
THIS CIRCULAR IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION

If you are in doubt as to any aspect of this circular or as to the action to be taken, you should consult your stockbroker or other registered dealer in securities, bank manager, solicitor, professional accountant or other professional adviser.

If you have sold or transferred all your shares in Shandong Xinhua Pharmaceutical Company Limited, you should at once hand this circular to the purchaser or transferee or to the bank, stockbroker or other agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.

Hong Kong Exchanges and Clearing Limited and The Stock Exchange of Hong Kong Limited take no responsibility for the contents of this circular, make no representation as to its accuracy or completeness and expressly disclaim any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of the contents of this circular.



山東新華製藥股份有限公司
Shandong Xinhua Pharmaceutical Company Limited

(a joint stock company established in the People's Republic of China with limited liability)

(Stock Code: 0719)

**(1) CONTINUING CONNECTED TRANSACTIONS
(2) PROPOSED ADOPTION OF SHARE OPTION SCHEME AND
THE PROPOSED GRANT THEREUNDER**

**Independent Financial Adviser
to the Independent Board Committee and the Disinterested Shareholders
in respect of the Continuing Connected Transactions**



中孚資本有限公司
HOLOGRAM CAPITAL LIMITED

A letter from the Board is set out on pages 1 to 36 of this circular. A letter from the Independent Board Committee containing its recommendations in respect of the Continuing Connected Transactions is set out on page 37 of this circular.

A letter from Hologram Capital Limited, the independent financial adviser in respect of the Continuing Connected Transactions, containing its advice to the Independent Board Committee and the Disinterested Shareholders is set out on pages 38 to 64 of this circular.

(i) A notice convening the EGM to be held at the conference room of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC on 28 December 2018, Friday at 2:00 p.m.; (ii) a notice convening the H Shareholders' Class Meeting to be held at the conference room of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC on 28 December 2018, Friday at 4:00 p.m. (or immediately after the conclusion or adjournment of the A Shareholders' Class Meeting to be held on the same day at the same venue at 3:00 p.m. or immediately after the conclusion or adjournment of the EGM); and (iii) the Proxy Forms for use at and the reply slips in relation to the EGM and the H Shareholders' Class Meeting were despatched by the Company on 12 November 2018 and also published and available for downloading on the websites of The Stock Exchange of Hong Kong Limited at www.hkex.com.hk and of the Company at <http://www.xhzy.com>.

Whether or not you intend to attend the EGM and the H Shareholders' Class Meeting, we encourage you to complete and return the Proxy Forms in respect of the EGM and the H Shareholders' Class Meeting in accordance with the instructions printed thereon as soon as possible and in any event not less than 24 hours prior to the commencement of such meetings (or any adjournments thereof). Completion and return of the Proxy Forms will not preclude you from attending and voting in person at the abovementioned meetings or any adjournment thereof (as the case may be) should you so wish. Shareholders who intend to attend the EGM and the H Shareholders' Class Meeting should also complete and return the reply slips in accordance with the instructions printed thereon.

12 December 2018

CONTENTS

	<i>Page</i>
DEFINITIONS	ii
LETTER FROM THE BOARD	1
LETTER FROM THE INDEPENDENT BOARD COMMITTEE	37
LETTER FROM THE INDEPENDENT FINANCIAL ADVISER	38
APPENDIX I – THE SHARE OPTION SCHEME	I-1
APPENDIX II – THE ASSESSMENT METHODS IN RESPECT OF THE IMPLEMENTATION AND MANAGEMENT OF THE SHARE OPTION SCHEME	II-1
APPENDIX III – GENERAL INFORMATION	III-1

DEFINITIONS

In this circular, the following expressions shall have the meanings set out below unless the context requires otherwise:

“A Share(s)”	A Share(s) of RMB1.00 each in the capital of the Company which is/are listed and traded on the Shenzhen Stock Exchange
“A Shareholder(s)”	holder(s) of A Shares
“A Shareholders’ Class Meeting”	the A Shareholders’ class meeting of the Company to be held on 28 December 2018
“Agreements”	the SXPGC Agreement and the SHHCC Agreement
“Articles of Association”	the articles of association of the Company
“Assessment Methods”	the Assessment Methods in Respect of the Implementation and Management of the 2018 Share Option Scheme of the Company
“associate”	has the meaning ascribed to it under the Listing Rules
“Bidding Website”	http://ebnew.com , an independent bidding website that provides a public bidding platform service for the trading of goods online
“Board”	the board of Directors
“Class Meetings”	the A Shareholders’ Class Meeting and the H Shareholders’ Class Meeting
“Company”	Shandong Xinhua Pharmaceutical Company Limited (山東新華製藥股份有限公司), a joint stock limited company established in the PRC with the H Shares and A Shares thereof listed on the Hong Kong Stock Exchange (stock code: 0719) and the Shenzhen Stock Exchange (stock code: 000756) respectively
“Company Law”	the Company Law of the PRC (as amended from time to time)
“connected person”	has the meaning ascribed to it under the Listing Rules
“Continuing Connected Transactions”	the continuing connected transactions under the renewed (i) SXPGC Agreement and (ii) SHHCC Agreement including without limitation to the proposed annual caps

DEFINITIONS

“controlling shareholder”	has the meaning ascribed to it under the Listing Rules
“Controlling Shareholder Group”	the controlling shareholder of the Company and controlling shareholders’ subsidiaries
“CSRC”	China Securities Regulatory Commission
“Director(s)”	director(s) of the Company
“Disinterested Shareholders”	Shareholders, other than SXPGC and Well Bring Limited, who are not required to abstain from voting on the resolutions on the Continuing Connected Transactions
“EGM”	the extraordinary general meeting of the Company to be held on 28 December 2018
“Exercise Date”	the date on which the Participants are entitled to exercise the Options, which must be a trading day (with the meanings ascribed thereto under the Shenzhen Listing Rules)
“Exercise Price”	the price at which an Option may be exercised, which shall, pursuant to the Share Option Scheme and subject to Note (1) to Rule 17.03(9) of the Listing Rules, be RMB5.98
“Grant”	the proposed grant of Options to the Participants pursuant to the Share Option Scheme totalling 16,250,000 Options, and unless the context should otherwise require the word “Grant” as a verb should be construed accordingly
“Group”	the Company and its subsidiaries
“H Share(s)”	H Share(s) of RMB1.00 each in the capital of the Company which is/ are listed and traded on the Hong Kong Stock Exchange
“H Shareholder(s)”	holder(s) of H Shares
“H Shareholders’ Class Meeting”	the H Shareholders’ class meeting of the Company to be held on 28 December 2018

DEFINITIONS

“HHGC”	Hualu Holdings Group Company Limited (華魯控股集團有限公司), a wholly state-owned company, the holding company of SXPGC and controlling shareholder of the Company and SHHGC
“HKD”	Hong Kong dollars, the lawful currency of Hong Kong
“holding company”	has the meanings ascribed to it under the Listing Rules
“Hong Kong”	the Hong Kong Special Administrative Region of the PRC
“Hong Kong Stock Exchange”	The Stock Exchange of Hong Kong Limited
“Incentive Measures”	上市公司股權激勵管理辦法 (the Administrative Measures on Share Incentives of Listed Companies*)
“Independent Board Committee”	the independent board committee of the Company comprising the independent non-executive Directors constituted for the purpose of considering the Continuing Connected Transactions
“Independent Financial Adviser”	Hologram Capital Limited, a corporation licensed to carry out type 6 (advising on corporate finance) regulated activity under the SFO, which has been appointed as the independent financial adviser to advise the Independent Board Committee and the Disinterested Shareholders in relation to the Continuing Connected Transactions
“Latest Practicable Date”	5 December 2018, being the latest practicable date prior to the printing of this circular for ascertaining certain information referred to in this circular
“Listing Rules”	the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange
“Main Board”	the Main Board of the Hong Kong Stock Exchange
“Option”	the right to be granted to a Participant to acquire one new A Share at the Exercise Price within the exercise period and subject to the terms and conditions of the Share Option Scheme

DEFINITIONS

“Participant”	a person eligible to be Granted the Option(s) under the Share Option Scheme
“PRC”	the People’s Republic of China
“Remuneration and Examination Committee”	The Remuneration and Examination Committee of the Board
“RMB”	Renminbi, the lawful currency of the PRC
“Scheme Documents”	the Share Option Scheme and the Assessment Methods
“Securities Law”	the Securities Law of the PRC (as amended from time to time)
“SFO”	the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)
“Shandong SASAC”	The Shandong Provincial State-owned Assets Supervision and Administration Commission
“Share(s)”	A Share(s) and/or H Share(s)
“Share Option Scheme”	the proposed share option scheme of the Company
“Shareholder(s)”	holder(s) of Share(s)
“Shenzhen Listing Rules”	Rules Governing the Listing of Securities on the Shenzhen Stock Exchange
“SHHCC”	Shandong Hualu Hengsheng Chemical Company Limited* (山東華魯恒升化工股份有限公司), of which SHHGC owned 32.32% of the total issued shares as of the Latest Practicable Date and is the largest shareholder thereof
“SHHCC Agreement”	the agreement entered into between the Company and SHHCC dated 22 October 2018
“SHHGC”	Shandong Hualu Hengsheng Group Company Limited* (山東華魯恒升集團有限公司), a wholly-owned subsidiary of HHGC

DEFINITIONS

“Supervisors”	the supervisors of the Company
“SXPGC”	Shandong Xinhua Pharmaceutical Group Company Limited* (山東新華醫藥集團有限責任公司), a wholly state-owned company which as of the Latest Practicable Date owned 32.94% of the total issued Shares of the Company and was the immediate controlling shareholder and largest Shareholder thereof
“SXPGC Agreement”	the agreement entered into between the Company and SXPGC dated 22 October 2018
“Validity Period”	the period during which the Share Option Scheme is in effect
“Zibo”	Zibo City, Shandong Province, the PRC
“%”	per cent

Certain English translations of Chinese names or words marked with “” in this circular are included for reference purpose only and should not be regarded as the official English translations of such Chinese names or words.*

LETTER FROM THE BOARD



山東新華製藥股份有限公司
Shandong Xinhua Pharmaceutical Company Limited

(a joint stock company established in the People's Republic of China with limited liability)

(Stock Code: 0719)

Executive Directors:

Mr. Zhang Daiming (*Chairman*)
Mr. Du Deping

Non-executive Directors:

Mr. Ren Fulong
Mr. Xu Lie
Mr. Zhao Bin

Independent Non-executive Directors:

Mr. Li Wenming
Mr. Du Guanhua
Mr. Lo Wah Wai

Registered Address:

Chemical Industry Area of Zibo Hi-tech
Industry Development Zone,
Zibo City,
Shandong Province, PRC

12 December 2018

To Shareholders

Dear Sir or Madam,

(1) CONTINUING CONNECTED TRANSACTIONS
(2) PROPOSED ADOPTION OF SHARE OPTION SCHEME AND
THE PROPOSED GRANT THEREUNDER

I. INTRODUCTION

The purpose of this circular is to provide you with the relevant information for making informed decisions in respect of the resolutions at the EGM and the H Shareholders' Class Meeting.

LETTER FROM THE BOARD

II. CONTINUING CONNECTED TRANSACTIONS

A. Background information

Reference is made to the announcement of the Company dated 22 October 2018 in relation to the Continuing Connected Transactions.

SXPGC Agreement

On 29 October 2015, the Company entered into an agreement in relation to the Group purchasing and selling certain products and services from and to the Controlling Shareholder Group for a period of three years from 1 January 2016 to 31 December 2018. This agreement will expire on 31 December 2018.

In the circumstances, the Company has entered into a renewed SXPGC Agreement with SXPGC and HHGC, the controlling shareholder of the Company and the holding company owning 100% interest in SXPGC respectively, for a period of another three years commencing from 1 January 2019 to 31 December 2021.

SHHCC Agreement

On 29 October 2015, the Company entered into an agreement in relation to the Group purchasing chemical products from SHHCC and its subsidiaries (the “**SHHCC Group**”) for a period from 1 January 2016 to 31 December 2018. This agreement will also expire on 31 December 2018.

In the circumstances, the Company has entered into a renewed SHHCC Agreement with SHHCC for a period of three years commencing from 1 January 2019 to 31 December 2021.

B. The Continuing Connected Transactions

Transactions under the renewed SXPGC Agreement

Date

22 October 2018

LETTER FROM THE BOARD

Parties

- (i) the Company
- (ii) SXPGC and HHGC

Principal terms and conditions

Save for the proposed annual caps for years 2019, 2020 and 2021, the terms and provisions and transactions provided for hereinafter under the renewed SXPGC Agreement remain unchanged in all material respects and all arrangements in relation thereto including without limitation the internal control measures and procedures and pricing mechanisms previously disclosed in the circular of the Company dated 14 December 2015 will continue to apply under the renewed SXPGC Agreement.

The SXPGC Agreement contains the following principal terms:

- (1) The Group will purchase the following products and services from the Controlling Shareholder Group at market prices:
 - (a) accessories in respect of the repairs and maintenance of equipment and tools, hardware, valves, instruments and meters, bearings, pumps, chemical reagents, glass wares, and the repair and maintenance of the same;
 - (b) packaging services and packaging materials including light plates, woodwork, packaging, blow moulding, colour printing, paper tray and cardboard drums, bottles and other assorted packing materials; and
 - (c) trimethyl orthoformate, diethyl malonate, dimethyl malonate, chloropropionyl chloride, sodium methylate, chloroacetic acid, sulphuric acid, salicylic acid, dimethyl sulphate, sodium sulphate, reductant and other chemicals required by the Group for the production of pharmaceutical products;
- (2) The Group will sell the following products to the Controlling Shareholder Group:
 - (a) water, electricity and steam, at cost plus corresponding tax and management fees; and
 - (b) sundry items of by-products during the manufacturing processes which can be recycled, e.g. waste water, waste gas and other solid waste, at market prices;

LETTER FROM THE BOARD

In any event, all of the relevant prices will not be lower than the selling prices in respect of such items as offered by the Group to any independent third parties.

- (3) Payment term: each party will pay to the other party for the products ordered or services provided in a timely manner as specified in each purchase order placed from time to time.
- (4) The Group is not restricted from conducting transactions with any third parties for the sale and purchase of the relevant products and the provisions of services.

Term

The term of the SXPGC Agreement will run from 1 January 2019 to 31 December 2021.

Pricing and internal control measures

1. Purchase of products

(a) Pricing

The Group sources all its products under the SXPGC Agreement through suppliers who participate in the Bidding Website. The Company would place requests for products through the Bidding Website and then observe and evaluate the bidding prices offered by various suppliers (which may include the Controlling Shareholder Group as well as independent third parties who have shown interest in placing a bid). The exact number of quotations will depend on the category of the products/types of raw materials required but at least three quotations from suppliers independent from and unrelated to each other will be sought to ensure the prices and terms of provision offered by SXPGC are no less favourable than the offers available in the market. The bidding process will generally permit the procurement team of the Company to identify suppliers and to gain an understanding of the prevailing market prices of products at any particular time.

The Company has adopted a tripartite arrangement before coming to the best available bidding price in respect of a procurement of the products. As the first step the Company has maintained a list of qualified suppliers and only suppliers whose product samples and production procedures meeting the prescribed standards of the industry and of the Company may enter into the list and supply to the Company. Any potential supplier who comes up with a bid for the Company's placing request for products on the Bidding

LETTER FROM THE BOARD

Website has to go through the same product safety examination and production procedure inspection before its bid be further considered. As a second step, three qualitative factors in relation to a bid will regularly be considered namely the reputation and track record of the supplier in supplying the products, the specification of the products they offer and the quality of their samples, and the proposed delivery and payment terms. As the last step in determining the best available bidding prices, for potential suppliers who pass the abovementioned procedures the quantitative assessment of “the lowest bid stands out” applies. After identifying the potential suppliers who offered the best available bidding prices on the Bidding Website by this tripartite procedure, the Company’s procurement team will then evaluate the bidding prices with reference to market information (including pricing trends of relevant products) published by the daily industry newspaper 中國化工報 (China Chemical Industry News*) and the industry website 中宇資訊 (www.chem365.net), which update pricing information daily, in considering whether the offered prices are comparable to the prevailing market rate.

Following evaluation of bid orders offered by potential suppliers by the Company’s procurement team, the Company may directly accept a bid order through the Bidding Website. Prior to acceptance of a bid, the Company does not have any binding obligation to conclude any purchases with any supplier for the sale and purchase of the relevant products.

In any case, the Company is not restricted under the SXPGC Agreement from acquiring products from other third parties.

(b) Procedures and internal control measures

1. At the end of each month, the production department will communicate with the procurement department to review the inventory level of raw materials required for the production of products and determine whether the Company needs to acquire more raw materials. If this is necessary, the procurement department will prepare a request form for the acquisition of raw materials. Such request will require the authorisation of the head of the finance department.
2. Upon obtaining approval from the finance department, the procurement department will convene a procurement committee (“**Procurement Committee**”), consisting of representatives from (i) the audit department, (ii) the production department, (iii) the quality assurance department, (iv) the procurement department and (v) the finance department. As of

LETTER FROM THE BOARD

the Latest Practicable Date, the regular representation of the various departments in the Procurement Committee is as follows: one member from the audit department, five members from the production department, one member from the quality assurance department, five members from the procurement department and one member from the finance department, of which the procurement department representatives and the representatives of the other departments have served the Company for at least six years and five years respectively and are now serving either as departmental heads or key managers. None of the members of the Procurement Committee or their respective close associates (as defined under the Listing Rules) are interested in the securities of the Controlling Shareholder Group and none of them are concurrently employed therein.

3. The Procurement Committee will then place the request for raw materials through the Bidding Website and then observe and evaluate the bidding prices which may be offered by various suppliers on the Bidding Website.
4. The Bidding Website will permit the Procurement Committee to assess the market prices of products at a particular time. The Procurement Committee will seek quotations from at least three suppliers unrelated to and independent from each other. Upon receiving the quotations from suppliers through the Bidding Website, the Procurement Committee will review their quotations.
5. In the event that there is only one bidder, the Procurement Committee will continue to proceed with the process and will not cancel the tender.
6. The Procurement Committee will follow a tripartite arrangement before coming to the best available bidding price in respect of a procurement of products. As the first step the Company has maintained a list of qualified suppliers and only suppliers whose product samples and production procedures meeting the prescribed standards of the industry and of the Company may enter into the list and supply to the Company. Any potential supplier who comes up with a bid for the Company's placing request for products on the Bidding Website has to go through the same product safety examination and production procedure inspection before its bid be further considered. As a second step, three qualitative factors in relation to a bid will regularly be considered namely the reputation and track record of the supplier in supplying the relevant products, the specification of the products they offer and the quality of their samples,

LETTER FROM THE BOARD

and the proposed delivery and payment terms. As the last step in determining the best available bidding process, for potential suppliers who pass the abovementioned procedures the quantitative assessment of “the lowest bid stands out” applies.

7. The Procurement Committee will evaluate the quotations offered on the Bidding Website with reference to market information (including pricing trends of relevant products) published by the daily industry newspaper 中國化工報 (China Chemical Industry News*) and the industry website 中宇資訊 (www.chem365.net), which update pricing information daily, in considering whether offered price is comparable to the prevailing market rate.
8. Upon the advice from the Procurement Committee, (i) the head of the audit department, (ii) the head of the production department, (iii) the head of the quality assurance department, (iv) the head of the procurement department and (v) the head of the finance department will discuss and approve which supplier to be selected.
9. After the offer has been awarded, the head of the procurement department will sign a formal contract with the selected supplier on behalf of the Company.

2. Procurement of services

(a) Pricing

The pricing in relation to services, for instance, certain maintenance work, acquired under the SXPGC Agreement are determined through a bidding process. The Group would conduct an open tender process when the relevant service is required. In such open tender process, interested suppliers (which may include the Controlling Shareholder Group) may bid for the supply of such service, following which a legally binding transaction will be entered for the supply of the service to the lowest bidder.

