30 September 2021 against the total annual cap for the year ending 31 December 2021.

3. Such amount represents the transaction amount for the sale of pharmaceutical intermediaries, APIs and provisions of engineering design services by the Group to Shandong Lukang and/or its subsidiaries for the nine months ended 30 September 2021.

4. The utilisation rate was calculated by dividing the transaction amount for the sale of pharmaceutical intermediaries, APIs and provisions of engineering design services by the Group to Shandong Lukang and/or its subsidiaries for the nine months ended 30 September 2021 against the total annual cap for the year ending 31 December 2021.

As shown in the table above, for the nine months ended 30 September 2021, the Group utilised approximately 33.0% of the approved annual cap for the purchase of pharmaceutical preparation products and APIs from Shandong Lukang and/or its subsidiaries for the year ending 31 December 2021. According to the Management, the relatively low utilisation rate was mainly due to the shortage in supply of the chemical raw materials, which affected the production capacity of Shandong Lukang. Due to such production capacity limitation of Shandong Lukang, the Group had to source pharmaceutical preparation products and APIs from other suppliers.

For illustration purpose, the annualised transaction amount for the purchase of pharmaceutical preparation products and APIs by the Group from Shandong Lukang and/or its subsidiaries for the year ending 31 December 2021 is approximately RMB6.2 million, which represents a utilisation rate of approximately 44.3%.

In addition to the above, for the nine months ended 30 September 2021, the Group utilised approximately 20.7% of the approved annual cap for the sale of pharmaceutical intermediaries, APIs and provisions of engineering design services to Shandong Lukang and/or its subsidiaries for the year ending 31 December 2021. We understand from the Management that the low utilisation rate was primarily due to the implementation of a new procurement policy for Prendnisone Acetate by Shandong Lukang during the year due to the relocation of its relevant production plant and facilities requiring the use of Prendnisone Acetate, and the Group had to be re-evaluated as a supplier under the new policy. This in turn delayed the supply of Prendnisone Acetate from the Group to Shandong Lukang and had a negative impact on the Group's sales to Shandong Lukang for the nine months ended 30 September 2021.

For illustration purpose, the annualised transaction amount for the sale of pharmaceutical intermediaries, APIs and provisions of engineering design services by the Group to Shandong Lukang and/or its subsidiaries for the year ending 31 December 2021 is approximately RMB3.9 million, which represents a utilisation rate of approximately 27.9%.

Proposed Annual Caps

	Proposed annual cap for		
	Year ending 31 December 2022	**Year ending 31 December 2023**	**Year ending 31 December 2024**
	RMB'000	*RMB'000*	*RMB'000*
Purchase of pharmaceutical preparation products and APIs by the Group from Shandong Lukang and/or its subsidiaries	12,500	13,500	13,500
Sale of pharmaceutical intermediaries, APIs and provisions of engineering design services by the Group to Shandong Lukang and/or its subsidiaries	6,000	9,000	9,000
Total	18,500	22,500	22,500

With reference to the Letter from the Board, we noted that the proposed annual cap for the three years ending 31 December 2024 under the Shandong Lukang Agreement has been determined with reference to

(i) the historical amounts for the transactions between the Group and Shandong Lukang and/or its subsidiaries as disclosed above;

(ii) the expected demand for products to be purchased by the Group from Shandong Lukang and/or its subsidiaries:

(a) based on expected demand from customers of the Group for these products as well as end-products which require the use of these products in their product; and

(b) given the expected restoration of supply of raw chemical products necessary for the production of pharmaceutical preparation products and APIs demanded by the Group, the shortage of which hampered the production and supply of relevant products by Shandong Lukang and/or its subsidiaries to the Group in the year ended 31 December 2021 (during which period the Group have had to source the relevant products from independent third parties);

(iii) expected demand of products and services to be supplied by the Group to Shandong Lukang and/or its subsidiaries based on discussions with Shandong Lukang, with consideration given to the expected increase in sales of a certain product to Shandong Lukang and/or its subsidiaries following the expected completion of supplier evaluation of the Group in the year ending 31 December 2023 as part of its new procurement policy adopted and necessitated by the relocation of relevant production plants and equipment in the year ended 31 December 2021;

(iv) the prevailing market price as well as the market price trend for the relevant products and services to be purchased and/or sold (in particular, the increase in price of supply of a certain product to Shandong Lukang and/or its subsidiaries as agreed under the Shandong Lukang Agreement); and

(v) the anticipated business volume and production capacity of the Group.

