
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.

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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) 2017 PLAN FOR PROFIT DISTRIBUTION AND
CAPITAL RESERVE CAPITALISATION;
(2) AMENDMENTS TO THE ARTICLES OF ASSOCIATION;
(3) CONTINUING CONNECTED TRANSACTION: REVISION OF ANNUAL CAP FOR YEAR
2018 IN RESPECT OF THE TRANSACTIONS UNDER THE SHHCC AGREEMENT; AND
(4) PROPOSED APPOINTMENT OF INDEPENDENT NON-EXECUTIVE DIRECTOR**

**Independent Financial Adviser
to the Independent Board Committee and the Disinterested Shareholders
(in respect of the proposed revision of annual cap of the continuing connected transaction)**



中國農信財務顧問有限公司
China AF Corporate Finance Limited

A letter from the Board is set out on pages 4 to 31 of this circular. A letter from the Independent Board Committee containing its recommendations on the proposed revision of annual cap for year 2018 in respect of the continuing connected transactions under the SHHCC Agreement is set out on page 32 of this circular.

A letter from China AF Corporate Finance Limited, the independent financial adviser over the proposed revision of annual cap for year 2018 in respect of the continuing connected transactions under the SHHCC Agreement, containing its advice to the Independent Board Committee and the Disinterested Shareholders is set out on pages 33 to 48 of this circular.

(i) A notice convening the AGM to be held at the conference room of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC on 29 June 2018, Friday at 2:00 p.m.; (ii) a notice convening the 2018 First 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 29 June 2018, Friday at 4:00 p.m. (or immediately after the conclusion or adjournment of the 2018 first A Shareholders' class meeting); (iii) the forms of proxy for use at and the reply slips in relation to the AGM and the 2018 First H Shareholders' Class Meeting respectively were despatched by the Company on 15 May 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>. A supplemental notice in respect of the AGM and a revised proxy form for use thereat further setting out the resolution on the appointment of a new independent non-executive Director are despatched together with this circular and also published and available at the abovementioned websites. The supplemental notice in respect of the AGM is reproduced also on pages 54 to 56 of this circular.

Whether or not you intend to attend the AGM and the 2018 First H Shareholders' Class Meeting, we encourage you to complete and return the revised proxy forms in respect of the AGM and the proxy forms in respect of 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 revised proxy forms in respect of the AGM and the proxy forms in respect of the H Shareholders' Class Meeting will not preclude you from attending and voting in person at the AGM or the 2018 First H Shareholders' Class Meeting or any adjournment thereof (as the case may be) should you so wish. Shareholders who intend to attend the AGM and the 2018 First H Shareholders' Class Meeting should also complete and return the reply slips in accordance with the instructions printed thereon.

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DEFINITIONS

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

“2018 Annual Cap Revision”	the proposed revision of annual cap for the year ending 31 December 2018 in respect of the continuing connected transactions under the SHHCC Agreement
“2018 First H Shareholders’ Class Meeting”	the 2018 first H Shareholders’ class meeting of the Company to be held on 29 June 2018
“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
“AGM”	the annual general meeting for the year of 2017 of the Company to be held on 29 June 2018
“Article Amendments”	the amendments proposed to be made to the Articles of Association of which the details are set out in the paragraph headed “3. Proposed Amendments to the Articles of Association” in this circular
“Articles of Association”	the articles of association 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
“Capital Reserve Capitalisation”	the proposed issue of 3 Capitalisation Shares for every 10 Shares by way of capitalisation of the capital reserve of the Company
“Capitalisation Shares”	new Shares to be allotted and issued under the Capital Reserve Capitalisation by the Company
“CCASS”	the Central Clearing and Settlement System established and operated by HKSCC

DEFINITIONS

“Company”	山東新華製藥股份有限公司 (Shandong Xinhua Pharmaceutical Company Limited), a joint stock limited company incorporated in the PRC
“connected person”	has the meaning ascribed to it under the Listing Rules
“Director(s)”	director(s) of the Company
“Disinterested Shareholders”	Shareholders, other than SXPGC and Well Bring Limited, who are not due to their interests in the transactions required to abstain from voting on the resolution of the proposed revision of annual cap for year 2018 in respect of the continuing connected transactions under the SHHCC Agreement
“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
“HHGC”	華魯控股集團有限公司 (Hualu Holdings Group Company Limited), a wholly state-owned company, the controlling shareholder (as defined under the Listing Rules) of SXPGC and SHHGC
“HKD”	Hong Kong dollars, the lawful currency of Hong Kong
“HKSCC”	Hong Kong Securities Clearing Company Limited
“Hong Kong”	the Hong Kong Special Administrative Region of the PRC
“Hong Kong Stock Exchange”	The Stock Exchange of Hong Kong Limited
“Independent Board Committee”	the independent board committee of the Company comprising the independent non-executive Directors constituted for the purpose of considering the 2018 Annual Cap Revision

DEFINITIONS

“Independent Financial Adviser”	China AF Corporate Finance Limited, a corporation licensed to carry out type 6 (advising on corporate finance) regulated activity under the SFO and the independent financial adviser appointed to advise the Independent Board Committee and the Disinterested Shareholders on the 2018 Annual Cap Revision
“Latest Practicable Date”	31 May 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
“New A Shares”	the new A Shares to be allotted and issued under the Capital Reserve Capitalisation
“New H Shares”	the new H Shares to be allotted and issued under the Capital Reserve Capitalisation
“Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017”	The plan of the Company in respect of the Profit Distribution and the Capital Reserve Capitalisation for financial year 2017 as recommended by the Board and subject to, inter alia, the approval of Shareholders at general meeting and class meetings of H Shareholders and A Shareholders respectively
“PRC”	the People’s Republic of China which, for and only for the purpose of this circular only, does not include Hong Kong, the Macau Special Administrative Region and Taiwan
“Profit Distribution”	the proposed distribution of cash dividend of RMB0.05 (tax inclusive) per Share
“RMB”	Renminbi, the lawful currency of the PRC
“SFO”	the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)
“Share(s)”	A Share(s) and/or H Share(s)
“Shareholder(s)”	holder(s) of Share(s)

DEFINITIONS

“SHHCC”	山東華魯恒升化工股份有限公司 (Shandong Hualu Hengsheng Chemical Company Limited*), 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 dated 29 October 2015 entered into between the Company and SHHCC
“SHHGC”	山東華魯恒升集團有限公司 (Shandong Hualu Hengsheng Group Company Limited*), a wholly-owned subsidiary of HHGC
“SXPGC”	山東新華醫藥集團有限責任公司 (Shandong Xinhua Pharmaceutical Group Company Limited*), 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 largest Shareholder
“%”	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. If there is any inconsistency between such names or words and their English translations in this circular, the Chinese expressions shall prevail.*

EXPECTED TIMETABLE

The expected timetable for, inter alia, the Capital Reserve Capitalisation and Profit Distribution is set forth below:

Latest time for lodging transfer of H Shares for

entitlement to attend and vote at the AGM and

2018 First H Shareholders' Class Meeting 4:30 p.m. on Tuesday,
29 May 2018

Book closure period for determining H Shareholders' entitlement

to attend and vote at the AGM and

2018 First H Shareholders' Class Meeting Wednesday, 30 May 2018 to
Friday, 29 June 2018

Record date for determining A Shareholders' entitlement

to attend and vote at the AGM and

2018 first A Shareholders' class meeting Thursday, 21 June 2018

Latest time for H Shareholders to lodge revised proxy forms for the AGM 2:00 p.m. on Thursday,
28 June 2018

Latest time for H Shareholders to lodge proxy forms for

2018 First H Shareholders' Class Meeting 4:00 p.m. on Thursday,
28 June 2018

AGM 2:00 p.m. on Friday,
29 June 2018

EXPECTED TIMETABLE

2018 first A Shareholders' class meeting. 3:30 p.m. (or immediately after
the conclusion or adjournment of
the AGM) on Friday, 29 June 2018

2018 First H Shareholders' Class Meeting. 4:00 p.m. (or immediately after
the conclusion or adjournment of
the 2018 first A Shareholders'
class meeting) on Friday, 29 June 2018

Poll result announcements in respect of the AGM,
2018 First H Shareholders' Class Meeting and
2018 first A Shareholders' class meeting. Friday, 29 June 2018

*Subject to Shareholders' approval of the Plan for Profit Distribution and Capital Reserve Capitalisation for
Year 2017 at the AGM and the class meetings of H Shareholders and A Shareholders:*

Register of H Shareholders reopens. Tuesday, 3 July 2018

Last day of dealings in H Shares on a cum-entitlement basis. Thursday, 5 July 2018

First day of dealings in H Shares on an ex-entitlement basis Friday, 6 July 2018

Latest time for lodging transfer of H Shares for
entitlement to the Capital Reserve Capitalisation and
Profit Distribution 4:30 p.m. on Monday,
9 July 2018

Book closure period for determining H Shareholders' entitlement to
the Capital Reserve Capitalisation and
Profit Distribution Tuesday, 10 July 2018 to
Monday, 16 July 2018

Record date for determining H Shareholders' entitlement to
the Capital Reserve Capitalisation and
Profit Distribution Monday, 16 July 2018

Register of H Shareholders of the Company reopens. Tuesday, 17 July 2018

EXPECTED TIMETABLE

Expected date of despatch of certificates for the New H Shares. Friday, 27 July 2018

Expected date of Profit Distribution for H Shareholders Friday, 27 July 2018

Expected date of Profit Distribution for A Shareholders and
expected first day of listing of, and dealing in the New A Shares Friday, 27 July 2018

New H Shares expected to be listed on the
Hong Kong Stock Exchange and
dealing expected to commence 9:00 a.m. on Monday,
30 July 2018

All references to time in this circular are Hong Kong time.

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

Registered Address:

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

Non-executive Directors:

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

Independent non-executive Directors:

Mr. Li Wenming
Mr. Du Guanhua
Mr. Chan Chung Kik, Lewis

8 June 2018

To Shareholders

Dear Sir or Madam,

- (1) 2017 PLAN FOR PROFIT DISTRIBUTION AND
CAPITAL RESERVE CAPITALISATION;
(2) AMENDMENTS TO THE ARTICLES OF ASSOCIATION;
(3) CONTINUING CONNECTED TRANSACTION: REVISION OF ANNUAL CAP FOR YEAR
2018 IN RESPECT OF THE TRANSACTIONS UNDER THE SHHCC AGREEMENT; AND
(4) PROPOSED APPOINTMENT OF INDEPENDENT NON-EXECUTIVE DIRECTOR**

1. INTRODUCTION

The purpose of this circular is to provide you with the relevant information to enable you to make informed decisions in respect of the resolutions at the AGM and the 2018 First H Shareholders' Class Meeting.

LETTER FROM THE BOARD

2. PLAN FOR PROFIT DISTRIBUTION AND CAPITAL RESERVE CAPITALISATION FOR YEAR 2017

The Board proposed the Capital Reserve Capitalisation on the basis of 3 Capitalisation Shares for every 10 existing Shares by way of capitalisation of the capital reserve of the Company, representing a total increase of 143,506,026 Shares comprising of 45,000,000 New H Shares and 98,506,026 New A Shares based on the Company's total issued shares of 478,353,421 Shares comprising 150,000,000 H Shares and 328,353,421 A Shares as at 31 December 2017. The New A Shares and the New H Shares will be issued on a pro rata-basis. No fractional New H Shares shall be allotted to H Shareholders and fractional entitlements (if any) will be aggregated and sold for the benefit of the Company. In respect of A Shareholders, pursuant to 中國證券登記結算有限責任公司深圳分公司證券發行人權益分派及配股登記業務指南 (the Operational Guideline for Interest Distribution and Rights Issue Registration of Security Issuers*) published by the Shenzhen Branch of the China Securities Depository and Clearing Corporation Limited, "any fractional part of one share arising from transfer of shares shall be arranged in the sequence of amounts and the small amount shall be carried to shareholders with larger amount so as to reach the minimum unit of one share, and any fractional part of one cent arising from cash distribution shall be refunded to the relevant listed company". Any fractional New A Shares arising from the Capital Reserve Capitalisation will be processed based on the abovementioned applicable guideline accordingly.