The Company generally adopts the best available price approach in considering tenders, but it would also consider other factors including, inter alia, the reputation and track record of the supplier in supplying the relevant service, the quality of their services provided, the proposed period required for delivery of the service and payment terms.

LETTER FROM THE BOARD

The Company considers the above arrangement for determining pricing for the services under the SXPGC Agreement are on normal commercial terms, is in line with usual market practice and is fair and reasonable to the Company and its Shareholders as a whole.

In any case, the Company is not restricted under the SXPGC Agreement from acquiring the services from other third parties.

(b) Procedures and internal control measures

For procurement of services, the Group would conduct an open tender process. The procurement of the products and services is subject to the following tender procedure:

1. The department requiring certain service (“**Service Requiring Department**”) in the Company will issue a request to the factory unit planning department. The factory unit planning department will then communicate with the Service Requiring Department to prepare the tender invitation, which sets out the scope of work, the technical specifications, the estimated timeframe, a schedule of deliveries, closing date and time for submissions (the “**Tender Invitation**”). The tender will be subject to the approval of the mechanics department.
2. Together with the other departments set out in paragraph 3 below, the Service Requiring Department will establish a tender committee (the “**Tender Committee**”) to monitor the procurement process. For example, if it is the electricity department that requires certain service, the “Electricity Department – Tender Committee” will be established;
3. The Tender Committee will consist of representatives from (i) the department requiring the service, (ii) mechanics department, (iii) the quality assurance department, (iv) the environment and safety department and (v) the finance department.
4. The Tender Invitation will be issued by the Tender Committee to at least three or more service providers whose names appear on an approved service provider list. The approved service provider list will be reviewed by the mechanics department and the audit department annually.
5. In the event that there is only one bidder, the Tender Committee will continue to proceed with the process and not cancel the tender.

LETTER FROM THE BOARD

6. After the Tender Committee has received tenders, the Tender Committee will evaluate their proposals (including quotations). The Tender Committee generally adopts the best available price approach in considering tenders, but it would also consider other factors including, inter alia, (i) the reputation and track records of the service providers, (ii) the quality of their services provided, (iii) the proposed period required for delivery of the service; and (iv) the payment terms.
 7. Upon receiving the views of the Tender Committee, the tender will be discussed and signed off by the following persons: (i) the head of the department requiring the service, (ii) the head of the mechanics department, (iii) the head of the quality assurance department, (iv) the head of the environment and safety department and (v) the head of the finance department.
 8. After the tender has been awarded, the following departments will periodically review the services to be provided: (i) the department requiring the service, (ii) the quality assurance department; and (iii) the environment and safety department.
 9. The head of the Service Requiring Department will sign a formal contract with the selected service provider on behalf of the Company.
3. Supply of water, electricity and steam
- (a) Pricing

The pricing in relation to the supply of water, electricity and steam is determined on cost plus basis, namely priced at cost plus a percentage mark-up of up to 15%. The percentage mark-up is determined by the following formula:

Pricing Formula = Cost x (1 + Statutory Mark-up Percentage + Management Fee Mark-up Percentage)

where:

Cost means the aggregate of costs of water, electricity and steam, together with costs (including costs of repairs) in relation to the maintenance of the tubes used for supplying water, electricity and steam to the Controlling Shareholder Group.

Statutory Mark-up Percentage is 10%, being the minimum mark-up rate stipulated by the State Administration of Taxation of the PRC.

LETTER FROM THE BOARD

Management Fee Mark-up Percentage is a percentage up to a maximum of 5%, which shall cover (i) surcharges and taxes which may be imposed on the Company for supplying water, electricity and steam to the Controlling Shareholder Group and (ii) the administrative, personnel and operational expenses in relation to the supply of water, electricity and steam to Controlling Shareholder Group.

As the Controlling Shareholder Group does not and is unable to source water, electricity or steam in Zibo from any other entities other than the Company (as the Controlling Shareholder Group shares the same utility account in Zibo with the Company as the end-supplier), and the supply of water, electricity and steam by the Company to the Controlling Shareholder Group requires the maintenance of an historically established infrastructure (including tubes and facilities) that are used exclusively for such supply, there is no comparative pricing which can be used as reference for such pricing.

While the Cost is based on actual expenses incurred and the Statutory Mark-up Percentage is fixed, the variable costs in relation to the management, administration and maintenance of relevant facilities are consistently monitored by the finance department of the Company which prepares cost breakdown and analysis and evaluates the appropriateness of the Management Fee Mark-up Percentage periodically.

As the Company's principal or ordinary and usual course of business is not the supply of water, electricity or steam to the Controlling Shareholder Group or any independent third party, the charges for such supply are principally for the recovery of the actual cost for supplying water, electricity and steam to the Controlling Shareholder Group plus a mandatory statutory mark-up. As such, the Company is of the view that the price of water, electricity and steam charged is fair and reasonable to the Company and its Shareholders as a whole.

(b) Procedures and internal control measures

For the supply of water, electricity and steam to the Controlling Shareholder Group under the SXPGC Agreement, the finance department of the Company would regularly prepare cost breakdowns and analyses and assess the unit costs of such products in order to determine the unit sale prices. Further, in calculating the unit costs of such products, the finance department will adopt the following measures to ensure the prices charged are consistent with the Pricing Formula:

LETTER FROM THE BOARD

1. a monthly review of the unit costs calculation assumptions and basis with reference to the historical unit costs incurred to ensure the relevant assumptions and bases are appropriate;
 2. multiple levels of internal review by the finance department in respect of the scope and cost items covered by the cost breakdowns and analyses to ensure accurate calculation of unit costs, with the working papers prepared by accountants and reviewed by finance managers; and
 3. review of costs breakdowns and analyses in respect of the products by the operation department and the audit department of the Company.
4. Sale of sundry items
- (a) Pricing

The pricing in relation to the sale of sundry items of by-products produced during the manufacturing process including recycled waste water, waste gas and other solid waste are determined through an open tender process. Each quarter, the Group would conduct an open tender process in which at least three interested purchasers (which may include the Controlling Shareholder Group) may bid for the relevant sundry items, following which a legally binding transaction will be entered for the sale of the relevant sundry items to the bidder who has entered the highest price. As the sundry items are not required by the Group for production or operation and would build up costs on the part of the Group in keeping stock thereof, in the event that there is only one interested bidder participating in a bid, the sundry items would be sold to such bidder. Subject to the market condition and the stock of sundry items accumulated, the Group may conduct more than one open tender per quarter.

The Company considers the abovementioned arrangements in respect of the pricing of the sundry items is on normal commercial terms, in line with the relevant applicable usual market practice and is fair and reasonable to the Company and the Shareholders as a whole.

- (b) Procedures and internal control measures

For the sale of the sundry items of by-products, the Group would conduct an open tender process in which interested purchasers (which may include the Controlling Shareholder Group) may bid for the relevant sundry items each quarter. The process of the sale of the sundry items is subject to the following open tender procedures.

LETTER FROM THE BOARD

1. For each quarter, the inventory team of the production department of the Company will prepare a list of “sundry items of by-products from manufacturing process” for sale.
2. A sundry item bidding committee consisting of representatives from (i) the environment and safety department, (ii) the finance department, (iii) the audit department, (iv) the procurement department, and (v) the sales department (the “**Sundry Item Bidding Committee**”) will conduct an open tender. As of the Latest Practicable Date, the Sundry Item Bidding Committee is regularly composed of five representatives, in which each department has one representative. The procurement department representative and the representatives of the other departments have served the Company for at least six years and five years respectively and are now serving either as departmental heads or key managers. None of the members of the Sundry Item Bidding Committee or their respective close associates (as defined under the Listing Rules) are interested in the securities of the Controlling Shareholder Group and none of them are concurrently employed therein.
3. In the open tenders held, interested purchasers may place bids. Before submitting the bids they will be allowed to inspect samples of the sundry items. In general, no minimum reserve price is set for the disposal of the sundry items put for tender as the storage and maintenance costs can outweigh the proceeds from sales for these waste items which are not required for the operation and the production of the Group and amassing them is not in the best interest of the Group.
4. In general, the Sundry Item Bidding Committee will seek quotations from at least three purchasers who are unrelated to and independent from each other and on the qualified purchaser list allowed to participate in the tender. The qualified purchaser list is maintained and reviewed by the environment and safety department and the audit department annually based on such factors as the bidders’ resources, capabilities and track-records with the Company and as a precondition a purchaser may only be qualified if with the approval of the PRC Ministry of Environmental Protection to deal with scrap materials.
5. In the event that there is only one interested purchaser, the Sundry Item Bidding Committee will continue to proceed with the process and will not cancel the tender.

LETTER FROM THE BOARD

6. The interested purchasers are required to submit their confidential offer by a specified date. All tenders will then be reviewed by the Sundry Item Bidding Committee based on the best available price and with reference to the bidders' resources, financial capabilities and track records of dealing with the Company.
7. After the successful bidder is selected, the head of the sales department will sign a formal contract with the selected bidder on behalf of the Company.

Proposed annual caps for the renewed SXPGC Agreement

The proposed annual caps in relation to the relevant continuing connected transactions under the renewed SXPGC Agreement are as follows:

	2019	2020	2021
	<i>(RMB'000)</i>	<i>(RMB'000)</i>	<i>(RMB'000)</i>
Sale of waste materials, supply of water, electricity and steam to the Controlling Shareholder Group	15,000	16,000	18,000
Purchase of accessories, raw materials and packaging services and packaging materials from the Controlling Shareholder Group	125,000	140,000	155,000
Total	<u>140,000</u>	<u>156,000</u>	<u>173,000</u>

The Company determined the above annual caps under the SXPGC Agreement on basis of the following factors:

- (a) the historical figures in 2016, 2017 and January to September 2018 for the transactions between the Group and the Controlling Shareholder Group (see Table 1 – Historical figures of the transactions under the SXPGC Agreement below);

LETTER FROM THE BOARD

- (b) the demand set out by the Controlling Shareholder Group;
- (c) a lower production capacity of SXPGC and its subsidiaries expected for the following years during the term of the renewed SXPGC Agreement than that which was expected at the material time of drawing up the existing SXPGC Agreement;
- (d) the demand set out by the Group;
- (e) the development in the business of the Group; and
- (f) the expected trend in market prices of chemical products.

A. Analysis of the proposed annual caps in respect of sale of waste materials and supply of water, electricity and steam

The proposed annual caps in respect of the sale of waste materials and the supply of water, electricity and steam for years 2019, 2020 and 2021 is in the range of approximately 125% to 150.5% of the annualised figures for the year ending 31 December 2018.

The proposed annual caps represent a drop from the annual caps applicable to the continuing connected transactions under the existing SXPGC Agreement. This drop is attributable to a change in the business plans of SXPGC and its subsidiaries which would result in a lower production capacity expected for the following years during the term of the renewed SXPGC Agreement than that which was expected at the material time in 2015. This decrease in the expected production capacity will decrease the demand for the waste materials, water, electricity and steam under the SXPGC Agreement.

B. Analysis of the proposed annual caps in respect of purchase of accessories, raw materials and packaging services and materials

The proposed annual caps in respect of the Group's purchase of the captioned items under the renewed SXPGC Agreement for years 2019, 2020 and 2021 is in the range of approximately 162.3% to 204.3% of the annualised figures for the year ending 31 December 2018.

The proposed annual caps in respect of the captioned items under the renewed SXPGC Agreement for years 2019, 2020 and 2021 represent approximately 83.33% to 91.18% of the relevant annual caps for years 2016, 2017 and 2018 respectively under the

LETTER FROM THE BOARD

existing SXPGC Agreement. In coming up with the proposed annual caps the Board has taken into account various factors which have mixed effects on the expected annual caps required:

- (a) *Change in Production Capacity of the Counterparty:* as disclosed above, due to the drop in the production capacity of SXPGC and its subsidiaries expected for the following years during the term of the renewed SXPGC Agreement when compared with those expected at the material time of 2015 when drawing up the existing SXPGC Agreement, the amount that the Group is able to source under the renewed SXPGC Agreement will be affected;
- (b) *Growth in Size and Business:* the continuous growth and expansion of the Group – from its audited consolidated financial statements, the Group has recorded a rise of approximately 12.47% in operating income from year 2016 to year 2017; from the unaudited results for the nine months ended 30 September 2018, the Group has recorded an increase in operating income of approximately 14.68% when compared with the corresponding period in 2017. The total assets of the Group witnessed a 11.66% growth and 8.89% growth during the respective periods, indicating a positive growth trend in scale;
- (c) *Industry Outlook:* industry outlook as derived from the economic figures of year 2017 – according to the statistics of the PRC Ministry of Industry and Information Technology (the “MIIT”) in 2017年醫藥產業經濟運行分析 (Analysis for the Pharmaceutical Industry Economic Operation in 2017*) that it published, the total revenue of the pharmaceutical production industry in 2017 recorded a year-to-year growth of approximately 12.2%;
- (d) *Market Trend of Prices:* rise in the market prices of the chemical raw materials – from late 2017 onward due to the joint issuance of 關於做好京津冀及周邊地區醫藥企業2017–2018年採暖季錯峰生產的通知 (The Notice of Alternate Peak Heating Production by the Pharmaceutical Production Industry in Beijing, Tianjin and the Surrounding Areas for Year 2017 to Year 2018*) (the “Notice”) by MIIT and other relevant PRC governmental authorities there witnessed a considerable slowdown of volatile organic compounds-emitting pharmaceutical and chemical raw material production in Shandong Province, Beijing, Tianjin, Hebei Province, Shanxi Province and Henan Province and hence a tightening of the supply of chemical raw materials available to the Group from the accessible regions around and a rise of market prices thereof. As a result, if to spread the rise in procurement volume only over independent parties, the Group will need to engage a larger number of suppliers to secure an adequate amount of the chemical raw materials. The relevant transaction costs

LETTER FROM THE BOARD

including the intermediary costs of engaging and coordinating with a larger number of suppliers and the time cost in securing a steady and timely supply are expected to increase as a result. In this regard the Controlling Shareholder Group as a long-term supplier to the Group in respect of the required products under the SXPGC Agreement since 2006 has a long and credible track records and proven capable of securing for the Group a stable supply of part of the products required without however incurring the Group extra intermediary cost in procuring from and coordinating with an increased number of smaller-scale suppliers.

- (e) *Planned expansion in production:* for year 2019 the Group has planned for an expansion in its production including without limitation to a 30% increase in scale of the production of one of its key antipyretic analgesics products which has throughout the term of the existing SXPGC Agreement contributed to over 10% of the annual sales of the Group. The Group's demand for up-stream pharmaceutical intermediates will increase and of which such chemical raw materials as dimethyl sulphate and ibuprofen to be sourced from SXPGC alone are, subject to the pricing policies and internal control procedures set out above, expected to further rise from 9,700 tons to 12,000 tons and 850 tons to 1,200 tons respectively representing a range of 20% to over 40%. In view of this planned expansion, the Group therefore expects a step-up in the transaction amount in 2019 when compared with the annualised historical figure for the transactions conducted under the existing SXPGC Agreement for 2018. As of the Latest Practicable Date the Group has not yet determined its scale of production operations in respect of years 2020 and 2021 following the expanded scale of 2019, it has therefore drawn up a stable and moderate increment in the annual caps for the relevant years with reference to the historical growth track in size and business of the Group.

There is no major change between the underlying goods and services procured under the existing SXPGC Agreement and to be procured under the renewed SXPGC Agreement and, save for the revised annual caps as disclosed herein, all principal terms and arrangements in relation to the transactions contemplated thereunder remain unchanged in all material respects. Taking into account the abovementioned factors, the Board considers the proposed annual caps were drawn up with detailed consideration, supported with practical business needs and are conducive to the Group's control of procurement costs as by avoiding the incurrence of extra costs in procuring from and coordinating with an increased number of suppliers in the process of its expansion of production scale and are henceforth fair and reasonable and in the interests of the Company and Shareholders as a whole.

LETTER FROM THE BOARD

Table 1 – Historical figures of the transactions under the SXPGC Agreement

The table below summarises the historical transaction figures for the years ended 31 December 2016 and 2017 and the 9 months ended 30 September 2018:

	2016	2017	January to September 2018
	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>
Sale of waste materials, supply of water, electricity and steam to the Controlling Shareholder Group	10,160	10,707	8,962
Purchase of accessories, raw materials and packaging materials from the Controlling Shareholder Group	59,959	60,241	57,688
Total	<u>70,119</u>	<u>70,948</u>	<u>66,650</u>

Reasons for and benefits of the continuing connected transactions under the SXPGC Agreement

By renewing the SXPGC Agreement, the Group can continue to generate revenue from selling the relevant products to the Controlling Shareholder Group and to secure a steady supply of raw materials and miscellaneous products from the Controlling Shareholder Group without incurring extra costs by purchasing them through other parties.

As of the latest practicable date, the Group has not supplied water, electricity and steam other than to the Controlling Shareholder Group as this is not the Group's principal or ordinary and usual business and it has only done so on cost-plus basis

LETTER FROM THE BOARD

for the practicable reasons as disclosed under the section “II. Continuing Connected Transactions – B. The Continuing Connected Transactions – Transactions under the renewed SXPGC Agreement – Pricing and internal control measures – 3. Supply of water, electricity and steam – (a) Pricing” so that the supply is able to be carried out at a gain.

Therefore, the Directors consider that the entering into the renewed SXPGC Agreement is in the interests of the Company and its Shareholders as a whole. They also consider that the continuing connected transactions contemplated under the renewed SXPGC Agreement are on normal commercial terms and that the terms thereof being fair and reasonable.

Connected relationship

As at the Latest Practicable Date: (1) SXPGC held 32.94% of the total issued Shares of the Company and is a wholly-owned subsidiary of HHGC; (2) HHGC held 100% equity interests in China Shandong Group Limited and Shandong Hualu International Business Center Limited Company, which in turn held 99.91% and 0.09% shareholding in Well Bring Limited respectively; and (3) Well Bring Limited owned 2.86% of the total issued Shares of the Company. Accordingly, the transactions contemplated under the SXPGC Agreement will constitute continuing connected transactions under the Listing Rules.

Information about the Company and the controlling shareholder

The Company is a joint stock company established under the laws of the PRC with limited liability, of which the H Shares and A Shares are listed on the Main Board of the Hong Kong Stock Exchange and the Shenzhen Stock Exchange respectively. The Group is principally engaged in the development, manufacture and sales of bulk pharmaceuticals, preparations and chemical products.

SXPGC is a state-owned enterprise established in the PRC principally engaged in investments in the pharmaceutical industry and associated chemical production, packaging and supply of chemical engineering equipment. SXPGC is a wholly-owned subsidiary of HHGC, 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.

Implications under the Listing Rules

The highest annual cap in relation to the continuing connected transactions under the SXPGC Agreement for the years 2019, 2020 and 2021 is RMB173,000,000.

LETTER FROM THE BOARD

As one or more applicable percentage ratios (as defined in the Listing Rules) exceed 5% on an annual basis and the total consideration exceeds HK\$10,000,000, the continuing connected transactions contemplated under the renewed SXPGC Agreement will constitute non-exempt continuing connected transactions under Chapter 14A of the Listing Rules and are subject to the requirements in relation to announcement, disinterested Shareholders' approval, annual review and reporting and independent board committee and independent financial advisor.

Mr. Zhang Daiming, Mr. Ren Fulong, Mr. Xu Lie, Mr. Zhao Bin, Directors of the Company, have by virtue of their respective directorships or capacities as a member of the management in the Controlling Shareholder Group abstained from voting on the Board decision on the renewal of the SXPGC Agreement. Save as disclosed above, the Company is not aware of any other Directors who has a material interest in the SXPGC Agreement.

