

# **Migao Corporation**

## **Management Discussion and Analysis**

**Fiscal Year Ended September 30, 2007**

December 3, 2007

The following is Management's Discussion and Analysis ("MD&A") of the financial condition of Migao Corporation (the "Company" or "Migao") and the financial performance for the year ended September 30, 2007. This discussion and analysis should be read in conjunction with the audited Consolidated Financial Statements and related notes as at and for the years ended September 30, 2007 and 2006. Reference should also be made to the Company's filings with Canadian securities regulatory authorities which are available at [www.sedar.com](http://www.sedar.com).

All amounts are in Canadian dollars unless otherwise noted and prepared in accordance with Canadian Generally Accepted Accounting Policies.

At September 30, 2007, the Company had 37,040,428 common shares outstanding. At December 3, 2007, the Company has 37,276,018 common shares outstanding.

### **Forward-Looking Information**

The statements made in this MD&A that are not historical facts contain forward-looking information that involves risk and uncertainties. All statements, other than statements of historical facts, which address Migao's expectations, should be considered forward-looking statements. Such statements are based on management's exercise of business judgment as well as assumptions made by and information currently available to management. When used in this document, the words "may", "will", "anticipate", "believe", "estimate", "expect", "intend" and words of similar import, are intended to identify any forward-looking statements. You should not place undue reliance on these forward-looking statements. These statements reflect our current view of future events and are subject to certain risks and uncertainties as contained in the Company's filings with Canadian securities regulatory authorities. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results could differ materially from those anticipated in these forward-looking statements to reflect events or circumstances after the date hereof, or to reflect the occurrence of any unanticipated events. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our expectations will materialize. The forward-looking statements made in this MD&A describe our expectations as at December 3, 2007.

For a description of material factors that could cause our actual results to differ materially from the forward-looking statements in this MD&A, please see the Risk Factors section starting on page 18.

## **Overview**

Migao, through its wholly owned subsidiaries (referred herewith as “Sichuan Migao”, “Guangdong Migao”, “Liaoning Migao”, “Shanghai Migao” and “Changchun Migao”), owns land use rights and/or operates fertilizer production plants in various strategic locations in the People’s Republic of China (“PRC”) for the production and sales of specialty potash fertilizer (potassium nitrate and potassium sulphate), along with their by-products, to domestic markets in China. These fertilizers provide China’s economic crop (i.e. tobacco, fruit and vegetable) growers added opportunities for improving crop quality and increasing crop yield in an environmentally responsible manner, and contributing to the overall agricultural development of China.

China has few potash reserves and all are concentrated in the northwest where transportation costs to the economically developed eastern and southern coastal regions are prohibitive. Because of this shortage, the development of nitrogenous and phosphorous fertilizers in China has been rapid but the development of potash fertilizer has been slow, causing a usage imbalance. Migao is positioned to capitalize on the value added chemical fertilizer market in China.

In addition to measures based on Canadian generally accepted accounting principles (“GAAP”) in this MD&A, terms such as earnings before interest, taxes, depreciation and amortization (“EBITDA”); EBITDA and EBITDA margin are not defined by GAAP, and our use of such terms or measurement of such items may vary from that of other companies. In this MD&A, we describe certain income and expense items that are unusual or non-recurring. These terms are not defined by GAAP. Our usage of these terms may vary from the usage adopted by other companies. We provide this detail so that readers have a better understanding of the significant events and transactions that have had an impact on our results.

## Consolidated Results of Operations

### *Consolidated Financial Performance*

<i>in thousands of Canadian dollars except per share and percentages data</i>	<b>FY</b>	<b>FY</b>	<b>%</b>	<b>Q4</b>	<b>Q4</b>	<b>%</b>
	<b>2007</b>	<b>2006</b>	<b>change</b>	<b>2007</b>	<b>2006</b>	<b>change</b>
<b>Gross revenue</b>	<b>101,804</b>	<b>58,349</b>	<b>74%</b>	<b>25,496</b>	<b>15,434</b>	<b>65%</b>
<b>Gross profit</b>	<b>21,540</b>	<b>13,750</b>	<b>57%</b>	<b>4,246</b>	<b>3,626</b>	<b>17%</b>
<b>Gross profit (% of revenue)</b>	<b>21%</b>	<b>24%</b>	<b>(12%)</b>	<b>17%</b>	<b>23%</b>	<b>(26%)</b>
<b>Selected operating expenses:</b>						
<b>Selling</b>	<b>4,030</b>	<b>2,019</b>	<b>100%</b>	<b>765</b>	<b>592</b>	<b>29%</b>
<b>General and administrative</b>	<b>3,313</b>	<b>1,884</b>	<b>76%</b>	<b>581</b>	<b>694</b>	<b>(16%)</b>
<b>Professional</b>	<b>972</b>	<b>500</b>	<b>94%</b>	<b>261</b>	<b>156</b>	<b>67%</b>
<b>Stock-based compensation</b>	<b>908</b>	<b>370</b>	<b>145%</b>	<b>226</b>	<b>251</b>	<b>(10%)</b>
<b>Pre-operating costs</b>	<b>368</b>	<b>-</b>	<b>NA</b>	<b>368</b>	<b>-</b>	<b>NA</b>
<b>Finance costs</b>	<b>288</b>	<b>-</b>	<b>NA</b>	<b>288</b>	<b>-</b>	<b>NA</b>
<b>Income taxes</b>	<b>657</b>	<b>430</b>	<b>53%</b>	<b>(462)</b>	<b>112</b>	<b>(513%)</b>
<b>Income taxes (% of revenue)</b>	<b>1%</b>	<b>1%</b>	<b>-</b>	<b>(2%)</b>	<b>1%</b>	<b>(300%)</b>
<b>Effective tax rate (% of income before taxes)</b>	<b>6%</b>	<b>5%</b>	<b>20%</b>	<b>(25%)</b>	<b>5%</b>	<b>(600%)</b>
<b>Net income</b>	<b>11,206</b>	<b>8,598</b>	<b>30%</b>	<b>2,292</b>	<b>1,956</b>	<b>17%</b>
<b>Net income (% of revenue)</b>	<b>11%</b>	<b>15%</b>	<b>(27%)</b>	<b>9%</b>	<b>13%</b>	<b>(31%)</b>
<b>EBITDA</b>	<b>14,081</b>	<b>10,040</b>	<b>40%</b>	<b>2,214</b>	<b>2,592</b>	<b>(15%)</b>
<b>EBITDA (% of revenue)</b>	<b>14%</b>	<b>17%</b>	<b>(18%)</b>	<b>9%</b>	<b>17%</b>	<b>(47%)</b>
<b>Earnings per share (in \$):</b>						
<b>Basic</b>	<b>0.33</b>	<b>0.37</b>	<b>(11%)</b>	<b>0.06</b>	<b>0.08</b>	<b>(25%)</b>
<b>Diluted</b>	<b>0.32</b>	<b>0.37</b>	<b>(14%)</b>	<b>0.06</b>	<b>0.08</b>	<b>(25%)</b>

