ZTE CORPORATION
中興通訊股份有限公司
(A joint stock limited company incorporated in the People's Republic of China with limited liability)
(Stock Code: 763)

Overseas Regulatory Announcement
Response to the "Letter of Query on the Restructuring of ZTE Corporation" from Shenzhen Stock Exchange

This announcement is made pursuant to Rule 13.10B of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

On 24 November 2020, ZTE Corporation ("ZTE" or the "Listed Co") received the Letter of Query on the Restructuring of ZTE Corporation (Xu Ke Lei Chong Zu Wen Xun Han [2020] No. 16) issued by Shenzhen Stock Exchange ("Letter of Query"). As required by the Letter of Query, the Company has actively organised relevant parties to address the questions raised in the Letter of Query, and a response is put forth in the following.

Unless otherwise specified, terms or abbreviations used in this response have the same meanings as defined under the section headed "Definition" in the Overseas Regulatory Announcement ZTE Corporation Report on Acquisition of Assets by Issuance of Shares and Ancillary Fund-raising (Draft) (Revised Version).

Q1: On 3 February 2020, the Company completed its RMB11,500 million non-public issuance of A shares, out of which RMB9,100 million was applied to technology research and product development projects focused on 5G network evolution and the remainder as replenishment of working capital. As at 30 September, the Company's book balance of cash amounted to RMB43,500 million with a gearing ratio of 72.92%. The interval between the current ancillary fundraising and the previous non-public issuance of A shares is rather short. Please explain, taking into account the progress of utilisation of proceeds from the previous fundraising and shortfalls in working capital, the necessity of the current ancillary fundraising and the principal considerations and justification for utilising 50% of the ancillary funds as working capital replenishment, whether it is in compliance with the Regulatory Requirements for Directing and Regulating Financing Activities of Listed Companies, among others, and the remedial measures in connection with minority interests. The Independent Financial Adviser and legal adviser are asked to examine and furnish an unequivocal opinion.

I. Response

(I) Necessity of the current ancillary fundraising and the principal considerations and justification for utilising 50% of the ancillary funds as working capital replenishment

1. The period 2018 – 2020 is a phase of formation of global 5G technology standards and business incubation. The previous fundraising exercise of the Company was implemented against such a backdrop and currently proceeds raised have basically been utilised in full. The utilisation of proceeds from the previous fundraising exercise has effectively bolstered the Company's technological strengths prior to full-scale 5G commercialisation to lay the foundation for its development.

The period 2018–2020 is a phase of formation of global 5G technology standards and business incubation. At the meeting of the Board held on 31 January 2018, the Company planned for the non-public issuance of A shares to raise funds for "technology research and product development projects focused on 5G network evolution" and "replenishment of working capital" with an implementation cycle of three years (from January 2018 to January 2021). Depending on the actual progress of the projects, the Company might commit internal funds ahead of receipt of the proceeds, and replace such internal funds with the proceeds upon receipt of the latter.

As approved by the CSRC by virtue of the document "Approval for ZTE Corporation's non-public issuance of shares (Zheng Jian Xu Ke [2019] No. 1904), the Company raised net proceeds of RMB11,459 million through the non-public issuance of A shares, which proceeds were received on 14 January 2020. According to the Company's "Special report on the deposit and application of issue proceeds for the first-half year of 2020", as at 30 June 2020, the Company invested a total of RMB10,229 million in projects scheduled to be funded by issue proceeds, representing 89.27% utilisation. Utilisation of the remaining proceeds is expected to have been completed by January 2021, providing effective support for the Company's R&D in 5G network evolution over the past three years and bolstering the Company's technological strengths prior to full-scale 5G commercialisation to lay the foundation for its development.

Proceeds from the Company's previous fundraising exercise were utilised by the Company and 6 wholly-owned subsidiaries, excluding ZTE Microelectronics which was a non-wholly-owned subsidiary requiring continuous investment of substantial funds in chip design and development.

2. The ancillary fundraising exercise will be implemented against the backdrop of the Company's acquisition of minority interests in ZTE Microelectronics to further increase its control during a phase of 5G commercial network construction and expedited development of industrial applications worldwide, which will help ZTE Microelectronics to increase its investment in key 5G chip technologies on an ongoing basis and enhance its core competitive strengths.