To the best of the Directors' knowledge, information and belief, having made all reasonable enquiries, there is no other transaction entered into by the Group within a 12-month period from the Latest Practicable Date which would be, together with the transactions contemplated under the renewed SXPGC Agreements, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

Transactions under the renewed SHHCC Agreement

Date

22 October 2018

Parties

- (i) the Company
- (ii) SHHCC

Principal terms and conditions

Save for the proposed annual caps for years 2019, 2020 and 2021, the terms and provisions and transactions provided for hereinafter under the renewed SHHCC Agreement remain unchanged in all material respects and all arrangements in relation thereto including without limitation the internal control measures and procedures and pricing mechanisms previously disclosed in the circular of the Company dated 14 December 2015 will continue to apply under the renewed SHHCC Agreement.

LETTER FROM THE BOARD

The renewed SHHCC Agreement contains the following principal terms:

- (1) the Group may purchase from the SHHCC Group at market prices certain chemical products, such as acetic acid, acetic anhydride and other chemical raw materials (collectively, the “**Chemical Products**”).

The prices for the Chemical Products will be determined in accordance with the market prices.

All the relevant prices will not be higher than the selling prices in respect of such items as offered by the SHHCC Group to any independent third parties.

- (2) **Payment Term:** the Group will pay for the products provided in a timely manner as specified in each purchase order placed by the Group from time to time; and
- (3) The Group is not restricted from transacting with any third parties for the sale and purchase of the Chemical Products.

Term

The term of the renewed SHHCC Agreement will run from 1 January 2019 to 31 December 2021.

Pricing

The Group sources Chemical Products through suppliers who participate in the Bidding Website. The Company would place requests for Chemical Products through the Bidding Website and then observe and evaluate the bidding prices offered by various suppliers, which may include SHHCC as well as independent third parties who have shown interest in placing a bid. The exact number of quotations will depend on the category of relevant Chemical Products requested but at least three quotations from suppliers independent from and unrelated to each other will be sought to ensure the prices and terms of provision offered by SHHCC are no less favourable than the offers available in the market. The bidding process will generally permit the procurement team of the Company to identify supplies and to gain an understanding of the prevailing market prices of Chemical Products at any particular time.

LETTER FROM THE BOARD

The Company has adopted a tripartite arrangement before coming to the best available bidding price in respect of a procurement of Chemical Products. As the first step the Company has maintained a list of qualified suppliers and only suppliers whose product samples and production procedures meeting the prescribed standards of the industry and of the Company may enter into the list and supply to the Company. Any potential supplier who comes up with a bid for the Company's placing request for Chemical Products on the Bidding Website has to go through the same product safety examination and production procedure inspection before its bid be further considered. As a second step, three qualitative factors in relation to a bid will regularly be considered namely the reputation and track record of the supplier in supplying the relevant Chemical Products, the specification of the products they offer and the quality of their samples, and the proposed delivery and payment terms. As the last step in determining the best available bidding prices, for potential suppliers who pass the abovementioned procedures, the quantitative assessment of "the lowest bid stands out" applies. After identifying the potential suppliers who offered the best available bidding prices on the Bidding Website by this tripartite procedure, the Company's procurement team will then evaluate the bidding prices with reference to market information (including pricing trends of relevant Chemical Products) published by the daily industry newspaper 中國化工報 (China Chemical Industry News*) and the industry website 中宇資訊 (www.chem365.net), which update pricing information daily, in considering whether the offered prices are comparable to the prevailing market rate.

Following evaluation of bid orders offered by potential suppliers by the Company's procurement team, the Company may directly accept a bid order through the Bidding Website. Prior to acceptance of a bid, the Company does not have any binding obligation to conclude any purchases with any supplier for the sale and purchase of the relevant Chemical Products.

In any event, the Group is not restricted under the SHHCC Agreement from acquiring the Chemical Products from third parties.

Procedure and internal control measures

The same procedure and internal control measures in respect of the sourcing of chemical raw materials under the SXPGC Agreement applies to the transactions under the SHHCC Agreement.

LETTER FROM THE BOARD

Proposed annual caps for the SHHCC Agreement

The proposed annual caps in relation to the relevant continuing connected transactions under the SHHCC Agreement are as follows:

	2019 <i>(RMB'000)</i>	2020 <i>(RMB'000)</i>	2021 <i>(RMB'000)</i>
Purchase of Chemicals Products			
from the SHHCC Group	310,000	330,000	340,000

The Company determined the above annual caps under the SHHCC Agreement on basis of the following factors:

- (a) the historical figures in 2016, 2017 and 9 months from 31 January to 30 September 2018 for the transactions between the Group and SHHCC Group (see Table 2 – Historical figures of the transactions under the SHHCC Agreement below);
- (b) the demand set out by the Group;
- (c) the development in the business of the Group; and
- (d) the expected market trend of chemical raw materials.

Analysis of the proposed annual caps of the transactions under the renewed SHHCC Agreement

The proposed annual caps in respect of the purchase of the Chemical Products from the SHHCC Group for years 2019, 2020 and 2021 are in the range of approximately 155% to 170% of the annualised figures for the year ending 31 December 2018.

In coming up with the proposed annual caps under the SHHCC Agreement the Board has taken into account the following factors:

- (a) *Growth in Size and Business:* the continuous growth and expansion of the Group – from its audited consolidated financial statements, the Group has

LETTER FROM THE BOARD

recorded a rise of approximately 12.47% in operating income from year 2016 to year 2017; from the unaudited results for the nine months ended 30 September 2018, the Group has recorded an increase in operating income of approximately 14.68% when compared with the corresponding period in 2017. The total assets of the Group witnessed a 11.66% growth and 8.89% growth during the respective periods, indicating a positive growth trend in scale;

- (b) *Industry Outlook:* industry outlook as derived from the economic figures of year 2017 – according to the statistics of MIIT in the Analysis for the Pharmaceutical Industry Economic Operation in 2017 that it published, the total revenue of the pharmaceutical production industry in 2017 recorded a year-to-year growth of approximately 12.2%;
- (c) *Market Trend of Prices:* rise in the market prices of the Chemical Products – from late 2017 onward due to the joint issuance of the Notice by MIIT and other relevant PRC governmental authorities there witnessed a considerable slowdown of volatile organic compounds-emitting pharmaceutical and chemical raw material production in Shandong Province, Beijing, Tianjin, Hebei Province, Shanxi Province and Henan Province and hence a tightening of the supply of Chemical Products available to the Group from the accessible regions around and a rise of market prices thereof. As a result, if to spread the rise in procurement volume only over independent parties, the Group will need to engage a larger number of suppliers to secure an adequate amount of Chemical Products. The relevant transaction costs including the intermediary costs of engaging and coordinating with a larger number of suppliers and the time cost in securing a steady and timely supply are expected to increase as a result. In this regard SHHCC as a sizeable supplier of a market capitalisation over RMB30 billion and owning large-scale production bases for manufacturing Chemical Products has been able to meet the relevant requirements of the competent authorities and has not been prohibited from producing Chemical Products under the Notice. An increased sourcing and procurement under the SHHCC Agreement is therefore conducive to the Group's securing a stable supply of the Chemical Products without however incurring extra intermediary cost in procuring from and coordinating with an increased number of smaller-scale suppliers.

LETTER FROM THE BOARD

- (d) *Planned expansion in procurement:* in view of its growth in size, business and production operations, the Group has witnessed an increasing need to secure a stable and competitive supply of Chemical Products and will by the end of 2018 exhaust the annual cap of RMB200 million despite the disinterested Shareholders' approval for its 66% upward adjustment from RMB120 million in the annual general meeting of the Company dated 29 June 2018. The Group had planned an increase in sourcing from SHHCC for up to 30,000 tons of acetic acid and 6,000 tons of methylamine for year 2018 but managed to secure only part of them due to inter alia the limitation of the cap. With the proposed increase in annual caps under the renewed SHHCC Agreement the Group plans to, subject to the pricing policies and internal control measures set out above, increase its procurement of the Chemical Products from SHHCC with a range of 20% to 36% in 2019 counting in the possible price hikes of approximately 10% amidst the upward market trends of the Chemical Products. As of the Latest Practicable Date, the Group has not yet determined its procurement volumes in respect of years 2020 and 2021 and has therefore drawn up a stable and moderate increment in the annual caps for the relevant years with reference to the historical growth track in size and business of the Group.

There is no major change between the Chemical Products procured under the existing SHHCC Agreement and to be procured under the renewed SHHCC Agreement and, save for the revised annual caps as disclosed herein, all principal terms and arrangements in relation to the transactions contemplated thereunder remain unchanged in all material respects. Taking into account the abovementioned factors, the Board considers the proposed annual caps were drawn up with detailed consideration, supported with practical business needs and are conducive to the Group's securing a stable supply of Chemical Products and control of procurement costs as by avoiding the incurrence of extra costs in procuring from and coordinating with an increased number of suppliers in the process of its business expansion and development and are henceforth fair and reasonable and in the interests of the Company and Shareholders as a whole.

LETTER FROM THE BOARD

Table 2 – Historical figures of the transactions under the SHHCC Agreement

The table below summarises the historical transaction figures for the transactions between the Group and SHHCC for the years ended 31 December 2016 and 2017 and the 9 months ended 30 September 2018:

	2016	2017	January to September 2018
	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>
Purchase of Chemicals			
Products from the SHHCC Group	56,457	98,291	148,186

Reasons for and benefits of the continuing connected transactions under the SHHCC Agreement

By renewing the SHHCC Agreement, the Group can continue to secure a steady supply of Chemical Products from the SHHCC Group without incurring extra costs by purchasing them from other parties. Therefore, the Directors consider entry into the SHHCC Agreement is in the interests of the Company and its shareholders as a whole. They also consider that the continuing connected transactions contemplated under the renewed SHHCC Agreement are on normal commercial terms and that the terms thereof being fair and reasonable.

Connected relationship

As at the Latest Practicable Date: (i) SXPGC held 32.94% of the total issued Shares of the Company; (ii) HHGC owned 100% equity interest of SXPGC and SHHGC; and (iii) SHHGC owned 32.32% of the total issued share capital of SHHCC. Accordingly, the transactions contemplated under the SHHCC Agreement constitute continuing connected transactions under Chapter 14A of the Listing Rules.

Information relating to the Group and SHHCC

The Company is a joint stock company established under the laws of the PRC with limited liability, of which the H Shares and A Shares are listed on the Main Board of the Hong Kong Stock Exchange and the Shenzhen Stock Exchange respectively. The Group is principally engaged in the development, manufacture and sale of bulk pharmaceuticals, preparations and chemical products.

LETTER FROM THE BOARD

SHHCC is principally engaged in the production and sale of chemical products.

Implications under the Listing Rules

The highest annual cap in relation to the Continuing Connected Transactions under the SHHCC Agreement for the years 2019, 2020 and 2021 is RMB340,000,000.

As one or more applicable percentage ratios (as defined in the Listing Rules) exceed 5% on an annual basis and the total consideration exceeds HK\$10,000,000, the continuing connected transactions contemplated under the renewed SHHCC Agreement will constitute non-exempt continuing connected transactions under Chapter 14A of the Listing Rules and are subject to the requirements in relation to announcement, disinterested Shareholders' approval, annual review and reporting and independent board committee and independent financial advisor.

Mr. Zhang Daiming, Mr. Ren Fulong, Mr. Xu Lie, Mr. Zhao Bin, Directors of the Company, have by virtue of their respective directorships or capacities as a member of the management in the Controlling Shareholder Group abstained from voting on the Board decision on the renewal of the SHHCC Agreement. Save as disclosed above, the Company is not aware of any other Directors who has a material interest in the SHHCC Agreement.

To the best of the Directors' knowledge, information and belief, having made all reasonable enquiries, there is no other transaction entered into by the Group within a 12-month period from the Latest Practicable Date which would be, together with the transactions contemplated under the renewed SHHCC Agreement, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

C. Further internal control measures in place

For ensuring the Group's conformity with the pricing policies of the Agreements from time to time and for further enhancement of internal control, the following measures have been in place:

- (1) the Board, the audit committee of the Board and the independent non-executive Directors were required to and did review and approve the Agreements pursuant to the connected transaction decision policies of the Group;

LETTER FROM THE BOARD

- (2) the Group has assigned specific personnel to regularly monitor the total transaction amounts under the Agreements to ensure that they will not exceed the annual caps approved by the Shareholders;
- (3) the Company's management policies for connected transactions explicitly delimit the principles for determining the prices in respect of connected transactions and continuing connected transactions. When a business unit enters into contracts in accordance with an agreement of the continuing connected transactions, the price must be determined in accordance with the pricing terms and provisions set out in the relevant agreement; and
- (4) in respect of the internal control measures for each type of transactions, please refer to the corresponding procedures and internal control measures set out under the relevant sub-section in this circular.

The Directors are of the view that the measures, methods and procedures in place in relation to the Continuing Connected Transactions are clear-cut and adequate, have been effectively implemented and maintained for the existing Agreements and will continue to be effectively implemented and maintained under the renewed Agreements, so that the Continuing Connected Transactions will be conducted on normal commercial terms and not prejudicial to the interests of the Company and any Shareholders (minority Shareholders inclusive).

D. General information

Approval of the Disinterested Shareholders on the Continuing Connected Transactions contemplated under the renewed Agreements will be sought at the EGM by way of ordinary resolutions. SXPGC and Well Bring Limited, direct and indirect subsidiaries of HHGC holding 32.94% and 2.86% of the issued Shares of the Company respectively as of the Latest Practicable Date, shall abstain from voting on the Continuing Connected Transactions.

An Independent Board Committee comprising independent non-executive Directors has been established to advise the Disinterested Shareholders on the Continuing Connected Transactions. A letter from the Independent Board Committee containing its recommendations is set out on page 37 of this circular.

Hologram Capital Limited, a corporation licensed 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), has been appointed by the Company as the independent financial adviser to advise the Independent Board Committee and Disinterested Shareholders on the Continuing Connected Transactions. A letter from the Independent Financial Adviser containing its advice to the Independent Board Committee and the Disinterested Shareholders is set out on pages 38 to 64 of this circular.

LETTER FROM THE BOARD

The Independent Board Committee, having taken into account the advice of and the principal factors and reasons considered by the Independent Financial Adviser and the interest of the Disinterested Shareholders, considers the Continuing Connected Transactions fair and reasonable and are in the interests of the Company and the Shareholders as a whole. Accordingly, the Independent Board Committee recommends the Disinterested Shareholders to vote in favour of the relevant resolutions at the EGM to approve the Continuing Connected Transactions.

III. PROPOSED ADOPTION OF SHARE OPTION SCHEME

A. Introduction

At the EGM and the Class Meetings, resolutions will be proposed for the approval and adoption of the Assessment Methods and the Share Option Scheme in which, amongst other things, the proposed Grant to the Participants and the number of Options proposed to be Granted to each Participant are contained. Each of the proposed Grants to a Director has been approved by the independent non-executive Directors in compliance with Rule 17.04(1) of the Listing Rules. Pursuant to the Share Option Scheme, independent non-executive Directors are not eligible Participants and there is no independent non-executive Director who is also an Participant.

Please refer to Appendices I and II to this circular for full details of the key information contained in this section including without limitation to the scope of eligible Participants, the proposed Grant and the amount of the Options proposed to be Granted to each Participant, the Validity Period of the Share Option Scheme, the minimum period for which the Options must be held before it can be exercised, the performance targets of the Participants on which the exercise of the Options is conditional and the Assessment Methods, the Exercise Price and adjustments, the exercise period and circumstances under which the Options shall lapse.

B. Purpose of the Share Option Scheme and scope of eligible Participants

The Share Option Scheme is to further establish and improve the long-term incentive mechanism of the Company, attract and retain talents, mobilise the Directors, senior management, mid-level management and core backbone staff of the Company, and bind the interests of Shareholders, the Company and persons in charge of the operation of the Company together effectively, helping the various parties to attend to the long-term development of the Company. As such, the scope of eligible Participants include Directors, senior management, mid-level management and core backbone staff of the Company. The Board is of the view that the adoption of the Share Option Scheme serves to enable the

LETTER FROM THE BOARD

Company to move towards reaping the abovementioned benefits and therefore recommend the Shareholders to approve the resolutions in relation to the Scheme Documents at the EGM and the Class Meetings.

C. Source and number of the underlying Shares in respect of the Options to be Granted

As at the Latest Practicable Date, no share option scheme has ever been adopted by the Group. Only new A Shares will be issued upon exercise of the Options to be Granted and no H Shares can be issued under the Share Option Scheme. The Scheme Documents comprising the Share Option Scheme and the Assessment Methods which govern the performance targets on which the exercise of the Options is amongst other things conditional shall be considered and approved by the Shareholders, A Shareholders and H Shareholders at the EGM, the A Shareholders Class Meeting and H Shareholders Class Meeting respectively.

After the approval of the Share Option Scheme at the EGM and the Class Meetings, The Board will have to determine the date of the Grant which, pursuant to and as part of the Share Option Scheme, shall not be more than 60 days after the approval. The relevant filing/registration and disclosures are set to be completed within the said period and failure to do so will result in the termination of the Share Option Scheme and any and all Options will lapse accordingly.

Assuming full acceptance and exercise of the Options Granted, the Share Option Scheme will involve an issuance of a total of 16,250,000 new A Shares to the Participants, representing approximately 2.61% of the total issued Shares as at the Latest Practicable Date. Upon satisfaction of the terms and conditions of the exercise of the Options, each Option to be Granted to a Participant shall provide its holder a right to purchase at the Exercise Price during the Validity Period one new A Share ranking pari passu with the fully-paid A Shares in issue in all aspects including without limitation to voting, entitlements to distributions, transferability and any rights arising on liquidation of the Company. It is proposed that the Board shall on Shareholders' resolution of authorisation implements and manages the Share Option Scheme pursuant to the terms of the Scheme Documents, the Shareholders' authorisation and the applicable laws, rules and regulations but none of the Directors is a trustee of the Share Option Scheme or has a direct or indirect interest in any trustee of the Share Option Scheme.

D. Exercise period

Under the Share Option Scheme, the exercise of the Options is subject to a minimum 24-month period during which the Participants are not allowed to exercise any Options Granted. The Options shall be exercisable in three tranches upon expiry of 24 months from the date of Grant. Details are as follows:

LETTER FROM THE BOARD

Exercise period	Duration	Proportion of the Options to be Granted
First exercise period	Commencing from the first trading day (with the meaning ascribed thereto under the Shenzhen Listing Rules) after the expiry of the 24 th month from the date of Grant, and ending on the last trading day of the 36 th month from the date of Grant	34%
Second exercise period	Commencing from the first trading day after the expiry of the 36 th month from the date of Grant, and ending on the last trading day of the 48 th month from the date of Grant	33%
Third exercise period	Commencing from the first trading day after the expiry of the 48 th month period from the date of Grant, and ending on the last trading day of the 60 th month period from the date of Grant	33%

Options Granted and vested but failed to be exercised within the relevant exercise period shall lapse and will not be exercisable in the next exercise period.

Further, the Exercise Date shall be a trading day of the Shenzhen Stock Exchange and shall not fall within any of the following periods:

1. 30 days before the date of publication of the periodic results reports of the Company;
2. 10 days before the publication of profit alerts or warnings or the results preview on the Shenzhen Stock Exchange;
3. from the occurrence or entry into decision process of a material event (with the meanings ascribed thereto under the Shenzhen Listing Rules) that may significantly impact on the securities in respect of Company through the second trading day subsequent to its disclosure; and
4. any other periods required by the CSRC and the Shenzhen Stock Exchange from time to time.

LETTER FROM THE BOARD

E. Performance targets on which the exercise of the Options Granted are conditional

Pursuant to Share Option Scheme, a Participant's exercise of Options is conditional on and subject to his or her grading in the performance target review in the immediately preceding year. The details are provided for in the Assessment Methods and set out in Appendix II of this circular.