As part of the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017, the Board also proposed the Profit Distribution in a total amount of RMB23,917,671 based on the Company's total issued Shares of 478,353,421 Shares as at 31 December 2017.

The Capital Reserve Capitalisation is subject to the following conditions:

- (i) approval of the Shareholders by way of special resolutions at the AGM and at the class meetings of the H Shareholders and the A Shareholders to be held on 29 June 2018;
- (ii) Hong Kong Stock Exchange granting the listing of, and permission to deal in, the New H Shares; and
- (iii) compliance with the relevant legal procedures and requirements under the Company Law of the PRC to effect the Capital Reserve Capitalisation.

In respect of the Profit Distribution, the cash dividend on A Shares will be paid in RMB and that on H Shares in HKD. The actual dividend amount per Share in HKD will be calculated based on the average RMB-HKD benchmark middle rates released by the People's Bank of China for the 5 consecutive business days immediately prior to the date on which the AGM will be held. The Profit Distribution as part of the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 is subject to the approval of the Shareholders at the AGM and class meetings by way of special resolutions.

LETTER FROM THE BOARD

Status of Capitalisation Shares

The New H Shares proposed to be allotted pursuant to the Capital Reserve Capitalisation will rank pari passu in all respects with the H Shares existing as of the date of this circular, and the New A Shares proposed to be allotted pursuant to the Capital Reserve Capitalisation will rank pari passu in all respects with the A Shares existing as of the date of this circular. Holders of the Capitalisation Shares will be entitled to receive all future dividends and distributions (if any) which are declared, made or paid after the date on which the Capitalisation Shares are allotted and issued. The Capital Reserve Capitalisation will not result in any change to the rights of the Shares.

Overseas H Shareholders

As at the Latest Practicable Date, according to the latest register of members available to the Company, none of the H Shareholders as recorded on the register of members of the Company had an address which is outside Hong Kong.

Upon the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 becoming unconditional, the Company will consider if there are any overseas H Shareholders located in other jurisdictions, and if there are such overseas H Shareholders, then the Company will make enquiry regarding the legal restrictions (if any) under the laws of the relevant places and the requirements of the relevant regulatory bodies for the relevant overseas H Shareholders to be eligible to take part in the Capital Reserve Capitalisation and Profit Distribution pursuant to the Listing Rules.

Tax Arrangement in respect of the Profit Distribution

In accordance with the Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China which came into effect on 1 January 2008 and the Enterprise Income Tax Law of the People's Republic of China which came into effect on 24 February 2017, the Company is required to withhold and pay enterprise income tax at the rate of 10% on behalf of the non-resident enterprise Shareholders whose names appear on the register of members for H Shares. Subject to the approval of the Shareholders of the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017, the Company shall withhold and pay enterprise income tax in respect of the Profit Distribution for the non-resident enterprise Shareholders listed on the register of members for H Shares on Monday, 16 July 2018.

LETTER FROM THE BOARD

Subject to the approval of the Shareholders of the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017, pursuant to the rules of exemption of foreign individuals from individual income tax on dividend distributed by foreign-invested enterprises, which are set out in 《財政部國家稅務總局關於個人所得稅若干政策問題的通知》(財稅[1994]20號) (the Notice of the Ministry of Finance and the State Administration of Taxation on Certain Policies Regarding Individual Income Tax (Caishui [1994] 20)*) dated 13 May 1994, when the Company makes the Profit Distribution to individual H Shareholders whose names are listed on the Company's register of holders of H Shares on Monday, 16 July 2018, the Company will have to make the Profit Distribution to such individual H Shareholders in full (not including investors investing in the H Shares via Southbound Trading (as defined below) who are domestic individuals in the PRC).

As such, any H Shares not registered in the name(s) of individuals (which, for this purpose, includes Shares registered in the name of HKSCC Nominees Limited, other nominees, trustees, or other organisations or groups) shall be deemed to be H Shares held by non-resident enterprise Shareholder(s), and the PRC Enterprise Income Tax shall be withheld from any dividends payable thereon.

Profit Distribution for investors of Northbound Trading

For investors through Hong Kong Stock Exchange (including enterprises and individuals) investing in the A Shares listed on the Shenzhen Stock Exchange (the “**Northbound Trading**”), their dividends will be distributed in RMB by the Company through the Shenzhen Branch of China Securities Depository and Clearing Corporation Limited to the account of the nominee holding such Shares. The Company will withhold and pay income taxes at the rate of 10% on behalf of these investors and will report to the tax authorities for the withholding. For investors of Northbound Trading who are tax residents of other countries and whose country of tax residency is a country which has entered into a tax treaty with the PRC stipulating a dividend tax rate of lower than 10%, those enterprises and individuals may, or may entrust a withholding agent to, apply to the competent tax authorities for the entitlement of the rate under such tax treaty. Upon approval by the tax authorities, the paid amount in excess of the tax payable based on the tax rate according to such tax treaty will be refunded to those enterprises and individuals by the tax authorities.

The date of distribution of cash dividend and other arrangements for the investors of Northbound Trading will be the same as those for the A Shareholders.

LETTER FROM THE BOARD

Profit Distribution for investors of Southbound Trading

For investors through the Shenzhen Stock Exchange (including enterprises and individuals) investing in the H Shares listed on Hong Kong Stock Exchange (the “**Southbound Trading**”), after receipt of any dividend in a foreign currency from HKSCC or the Company, China Securities Depository and Clearing Corporation Limited will effect currency exchange, clearing and distribution of the cash dividends to the relevant investors of H Shares of Southbound Trading through its depository and clearing system.

The cash dividend for the investors of H Shares of Southbound Trading will be paid in RMB. Pursuant to 《關於深港股票市場交易互聯互通機制試點有關稅收政策的通知》(財稅[2016]127號) (Notice on Taxation Policies concerning the Pilot Program of an Interconnection Mechanism for Transactions in the Shenzhen and Hong Kong Stock Markets (Cai Shui [2016] No.127)*) jointly promulgated by the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission, for dividends derived by PRC individual investors from investing in shares listed on the Hong Kong Stock Exchange through Shenzhen-Hong Kong Stock Connect, H-share companies shall withhold individual income tax at a tax rate of 20% for the investors. For PRC securities investment funds investing in shares listed on Hong Kong Stock Exchange through Shenzhen-Hong Kong Stock Connect, the above rules also apply and individual income tax shall be levied on dividends derived therefrom. Dividends derived by PRC enterprise investors from investing in shares listed on Hong Kong Stock Exchange through Shenzhen-Hong Kong Stock Connect shall be reported and paid by the enterprise investors themselves. H-share companies will not withhold or pay enterprise income tax on their behalf in the distribution of dividends.

The Company, its Directors and the working parties involved in the Profit Distribution shall have no liability in respect of any claims arising from any delay in, or inaccurate determination of the status of the Shareholders or any disputes over the mechanism of withholding or any other tax implications in relation to the Profit Distribution.

Tax Arrangement in respect of the Capital Reserve Capitalisation

There will be no levy of PRC taxation in respect of the Capitalisation Shares under the Capital Reserve Capitalisation.

LETTER FROM THE BOARD

Eligibility for Capitalisation Shares for Shareholders trading through Shenzhen-Hong Kong Stock Connect

As at the Latest Practicable Date, the H Shares are eligible for Southbound Trading and the A Shares are eligible for Northbound Trading under the Shenzhen-Hong Kong Stock Connect. Subject to compliance with the relevant laws or regulations in the PRC, New H-Shares will be allotted to the H Shareholders in the PRC who are holding the H Shares through Shenzhen-Hong Kong Stock Connect and New A-Shares will be allotted to the A Shareholders in Hong Kong who are holding the A Shares through Shenzhen-Hong Kong Stock Connect.

Effect to the shareholding upon completion of the Capital Reserve Capitalisation

Set out below is the shareholding structure of the Company as at the Latest Practicable Date and immediately upon completion of the Capital Reserve Capitalisation (assuming that no other Shares are allotted or issued and no existing Shares bought back prior to the allotment and issuance of the Capitalisation Shares under the Capital Reserve Capitalisation, upon satisfaction of the conditions set out above):

	As at the Latest Practicable Date		Immediately upon completion of the Capital Reserve Capitalisation	
	<i>Number of Shares</i>	<i>Approximate percentage of total issued shares</i>	<i>Number of Shares</i>	<i>Approximate percentage of total issued shares</i>
H Shares	150,000,000	31.36%	195,000,000	31.36%
A Shares	328,353,421	68.64%	426,859,447	68.64%
Total	478,353,421	100.00%	621,859,447	100.00%

LETTER FROM THE BOARD

Application for listing

The A Shares and H Shares of the Company are listed on the Shenzhen Stock Exchange and Hong Kong Stock Exchange respectively. Application has been made by the Company to the Hong Kong Stock Exchange for the approval for the listing of, and permission to deal in, the New H Shares. The New A Shares will be listed on the Shenzhen Stock Exchange. Subject to the satisfaction of the conditions as set out in this circular (including without limitation the granting of the aforesaid approval by the Hong Kong Stock Exchange), the New H Shares will be accepted as eligible securities by HKSCC for deposit, clearance and settlement in CCASS. All necessary arrangements will be made by the Company for the New H Shares to be admitted into CCASS. All activities under CCASS are subject to the General Rules of CCASS and CCASS Operational Procedures in effect from time to time.

Aside from the Hong Kong Stock Exchange, the New H Shares will not be listed at or dealt in any other stock exchanges, and the Company is not currently seeking for or proposing to seek for the listing at or dealing in any other stock exchanges for the New H Shares.

Subject to the Plan for the Profit Distribution and Capital Reserve Capitalisation for Year 2017 becoming unconditional, the certificates for the New H Shares and the cheques for the Profit Distribution will be despatched by ordinary post to the H Shareholders who are entitled thereto at their own risk. In case of joint shareholding, the certificates for the New H Shares and the cheques for the Profit Distribution will be posted to the first named person on the H Shareholder's register in respect of such joint shareholding. For the date of despatch of the certificates for the New H Shares and the cheques for the Profit Distribution and the date of the commencement of dealings in the New H Shares, please refer to the section headed "Expected Timetable" of this circular.

Closure of registrar of members

In order to determine the list of H Shareholders who are entitled to the Capital Reserve Capitalisation and Profit Distribution, the Company's register of members of H Shares will be closed from Tuesday, 10 July 2018 to Monday, 16 July 2018, both days inclusive, during which period no transfer of H Shares will be effected. H Shareholders whose names appear on the Company's register of members on Monday, 16 July 2018 are entitled to receive the New H Shares and Profit Distribution. In order to receive the New H Shares and Profit Distribution, H Shareholders whose transfers have not been registered shall deposit the transfer documents together with the relevant share certificates at the H share registrar of the Company, Hong Kong Registrars Limited (the "**H Share Registrar**") at or before 04:30 p.m. on Monday, 9 July 2018. The address of the transfer office of the H Share Registrar is at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong. H Shareholders whose names appear on the Company's register of members on Monday, 16 July 2018 are entitled to receive the New H Shares and Profit Distribution.

LETTER FROM THE BOARD

Odd lot arrangement

In order to alleviate the difficulties arising from the existence of odd lots of the H Shares as a result of the Capital Reserve Capitalisation, the Company has appointed Hong Kong Registrars Limited as an agent to provide matching services on a best effort basis to the H Shareholders who wish to top up or sell their holdings of odd lots of the H Shares during the period from 9:00 a.m. on Monday, 30 July 2018 to 4:30 p.m. on Friday, 17 August 2018, both days inclusive. Holders of the H Shares in odd lots represented by the existing share certificates for the H Shares who wish to take advantage of this facility either to dispose of their odd lots of the H Shares or to top up their odd lots of H Shares may directly or through their brokers contact Hong Kong Registrars Limited at 17M Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong or at telephone number (852) 2862 8555 during office hours (i.e. 9:00 a.m. to 6:00 p.m.) within such period.