At present, the world is undergoing a phase of 5G commercial network construction and expedited development of industrial applications of 5G. Global 5G service deployment is expected to roll out in full gear in the next five years, underpinned by a rapidly maturing industry chain and vigorous supply of innovative applications driving a new boom for the communications industry. Chip design and development is a key component in 5G technological innovation. The acquisition of minority interests in the ZTE Microelectronics will further enhance the Company's management control over ZTE Microelectronics, on the basis of which the Company would be able to roll out more sophisticated investment development planning for chip design, such as the R&D of key 5G wireless access chip technology enabling stronger computational ability, larger storage, a greater range of access port and a higher level of integration, as well as key 5G carrier network chip technology compatible with generational upgrade requirements such as greater capacity, larger bandwidth, lower time latency and programmability.

In order to develop its core technological competitiveness, the R&D expenditure of ZTE Microelectronics has been growing at a rate of over 20% in recent years, and is expected to maintain relatively fast growth in the future. The application of ancillary funds raised in the key 5G chip R&D projects of ZTE Microelectronics in support of its technological innovation in 5G chip will enable ZTE Microelectronics to increase its investment in key 5G chip technologies on a continuous basis and enhance its core competitiveness. At the same time, practical experiences in key 5G chip technological research and product development will drive overall improvements in the Company's ability in design technology and commercialisation, providing support in its effort to seize opportunities in the ICT sector, expand into new business segments and contribute to the development of digital economy.

3. In view of the complicated internal as well external conditions in the post-epidemic era and ongoing growth in R&D investment and market demand for 5G, the Company's working capital requirements are expected to further increase, and the partial application of ancillary funds raised as working capital replenishment for the Company will help to meet shortfalls in future working capital requirements and optimise its capital structure.

Based on the Company's historical operating conditions and past experience in funding management, the Company would usually require cash sufficient to meet expenditure for three months to ensure secure cash flow. The Company's cash expenditure for Q3 2020 amounted to RMB41,000 million. As at 30 September 2020, the Company's book balance of cash amounted to RMB43,500 million (out of which RMB2,000 million represents restricted cash such as deposits, etc). The current cash balance can ensure secure cash flow only to the extent of the Company's current scale of operation.

Given the complicated internal and external environment in the post-epidemic era and the ongoing growth in inventory levels, R&D investment and 5G market demand, the Company's working capital requirements are expected to increase further. First of all, the Company's inventory level will increase notably, as the Company is required to increase its inventories in order to maintain the stability of its business chain amidst the complicated internal and external environment in the post-epidemic. The carrying amount of inventory balance as at 30 September 2020 increased by RMB11,665 million compared to the end of 2019. Second, the requirement for R&D investment continued to grow, as the Company continued to increase its R&D investment and expand its R&D teams in recent years. As at 30 September 2020, the Company had a R&D headcount of 32,000, a notable increase compared to 28,000 at the end of 2019. The Company's R&D expenditure for 2018, 2019 and the nine months ended 30 September 2020 amounted to RMB10,906 million, 12,548 million and 10,791 million, respectively, accounting for 12.75%, 13.83% and 14.56%, respectively, of the Company's operating income for the same periods in a trend of ongoing increase. Such R&D expenditure is expected to grow at a relatively fast rate in the future. Third, market demand for 5G is driving rapid growth in operating income. The Company's operating income for Q3 2020 grew by 37.18%, year-on-year, to RMB26,930 million. The notable increase in inventory requirements, ongoing growth in R&D investment requirements and rapid growth in operating income call for the Company to continue to increase its working capital and cash on hand correspondingly. The partial application of ancillary funds as working capital replenishment will help us to meet the shortfall in future working capital requirements.

In the meantime, as at 30 September 2020, the Company's gearing ratio was 72.92%, which was 4.44 percentage points higher compared to 68.48% as at the end of 2017 representing a high level compared to recent years. The Company's gearing ratio is also the highest among the global big four communication equipment manufacturers, approximately 7 percentage points higher compared to the average gearing ratio of the industry as at the end of 2019. As at 30 September 2020, the balances of short-term loans, short-term bonds payable and long-term loans amounted to RMB14,983 million, RMB8,000 million and RMB21,464 million, respectively. While the Company meets its growing working capital requirements mainly through debt financing, the scope for fundraising solely through debt financing is rather limited given its current gearing ratio. Hence, equity financing needs to be sought to optimise its capital structure and lower its gearing ratio.