F. Exercise Price

Subject to Note (1) to Rule 17.03(9) of the Listing Rules namely the exercise price of an Option shall be at least the higher of (a) the closing price of the H Shares as stated in the Hong Kong Stock Exchange's daily quotations sheet on the business day (with the meaning ascribed thereto under the Listing Rules) on which the Options are Granted; and (b) the average closing price of the H Shares as stated in the Hong Kong Stock Exchange's daily quotations sheets for the five business days immediately preceding the date of Grant, the Exercise Price shall be RMB5.98 per new A Share to be issued upon the exercise of an Option. Should the Exercise Price fall below the minimum closing price or average closing price provided for under Note (1) to Rule 17.03(9) of the Listing Rules ("**Minimum Permissible Price**"), the Exercise Price shall be the Minimum Permissible Price.

The proposed Exercise Price was determined with reference to:

- (i) the average of the trading prices of the A Shares (being the total daily trading turnover on the last trading day (with the meaning ascribed thereto under the Shenzhen Listing Rules) immediately preceding the date of announcement of the Share Option Scheme namely 6 November 2018 (the "**Announcement Day**") divided by the total daily trading volume on the last trading day immediately preceding the Announcement Day) quoted on the Shenzhen Stock Exchange on the last trading day immediately preceding the Announcement Day, being RMB5.98 per A Share;
- (ii) the average of the trading prices of the A Shares quoted on the Shenzhen Stock Exchange for the last 20 trading days immediately preceding the Announcement Day, being RMB5.64 per A Share;
- (iii) the closing price of the A Shares quoted on the Shenzhen Stock Exchange on the last trading day immediately preceding the Announcement Day, being RMB5.97 per A Share;

LETTER FROM THE BOARD

- (iv) the average of the closing prices of the A Shares quoted on the Shenzhen Stock Exchange for the last 30 trading day immediately preceding the Announcement Day, being RMB5.81 per A Share; and
- (v) the net asset value per Share attributable to Shareholders for year 2017, being RMB3.99.

G. Conditions of the Scheme Documents

The proposed Scheme Documents have gained the support of the controlling shareholder and been approved by the Board and filed with the Shandong SASAC and shall take effect upon Shareholders' approval at a general meeting and Class Meetings.

H. Implications under the Listing Rules

The Share Option Scheme constitutes a share option scheme under Chapter 17 of the Listing Rules and pursuant to Rule 14A.92(3)(a) any Grant to a connected person of the Company is fully exempted from the requirements of approval by Shareholders, annual review and reporting and announcement and circular under Chapter 14A of the Listing Rules. Under the Share Option Scheme, no independent non-executive Director is eligible for being a Participant and there is no Participant to whom the new A Shares to be issued upon exercise of the Options Granted thereto will exceed 1% of the A Shares in issue. Directors who are also intended Participants under the proposed Share Option Scheme have not voted on any Board resolutions on the proposed Share Option Scheme and/or the proposed Grant to themselves.

LETTER FROM THE BOARD

As disclosed hereinabove and in Appendices I to II to this circular:

- (a) by (i) the minimum 24-month period from the date of the Grant before entry into any exercise period in which the Options Granted may be exercised; (ii) dividing the exercise periods of the Options into three approximately equal tranches commencing on the first trading day after the expiry of the 24th month, 36th month and 48th month from the date of the Grant respectively; and (iii) the mechanism that cessation of service due to layoff, dismissal or termination of engagement by the Company will render all outstanding Options Granted to a Participant lapse, the Share Option Scheme will help to retain talents and prolong their valuable services to the Group;
- (b) by the performance targets of the Company and of each Participant on which the exercise of the Options Granted shall be conditional, the Participants are expected to be incentivised to deliver outstanding work performance to meet the targets of the individual assessment while bearing in mind that as a whole the overall performance of the Company will have to be attained in order for any Options Granted to be exercisable in the first place. The interests of the Company and of the Participants as both expected Shareholders and staff of the Group are therefore expected to be aligned; and
- (c) by setting the Exercise Price no lower than the relevant prices prior to the Announcement Day (as defined and detailed in the section “II. Proposed Grant Under the Share Option Scheme – 2. Exercise Price and basis of determination” in Appendix I to this circular), the net asset value per Share attributable to Shareholders for year 2017 and the Minimum Permissible Price, it is explicitly set that the value of the Company should be going up and should not be lower than when the proposed adoption of the Share Option Scheme was announced, the net asset value as of the past financial year or when the Options are Granted, and that the Participants will be directed to attend to the long-term interests of the Company which would need to be reflected into Share price before any exercise of Options at the Exercise Price becomes profitable.

In view of the above, the terms of the Scheme Documents are expected to serve the purposes of the Share Option Scheme.

LETTER FROM THE BOARD

I. Solicitation of votes by Independent Non-executive Directors

Pursuant to the Incentive Measures, independent directors of a company whose securities are listed on the Shenzhen Stock Exchange should solicit votes publicly from its shareholders on resolutions in relation to the adoption of an equity incentive scheme. The purpose of such arrangement is to encourage the securities holders to participate in the voting on the resolutions on the adoption of equity incentive schemes as by providing them with an additional way of participation in the meeting(s) of such securities holders.

As the A Shares of the Company are listed and tradable on the Shenzhen Stock Exchange, the independent non-executive Directors have nominated Mr. Li Wenming to solicit on their behalf Shareholders' votes on all special resolutions in relation to the Scheme Documents to be tabled at the Meetings. No solicitation is made on the other resolutions which are not related to the Scheme Documents.

Mr. Li Wenming has for the abovementioned purpose prepared the proxy forms for appointing himself as a proxy at the EGM and the H Shareholders Class Meeting respectively. Such proxy form specific to the independent non-executive Directors' solicitation of votes were together with the notice of the EGM and the H Shareholders' Meeting (the "**Meeting Notice**"), the regular proxy forms (together with the independent non-executive Directors' proxy forms, the "**Proxy Forms**") and the reply slips in respect of such meetings despatched by the Company on 12 November 2018 and also published and made available for downloading on the websites of The Stock Exchange of Hong Kong Limited at www.hkex.com.hk and of the Company at . Please refer to the Meeting Notice and the instructions imprinted on the Proxy Forms for details of the solicitation arrangement.

IV. EGM AND CLASS MEETINGS

The proposed resolutions in relation to the Scheme Documents are subject to, among other things, the approval by way of special resolutions of Shareholders at a general meeting and of the H Shareholders and A Shareholders at their respective class meetings. It is therefore proposed that the EGM and the Class Meetings be convened to propose resolutions to vote, among other things, to approve the abovementioned resolutions. To the extent that the Company is aware having made all reasonable enquiries, eligible Participants under the Share Option Scheme and any of their respective associates who were in aggregate interested in less than 1% of the total number of issued Shares of the Company as at the Latest Practicable Date will abstain from voting at the Meetings on the resolutions in relation to the Scheme Documents.

LETTER FROM THE BOARD

The Continuing Connected Transactions are subject to the approval of the Disinterested Shareholder by way of ordinary resolutions at the EGM. SXPGC and Well Bring Limited, direct and indirect subsidiaries of HHGC holding 32.94% and 2.86% of the issued Shares of the Company respectively as of the Latest Practicable Date, shall abstain from voting on the Continuing Connected Transactions.

To the best knowledge and belief of the Directors, save for SXPGC and Well Bring Limited in respect of the resolutions on the Continuing Connected Transactions, none of the Shareholders are required to abstain from voting on any other resolutions at the EGM or the Class Meetings under the Listing Rules.

(i) A notice convening the EGM and the H Shareholders' Class Meeting to be held at the conference room of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC on Friday, 28 December 2018 at 2:00 p.m. and 4:00 p.m. (or immediately after the conclusion or adjournment of the A Shareholders' Class Meeting of even date at the same venue) respectively and (ii) the Proxy Forms for use at and the reply slips in relation to the EGM and the H Shareholders' Class Meetings were despatched by the Company on 12 November 2018 and published and available for downloading on the websites of Hong Kong Stock Exchange at www.hkex.com.hk and of the Company at . As disclosed in the Meeting Notice, for the purpose of determining the H Shareholders entitled to attend and vote at the EGM and the H Shareholders' Class Meeting, the register of members of the H Shares of the Company has been scheduled to close from 28 November 2018 to 28 December 2018 (both days inclusive), during which period no transfer of H Share will be registered. Shareholders whose names appear on the register of members of the H Shares of the Company kept with the Hong Kong Registrars Limited at 4:30 p.m. on Tuesday, 27 November 2018 are entitled to attend the EGM and the H Shareholders' Class Meeting. Whether or not you intend to attend, we encourage you to complete and return the Proxy Forms in accordance with the instructions printed thereon as soon as possible and in any event not less than 24 hours prior to the respective commencements of such meetings (or any adjournments thereof). For the corresponding arrangements applicable to the A Shareholders, please refer to the meeting notices to A Shareholders with which the relevant forms of proxy and reply slips were enclosed, as published by the Company on the website of the Shenzhen Stock Exchange on 12 November 2018.

LETTER FROM THE BOARD

V. RECOMMENDATIONS

The Board considers that the proposed resolutions set out above are in the interests of the Company and the Shareholders as a whole. Accordingly, the Board recommends that Shareholders eligible to vote at the EGM and the Class Meetings to attend and vote in favour of the resolutions.

The Independent Board Committee, having taken into account the advice from the Independent Financial Adviser, considers the Continuing Connected Transactions fair and reasonable and in the interests of the Company and the Shareholders as a whole. Accordingly, the Independent Board Committee would recommend the Disinterested Shareholders to vote in favour of the relevant resolutions at the EGM to approve the Continuing Connected Transactions.

Yours faithfully,

By order of the Board of Directors

Shandong Xinhua Pharmaceutical Company Limited

Zhang Daiming

Chairman

LETTER FROM THE INDEPENDENT BOARD COMMITTEE



山東新華製藥股份有限公司
Shandong Xinhua Pharmaceutical Company Limited

(a joint stock company established in the People's Republic of China with limited liability)

(Stock Code: 0719)

12 December 2018

To the Disinterested Shareholders

Dear Sir or Madam,

We have been appointed as members of the Independent Board Committee to advise the Disinterested Shareholders of the Company on the Continuing Connected Transactions under the renewed Agreements including without limitation to their respective proposed annual caps, of which details are set out in the letter from the Board contained in the circular of the Company (the “**Circular**”) of which this letter forms part. Unless the context otherwise requires, terms defined in the Circular shall have the same meanings when used in this letter.

Your attention is drawn to the letter from the Board and the advice of Hologram Capital Limited in its capacity as the Independent Financial Adviser in respect of whether the Continuing Connected Transactions are on normal commercial terms, fair and reasonable and in the interests of the Company and its Shareholders as a whole, as set out in the letter from the Independent Financial Adviser and in the Circular.

Having taken into account the advice of and the principal factors and reasons considered by the Independent Financial Adviser in relation thereto as stated in its letter and the interests of the Disinterested Shareholders, we consider the Continuing Connected Transactions fair and reasonable and are in the interests of the Company and the Shareholders as a whole. Accordingly, we recommend the Disinterested Shareholders to vote in favour of the ordinary resolutions to be proposed at the EGM in respect of the Continuing Connected Transactions.

The Independent Board Committee

Mr. Du Guanhua

Mr. Li Wenming

Mr. Lo Wah Wai

Independent non-executive Directors

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The following is the full text of the letter of advice from the Independent Financial Adviser to the Independent Board Committee and the Disinterested Shareholders in relation to the Continuing Connected Transactions, which has been prepared for the purpose of inclusion in this circular.



中孚資本有限公司
HOLOGRAM CAPITAL LIMITED

Hologram Capital Limited

Room 1402-1403, 14/F., Double Building

22 Stanley Street, Central, Hong Kong

中孚資本有限公司

香港中環士丹利街22號

登寶大廈 14樓 1402-1403室

12 December 2018

To the Independent Board Committee and the Disinterested Shareholders of Shandong Xinhua Pharmaceutical Company Limited

Dear Sir/Madam,

CONTINUING CONNECTED TRANSACTIONS

INTRODUCTION

We refer to our appointment as the Independent Financial Adviser to advise the Independent Board Committee and Disinterested Shareholders on the Continuing Connected Transactions, details of which are set out in the letter from the Board (the “**Board Letter**”) contained in the circular to the Shareholders dated 12 December 2018 (the “**Circular**”), of which this letter forms part. Terms used herein have the same meanings as defined elsewhere in the Circular unless the context require otherwise.

Reference is made to the announcements of the Company dated 29 October 2015, 20 April 2018 and 22 October 2018 and the circulars dated 14 December 2015 and 8 June 2018, in respect of, amongst other things, the continuing connected transactions of the Company.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The SXPGC Agreement

On 29 October 2015, the Company entered into an agreement with SXPGC, the immediate controlling shareholder of the Company, in relation to the Group purchasing and selling certain products and services from and to the Controlling Shareholder Group for a period of three years from 1 January 2016 to 31 December 2018 (the “**Existing SXPGC Agreement**”). In the circumstances, the Company has entered into the SXPGC Agreement for a period of another three years commencing from 1 January 2019 to 31 December 2021.

As at the Latest Practicable Date, (1) SXPGC held 32.94% of the total issued Shares of the Company and is a wholly-owned subsidiary of HHGC; and (2) HHGC held 100% equity interests in China Shandong Group Limited and Shandong Hualu International Business Center Company Limited, which in turn held 99.91% and 0.09% shareholding in Well Bring Limited respectively; (3) Well Bring Limited owned 2.86% of the total issued Shares of the Company. Accordingly, the transactions contemplated under the SXPGC Agreement will constitute continuing connected transactions under the Listing Rules.

The highest annual cap in relation to the continuing connected transactions under the SXPGC Agreement for the years 2019, 2020 and 2021 is RMB173,000,000.

As one or more applicable percentage ratios (as defined in the Listing Rules) exceed 5% on an annual basis and the total consideration exceeds HK\$10,000,000, the continuing connected transactions contemplated under the SXPGC Agreement will constitute non-exempt continuing connected transactions under Chapter 14A of the Listing Rules and are subject to the reporting, announcement, annual review and Disinterested Shareholders’ approval requirements under Chapter 14A of the Listing Rules.

Mr. Zhang Daiming, Mr. Ren Fulong, Mr. Xu Lie, Mr. Zhao Bin, being the Directors, have by virtue of their respective directorships or capacities as a member of the management in the Controlling Shareholder Group abstained from voting on the Board decision regarding the SXPGC Agreement. Save as disclosed above, the Company is not aware of any other Directors who has a material interest in the SXPGC Agreement.

To the best of the Directors’ knowledge, information and belief, having made all reasonable enquiries, there is no other transaction entered into between the Group and the Controlling Shareholder Group and/or its ultimate beneficial owner within a 12-month period from the Latest Practicable Date which would be, together with the transactions contemplated under the SXPGC Agreement, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The SHHCC Agreement

On 29 October 2015, the Company entered into an agreement with SHHCC in relation to the Group purchasing chemical raw materials from SHHCC and/or its subsidiaries (the “**SHHCC Group**”) for a period of three years commencing from 1 January 2016 to 31 December 2018 (the “**Existing SHHCC Agreement**”). In the circumstances, the Company has entered into the SHHCC Agreement for a period of another three years commencing from 1 January 2019 to 31 December 2021.

As at the Latest Practicable Date, (1) SXPGC held 32.94% of the total issued Shares of the Company; HHGC owned 100% equity interest of SXPGC and SHHGC; and (2) SHHGC owned 32.32% of the total issued share capital of SHHCC. Accordingly, the transactions contemplated under the SHHCC Agreement will constitute continuing connected transactions under Chapter 14A of the Listing Rules.

The highest annual cap in relation to the continuing connected transactions under the SHHCC Agreement for the years 2019, 2020 and 2021 is RMB340,000,000.

As one or more applicable percentage ratios (as defined in the Listing Rules) exceed 5% on an annual basis and the total consideration exceeds HK\$10,000,000, the continuing connected transactions contemplated under the SHHCC Agreement will constitute non-exempt continuing connected transactions under Chapter 14A of the Listing Rules and are subject to the reporting, announcement, annual review and Disinterested Shareholders’ approval requirements under Chapter 14A of the Listing Rules.

To the best of the Directors’ knowledge, information and belief, having made all reasonable enquiries, there is no other transaction entered into between the Group and SHHCC Group and its ultimate beneficial owner within a 12-month period from the Latest Practicable Date which would be, together with the SHHCC Agreement, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

THE INDEPENDENT BOARD COMMITTEE

An Independent Board Committee comprising all of the independent non-executive Directors, namely Mr. Du Guanhua, Mr. Li Wenming and Mr. Lo Wah Wai, has been established to advise the Disinterested Shareholders on (i) the SXPGC Agreement and the proposed annual caps in relation to the relevant continuing connected transactions contemplated thereunder; and (ii) the SHHCC Agreement and the proposed annual caps in relation to the relevant continuing connected transactions contemplated thereunder.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We have been approved and appointed by the Independent Board Committee to advise the Independent Board Committee and the Disinterested Shareholders as to (i) whether the terms of the Agreements (including the respective proposed annual caps) are in the ordinary course of business of the Group, on normal commercial terms, fair and reasonable so far as the Disinterested Shareholders are concerned, and in the interests of the Company and the Shareholders as a whole; and (ii) whether the Disinterested Shareholders should vote in favour of the Continuing Connected Transactions at the EGM.

OUR INDEPENDENCE

As at the Latest Practicable Date, we did not have any relationship with, or interest in, the Company or any other parties that could reasonably be regarded as relevant to our independence. Save for this appointment as the Independent Financial Adviser in respect of the Continuing Connected Transactions, there were no other engagements between us and the Company or any other parties to the Agreements in the last two years. Apart from normal professional fees payable to us in connection with this appointment as the Independent Financial Adviser, no arrangement exists whereby we will receive any fees or benefit from the Company, its subsidiaries, its associates or their respective substantial shareholders or associates or any other parties to the Agreements. Accordingly, we consider that we are independent pursuant to Rule 13.84 of the Listing Rules.

BASIS OF OUR OPINION

In formulating our opinion and recommendation, we have reviewed, amongst others, the announcement of the Company dated 22 October 2018 in relation to the Continuing Connected Transactions and the Agreements, the annual reports of the Company for the years ended 31 December 2016 and 2017 (the “**Annual Report 2016**” and “**Annual Report 2017**” respectively), the interim reports of the Company for the six months ended 30 June 2017 and 2018 (the “**Interim Report 2017**” and “**Interim Report 2018**” respectively) and have enquired with and reviewed the information, opinions and representations contained or referred to in the Circular and/or provided to us by the Company and the management of the Group.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We have relied on the statement, information and representations contained or referred to in the Circular and the information, opinion and representations provided to us by the management of the Company and the Directors. We have assumed that all information, opinion and representations contained or referred to in the Circular and all statement, information and representations which have been provided by the management of the Company and the Directors, for which they are solely and wholly responsible, were true, accurate and complete at the time when they were made and continue to be so at the date hereof. We have no reason to suspect that any material facts or information have been withheld or to doubt the truth, accuracy and completeness of the information and facts contained in the Circular, or the reasonableness of the opinions expressed by the Company, its advisers and/or the Directors, which have been provided to us. The Directors collectively and individually accept full responsibility for the accuracy of the information in the Circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief, the information contained in the Circular is accurate and complete in all material respect and not misleading or deceptive, and there are no other facts the omission of which would make any statement in the Circular misleading. We consider that we have taken sufficient and necessary steps on which to form a reasonable basis and an informed view for our opinion in compliance with Rule 13.80 of the Listing Rules.