Holders of the H Shares in odd lots should note that successful matching of the sale and purchase of odd lots of the H Shares is not guaranteed. The H Shareholders are recommended to consult their professional advisers if they are in doubt about the above facility.

Statement to be made on acquisition of Shares

The Company shall ensure that all its listing document(s) and share certificates include the statements stipulated below and shall instruct and cause its share registrar not to register the subscription, purchase or transfer of any of its Shares in the name of any particular holder unless and until such holder delivers to such share registrar a signed form in respect of such Shares bearing statements to the following effect:

- (i) the acquirer of Shares agrees with the Company and each of its Shareholders, and the Company agrees with each Shareholder, to observe and comply with the Company Law of the PRC, the Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies and the Articles of Association;
- (ii) the acquirer of Shares agrees with the Company, each of its Shareholders, Directors, supervisors, managers and officers, and the Company acting for itself and for each Director, supervisor, manager and officer agrees with each Shareholder, to refer all differences and claims arising from the Articles of Association or any rights or obligations conferred or imposed by the Company Law of the PRC or other relevant laws and administrative regulations concerning the affairs of the Company to arbitration in accordance with the Articles of Association. Any reference to arbitration will be deemed to authorise the arbitration tribunal to conduct its hearing in open session and to publish its award. Such arbitration will be final and conclusive;

LETTER FROM THE BOARD

- (iii) the acquirer of Shares agrees with the Company and its Shareholders that H Shares are freely transferable by the holder of such Shares; and
- (iv) the acquirer of Shares authorises the Company to enter into a contract on his behalf with each director and officer whereby such directors and officers undertake to observe and comply with their obligations to shareholders stipulated in the Articles of Association.

Warning of risks of dealing in the H Shares

H Shareholders should note that the existing H Shares are expected to be dealt in on an entitlement basis for entitlement to the New H Shares and the Profit Distribution from Friday, 6 July 2018. If the conditions in respect of the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 (as set out above under the section headed “2. PLAN FOR PROFIT DISTRIBUTION AND CAPITAL RESERVE CAPITALISATION FOR YEAR 2017”) are not fulfilled, the Capital Reserve Capitalisation and the Profit Distribution as integral parts to the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 will not proceed. If in doubt, investors are recommended to consult their professional advisers.

Reasons for the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017

Based on the positive expectations on the future development of the Company, and with reference to the operating and the overall financial status of the Company, the Board proposed the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 so as to share the fruits of the Company's business performance with the Shareholders.

In respect of the Capital Reserve Capitalisation, in recognition of the continuous support of the Shareholders and to encourage the Shareholders to continue to support the Company's future development, the Board believes that the Capital Reserve Capitalisation will allow the Shareholders to enjoy a pro-rata increase in the number of Shares held by them in the Company without incurring any significant costs to them. Although the Capital Reserve Capitalisation is not expected to increase the Shareholders' proportionate equity interests in the Company, the Capital Reserve Capitalisation will increase the number of Shares to be held by the Shareholders, which will afford the Shareholders with more flexibility in managing their own investment portfolios such as giving them more convenience in disposing of a portion of the Shares and realising a cash return at their discretion. Since the Capital Reserve Capitalisation will increase the number of Shares to be held by the Shareholders, the Board expects that the Capital Reserve Capitalisation would enhance the liquidity of the Shares in the market. In this regard the Board is aware that any odd lots of the New H Shares that result from the Capital Reserve Capitalisation may limit the enhancement of the liquidity of Shares that the Board wishes to attain and has therefore as a safeguard and for alleviating any difficulties arising from such odd lots appointed Hong Kong Registrars Limited

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as an agent to provide matching services to the H Shareholders who wish to top up or sell their holdings of odd lots of the H Shares. The Company believes that the topped-up H Shares will give Shareholders greater flexibility in managing their investment portfolio such as disposing of a portion of the Shares and realising a cash return at their discretion whereas the odd lots sold via the matching services will increase the Shares available in open market. As such, an increased supply of the Shares in the open market can be achieved and broadening of the Shareholder base of the Company be attained. For details of the matching services provided by Hong Kong Registrars Limited, please refer to the section headed “2. PLAN FOR PROFIT DISTRIBUTION AND CAPITAL RESERVE CAPITALISATION FOR YEAR 2017 – Odd lot arrangement” in this circular.

Besides, the Capital Reserve Capitalisation is expected to decrease the trading price per Share traded after ex-entitlement to the Capitalisation Shares. This decrease in the trading price for each Share traded after ex-entitlement will reduce transaction costs incurred by the Shareholders and potential investors in the Company for acquiring each board lot of Shares in future and hence help further to broaden the shareholder base of the Company.

The Board has considered other methods such as a sub-division of Shares to achieve the above purposes. Having considered the procedures involved and costs to be incurred, the Directors consider that the Capital Reserve Capitalisation is the suitable way of achieving the abovementioned purposes taking into account the interests of the Company and the Shareholders as a whole. Furthermore, under the applicable laws, rules and regulations of the PRC and the relevant requirements of the Shenzhen Stock Exchange, the nominal value of the shares of a company incorporated in the PRC shall not be less than RMB1.00; as such, sub-division of the Shares is not feasible to the Company pursuant to the relevant requirements.

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3. PROPOSED AMENDMENTS TO THE ARTICLES OF ASSOCIATION

The Board proposes to make the following amendments to the Articles of Association with a view to enabling the changes in the capital structure and registered capital of the Company resulting from the Capital Reserve Capitalisation:

Current Article 20	Amended Article 20
By approval of the companies examination and approval department authorised by the State Council, the total number of ordinary shares of the Company could issue was 457,312,830 shares, including 217,440,000 state-owned shares issued to the promoter of the Company at the time when the Company was established, 16,719,500 legal person shares and 33,153,330 employee shares. As approved by China Securities Regulatory Commission, the Company issued 150,000,000 overseas listed foreign shares in 1996 and 10,000,000 domestically listed domestic shares to the domestic public in 1997. As approved by China Securities Regulatory Commission, the Company issued 30,000,000 domestically listed domestic shares to the domestic public in 2001. Meanwhile, the state-owned shares of the Company held by Shandong Xinhua Pharmaceutical Group Company Limited disposed of 3,000,000 shares in accordance with Cai Shui Cai Qi Bian Han [2001] No. 78 issued by the Ministry of Finance. In accordance with Lu Guo Zi Chan Quan Han [2006] No.74 issued by Shandong Provincial State-owned Assets Supervision and Administration Commission, Shandong Xinhua Pharmaceutical Group Company Limited offered 26,653,665 shares to all holders of circulating A shares as consideration.	By approval of the companies examination and approval department authorised by the State Council, the total number of ordinary shares of the Company could issue was 457,312,830 shares, including 217,440,000 state-owned shares issued to the promoter of the Company at the time when the Company was established, 16,719,500 legal person shares and 33,153,330 employee shares. As approved by China Securities Regulatory Commission, the Company issued 150,000,000 overseas listed foreign shares in 1996 and 10,000,000 domestically listed domestic shares to the domestic public in 1997. As approved by China Securities Regulatory Commission, the Company issued 30,000,000 domestically listed domestic shares to the domestic public in 2001. Meanwhile, the state-owned shares of the Company held by Shandong Xinhua Pharmaceutical Group Company Limited disposed of 3,000,000 shares in accordance with Cai Shui Cai Qi Bian Han [2001] No. 78 issued by the Ministry of Finance. In accordance with Lu Guo Zi Chan Quan Han [2006] No.74 issued by Shandong Provincial State-owned Assets Supervision and Administration Commission, Shandong Xinhua Pharmaceutical Group Company Limited offered 26,653,665 shares to all holders of circulating A shares as consideration.

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Current Article 20	Amended Article 20
<p>By the Approval Document [2017] No. 459 issued by the China Securities Regulatory Commission, for the year 2017 the Company was allowed to proceed with the non-public issuance of 21,040,591 domestic shares to be listed in the PRC. Upon completion of the issuance, the structure of share capital of the Company is: the total number of shares is 478,353,421 shares, of which all are ordinary shares and listed domestic shares in the PRC are 328,353,421 shares, representing approximately 68.64% of the total number of shares of the Company; overseas listed foreign shares are 150,000,000 shares, representing approximately 31.36% of the total number of shares of the Company</p>	<p>By the Approval Document [2017] No. 459 issued by the China Securities Regulatory Commission, for the year 2017 the Company was allowed to proceed with the non-public issuance of 21,040,591 domestic shares to be listed in the PRC. Upon completion of the issuance, the structure of share capital of the Company is: the total number of shares is 478,353,421 shares, of which all are ordinary shares and listed domestic shares in the PRC are 328,353,421 shares, representing approximately 68.64% of the total number of shares of the Company; overseas listed foreign shares are 150,000,000 shares, representing approximately 31.36% of the total number of shares of the Company.</p> <p><u>On implementation of the Profit Distribution Plan 2017, the structure of share capital of the Company is: the total number of shares is 621,859,447 shares, of which all are ordinary shares comprising listed domestic shares in the PRC of 426,859,447 shares, representing approximately 68.64% of the total number of shares of the Company, and overseas listed foreign shares of 195,000,000 shares, representing approximately 31.36% of the total number of shares of the Company.</u></p>

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Current Article 23	Amended Article 23
The registered capital of the Company is RMB478,353,421 yuan.	The registered capital of the Company is RMB <u>621,859,447</u> yuan.

Subject to the approval of the Shareholders, the abovementioned amendments to the Articles of Association will have the effect of aligning the structure of share capital of the Company with that upon the Capital Reserve Capitalisation and reflecting the changes thereof resulting from the Capital Reserve Capitalisation.

In addition, for further enhancement of the corporate governance of the Company, the Board proposes further amendments to the Articles of Association as follows:

Current Article 121(a)	Amended Article 121(a)
<p>A list of candidates to be appointed as directors of the Company shall be submitted to the shareholders' at a shareholders' general meeting in the form of motion for approval.</p> <p>Candidates for independent directors of the Company shall be nominated by the Company's board of directors, the supervisory committee or shareholders who individually or jointly hold more than 1% of the Company's voting shares and such candidates shall be considered for election by the shareholders at a shareholders' general meeting.</p> <p>Candidates other than those nominated as independent directors shall be nominated by the board of directors, the supervisory committee or shareholders who individually or jointly hold more than 5% of the Company's voting shares and shall be considered for election elected by the shareholders at a shareholders' general meeting.</p>	<p>A list of candidates to be appointed as directors of the Company shall be submitted to the shareholders at a shareholders' general meeting in the form of motion for approval.</p> <p>Candidates for independent directors of the Company shall be nominated by the Company's board of directors, the supervisory committee or shareholders who individually or jointly hold more than 1% of the Company's voting shares and such candidates shall be considered for election by the shareholders at a shareholders' general meeting.</p> <p>Candidates other than those nominated as independent directors shall be nominated by the board of directors, the supervisory committee or shareholders who individually or jointly hold more than <u>3%</u> of the Company's voting shares and shall be considered for election by the shareholders at a shareholders' general meeting.</p>

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Current Article 121(c)	Amended Article 121(c)
<p>Non-independent directors shall be elected in the following manner:</p> <p>(1) the nominator of a candidate for non-independent director shall seek the consent of the nominee, review and consider the occupation, academic qualifications, rank and detailed working experience including all part-time jobs of the nominee and provide written proofs of the same to the Company before making the nomination. The candidate shall provide written confirmation to the Company agreeing to be nominated, and shall provide an undertaking in relation to the truthfulness and completeness of his particulars disclosed and guaranteeing the performance of a director's duties after being elected.</p> <p>(2) If the nomination of candidates for non-independent directors is made before the Company's convening of a board meeting, the written proofs of the nominee referred to in sub-paragraph (1) above shall be disclosed together with the board resolution.</p>	<p>Non-independent directors shall be elected in the following manner:</p> <p>(1) the nominator of a candidate for non-independent director shall seek the consent of the nominee, review and consider the occupation, academic qualifications, rank and detailed working experience including all part-time jobs of the nominee and provide written proofs of the same to the Company before making the nomination. The candidate shall provide written confirmation to the Company agreeing to be nominated, and shall provide an undertaking in relation to the truthfulness and completeness of his particulars disclosed and guaranteeing the performance of a director's duties after being elected.</p> <p>(2) If the nomination of candidates for non-independent directors is made before the Company's convening of a board meeting, the written proofs of the nominee referred to in sub-paragraph (1) above shall be disclosed together with the board resolution.</p>

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Current Article 121(c)	Amended Article 121(c)
<p>(3) If the shareholders who individually or jointly hold more than 5% of the Company's voting shares or the supervisory committee puts forward a provisional motion at an AGM of the Company for election of non-independent directors, a written notice stating their intention to nominate a candidate for directors and the nominee's consent to be nominated together with the written proofs and undertaking of the nominee referred to in sub-paragraph (1) above shall be delivered to the Company not less than seven (7) days before the general meeting, and the period granted by the Company for lodging the above notice and documents by the relevant nominator (such period shall commence from the date after the issue of the notice of the general meeting) shall not be less than seven (7) days.</p>	<p>(3) If the shareholders who individually or jointly hold more than <u>3%</u> of the Company's voting shares or the supervisory committee puts forward a provisional motion at an AGM of the Company for election of non-independent directors, a written notice stating their intention to nominate a candidate for directors and the nominee's consent to be nominated together with the written proofs and undertaking of the nominee referred to in sub-paragraph (1) above shall be delivered to the Company not less than seven (7) days before the general meeting, and the period granted by the Company for lodging the above notice and documents by the relevant nominator (such period shall commence from the date after the issue of the notice of the general meeting) shall not be less than seven (7) days.</p>

Note: The amendments to the Articles of Association were drafted in Chinese and the English translation is for reference only. In case of any inconsistencies between the Chinese and the English versions, the Chinese version shall prevail.