### *Quarterly Results*

<i>in thousands of Canadian dollars except per share and percentage data</i>	<b>Fiscal 2007</b>				<b>Fiscal 2006</b>			
	<b>Q4</b>	<b>Q3</b>	<b>Q2</b>	<b>Q1</b>	<b>Q4</b>	<b>Q3</b>	<b>Q2</b>	<b>Q1</b>
<b>Sales</b>	<b>25,496</b>	26,865	27,712	21,731	15,434	15,426	15,100	12,388
<b>Gross profit</b>	<b>4,246</b>	6,339	6,281	4,674	3,626	3,113	4,310	2,701
<b>Gross profit (% of revenue)</b>	<b>17%</b>	24%	23%	22%	23%	20%	29%	22%
<b>Selected operating expenses:</b>								
<b>Selling</b>	<b>765</b>	950	1,335	980	592	193	771	463
<b>G &amp; A</b>	<b>581</b>	968	1,018	746	694	545	367	278
<b>Professional</b>	<b>261</b>	321	179	211	156	124	69	151
<b>Stock-based compensation</b>	<b>226</b>	186	245	251	251	119	-	-
<b>Pre-operating costs</b>	<b>368</b>	-	-	-	-	-	-	125
<b>Finance costs</b>	<b>288</b>	-	-	-	-	-	-	-
<b>Income taxes</b>	<b>(462)</b>	791	200	128	112	161	157	-
<b>Income taxes (% of revenue)</b>	<b>(2%)</b>	3%	1%	1%	1%	1%	1%	-
<b>Effective tax rate (% of income before taxes)</b>	<b>(25%)</b>	20%	6%	5%	5%	7%	5%	0.1%
<b>Net income</b>	<b>2,292</b>	3,167	3,338	2,409	1,956	2,006	2,949	1,686
<b>Net income (% of revenue)</b>	<b>9%</b>	12%	12%	11%	13%	13%	20%	14%
<b>EBITDA</b>	<b>2,214</b>	4,530	4,250	3,087	2,592	2,439	3,319	1,690
<b>EBITDA (% of revenue)</b>	<b>9%</b>	17%	15%	14%	17%	16%	22%	14%
<b>EPS:</b>								
<b>Basic</b>	<b>0.06</b>	0.09	0.10	0.08	0.08	0.08	NA	NA
<b>Diluted</b>	<b>0.06</b>	0.08	0.10	0.08	0.08	0.08	NA	NA

**Revenues**

Revenues were \$25.5 million and \$101.8 million for the quarter and year ended September 30, 2007, compared with \$15.4 million and \$58.3 million for the same periods last year, representing an increase of \$10.1 million (or 65%) and \$43.5 million (or 74%), respectively. The significant increases are mainly due to the expanded production capacity in Sichuan and Guangdong facilities during the year. The run rate for the core products was at 200,000 tonnes as of September 30, 2007, compared with 120,000 tonnes as of September 30, 2006.

Revenues for the quarter ended September 30, 2007 decreased by \$1.4 million (or 5%) to \$25.5 million (from \$26.9 million) compared with the previous quarter ended June 30, 2007. Certain modules of Sichuan Migao underwent scheduled maintenances for a total of approximately a week during the quarter. Lower average exchange rates between Chinese Renminbi and Canadian dollar for the quarter ended September 30, 2007 compared with the previous quarter ended June 30, 2007 also contributed to the lower sales. In Chinese Renminbi terms, revenues for the quarter ended September 30, 2007 decreased by less than 2% compared with the previous quarter ended June 30, 2007.

The facilities of the Company, according to their design, are required to undergo scheduled maintenance which results in stoppage of production for a two to four week period, every twelve to eighteen months. The most recent maintenance of Sichuan Migao occurred in September 2006, and was its second maintenance since the facility commenced operation in December 2003, with the first maintenance performed in June 2005. The most recent maintenance in Guangdong Migao occurred in July 2006, and was its first maintenance since the facility commenced operation in December 2004. Both revenue and cost of goods sold are negatively affected during such periods. However, the management is not expecting future maintenances to impact significantly on its financial results in any one particular quarter than others due to the planned spread-out in timing.

The following is a summary of the Company's facilities and production capacities as of September 30, 2007.

	<b>Core Product</b>	<b>Annual Capacity (tonnes)</b>	<b>By-Product</b>	<b>Annual Capacity (tonnes)</b>	<b>Production Commencement</b>
<b>Sichuan</b>					
- Phase I	Potassium Nitrate	20,000	Ammonium Chloride	11,200	December 2003
- Phase II	Potassium Nitrate	20,000	Ammonium Chloride	11,200	September 2004
- Phase III (Stage I)	Potassium Nitrate	20,000	Ammonium Chloride	11,200	November 2006
<b>Guangdong</b>					
- Phase I	Potassium Sulphate	40,000	Hydrochloric Acid	48,000	December 2004
- Phase II (Stage I)	Potassium Sulphate	40,000	Hydrochloric Acid	48,000	November 2006
- Phase II (Stage II)	Potassium Sulphate	20,000	Hydrochloric Acid	24,000	January 2007
<b>Liaoning</b>					
- Phase I	Potassium Sulphate	40,000	Hydrochloric Acid	48,000	December 2005
<b>Total</b>		200,000		201,600	

*Note: "Annual Capacity" denotes the design capacities of the facilities. Actual production has exceeded design capacities by 5 to 10 percent annually.*

The Company continues to see strong demand for its core products: potassium nitrate and potassium sulphate, as well as its by-products: ammonium chloride and hydrochloric acid.

Migao earns all of its revenues in Chinese Renminbi. Accordingly, reported revenues will fluctuate with changes in the exchange rate to Canadian dollars. The average exchange rate for the quarter and year ended September 30, 2007 were \$0.1382 and \$0.1443 to 1 Chinese Renminbi. The average exchange rate for the quarter and year ended September 30, 2006 were \$0.1407 and \$0.1424 to 1 Chinese Renminbi. The average exchange rate for the previous quarter ended June 30, 2007 was \$0.1430 to 1 Chinese Renminbi.

### ***Geographic Revenues***

The Company earns virtually all of its revenues in the PRC, with only minor export sale. At the moment, there is no plan to expand into exporting products on a large scale, as the Chinese demand is far from satiated.

### ***Gross Profit***

Gross profits were \$4.2 million and \$21.5 million for the quarter and year ended September 30, 2007, compared to \$3.6 million and \$13.8 million for the same periods last year, representing an increase of \$0.6 million (or 17%) and \$7.7 million (or 57%), respectively. The significant increases are mainly due to the expanded production capacity in Sichuan and Guangdong facilities during the year. Gross margin as a percentage of sales for the quarter and year ended September 30, 2007 decreased by 6% to 17% (from 23%) and decreased by 3% to 21% (from 24%), respectively, compared with the same periods last year.

Gross profit for the quarter ended September 30, 2007 decreased by \$2.1 million (or 33%) to \$4.2 million (from \$6.3 million) compared with the previous quarter ended June 30, 2007. Gross margin as a percentage of sales for the quarter ended September 30, 2007 decreased by 7% to 17% (from 24%) compared with the previous quarter ended June 30, 2007.

The substantial lower gross profit margin for the quarter ended September 30, 2007 compared with previous three quarters is due to the following:

- Value-added taxes (“VAT”) paid in earlier quarters on certain raw material in the production of potassium nitrate were ruled non-refundable which resulted in an adjustment of approximately \$1.2 million (RMB 8 million) in the quarter ended September 30, 2007.
- Unexpected increased costs in the sulphuric acid raw material attributable to the production of potassium sulphate, impacted by world-wide price increases of sulphur

The Company since then has increased its selling prices substantially on the core products to account for the increase in VAT and sulphuric acid cost in order to maintain its normal gross margin rate. Management is also confident that the supply of raw materials, including sulphuric acid, will continue to be reliable.

### ***Selling Expenditures***

Selling expenditures for the quarter and year ended September 30, 2007 increased by \$0.2 million (or 29%) to \$0.8 million (from \$0.6 million) and \$2 million (or 100%) to \$4 million (from \$2 million), respectively, compared with the same periods last year. Selling expenditures as a percentage of sales for the quarter and year ended September 30, 2007 decreased by 1% to 3% (from 4%) and increased slightly by 0.5% to 4% (from 3.5%) compared with the same periods last year.