We relied on the Company that it has provided us sufficient information to reach an informed view and to provide a reasonable basis for our opinion. We have not, however, conducted any independent in-depth investigation into the business and affairs of the Group, parties to the Agreements or their respective subsidiaries or associates, nor have we considered the taxation implication on the Group or the Shareholders as a result of the Agreements. 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. Shareholders should note that subsequent developments (including any material change in the market and economic conditions) may affect and/or change our opinion and we have no obligation to update this opinion to consider events occurring after the Latest Practicable Date or to update, revise or reaffirm our opinion. Nothing contained in this letter should be construed as a recommendation to hold, sell or buy any shares or any other securities of the Company.

Lastly, where information in this letter has been extracted from published or otherwise publicly available sources, it is our responsibility to ensure that such information has been correctly extracted from the relevant sources while we are not obligated to conduct any independent in-depth investigation into the accuracy and completeness of those information.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

PRINCIPAL FACTORS AND REASONS CONSIDERED

In formulating our opinion and recommendation to the Independent Board Committee and Disinterested Shareholders, we have taken into consideration of the following principal factors and reasons:

1 Information on the Group

The Company is a joint stock company established under the laws of the PRC with limited liability, of which the H Shares and A Shares are listed on the Main Board and the Shenzhen Stock Exchange respectively. The Group principally engages in the development, manufacture and sales of bulk pharmaceuticals, preparations and chemical products.

Set out below are selected information from the consolidated financial results of the Group for (i) the years ended 31 December 2016 and 2017 (“FY2016” and “FY2017” respectively) as extracted from the Annual Report 2016 and Annual Report 2017; and (ii) the six months ended 30 June 2017 and 2018 (“1H17” and “1H18” respectively) as extracted from the Interim Report 2017 and Interim Report 2018:

	FY2016 <i>(Audited)</i> <i>(RMB million)</i>	FY2017 <i>(Audited)</i> <i>(RMB million)</i>	1H17 <i>(Unaudited)</i> <i>(RMB million)</i>	1H18 <i>(Unaudited)</i> <i>(RMB million)</i>
Operating income	4,015	4,516	2,403	2,688
Chemical bulk drugs	1,770	1,965	1,050	1,174
Preparations	1,748	1,982	1,067	1,183
Medical intermediaries and other products	497	569	286	331
Operating cost	3,014	3,248	1,743	1,939
Chemical bulk drugs	1,309	1,397	724	852
Preparations	1,281	1,382	784	783
Medical intermediaries and other products	424	469	235	304

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

FY2017

As depicted by the above table, the Group recorded an increase of approximately 12.47% in operating income from approximately RMB4,015 million for FY2016 to approximately RMB4,516 million for FY2017. Meanwhile, the Group recorded an increase of approximately 7.77% in operating cost from approximately RMB3,014 million for FY 2016 to approximately RMB3,248 million for FY2017.

1H18

As shown in the above table, the Group recorded an increase of approximately 11.83% in operating income from approximately RMB2,403 million for 1H17 to approximately RMB2,688 million for 1H18. Meanwhile, the Group recorded an increase of approximately 11.23% in operating cost from approximately RMB1,743 million for 1H17 to approximately RMB1,939 million for 1H18.

We noted that the chemical bulk drugs and preparation industry segments are the main income contributors of the Group, which in aggregate contributed approximately 87.4% and 87.7% of the total operating income of the Group for FY2017 and 1H18 respectively. We consider that the business activities in relation to the chemical bulk drugs and preparation industries are in the ordinary and usual course of business of the Group.

We noted from the Annual Report 2017 that (i) the continuous deepening of reform of pharmaceutical and healthcare system provides additional opportunities for accelerated development; (ii) the Company will put greater effort in development of bulk drugs and accelerate the implementation of its greater preparations strategy; and (iii) the rising cost of procurement is one of the factors which has hampered the profitability of the Company. As such, we believe the entering into of the Agreements can enhance the growth and profitability of the Group in the long run by securing a steady supply of chemical products and raw materials without incurring extra costs, and we are of the view that the Continuing Connected Transactions are in the best interest of the Company and its Shareholders as a whole.

2 Background of and reasons for the Continuing Connected Transactions

2.1 *The SXPGC Agreement*

On 29 October 2015, the Company and SXPGC entered into the Existing SXPGC Agreement in relation to the Group purchasing and selling certain products and/or services from and to the Controlling Shareholder Group for a period of three years from 1 January 2016 to 31 December 2018. On 22 October 2018, the Company has entered into the SXPGC Agreement for a period of another three years commencing from 1 January 2019 to 31 December 2021.

As set out in the Board Letter, SXPGC is a state-owned enterprise established in the PRC principally engaged in investments in the pharmaceutical industry and associated chemical production, packaging and supply of chemical engineering equipment. SXPGC is a wholly-owned subsidiary of HHGC, 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. By virtue of the SXPGC Agreement, the Group can continue to generate operating income from selling the relevant products to the Controlling Shareholder Group and to secure a steady supply of raw materials and miscellaneous products from the Controlling Shareholder Group without incurring extra costs by purchasing them through other parties.

The Group has been purchasing accessories, raw materials and packaging services and package materials (the “**Purchase Products and Procure Services**”) from the Controlling Shareholder Group under the terms and conditions of the Existing SXPGC Agreement. We are given to understand that procuring the Purchase Products and Procure Services from the Controlling Shareholder Group provides the Group an advantage in reducing the transportation costs and time as certain subsidiaries of the SXPGC are located within the same city as certain members of the Group. The historical unique relationship and long-term cooperation between the SXPGC and the Group has also enabled SXPGC to gain a comprehensive and deep understanding of the Group’s features and general business needs. Compared to third parties, SXPGC can provide responsive support services in a speedy and stable manner, thereby achieving efficient business cooperation. In addition, identifying new suppliers without previous track records with the Company may incur extra risks in the process of adopting and cooperating with unfamiliar suppliers. Provided that the prices and services provided to the Group will be determined in accordance with the market practice and all the relevant prices will not be higher than the selling prices offered by any independent third parties, the Group expects such transactions to be ongoing.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The Group has also been selling water, electricity and steam (the “**Supply Goods**”) and sundry items of by-products during the manufacturing processes (the “**Sale Products**”) to the Controlling Shareholder Group under the Existing SXPGC Agreement and in return, after deducting the relevant taxes and costs (fully charged to the Controlling Shareholder Group), the Company will receive a fee that contributes to the Group’s operating income. Given that such transactions will provide additional operating income to the Company and that the relevant prices will not be lower than the prices offered by the Group to any independent third parties, the Group expects to continue such transactions in the future. We are given to understand that not many companies in the market would purchase waste materials for recycling and thus we believe the cessation of supplying the Supply Goods to SXPGC solely because of its connected relationship with the Group is not economical as the Company may not be able to find alternative buyers.

In light of (i) the nature of the businesses of the Group and SXPGC; (ii) the transactions under the Existing SXPGC Agreement have been ongoing for years and are expected to be continued in the future; (iii) the SXPGC Agreement serves as a continuation of the Existing SXPGC Agreement; (iv) the transactions contemplated under the SXPGC Agreement will generate operating income to the Group; and (v) the situation that not many companies in the market would purchase waste materials for recycling, we consider that the entering into of the SXPGC Agreement is in the ordinary and usual course of business as well as in the interests of the Company and the Disinterested Shareholders as a whole.

2.2 *The SHHCC Agreement*

On 29 October 2015, the Company entered into the Existing SHHCC Agreement in relation to the Group purchasing chemical raw materials (the “**Chemical Products**”) from the SHHCC Group for a period of three years from 1 January 2016 to 31 December 2018. On 22 October 2018, the Company has entered into the SHHCC Agreement for a period of another three years commencing from 1 January 2019 to 31 December 2021.

As set out in the Board Letter, SHHCC is principally engaged in the production and sale of chemical products. By virtue of the SHHCC Agreement, the Group can continue to secure a steady supply of chemical raw materials from the SHHCC Group without incurring extra costs by purchasing them through other parties.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

As advised by the Company, the transactions under the Existing SHHCC Agreement are continuing now and are expected to continue in the future. The Group has also procured the Chemical Products from other independent suppliers. We are given to understand that procuring the Chemical Products from independent suppliers is generally more time consuming as a result of complicated communication flow, which is mainly due to the fact that independent suppliers are mostly retailers and thus the entire ordering procedure involves multiple order requests to a number of independent suppliers. It is not uncommon that delays in arrival of the Chemical Products would occur due to insufficient inventories. In such cases, re-ordering would take additional time for completion of the whole procuring process. The Company further advised that more transaction costs are incurred if it procures the Chemical Products from a greater number of suppliers (i.e. handling costs, transportation costs etc.) as each supplier charges the Company transactions costs individually. In addition, we conducted research on SHHCC and understood that it is a listed company on the Shanghai Stock Exchange (stock code: 600426), a highly reputed large-scale integrated enterprise mainly engaged in manufacturing chemical fertilizers and in chemical industry. As such, we consider that if the Group procures from the SHHCC Group, it will allow the Group to achieve more stable supply comparing to sourcing from independent suppliers as SHHCC is a large chemical products manufacturing group. Therefore, the entering into of the SHHCC Agreement will enable the Company to reduce transaction costs and achieve logistical and communication efficiency as the number of suppliers can be reduced and the ordering procedure may be streamlined, if SHHCC is qualified and allowed to supply the majority of the Chemical Products the Company demands.

In light of (i) the nature of the businesses of the Group and SHHCC; (ii) the transactions under the Existing SHHCC Agreement have been ongoing for years and are expected to be continued in the future; (iii) the SHHCC Agreement serves as a continuation of the Existing SHHCC Agreement; (iv) the purchasing of the Chemical Products from the SHHCC Group helps the Group to reduce procurement costs and enhance the overall transaction efficiency; and (v) the transactions under the SHHCC Agreement allow the Group to achieve a stable and prompt supply of the Chemical Products, we consider that the entering into of the SHHCC Agreement is in the ordinary and usual course of business as well as in the interests of the Company and the Disinterested Shareholders as a whole.

3 Principal terms of the Agreements

3.1 *The SXPGC Agreement*

Full details of the principal terms and conditions of the SXPGC Agreement including, among other things, (i) pricing for the Purchase Products and Procure Services under the SXPGC Agreement; (ii) pricing in relation to the Supply Goods under the SXPGC Agreement; (iii) pricing in relation the Sale Products under the SXPGC Agreement; and (iv) the respective payment terms, are listed out in the Board Letter under the section headed “B. The Continuing Connected Transactions”.

We have reviewed the SXPGC Agreement and noted that pursuant to the SXPGC Agreement (the term of which runs from 1 January 2019 to 31 December 2021), the transactions contemplated thereunder shall be conducted on normal commercial terms and by arm’s length negotiation, or on terms no less favorable to the Company than those available to or from other parties and the pricing of the products or services be agreed by reference to, amongst others, the then prevailing market prices of the products/services at the relevant time. Also, the Group are not restricted from conducting transactions with any third parties for the purchase and sale of the relevant products and the provisions of services under the SXPGC Agreement.

Pricings in relation to the Purchase Products and Procure Services

As set out in the Board Letter, the Group sources all its products under the SXPGC Agreement (the “**Purchase Products**”) through suppliers who are participants in the Bidding Website, which provides a public bidding platform service for the trading of goods online. We noted from the Bidding Website that it provides a business-to-business public auction and bidding platform for the trading of certain goods and services online and was given the top creditability “AAA” ranking by iTrust (<http://www.itrust.org.cn>), a reputable and registered credit assessment platform in the PRC which is recognized and supported by various departments of the Chinese government. As such, we consider the Bidding Website to be reliable.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

As confirmed by the Company, the Group is independent from the Bidding Website and its providers and the Bidding Website is a public trading platform which provides information in respect of the prevailing market prices for a wide range of products and services available at a given time. We further noted that the Controlling Shareholder Group is an existing user of the Bidding Website and the categories of goods and services available from it cover various industries, including but not limited to international and domestic equipment, engineering, material and services. As set out in the Board Letter, the Company may place requests for the Purchase Products through the Bidding Website and subsequently obtains price quotes offered by various suppliers, which may include the Controlling Shareholder Group since it is an existing user of the Bidding Website. The exact number of quotations depends on the category of the products and the type of raw materials. The bidding process will generally permit the procurement team of the Company to gain an understanding of the prevailing market prices of the Purchase Products at any particular time. The Group may directly accept the best available offer through the Bidding Website after evaluation by the procurement team of the Company and assessment of its internal control policies. Prior to acceptance of an offer, the Company does not have any binding obligation to conclude any purchase with any supplier for the sale and purchase of the relevant products and services. Save as the pricing factor during the evaluation process, the Company will also consider other factors, including but not limited to previous track records and reputation of the supplier, the quality of their products and the respective delivery and payment terms. We obtained 3 recent bid orders from the Company and noted that after the Company had placed requests for certain products, both the Controlling Shareholder Group and independent providers offered their respective quotes during the auction.

Further advised by the Company, the procurement team of the Company will evaluate the quotations offered on the Bidding Website with reference to market information (including pricing trends of relevant products and services) published by the two local media, namely the China Chemical Industry News (中國化工報) and the industry website (www.chem365.net) Zhongyu Info (中宇資訊) (the “**Local Media**”), which are easily accessible by the general public and contain updated information of the chemical industry in the PRC, in considering whether the prices are comparable to the prevailing market rates. We conducted research and noted that the China Chemical Industry News has been published for more than two decades while the Zhongyu Info has been founded for over a decade, both of which have up to date market information regarding the chemical industry which could be made reference to evaluate the quotations received by the Company.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Pricings in relation to the services procured under the SXPGC Agreement are determined through tender processes. The Company advised that the services procured are usually related to certain maintenance work. Typically, the Group would conduct an open tender process via independent professional intermediaries when the relevant service is required. In such open tender process, interested suppliers (which may include SXPGC) may give quotes for the supply of such service, following which a legally binding transaction will be entered into for the supply of the service. The Company generally adopts the best available price approach in considering tenders, but will also consider other factors including but not limited to the reputation and track records of the suppliers in supplying the relevant services, the quality of their products and the respective delivery and payment terms. The providers (both the Controlling Shareholder Group and independent providers) will consider the bid orders from the Company and tender for the services if they are interested. We are given to understand that the Company has seldom procured services under the SXPGC Agreement lately. As confirmed by the Company, it would place requests with the same terms for the services to both the Controlling Shareholder Group and independent providers, in the event that the services under the SXPGC Agreement is required in the future.

Pricings in relation to the Supply Goods

As disclosed in the Board Letter, pricings in relation to the Supply Goods are determined on cost plus basis determined as follow (the “**Formula**”):

$(\text{cost} \times (1 + \text{statutory mark-up percentage} + \text{management fee mark-up percentage}))$

The cost referred in the Formula is the aggregate of costs of water, electricity and steam, together with the repairing costs associated to the maintenance of tubes used for supplying the Supply Goods to the Controlling Shareholder Group.

The statutory mark-up percentage is determined in accordance to the “PRC Provisional Regulations On Value Added Tax Implementation Details*” (中華人民共和國增值稅暫行條例實施細則) issued by the State Administration of Taxation (國家稅務總局), which requires the Company to charge the Supply Goods at a minimum mark-up rate of 10%.

The management fee mark-up percentage of up to a maximum of 5% covers (i) surcharges and taxes which may be imposed on the Company for supplying the Supply Goods to the Controlling Shareholder Group; and (ii) associated administrative, personnel and operational expenses relating to supplying the Supply Goods to the Controlling Shareholder Group.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We are given to understand that the Controlling Shareholder Group is unable to source Supply Goods from any other entities other than the Company (as SXPGC and its subsidiaries share the same utility account as the Company with the end-supplier), and the supply of the Supply Goods by the Company to the Controlling Shareholder Group requires the maintenance of a historically established infrastructure (including tubes and facilities) that are used exclusively for such supply. There is no comparative pricing which can be used as reference for such pricing. While the cost and the statutory mark-up percentage referred in the Formula are either based on actual expenses incurred or are fixed, the variable costs associated with management, administration and maintenance of relevant facilities are consistently monitored by the finance department of the Company, which prepares costs breakdown and analysis on a periodical basis and evaluate the appropriateness of the management fee mark-up percentage.

As the Company's principal, ordinary and usual course of business is not supplying the Supply Goods to the Controlling Shareholder Group or any independent third party, the charges for such supply are intended only for cost recovery plus a compulsory statutory mark-up.

The management fee mark-up percentage will be determined based on the actual costs associated with management, administration and maintenance incurred by the Group in supplying of the Supply Goods. As advised by the Company, based on the internal records of the Company, the rate charged by the Company to the Controlling Shareholder Group of the management fee varies from 1% to not more than 5% in the previous years, depends on the extent of wearing down of the infrastructure used for supplying the Supply Goods.

Despite the fact that there are no available comparable information because the Group have not entered into any sale transaction with other independent third parties in relation to supplying of the Supply Goods except with the Controlling Shareholder Group, we are of the view that the management fee mark-up percentage is prearranged on normal commercial terms, given that (i) the management fee mark-up percentage has made reference to the previous records of the Company and falls within the historical range of 1% to 5%; (ii) the management fee mark-up percentage is charged principally to recover the related operational costs of the Group in the process of supplying the Supply Goods; and (iii) the Company has assigned its finance department to prepare costs breakdown and analysis on a periodic basis. Accordingly, we consider the Formula including the management fee mark-up percentage of not more than 5% is fair and reasonable so far as the Disinterested Shareholders are concerned.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Pricings in relation to the Sale Products

As discussed in the Board Letter, pricings in relation to the Sale Products are determined through a bidding process conducted by the Group on a quarterly basis. Each quarter, the Group conduct an open tender process and invite purchasers (including SXPGC and independent third parties), based on, among other factors, their resources, capabilities and track records with the Company, to bid for the Sale Products and the highest price would be the selected price of the Sale Products for that particular quarter. The Company will invite not less than 3 purchasers (which may include the Controlling Shareholder Group) to take part in the bidding process and sale transactions will only be executed if the purchaser agrees with the selected price. As the Sale Products are not required by the Group and they incur storage costs, the Company will still sell the Sale Products in the event that there is only one interested bidder. We have obtained and reviewed 3 bidding documents from the Company and noted that both the Controlling Shareholder Group and independent purchasers had participated in the bid for the Sale Products and the highest price was adopted as the selected price.

On top of the above-mentioned, we noted from the Board Letter that internal control policies have been adopted by the Company to ensure the Group's conformity with the pricing policies of, among other things, the SXPGC Agreement from time to time. Individual committee will be formed respectively in relation to (i) the Purchase Products; (ii) the procurement of services; and (iii) the Sale Products, for reviewing, approving and monitoring the respective transactions. The committees will review and compare the price and terms offered by the Controlling Shareholder Group with other suppliers or purchasers, subject to the type of the products to be purchased or sold and services to be procured under the SXPGC Agreement to make sure the prices and terms offered by the Controlling Shareholder Group are fair and reasonable that they are no less favorable than those offered by the independent suppliers or purchasers. As for the supply of Supply Goods to the Controlling Shareholder Group under the SXPGC Agreement, the finance department of the Company would regularly prepare costs breakdown and analysis and assess the unit cost of products in order to determine the unit sale price.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

In considering that the operation and finance departments of the Company are notably involved in the internal control policies, we have reviewed the experience of the heads of the operation department and finance department and noted that (i) the head of the operation department began working in the Company since 1989 and has extensive knowledge of the operation of the Group as well as more than 28 years of pharmaceutical related experience; and (ii) the head of the finance department also has more than 18 years of pharmaceutical related experience and one of his main responsibilities is to monitor the market prices of the Purchase Products and the Sale Products of the Group. Based on their extensive knowledge of the operation of the Group and pharmaceutical related experience, we believe they are competent to perform the role of supervising and monitoring the internal control measures adopted by the Company.

