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**THIS CIRCULAR IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION**

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**If you are in any doubt** about this circular or as to the action to be taken, you should consult your stockbroker, 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)

**CONTINUING CONNECTED TRANSACTIONS  
AND THE PROPOSED ANNUAL CAPS**

**Independent Financial Adviser to  
the Independent Board Committee and the Independent Shareholders**

**VEDA | CAPITAL**  
**智 略 資 本**

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A letter from the Board is set out on pages 1 to 8 of this circular. A letter from the Independent Board Committee containing its recommendations in respect of the Continuing Connected Transactions is set out on pages 9 to 10 of this circular. A letter from Veda Capital, the independent financial adviser, containing its advice to the Independent Board Committee and the Independent Shareholders is set out on pages 11 to 20 of this circular.

A notice convening an extraordinary general meeting of the Company to be held at the Company's conference room at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, The People's Republic of China on Friday, 16 August 2013 at 9:00 a.m. together with the form of proxy and reply slip were issued on 2 July 2013. Whether or not you are able to attend the meeting, we encourage you to complete and return the form of proxy 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 the extraordinary general meeting to the company secretary's office of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, The People's Republic of China.

Completion and return of the form of proxy will not preclude you from attending and voting at the meeting should you so wish.

30 July 2013

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## DEFINITIONS

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

|                                     |   |
|-------------------------------------|---|
| “Agreement”                         | the chemical product supply agreement entered into between the Company and Hualu Hengsheng on 28 June 2013 commencing from the date when approval thereof has been obtained both at the EGM and at Hualu Hengsheng’s board meeting (or shareholders’ meeting) and ending on 31 December 2015; |
| “Articles of Association”           | the articles of association of the Company;   |
| “Board”                             | the board of Directors;   |
| “Company”                           | 山東新華製藥股份有限公司 (Shandong Xinhua Pharmaceutical Company Limited), a joint stock company incorporated in the PRC with limited liability;  |
| “Continuing Connected Transactions” | the purchase of certain chemical products by the Group from Hualu Hengsheng and/or its subsidiaries under the Agreement;  |
| “Directors”                         | the directors of the Company including independent non-executive Directors;   |
| “EGM”                               | the extraordinary general meeting of the Company to be held on 16 August 2013 for the purpose of approving the Continuing Connected Transactions and the proposed annual caps under the Agreement;  |
| “Group”                             | the Company and its subsidiaries;   |
| “HHGC”                              | means 華魯控股集團有限公司 (Hualu Holdings Group Company Limited), a wholly state-owned company, the controlling shareholder of SXPGC and SHHGC;  |
| “Hong Kong”                         | Hong Kong Special Administrative Region of the PRC;   |
| “HK\$”                              | Hong Kong dollars, the lawful currency of Hong Kong;  |
| “Hualu Hengsheng”                   | means 山東華魯恒升化工股份有限公司 (Shandong Hualu Hengsheng Chemical Company Limited), a subsidiary of SHHGC;  |

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## DEFINITIONS

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|-------------------------------|--|
| “Independent Board Committee” | the independent board committee of the Company comprising three independent non-executive Directors, which is constituted for the purpose of considering the Agreement and the proposed annual caps thereunder;  |
| “Independent Shareholders”    | the Shareholders other than SXPGC and its associates (as defined under the Listing Rules);   |
| “Latest Practicable Date”     | 24 July 2013, being the last practicable date prior to printing of this circular for ascertaining certain information contained herein;  |
| “Listing Rules”               | the Rules Governing the Listing of Securities on the Stock Exchange;   |
| “PRC”                         | the People’s Republic of China;  |
| “RMB”                         | Renminbi, the lawful currency of the PRC;  |
| “SFO”                         | the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong);   |
| “Shareholders”                | the shareholders of the Company;   |
| “SHHGC”                       | means 山東華魯恒升集團有限公司 (Shandong Hualu Hengsheng Group Company Limited), a wholly-state-owned company via HHGC and holds and owns 31.15% of the total issued share capital of Hualu Hengsheng and is currently the largest shareholder of Hualu Hengsheng; |
| “Stock Exchange”              | The Stock Exchange of Hong Kong Limited;   |
| “Supervisors”                 | the supervisors of the Company;  |
| “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 holds and owns 36.32% of the total issued share capital of the Company and is currently the largest shareholder of the Company;              |

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## DEFINITIONS

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|                |   |
|----------------|---|
| “Veda Capital” | Veda Capital Limited, a licensed corporation to carry out type 6 regulated activities under the SFO, the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in relation to the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement; and |
| “Zibo”         | Zibo City, situated in Shandong Province of the PRC.  |



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  
Mr. Zhao Songguo

*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. Zhu Baoquan  
Mr. Bai Huiliang  
Mr. Kwong Chi Kit, Victor

30 July 2013

*To the Shareholders*

Dear Sir or Madam,

**CONTINUING CONNECTED TRANSACTIONS  
AND THE PROPOSED ANNUAL CAPS**

**I. INTRODUCTION**

The purpose of this circular is to provide you with the information regarding resolutions to be proposed at the EGM in relation to the Agreement and the proposed annual caps in respect of the Continuing Connected Transactions under the Agreement.