In view of the above, the raising of ancillary funds will enable ZTE Microelectronics to enhance its core competitive strengths and seize opportunities in 5G commercial applications by continuously increasing its investment in key 5G chip technology and is therefore necessary. The application of 50% of the proceeds from the ancillary fundraising as working capital replenishment is justified as it would help the Company to meet shortfalls in future working capital requirements and optimise the Company's capital structure.

(II) Whether in compliance with Regulatory Requirements for Directing and Regulating Financing Activities of Listed Companies, among others

In accordance with the Q&A on Regulation over Issuance - Regulatory Requirements for Directing and Regulating Financing Activities of Listed Companies (Revised Version) implemented with effect from 14 February 2020, "If a listed company applies for additional issuance, allocation of shares, or non-public issuance of shares, the date of resolution of the Board of Directors of this issuance shall not be less than 18 months from the date of the previous issue proceeds in principle. If the previous issue proceeds are basically used or the use of the previous issue proceeds are not changed and invested as planned, the above restrictions can be waived, but the corresponding interval shall not be less than 6 months in principle." According to the Company's "Special report on the deposit and application of issue proceeds for the first-half year of 2020", as at 30 June 2020, the Company invested a total of RMB10,229 million in projects scheduled to be funded by issue proceeds, representing 89.27% utilization, the previous issue proceeds are basically used and use of the previous issue proceeds are not changed and invested as planned. The previous issue proceeds of the Company were received on 14 January 2020, and it has been more than 6 months since the date of resolution of the Board of Directors (namely, October 28, 2020) of Proposal for Share Issue for Asset Acquisition and Raising of Ancillary Funds. Therefore, the ancillary funds raised of the Company is in compliance with the provisions.

In accordance with the Applicable Guidelines under Regulatory Rules – Listed Category No. 1 implemented with effect from July 2020, "If ancillary funds are applied as working capital replenishment, the amount utilised for debt repayment shall be not more than 25% of the pricing of the transaction; or not more than 50% of the total amount of ancillary funds raised.” The amount of the issue proceeds of the Company is RMB2.61 billion, of which RMB1.30 billion is applied as working capital replenishment, which is not more than 50% of the total amount of ancillary funds raised. Therefore, the ancillary funds raised of the Company is in compliance with the provisions.

Therefore, the ancillary funds raised of the Company is in compliance is in compliance with the pertinent provisions under the Applicable Guidelines under Regulatory Rules – Listed Category No. 1 (CSRC July 2020) and the Q&A on Regulation over Issuance - Regulatory Requirements for Directing and Regulating Financing Activities of Listed Companies (Revised Version) (CSRC 14 February 2020).

(III) Remedial measures in connection with minority interests

The Company has adopted effective remedial measures in connection with compensation for minority interests following the raising of ancillary funds, the details of which are as follows:

1. Seizing opportunities in the communication market with full effort to achieve stable growth in market shares

At present, the world is undergoing the phase of 5G commercial network construction and expedited development of industrial applications. Thanks to consistent investment in innovation over the years in line with its core 5G development strategy, the Company is equipped with the ability to provide a complete range of end-to-end 5G solutions and well-positioned to advance its large-scale global 5G commercial deployment on the back of its leading technologies, products and solutions in wireless products, core networks, bearers, chips, terminals and industrial applications. Following the completion of the Transaction, the Company will continue to seize opportunities in the communication market to achieve stable growth in its market shares and profitability.

2. Control over management and operational risks facilitated through ongoing improvements to corporate governance structure

The Company will continue to improve its corporate governance structure and enhance its internal control regime in accordance with requirements of the Company Law, the Securities Law and Corporate Governance Standards for Listed Companies and other pertinent laws, regulations and regulatory documents, so as to ensure sound and effective exercise of powers by the Board, Supervisory Committee and management which will allow stringent control over management and operational risks while facilitating efficient decision-making, thereby offering effective protection for investors’ interests, in particular the lawful interests of minority shareholders.