We enquired with and noted that the management of the Company is aware of the principles of the pricing of products and services offer to connected persons under a continuing connected transaction shall be (i) based on market prices of the products and services and the pricing offer to the connected persons and no less than the price of same product quoted by independent suppliers or purchasers in the market; and (ii) on normal commercial terms. Given that (i) the Company will treat SXPGC and other independent parties equally and compare the price and terms offered by SXPGC with those provided by independent suppliers or purchasers on normal commercial terms; and (ii) the Directors and management of the Company will carefully monitor the respective market prices of the Sale Products and the Purchase Products and Procure Services so as to ensure that the internal control policies are strictly followed, we consider the pricings of the Purchase Products and Procure Service, the Supply Goods and the Sale Products are fair and reasonable so far as the Disinterested Shareholders are concerned.

We have also obtained and reviewed randomly selected samples of purchase orders provided by the Company with the independent third parties, the transactions relating to the Sale Products and the Purchase Products and Procure Services entered into by the Company with SXPGC and the transactions relating to the purchases of the products and services similar to the Sale Products and the Purchase Products and Procure Services with other suppliers who are independent third parties of the Company. We noted from the samples that purchases from both the SXPGC and independent third parties required settlements after delivery and acceptance check. During our process of reviewing of the samples of purchase orders, we did not notice any terms offered by SXPGC to be irregular or more favorable than those offered by other suppliers.

Also, we have reviewed the Existing SXPGC Agreement and noted that, except for the duration term of the SXPGC Agreement, other terms of the SXPGC Agreements are the same as the terms of the Existing SXPGC Agreement.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Given the above, we are of the view that the terms of the SXPGC Agreement are on normal commercial terms and are fair and reasonable so far as the Disinterested Shareholders are concerned.

3.2 *The SHHCC Agreement*

Full details of the principal terms and conditions of the SHHCC Agreement dated 22 October 2018 including, among other things, pricing for the Chemical Products and the respective payment terms are listed out in the Board Letter under the section headed “B. The Continuing Connected Transactions”.

We have reviewed the SHHCC Agreement and noted that pursuant to the SHHCC Agreement (the term of which runs from 1 January 2019 to 31 December 2021), the transactions contemplated thereunder shall be conducted on normal commercial terms and by arm’s length negotiation, or on terms generally no less favorable to the Company than those available to or from other parties and the pricing of the products be agreed by reference to, amongst others, the then prevailing market prices of the products at the relevant time. As advised and confirmed by the Company, the Chemical Products will be delivered to the Group upon receipt of payments made by the Group to SHHCC Group in relation to such products and the terms under the SHHCC Agreement is generally in line with the usual market practice. Also, the Group is not restricted from conducting transactions with any third parties for the sale and purchase of the relevant products under the SHHCC Agreement.

Pricing for purchase of the Chemical Products

As advised by the Company, similar to the pricing of the Purchase Products under the SXPGC Agreement, the Group sources all its Chemical Products through suppliers who are participants in the Bidding Website. General information of the Bidding Website is disclosed above under the sub-section headed “The SXPGC Agreement”. In short, the Bidding Website provides an independent and reliable public bidding platform service for trading of goods online. The Company may through the Bidding Website place requests for certain Chemical Products and then obtain the price quotes offered by various suppliers which may include members of the SHHCC Group as well as other independent third parties. The bidding process will generally permit the procurement team of the Company to gain an understanding of the prevailing market prices of the Chemical Products at any particular time. The Group may directly accept the best available offer through the Bidding Website after evaluation by the procurement team of the Company and assessment of its internal control policies. Prior to acceptance of an offer, the Company does not have any binding obligation to conclude any purchase with any supplier for the sale and purchase of the relevant products. Save as the pricing factor during the evaluation process, the Company will also consider other factors, including but not limited to previous track records and reputation of the suppliers, the quality

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

of their products and the respective delivery and payment terms. We obtained 3 recent randomly selected bid orders from the Company and noted that after the Company had placed requests for certain Chemical Products, both the SHHCC Group and independent sellers offered their respective price quotes.

Furthermore, the procurement team of the Company will evaluate the prices offered on the Bidding Website with reference to market information, including pricing trends of relevant Chemical Products, published by the Local Media which are easily accessible by the general public and contained updated information of the chemical industry in the PRC, in considering whether the offer prices are comparable to the prevailing market rates.

We noted from the Board Letter that the Company has also adopted internal control policies to ensure the Group's conformity with the pricing policies of, among other things, the SHHCC Agreement from time to time. The internal control policies, similar to those discussed above in relation to the Purchased Products under the SXPGC Agreement, are in place to make sure the prices and terms offered by the SHHCC Group are fair and reasonable that they are no less favorable than those offered by the independent suppliers.

As advised by the Company, the department heads that are responsible for the assessment of the supplier's product qualities and production capacities and reviewing the price and terms of the purchase are the same for the SXPGC Agreement and the SHHCC Agreement. The relevant experience and qualifications are disclosed in the above under the sub-section headed "The SXPGC Agreement". The Directors and management of the Company will carefully monitor the respective market prices of the Chemical Products as to ensure that the internal control policies are strictly followed.

Nonetheless, we have obtained and reviewed randomly selected samples of purchase orders provided by the Company with the independent third parties, the transactions relating to the purchases of the Chemical Products entered into by the Group with SHHCC and the transactions relating to the purchases of the products similar to the Chemical Products with other suppliers who are independent third parties of the Company. We noted from the samples that prepayments were needed for the purchase of Chemical Products from the SHHCC Group while purchasing from independent third parties required settlements after delivery and acceptance check. We enquired with and were advised by the Company that the Company would generally adopt the best available price approach in assessing the bids and consider, in addition to the payment terms, a bunch of factors including but not limited to the reputation and track records of the supplier and quality of their products. Save for the prepayment requirement, during our process of reviewing the samples of purchase orders, we did not notice any other terms offered by the SHHCC Group to be irregular or less favorable than those offered by other suppliers.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Given the above, we are of the view that the terms of the SHHCC Agreement are on normal commercial terms and are fair and reasonable so far as the Disinterested Shareholders are concerned.

4 The proposed annual caps

4.1 The SXPGC Agreement

As disclosed in the Board Letter, the proposed annual caps in relation to the continuing connected transactions under the SXPGC Agreement are as follows:

	For the year ending 31 December		
	2019	2020	2021
	(RMB'000)	(RMB'000)	(RMB'000)
Sale Products to the Controlling Shareholder Group	15,000	16,000	18,000
Purchase Products and Procure Services from the Controlling Shareholder Group	<u>125,000</u>	<u>140,000</u>	<u>155,000</u>
Total	<u><u>140,000</u></u>	<u><u>156,000</u></u>	<u><u>173,000</u></u>

The Company determined the above annual caps under the SXPGC Agreement on the basis of the following factors:

- (a) The historical figures in 2016, 2017 and January to September 2018 for the transactions between the Group and the Controlling Shareholder Group (see Table 1 below);
- (b) the demand set out by the Controlling Shareholder Group;
- (c) the demand set out by the Group;
- (d) the development in the business of the Group; and
- (e) the expected trend in market prices of chemical products.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Table 1

	2016	2017	January to September 2018
	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>
Sale Products to the Controlling Shareholder Group	10,160	10,707	8,962
Purchase Products and Procure Services from the Controlling Shareholder Group	59,959	60,241	57,688
Total transaction amounts	<u>70,119</u>	<u>70,948</u>	<u>66,650</u>
	2016	2017	2018
	<i>(RMB'000)</i>	<i>(RMB'000)</i>	<i>(RMB'000)</i>
Historical annual caps	180,000	195,000	210,000
Utilisation rate (approximately)	38.96%	36.38%	31.73%

The historical and projected transaction amounts

As noted from the Table 1 above, the total transaction amounts for the year 2017 represented a subtle increase of approximately 1.18% as compared to that in 2016. The total transaction amounts recorded approximately RMB66.65 million for the 9 months ended September 2018.

The utilisation rates in 2016 and 2017 amounted to approximately 39% and 36% respectively. We have enquired with and given to understand the reasons for such low utilisation rates is primarily due to, among others, the fact that (i) the previous annual caps assumed the Controlling Shareholder Group could offer the best available prices in relation to the Purchase Products and Procure Services demanded by the Company; (ii) the Controlling Shareholder Group had in fact often failed to offer the best available prices for certain Purchase Products and Procure Services as compared to that of the counterparties on the Bidding Website; and (iii) the Controlling Shareholder Group did not expand its operation scale as planned in the past 3 years. The decrease in the expected production capacity of the Controlling Shareholder Group in turn decreases its demand for the Sale Products and the amount of Purchase Products that the Group is able to source under the SXPGC Agreement. As a result, the Company has decided to lower the proposed annual caps to account for such shortfall in expectations, despite the fact that it anticipates the total transaction amounts with the Controlling Shareholder Group will continue to grow at a modest pace.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We have reviewed the demand projections for the Sale Products and the Purchase Products and Procure Services related transactions prepared by the Company (the “**SXPGC Projections**”), which was reviewed by the audit department of the Company and approved by the Board. We noted that the Company anticipated an aggregate of RMB131 million, RMB148 million and RMB166 million transaction amounts for the Sale Products and the Purchase Products and Procure Services as mentioned under the SXPGC Agreement for the years ending 31 December 2019, 2020 and 2021 respectively. The estimated total transaction amounts from the Controlling Shareholder Group are expected to grow steadily in the coming years, given (i) the Company’s plan to continue the development of bulk drugs market and expand the sales of bulk drugs; and (ii) the Company’s expectation to increase the consumption of chemical products. We note that the proposed annual cap for the year 2019 represents a significant increment of approximately 57% as compared to the annualized historical amount for 2018, which is followed by stable year-on-year increments of approximately 11% in the proposed annual caps for the years 2020 and 2021. In the process of reviewing the basis and assumptions of the SXPGC Projections, we have enquired with and given to understand that the Company will undergo a major expansion in 2019 to increase the production capacity of certain medical products, which accounts for over 10% of the annual sales of the Group, and the production scale is expected to increase by approximately 30%. To cater for such expansion, a surge of demand for related chemical materials is anticipated in 2019. As confirmed by the Company, there is currently no specific expansion plan in 2020 and 2021 and thus the Company expects steady natural growth for the two years ending 2021. As discussed previously in the section headed “1. Information of the Group”, the Group recorded a year-on-year increase of approximately 12.47% in operating income for FY2017 and a year-on-year increase of approximately 11.83% in operating income for 1H18. Therefore, we consider the steady natural growth rate of approximately 11% for the two years ending 2021 is justifiable. Taking into account the planned expansion in 2019 and the historical growth rate of the Group, we are of the view that the proposed annual caps, with greater year-on-year growth in 2019 and followed by steady milder year-on-year growth in 2020 and 2021, are fair and reasonable.

We further noted the proposed annuals caps account for approximately 94%, approximately 95% and approximately 96% of the SXPGC Projections for the three years ending 2021 respectively. According to the management of the Company, a buffer of 4% – 6% is included in the proposed annual caps to (i) account for the uncertainty regarding the possibility that the Controlling Shareholder Group would be able to offer the best available prices; and (ii) cater for the acute increase in prices of chemical products as a result of supply/demand imbalances.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Given that (i) the historical low utilization rates of the annual caps in previous years; (ii) the proposed annual caps are derived from the SXPGC Projections together with a buffer; (iii) the Company's intention to expand its business and consumption of chemical products; and (iv) it would be administratively costly and cumbersome for the Company to go through the entire Disinterested Shareholders' approval process to take advantage of superior bids that may be tendered by the Controlling Shareholder Group if the annual caps are set too low and subsequently being exceeded, we are of the view that the proposed annual caps are reasonably determined in the interests of the Company and its Shareholders as a whole.

Overview of the pharmaceutical industry

In supplement to the analysis of the pharmaceutical industry set out in the Board Letter under the sub-section headed "Analysis of the proposed annual caps of the transactions under the renewed SHHCC Agreement", we have also conducted research and noted from the publication《2017年醫藥產業經濟運行分析》(Analysis for the Pharmaceutical Industry Economic Operation in 2017*) released by the Ministry of Industry and Information Technology of the PRC that, the demand for the pharmaceutical products was expected to grow continuously with a steady rate due to the continued support by the government policy for pharmaceutical innovation research and development. It is reported that the medical innovation environment has improved significantly with the continuous deepening of the review and approval reform. Having considered the growth prospect of the industry as discussed above, we are of the view that the Company's plan to continue the development of bulk drugs market and expand the sales of bulk drugs and its expectation to increase the consumption of the chemical products are fair and reasonable.

Based on the above mentioned, we are of the view that the proposed annual caps of the continuing connected transactions under the SXPGC Agreement are fair and reasonable so far as the Disinterested Shareholders are concerned.

4.2 The SHHCC Agreement

As disclosed in the Board Letter, the proposed annual caps in relation to the continuing connected transactions under the SHHCC Agreement are as follows:

	For the year ending 31 December		
	2019	2020	2021
	<i>(RMB'000)</i>	<i>(RMB'000)</i>	<i>(RMB'000)</i>
Purchase of Chemical Products from			
SHHCC Group	310,000	330,000	340,000

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The Company determined the above annual caps under the SHHCC Agreement on the basis of the following factors:

- (a) the historical figures in 2016, 2017 and 9 months from 31 January to 30 September 2018 for the transactions between the Group and the SHHCC Group (see table 2 below);
- (b) the demand set out by the Group;
- (c) the development in the business of the Group; and
- (d) the expected market trend of the Chemical Products.

Table 2

	2016	2017	January to September 2018
	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>	<i>(Rounded to the nearest RMB'000)</i>
Purchase of Chemical Products from the SHHCC Group	56,457	98,291	148,186
	2016	2017	2018
	<i>(RMB'000)</i>	<i>(RMB'000)</i>	<i>(RMB'000)</i>
Historical annual caps	80,000	100,000	200,000 <i>(Note)</i>
Utilisation rate (approximately)	70.57%	98.29%	74.10%

Note: On 29 June 2018, the Shareholders resolved to revise the annual cap of the Existing SHHCC Agreement for the year 2018 in respect of the transactions entered into between the Company and SHHCC from RMB120,000,000 to RMB200,000,000.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The historical and projected transaction amounts

As noted from the Table 2 above, the transaction amounts for the purchase of the Chemical Products from the SHHCC Group in 2017 represented an increase of approximately 74% as compared to that in 2016. The total transaction amounts recorded approximately RMB148.19 million for the 9 months ended September 2018.

The utilisation rates in 2016 and 2017 amounted to approximately 71% and 98% respectively. We have enquired with and given to understand such high utilization rate are due to (i) the growth in and profitability of the pharmaceutical production industry; and (ii) the fact that the Group had been able to capture the growth in the industry. Reference is also made to the annual cap revision resolved on 29 June 2018, the original annual cap of the Existing SHHCC Agreement for the year 2018 in respect of the transactions entered into between the Company and SHHCC was raised from RMB120 million to RMB200 million to cope with the increased demand for the Chemical Products.

We observed that the proposed annual caps are significantly higher than the historical figures. As disclosed in the 2017 Annual Report and discussed previously, the Company expects to put greater effort in the development of bulk drugs market to expand its sales. To cope with the intentions of the Group and to seize opportunities in the pharmaceutical industry and to improve profitability of the Group, the Company indicates that there will be significant increase in the consumption of certain Chemical Products. Such demand for Chemical Products is subject to the tender process for procurement on the Bidding Website and the procurement may be sourced from the SHHCC Group. In addition, the Company advises that recent market prices of the Chemical Products are increasing and the Company expects that the prices to increase continuously. As disclosed under the section headed “1. Information on the Group”, we noted from the Annual Report 2017 and Interim Report 2018 that the operating cost of the Group has been rising and the rising cost of procurement is one of the factors which has hampered the profitability of the Company. Increased annual caps for sourcing and procurement under the SHHCC Agreement may enable the Group to lower such costs by avoiding the intermediary costs during the procurement process. Given (i) the transactions amounts are in line with the demand for pharmaceutical products; (ii) the recent increasing trend of market prices of the Chemical Products; and (iii) the SHHCC Projection together with the historical utilisation rates, we consider that the proposed annual caps are reasonable.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We have further reviewed the demand projections for the Chemical Products related transactions prepared by the Company (the “**SHHCC Projections**”), which was reviewed by the audit department of the Company and approved by the office of the Board and noted that the Company anticipated a total of RMB291 million, RMB317 million and RMB328 million purchase amounts for the Chemical Products as mentioned under the SHHCC Agreement for the years ending 31 December 2019, 2020 and 2021 respectively. We note that the proposed annual cap for the year 2019 represents a significant increment of approximately 57% as compared to the annualized historical amount for 2018, which is followed by year-on-year increments of approximately 6% and 3% in the proposed annual caps for the years 2020 and 2021 respectively. In the process of reviewing the basis and assumptions of the SXPGC Projections, we were aware of the revision of annual cap approved at the annual general meeting of the Company dated 29 June 2018. We have enquired with and given to understand that the transacted amounts in 2018 were limited by the annual cap, despite the upward adjustment of 66% from RMB120 million to RMB200 million. Without such limitation of the cap, the Group would have sourced more Chemical Products to cater for its business and production operations. Given the experience of costly and cumbersome process in getting approval for revision of the annual cap, the Company proposed to uplift the annual cap significantly for the year 2019 to meet the Group’s imminent demand for the Chemical Products. The Company further disclosed that it has currently no concrete plan for expanding the scale of procurement and some of the Chemical Products sourced from the SHHCC Group will remain at the same level once the planned amounts (being the same planned amounts as in 2018) are reached. Taking into account the exhausted annual cap in 2018 and the sourcing of the Chemical Products from the SHHCC Group was still limited by the later revised annual cap for the year 2018, we consider the significantly increase in the proposed annual cap for the year 2019 reasonably determined and we believe that the modest increments in the following two years are justifiable as they are capped by the Group’s procurement plan with reference to the SHHCC Projections.

We also noted the proposed annual caps account for approximately 94%, approximately 96% and approximately 97% of the SHHCC Projections for the three years ending 2021 respectively. According to the management of the Company, a buffer of 3%-6% is included in the proposed annual caps to (i) account for the uncertainty regarding the possibility that the SHHCC would be able to offer the best available prices; and (ii) cater for the acute increase in prices of Chemical Products as a result of supply/demand imbalances. As the SHHCC Projections are based on current available data and information to the Group and having taking into account that SHHCC is a highly reputed large-scale integrated enterprise mainly engaged in manufacturing chemical fertilizers and in chemical industry and the location and efficiency advantages currently enjoyed by the Group, the Company may possibly increase transactions with SHHCC. Given that the prices offered by the SHHCC Group are as competitive as the market prices obtained on the Bidding Website by other parties at a given time for certain Chemical Products, we consider the SHHCC Projections to be justifiable.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Provided that (i) it is in the best interest of the Company and its Shareholders as a whole to be not restricted from procuring the Chemical Products from any bidder (which may be the SHHCC Group) who is able to offer the best available bids over the others, in particular, a bidder with a familiar and reliable track record of providing products and services which satisfy the Company; (ii) the Company expects to put greater effort in the development of bulk drugs market to expand its sales which will increase the demand of Chemical Products; (iii) the proposed annual caps are derived from the SHHCC Projections together with a buffer; (iv) it would be administratively costly and cumbersome for the Company to go through the entire Disinterested Shareholders' approval process to take advantage of superior bids that may be tendered by the SHHCC Group if the annual caps are set too low and subsequently being exceeded, we are of the view that the higher proposed annual caps are determined in the interests of the Company and its Shareholders as a whole.

Based on the above mentioned, we are of the view that the proposed annual caps of the continuing connected transactions under the SHHCC Agreement are fair and reasonable so far as the Disinterested Shareholders are concerned.

5 Internal control measures

As set out in the Board Letter, as a general rule, the continuing connected transactions of the Group will be conducted on normal commercial terms and on terms that are fair and reasonable and in the interests of the Company and the Shareholders as a whole.