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## LETTER FROM THE BOARD

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### II. CONTINUING CONNECTED TRANSACTIONS AND PROPOSED ANNUAL CAPS

#### A. Background Information

On 28 June 2013, the Company and Hualu Hengsheng entered into the Agreement pursuant to which the Group agrees to purchase from Hualu Hengsheng and/or its subsidiaries and Hualu Hengsheng and/or its subsidiaries agree to supply to the Group chemical products such as Acetic acid (醋酸) and Acetic anhydride (酞酐) at market prices. An announcement was made on 28 June 2013.

#### B. The Agreement

**Date:** 28 June 2013

**Parties:** (i) the Company

(ii) Hualu Hengsheng

##### *Principal terms and conditions*

The terms of the Agreement have been arrived at after arm's length negotiation between the Company and Hualu Hengsheng and are on normal commercial terms. The principal terms and conditions are as follows:

1. The term of the Agreement is for a term commencing from the date when approval thereof has been obtained both at the EGM and at Hualu Hengsheng's board meeting (or shareholders' meeting) and ending on 31 December 2015.
2. The selling prices for the chemical products charged by Hualu Hengsheng and/or its subsidiaries shall be determined at market prices.
3. Under the same conditions, Hualu Hengsheng and/or its subsidiaries shall provide the chemical products to members of the Group in priority to other purchasers of the products.
4. Under the same conditions, the Group shall purchase the chemical products from Hualu Hengsheng and/or its subsidiaries in priority to other independent third parties.
5. Either the Company or Hualu Hengsheng is entitled to terminate the Agreement with three-month prior written notice.

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## LETTER FROM THE BOARD

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### *Payment terms*

The chemical products purchased under the Agreement will be delivered to the Group upon receipt of payments made by the Group to Hualu Hengsheng and/or its subsidiaries in relation to such products.

### *Proposed annual caps for the Agreement*

The proposed annual caps for the Continuing Connected Transactions under the Agreement for the three years ending 31 December 2015 are set out below:

|                      | <b>2013</b><br><i>(RMB'000)</i> | <b>1 January 2014 –<br/>31 December 2014</b><br><i>(RMB'000)</i> | <b>1 January 2015 –<br/>31 December 2015</b><br><i>(RMB'000)</i> |
|----------------------|---------------------------------|--|--|
| Proposed annual caps | <u>70,000</u>                   | <u>150,000</u>   | <u>200,000</u>   |

In arriving at the above proposed annual caps, the Directors have taken into account the following factors:

- (a) the historical amount of the relevant chemical products the members of the Group placed with other independent suppliers. The historical transaction amount in 2011, 2012 and the six months period from January to June 2013 are RMB127,263,861, RMB141,756,453 and RMB68,750,000 respectively;
- (b) the projected demand for the relevant products by the members of the Group;
- (c) the business development of the members of the Group;
- (d) the projected increase in the market prices of the relevant chemical products; and
- (e) the fact that the transactions under the Agreement will only commence in the second half of 2013 subject to the Independent Shareholders' approval.



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## LETTER FROM THE BOARD

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On basis of the above, it is estimated that:

- (a) the demand for the relevant chemical products by the members of the Group in 2014 may be slightly more than double of that in the second half of 2013;
- (b) the demand for the relevant chemical products by the members of the Group may have an approximate 25% increase in 2015 comparing with that of 2014 as a result of the expansion in both market segment (due to the gradual recovery of the global economy subsequent to the 2008 financial crisis) and production volume (due to the implementation of the business plan of the Group to speed up the development of new products);
- (c) the market prices of the relevant chemical products may have an approximate 10% increase in 2015 comparing with that of 2014 due to the fact that the general price of the chemical products has, subsequent to the 2008 financial crisis, been tumbling and reaching a historical low position. It is expected that the chemical product market will soon recover following the recovery of the global economy leading to an increase of price of the chemical products.

### *Reasons for and benefits of the Continuing Connected Transactions under the Agreement*

Pursuant to the Agreement, the selling price for the chemical products charged by Hualu Hengsheng and/or its subsidiaries shall be determined at market price. The “market price” means the prevailing price of the chemical products in the market at the relevant time. In practice, the Company will make reference to the purchase price of similar products offered by other independent third parties so as to ensure that the price of the products offered by Hualu Hengsheng and/or its subsidiaries is in line with the market price. If any chemical product under the Agreement is offered at a lower price by an independent third party, according to the Agreement, the Group is free to purchase such product from that independent third party at the lower purchase price.

As to the payment terms, Hualu Hengsheng offers similar payment terms to other purchasers of the same products. The payment terms offered by other independent third parties to the Group are also very similar to those offered by Hualu Hengsheng. The Board is of the view that the payment terms are in line with the usual market practice and are on normal commercial terms and fair and reasonable.

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## LETTER FROM THE BOARD

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As to other terms of the Agreement, the Board is also of the view that they are on normal commercial terms and fair and reasonable. According to the Agreement, under the same conditions, Hualu Hengsheng and/or its subsidiaries shall provide the chemical products to the members of the Group in priority to other purchasers of the products. Similarly, under the same conditions, the Group shall purchase the Chemical Products from Hualu Hengsheng and/or its subsidiaries in priority to other independent third party. The Board considers this term to be common in similar commercial contracts and is fair and reasonable based on its reciprocity.