Selling expenditures for the quarter ended September 30, 2007 decreased by \$0.2 million (or 19%) to \$0.8 million (from \$1 million) compared with the previous quarter ended June 30, 2007. Selling expenditures as a percentage of sales for the quarter ended September 30, 2007 decreased by 0.5% to 3% (from 3.5%) compared with the previous quarter ended June 30, 2007.

Selling expenditures include transportation and related costs incurred for delivery of goods to customers and depreciation on capital assets used by the sales department.

### ***General and Administrative Expenditures***

General and administrative expenditures for the quarter and year ended September 30, 2007 decreased slightly by \$0.1 million (or 16%) to \$0.6 million (from \$0.7 million) and increased by \$1.4 million (or 76%) to \$3.3 million (from \$1.9 million), respectively, compared with the same periods last year. General and administrative expenditures as a percentage of sales for the quarter and year ended September 30, 2007 decreased by 2.2% to 2.3% (from 4.5%) and increased slightly by 0.1% to 3.3% (from 3.2%), respectively, compared with the same periods last year.

General and administrative expenditures for the quarter ended September 30, 2007 decreased by \$0.4 million (or 40%) to \$0.6 million (from \$1 million) compared with the previous quarter ended June 30, 2007. General and administrative expenditures as a percentage of sales for the quarter ended September 30, 2007 decreased by 1.3% to 2.3% (from 3.6%) compared with the previous quarter ended June 30, 2007.

General and administrative expenditures include personnel costs for production, finance, human resources and management staff as well as facilities expenses, supplies and equipment depreciation.

#### ***Professional and Consulting Expenditures***

Professional and consulting expenditures for the quarter and year ended September 30, 2007 increased by \$0.1 million (or 67%) to \$0.3 million (from \$0.2 million) and increased by \$0.5 million (or 94%) to \$1 million (from \$0.5 million), respectively, compared with the same periods last year. Professional and consulting expenditures as a percentage of sales for the quarter and year ended September 30, 2007 were unchanged at 1% compared with the same periods last year.

Professional and consulting expenditures for the quarter ended September 30, 2007 was unchanged at \$0.3 million compared with the previous quarter ended June 30, 2007. Professional and consulting expenditures as a percentage of sales for the quarter ended September 30, 2007 was unchanged at 1% compared with the previous quarter ended June 30, 2007.

Professional and consulting expenditures mainly include corporate level legal, accounting, auditing, consulting and directors' fees.

#### ***Earnings***

Net earnings for the quarter and year ended September 30, 2007 increased by \$0.3 million (or 17%) to \$2.3 million (from \$2 million) and increased by \$2.6 million (or 30%) to \$11.2 million (from \$8.6 million), respectively, compared with the same periods last year. Net earnings as a percentage of sales for the quarter and year ended September 30, 2007 decreased by 4% to 9% (from 13%) and by 4% to 11% (from 15%), respectively, compared with the same periods last year.

Net earnings for the quarter ended September 30, 2007 decreased by \$0.9 million (or 28%) to \$2.3 million (from \$3.2 million) compared with the previous quarter ended June 30, 2007. Net earnings as a percentage of sales for the quarter ended September 30, 2007 decreased by 3% to 9% (from 12%) compared with the previous quarter ended June 30, 2007.

#### ***Earnings before Income Taxes, Depreciation and Amortization ("EBITDA")***

EBITDA for the quarter and year ended September 30, 2007 decreased by \$0.4 million (or 15%) to \$2.2 million (from \$2.6 million) and increased by \$4.1 million (or 40%) to \$14.1 million (from \$10 million), respectively, compared with the same periods last year. EBITDA as a percentage of sales for the quarter and

year ended September 30, 2007 decreased by 8% to 9% (from 17%) and decreased by 3% to 14% (from 17%), respectively, compared with the same periods last year.

EBITDA for the quarter ended September 30, 2007 decreased by \$2.3 million (or 51%) to \$2.2 million (from \$4.5 million) compared with the previous quarter ended June 30, 2007. EBITDA as a percentage of sales for the quarter ended September 30, 2007 decreased by 8% to 9% (from 17%) compared with the previous quarter ended June 30, 2007.

### ***Income Tax Rates***

Income tax is levied on a calendar year basis separately for each subsidiary of the Company in accordance with the tax regulations of the People's Republic of China. Each of the Company's operating facilities has been and will be enjoying the "Exempt Two, Reduced Three" income tax policy for being Foreign Invested Enterprise ("FIE"), and are income tax exempt for the first two profitable years and at a reduced rate (50% of normal State level income tax plus local tax) for the next three profitable years. More specifically, Sichuan Migao was exempt from income tax for the calendar year 2004 and 2005, and started to pay a combined 10.5% income tax (reduced from the normal 18% - 15% State level plus 3% local) from beginning of calendar 2006 until the end of calendar 2008.

Guangdong Migao was exempt from income tax for the calendar year 2005 and 2006, and started to pay a combined 15% income tax (reduced from the normal 27% - 24% State level plus 3% local) from beginning of calendar 2007 until the end of calendar 2009.

Liaoning Migao is exempt from income tax for the calendar year 2006 and 2007, and will start to pay a combined 15.5% income tax (reduced from the normal 28% - 25% State level plus 3% local) from beginning of calendar 2008 until the end of calendar 2010.

The National People's Congress of China approved legislation relating to tax reforms on March 16, 2007. As of January 1, 2008, the tax incentives for FIE's will be removed with the State level income tax rate reduced to 25% from 30%. The three operating subsidiaries of the Company will enjoy the tax holidays as summarized above with new State level income tax rate applicable once coming out of its respective tax holiday period. It is our belief that the two subsidiaries (Changchun Migao & Shanghai Migao) currently under construction will be enjoying the similar tax holiday as the three operational subsidiaries for their first five profitable years upon commencement of operation. However, no certainty can be provided as no advance ruling is to be issued.

### ***Expansion Projects***

#### **Sichuan Migao**

Stage two of the Phase III potassium nitrate project, which is to add an additional 20,000 tonnes of potassium nitrate capacity, was completed in early October and production began on October 26, 2007. Both the production schedule and the construction costs were in line with company expectations. The expanded

production capacity brings the total capacity of the Sichuan Migao facility to 80,000 tonnes of potassium nitrate. All of the production from the 80,000 tonne potassium nitrate facility has been sold into the spring of 2008.

#### Shanghai Migao

On November 11, 2006, the Company announced that a potassium sulphate facility, with 40,000 tonnes of initial capacity, will be constructed in the city of Shanghai and is scheduled to be completed by early calendar year 2008.

#### Changchun Migao

On February 27, 2007, the Company announced that a potassium sulphate facility, with 40,000 tonnes of initial capacity, will be constructed in the city of Changchun, province of Jilin and was originally scheduled to be completed by the early part of the calendar year 2008. The facility was completed on October 18, 2007. Full production from the newly opened facility was scheduled to be phased in over an eight week period. The first 20,000 tonnes of production began on November 21, 2007, and the second 20,000 tonnes is scheduled to come online on December 21, 2007. Therefore, full scale production from the 40,000 tonne expansion is ahead of schedule.