Subject to the approval of the Shareholders, the abovementioned amendments to articles 121(a) and (c) will have the effect of lowering Shareholders' nomination threshold in respect of candidates for directorships of the Company (other than candidates for independent directorships) from individually or jointly holding more than 5% of the Company's voting Shares to more than 3% thereof. The Shareholders' nomination threshold in respect of independent directorships shall remain unchanged at individually or jointly holding more than 1% of the Company's voting Shares.

A special resolution will be proposed at the AGM to approve the Article Amendments. It is proposed that the AGM shall authorise the Board to make appropriate adjustments to the Article Amendments above whenever necessary in the process of submitting the same for approval, as required from time to time by the relevant regulatory authorities (including without limitation to the administration authorities of industry and commerce and the Shenzhen Stock Exchange).

The proposed amendments to the Articles of Association will become effective upon approval by regulatory bodies and completion of the Capital Reserve Capitalisation.

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4. CONTINUING CONNECTED TRANSACTION: REVISION OF ANNUAL CAP FOR YEAR 2018 IN RESPECT OF THE TRANSACTIONS UNDER THE SHHCC AGREEMENT

Reference is made to the announcements dated 29 October 2015 and 20 April 2018 and the circular dated 14 December 2015 of the Company in respect of, amongst other things, the continuing connected transactions under the SHHCC Agreement.

As disclosed in the abovementioned announcements and circular and approved at the 2015 Second Extraordinary General Meeting of the Company on 29 December 2015, the Company has entered into the SHHCC Agreement with SHHCC. The Company has been monitoring transactions carried out under the SHHCC Agreement.

For reasons set out in the section headed “Reasons and benefits for the 2018 Annual Cap Revision” below in this circular, the Directors expect that the existing annual cap for the year ended 31 December 2018 in respect of transactions under the SHHCC Agreement will not be sufficient for the Group’s needs.

SHHCC Agreement

Date

29 October 2015

Parties

(i) The Company and (ii) SHHCC

Subject matter and principal terms

Pursuant to the SHHCC Agreement:

- (a) the Company and/or its subsidiaries may purchase from SHHCC and/or its subsidiaries at market prices certain chemical products, such as acetic acid, acetic anhydride and other chemical raw materials (collectively, the “**Chemical Products**”);
- (b) the prices for the Chemical Products stated above will be determined in accordance with the market prices;
- (c) all of the relevant prices will not be higher than the selling prices in respect of such items as offered by SHHCC and/or its subsidiaries to any independent third parties;

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- (d) the Company will pay to the counterparty for the products provided in a timely manner as specified in each purchase order placed by the Company and/or its subsidiaries from time to time. Payment will be made within 60 days after invoicing; and
- (e) the Company and/or its subsidiaries are not restricted from conducting transactions with any third parties for the sale and purchase of the relevant products.

Term

The SHHCC Agreement has run from 1 January 2016 and will end on 31 December 2018.

Pricing

Pursuant to the SHHCC Agreement, the transactions contemplated thereunder shall be conducted in accordance with the following pricing policy:

- (a) the Company and/or its subsidiaries source all its 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;
- (b) 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 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

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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;

- (c) 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; and
- (d) in any case, the Company is not restricted under the SHHCC Agreement from acquiring the Chemical Products from other third parties.

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 (the “**Procurement Committee**”), consisting of representatives from (i) the department of audit, (ii) the department of production, (iii) the quality assurance department, (iv) the procurement department; and (v) the finance department. As of the Latest Practicable Date, the regular representation of the various departments in the Procurement Committee is as follows: one member from the department of audit, five members from the department of production, 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 of the Company or its holding company or their respective associated companies and subsidiaries, SHHCC inclusive and none of them are concurrently employed therein.

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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 but 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 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 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 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 and services) 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 updates 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 department of audit, (ii) the head of the department of production, (iii) the head of the quality assurance department, (iv) the head of the department of procurement 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.

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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 have approved the SHHCC Agreement according to the connected transaction decision policy;
- (2) the Group has assigned specific personnel to regularly monitor the total transaction amount under the SHHCC Agreement to ensure that it will not exceed the annual cap for each year;
- (3) the Company's management policies for connected transactions has set out the principles for determining the prices for connected transactions. When each unit of business enters into contracts in accordance with the framework agreements of the continuing connected transactions, the price must be determined in accordance with the pricing standards as agreed in the continuing connected transaction agreements.

The Directors are of the view that these measures, methods and procedures are clear-cut and adequate and have been effectively implemented and maintained so that they can ensure that the transactions under the SHHCC Agreement are conducted on normal commercial terms and not prejudicial to the interests of the Company and the minority Shareholders.

Historical figures of the transactions under the SHHCC Agreement

The table below summarises the historical transaction figures and the original annual caps for the transactions between the Group and SHHCC for the years ended 31 December 2016 and 2017 and the three months ended 31 March 2018:

	Year ended		Year ended		Three months	
	31 December	Annual cap	31 December	Annual cap	ended 31 March	Annual cap
	2016 (audited)	for 2016	2017 (audited)	for 2017	2018 (unaudited)	for 2018
	<i>(rounded to</i>		<i>(rounded to</i>			<i>(rounded to</i>
	<i>the nearest</i>		<i>the nearest</i>			<i>the nearest</i>
	<i>RMB'000)</i>	<i>(RMB'000)</i>	<i>RMB'000)</i>	<i>(RMB'000)</i>	<i>(RMB'000)</i>	<i>RMB'000)</i>
Purchase of Chemical Products from SHHCC						
and/or its subsidiaries	56,457	80,000	98,290	100,000	40,180	120,000

Note: the figures are tax-exclusive.

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Revision of annual cap for year 2018

Based on the business volume, growth and production capacity of the Group and its business needs and operating conditions and the economic outlooks of the industry and the PRC, the Board proposes to revise the annual cap for year 2018 as follows:

	Original Annual Cap (RMB'000)	Proposed revised Annual Cap (RMB'000)
For the year ending 31 December 2018	120,000	200,000

Note: the figures are tax-exclusive.

Save for the abovementioned proposed revision of the annual cap for year 2018, the transactions provided for under the SHHCC Agreement remain unchanged in all respects and all arrangements in relation thereto including without limitation the internal control measures and procedures and pricing mechanism previously disclosed in the circular of the Company dated 14 December 2015 continue to remain in full force and effect.

Reasons and benefits for the 2018 Annual Cap Revision

The proposed revision of the annual cap for the year ending 31 December 2018 in respect of the transactions under the SHHCC Agreement is primarily due to: (i) the Group's expected increase in procurement under the SHHCC Agreement of up to approximately RMB50 million in view of the expanding business volume and growth of the Group and the business needs deriving therefrom and the industry outlook as derived from the economic figures of year 2017; (ii) an expected further increase of approximately RMB30 million in the transactional amount under the SHHCC Agreement in view of the anticipated substantial rise in the market prices of the Chemical Products in comparison of those of 2017; and (iii) the needs to secure a steady supply of Chemical Products and to control the rise in intermediary costs in sourcing and procurement amidst the abovementioned expanding business scale and rise in market prices of the Chemical Products.

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Analysis of the 2018 Annual Cap Revision

The Board has considered the following factors in coming up with the 2018 Annual Cap Revision:

- (a) the continuous growth and expansion of the Group during the contractual period of the SHHCC Agreement – 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 three months ended 31 March 2018, the Group has recorded an increase in operating income of approximately 9.42% when compared with the corresponding period in 2017. The total assets of the Group witnessed a 11.66% growth and 2.82% growth during the respective periods, indicating a positive growth trend in scale;
- (b) 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%;
- (c) Rise in the market prices of the Chemical Products – 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 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.

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Having taken into account the abovementioned factors and based on the historical transaction volume and growth path of the business of Group and its understanding of the market conditions and trends of the industry including without limitation the sale side and the cost side, the Board expects the annual cap in respect of the transactions under SHHCC Agreement will need to increase by approximately RMB80 million in total.

The Directors (including the independent non-executive Directors) consider that the 2018 Annual Cap Revision in the ordinary and usual course of business of the Company, on normal commercial terms and in the interests of the Company and its Shareholders as a whole.

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 of HHGC and/or SXPGC abstained from voting on the Board decision on the 2018 Annual Cap Revision. Save as disclosed above, the Company is not aware of any other Directors who has a material interest in the 2018 Annual Cap Revision and/or the transactions under the SHHCC Agreement.

Listing Rules implications

As at the Latest practical Date, HHGC holds 100% equity interest of SXPGC. SXPGC owns 32.94% of the total issued Shares of the Company and is the single largest shareholder of the Company. HHGC holds 100% equity interest of SHHGC, and SHHGC in turn owns 32.32% of the total issued Shares of SHHCC and is the largest shareholder thereof. SHHCC is therefore an associate of HHGC and for this reason a connected person of the Company. Accordingly, the transactions provided for under the SHHCC Agreement constitute continuing connected transactions under Chapter 14A of the Listing Rules.

For the proposed revised annual cap for year 2018 under the SHHCC Agreement, as one or more of the applicable percentage ratios (as defined under Chapter 14A of the Listing Rules) exceed 5%, the 2018 Annual Cap Revision is subject to the reporting, annual review, announcement 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 the SHHCC and its ultimate beneficial owner within a 12-month period from the Latest Practicable Date which would be, together with the 2018 Annual Cap Revision and/or the transactions under SHHCC Agreement, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

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Information relating to SHHCC

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

Information relating to 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 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.

General information

Approval of the Disinterested Shareholders on the 2018 Annual Cap Revision will be sought at the AGM by way of ordinary resolution. 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 in relation to the 2018 Annual Cap Revision.

An Independent Board Committee comprising independent non-executive Directors has been established to advise the Disinterested Shareholders on the 2018 Annual Cap Revision. A letter from the Independent Board Committee containing its recommendations on the 2018 Annual Cap is set out on page 32 of this circular.

China AF Corporate Finance 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 2018 Annual Cap Revision. A letter from China AF Corporate Finance Limited containing its advice to the Independent Board Committee and the Disinterested Shareholders in relation to the 2018 Annual Cap Revision is set out on pages 33 to 48 of this circular.