By virtue of the Agreement, the Group will be able to purchase the chemical products from Hualu Hengsheng and/or its subsidiaries direct and can therefore reduce the number of intermediaries involved. This is because the Group used to purchase chemical products from various independent suppliers who are chemical products retailers. As a result, in order to ensure that the Group is able to purchase sufficient amount of chemical products and/or a specific kind of chemical product which may be difficult to find in the market, purchasing orders would need to be placed with various different suppliers from time to time. Hualu Hengsheng and/or its subsidiaries are a large chemical product manufacturing group and therefore, by purchasing directly from Hualu Hengsheng and/or its subsidiaries, the Group can obtain the majority of the chemical products it requires instead of buying them through different suppliers thereby reducing the number of intermediaries involved.

The involvement of fewer intermediaries can help reduce the procurement costs relating to the purchase of the chemical products. More transaction costs (such as handling costs, administration costs, etc.) would be incurred by procuring the chemical products from different independent suppliers as each independent supplier charges the Company transaction costs individually. Further, it takes a longer time to obtain products from independent suppliers as this involves placing orders with various different suppliers which makes the entire ordering procedure more lengthy and complicated. Transportation costs can also be reduced as firstly, Hualu Hengsheng and/or its subsidiaries and the Group are more proximate in location as compared to that of independent suppliers and secondly, an economy of scale in relation to the transportation costs can be achieved as under the same condition, the Group would purchase the majority of the chemical products it requires from Hualu Hengsheng and/or its subsidiaries.

Additionally, a stable supply of the products can be maintained as Hualu Hengsheng and/or its subsidiaries are themselves a large chemical product manufacturing group.

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## LETTER FROM THE BOARD

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In view of the above, the Directors consider that the entering into the Agreement is in the best interest of the Company and its shareholders as a whole. They also consider that the Agreement has been negotiated on an arm's length basis and the Continuing Connected Transactions contemplated under the Agreement are entered into in the ordinary and usual course of business on basis of normal commercial terms and that the terms of the Continuing Connected Transactions under the Agreement and the proposed annual caps thereof are fair and reasonable.

### *Connected relationship*

As at the Latest Practicable Date, HHGC holds 100% equity interest of SHHGC. SHHGC holds and owns 31.15% of the total issued share capital of Hualu Hengsheng and is the largest shareholder thereof. HHGC holds 100% equity interest of SXPGC. SXPGC holds and owns 36.32% of the total issued share capital of the Company and is the largest shareholder of the Company. Accordingly, Hualu Hengsheng, being an associate of HHGC, is a connected person of the Company and the transactions contemplated under the Agreement constitute continuing connected transactions under Chapter 14A of the Listing Rules.

### *Implications under the Listing Rules*

In respect of the proposed annual caps under the Agreement for the three years ending 31 December 2015, as one or more of the applicable percentage ratios (as defined in the Listing Rules) exceed 5% and the annual consideration exceeds HK\$10,000,000, the Continuing Connected Transactions contemplated under the Agreement constitute non-exempt continuing connected transactions and are subject to the reporting and announcement requirements under rules 14A.45 to 14A.47 of the Listing Rules, the independent shareholders' approval requirements under rule 14A.48 of the Listing Rules, the annual review requirements under rules 14A.37 to 14A.40 of the Listing Rules and the requirements set out in 14A.35(1) and 14A.35(2) of the Listing Rules.

### *Information about the Company and Hualu Hengsheng*

The Company is mainly engaged in the development, manufacture and sales of bulk pharmaceuticals, preparations and chemicals products.

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

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## LETTER FROM THE BOARD

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### **C. Independent Board Committee**

An Independent Board Committee has been formed to advise the Independent Shareholders in connection with the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

### **III. EXTRAORDINARY GENERAL MEETING**

The Directors have resolved to convene the EGM to consider and approve the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement. Notice of the EGM together with the form of proxy and reply slip were issued on 2 July 2013. Whether or not you are able to attend the EGM, we encourage you to complete and return the form of proxy 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 the EGM, to the company secretary of the Company at No. 1 Lutai Ave., Hi-tech District, Zibo City, Shandong Province, PRC. Completion and return of the form of proxy will not preclude you from attending and voting at the EGM should you so wish.

### **IV. RECOMMENDATION**

The Directors (including the independent non-executive Directors) consider that the approval of the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement are in the best interests of the Company and its Shareholders as a whole and are fair and reasonable as far as the Shareholders are concerned.

The Independent Board Committee comprising independent non-executive Directors of the Company has been appointed to advise the Independent Shareholders on the approval of the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement. Veda Capital has been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in respect of the same.

After taking into account the reasons for and benefits of the Agreement and the opinion of Veda Capital, the Independent Board Committee considers that the approval of the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement are fair and reasonable as far as the Independent Shareholders are concerned. Accordingly, the Independent Board Committee recommends the Independent Shareholders to vote in favour of the resolution to be proposed at the EGM to approve the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

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## LETTER FROM THE BOARD

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All connected persons or Shareholders with a material interest in the transactions and its associates shall abstain from voting in approving the Agreement, and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

**SXPGC is the direct controlling shareholder of the Company and holding 36.32% of the issued share capital of the Company. Pursuant to the Listing Rules, SXPGC and its associates will abstain from voting in the EGM to approve the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement and all matters contemplated thereunder.**

The Independent Shareholders will be asked to consider and, if thought fit, approve by poll the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

Yours faithfully,  
By order of the Board of Directors  
**Shandong Xinhua Pharmaceutical Company Limited**  
**Zhang Daiming**  
*Chairman*



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)

*Independent Non-executive Directors:*

Mr. Zhu Baoquan

Mr. Bai Huiliang

Mr. Kwong Chi Kit, Victor

*Registered Address:*

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

30 July 2013

*To the Independent Shareholders*

Dear Sir or Madam,

**CONTINUING CONNECTED TRANSACTIONS  
AND THE PROPOSED ANNUAL CAPS**

We refer to this circular dated 30 July 2013 issued by the Company to its Shareholders, 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.