### **Liquidity and Capital Resources**

<i>(in thousands of Canadian dollars except for ratios)</i>	<b>September 30, 2007</b>	<b>September 30, 2006</b>
<b>Current Ratio</b>	3.03 : 1	2.89 : 1
<b>Cash</b>	17,453	16,316
<b>Working Capital</b>	36,669	19,362
<b>Total Assets</b>	100,027	57,087
<b>Total Debt</b>	18,031	10,228
<b>Total Equity</b>	81,995	46,859
<b>Debt to Equity Ratio</b>	0.22 : 1	0.22 : 1

#### ***Cash Position***

Cash and cash equivalents totalled \$17.5 million as of September 30, 2007, representing an increase of \$1.1 million and \$2.1 million compared with the balances as of September 30, 2006 and June 30, 2007, respectively. The increase for the quarter ended September 30, 2007 is a result of \$3.9 million from operation, \$1.8 million of cash flow from bank loan, \$3.2 million from exercise of options and warrants, offset by \$3.2 million invested in capital assets for the construction of Sichuan, Shanghai and Changchun Migao, and \$3.6 million payments for land use rights.

Migao has approximately \$4.7 million of land use rights payable. These payables may come due in the first quarter of fiscal 2008.

The Company believes that its current cash position is sufficient to meet the ongoing needs of the business. However, the Company may choose to access capital markets and/or bank financing for funding of future expansion and other opportunities.

### ***Working Capital***

Working capital was \$36.7 million as of September 30, 2007, representing an increase of \$17.3 million and decrease of \$5.9 million compared with balances as of September 30, 2006 and June 30, 2007, respectively. This latter decrease is primarily attributable to the \$5.3 million decrease in accounts receivable, \$0.3 million decrease in inventory, \$1.8 million increase in bank indebtedness, \$3 million increase in accounts payable and accrued liabilities and \$2.6 million increase in customer deposits, offset by \$3.8 million increase in prepayments, \$1.2 million increase in income taxes receivable and \$2.1 million increase in cash and cash equivalents.

The substantial decrease in accounts receivable and increase in customer deposits as of September 30, 2007 compared to June 30, 2007 is due to the strong collection from clients during the quarter ended September 30, 2007. This is in line with management's expectation at the end of the previous quarter. It also demonstrates the strong financial condition and credit worthiness of the Company's major customers.

### ***Plant and Equipment, Construction in Progress, Land Use Rights***

Plant and equipment net of accumulated depreciation and amortization was \$20.5 million at September 30, 2007 compared with \$13.5 million and \$21 million as of September 30, 2006 and June 30, 2007, respectively. The decrease during the quarter ended September 30, 2007 is partly due to the appreciation of Canadian dollar against Chinese RMB as of September 30, 2007 compared to June 30, 2007. On June 11, 2007, Guangdong Migao was approved by the local tax authority for tax credits totalling \$1.4 million (RMB 10.4 million) on purchases of domestic equipment during calendar year 2006. These credits will be applied against future profit taxes levied to Guangdong Migao, and used to offset the capital costs of its plant and equipment. Sichuan Migao was also approved for tax credits of \$0.4 million (RMB 2.8 million) and value-added tax refund of \$0.2 million (RMB 1.6 million). They were recorded to reduce the cost of equipment.

The Chinese tax regulations allow tax credits to be applied for up to 40% of expenditures on purchases of domestic made equipments. Once approved, such credits can be utilized against income taxes to be levied in future years.

On June 11, 2007, Guangdong Migao was approved by the local tax authority for tax credits totalling \$1,383,394 (RMB 10,424,975) on purchases of domestic equipment during calendar year 2006. These credits will be applied against future profit taxes levied to Guangdong Migao and they have been recorded to reduce the cost of equipment. Sichuan Migao was also approved for tax credits of \$369,797 (RMB 2,786,714) and

value-added tax refund of \$210,962 (RMB 1,589,770). They were recorded to reduce the cost of equipment.

Construction in progress was \$6 million at September 30, 2007 compared with \$6.2 million and \$4.1 million as of September 30, 2006 and June 30, 2007, respectively. The balance consists mainly of the construction costs attributed to Sichuan, Shanghai and Changchun Migao.

Land use rights net of accumulated amortization was \$18.4 million at September 30, 2007 compared with \$7.8 million and \$12.7 million as of September 30, 2006 and June 30, 2007. The increase during the quarter ended September 30, 2007 is mainly due to the acquisitions in Sichuan, Zunyi and Tianjin sites and offsets by appreciation of Canadian dollar against Chinese RMB as of September 30, 2007 compared to June 30, 2007.

#### ***Contractual Obligations Summary***

- Purchase commitments for raw materials and supplies in the amount of \$2.4 million (RMB 18 million) exist as of September 30, 2007. They were entered into in the normal course of business.
- Commitments on capital expenditures in the amount of \$3.9 million (RMB 29 million) exist as of September 30, 2007. They were entered into in the normal course of business.

The following table summarizes our contractual obligations as at September 30, 2007, and the effect such obligations are expected to have on our liquidity and cash flows in future years. The table excludes amounts already recorded on the consolidated balance sheet as current liabilities and certain other purchase obligations discussed above.

	2008	2009	2010	2011	2012	thereafter
<b>Operating lease</b>	<b>\$ 70,194</b>	<b>\$ 71,163</b>	<b>\$ 72,132</b>	<b>\$ 73,101</b>	<b>NIL</b>	<b>NIL</b>

#### ***Disclosure Controls and Procedures and Internal Control over Financial Reporting***

Management has evaluated the effectiveness of the Company's disclosure controls and procedures as at September 30, 2007 and has concluded, based on its evaluation, that these controls and procedures provide reasonable assurance that material information relating to the Company is made known to management and reported as required.

Management is also responsible for the design of internal controls over financial reporting in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles. Management has engaged external consultants to evaluate the design of the Company's internal controls and procedures over financial reporting as at September 30, 2007, and believes the design to be sufficient and appropriate to provide such reasonable assurance.

The consultants have made recommendations for improvement in certain aspects of the Company's system of internal controls, and management intends to formalize approval and review processes by using checklists and initialing source documents, reconciliations and other accounting worksheets on a more consistent basis. The Company has begun the process of hiring additional qualified personnel to assist in the implementation of the above items.

In addition, the Company maintains a lean financial department in which finance staff are cross trained to handle non compatible functions in case of emergency, illness, staff turnover or other situations. This cross training could result in a lack of segregation of duties. Management mitigates this risk by being aware of whenever incompatible functions are performed and providing additional review and oversight. Despite management's best efforts, there can be no assurance that the risk of material statement in this situation can be reduced.

It should be noted that while the Officers of the Company, as certified in the Company's Annual Filings and as required under Multilateral Instrument 52-109 issued by the Canadian Securities Administrators, have evaluated the effectiveness of these disclosure controls and procedures for the year ended September 30, 2007 and have concluded that they are being maintained as designed, they do not expect that the disclosure controls and procedures or internal controls over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

## **Capital Structure**

The Company is authorized to issue an unlimited number of common shares, each common share providing the holder with one vote. As of December 3, 2007, there were:

- 37,276,018 common shares outstanding.
- 1,185,000 stock options outstanding, with exercise prices of between \$2.85 to \$8.46, and weighted average contractual life of 3.58 years. 288,333 of these stock options are exercisable as of December 4, 2007.
- 2,260,943 warrants outstanding, with exercise price of \$3.70, exercisable before May 18, 2008.
- 2,666,250 warrants outstanding, with exercise price of \$5.30, exercisable before February 22, 2009.
- 5,862 agent compensation options outstanding, with exercise price of \$2.85 per compensation unit. Each compensation unit consists of one common share of the Company and one-half warrant. Each whole warrant entitles the agent to purchase one common share at \$3.70 before May 18, 2008.
- 225,938 agent compensation options outstanding, with exercise price of \$4.15 per compensation unit. Each compensation unit consists of one common share of the Company and one-half warrant. Each whole warrant entitles the agent to purchase one common share at \$5.30 before February 22, 2009.

## **Off-Balance Sheet Arrangement**

The Company does not have any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on the results of operations or financial condition of Migao including, without limitation, such considerations as liquidity and capital resources that have not previously been discussed.