The Group has adopted an internal reporting and monitoring policy on connected transactions, pursuant to which the management of the Group will monitor and review the continuing connected transactions on a quarterly basis (including, among others, the transaction amount of the continuing connected transaction during the quarter). We have obtained and reviewed the set of the internal reporting and monitoring policy on connected transactions and consider that the internal reporting and monitoring policy adopted by the Group is in place to ensure the continuing connected transactions are conducted on normal commercial terms and not prejudicial to the interests of the Company and the minority Shareholders.

The Company has engaged the Company's auditor to review and report to the Board on the continuing connected transactions every year in accordance with Rule 14A.56 of the Listing Rules. The independent non-executive Directors will also review the transactions under the Agreements on an annual basis. Accordingly, the Directors consider that the internal control system of the Group is effective to ensure that the transactions contemplated under the Agreements will be conducted on normal commercial terms and in the interests of the Company and the Shareholders as a whole.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

We have reviewed the Annual Report 2016 and Annual Report 2017 of the Company for the two financial years ended 31 December 2017 and noted that both the independent non-executive Directors and auditors of the Company, have confirmed that the continuing connected transactions under the Existing Agreements are in accordance with the requirements set out above for the two years ended 31 December 2017.

As advised by management of the Company, the Company will make timely announcement(s) and seek Disinterested Shareholders' pre-approval, initial by the Board, in the event that any adjustment to any annual cap becomes foreseeable, based on the periodic report submitted.

Based on the above procedures and policies, we are of the view that there are sufficient internal controls in place to ensure the continuing connected transactions are conducted on normal commercial terms and not prejudicial to the interests of the Company and the minority Shareholders.

RECOMMENDATIONS

Having considered the above principal factors and reasons, we are of the view that the terms of and proposed annual caps in relation to the Continuing Connected Transactions are on normal commercial terms, fair and reasonable so far as the Disinterested Shareholders are concerned and the entering into of the Agreements is in the interests of the Company and the Disinterested Shareholders as a whole. We would therefore recommend the Disinterested Shareholders and advise the Independent Board Committee to recommend the Disinterested Shareholders to vote in favour of the relevant resolutions for approving the Continuing Connected Transactions at the EGM.

Yours faithfully,
For and on behalf of
Hologram Capital Limited
Michael Leung
Director

Mr. Michael Leung is a person licensed under the SFO to carry out type 6 (advising on corporate finance) regulated activities under the SFO and regarded as a responsible officer of Hologram Capital Limited and has over 17 years of experience in corporate finance industry.

The following summarises all principal terms of the Share Option Scheme and the proposed Grant thereunder.

I. OPERATIVE TERMS OF THE SHARE OPTION SCHEME

1. Purpose of the Share Option Scheme

The Share Option Scheme is to further establish and improve the long-term incentive mechanism of the Company, attract and retain talents, mobilise the Directors, senior management, mid-level management and core backbone staff of the Company, and bind the interests of Shareholders, the Company and persons in charge of the operation of the Company together effectively, helping the various parties to attend to the long-term development of the Company.

2. Basis for determining the Participants and the scope of Participants of the Share Option Scheme

(1) Basis for determining the Participants

Participants of the Share Option Scheme are determined in accordance with such relevant laws, regulations and regulatory documents as the Company Law, the Securities Law, the Incentive Measures, and the relevant provisions of the Articles of Association with reference to the actual condition of the Company.

(2) Scope of Participants

Proposed Participants of the Share Option Scheme include the Directors, senior management, mid-level management and core backbone staff of the Company.

In respect of the abovementioned Participants, any such Director and senior management must have been appointed by Shareholders or the Board. A Participant must at the time of the Grant and of the assessment of his or her performance targets serve a post in the Company or its subsidiaries and have entered into an employment agreement or engagement agreement therewith.

The Participants do not include any independent Directors, the Supervisors, and any Shareholder or actual controller of the Company jointly or individually holding more than 5% of the Shares and their respective spouses, parents and children.

Further, during the Validity Period, Participants shall not also be participants of an equity incentive scheme of another company whose securities are listed on a stock exchange, and persons who are participants of such other incentive schemes during the life of such schemes shall not be Participants of the Share Option Scheme.

3. Source and number of Shares under the Share Option Scheme

(1) *Source of the underlying Shares of the Share Option Scheme*

The underlying Shares of the Share Option Scheme shall be ordinary A Shares issued to the Participants by the Company pursuant to the terms and provisions of the Share Option Scheme and the Grant.

(2) *Number of underlying Shares*

The total number of the A Shares which may be issued upon exercise of the Options Granted under the Share Option Scheme is 16,250,000 A Shares, representing approximately 2.61% of the total number of Shares in issue of the Company. Upon satisfaction of the terms and conditions of the exercise of the Options, each Option shall provide its holder a right to purchase one A Share at the Exercise Price during the Validity Period. The Options shall not be applied for such purposes as serving as a collateral or setting off or repaying debts, and shall not be assigned.

There is no Participant to whom the aggregate number of the A Shares to be issued upon exercise of his or her Options may exceed 1% of Company's total share capital.

During the Validity Period, a Participant who is a Director or member of the senior management should not derive any estimated income from his or her Options 30% higher than his or her overall remunerations (any estimated income deriving from share options or equity interests in respect of the Company which forms part of his or her remunerations inclusive) or any actual income 40% higher than his or her overall remunerations (any income deriving from the Options inclusive).

4. Validity Period, date of Grant, vesting period, Exercise Date and the relevant lock-up requirements

(1) *Validity Period*

The Validity Period of the Share Option Scheme commences from the date of Grant and shall last for a period of 60 months or until the date on which all the Options have been exercised or lapsed, whichever earlier.

(2) *Date of Grant*

Please see the section headed “Proposed Grant Under the Share Option Scheme — 3. Date of Grant” below in this Appendix for further information on the proposed date of Grant under the Share Option Scheme.

(3) *Vesting period*

The Options will have vesting periods of 24 months, 36 months and 48 months from the date of Grant respectively.

(4) *Exercise period and Exercise Date*

The Options are exercisable in three tranches upon expiry of 24 months from the date of Grant. Details are as follows:

Exercise period	Duration	Proportion of the Options to be Granted
First exercise period	Commencing from the first trading day after the expiry of the 24th month from the date of Grant, and ending on the last trading day of the 36th month from the date of Grant	34%
Second exercise period	Commencing from the first trading day after the expiry of the 36th month from the date of Grant, and ending on the last trading day of the 48th month from the date of Grant	33%
Third exercise period	Commencing from the first trading day after the expiry of the 48th month period from the date of Grant, and ending on the last trading day of the 60th month period from the date of Grant	33%

Trading day herein have the meaning ascribed thereto under the Shenzhen Listing Rules. Options Granted and exercisable but failed to be exercised within the relevant exercise period shall lapse and shall not be exercised in the next exercise period.

(5) *Lock-up arrangements*

The lock-up provisions of the Share Option Scheme shall be implemented in accordance with the relevant laws, regulations and regulatory documents including the Company Law, the Securities Law, the Shenzhen Listing Rules and the Articles of Association. Details are as follows:

- (i) where a Participant is a Director or a member of the senior management of the Company, the number of the Shares that may be transferred each year during his or her term of office must not exceed 25% of the total number of Shares held by him or her. No Share held may be transferred within half a year after his or her termination of office.
- (ii) where a Participant is a Director or a member of the senior management of the Company and he or she should dispose of any Shares within six months after any purchase of Shares, or if he or she should purchase Shares within six months after disposal thereof, all gains deriving therefrom should be transferred to the Board for the benefit of the Company.
- (iii) where, during the Validity Period, there is any change to the requirements regarding the transfer of A Shares by a Director and senior management under such applicable laws, regulations and regulatory documents as the Company Law, the Securities Law and the Articles of Association, a Participant shall comply with the amended laws, regulations and regulatory documents.
- (iv) where a Participant is a Director or a member of the senior management of the Company, not less than 20% of the Options Granted thereto should be withheld from exercising until having met his or her performance targets at the expiry of the term of office. Where the term of office of such Participant will only end after the Validity Period, reference will be made to his or her assessment results in the year when the Validity Period expires so that the Options vested may be exercised within the Validity Period.

5. Exercise Price and basis of determination

Please see the section headed “II. Proposed Grant Under the Share Option Scheme - 4. Exercise Price and basis of determination” below in this Appendix for further information on the Exercise Price and its basis of determination.

6. Conditions of Grant and exercise of Options***(1) Conditions of Grant of Options***

There is no occurrence of any of the following in respect of the Company:

- (i) issue of the auditors’ report with qualified opinion or which indicates an inability to give opinion by a certified public account with respect to the financial report of the Company for its most recent accounting year;
- (ii) issue of the auditors’ report with qualified opinion or which indicates an inability to give opinion by a certified public account with respect to the internal control of the Company in its financial report for the most recent accounting year;
- (iii) violation of laws and regulations, the Articles of Association or any undertaking publicly made in respect of distribution of profits in the 36 months after listing of the securities on a stock exchange;
- (iv) under applicable laws and regulations, no equity incentive is allowed; and
- (v) such other circumstances as determined by the CSRC.

Further, in the event that any of the above should occur, all outstanding Options Granted shall lapse accordingly.

There is no occurrence of any of the following in respect of a Participant:

- (i) he or she has been held by a stock exchange to be a person unsuitable for the relevant post(s) in the last 12 months;
- (ii) he or she has been held by the CSRC or its derived agencies as a person unsuitable for the relevant post(s) in the last 12 months;
- (iii) he or she has been imposed by the CSRC or any of its derived agencies with administrative penalties or measures prohibiting access into the market in the last 12 months by reason of material violation of laws and regulations;
- (iv) he or she is under the Company Law prohibited from acting as a director or a member of the senior management of a company;
- (v) he or she is under applicable laws and regulations not allowed to participate in an equity incentive scheme of a listed company; and
- (vi) such other circumstances as determined by the CSRC.

Further, in the event that any of the above should occur to a Participant, all outstanding Options Granted thereto shall lapse accordingly.

The Company has attained its performance targets as follows:

- (i) its operating revenue for year 2017 is not less than RMB4.5 billion; and
- (ii) the growth in the return on net assets for year 2017 is not lower than 50% using the average return on net assets from years 2015 through 2017 as basis; and
- (iii) the abovementioned performance targets are not lower than the average level of the same industry.

Under the Share Option Scheme, return on net assets should be computed based on the weighted average net assets less gains or losses in respect of extraordinary items, whereas the “same industry” refers to all A share issuers whose securities are listed on the stock exchanges of the PRC in the Chemical Pharmaceutical Manufacturing Industry of the Medicine/Bio sector as provided for by the SWS Research sector categorisation.

(2) Conditions of exercise of Options

Further and subject to the satisfaction of the abovementioned conditions, the Options are only exercisable upon satisfaction of the following conditions:

(i) Performance targets of the Company

The Options under the Grant of Options are subject to three assessment years from the accounting year of 2019 through the accounting year of 2021. Assessment will be made once a year. Participants can only exercise their Options if the Company attains the following performance targets:

Exercise period	Performance targets
First exercise period	<p>(a) the operating revenue in respect of 2019: (i) shall not be less than RMB5.2 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and</p> <p>(b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2019 shall not be lower than 55% or the average level of the same industry.</p>
Second exercise period	<p>(a) the operating revenue in respect of 2020: (i) shall not be less than RMB5.6 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and</p> <p>(b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2020 shall not be lower than 60% or the average level of the same industry.</p>

Exercise period	Performance targets
Third exercise period	<p>(a) the operating revenue in respect of 2021: (i) shall not be less than RMB6 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and</p> <p>(b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2021 shall not be lower than 65% or the average level of the same industry.</p>

Material changes in the net profits of the comparable companies in the same industry of and excessive deviances from the extreme values of the samples may be removed or substituted with other samples.

During the Validity Period, increases in net assets resulting from such corporate actions as open offers or placings in the current period or in future which affect the Group's net assets may, for the purpose of assessing the Company's performance, be counted out from the calculation of the increase in net assets.

If any condition of exercise is not satisfied in the relevant exercise period, the Options Granted and otherwise exercisable in that exercise period cannot be carried over to the next exercise period and shall lapse and be cancelled.

(ii) Performance target of the Participants

According to the Assessment Methods, the assessment results of a Participant will be one of the conditions whether his or her Options can be exercised. Details are as follows:

Assessment Grade	Parameter
Excellent (A)	100%
Good (B)	100%
Passed (C)	80%
Failed (D)	0%

Subject to the satisfaction of the conditions listed under the paragraph “I. Operative Terms of the Share Option Scheme – 6. Conditions of Grant and exercise of Options – (1) Conditions of Grant of Options” in this Appendix and the performance targets of the Company in the relevant year, the actual number of the Options exercisable by a Participant in that year will be the product of a parameter and the Participant’s Options exercisable in the year.

Where a Participant fails to meet his or her performance target, the Options corresponding to that exercise period shall not be exercised and shall lapse and be cancelled accordingly.

7. Methods of and procedures for adjustment

(1) Adjustment of the number of Options

In the event of capitalisation issue, bonus issue, rights issue, Share subdivision or Share consolidation of the Company prior to any exercise of Options, adjustments will be made as follows:

(i) Capitalisation issue, bonus issue and share subdivision

$$Q = Q_0 \times (1 + n)$$

Where: Q_0 represents the number of the Options prior to adjustment;

n represents the ratio of increase per Share resulting from capitalisation issue, bonus issue or Share subdivision (i.e. the number of increased Share(s) per Share upon capitalisation issue, bonus issue or Share subdivision); and

Q represents the number of the Options after adjustment.

(ii) Rights issue

$$Q = Q_0 \times P_1 \times (1 + n) / (P_1 + P_2 \times n)$$

Where: Q_0 represents the number of the Options prior to adjustment;

P_1 represents the closing price of Shares on the record date;

P_2 represents the subscription price in respect of the rights issue;

n represents the basis of the rights issue (i.e. the number of Shares to be issued under the rights issue in proportion to the total share capital of the Company prior to the rights issue); and

Q represents the number of Options after adjustment.

(iii) Share consolidation

$$Q = Q_0 \times n$$

Where: Q_0 represents the number of Options prior to the adjustment;

n represents the ratio of consolidation of Shares (i.e. one Share of the Company be consolidated into n Shares); and

Q represents the number of Options subsequent to the adjustment.

(2) *Adjustment of the Exercise Price*

In the event of dividend distribution, capitalisation issue, bonus issue, rights issue, Share subdivision or Share consolidation of the Company prior to any exercise of Options, adjustments will be made as follows:

(i) *Capitalisation issue, bonus issue and Share subdivision*

$$P = P_0 / (1 + n)$$

Where: P_0 represents the Exercise Price prior to the adjustment;

n represents the ratio of increase per Share resulting from the issue of Shares under the capitalisation issue, bonus issue or Share subdivision; and

P represents the adjusted Exercise Price.

(ii) *Rights issue*

$$P = P_0 \times (P_1 + P_2 \times n) / (P_1 \times (1 + n))$$

Where: P_0 represents the Exercise Price prior to the adjustment;

P_1 represents the closing of price of Shares as at the record date;

P_2 represents the subscription in respect of price of the rights issue;

n represents the ratio of the rights issue (i.e. the number of Shares to be issued under the rights issue in proportion to the total share capital of the Company prior to the rights issue); and

P represents the adjusted Exercise Price.

(iii) Share consolidation

$$P = P_0/n$$

Where: P_0 represents the Exercise Price prior to the adjustment;

n represents the ratio of Share consolidation (i.e. one Share of the Company be consolidated into n Shares); and

P represents the adjusted Exercise Price.

(iv) Dividend distribution

$$P = P_0 - V$$

Where: P_0 represents the Exercise Price prior to the adjustment;

V represents the dividend per Share; and

P represents the adjusted Exercise Price, which shall be a positive number.

(3) Issuance of new Shares

Save as disclosed, issuance of new Shares otherwise will not result in the adjustment of the number or Exercise Price of the Options.

(4) Procedures for adjustments

Standing authorisation will be sought from Shareholders so that the Board may adjust the Exercise Price and/or the number of Options under the Share Option Scheme in the event of the abovementioned circumstances. A legal adviser will be engaged to advise the Board whether any such adjustment is in compliance with the Incentive Measures, the Articles of Association and the Share Option Scheme.

8. Amendments to or Termination of the Share Option Scheme

For proposed amendment or termination of the Share Option Scheme after the approval of the Shareholders at a general meeting and the Class Meetings, the Company will table the same at a further general meeting and Class Meetings for consideration and approval, provided that any amendment must not:

- (1) result in advancing the exercise of the Options or the unlocking of the lock-up arrangements; or
- (2) save provided for under “7. Methods of and procedures for adjustment” immediately before this paragraph, lower the Exercise Price.

Where the Share Option Scheme is terminated, from the date of announcement of the resolution thereon there should be no other equity incentive scheme submitted for approval within three months’ time.

9. Others

- (1) The Share Option Scheme was formulated by the Remuneration and Examination Committee and approved by the Board and will become effective from the date of approval at a general meeting and Class Meetings.
- (2) If approved by Shareholders, the Board shall be authorised to implement, manage and construe the Share Option Scheme in accordance with the terms and provisions of the Share Option Scheme and in compliance with the applicable laws, rules and regulations including without limitation to the Listing Rules.

II. PROPOSED GRANT UNDER THE SHARE OPTION SCHEME**1. Number of the underlying Shares in respect of the Options under the Grant**

The total number of the underlying Shares in respect of the Options proposed to be Granted pursuant to the Share Option Scheme is 16,250,000 A Shares, representing approximately 2.61% of the Company’s total Shares in issue as of the date hereof.

2. Distribution of the Options proposed to be Granted under the Share Option Scheme

The total number of proposed Participants to whom the Options are proposed to be Granted is 185, representing 2.91% of the total number of the staff of the Company as at 30 June 2018 comprising Directors, senior management, mid-level management and core backbone staff of the Company, of which the distribution details are set out below.

Name	Principal office(s) held in the Company	Number of Options proposed to be Granted (,000 A Shares)	Percentage to total number of the Options proposed to be Granted (%)	Percentage to total issued A Shares as of the Latest Practicable Date	Percentage to total issued Shares as of the Latest Practicable Date
Zhang Daiming	Chairman, Executive Director	300	1.85%	0.07%	0.05%
Ren Fulong	Non-executive Director	270	1.66%	0.06%	0.04%
Du Deping	Executive Director, General manager	270	1.66%	0.06%	0.04%
Xu Lie	Non-executive Director	220	1.35%	0.05%	0.04%
Wang Xiaolong	Deputy general manager	220	1.35%	0.05%	0.04%
Dou Xuejie	Deputy general manager	220	1.35%	0.05%	0.04%
Du Deqing	Deputy general manager	220	1.35%	0.05%	0.04%
He Tongqing	Deputy general manager	220	1.35%	0.05%	0.04%
Hou Ning	Financial controller	220	1.35%	0.05%	0.04%
Zheng Zhonghui	Deputy general manager	220	1.35%	0.05%	0.04%
Cao Changqiu	Company secretary, Secretary to the Board	160	0.98%	0.04%	0.03%
Mid-level management and core backbone staff (174 proposed grantees in total)		13,710	84.37%	3.2%	2.20%
Total		16,250	100%^{Note}	3.81%	2.61%

Note: The breakdown of the percentage figures may not add up to 100% due to rounding.

The proposed plan of the Share Option Scheme including without limitation to the proposed distribution of the Grant set out above has been approved by the Remuneration and Examination Committee and the Board and has been made available for the view and opinion of the Independent non-executive Directors and the Supervisory Committee and of the Company. Each of the proposed Grants to a Director abovementioned has been approved by the independent non-executive Directors in compliance with Rule 17.04(1) of the Listing Rules.