As the Independent Board Committee, we have been appointed to advise the Independent Shareholders as to whether, in our opinion, the approval of the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement, are in the interests of the Company and the Shareholders as a whole and whether they are fair and reasonable so far as the Independent Shareholders are concerned. None of the members of the Independent Board Committee have any direct or indirect interest in the Continuing Connected Transactions. In addition, Veda Capital has been appointed as the independent financial adviser to advise you and us on this matter.

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## LETTER FROM THE INDEPENDENT BOARD COMMITTEE

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We wish to draw your attention to (i) the letter of advice from Veda Capital as set out on pages 11 to 20 of this circular; and (ii) the letter from the Board on pages 1 to 8 of this circular, which set out information relating to, and the reasons for and benefits of entering into the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

As the Company's independent Directors, we have discussed with the management of the Company the reasons for and benefits of entering into the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement. We have considered the factors and reasons considered by, and the opinions and recommendations of, Veda Capital as set out on pages 11 to 20 of this circular. We concur with the view of Veda Capital that the Agreement and the annual caps in relation to the Continuing Connected Transactions under the Agreement are entered into in the ordinary and usual course of business of the Company, on normal commercial terms and fair and reasonable so far as the Shareholders are concerned and are in the interests of the Company and the Shareholders as a whole. Accordingly, we recommend the Independent Shareholders to vote in favour of entering into the Agreement and the annual caps in relation to the Continuing Connected Transactions under the Agreement to be proposed at the EGM.

Yours faithfully,

The Independent Board Committee of

**Shandong Xinhua Pharmaceutical Company Limited**

**Mr. Zhu Baoquan, Mr. Bai Huiliang, Mr. Kwong Chi Kit, Victor**

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## LETTER FROM VEDA CAPITAL

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*The following is the full text of the letter from Veda Capital setting out the advice to the Independent Board Committee and the Independent Shareholders in respect of the terms of and proposed annual caps in relation to the Continuing Connected Transactions under the Agreement, which has been prepared for the purpose of inclusion in this circular.*

**VEDA | CAPITAL**  
**智 略 資 本**

**Veda Capital Limited**  
Suite 3711, 37/F  
Tower II, Times Square  
1 Matheson Street  
Causeway Bay  
Hong Kong

30 July 2013

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

Dear Sirs,

### **CONTINUING CONNECTED TRANSACTIONS AND PROPOSED ANNUAL CAPS**

#### **INTRODUCTION**

We refer to our appointment to advise the Independent Board Committee and the Independent Shareholders in respect of the terms of and proposed annual caps in relation to the Continuing Connected Transactions under the Agreement, details of which are set out in the circular to the Shareholders dated 30 July 2013 (the “**Circular**”), of which this letter forms part. Terms used in this letter have the same meanings as defined in the Circular unless the context requires otherwise.

On 28 June 2013, the Company and Hualu Hengsheng entered into the Agreement pursuant to which the Group agrees to purchase from Hualu Hengsheng and/or its subsidiaries and Hualu Hengsheng and/or its subsidiaries agree to supply to the Group certain chemical products such as Acetic acid (醋酸) and Acetic anhydride (酞酐) (the “**Chemical Products**”) at market prices for a period from the date when approval thereof has been obtained both at the EGM and at Hualu Hengsheng’s board meeting (or shareholders’ meeting) and ending on 31 December 2015.



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## LETTER FROM VEDA CAPITAL

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As at the Latest Practicable Date, HHGC holds 100% equity interest of SHHGC. SHHGC holds and owns 31.15% of the total issued share capital of Hualu Hengsheng and is the largest shareholder thereof. HHGC holds 100% equity interest of SXPGC. SXPGC holds and owns 36.32% of the total issued share capital of the Company and is the largest shareholder of the Company. Accordingly, Hualu Hengsheng, being an associate of HHGC, is a connected person of the Company and the transactions contemplated under the Agreement constitute continuing connected transactions under Chapter 14A of the Listing Rules.

The proposed annual caps under the Agreement for the three years ending 31 December 2015, as one or more of the applicable percentage ratios (as defined in the Listing Rules) exceed 5% and the annual consideration exceeds HK\$10,000,000, the Continuing Connected Transactions contemplated under the Agreement constitute non-exempt continuing connected transactions and are subject to the reporting and announcement requirements under rules 14A.45 to 14A.47 of the Listing Rules, the independent shareholders' approval requirement under rule 14A.48 of the Listing Rules, the annual review requirements under rules 14A.37 to 14A.40 of the Listing Rules and the requirements set out in 14A.35(1) and 14A.35(2) of the Listing Rules.