## **Transactions with Related Parties**

As of September 30, 2007, amount due to Liaoning Yongcheng Economic and Trade Development Co. Ltd. ("LYEDC") was \$45,387. LYEDC and the Company are ultimately controlled by the same shareholder. The amounts are non-interest bearing and due on demand.

## **Proposed Transactions**

Migao is not a party to any proposed transaction that may have an effect on the financial condition, results of operations or cash flows or proposed asset or business acquisition or disposition.

## **Critical Accounting Policies**

This MD&A should be read in conjunction with the Company's audited Consolidated Financial Statements for the year ended September 30, 2007 and the notes thereto. To aid in understanding the Company's financial reporting its critical accounting policies are described below. Accounting policies are critical if they rely on a substantial amount of judgment in their application or if they result from a choice between accounting alternatives and that choice has a material impact on reported results or financial position.

### ***Basis of presentation***

These consolidated financial statements (the "financial statements") have been prepared by management in accordance with GAAP and include the accounts of the Company and its subsidiaries in the PRC.

### ***Cash equivalents***

For the purpose of the consolidated statements of cash flows, the Company considers cash equivalents to be cash and highly liquid investments with original maturities of three months or less.

### ***Inventory***

Raw materials are valued at the lower of cost and replacement cost. Finished goods are valued at the lower of cost and net realizable value. The cost of finished goods comprises direct materials and, where applicable, direct labor costs and overhead costs. Cost is determined using the weighted-average method. Net realizable value represents the anticipated selling price less all further costs for distribution.

***Plant and equipment***

Plant and equipment are recorded at cost. Amortization is provided over the expected useful lives of the plant and equipment with a 10% residual value using the following methods and annual rates:

Building and improvements	-	20 years straight line
Machinery and equipment	-	10 years straight line
Vehicles	-	5 years straight line
Office equipment	-	5 years straight line

***Construction in progress***

Construction in progress represents properties under construction and is stated at cost. Construction in progress is not amortized until such time as the assets are completed and put into operational use.

***Land use rights***

Land use rights are recorded at cost and are amortized over 50 to 70 years, which are the terms of the land use rights set by the Chinese government.

***Impairment of long-lived assets***

Long-lived assets held for use are reviewed for impairment when events or changes in circumstances indicate that their carrying value may not be recoverable. When the carrying value is not recoverable from future cash flows on an undiscounted basis and the carrying value exceeds the assets' fair value, an impairment loss is recorded for the excess of carrying value over fair value.

***Income taxes***

The Company uses the liability method of accounting for income taxes. Under this method, income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on income tax assets and liabilities is reflected in operations in the period in which the change occurs. Valuation allowances are established when necessary to reduce future tax assets to the amount expected to be realized.

***Income per share***

Basic income per share is computed using the weighted average number of common shares outstanding during the year. Diluted income per share is computed giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares using the treasury stock method, except when their effect would be anti-dilutive. The treasury stock method assumes

that proceeds received from the exercise of stock options and warrants are used to repurchase common shares at the prevailing market rate.

***Revenue recognition***

Revenue is recognized when goods are shipped and all significant risks and rewards of ownership passed to the customer with collection of revenue reasonably assured.

***Pre-operating costs***

All expenditures incurred prior to the commencement of commercial operations are expensed.

***Foreign exchange***

The Company's functional currency is the Canadian dollar and the Subsidiaries' functional currency is the Chinese Renminbi ("RMB"). The accounts of the Subsidiaries are translated into Canadian dollars using the current rate method. Under this method, assets and liabilities are translated at the year end rate of exchange. Revenues and expenses are translated into Canadian dollars at the average rate of exchange for the period. Exchange gains and losses from foreign currency translations are recorded in shareholders' equity as other comprehensive income.

***Measurement uncertainty***

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Black-Scholes option valuation model, used by the Company to determine fair values, was developed for use in estimating the fair value of freely traded options. This model requires the input of highly subjective assumptions including future stock price volatility and expected time until exercise. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore the existing model does not necessarily provide a reliable single measure of the fair value of the Company's stock options granted during the year.

***Recent Canadian accounting pronouncements******Inventories***

In June 2007, the Canadian Institute of Chartered Accountants ("CICA") released new Handbook Section 3031, "Inventories", replacing Section 3030, effective for annual and interim periods for fiscal year beginning on or after January 1, 2008. This Section provides guidance on the determination of cost and its subsequent

recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

*Financial Instruments – Disclosures and Presentation*

In December 2006, the CICA released new Handbook Section 3862, “Financial Instruments - Disclosures”, and Section 3863, “Financial Instruments - Presentation”, replacing Section 3861, effective for annual and interim periods for fiscal year beginning on or after October 1, 2007.

Section 3862 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- (a) the significance of financial instruments for the entity's financial position and performance; and
- (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks.

Section 3863 is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows. This Section establishes standards for presentation of financial instruments and non-financial derivatives. It deals with the classification of financial instruments, from the perspective of the issuer, between liabilities and equity, the classification of related interest, dividends, losses and gains, and the circumstances in which financial assets and financial liabilities are offset.

***Accounting policy changes including initial adoption***

Effective October 1, 2006, the Company implemented the new CICA accounting sections: 3855 (Financial Instruments – Recognition and Measurement), 3861 (Financial Instruments – Disclosure and Presentation), 3865 (Hedges), and 1530 (Comprehensive Income). These new accounting policy changes have been implemented prospectively with no restatement of comparative financial statements, except as noted below.

Comprehensive income includes net income and other comprehensive income. It is defined as the change in equity (net assets) of a company during the period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during the period except those resulting from investments by owners and distributions to owners. The only item included in other comprehensive income is the foreign currency translation of self-sustaining foreign operations. As a result, the previously recorded currency translation account on the consolidated balance sheets' shareholders' equity section has been eliminated and included as “accumulative other comprehensive income” in shareholders' equity. Furthermore, the gain (or loss) from translating the Company's self-sustaining foreign operations is now recorded as other comprehensive income. Prior years financial statements have been restated to reflect this change. The Company's earnings per share presented on the consolidated statements of income is based upon its net income and not comprehensive income.

The adoption of sections 3855, 3861 and 3865 had no impact on the Company's financial statements.

## **Financial Instruments and Other Instruments**

Migao is not a party to any financial instrument, as the term is defined in National Instrument 51-102F1, paragraph 1.14.

## **Risk Factors**

The following are certain risk factors inherent in the Company's business and an investment in shares of the Company. These risks and uncertainties are not the only ones facing the Company. Additional risks and uncertainties not currently known to the Company, or that the Company currently considers immaterial, may also impair the operations of the Company. If any such risks actually occur, the business, financial condition, liquidity and results of operations of the Company could be materially adversely affected.

### **Company Risk Factors**

#### ***Execution of the Business Plan***

Although management of the Company has developed a business plan, there can be no assurance that the business plan will succeed in whole or in part.

The success of the Company's expansion strategy will depend on a number of factors. There can be no assurance that the Company will be able to achieve planned growth. There can be no assurance that the Company's expansion strategy will be successful, that modifications to its strategy will not be required or that the Company will be able to enhance profitability. In addition, such growth could place a significant strain on the Company's management, operational, financial and other resources. The Company's ability to manage its growth effectively will require it to develop its management information systems capabilities and improve its operational and financial systems. Moreover, the Company will need to train, motivate and manage its employees and attract senior managers and technical professionals. Any failure to expand these areas and implement and improve such systems, procedures, and controls in an efficient manner and to train, motivate and manage its employees and attract senior managers and technical professionals at a pace consistent with the Company's business could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company has targeted the potash chemical fertilizer market in China as a focus for its business. There can be no assurance that this market will develop and, given the Company's limited experience and operating history in this market, there is no assurance that the Company's investment and efforts in this market will be successful, which may adversely affect the Company's business, financial condition and operating results.