We had obtained and reviewed the Group's internal budget in relation to the transactions with Shandong Lukang and/or its subsidiaries for the three years ending 31 December 2024. We noted that the transaction volume was determined in accordance with the agreed transaction volume estimate between the Group and Shandong Lukang, as set out in the Shandong Lukang Agreement which we reviewed. We also noted that the unit prices stated in the internal budget for the products/services are in line with the historical prices of similar products/services.

In relation to the purchase of pharmaceutical preparation products and APIs, we noted the historical utilisation was limited by the limited production capacity of Shandong Lukang as a result of a shortage in supply of chemical raw materials necessary for its production. We had reviewed correspondences between the Group and Shandong Lukang in which Shandong Lukang has confirmed that its production capacity shall resume to normal for the year ending 31 December 2022, and hence the Group expects the purchase of pharmaceutical preparation products and APIs will increase accordingly.

In relation to the sale of pharmaceutical intermediaries and APIs, we understand from the Management that the re-evaluation of the Group under the new procurement policy of Shandong Lukang for Prendnisone Acetate is expected to completed by 2023. As such, the agreed transaction volumes between the Group and Shandong Lukang for the two years ending 31 December 2024 have taken into account the expected increase in sales of Prendnisone Acetate. Furthermore, the agreed transaction amount between the Group and Shandong Lukang has also taken into consideration the expected increase in price of Tetramethyl Guanidine of approximately 1.5 times, which has been agreed between the Group and Shandong Lukang in the Shandong Lukang Agreement which we reviewed.

Furthermore, we noted that the proposed annual caps have been adjusted downwards as compared to the approved annual cap for the year ending 31 December 2021, reflecting the Management's consideration of the actual utilisation of the relevant cap to-date.

Taking into account the Group's expanding operations and growing revenue as elaborated under the section headed "1.6 Financial performance of the Group" in this letter, the Management believes, and we concur, that the proposed annual caps offer flexibility to the Group to source pharmaceutical preparation products and APIs from different suppliers, and expand its sales channel regarding the sale of pharmaceutical intermediaries and APIs. This is also in line with the Group's intention to leverage on its leading role in market and expand its market share as elaborated under the section headed "1.7 Prospects of the Group" in this letter.

In light of the above, we believe the proposed annual caps for the three years ending 31 December 2024 under the Shandong Lukang Agreement were estimated based on reasonable ground, and are therefore fair and reasonable so far as the Company and the Independent Shareholders are concerned.

(ii) ***The China Shandong Agreement***

2021 approved annual cap and historical transaction amount

The table below sets out the 2021 approved annual cap and the historical transaction amount for the nine months ended 30 September 2021.

	For the year ending 31 December 2021
	USD'000
Sale of chemical drug products and chemical products by the Company to China Shandong Group and/or its subsidiaries:	
Approved annual cap	15,000
Historical transaction amount *(Note 1)*	4,104
Utilisation percentage *(Note 2)*	27.4%

Notes:

1. Such amount represents the transaction amount for the sale of chemical drug products and chemical products by the Company to China Shandong Group and/or its subsidiaries for the nine months ended 30 September 2021.

2. The utilisation rate was calculated by dividing the transaction amount for the sale of chemical drug products and chemical products by the Company to China Shandong Group and/or its subsidiaries for the nine months ended 30 September 2021 against the total annual cap for the year ending 31 December 2021.

As shown in the table above, for the nine months ended 30 September 2021, the Group utilised approximately 27.4% of the approved annual cap for the sale of chemical drug products and chemical products to China Shandong Group and/or its subsidiaries for the year ending 31 December 2021. The relatively low utilisation rate was mainly attributable to the COVID-19 pandemic, resulting in an increase in the ocean freight price. As a result, the increasing costs had transferred partly into the price of the products, and negatively affected the demand and sales of chemical drug products and chemical products to China Shandong Group and/or its subsidiaries.