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 that the 2018 Annual Cap Revision is fair and reasonable and is in the interests of the Company and the Shareholders as a whole. Accordingly, the Directors (including the independent non-executive Directors) recommend the Disinterested Shareholders to vote in favour of the relevant resolution at the AGM to approve the 2018 Annual Cap Revision.

LETTER FROM THE BOARD

5. PROPOSED APPOINTMENT OF INDEPENDENT NON-EXECUTIVE DIRECTOR

Reference is made to the announcements of the Company dated 25 April 2018 and 17 May 2018 in relation to the proposed change of an independent non-executive Director.

In view of Mr. Chan Chung Kik, Lewis' ("Mr. Chan") tendering of resignation on 25 April 2018 from his offices of an independent non-executive Director, the chairman of the Audit Committee and a member of the Remuneration and Examination Committee of the Board (the "Resignation") to take effect from the assumption of office by a new independent non-executive Director in his replacement, the Board has on 16 May 2018 resolved to nominate Mr. Lo Wah Wai ("Mr. Lo"), a practicing member of the Hong Kong Institute of Certified Public Accountants and a member of the American Institute of Certified Public Accountants, as an independent non-executive Director candidate for a term concurrent with the ninth session of the Board until 22 December 2020 to fill the upcoming vacancy resulting from the Resignation.

The appointment of Mr. Lo is subject to and shall take effect from the approval of the Shareholders by way of ordinary resolution at the AGM. Subject to the aforementioned, Mr. Lo will be appointed as the Chairman of the Audit Committee, a member of the Remuneration and Examination Committee and a member of the Nomination Committee of the Board.

As disclosed in the abovementioned announcements, Mr. Chan has agreed to hold office and continue to perform his functions and duties as an independent non-executive Director and as the chairman or member of the Board committees pursuant to 關於在上市公司建立獨立董事制度的指導意見 (Guidelines for Establishing the Independent Directors System for Listed Companies*) issued by the China Securities Regulatory Commission and the applicable laws, rules and regulations until the appointment of the new independent non-executive Director should take effect.

The biography of Mr. Lo is as follows:

LO Wah Wai (盧華威), aged 55, graduated with a bachelor's degree in business administration from The Chinese University of Hong Kong in 1986 and a master's degree in management science from New Jersey Institute of Technology in the United States in 1992. Mr. Lo is a practicing member of the Hong Kong Institute of Certified Public Accountants and is a member of the American Institute of Certified Public Accountants. Mr. Lo has more than 20 years' service experience in auditing and business consulting services, in which he had more than seven years' experience in auditing and business consulting services in an international accounting firm (Deloitte Touche Tohmatsu), of which two years were spent in the United States of America. Save from serving as an incumbent director of BMI Consultants Limited, Mr. Lo is also an independent non-executive director of Chongqing Machinery & Electric Co., Ltd. (stock code: 2722) and Tenfu (Cayman) Holdings Company Limited (stock code: 6868), of which both are listed on the main board of the Hong Kong Stock Exchange.

LETTER FROM THE BOARD

As far as the Directors are aware, save as disclosed above, Mr. Lo does not hold any directorship in any other public companies of which the securities are listed on any securities market in Hong Kong or overseas in the past three years and does not have any relationship with any Directors, supervisors, senior management or substantial shareholders of the Company, nor does he hold any position in the Group.

As at the Latest Practicable Date, Mr. Lo did not have any interest in the shares of the Company or its associated companies within the meaning of Part XV of the SFO.

Save as disclosed above, as far as the Directors are aware there is no other information in relation to the appointment of Mr. Lo which is required to be disclosed pursuant to the requirements set out in Rules 13.51(2)(h) to (v) of the Listing Rules, nor are there any matters which need to be brought to the attention of the Shareholders.

The Company has not entered into any service contract with Mr. Lo. The proposed amount of Mr. Lo's emoluments for 2018 is RMB35,000, which is recommended with reference to the emoluments of other independent non-executive Directors and the remaining period of financial year 2018 of the Company and is subject to Shareholders' approval by way of ordinary resolution in tandem with those of the Directors and supervisors of the Company at the AGM.

6. AGM AND CLASS MEETINGS

The proposed resolutions in relation to the Plan for Profit Distribution and Capital Reserve Capitalisation for Year 2017 is subject to, among other things, the approval of the Shareholders at general meeting and of the H Shareholders and A Shareholders at their respective class meetings by way of special resolutions. It is therefore proposed that the AGM, the 2018 First H Shareholders' Class Meeting and the 2018 first A Shareholders' class meeting be convened to propose resolutions to vote, among other things, to approve the aforesaid proposed resolutions.

The Article Amendments are subject to, amongst other things, approval of the Shareholders by way of special resolution at the AGM.

The 2018 Annual Cap Revision is subject to the approval of the Disinterested Shareholders by way of ordinary resolution at the AGM. 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 2018 Annual Cap Revision.

The appointment of Mr. Lo Wah Wai as an independent non-executive Director is subject to approval of the Shareholders by way of ordinary resolution at the AGM.

LETTER FROM THE BOARD

To the best knowledge and belief of the Directors, save for SXPGC and Well Bring Limited in respect of the resolution of the 2018 Annual Cap Revision, none of the Shareholders are required to abstain from voting on any other resolutions at the AGM, the 2018 First H Shareholders' Class Meeting and the 2018 first A Shareholders' class meeting.

(i) A notice convening the AGM to be held at the conference room of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC at 2:00 p.m. on Friday, 29 June 2018; (ii) a notice convening the 2018 First 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 at 4:00 p.m. on Friday, 29 June 2018 (or immediately after the conclusion or adjournment of the 2018 first A Shareholders' class meeting of even date); (iii) the forms of proxy for use at and the reply slips in relation to the AGM and the 2018 First H Shareholders' Class Meeting respectively were despatched by the Company on 15 May 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 <http://www.xhzy.com>. A supplemental notice in respect of the AGM (reproduced also on pages 54 to 56 of this circular) and a revised proxy form for use thereat further setting out the resolution on the appointment of a new independent non-executive Director are despatched together with this circular and published and available at the abovementioned websites. Whether or not you intend to attend the AGM or the 2018 First H Shareholders' Class Meeting, we encourage you to complete and return the revised proxy forms in respect of the AGM and the proxy forms in respect of 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).

7. 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 the Shareholders to vote in favour of the resolutions proposed at the AGM and the 2018 First H Shareholders' Class Meeting.

The Independent Board Committee, having taken into account the advice from the Independent Financial Adviser, considers that the 2018 Annual Cap Revision is fair and reasonable and is 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 resolution at the AGM to approve the 2018 Annual Cap Revision.

LETTER FROM THE BOARD

8. RESPONSIBILITY STATEMENT

This circular includes particulars given in compliance with the Listing Rules for the purpose of giving information with respect to the Company. The information contained herein relating to the Company has been supplied by the Directors, who collectively and individually accept full responsibility for the accuracy of the information contained in this circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief, no other facts are omitted in this circular which would make any statement herein misleading insofar as it relates to the Company.

By order of the Board

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)

8 June 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 proposed revision of annual cap for year 2018 in respect of the continuing connected transactions under the SHHCC Agreement, 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 Independent Financial Adviser in its capacity as the independent financial adviser in respect of whether the 2018 Annual Cap Revision is on normal commercial terms, in the ordinary and usual course of business of the Group, fair and reasonable and in the interest 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 2018 Annual Cap Revision fair and reasonable and is 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 resolution to be proposed at the AGM in respect of the 2018 Annual Cap Revision.

The Independent Board Committee

Mr. Li Wenming Mr. Du Guanhua Mr. Chan Chung Kik, Lewis

Independent non-executive Directors

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

The following is the full text of a letter of advice from the Independent Financial Adviser to the Independent Board Committee and the Disinterested Shareholders in relation to the proposed revision of annual cap for year 2018 in respect of the continuing connected transaction under the SHHCC Agreement which has been prepared for the purpose of inclusion in this Circular.



中國農信財務顧問有限公司
China AF Corporate Finance Limited

China AF Corporate Finance Limited
Units 2303–2306, 23/F.,
Great Eagle Centre
23 Harbour Road
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H.K.
中國農信財務顧問有限公司
香港灣仔港灣道23號鷹君中心
23樓2303–2306室

8 June 2018

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

Dear Sir or Madam,

CONTINUING CONNECTED TRANSACTION: REVISION OF ANNUAL CAP FOR YEAR 2018 IN RESPECT OF THE TRANSACTIONS UNDER THE SHHCC AGREEMENT

INTRODUCTION

We refer to our engagement as the Independent Financial Adviser to the Independent Board Committee and the Disinterested Shareholders of the Company in relation to the 2018 Annual Cap Revision. Details of the SHHCC Agreement, the transactions contemplated thereunder and the 2018 Annual Cap Revision are set out in the letter from the Board (the “**Board Letter**”) in this circular of the Company to the Shareholders dated 8 June 2018 (the “**Circular**”), of which this letter forms a part. Terms used in this letter have the same meanings as those defined in the Circular unless the context requires otherwise.

As at the Latest Practicable Date, HHGC holds 100% equity interest of SXPGC. SXPGC owns 32.94% of the total issued Shares of the Company and is the single largest shareholder of the Company. HHGC holds 100% equity interest of SHHGC, and SHHGC in turn owns 32.32% of the total issued share capital of SHHCC and is the largest shareholder thereof. SHHCC is therefore an associate of HHGC and for this reason a connected person of the Company. Accordingly, the transactions provided for under the SHHCC Agreement constitute continuing connected transactions under Chapter 14A of the Listing Rules.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

For the 2018 Annual Cap Revision, as one or more of the applicable percentage ratios (as defined under Chapter 14A of the Listing Rules) exceed 5%, the 2018 Annual Cap Revision is subject to the reporting, annual review, announcement 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 the SHHCC and its ultimate beneficial owner within a 12-month period from the Latest Practicable Date which would be, together with the 2018 Annual Cap Revision and/or the transactions under the SHHCC Agreement, regarded as a series of transactions treated as if they are one transaction under Rules 14A.81 of the Listing Rules.

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 of HHGC and/or SXPGC abstained from voting on the Board decision on the 2018 Annual Cap Revision. Save as disclosed above, the Company is not aware of any other Directors who has a material interest in the 2018 Annual Cap Revision.

The Independent Board Committee comprising independent non-executive Directors, namely, Mr. Li Wenming, Mr. Du Guanhua and Mr. Chan Chung Kik, Lewis, has been established to consider and advise the Disinterested Shareholders in relation to the 2018 Annual Cap Revision. As the Independent Financial Adviser to the Independent Board Committee and the Disinterested Shareholders, our role is to give an independent opinion to the Independent Board Committee and the Disinterested Shareholders as to whether the terms of the 2018 Annual Cap Revision are fair and reasonable so far as the Disinterested Shareholders are concerned, whether the 2018 Annual Cap Revision is on normal commercial terms and in the ordinary and usual course of business of the Group and in the interests of the Company and the Shareholders as a whole. We would also give independent advice to the Independent Board Committee and recommendation to the Disinterested Shareholders as to whether the Disinterested Shareholders should vote in favour of the ordinary resolution to be proposed at the AGM to be convened and held by the Company to, among other things, seek Disinterested Shareholders' approval of the 2018 Annual Cap Revision.