#### ***Dependence on Key Personnel***

Due to the specialized and sophisticated nature of the Company's business, the Company is highly dependent on the continued service of, and on its ability to attract and retain, qualified technical, marketing and

managerial personnel, particularly highly skilled engineers involved in the development of new products and processes and test technicians involved in the quality of existing products. Due to the relatively small size of the Company, the loss of any of these persons or the Company's inability to attract and retain additional highly skilled employees may adversely affect its business operations, financial condition and operating results. The Company does not currently carry any keyman life insurance on any of its executives.

This is also of particular concern in China for a number of reasons. First, intellectual property rights are not as well protected or highly valued in China as in certain other countries, and it is not uncommon for employees to take trade secrets and confidential information with them to new employers. This could have a significant negative impact on the Company's competitiveness. Second, when senior managers quit or are terminated, it is not uncommon for the employees they supervised to leave with them, taking significant institutional knowledge. Finally, with the growth of China's economy has come newfound mobility for employees such that many employees change jobs on a regular basis. The Company expects that it will need to provide incentives to retain its key personnel and such incentives could decrease its profitability, financial condition and operating results.

#### ***Key Relationships***

To date, the success of Migao Group has been, in part, dependent on personal and corporate relationships with suppliers, customers and certain government officials. The alteration or termination of these relationships could have a substantial impact on the future success of the Company and may adversely affect the Company's business, financial condition and operating results.

#### ***Dependence on Key Customers***

For Fiscal 2007, two customers individually comprised 56% and 6% of revenue for Migao Group. At September 30, 2007, three customers represented 19%, 18% and 18% of total accounts receivable. There can be no assurance that Migao Group will be able to retain its relationships with these or other key customers and there can be no assurance that such customers will continue to purchase products from Migao Group in the future. Any negative change involving any of Migao Group's largest customers, including but not limited to any such customer's financial condition or desire to continue purchasing Migao Group's products, could result in a significant reduction in business that could have a material adverse effect on the Company's business, results of operations and financial condition.

#### ***Competition***

The Company expects to encounter competition from other entities having a business objective similar to its own. Many of these entities are well established and have extensive experience in connection with identifying and effecting business acquisitions directly or through affiliates. Many of these competitors possess greater financial, technical, personnel, and other resources than the Company and there can be no assurance that the Company will have the ability to compete successfully.

Competitors may introduce technological innovation in any of the Company's businesses, resulting in increased competitive pressures. The Company's financial resources will be relatively limited when contrasted with those of many of their competitors. Although the Company's projections assume that the industry will generate competition, there can be no assurances on how any level of competition may impact the future revenues of the Company. China can be a fiercely competitive market and small price or quality differentials between otherwise competitive goods and services can make an enormous difference to the consumer. See "The Business – Competition" above.

#### ***Market Factors and Volatility of Commodity Prices***

Various commodity raw materials are used in the products manufactured by Migao Group. Commodity prices are subject to volatile price changes resulting from a variety of factors including international economic trends, global and regional demand, interest rates and global and regional consumption patterns. Accordingly, the Company is exposed to market risk from fluctuating market prices of certain commodity raw materials.

There is also a risk that market prices of other inputs required for the Company's business, such as electricity and natural gas, may fluctuate, exposing the Company to market risk. In addition, if temporary shortages due to disruptions in supply caused by weather, transportation, production delays or other factors require the Company to secure its raw materials or other inputs from other sources than its current suppliers, there can be no assurance that the Company will be able to do so on terms as favourable as its current terms or at all.

The Company's financial performance is also linked to the selling prices of its products. Historically, prices for fertilizer products have been volatile. The price at which the Company sells its fertilizer products and other products could fall or fluctuate unpredictably in the event of changes in industry supply and demand conditions. The Company is not able to predict future market conditions and selling prices of its products with any certainty.

Any price volatility in raw materials, other inputs or in the Company's products may have a material adverse effect on the Company's business, results of operations, cash flow, and the Company's ability to satisfy its debt obligations and capital expenditure requirements. There is a potential risk that the Chinese government may impose price controls on the Company's products which could have a material adverse effect on the Company's business, financial condition and results of operations.

#### ***Environmental Risks and Hazards***

The Company's operations are subject to various environmental laws which regulate matters such as health, safety, treatment of waste and land use. Failure to comply with applicable laws, regulations, and licensing requirements may result in enforcement actions thereunder. Penalties could include suspension or revocation of necessary licenses or permits, civil liability or the imposition of fines. The cost of compliance, remediation or liability could materially affect future operating results. Furthermore, the operational or financial impact of

new or amended laws or regulations cannot be predicted and could have a material adverse impact on the Company's business, financial condition and operating results.

### ***Operating Risks***

The Company's plants are in the early stages of development and have short operating histories. There is a risk that the plants may not continue to be profitable or successful. There can be no assurance that the additional plants will commence commercial operation on schedule or at all, or that the plants will operate at planned production capacity. The delay or cancellation of any of planned plant expansions may affect the Company's ability to satisfy customer orders.

There are also many risks associated with operating facilities, including the ability to secure raw materials and components, utility prices, the failure or substandard performance of equipment, hiring and maintaining a productive and reliable workforce, labour disputes, natural disasters, suspension of operations and compliance with existing and new governmental statutes, regulations, and policies. The occurrence of material operational problems, including but not limited to any of the events described above, could have a material adverse effect on the Company's business, financial condition and results of operations.

Achieving market success will require substantial marketing efforts and the expenditure of significant funds to inform potential customers, including third party distributors, of the distinctive characteristics and benefits of Migao Group's products and services. The Company's long-term success may also depend, to a significant extent, on its ability to expand its present internal marketing organization. The Company will, among other things, have to attract and retain experienced marketing and sales personnel. No assurance can be given that the Company will be able to attract and retain qualified or experienced marketing and sales personnel or that any efforts undertaken by such personnel will be successful.

To the extent that customers delay, reduce, or cancel orders or are unable or refuse to pay for products and services purchased in a timely fashion or at all, the Company's business, financial condition and results of operations could be adversely affected.

### ***Proprietary Rights***

Proprietary protection of Migao Group's processes, apparatuses and other technology is important to the business. Consequently, the Company relies on judicial enforcement for protection of its patents. There can be no assurance that any of the Company's patents will not be challenged, invalidated or circumvented. Furthermore, if any pending patent application filed by Migao Group does not result in an issued patent, then the use of any such intellectual property by competitors could have an adverse effect on the Company's business, financial condition, results of operations or cash flow. Additionally, competitors or other third parties may obtain patents that restrict or preclude the Company's ability to lawfully produce or sell its products in a competitive manner which could have an adverse effect on the Company's business, financial condition, results of operations or cash flow.

***Infrastructure***

Industrial activities depend, to one degree or another, on adequate infrastructure. Reliable roads, bridges, power sources and water supply are important determinations, which affect capital and operating costs. Unusual or infrequent weather phenomena, malfunction, sabotage, government or other interference in the maintenance or provision of such infrastructure could adversely affect the Company's business and operations, financial condition and results of operations.

***Future Capital Requirements***

The development of the business of the Company may require substantial additional financing. The Company's future capital requirements will depend upon many factors, including maintenance, plant expansion and expansion of its sales and marketing efforts. Failure to obtain sufficient financing may result in delaying, scaling back, elimination of, or indefinite postponement of, the development schedule and its current or future programs. There can be no assurance that additional capital or other types of financing will be available if needed or that, if available, the terms of such financing will be favourable to the Company. Lending may be obtained from Canadian banks, Chinese banks or other debt markets.