For illustration purpose, the annualised transaction amount for the sale of chemical drug products and chemical products to China Shandong Group and/or its subsidiaries for the year ending 31 December 2021 is approximately USD5.5 million, which represents a utilisation rate of approximately 36.7%.

Proposed Annual Caps

	Proposed annual cap for		
	Year ending 31 December 2022	**Year ending 31 December 2023**	**Year ending 31 December 2024**
	USD'000	*USD'000*	*USD'000*
Sale of chemical drug products and chemical products by the Company to China Shandong Group and/or subsidiaries	8,000	10,000	11,000

With reference to the Letter from the Board, we noted that the proposed annual cap for the three years ending 31 December 2024 under the China Shandong Agreement has been determined with reference to (i) the historical amounts for the transactions between the Group and China Shandong Group and/or its subsidiaries; (ii) the expected demand for the chemical drug products and chemical products to be sold by the Group to China Shandong Group and/or its subsidiaries based on discussions with China Shandong Group; (iii) the prevailing market price as well as market price trend for chemical drug products and chemical products to be sold under the agreement; and (iv) the anticipated business volume and production capacity of the Company.

We had obtained and reviewed the Group's internal budget in relation to the transactions with China Shandong Group and/or its subsidiaries for the three years ending 31 December 2024. We noted that the transaction volume was determined in accordance with the agreed transaction volume estimate between the Group and the China Shandong Group, as set out in the China Shandong Agreement which we reviewed. We also noted that the unit prices stated in the internal budget for the products/services are in line with the historical prices of similar products/services.

Furthermore, we noted that the proposed annual caps have been adjusted downwards as compared to the approved annual cap for the year ending 31 December 2021, reflecting the Management's consideration of the actual utilisation of the relevant cap to-date.

Taking into account the Group's expanding operations and growing revenue as elaborated under the section headed "1.6 Financial performance of the Group" in this letter, the Management believes, and we concur, that the proposed annual caps offer flexibility to the Group to expand its sales channel regarding the sale of chemical drug products and chemical products. This is also in line with the Group's intention to leverage on its leading role in market and expand its market share as elaborated under the section headed "1.7 Prospects of the Group" in this letter.

In light of the above, we believe the proposed annual caps for the three years ending 31 December 2024 under the China Shandong Agreement were estimated based on reasonable ground, and are therefore fair and reasonable so far as the Company and the Independent Shareholders are concerned.

(iii) The Hualu Hengsheng Agreement

Approved annual caps and historical transaction amount

The table below sets out the approved annual caps and the historical transaction amounts for the two years ended 2020 and the nine months ended 30 September 2021.

	Historical amounts		
	Year ended 31 December 2019	**Year ended 31 December 2020**	**Year ending 31 December 2021**
	RMB'000	*RMB'000*	*RMB'000*
Purchase of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries:			
Approved annual caps	310,000	330,000	340,000
Historical transaction amount	139,108	127,345	140,489 *(Note 1)*
Utilisation percentage	44.9%	38.6%	41.3% *(Note 2)*

Notes:

1. Such amount represents the transaction amount for the purchase of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries for the nine months ended 30 September 2021.

2. The utilisation rate was calculated by dividing the transaction amount for the purchase of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries for the nine months ended 30 September 2021 against the total annual cap for the year ending 31 December 2021.

As shown in the table above, the Group utilised approximately 44.9% and 38.6% of the approved annual caps for the two years ended 31 December 2020, respectively. For the nine months ended 30 September 2021, the Group utilised approximately 41.3% of the approved annual cap for the year ending 31 December 2021.

We understand from the Management, various repairment and improvement on the Company's production facilities during the year ended 31 December 2019 had slowed down the production. As such, the demand for chemical raw materials had decreased, which in turn affected the purchase amount of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries.

The purchase amount further decreased during the year ended 31 December 2020 as a result of the ongoing COVID-19 pandemic, which created significant delays in global logistics and uncertainties in the market. As a result, the demand from downstream customers decreased and the Group had to decrease the production, which in turn affected the purchase amount of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries.