SXPGC and its associates will be required to abstain from voting at the EGM which will be convened and held to seek approval from the Independent Shareholders in relation to the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

The Independent Board Committee has been established to advise the Independent Shareholders on the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

### **BASIS OF OUR OPINION**

In formulating our opinion and advice, we have relied upon accuracy of the information and representations contained in the Circular and information provided to us by the Company, the Directors and the management of the Company. We have assumed that all statements, information and representations made or referred to in the Circular and all information and representations which have been provided by the Company, the Directors and the management of the Company, for which they are solely and wholly responsible, were true at the time they were made and continue to be true as at the Latest Practicable Date. We have also assumed that all statements of belief, opinion and intention made by the Directors in the Circular were reasonably made after due and careful enquiry and were based on honestly-held opinions.

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## LETTER FROM VEDA CAPITAL

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The Directors have collectively and individually accepted full responsibility for the accuracy of the information contained in the Circular and have confirmed, having made all reasonable enquiries, which to the best of their knowledge and belief, there are no other facts the omission of which would make any statements in the Circular misleading. We have no reason to believe that any information and representations relied on by us in forming our opinion is untrue, inaccurate or misleading, nor are we aware of any material facts the omission of which would render the information provided and the representations made to us untrue, inaccurate or misleading. We have not, however, conducted any independent in-depth investigation into the business affairs, financial position or future prospects of the Group, nor have we carried out any independent verification of the information provided by the Directors and management of the Company.

### **PRINCIPAL FACTORS AND REASONS CONSIDERED**

In giving our recommendation to the Independent Board Committee and the Independent Shareholders in respect of the terms of and proposed annual caps in relation to the Continuing Connected Transactions under the Agreement, we have taken into consideration the following principal factors and reasons:

#### **I. Information on the Company and Hualu Hengsheng**

The Company is mainly engaged in the development, manufacture and sales of bulk pharmaceuticals, preparations and chemicals products.

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

#### **II. Background and reasons for the Agreement**

On 28 June 2013, the Company and Hualu Hengsheng entered into the Agreement pursuant to which the Group agrees to purchase from Hualu Hengsheng and/or its subsidiaries and Hualu Hengsheng and/or its subsidiaries agree to supply to the Group the Chemical Products at market prices. As advised by the Company, the Chemical Products are principally utilized on the production of pharmaceutical medicine of the Group.

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## LETTER FROM VEDA CAPITAL

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As noted from the annual report of the Company for the year ended 31 December 2012 (“AR2012”), the profit attributable to the owners of the Company for the year ended 31 December 2012 was approximately RMB22,417,000, representing a decrease of approximately 69.86% from that for the year ended 31 December 2011. Also noted from the AR2012, the market competition of the bulk pharmaceuticals industry is intense and there is no significant improvement in the market demand. In order to remain competitive, the Group will strengthen the hierarchy management of and cooperation with suppliers and further reduce the number of exclusive suppliers. The Group seeks to further reduce procurement costs through improving and standardizing the procurement management measures.

As advised by the Company, the Group currently procures the Chemical Products from more than 10 independent suppliers, who are chemical products retailers dispersed across Shandong. As noted from the Board Letter, by entering into the Agreement, the Group will be able to purchase the Chemical Products from Hualu Hengsheng and/or its subsidiaries directly and can therefore reduce the number of intermediaries involved and the procurement costs thereof where purchases are made through other third parties. We are given to understand from the Directors that procuring the Chemical Products from independent suppliers generally takes longer time of completion as communication has to flow through several parties as the independent suppliers are only retailers and the entire ordering procedure is more complicated as the Company has to place orders to more than 10 different independent suppliers. And sometimes, there is delay of arrival of the Chemical Products due to insufficient inventories, such that the independent suppliers have to re-order which take additional time on the completion. Furthermore, it is advised by the Company that more transaction costs are incurred by procuring the Chemical Products from independent suppliers (i.e. handling costs, transportation costs, administration costs etc.) as each independent supplier charges the Company transaction costs individually. Therefore, the entering into the Agreement will help the Company to cut down the transaction costs and achieve a higher logistical and communication efficiency as the number of suppliers will be significantly reduced such that the ordering procedure can be managed more efficiently, requiring less labor, as well as achieving economic of scale in relation to the transportation cost as Hualu Hengsheng will supply majority of the Chemical Products. In addition, we conducted research on Hualu Hengsheng and understand that it is a listed company on the Shanghai Stock Exchange (stock code: 600426) (<http://www.hl-hengsheng.com/>), a highly reputed large-scale integrated enterprise mainly engaged in manufacturing chemical fertilizers and in chemical industry, and is one of China’s top 500 chemical industrial enterprises. It is believed that the Group procures from Hualu Hengsheng will allow them to achieve a more stable supply in comparison to the independent suppliers as Hualu Hengsheng is a large chemical products manufacturing group.

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## LETTER FROM VEDA CAPITAL

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Having considered (i) the business nature of the Group and Hualu Hengsheng; (ii) the purchasing of the Chemical Products from Hualu Hengsheng helps the Group to reduce procurement costs and the number of intermediaries which directly enhances the overall transaction efficiency; and (iii) the Continuing Connected Transactions allow the Group to achieve a stable and prompt supply of the Chemical Products, we concur with the view of the Directors that the entering into of the Agreement is in the interests of the Company and the Shareholders as a whole.