There is no assurance that the Company's business will generate sufficient cash flow from operations in the future to service its debt and make necessary capital expenditures, in which case the Company may seek additional financing, dispose of certain assets or seek to refinance some or all of its debt.

Although Chinese banks are in the midst of reform, the basis on which they can lend money is not transparent and they do not often lend money to foreign invested enterprises. Obtaining financing from a Chinese bank will, to a certain extent, involve leveraging personal relationships. There is no guarantee that Migao Group will have the right relationships if and when it requires further financing. The Chinese government has articulated the need to try and control the rate of economic growth in China and has set out stricter lending policies, and this too could affect the Company's ability to obtain future bank financing.

***Technical Substitution***

Presently, the "Double Decomposition Process" process is used by Sichuan Migao to produce agricultural potassium nitrate. However, along with the discovery of new resources, technical progress, and the increasing advances in chemical production, new processes may be developed to produce higher quality and/or lower cost agricultural potassium nitrate.

Guangdong Migao and Liaoning Migao installed the "Mannheim Process" to produce potassium sulphate, one of the most commonly used quality potassium sulphate processes in the world. In recent years, a number of different potassium sulphate productive technologies have been developed in China. Though none of them are currently widely used due to lack of operational history and a lack of raw materials, there may be new potassium sulphate production processes developed or employed which may have new or additional benefits.

The development of new technologies and fertilizer related products could have an adverse effect on the Company's business, financial condition and operating results.

### ***Exchange Rate Fluctuations***

The value of the RMB fluctuates and is subject to various factors such as changes in the PRC political and economic conditions. Since 1994, the official exchange rate for the conversion of RMB to US dollars has generally been stable. On July 21, 2005, the RMB was revaluated upwards by approximately 2% against the US dollar when the People's Bank of China ("PBOC") announced the change of the RMB exchange regime from a US dollar peg system to a managed floating exchange rate regime based on a basket of currencies. Thereafter, the RMB is allowed to fluctuate daily by not more than 0.3% against the US dollar.

Exchange rate fluctuations may adversely affect the Company's financial position and results. There is no assurance that the value of the RMB will remain at the current level against the US dollar or against any other foreign currency. The Company does not currently have in place a policy for managing or controlling foreign currency risks since, to date, its primary activities have not resulted in material exposure to foreign currency risk.

As the Company reports financial results in Canadian dollars but earns its revenue in RMB, an increase in the Canadian dollar relative to the RMB will adversely affect the value, translated or converted into Canadian dollars, of the Company's revenue and net income.

### ***Insurance***

The operating entities in Migao Group maintain property and casualty insurance on certain of their assets. However, not all risks are covered by insurance and no assurance can be given that insurance will be consistently available or will be consistently available on an economically feasible basis. Operating entities in Migao Group may also elect not to be insured against certain liabilities due to high premium costs or for other reasons. Furthermore, although the subsidiaries maintain insurance against such claims and in such amounts each considers adequate, there can be no assurance that such insurance policies will be sufficient to cover each and every claim or loss involving the subsidiaries. In the event the subsidiaries were to suffer an uninsured loss, their business, financial condition and results of operations could be materially adversely affected.

### ***Foreign Operations***

Currently, the Company's operations are conducted in the PRC and it is anticipated that this will continue to be the case. As such, the Company's operations are exposed to various levels of political, economic and other risks and uncertainties. These risks and uncertainties include, but are not limited to: currency exchange rates; high rates of inflation; labour unrest; renegotiation or nullification of existing concessions, licenses, permits and contracts; changes in taxation policies; restrictions on foreign exchange; government corruption; changing political conditions; currency controls and governmental regulations that favour or require the awarding of

contracts to local contractors or require foreign contractors to employ citizens of, or purchase supplies from, a particular jurisdiction.

Changes, if any, in investment policies or shifts in political attitudes in China may adversely affect the Company's operations or profitability. Operations may be affected in varying degrees by government regulations with respect to, but not limited to, restrictions on production, price controls, export controls, currency remittance, income taxes, foreign investment, environmental legislation, land use, land claims of local people and water use. Any events resulting in an adverse impact on the Chinese economy will likely have an adverse effect on the Company's profitability and prospects.

The occurrence of these various factors and uncertainties cannot be accurately predicted and could have an adverse effect on the Company's business, financial condition and results of operations. See "Risks of Doing Business in China" below.

#### ***Weather Conditions and Natural Disasters***

Weather conditions affect the demand for the Company's products and the availability of raw materials and other inputs. For example, weather conditions such as floods, drought, or frost can cause crop failures that in turn affect the demand for fertilizer. Unfavourable weather conditions or the occurrence of natural disasters (such as damage by fire, insect infestation and earthquakes) may affect the Company's business, financial condition and results of operations.

#### ***Control by Management***

Management will have significant aggregate stock ownership and effective control, with the ability to perpetuate their status as officers and directors and, therefore, conduct the business and affairs of the Company. While the rights of minority shareholders would be protected in Canada, judgements rendered against the Company and/or the subsidiaries would likely not be enforceable in China.

#### ***Seasonality***

The Company is exposed to some seasonality risk due to factors including, but not limited to, the nature of its products, weather conditions and the buying patterns of major customers. These potential seasonality factors should also be considered together with the growth of the business. While some factors are not within its control, the Company can mitigate the risk by negotiating purchasing times with major customers and establishing a sales network across the country to span different regions and weather conditions.

#### ***Dividends***

The Company has no present intention to declare or pay any dividends in the foreseeable future. The future dividend policy will be determined by the Board of Directors of the Company. See "Dividends" below.

### *Conflicts of Interest*

Certain of the directors and officers of the Company also serve as directors and/or officers of other companies and consequently there exists the possibility for such directors and officers to be in a position of conflict. Any decision made by any of such directors and officers involving the Company will be made in accordance with their duties and obligations to deal fairly and in good faith with a view to the best interests of the Company and its shareholders.

### **Risks of Doing Business in China**

#### *State Ownership*

The Company carries on its business in China and derives all of its profit from the activities of its subsidiaries. As such, the Company's subsidiaries' results of operations, financial position and prospects are subject to a significant degree to economic, political, social and legal developments in China.

The Chinese economy differs from the economies of most developed countries in a number of respects, including its structure, the level of government involvement, the level of development, the control of foreign exchange and the allocation of resources.

Before its adoption of reform and open door policies beginning in 1978, China was primarily a planned economy. Since that time, China's economy has been undergoing a transition from a planned economy to a more market-oriented economy. Although in recent years the Chinese government has implemented economic reforms, reduced state ownership and established sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the Chinese government. In addition, the Chinese government continues to play a significant role in regulating industry by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, control for foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. Furthermore, government policies relating to currency conversion, taxation, import restrictions and the trading of imported goods, among others, continue to have a significant impact on the overall economy, as does the presence of the government as a market participant as well as the market regulator. Many of the policy changes initiated since 1978 are unprecedented in China, experimental in nature, and are frequently refined and readjusted. Political and social factors may also lead to further refinements and readjustments. Any changes in Chinese political, economic, or social conditions, or to the current laws and regulations, or their interpretations may adversely affect the Company's profitability and prospects.

The economy of China has experienced significant growth in the past 20 years, but growth has been uneven both geographically and among various sectors of the economy. The Chinese government has implemented various macro-economic control measures from time to time in order to try and control the rate of economic growth, including certain measures which were put in place to restrict bank lending. Some of these measures

may have a negative effect on the Company. For example, the Company's operating results and financial position may be adversely affected by: changes in the rate or method of taxation; imposition of additional restrictions on currency conversion and remittances abroad; reduction in tariff or quota protection and other import restrictions; changes in the usage and costs of state-controlled transportation services; and, state policies affecting the fertilizer industry. In addition, such macro-economic control measures may have a general adverse impact on the Chinese economy that would, in turn likely have an adverse impact on the Company's business and profitability.