3. Date of Grant

After the approval of the Share Option Scheme at a general meeting and the Class Meetings, The Board will determine the date of the Grant which, pursuant to the proposed Share Option Scheme, shall not be more than 60 days after the approval. The relevant filing/registration and disclosures are set to be completed within the said period and failure to do so will result in the termination of the Share Option Scheme and any and all Option will lapse accordingly.

Pursuant to the Listing Rules, the date of the Grant must be a trading day (with the meaning ascribed thereto under the Listing Rules) and must not fall within the period commencing one month immediately before the earlier of:

- (1) the date of the Board meeting (as such date is first notified to the Hong Kong Stock Exchange pursuant to the Listing Rules) for approving the Company's results; and
- (2) the deadline for the Company to announce its results under the Listing Rules or other applicable laws, rules and regulations and ending on the date of the results announcement of the Company.

4. Exercise Price and basis of determination

Subject to Note (1) to Rule 17.03(9) of the Listing Rules namely the exercise price of an Option shall be at least the higher of (a) the closing price of the H Shares as stated in the Hong Kong Stock Exchange's daily quotations sheet on the business day (with the meaning ascribed thereto under the Listing Rules) on which the Options are Granted; and (b) the average closing price of the H Shares as stated in the Hong Kong Stock Exchange's daily quotations sheets for the five business days immediately preceding the date of Grant, the Exercise Price of the Options pursuant to the Share Option Scheme is RMB5.98 per A Share. The Exercise Price shall not be less than the nominal value of the Shares and the higher of:

- (i) the average of the trading prices of the A Shares (being the total daily trading turnover on the last trading day immediately preceding the date of announcement of the Share Option Scheme namely 6 November 2018 (the "**Announcement Day**") divided by the total daily trading volume on the last trading day immediately preceding the Announcement Day) quoted on the Shenzhen Stock Exchange on the last trading day immediately preceding the Announcement Day, being RMB5.98 per A Share;
- (ii) the average of the trading prices of the A Shares quoted on the Shenzhen Stock Exchange for the last 20 trading days immediately preceding the Announcement Day, being RMB5.64 per A Share;

- (iii) the closing price of the A Shares quoted on the Shenzhen Stock Exchange on the last trading day immediately preceding the Announcement Day, being RMB5.97 per A Share;
- (iv) the average of the closing prices of the A Shares quoted on the Shenzhen Stock Exchange for the last 30 trading day immediately preceding the Announcement Day, being RMB5.81 per A Share; and
- (v) the net asset value per Share attributable to Shareholders for year 2017, being RMB3.99.

“Trading day” under this paragraph has same meanings as under the Shenzhen Listing Rules.

III. MECHANISM FOR SPECIFIC OCCURRENCES TO THE COMPANY OR THE PARTICIPANTS UNDER THE SHARE OPTION SCHEME

(1) Occurrences in relation to the Participants

A. Change of position

Any change of position or duties of a Participant out of the needs and arrangement of the Group including without limitation to secondment will not cause any change to the Options Granted thereto and any performance targets in respect of the Participant shall be assessed in accordance with those applicable to the new position or duties.

B. Cessation of service

For cessation of service to the Group due to retirement, the Options Granted to the relevant Participant shall be dealt with in accordance with the terms and provisions of the Share Option Scheme set out above in the same manner as before the retirement save that the attainment of performance targets may no longer form a condition of the exercise of the Options Granted to the Participant.

For cessation of service due to layoff, dismissal or termination of engagement by the Company, all outstanding Options Granted to the relevant Participant shall lapse accordingly.

C. Violations, breaches and improper conducts

In the event that a Participant prejudices the interest or reputation of the Company, causes direct or indirect economic losses to the Company, violates applicable laws, regulations, the Articles of Association, rules of the management of the Group or work discipline, commits unauthorised divulgence of confidential operation or technical information of the Company or breaches or dereliction of duties, fails to accomplish specific designated tasks of consequence and is accountable therefor or is put under political sanctions, the Participant's outstanding Options shall lapse accordingly and the Company shall be entitled to any gains having derived from the Options exercised.

D. Occurrences of regulatory implications

On occurrence of any of the following in respect of a Participant:

- (i) he or she has been held by a stock exchange to be a person unsuitable for the relevant post(s) in the last 12 months;
- (ii) he or she has been held by the CSRC or its derived agencies as a person unsuitable for the relevant post(s) in the last 12 months;
- (iii) he or she has been imposed by the CSRC or any of its derived agencies with administrative penalties or measures prohibiting access into the market in the last 12 months by reason of material violation of laws and regulations;
- (iv) he or she is under the Company Law prohibited from acting as a director or a member of the senior management of a company;
- (v) he or she is under applicable laws and regulations not allowed to participate in an equity incentive scheme of a listed company; and
- (vi) such other circumstance as determined by the CSRC,

all outstanding Options Granted thereto shall lapse accordingly.

E. Incapability

In the event that a Participant becomes incapacitated for work and the incapacity should arise in the course of his or her engagement and out of work injuries, all Options Granted shall be dealt with pursuant to the terms and provisions of the Share Option Scheme in the same manner as prior to the incapacity, save that the attainment of performance targets may no longer form a condition of the exercise of the Participants' outstanding Options.

For a Participant who falls incapacitated for reasons otherwise, all outstanding Options Granted thereto shall not be exercised and shall lapse accordingly.

In the event that a Participant should become an independent Director or Supervisor of the Company, the outstanding Options Granted thereto shall lapse accordingly.

F. Death

If a Participant should decease in the course of his or her engagement for performance of work duties, all outstanding Options Granted thereto shall be dealt with pursuant to the terms and provisions of the Share Option Scheme in the same manner as prior to the death, save that the attainment of performance targets may no longer form a condition of the exercise of the Participants' outstanding Options and that the Options may be exercised by the heir of the estate or statutory successor of the Participant.

For the death of a Participant for reasons otherwise, all outstanding Options Granted thereto and not exercised shall lapse accordingly.

Where required, circumstances not provided for herein shall be reported to the Remuneration and Examination Committee for determination.

(2) Occurrences in relation to the Company

On occurrence of any of the following in respect of the Company:

- (i) issue of the auditors' report with qualified opinion or which indicates an inability to give opinion by a certified public account with respect to the financial report of the Company for its most recent accounting year;

- (ii) issue of the auditors' report with qualified opinion or which indicates an inability to give opinion by a certified public account with respect to the internal control of the Company in its financial report for the most recent accounting year;
- (iii) violation of laws and regulations, the Articles of Association or any undertaking publicly made in respect of distribution of profits in the 36 months after listing of its securities on a stock exchange;
- (iv) under applicable laws and regulations, no equity incentive is allowed; and
- (v) such other circumstances as determined by the CSRC,

the Share Option Scheme shall terminate accordingly and the outstanding Options Granted and not exercised shall lapse.

For the avoidance of doubt, any merger, spinoff or change of control of the Company will not on its own cause any change to the Share Option Scheme.

IV. ACCOUNTING TREATMENTS

Pursuant to the relevant requirements in respect of fair value determination under the *Accounting Standards for Business Enterprises No. 22 – Recognition and Measurement of Financial Instruments* (the “**Accounting Standards for Business Enterprise No. 22**”), a suitable pricing model is required to be applied to compute the fair value of share options. As such the Black-Scholes model has been applied to compute the fair value of the Options prior to the re-application thereof for the definitive computation on the actual date of Grant.

Pursuant to the relevant requirements under *Accounting Standards for Business Enterprises No. 11 – Share-based Payments* (the “**Accounting Standards for Business Enterprise No. 11**”), the Company will update the number of Options expected to be exercisable on each balance sheet day during the vesting period with reference to such subsequent information as the latest available figures of Participants entitled to exercise the Options and the status of attainment of the performance targets. Services received during the current period will be charged to relevant costs or fees and capital reserve based on the fair value on the date of Grant.

By applying the Black-Scholes Model as the pricing model, the fair value of each Option amounted to RMB1.75. Parameters were as follows:

- (1) price of the underlying Share: RMB5.97 (assuming the closing price of the A Shares quoted on the Shenzhen Stock Exchange (the “**Closing Price**”) on the last trading day immediately preceding the Announcement Day namely RMB5.97 per A Share is the Closing Price on the date of Grant)
- (2) expected life: 4 years
- (3) historical volatility: 30.91% (the volatility rate of the Shenzhen Stock Exchange Component Index for the last four years adopted)
- (4) risk-free interest rate: 3.28% (the four-year yield to maturity of the treasury bond adopted)

The Company will determine the fair value of the Options on the date of the Grant with the relevant tools of valuation and ultimately recognise the share-based payment expenses in respect of the Share Option Scheme. Such expenses will be recognised at phrases along the implementation process of the Share Option Scheme with reference to proportion of the Options exercised. The incentive costs incurred in respect of the Share Option Scheme will be recorded as recurring items.

Assuming the grant of Options takes place in December 2018, the amortisation costs of Share Options from 2018 to 2022 will be as follows:

Unit: 0,000

Amount of Options	Costs of Options	2018	2019	2020	2021	2022
			<i>in RMB</i>			
1,625	2,843.75	85.91	1,030.86	990.58	521.36	215.04

The above is not the final definitive costs which would, amongst others, relate to the actual numbers of Options alive and lapsed, the actual date of Grant and the Closing Price of the date on Grant. All effects on the operating results of the Group will be subject to annual financial accounts audited by the external auditor of the Company.

The following summarises all principal terms of the Assessment Methods.

Purpose of Assessment

The purpose of the Assessment Methods is to further improve the corporate governance structure of the Company, to develop a sound appraisal system for assessing (the “**Assessment**”) the performance targets of the Participants, to establish a mechanism of the effects of incentives and restraints that aligns responsibilities, rights and interests and to incentivise the Participants to perform duties with honesty and diligence, so that the development strategies and operation objectives of the Company can be attained, the sustainable development of the Company can be furthered and the implementation of the Share Option Scheme smoothened.

Principles of Assessment

The principles of Assessment is impartiality, openness and fairness. Assessment should be conducted in strict accordance with the measures herein and the performance targets of the Participants so as to align the Share Option Scheme and the work performance and contribution of the Participants, which would in turn help enhance performance and maximise the interests of Company and the Shareholders.

Objects of Assessment

The Participants of the Share Option Scheme including the Directors, senior management, mid-level management and core backbone staff of the Company.

Assessment bodies

The Remuneration and Examination Committee shall lead and be in charge of the organisation of the Assessment, reviewing and making decisions on the results and making necessary adjustments on such indicators and results substantially impacted on by changes in the objective environments. The departments of human resources, of development planning and of finance and assets shall be responsible for providing such assistance as collecting, providing and verifying the relevant data and computing and collating the Assessment performance for producing Assessment result reports.

Assessment period

Annual Assessment of performance targets will be held in years 2019, 2020 and 2021, being approximately a year before the three tranches of the Options may be exercised respectively. Assessment results of each of these years of Assessment will apply to the exercise of Options in the next coming exercise period of Options.

Performance targets*Performance targets in respect of the Group*

The targets in respect of the performance of the Group on which the exercise of Options in each exercise period is conditional are summarised as follows:

Exercise period	Performance targets
First exercise period	<ul style="list-style-type: none"> (a) the operating revenue in respect of 2019: (i) shall not be less than RMB5.2 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and (b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2019 shall not be lower than 55% or the average level of the same industry.
Second exercise period	<ul style="list-style-type: none"> (a) the operating revenue in respect of 2020: (i) shall not be less than RMB5.6 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and (b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2020 shall not be lower than 60% or the average level of the same industry.
Third exercise period	<ul style="list-style-type: none"> (a) the operating revenue in respect of 2021: (i) shall not be less than RMB6 billion; (ii) should represent a rise in the percentile at which the Company is ranked in the same industry when compared with the time of the Grant; and (iii) shall not be lower than the average level of the same industry; and (b) using the average return on net assets from years 2015 to 2017 as basis, the growth in the return on net assets in respect of 2021 shall not be lower than 65% or the average level of the same industry.

“Same industry” in the context herein and of the Share Option Scheme shall refer to all A share issuers whose securities are listed on the stock exchanges of the PRC in the Chemical Pharmaceutical Manufacturing Industry of the Medicine/Bio sector as provided for by the SWS Research sector categorisation.

Material changes in the net profits of the comparable companies in the same industry of and excessive deviances from the extreme values of the samples may be removed or substituted with other samples.

During the Validity Period, increases in net assets resulting from such corporate actions as open offers or placings in the current period or in future which affect the Group’s net assets may, for the purpose of assessing the Company’s performance, be counted out from the calculation of the increase in net assets.

If any condition of exercise is not satisfied in the relevant exercise period, the Options otherwise exercisable in that exercise period cannot be carried over to the next exercise period and shall lapse and be cancelled.

Performance target of the Participants

The grading of the Assessment of the Participants’ work performance is as follows:

Assessment Grade	Parameter
Excellent (A)	100%
Good (B)	100%
Passed (C)	80%
Failed (D)	0%

Subject to the satisfaction of other conditions of the exercise of the Options including the Group’s attainment of its performance targets in the relevant year, the actual number of the Options exercisable by a Participant in that year will be the product of a parameter and the Participant’s Options exercisable in the year. Where a Participant fails the Assessment, the Options corresponding to that exercise period shall not be exercised and shall lapse accordingly.

Assessment results of the Participants will be filed and maintained for at least five years.

Feedback and grievance

Participants who differ about their Assessment results may communicate with the corresponding Assessment bodies and, if failed, may lodge their cases with the Remuneration and Examination Committee which shall within 10 business days reply thereto.

These Assessment Methods take effect on approval of Shareholders and in event of conflict with applicable laws, rules and regulations such applicable laws, rules and regulations shall prevail.

1. RESPONSIBILITY STATEMENT

This 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 Company. The Directors having made all reasonable enquiries, confirm that to the best of their knowledge and belief the information contained in this 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 herein or this circular misleading.

2. INTERESTS OF DIRECTORS AND SUPERVISORS

As at the Latest Practicable Date, the following Directors and Supervisors are interested in the securities of the Company:

Name	Number of A Shares (Long Position)	Percentage of the total issued Shares as of the Latest Practicable Date
		(Note 1)
		(%)
Directors		
Mr. Zhang Daiming	190,358 (Note 2)	0.031
Mr. Ren Fulong	58,296 (Note 3)	0.009
Mr. Du Deping	151,568 (Note 3)	0.024
Mr. Xu Lie	81,614 (Note 3)	0.013
Supervisors		
Mr. Li Tianzhong	93,272 (Note 3)	0.015
Ms. Hu Yanhua	34,977 (Note 3)	0.006

Notes:

1. Rounded to the nearest three decimal places.
2. Of the 190,358 A Shares, 15,470 A Shares were held personally by Mr. Zhang Daiming and 174,888 A Shares by the Employee Stock Ownership Scheme of the Company of which Mr. Zhang is a participant.
3. These A Shares were held by the Employee Stock Ownership Scheme of the Company of which the relevant person is a participant.

Save as disclosed above, no Director, Supervisor or chief executive of the Company was interested in the equity or debt securities of the Company or any associated corporations (within the meaning of the SFO) which (i) were required to be notified to the Company and the Hong Kong Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short positions which they are taken or deemed to have under such provisions of the SFO); (ii) were required, pursuant to section 352 of the SFO, to be entered in the register referred to therein; or (iii) were required, pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers, to be notified to the Company and the Hong Kong Stock Exchange.

3. MATERIAL INTEREST

As at the Latest Practicable Date, save as disclosed, none of the Directors had a material interest in the Continuing Connected Transactions.

As at the Latest Practicable Date, none of the Company, its holding company and fellow subsidiaries of its controlling shareholder had entered into any contracts in relation to the Group's business in which any Directors or Supervisors had a material interest, whether directly or indirectly.

As at the Latest Practicable Date, none of the Directors had any direct or indirect interest in any assets which have been, since the date to which the latest published audited accounts of the Group were made up, acquired or disposed of by, or leased to any member of the Group, or are proposed to be acquired or disposed of by, or leased to, any member of the Group.

4. COMPETING INTEREST

As at the Latest Practicable Date, none of the Directors or their respective associates had any interest in any business which competes or was likely to compete, either directly or indirectly, with the business of the Group.

5. INTERESTS OF SUBSTANTIAL SHAREHOLDERS

As at the Latest Practicable Date, so far as was known to the Directors, the persons (other than a Director, a Supervisor or chief executive of the Company) who had an interest or a short position in the Shares or underlying Shares which would fall to be disclosed to the Company under the provisions of Divisions 2 and 3 of Part XV of the SFO or who was (other than HKSCC (Nominees) Limited), directly or indirectly, interested in 10% or more of the nominal value of any class of Shares carrying rights to vote in all circumstances at general meetings of the Company were as follows:

Name of Shareholder	Class of Shares	Number of Shares held	Percentage of the total issued Shares (%)
SXPGC	A Shares	204,864,092	32.94

SXPGC is a wholly state-owned company and a wholly-owned subsidiary of HHGC. As of the Latest Practicable Date, HHGC held also 100% equity interests in China Shandong Group Limited and Shandong Hualu International Business Center Limited Company, which in turn held 99.91% and 0.09% shareholding in Well Bring Limited respectively. Well Bring Limited owned 17,791,800 H Shares or approximately 2.86% of the total issued shares of the Company as of the Latest Practicable Date.

Mr. Zhang Daiming is the chairman of the Company and is also the chairman of SXPGC. Mr. Ren Fulong, a Director of the Company, is also a director and the general manager of SXPGC. Mr. Xu Lie, a Director of the Company, is also a director and the chairman of labour union of SXPGC. Mr. Zhao Bin, a Director of the Company, is also the assistant general manager and the director of discipline inspection and supervision of HHGC. Mr. Li Tianzhong, a Supervisor of the Company, is also a deputy general manager of SXPGC.

6. MATERIAL ADVERSE CHANGE

The Directors confirm that there has been no material adverse change in the overall financial or trading position or outlook of the Group since 31 December 2017, being the date to which the latest published audited consolidated financial statements of the Group were made up, up to and including the Latest Practicable Date.

7. CONSENT OF EXPERT

The following expert has given and has not withdrawn its written consent to the issuance of this circular with the inclusion of its letter and reference to its name in the form and context in which it appears:

Name	Qualification
Hologram Capital Limited	a licensed corporation to carry out type 6 regulated activity (advising on corporate finance) under the SFO

To the best knowledge of the Directors, as at the Latest Practicable Date, the Independent Financial Adviser did not have any shareholding in any member of the Group or the right (whether legally enforceable or not) to subscribe for or to nominate persons to subscribe for securities in any member of the Group.

To the best knowledge of the Directors, as at the Latest Practicable Date, the Independent Financial Adviser did not have any direct or indirect interest in any asset which had been acquired or disposed of by or leased to the Company, or were proposed to be acquired or disposed of by or leased to the Company, since 31 December 2017, being the date to which the latest published audited financial statements of the Company were made up.

8. SERVICE CONTRACT

As at the Latest Practicable Date, none of the Directors and Supervisors had entered into, or proposed to enter into, a service contract with the Company or any member of the Group which does not expire or is not terminable by such member of the Group within one year without payment of compensation, other than statutory compensation.

9. VOTE BY POLL

Pursuant to Rule 13.39(4) of the Listing Rules, the vote of Shareholders at the EGM shall be taken by poll.

10. DOCUMENTS AVAILABLE FOR INSPECTION

Copies of the renewed Agreements, the Scheme Documents, the written consent from the Independent Financial Adviser referred to in the paragraph headed “7. Consent of Expert” in this appendix and the Articles of Association will be available for inspection at the office of Charltons, the Hong Kong legal advisers to the Company, at 12th Floor, Dominion Centre, 43–59 Queen’s Road East, Hong Kong during normal business hours on any weekday (except general holidays) from the date of this circular up to and including the date of the EGM and the Class Meetings.