*Principal terms of the Agreement*

**Date:** 28 June 2013

**Parties:** (i) the Company

(ii) Hualu Hengsheng

*Principal terms and conditions*

As noted in the Board Letter, the terms of the Agreement have been arrived at after arm's length negotiation between the Company and Hualu Hengsheng and are on normal commercial terms. The principal terms and conditions are as follows:

1. The term of the Agreement is for a term commencing from the date when approval thereof has been obtained both at the EGM and at Hualu Hengsheng's board meeting (or shareholders' meeting) and ending on 31 December 2015.
2. The selling prices for the Chemical Products shall be determined at market prices.
3. Under the same conditions, Hualu Hengsheng and/or its subsidiaries shall provide the Chemical Products to members of the Group in priority to other purchasers of the products.
4. Under the same conditions, the Group shall purchase the Chemical Products from Hualu Hengsheng and/or its subsidiaries in priority to other independent third parties.
5. Either the Company or Hualu Hengsheng is entitled to terminate the Agreement with three-month prior written notice.

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## LETTER FROM VEDA CAPITAL

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As noted from the Board Letter, the “market price” means the prevailing price of the Chemical Products in the market at the relevant time. In practice, the Company will make reference to the purchase price of similar products offered by other independent third parties so as to ensure that the price of the Chemical Products is in line with the market price. If any of the Chemical Products is offered at a lower price by an independent third party, according to the Agreement, the Group is free to purchase such product from that independent third party at the lower purchase price.

### *Payment terms*

The Chemical Products will be delivered to the Group upon receipt of payments made by the Group to Hualu Hengsheng and/or its subsidiaries in relation to such products.

As advised by the Company, the terms under the Agreement are in line with the usual market practice.

We have reviewed the Agreement and noted that pursuant to the Agreement, the transactions contemplated thereunder shall be conducted on normal commercial terms and by arm’s length negotiation. We have also reviewed the internal control manual in respect of connected transactions of the Company and pursuant to such internal control manual, the principles of the pricing of products offer to/from connected persons under a continuing connected transaction shall be (i) based on market prices of the products and the pricing offer from the connected persons shall not be higher than the price of same product quoted by independent suppliers in the market and the terms offer from the connected persons should be no less favourable to the Company than those available to or from other parties; and (ii) on fair and reasonable basis. We are given to understand from the Company that, in order to ensure the transactions under the Agreement are on normal commercial terms and fair and reasonable and in compliance with the terms of the Agreement, the pricing of the transactions will be agreed after available and comparable agreements of the independent suppliers are reviewed and compared by the management.

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

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## LETTER FROM VEDA CAPITAL

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### *Proposed annual caps for the Agreement*

The proposed annual caps for the Continuing Connected Transactions under the Agreement for the three years ending 31 December 2015 are set out below:

|                      | <b>2013</b><br>(RMB'000) | <b>1 January 2014 –<br/>31 December 2014</b><br>(RMB'000) | <b>1 January 2015 –<br/>31 December 2015</b><br>(RMB'000) |
|----------------------|--------------------------|---|---|
| Proposed annual caps | <u>70,000</u>            | <u>150,000</u>  | <u>200,000</u>  |

As noted from the Board Letter, the Company has determined the above annual caps based on (i) the historical amount of the Chemical Products the members of the Group placed with other independent suppliers, with the historical transaction amounts for the Chemical Products in 2011, 2012 and the six months period from January to June 2013 are RMB127,263,861, RMB141,756,453 and RMB68,750,000 (the “**2013 First Half Historical Amount**”) respectively; (ii) the projected demand for the relevant products by the members of the Group; (iii) the business development of the members of the Group; (iv) the projected increase in the market prices of the Chemical Products; and (v) the fact that the transactions under the Agreement will only commence in the second half of 2013 subject to the Independent Shareholders’ approval.

We noted that the proposed annual cap for the half year ending 31 December 2013 is just slightly more than the 2013 First Half Historical Amount and the aggregate of the proposed annual cap for the half year ending 31 December 2013 and the 2013 First Half Historical Amount in the amount of approximately RMB138,750,000 is comparable to the transaction amount of RMB141,756,453 for the year ended 31 December 2012. In light of the Company has advised that the 4th quarter of a year is usually the peak season for the pharmaceutical product industry in which the size of the demand and price will be adjusted upwards, we consider the proposed annual cap under the Agreement for the remaining period of 2013 is fair and reasonable and in the interests of the Company and the Independent Shareholders as a whole.

The proposed annual cap of RMB150,000,000 for the year ending 31 December 2014 represents more than two times of the remaining period of 2013 of RMB70,000,000. In light of (i) the proposed annual cap in 2014 has taken into consideration that the orders will be on 12-month basis whilst that the continuing connected transaction in 2013 will commence after the EGM (subject to the Independent Shareholders’ approval) which is expected to be held in August 2013; and (ii) the proposed annual cap of RMB150,000,000 for the year ending 31 December 2014 represents only a slight increase of approximately 5.82% from the transaction amount of RMB141,756,453 for the year ended 31 December 2012, we consider the proposed annual cap under the Agreement for the year ending 31 December 2014 is fair and reasonable and in the interests of the Company and the Independent Shareholders as a whole.

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## LETTER FROM VEDA CAPITAL

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Concerning the proposed annual cap in 2015 which represents a considerable increase of roughly 33.33% as compared to that in 2014, we noted from the Board Letter that the Company considers the demand for the Chemical Products by the members of the Group may have an approximate 25% increase in 2015 comparing with that of 2014 and the market prices of the Chemical Products may have an approximate 10% increase in 2015 comparing with that of 2014.