### ***Government Sector Intervention***

The central and local governments exercise a substantial degree of influence over the fertilizer industry in China and, as a result, set standards that new entrants must meet through approval of major capital expenditure projects; setting or approving the framework for the pricing of electricity and other utilities and railway transportation; and setting tax levies and incentives, import quotas and tariffs, and safety, environmental and quality standards.

If the Chinese government changes its current policies, or the interpretation of those policies, the Company may face significant constraints on its flexibility and ability to expand its business operations or to maximize its profitability. Under current Chinese regulatory requirements, all major capital expenditure projects require Chinese national and/or provincial government approval.

### ***Foreign Investment***

In China, companies with a foreign ownership component could be required to work within a framework which is different to that imposed on local companies. However, the Chinese government is opening up opportunities for foreign investment in fertilizer projects and this process is expected to continue, especially with China's entry into the World Trade Organization. However, if the Chinese government should reverse this trend and impose greater restrictions on foreign companies, the Company's ability to conduct business in China could be negatively affected.

### ***Repatriation of Profit and Currency Conversion***

The PRC government imposes control over the convertibility of the RMB into foreign currencies. With effect from July 21, 2005, the PRC government has reformed the RMB exchange rate regime into a managed floating exchange rate regime based on market supply and demand with reference to a portfolio of currencies, giving more flexibility as compared with the former system in which the RMB was pegged to the US dollar. See "Exchange Rate Fluctuations" above. Under such reformed system, the PBOC announces the closing price of a foreign currency traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each working day, and will make it the central parity for trading against the RMB on the following working day. PRC banks licensed to engage in foreign exchange transactions use the closing price announced by the PBOC as a basis and decide a rate of their own to enter into foreign exchange sale and purchase

transactions with customers; such rate shall be within a specified floating band around the central parity which may be adjusted by the PBOC from time to time according to the economic and financial condition in the PRC. Although such new regulations have provided for greater liquidity of the RMB, the RMB is still not a freely convertible currency.

Migao Group subsidiaries earn all of their revenues in RMB. Under current regulations, there is no restriction on foreign exchange conversion on the current account (including dividend payments to foreign investors) although any foreign exchange transaction on the capital account is subject to significant foreign exchange controls and requires the prior approval from the State Administration of Foreign Exchange (“SAFE”). However, even on the current account, the RMB is not a freely convertible currency. Migao Group subsidiaries are allowed to pay outstanding current account obligations in foreign exchange but must present the proper documentation to a designated foreign exchange bank to prove the authenticity of foreign exchange under the current account. While the Chinese government is generally relaxing restrictions on foreign trade and investment, there is no certainty that all future local currency can be repatriated.

There can also be no assurance that the availability of foreign currency will be sufficient for the Company’s subsidiaries to satisfy their other foreign currency obligations. This may, in turn, adversely affect the Company’s ability to pay dividends. There is also no guarantee that foreign exchange control policies will not be changed so as to require government approval to convert RMB into foreign currency on the current account. In addition, failure to obtain approval from SAFE for currency conversion on the capital account may impact on the Company’s capital expenditure plans and its ability to expand in accordance with its objectives.

### ***Tax***

The Company’s subsidiaries receive special tax treatment in China. As a result of national tax regulations and local incentives, a reduced enterprise income tax rate is granted to foreign invested companies registered in specific economic development zones. Accordingly, the subsidiaries pay enterprise income tax at a reduced rate.

As discussed above under “The Business - Fertilizer Production Facilities - Taxation”, the EITL enacted in March 2007 will remove the tax incentives currently offered to foreign invested enterprises since wholly domestically owned companies did not receive such incentives. Established Migao Group enterprises may enjoy certain “grandfathering” provisions under the EITL, however there can be no certainty in this regard until each subsidiary applies for, and if available to it, receives approval for such provisions. Any increase in the tax rate to which the Company or its subsidiaries are subject pursuant to the EITL or otherwise will reduce the net profitability of the Company. Such reduction could be material and historical financial results may thus not be indicative of results for future periods.

Under current Chinese laws, any dividends HK Migao may receive from its Migao Group subsidiaries are not subject to Chinese tax. There can be no assurance that these dividends will continue not to be subject to tax in the future.

#### ***Shareholders' Rights and Enforcement of Judgements***

As Chinese legal entities, Migao Group subsidiaries are subject to Chinese company law and regulations. Chinese company law, in general, and provisions for the protection of shareholders' rights and access to information, in particular, are less developed than those applicable to companies in other countries. Substantially all of the Company's assets, through its subsidiaries, are located in China. China does not have a treaty with Canada providing for the reciprocal recognition and enforcement of judgements of courts and, as such, recognition and enforcement in China of judgements of a Canadian court in relation to any matter not subject to a binding arbitration provision may be difficult or impossible. Although the rights of minority shareholders in the Company would be protected in Canada, judgements rendered against the Company and/or its subsidiaries would likely not be enforceable in China.

#### ***Developing Legal System***

The Chinese legal system is a system based on written statutes that are often incomplete or drafted ambiguously. They are interpreted by the Supreme Peoples' Court and prior court decisions may be cited for reference but have limited precedential value. Since 1979, the Chinese government has been developing a comprehensive system of commercial laws, and considerable progress has been made in introducing laws and regulations dealing with economic matters such as foreign investment, corporate organization and governance, commerce, taxation and trade.

However, because these laws and regulations are relatively new, and because of the limited volume of published cases and their non-binding nature, interpretation and enforcement of these laws and regulations involve uncertainties. In addition, many judges in the PRC take a pragmatic view of the law and seek to resolve problems without necessarily enforcing the legal rights of the aggrieved parties. As the Chinese legal system develops, changes in such laws and regulations, their interpretation, or their enforcement, may have a material effect on the Company.

#### ***Protection of Intellectual Property Rights***

Intellectual property rights in China are still developing and there are uncertainties involved in intellectual property rights protection and the enforcement of such protection. The Company will need to pay special attention to protecting its intellectual property and trade secrets. Failure to do so could lead to the loss of a competitive advantage that could not be compensated by a damages award.

***Permits and Business Licenses***

Migao Group subsidiaries hold various permits, business licenses and approvals authorizing their operations and activities which are subject to periodic review and re-assessment by the Chinese authorities. Standards of compliance necessary to pass such reviews change from time to time and differ from jurisdiction to jurisdiction, leading to a degree of uncertainty. If renewals, or new permits, business licenses, or approvals required in connection with existing or new facilities or activities, are not granted or are delayed, or if existing permits, business licenses or approvals are revoked or substantially modified, the Company may suffer a material adverse effect. If new standards are applied to renewals or new applications, it could prove costly to the Company to meet any new level of compliance.

***Appropriation***

Migao Group subsidiaries have purchased certain land use rights in China. Under Chinese law, land use rights can be revoked in the public interest, although holders of such appropriated land use rights typically receive compensation. Events in China have shown that the public interest rationale is interpreted quite broadly and the process of land appropriation may be less than transparent.

***Availability of Land***

Land in China is divided into agricultural land, construction land and unused land. In October 2007, a new policy was issued by the Chinese government restricting the use or conversion of agricultural land for non-agricultural purposes (which would include Migao Group's purposes). While the policy does not prohibit the use of agricultural land for non-agricultural purposes, it may make it more difficult for Migao Group to secure new land and/or increase the price of available properties.