As at the Latest Practicable Date, we did not have any relationship or interest with the Company, its subsidiaries and any other party that could reasonably be regarded as relevant to the independence of us, and we were not connected with the Directors, chief executives and substantial shareholders of the Company or any of their respective associates. We had not acted as an independent financial adviser and had not provided any other service to the Company or any of its subsidiaries or their respective associates during the past two years. Apart from the normal professional fees paid or payable to us in connection with this engagement as the Independent Financial Adviser to the Independent Board Committee and the Disinterested Shareholders, no arrangement exists whereby we had received or will receive any fee or benefit from the Company or any of its subsidiaries or any other party to the 2018 Annual Cap Revision. Accordingly, we consider that we are eligible to give independent advice under this engagement on the 2018 Annual Cap Revision.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

BASIS OF OUR OPINION

In formulating our recommendation, we have reviewed and relied on (i) the information and facts contained or referred to in the Circular; (ii) the first quarter results for the period commencing from 1 January 2018 to 31 March 2018 (the “**2018 First Quarter Results**”), the annual results for the year ended 31 December 2017 (the “**2017 Annual Results**”) and the annual report for the year ended 31 December 2016 (the “**2016 Annual Report**”) of the Group; (iii) the information supplied by the Group and relevant personnel; (iv) the opinions expressed by and the representations of the Directors and the management of the Company; and (v) the relevant public information as later disclosed in this letter. We have assumed that all information, representations and opinions contained or referred to in the Circular and all information, facts, representations and opinions which have been provided by the Directors or management of the Company for which they are solely responsible, are true and accurate at the time they were made and will continue to be accurate at the date of the despatch of the Circular. We are also not aware that any statements of belief, opinion and intention made by the Directors in the Circular were not reasonably made after due and careful enquiry and not based on honestly-held opinions. We have no reason to doubt the truth, accuracy and completeness of the information and representations provided to us by the Directors and we have been advised by the Directors that no material facts have been omitted from the information and representations provided in and referred in the Circular.

We consider that we have been provided with sufficient information to enable us to reach an informed view and to justify our reliance on the accuracy of the information and representations contained in the Circular and to provide a reasonable basis for our opinion. We have not, however, carried out any independent verification of the information provided by the Directors and management of the Company, nor have we conducted an independent investigation into the business and affairs of the Company or any of its respective subsidiaries or associates.

PRINCIPAL FACTORS AND REASONS CONSIDERED

In giving our recommendation to the Independent Board Committee and the Disinterested Shareholders on the 2018 Annual Cap Revision, we have taken into consideration the following principal factors and reasons:

1. Background of the Group, SHHCC and the 2018 Annual Cap Revision

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 of the Hong Kong Stock Exchange and the Shenzhen Stock Exchange respectively. The Group principally engages in the development, production and distribution of chemical bulk drugs, preparations, medical intermediates and other products.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Principal financial information of the Group

Set forth below are selected items from the consolidated financial results of the Group for the year ended 31 December 2016 and 2017, respectively (“**FY2016**” and “**FY2017**”), and the three months ended 31 March 2017 and 2018, respectively, as extracted from the 2017 Annual Results and 2018 First Quarter Results.

	Year ended	Year ended	Three months	Three months
	31 December 2016	31 December 2017	ended 31 March	ended 31 March
			2017	2018
	(Audited)	(Audited)	(Unaudited)	(Unaudited)
	(RMB million)	(RMB million)	(RMB million)	(RMB million)
	(approximately)	(approximately)	(approximately)	(approximately)
Operating income	4,014.96	4,515.72	1,295.38	1,417.35
Net profit attributable to				
Shareholders	122.27	209.59	51.55	67.59

Set forth below are selected items from the consolidated financial positions of the Group as at the dates indicated as extracted from the 2017 Annual Results and 2018 First Quarter Results.

	As at	As at	As at
	31 December 2016	31 December 2017	31 March 2018
	(Audited)	(Audited)	(Unaudited)
	(RMB million)	(RMB million)	(RMB million)
	(approximately)	(approximately)	(approximately)
Total assets	4,722.79	5,273.65	5,422.25
Total of equity assigned to the Shareholders	1,988.42	2,480.02	2,514.62

For FY2017

As depicted by the above table, the Group recorded an increase of approximately 12.47% in operating income from approximately RMB4,014.96 million for FY2016 to approximately RMB4,515.72 million for FY2017. The Group recorded an increase of approximately 71.42% in net profit attributable to Shareholders from approximately RMB122.27 million for FY2016 to approximately RMB209.59 million for FY2017.

As at 31 December 2017, the Group recorded total assets and total of equity assigned to the Shareholders of approximately RMB5,273.65 million and RMB2,480.02 million, respectively, representing an increase of approximately 11.66% and 24.72% as compared to the corresponding figures as at 31 December 2016, respectively.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

For the three months ended 31 March 2018

As disclosed in the above table, the Group recorded an increase of approximately 9.42% in operating income from approximately RMB1,295.38 million for the three months ended 31 March 2017 to approximately RMB1,417.35 million for the three months ended 31 March 2018. The Group recorded an increase of approximately 31.12% in net profit attributable to Shareholders from approximately RMB51.55 million for the three months ended 31 March 2017 to approximately RMB67.59 million for the three months ended 31 March 2018.

As at 31 March 2018, the Group recorded total assets and total of equity assigned to the Shareholders of approximately RMB5,422.25 million and RMB2,514.62 million, respectively, representing an increase of approximately 2.82% and 1.40% as compared to the corresponding figures as at 31 December 2017, respectively.

Information on SHHCC and the SHHCC Agreement

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

As mentioned in the circular of the Company dated 14 December 2015 (the “**2015 Circular**”) and the subsequent approval at the 2015 Second Extraordinary General Meeting of the Company on 29 December 2015, the Company has entered into the SHHCC Agreement with SHHCC on 29 October 2015 in relation to the Group purchasing the Chemical Products from SHHCC and/or its subsidiaries for a period of three years from 1 January 2016 to 31 December 2018.

Principal terms of the SHHCC Agreement

Pursuant to the SHHCC Agreement:

- a) the Group will purchase the Chemical Products from SHHCC and/or its subsidiaries at market prices;
- b) the prices for the Chemical Products will be determined in accordance with the market prices;
- c) all of the relevant prices will not be higher than the selling prices in respect of such items as offered by SHHCC and/or its subsidiaries to any independent third parties;
- d) the Company will pay to the counterparty for the products provided in a timely manner as specified in each purchase order placed by the Group from time to time. Payment will be made within 60 days after invoicing; and

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

- e) the Group is not restricted from conducting transactions with any third parties for the sale and purchase of the relevant products.

Pricing of the SHHCC Agreement

The transactions under the SHHCC Agreement shall be conducted in accordance with the following pricing policy:

- a) the Group sources all its Chemical Products through suppliers who are participants 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;
- b) 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 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 process, 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 updates pricing information daily, in considering whether offered price is comparable to the prevailing market rate;

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

- c) 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; and
- d) in any case, the Company is not restricted under the SHHCC Agreement from acquiring the Chemical Products from other third parties.

Information on the original annual caps under the SHHCC Agreement

Set out below is a summary of (i) the historical transaction amounts of the Chemical Products between the Group and SHHCC and/or its subsidiaries for the two years ended 31 December 2017 and the three months ended 31 March 2018; (ii) the original annual caps under the SHHCC Agreement for the three years ending 31 December 2018; and (iii) the utilisation rates of the original annual caps under the SHHCC Agreement for the transaction of the Chemical Products.

	Year ended 31 December 2016 (RMB'000) (approximately)	Year ended 31 December 2017 (RMB'000) (approximately)	Year ending 31 December 2018 (unless otherwise specified) (RMB'000) (approximately)
Historical transaction amounts	56,457	98,290	40,180 <i>(For the three months ended 31 March 2018)</i>
Original annual caps	80,000	100,000	120,000
Utilisation rates	70.57%	98.29%	33.48%

The above table shows that (i) the utilisation rates of the original annual caps under the SHHCC Agreement for the two years ended 31 December 2017 have been at high levels, being approximately 70.57% and 98.29%, respectively; and (ii) for the first three months up to 31 March 2018, approximately 33.48% of the original annual cap under the SHHCC Agreement for the year ending 31 December 2018 has already been utilised.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

2. Reasons for the 2018 Annual Cap Revision

The need for the 2018 Annual Cap Revision

As disclosed in the Board Letter, based on the business volume, growth and production capacity of the Group and its business needs and operating conditions and the general economic outlook of the industry and the PRC, the Board proposes to revise the annual cap for the year ending 31 December 2018 as follows:

	Original annual cap (RMB'000)	Proposed revised annual cap (RMB'000)
For the year ending 31 December 2018	120,000	200,000

Note: the figures are tax-exclusive.

Save for the abovementioned proposed revision of the annual cap for the year ending 31 December 2018, the transactions provided for under the SHHCC Agreement remain unchanged in all respects and all arrangements in relation thereto including without limitation the internal control measures and procedures and pricing mechanism previously disclosed in the 2015 Circular continue to remain in full force and effect.

Our investigation into such need

As disclosed in the 2017 Annual Results, the Company expects to put greater effort in the development of bulk drugs market to expand its sales. As a result, it is believed that there will be a significant increase in the consumption of the Chemical Products.

In this connection, we have conducted research and noted from the publication named 《2017年1–9月醫藥工業主要經濟指標完成情況》(Status of main economic indicators of the pharmaceutical industry from January to September of year 2017*) released by the Ministry of Industry and Information Technology of the PRC (the “MIIT”) that, for the period from January to September of year 2017, (i) the total revenue of the pharmaceutical production industry amounted to approximately RMB2,293.65 billion, representing a growth of approximately 11.70%; and (ii) the total profit of the pharmaceutical production industry amounted to approximately RMB255.73 billion, representing an increase of approximately 17.54%, when compared to the respective figures for the corresponding period in the preceding year. We consider that the industry had been growing and are not aware of any factor which may impede its future development. Having considered the growth in and profitability of the industry as discussed above, we are of the view that the Company’s plan to (i) continue the development of bulk drugs market; (ii) expand the sales of bulk drugs; and its expectation to (iii) increase the consumption of the Chemical Products are fair and reasonable.

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Furthermore, as disclosed in the 2016 Annual Report and 2017 Annual Results, the operating income of the Group had been increasing between year 2012 and year 2017 (2012: RMB3,248.48 million; 2013: RMB3,391.23 million; 2014: RMB3,589.75 million; 2015: RMB3,597.03 million; 2016: RMB4,014.96 million; and 2017: RMB4,515.72 million). The net profit assigned to the Shareholders had also been increasing between year 2012 and year 2017 (2012: RMB30.84 million; 2013: RMB39.15 million; 2014: RMB50.73 million; 2015: RMB83.06 million; 2016: RMB122.27 million; and 2017: RMB209.59 million). Based on the above, we consider that alongside the growth in and profitability of the pharmaceutical production industry as discussed in the previous paragraph, the Group had been able to capture such business opportunities and achieve satisfactory financial performance during the years. We are not aware of any factor which may hinder the Group to take advantage of the growing trend in the pharmaceutical production industry and expand its sales.

In light of (i) the growth in and profitability of the pharmaceutical production industry; and (ii) that the Group had been able to capture the growth in the industry and we have no reason to doubt the Group's ability to continue to do so, we believe the Group's plan to develop and expand the sales of bulk drugs is fair and reasonable and could further strengthen the Group's operation results and fuel its growth. Therefore, we concur with the Board that the 2018 Annual Cap Revision is needed for the Group to cope with the increased demand for the Chemical Products and is in the interest of the Company and the Disinterested Shareholders as a whole.

The amount of the 2018 Annual Cap Revision

According to the Board Letter, the 2018 Annual Cap Revision is primarily due to:

- (i) the Group's expected increase in procurement under the SHHCC Agreement of up to approximately RMB50 million in view of the expanding business volume and growth of the Group and the business needs deriving therefrom and the industry outlook as derived from the economic figures of year 2017;
- (ii) an expected further increase of approximately RMB30 million in the transactional amount under the SHHCC Agreement in view of the anticipated substantial rise in the market prices of the Chemical Products in comparison of those of 2017; and
- (iii) the needs to secure a steady supply of Chemical Products and to control the rise in intermediary costs in sourcing and procurement amidst the abovementioned expanding business scale and rise in market prices of the Chemical Products.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

Our investigation into the Board's view on controlling intermediary costs

As advised by the management of the Company, the Group has also been procuring some of the Chemical Products from independent suppliers other than SHHCC and/or its subsidiaries. Nonetheless, due to the implementation of the Notice (as defined below), the supply of the Chemical Products in the market has decreased, and it takes more time for the Group to source and engage independent suppliers for the procurement of the Chemical Products. The relevant transaction costs of the Group are hence expected to increase.