As advised by the Company, the market of the chemical products is directly linked to the overall economy performance. The chemical products market is currently encountering a depressive state, whereas the general price of the chemical products has been tumbling for a period and reaching a historical low position. It is believed by the Company that following the recovery of the global economy subsequent to the financial crisis 2008, the recovery of the chemical products market will soon be seen and therefore, the Company projects an increase of price of the Chemical Products.

Also noted from the AR2012, the business plan of the Group in 2013 are (i) aggressively pushing ahead with the internationalization strategy to ensure continuing growth in export of major bulk pharmaceuticals; (ii) speeding up the development of new products, and several new products will be approved in 2013; (iii) putting greater efforts on the improvement and optimization of production process, and strengthening of quality control; (iv) ensuring the production relocation of the aspirin production line be completed as scheduled, and the technological renovation for the “5A” products series to be completed smoothly; and (v) implementing the centralized capital management and apply strict restrictions on capital approval authority and process for capital approval.

As discussed with the Directors, they consider that with the abovementioned business plans will considerably improve the demand and supply of the pharmaceutical products of the Company. It is expected that the Company will formulate proper marketing strategy through the “one strategy for one product” approach for key products, as to enlarge the Company’s market share. For the international market, the Company will have direct communication with the international clients in order to develop a stable relationship with them and to gradually capture the international market share. Also, more investment will be focused on the research and development of the Company such that more new projects or products will be launched. The Company is currently striving for registration of eight new products, obtaining of eight patent pending numbers, completion of mid-scale trial productions for nine projects, completion of laboratory research for eight projects, and prepare for another 16 new projects. Also, the Directors advised that the process of strengthening the hierarchy management of and cooperation with suppliers and further reduce the number of exclusive suppliers will enhance the production efficiency significantly such that more output can be achieved with the same amount of operation hours. To cope with the expansion in both market segment and production volume, the Company indicates that there will be a significant increase in the consumption of the Chemical Products in 2015, with the inclusion of time lag for the entire implementation and execution, which could be reflected on the advancement of the proposed annual cap for the year ending 31 December 2015.

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## LETTER FROM VEDA CAPITAL

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According to the National Bureau of Statistics of China (<http://www.stats.gov.cn/>), China overtook Japan as the second largest economy in the world in terms of nominal gross domestic product (“GDP”) in the second quarter of 2010. According to the statistics published by the National Bureau of Statistics of China, the GDP of the PRC increased from RMB31,405 billion to RMB59,132 billion from 2008 to 2012, representing a compounded annual growth rate of approximately 17.1%. Strong growth in the PRC economy and per capita GDP has resulted in an increase in disposable income in China and improvement in living standards. Despite the fact that the International Monetary Fund has lowered the GDP forecast of the PRC for 2014, it is still expected that the growth of economy will be approximately 7.75%.

In general, the demand in the pharmaceutical industry relies on the economy condition and the core factor is the unemployment rate. Unemployment affects the industry in two major ways, with the unemployed do not have fund to buy pharmaceutical products and citizens rely on jobs to provide health insurance. With a better global economy prospect, employment rate is expected to go up, which results in higher demand of pharmaceutical products.

Population is another principal factor which influences the demand of the pharmaceutical products. According to the National Bureau of Statistics of China, the population of the PRC stood at 1.32 billion at the end of 2008, which was about 2.5 times the number in 1949 when the PRC was founded and it is projected by the official that the population will grow to 1.39 billion by the end of 2015, implying a potential demand growth for the pharmaceutical products.

In 2009, the State Council of the PRC announced the country’s healthcare reforms, aimed to expand the sponsored medical insurance network to cover 90% of the population, with each person covered by the system receiving an annual subsidy of RMB120 in 2010. In 2011, the annual subsidy has increased to RMB200 per person, which was a 20% year-on-year improvement. At the same time, the PRC government will build hospitals and improve medical services at the county level and remote areas, and expedite the reform of state-run hospitals, strengthening their administration, operation and supervision. Besides, according to a newsletter published by the 17th China International Pharmaceutical Industry Exhibition (<http://www.china-pharm.net>), an exhibition co-organized by China Center for Pharmaceutical International Exchange and Messe Dusseldorf (Shanghai) Co., Ltd., it is noted that the PRC is the largest emerging pharmaceutical market in the world. Based on the IMS Health (a leading provider of information, services and technology for the healthcare industry) forecast, the PRC will enjoy a higher growth rate than other markets, and will become the second largest pharmaceutical market in the world by 2020, only after the U.S.. By then, the market volume in the PRC will reach US\$109.5 billion with the market share increasing from 3% to 7.5%.



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## LETTER FROM VEDA CAPITAL

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In relation to (i) the projected increase in the market price of the overall chemical products due to global economic recovery and the current depressive state of the chemical products market; (ii) the expected demand increase in raw materials as indicated by the business plan of the Company; (iii) the positive anticipation of the PRC economy and population growth, and the healthcare policy implementation; and (iv) the Company's targets to increase the market share globally and to improve the production efficiency, we are of the view that the basis adopted to determine the proposed annual cap for the year ending 31 December 2015 under the Agreement is fair and reasonable so far as the Independent Shareholders are concerned.

Given the above, we are of the view that the basis adopted to determine the proposed annual caps of the Continuing Connected Transactions under the Agreement are fair and reasonable so far as the Independent Shareholders are concerned.