Both the transaction amount and the utilisation rate had increased slightly for the year ending 31 December 2021. We understand from the Management that such increase was mainly attributable to the slight recovery of global logistics and market sentiment during the nine months ended 30 September 2021.

For illustration purpose, the annualised transaction amount for the purchase of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries for the year ending 31 December 2021 is approximately RMB187.3 million, which represents a utilisation rate of approximately 55.1%.

Proposed Annual Caps

	Proposed annual cap for		
	Year ending 31 December 2022	**Year ending 31 December 2023**	**Year ending 31 December 2024**
	RMB'000	*RMB'000*	*RMB'000*
Purchase of chemical raw materials by the Group from Hualu Hengsheng and/or its subsidiaries	257,000	234,000	234,000

With reference to the Letter from the Board, we noted that the proposed annual cap for each year under the Hualu Hengsheng Agreement has been determined with reference to (i) the historical amounts for the transactions between the Group and Hualu Hengsheng and/or its subsidiaries as disclosed above; (ii) the expected demand for the chemical raw materials to be purchased by the Group from Hualu Hengsheng and/or its subsidiaries based on expected demand from customers of the Group for end-products which require the use of relevant chemical raw materials; (iii) the prevailing market price as well as market price trend for chemical raw materials to be purchased under the agreement; and (iv) the anticipated business volume and production capacity of the Company.

We had obtained and reviewed the Group's internal budget in relation to the transactions with Hualu Hengsheng and/or its subsidiaries for the three years ending 31 December 2024. We noted that the transaction volume was determined in accordance with the agreed transaction volume estimate between the Group and Hualu Hengsheng, as set out in the Hualu Hengsheng Agreement which we reviewed. We also noted that the unit prices stated in the internal budget for the products/services are in line with the historical prices of similar products/services.

Furthermore, we noted that the proposed annual caps have been adjusted downwards as compared to the approved annual cap for the year ending 31 December 2021, reflecting the Management's consideration of the actual utilisation of the relevant cap to-date.

Taking into account the Group's expanding operations and growing revenue as elaborated under the section headed "1.6 Financial performance of the Group" in this letter, the Management believes, and we concur, that the proposed annual caps offer flexibility to the Group to source chemical raw materials from different suppliers. This is also in line with the Group's intention to leverage on its leading role in market and expand its market share as elaborated under the section headed "1.7 Prospects of the Group" in this letter.

In light of the above, we believe the proposed annual caps for the three years ending 31 December 2024 under the Hualu Hengsheng Agreement were estimated based on reasonable ground, and are therefore 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 CCT Agreements.

The Management will discuss and consider the terms and conditions as well as the pricing mechanism of each transaction contemplated under the CCT Agreements before entering into those transactions in order to ensure that they are on normal commercial terms.

In addition, we noted that the finance department of the Company will review the relevant transactions on a monthly 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 CCT Agreements; (ii) the annual caps (as applicable) have not been exceeded; and (iii) the pricing mechanism has been effectively implemented.

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 CCT Agreements to confirm that the pricing mechanisms and annual caps 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) sample monthly reports issued by the finance department of the Company regarding the actual transaction amounts between the Group and the connected persons including the remaining transaction amounts under the approved annual caps for transactions under each of the CCT Agreements; (ii) independent auditors' confirmation in respect of the transactions between the Group and the connected persons under the Hualu Hengsheng Agreement in the annual report of the Group for the year ended 31 December 2020; and (iii) confirmation made by the independent non-executive Directors' on the annual report of the Group for the year ended 31 December 2020 regarding transactions under the Hualu Hengsheng Agreement; and after taking into account the fact that the annual caps for the CCT Agreements had not been exceeded, we are of the view that such internal control measure for monitoring the transactions contemplated under the CCT Agreements 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 CCT Agreements 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 CCT Agreements are on normal commercial terms and are fair and reasonable; and (ii) the continuing connected transactions under the CCT Agreements 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 IBC 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 the CCT Agreements (including the respective proposed annual caps thereof) and we recommend 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.*