With reference to the publication named 《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 distorting peak heating production by the pharmaceutical production industry in Beijing, Tianjin and the surrounding areas for year 2017 to 2018*, the “**Notice**”) jointly issued by the MIIT, Ministry of Ecology and Environment of the PRC (“**MEE**”), National Health Commission of the PRC and State Administration for Market Regulation of the PRC dated 6 November 2017, the PRC government (i) expected to fulfill the air pollution control requirement under the publication 《京津冀及周邊地區2017–2018年秋冬季大氣污染綜合治理攻堅行動方案(環大氣[2017]110號)》(Action plan for comprehensive prevention of air pollution in the autumn and winter of year 2017 to 2018 in Beijing, Tianjin and the surrounding areas (2017 No.110)*) issued by the MEE dated 21 August 2017; and (ii) ordered that from 15 November 2017 to 15 March 2018, the pharmaceutical production companies in Beijing, Tianjin, Hebei Province, Shanxi Province, Shandong Province and Henan Province (the “**Cities**”) which would discharge volatile organic compounds during the chemical raw materials/pharmaceutical products production were prohibited to continue the relevant production, unless they were for public use and approved by the local government. As a result, the supply of the Chemical Products in the Cities was adversely affected, and with the tight supply of the Chemical Products, the relevant prices also increased.

Further to studying the aforesaid documents, we have enquired the Company and understood that (i) it is inevitable to discharge volatile organic compounds during the production of most of the Chemical Products, and hence the production of the Chemical Products by most of the companies was prohibited during the period from 15 November 2017 to 15 March 2018 as covered in the Notice (the “**Notice Period**”) which directly impacted and lowered the supply of the Chemical Products in the market during the Notice Period; and (ii) independent suppliers of the Chemical Products of the Company (which does not include SHHCC) are generally retailers only who do not produce the Chemical Products themselves, and their supply of the Chemical Products was adversely affected during the Notice Period as it became more difficult and/or costly for them to source the Chemical Products from other relevant suppliers in the market. Having considered the above and the Notice, we concur with the Board's view that the implementation of the Notice has lowered the supply of the Chemical Products in the market, particularly those by the Company's suppliers (excluding SHHCC). We further understand that the Company's procurement from independent suppliers has to flow through several parties. With lowered supply of the Chemical

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Products in the market, it would be more time consuming and a higher cost for the Company to procure the Chemical Products from independent suppliers as the Company may need to approach more independent suppliers before securing a sufficient amount of Chemical Products for its needs, and higher transaction costs would be incurred for the Group to engage independent suppliers during the Notice Period. In spite of the recent lapse of the Notice Period, we are of the view that there is no guarantee the PRC government will not implement similar policies from time to time in the future.

Alternatively, we have conducted research on SHHCC and noted that it is a listed company on the Shanghai Stock Exchange (stock code: 600426) with a market capitalisation of over RMB30 billion as at the Latest Practicable Date. We understand from the Company that the production of SHHCC complies with the requirement of the local government and thus SHHCC was not prohibited to continue the production of the Chemical Products during the Notice Period. We have also reviewed the annual report of SHHCC for the year ended 31 December 2017 published on the website of the Shanghai Stock Exchange (<http://www.sse.com.cn/>) and noted that SHHCC recorded inventories, which primarily comprised chemical-related raw materials and products, of approximately RMB520.97 million and RMB406.11 million as at 1 January 2017 and 31 December 2017, respectively. Based on the large scale of operation and production of SHHCC, the fact that its production complies with the requirement of the local government and it was not prohibited to produce the Chemical Products during the Notice, and the sufficient level of inventories of SHHCC, we consider that SHHCC will be less likely to be affected by policies like the Notice, and can maintain a relatively stable production and supply level of the Chemical Products. Hence we concur with the Board's view that the Group could obtain a stable supply of the Chemical Products from SHHCC without the need to incur significant extra transaction costs in identifying and procuring from other independent suppliers. Accordingly, we believed that the 2018 Annual Cap Revision is fair and reasonable so far as the Disinterested Shareholders are concerned.

Our investigation into the Board's view on the anticipated rise in the market prices of the Chemical Products

Pursuant to the SHHCC Agreement, the Group sources the Chemical Products through suppliers who are participants in the Bidding Website (www.ebnew.com). 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. It was given the top creditability ranking "AAA" in year 2016 by Internet Security of China (中國互聯網協會), which was established on 25 May 2001 and is governed by the MIIT. The Bidding Website is a public bidding platform which provide information in respect of the prevailing market prices for the products and services at a given time. As confirmed by the Company, the Group is independent from the Bidding Website and its providers. Based on the above, we consider that the Bidding Website is a reliable reference to the prevailing market prices for the goods and services contained therein.

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As set out in the SHHCC Agreement, the Company places requests for the Chemical Products and then obtain bidding prices offered by various suppliers which may include SHHCC and/or its subsidiaries. We have obtained more than 20 randomly selected samples of procurement records of the Company from both SHHCC and other independent suppliers and studied the procurement prices of the relevant Chemical Products for the period from March 2017 to March 2018. We believe such method enables us, and the number of the samples is sufficient for us, to understand the movement in procurement prices from both major suppliers and minority suppliers of the Group while maintaining an unbiased selection basis which we consider to be fair and reasonable for comparison purpose. We noted that the Group mainly sources acetic anhydride, monomethylamine and acetic acid through the Bidding Website and the bidding prices of acetic anhydride, monomethylamine and acetic acid as at 31 March 2018 have increased by approximately 26.7%, 17.0% and 148.0%, respectively (as calculated with the lowest bidding price), when comparing to those as at 31 March 2017. In particular, such bidding prices have increased by approximately 27.0%, 16.9% and 20.2% respectively during the Notice Period. The management of the Company considers, and we concur, that the significant rise in the bidding prices of the relevant Chemical Products could be attributed to the reduced supply of the Chemical Products in the Cities as a result of the implementation of the Notice.

Having considered that (i) it is reasonable to suggest the implementation of the Notice could have pushed up the prices of the Chemical Products; and (ii) as shown in the quotation record of the Bidding Website, the bidding prices of acetic anhydride, monomethylamine and acetic acid as at 31 March 2018 indeed represent a significant increase when compared to those as at 31 March 2017, in particular during the Notice Period, we concur with the Board's anticipation of rise in the market prices of the Chemical Products for the year ending 31 December 2018.

Our investigation into the Board's view on determining the amount of the 2018 Annual Cap Revision

We have enquired with the Company and understood that the proposed revised annual cap of approximately RMB200 million for the year ending 31 December 2018 under the SHHCC Agreement has been determined with reference to the estimated transaction amount of the Chemical Products for the same year, which was estimated by the management of the Company using (i) the historical transaction amount under the SHHCC Agreement, being the sum of the multiple of each Chemical Product's historical price and historical volume, of approximately HK\$98.29 million for the year ended 31 December 2017 as the base number; with markups on (ii) the price which differ among different Chemical Products; and (iii) the volume which also differ among different Chemical Products. When determining the estimated markups, the management of the Company has taken into account, among others, the market conditions and outlooks of the industry, the business and operation volume and growth of the Group. In this sense, the estimated amount is approximately RMB192.03 million, and among the difference between this estimated amount and the historical transaction amount for the year ended 31 December 2017, approximately one-third was attributable to the markups on prices and the remaining approximately two-third was attributable to the markups on volumes.

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We consider that it is fair and reasonable to use the latest historical transaction amount as base number because it represented actual transaction prices and volumes of the Chemical Products for the year ended 31 December 2017.

Further, we note that the estimated markups on the prices of the Chemical Products are generally in line with the rise in bidding prices of the relevant Chemical Products observed by us through the procurement records of the Company. We hence consider this estimated markups on the prices of the Chemical Products to be justifiable.

Regarding the estimated markups on the volumes of the Chemical Products, we are aware that the management of the Company has been based on their experience in the industry and has generally taken into account the market conditions and the Group's own business needs. We have also studied the market and economic outlooks of the industry as well as the Group's business growth and development, details of which are set out in the sub-section headed "The need for the 2018 Annual Cap Revision – Our investigation into such need" in the above, and concur with the Board's view on the Group's business needs on the Chemical Products. We have no reason to doubt the management's estimation of the markups on the volume of the Chemical Products.

Based on the above, we consider that the estimated transaction amount of the Chemical Products of approximately RMB192.03 million for the year ending 31 December 2018 is justifiable. We further consider that it is appropriate to add some buffer to such estimated amount. As a result, we are of the view that the amount of the 2018 Annual Cap Revision, being RMB200 million for the year ending 31 December 2018, is fair and reasonable.

Summary of our review on the reasons for the 2018 Annual Cap Revision

To summarise our review on the reasons for the 2018 Annual Cap Revision, we have:

- (i) researched on the market conditions and economic outlooks of the industry through the publication 《2017年1–9月醫藥工業主要經濟指標完成情況》 (Status of main economic indicators of the pharmaceutical industry from January to September of year 2017*) released by the MIIT and found that the pharmaceutical production industry was growing in terms of total revenue and total profit. On the other hand, we have also studied the business volume, growth and production capacity of the Group by reviewing the 2016 Annual Report and 2017 Annual Results and analysing the Group's operating income and net profit. Having considered both of the above, we are of the view that the Group has been able to continuously capture market opportunities and that the Company's plan to put greater effort in the development of bulk drugs market and to expand its sales is justifiable and fair and reasonable;

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- (ii) studied the Notice and obtained the understanding from the Company that the Notice lowered the supply of the Chemical Products in the market and increased the Group's transaction costs for engaging independent suppliers. Alternatively, we consider that, after studying information on SHHCC's operation and inventories as mentioned above, it is less likely for SHHCC to be affected by policies like the Notice, and can maintain a relatively stable production and supply level of the Chemical Products such that by procuring from it, the Group can reduce the intermediary costs which would otherwise be incurred if the Group had to engage various independent suppliers;
- (iii) obtained randomly selected samples of procurement records of the Company from both SHHCC and other independent suppliers on an unbiased basis and found that the procurement prices of various Chemical Products have increased between 31 March 2017 and 31 March 2018; and
- (iv) studied the basis of the Company's management on determining the amount of the 2018 Annual Cap Revision which is analysed in the previous sub-section. We understand that the Company's management has made reference to the market conditions and the Group's own business development and needs when determining such amount.

As a result of all the above, we consider that the 2018 Annual Cap Revision is fair and reasonable and in the interest of the Company and the Disinterested Shareholders as a whole, and that the terms thereunder are also justifiable and hence fair and reasonable.

3. Our review on the internal control policies in relation to the 2018 Annual Cap Revision

We note that the Company has adopted various policies to monitor the pricing and quality of Chemical Products procured from the Group's suppliers including SHHCC from time to time. Details of such policies are set out in the paragraph headed "Information on SHHCC and the SHHCC Agreement – Pricing of the SHHCC Agreement" in this letter. We consider that such policies could help the Group obtain the best available bidding prices when procuring the Chemical Products and ensure satisfactory quality of the Chemical Products at the same time.

We also understand from the management of the Company that, for the purpose of the 2018 Annual Cap Revision, the Group would continue to adopt the internal control policies (the "IC Policies") under the SHHCC Agreement. In particular, the primary purpose of the IC Policies is to ensure the Group's conformity with the pricing policies of, among others, the SHHCC Agreement from time to time. The IC Policies would continue to be conducted and supervised by the financial department, office of the Board, the independent non-executive Directors and the audit department of the Group.

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In respect of the procurement for the Chemical Products, the Company has established the procurement committee consisting of representatives from the audit department, the production department, the quality assurance department, the procurement department and the finance department. The production department will communicate with the procurement department to evaluate the inventory level of raw materials for the production of products at the end of each month. When procurement for the Chemical Products is considered to be necessary, the procurement department will prepare and submit procurement requests to the head of the financial department for review and approval. After obtaining the approval from the head of the financial department, the procurement committee will then place the procurement requests on the Bidding Website and then obtain the bidding prices offered by various suppliers including but not limited to SHHCC and/or its subsidiaries. The procurement committee will seek quotations from at least three suppliers unrelated to and independent from each other (which may include SHHCC and/or its subsidiaries) and review and compare the prices and terms among them and with market information. By this bidding process, the Company can ensure that the prices and terms offered by SHHCC are comparable to the prevailing market price and that they are not less favorable than those offered by other independent suppliers. Upon the advice from the procurement committee, (i) the head of the department of audit, (ii) the head of the department of production, (iii) the head of the quality assurance department, (iv) the head of the department of procurement and (v) the head of the finance department will discuss and approve which supplier to be selected.