### RECOMMENDATION

Having considered the above principal factors and reasons, we are of the view that the terms under the Agreement are conducted in the ordinary and usual course of business of the Group and the terms and conditions of the Agreement including the proposed annual caps of the Continuing Connected Transactions under the Agreement, are on normal commercial terms, fair and reasonable so far as the Independent Shareholders are concerned and in the interests of the Group and the Shareholders as a whole. Accordingly, we advise the Independent Board Committee to recommend the Independent Shareholders, and we also recommend the Independent Shareholders, to vote in favour of the relevant resolutions for approving the Agreement and the proposed annual caps in relation to the Continuing Connected Transactions under the Agreement.

Yours faithfully,  
For and on behalf of  
**Veda Capital Limited**  
**Julisa Fong**  
*Managing Director*

## 1. RESPONSIBILITY STATEMENT

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

## 2. SHARE CAPITAL

As at the Latest Practicable Date, the total number of issued shares of the Company was 457,312,830, comprising 307,312,830 A shares listed on the Shenzhen Stock Exchange and 150,000,000 H shares listed on the Stock Exchange.

## 3. DISCLOSURE OF INTEREST

As at the Latest Practicable Date, the following senior officer held shares in the Company:

| Name                   | Number of A Shares | Percentage of<br>the total issued share<br>capital of the Company<br>(%) |
|------------------------|--------------------|--|
| <b>Senior officer:</b> |                    |  |
| Mr. Cao Changqiu       | 1,281              | 0.00028  |

Save as disclosed above, as at the Latest Practicable Date:

- (a) none of the Directors, Supervisors and 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 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 Companies, to be notified to the Company and the Stock Exchange;

- (b) none of the Directors or Supervisors of the Company was materially interested in any contract or arrangement subsisting at the date of this circular, and which was significant in relation to the business of the Group;
- (c) none of the Directors, Supervisors of the Company and Veda Capital had any direct or indirect interest in any assets which had since 31 December 2012, being the date to which the latest published audited financial statements of the Company were made up, been 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; and
- (d) none of the Directors or their respective associates had any interest in any company or business which competes or may compete with the businesses of the Group.

#### 4. SUBSTANTIAL SHAREHOLDERS

As at the Latest Practicable Date, so far as was known to the Directors and chief executive of the Company, the persons, other than a Director or chief executive of the Company, who had an interest or a short position in the shares and 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 is directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of the Company were as follows:

| No. | Name of Shareholder      | Class of shares         | Number of<br>shares held | Percentage of<br>the total issued<br>share capital<br>(%) |
|-----|--------------------------|-------------------------|--------------------------|---|
| 1.  | SXPGC                    | State-owned<br>A Shares | 166,115,720              | 36.32   |
| 2.  | HKSCC (Nominees) Limited | Listed H Shares         | 148,027,998              | 32.37   |

SXPGC is a wholly-state owned company. Mr. Zhang Daiming is the chairman of the Company and is also the chairman of SXPGC. Mr. Ren Fulong being a Director of the Company is also a director and a general manager of SXPGC. Mr. Xu Lie being a Director of the Company is also a director of SXPGC.

Save as disclosed above, the Directors and chief executive of the Company are not aware that there is any party who, as at the Latest Practicable Date, had an interest or a short position in the shares and 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 is, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any other member of the Group.

## 5. MATERIAL ADVERSE CHANGE

As at the Latest Practicable Date, the Directors were not aware of any material adverse change in the financial or trading position of the Group since 31 December 2012, the date to which the latest audited financial statements of the Group were made up.

## 6. LITIGATION

No member of the Group is engaged in any litigation or arbitration or claim of material importance and there is no litigation or arbitration or claim of material importance known to the Directors to be pending or threatened by or against any member of the Group.

## 7. CONSENTS OF EXPERT

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

| <b>Names</b> | <b>Qualifications</b>   |
|--------------|---|
| Veda Capital | a licensed corporation to carry out type 6 (advising on corporate finance) regulated activities under the SFO |

To the best knowledge of the Directors, as at the Latest Practicable Date, Veda Capital 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, Veda Capital 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 was proposed to be acquired or disposed of by or leased to the Company, since 31 December 2012, being the date to which the latest published audited financial statements of the Company were made up.

**8. SERVICE CONTRACTS**

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. MATERIAL INTEREST**

As at the Latest Practicable Date, none of the Directors had a material interest in the Continuing Connected Transactions under the Agreement.

As at the Latest Practicable Date, none of the Company, its holding company and fellow subsidiaries of the controlling company 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.

**10. COMPETING INTEREST**

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

**11. VOTE BY POLL**

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

**12. MISCELLANEOUS**

- (a) The joint secretaries of the Company are Mr. Cao Changqiu, who graduated from Qingdao Ocean University, specialising in economic management in 1991 and Ms. Guo Lei, who graduated from Guangzhou Foreign Trade College, specialising in accounting in 1992.
- (b) The share registrar of the Company in Hong Kong is Hong Kong Registrar Limited, 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong.
- (c) In the case of any discrepancy, the Chinese text of this circular shall prevail over the English text.

**13. DOCUMENTS FOR INSPECTION**

Copies of the following documents will be available for inspection at the office of Charltons, being 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 EGM:

- (a) the Agreement;
- (b) the letter of recommendation from the Independent Board Committee of the Company to the Independent Shareholders as set out in this circular;
- (c) the letter of advice from Veda Capital as set out in this circular; and
- (d) the written consent from Veda Capital referred to in paragraph 7 of this appendix.