To further enhance the IC Policies, the Group has also assigned specific personnel to regularly monitor the total transaction amount under the SHHCC Agreement to ensure that it will not exceed the revised annual cap proposed under the 2018 Annual Cap Revision.

Having reviewed the above and considered that (i) the Group adopts a bidding process when procuring the Chemical Products and the procurement committee will seek quotations from at least three suppliers unrelated to and independent from each other (which may include SHHCC and/or its subsidiaries), followed by review and comparison between each other and with market information; (ii) the procurement committee will then submit the quotations to the five heads of department appointed by the Group with reasonable experience and qualifications, details of which are explained in the Board Letter; (iii) the Group has assigned specific personnel to regularly monitor the total transaction amount under the SHHCC Agreement; and (iv) the IC Policies would continue to be conducted and supervised by various members of the Company's management, we consider that the Group can obtain best bidding prices under the SHHCC Agreement and concur with the Directors that the IC Policies can ensure the Group's conformity with the pricing policies of the SHHCC Agreement from time to time and that the revised annual cap proposed under the 2018 Annual Cap Revision would not be exceeded. We believe that the interest of the Disinterested Shareholders can be safe guarded under such circumstances.

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RECOMMENDATION

Taking into consideration that (i) a high utilisation rates of the original annual caps under the SHHCC Agreement for the two years ended 31 December 2017 and the three months ended 31 March 2018; (ii) the expected increase in the Company's demand for the Chemical Products; (iii) the decreased supply of the Chemical Products due to the implementation of the Notice; (iv) the transactions under the SHHCC Agreement could allow the Company to obtain a stable supply of the Chemical Products and help the Company to save transaction costs which would have been incurred if the Company need to identify and procure the Chemical Products from other independent suppliers; (v) under the SHHCC Agreement, the Group will source the Chemical Products from various suppliers including but not limited to SHHCC and/or its subsidiaries through the Bidding Website, which we consider to be a fair and reliable reference to the prevailing market prices thereof; (vi) the 2018 Annual Cap Revision has taken into account the increase in the market prices of the relevant Chemical Products; (vii) the basis of the Company's management on determining the amount of the 2018 Annual Cap Revision is justifiable; and (viii) the IC Policies have been well in place and will continue to apply which we consider to be acceptable, we are of the view that the 2018 Annual Cap Revision is fair and reasonable, and in the interests of the Company and its Shareholders as a whole. Accordingly, we advise the Independent Board Committee to recommend, that the Disinterested Shareholders vote in favour of the relevant resolution for approving the 2018 Annual Cap Revision to be proposed at the general meeting be convened and held to, among other things, seek Disinterested Shareholders' approval of the 2018 Annual Cap Revision.

Yours faithfully,

For and on behalf of

China AF Corporate Finance Limited

Kevin Chan

Director

Mr. Kevin Chan 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 Royal Excalibur Corporate Finance Company Limited and has over 19 years of experience in corporate finance industry.

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 of which omission 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	146,429 (Note 2)	0.031
Mr. Ren Fulong	116,591 (Note 3)	0.024
Mr. Du Deping	44,843 (Note 3)	0.009
Mr. Xu Lie	62,780 (Note 3)	0.013
Supervisors		
Mr. Li Tianzhong	71,748 (Note 3)	0.015
Ms. Hu Yanhua	26,905 (Note 3)	0.006

Notes:

1. Rounded to the nearest three decimal places.
2. Of the 146,429 A Shares, 11,900 A Shares were held personally by Mr. Zhang Daiming and 134,529 A Shares by 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 2018 Annual Cap Revision.

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	157,587,763	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 13,686,000 H Shares or approximately 2.86% of the total issued shares of the Company as of the Latest Practicable Date. Upon issuance of the New Shares under the Capital Reserve Capitalisation and assuming that there will be no change in their respective shareholdings in the Company before completion thereof, SXPGC and Well Bring Limited are expected to own 204,864,092 A Shares and 17,791,800 H Shares respectively. There will be no change as to the abovementioned percentages which their respective shareholdings represent of the total enlarged issued Shares.

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
China AF Corporate Finance 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, China AF Corporate Finance Limited 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, China AF Corporate Finance Limited 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 AGM and the class meetings shall be taken by poll.

10. DOCUMENTS AVAILABLE FOR INSPECTION

Copies of the SHHCC Agreement, the Articles of Association, the written consent from China AF Corporate Finance Limited referred to in the paragraph headed “7. Consent of Expert” in this appendix, the resolutions of the third regular meeting of the ninth session of the Board and the resolutions of the third extraordinary meeting of the ninth session of the Board 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 public holidays) from the date of this circular up to and including the date of the AGM and the class meetings.

SUPPLEMENTAL NOTICE OF AGM



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)

SUPPLEMENTAL NOTICE OF ANNUAL GENERAL MEETING

Reference is hereby made to the notice (the “**Initial Notice**”) of the annual general meeting (the “**AGM**”) of Shandong Xinhua Pharmaceutical Company Limited (the “**Company**”) dated 15 May 2018 which set out the resolutions to be considered and, if thought fit, approved by shareholders of the Company at the AGM to be held at 2:00 p.m. on Friday, 29 June 2018 at the Company’s conference room at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, the People’s Republic of China. This supplemental notice (the “**Supplemental Notice**”) shall be read together with the Initial Notice.

Unless otherwise stated, capitalised terms used in this Supplemental Notice shall have the same meanings as those defined in the Initial Notice.

SUPPLEMENTAL NOTICE IS HEREBY GIVEN that the AGM, to be held on the same date, at the same time and at the same place as scheduled in the Initial Notice, will consider and, if thought fit, approve the following ordinary resolution in addition to the resolutions set out in the Initial Notice:

ORDINARY RESOLUTION

10. To consider and approve the appointment of Mr. Lo Wah Wai as an independent non-executive director of the ninth session of the Board. ^{Note 10}

By Order of the Board
Shandong Xinhua Pharmaceutical Company Limited
Zhang Daiming
Chairman

8 June 2018, Zibo, PRC

SUPPLEMENTAL NOTICE OF AGM

Notes:

1. Please refer to the Initial Notice for details of other resolutions to be proposed at the AGM, closure of register of members in relation to the Meetings, qualification of the Shareholders for attending the AGM, registration procedures for attending the AGM and other relevant matters.
2. As the initial proxy form for the AGM (the “**Initial Proxy Form**”) which was sent together with the Initial Notice does not contain the additional resolution as set out in this Supplemental Notice, a revised proxy form for the AGM (the “**Revised Proxy Form**”) is sent together with this Supplemental Notice. Any H Shareholder who intends to appoint a proxy to attend the AGM and have not lodged the Initial Proxy Form is required to complete and lodge the Revised Proxy Form in accordance with the instructions printed thereon and lodging the Initial Proxy Form is not required. The Revised Proxy Form should be lodged to the office of the secretary to the Board (see Note 6 below) or with Hong Kong Registrars Limited, the share registrar for the Company’s H Shares, at 17M Floor, Hopewell Centre, 183 Queen’s Road East, Wanchai, Hong Kong. The Revised Proxy Form should be lodged no less than 24 hours before the time for the holding of the AGM (or any adjournment thereof) (the “**Closing Time**”).
3. Any H Shareholder who has already lodged the Initial Proxy Form with the Company should note that:
 - (i) where no Revised Proxy Form is lodged, the Initial Proxy Form, if duly completed in compliance with the instructions printed thereon and lodged before the Closing Time, will be treated as a valid proxy form lodged by such H Shareholder. The proxy so appointed by the H Shareholder will be entitled to vote or to abstain from voting on any resolution put to the AGM, including to vote or abstain at his/her discretion on the resolution as set out in this Supplemental Notice.
 - (ii) if a Revised Proxy Form duly completed in compliance with the instructions printed thereon is lodged before the Closing Time, the Initial Proxy Form previously lodged by the H Shareholder will be revoked and superseded. The Revised Proxy Form will then be treated as a valid proxy form lodged by the H Shareholder.
 - (iii) if the Revised Proxy Form is lodged after the Closing Time or is lodged before the Closing Time but is otherwise not in compliance with the instructions printed thereon, the Revised Proxy Form will be invalid, but any Initial Proxy Form duly completed in compliance with the instructions printed thereon and previously lodged before the Closing Time will entitle the proxy so appointed to vote in the manner as provided for in Note 3(i) above as if no Revised Proxy Form was lodged.
4. Shareholders entitled to attend and vote at the AGM may appoint one or more proxies (whether the person is a Shareholder or not) to attend and vote on his/her/its behalf at the AGM. When a Shareholder appoints more than one proxy, such proxies may only vote by way of poll.
5. Shareholders may only appoint a proxy or proxies in writing (i.e. in respect of H Shareholders, the Revised Proxy Form despatched to the H Shareholders together with this Supplemental Notice or a copy of it), which shall be in compliance with the instructions thereon and signed by the person appointing the proxy or proxies or by his/her/its duly authorised attorney. If the Revised Proxy Form is signed by an attorney, the document appointing the attorney must be certified by a notary public. If the appointing H Shareholder is a legal entity, its seal or the signature of its director(s) or representative(s) duly authorised in writing is required. To be valid, a notarially certified power of attorney or other authority (if any) and the Revised Proxy Form must be received by the office of the secretary to the Board (see Note 6 below) or the share registrar for the Company’s H Shares (see Note 2 above) 24 hours prior to the commencement of the AGM. The completion and deposit of the Revised Proxy Form will not preclude any Shareholder from attending and voting in person at the AGM or any adjournment thereof.

SUPPLEMENTAL NOTICE OF AGM

6. The address of the office of the secretary to the Board is as follows:
- No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC
Postal Code: 255086
Telephone: 86 533 2196024
Facsimile: 86 533 2287508
7. Shareholders or their proxies shall present proof of identity upon attending the AGM. Should a proxy be appointed, the proxy shall also present his/her form of proxy.
8. All references to time herein refer to Hong Kong time.
9. This Supplemental Notice and the Revised Proxy Form enclosed herewith apply to H Shareholders only; for the arrangements applicable to the A Shareholders, please refer to the notice(s) to A Shareholders published by the Company on the website of the Shenzhen Stock Exchange on 15 May 2018 and the supplemental notice(s) to A Shareholders of even date with this Supplemental Notice.
10. The biographical details and the details of the proposed appointment of Mr. Lo Wah Wai have been set out in the announcement of the Company dated 17 May 2018. Having considered each of the factors referred to in Rule 3.13 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “**Listing Rules**”) and given that the Board is not aware of any past or present financial or other interest of Mr. Lo in the business of the Group, any connection between Mr. Lo and the close connected persons of the Company or of any other factors that may affect Mr. Lo’s independence from the Company, the Board considers Mr. Lo to be independent under the meaning of Rule 3.13 of Listing Rules and believes Mr. Lo, a practising member of the Hong Kong Institute of Certified Public Accountants and a member of the American Institute of Certified Public Accountants, should be elected for filling the upcoming vacancy resulting from Mr. Chan Chung Kik, Lewis’ resignation from independent non-executive directorship of the Company and the chairmanship and membership of the Audit Committee and the Remuneration and Examination Committee of the Board respectively. For details of the resignation of Mr. Chan Chung Kik, Lewis, please refer to the announcement of the Company dated 25 April 2018.

DOCUMENTS AVAILABLE FOR INSPECTION

- a. Resolutions passed at the third regular meeting of the ninth session of the Board; and
- b. Resolutions passed at the third extraordinary meeting of the ninth session of the Board for year 2018.

As at the date hereof, the Board comprises:

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. Du Guanhua
Mr. Li Wenming
Mr. Chan Chung Kik, Lewis