3. Implementation of profit distribution policy and optimisation of mechanism for investment return

To improve the Listed Co’s profit distribution policy, facilitate the development of a more scientific, consistent and stable mechanism for shareholders’ return for the Listed Co, increase the transparency and operability of its profit distribution policy and decision-making, and offer genuine protection to the lawful interests of the public investors, the Listed Co has set out clear provisions on profit distribution policy in its Articles in accordance with the pertinent provisions of CSRC and the laws and regulations, taking into account the actual conditions of the Listed Co. In the future, the Listed Co will continue to maintain and improve its regulations for profit distribution to further enhance the mechanism for investors' return.

4. Undertakings by the Company's Directors, senior management and Controlling Shareholder in relation to the implementation of remedial measures

(1) Undertakings by the Company's Directors, senior management in relation to the implementation of remedial measures

Pursuant to the Undertaking in connection with Remedial Measures on Dilution of Return for the Current Period after the Restructuring signed by the Company's Directors, senior management, the Directors and senior management of the Company have undertaken, in relation to the implementation of remedial measures, that they will:

1. not be engaged in tunneling in favour of other units or individuals on a nil-payment basis or upon unfair terms, or otherwise compromise the interests of ZTE;

2. exercise restraint in spending when performing duties of their office;

3. not misappropriate ZTE's assets for investing activities or expenses not related to the performance of their duties;

4. procure the linking of the remuneration regime formulated by the Board or the Remuneration Committee of the Board with the implementation of ZTE's remedial measures;

5. procure the linking of the exercise conditions under ZTE's share option incentives to be announced with the implementation of ZTE's remedial measures;

6. willingly assume the liability for compensating ZTE and / or its shareholders in accordance with the law in the event of losses incurred by ZTE and / or its shareholders as a result of personal violation of or refusal to honour the undertaking.

(2) Undertakings by the Company's Controlling Shareholder in relation to the implementation of remedial measures

Pursuant to the Undertaking in connection with Remedial Measures on Dilution of Return for the Current Period after the Restructuring signed by the Controlling Shareholder, the Controlling Shareholder of the Company has undertaken, in relation to the implementation of remedial measures, that:

it will not, for so long as it remains the Controlling Shareholder of ZTE, act beyond its powers to interfere with ZTE's operating and management activities or expropriate ZTE's interests

II. Examination opinion of the intermediary agencies

Upon examination, the Independent Financial Adviser and legal adviser are of the view that: proceeds from the issuer's previous fundraising have basically been utilised in full, and the application of the proceeds from the ancillary fundraising in the key 5G chip R&D project and as working capital replenishment for the Listed Co is necessary, while the partial application as working capital replenishment is conducive to meeting shortfalls in future working capital requirements and optimising its capital structure and is therefore justified, and is in compliance with the Applicable Guidelines under Regulatory Rules – Listed Category No. 1 (CSRC July 2020) and the Q&A on Regulation over Issuance - Regulatory Requirements for Directing and Regulating Financing Activities of Listed Companies (Revised Version) (CSRC 14 February 2020), among others. The Company has formulated effective remedial measures in connection with minority interests which are able to protect minority interests.

Q2: On 23 November 2015, IC Fund entered into the Capital Increase Agreement of ZTE Corporation, Shenzhen Sai Jia Xun Investment Development Enterprise (Limited Partnership), National Integrated Circuit Industry Investment Fund Corporation and ZTE Microelectronics Technology Company Limited" with the Company, Sai Jia Xun and ZTE Microelectronics Technology Company Limited ("ZTE Microelectronics "), pursuant to which IC Fund subscribed for 24% shares in ZTE Microelectronics for a consideration of RMB2,400 million. On 10 September 2020, IC Fund, Renxing Technology, the Company and ZTE Microelectronics entered into an Equity Transfer Agreement, pursuant to which IC Fund would transfer the 24% equity interests in ZTE Microelectronics to Renxing Technology for a consideration of RMB3,315 million. On the same date, Hengjian Xinxin and Huitong Rongxin entered into the Cooperation Agreement with the Company and Renxing Technology, pursuant to which Hengjian Xinxin and Huitong Rongxin provided cooperation funds of RMB1,400 million and RMB1,200 million, respectively, to Renxing Technology to partially finance the consideration to be paid to IC Fund for the acquisition of 24% equity interests in ZTE Microelectronics. On 20 October, the transfer of 10.1349% equity interests in ZTE Microelectronics to Hengjian Xinxin for a consideration of RMB1,400 million and the transfer of 8.6870% equity interests in ZTE Microelectronics to Huitong Rongxin for a consideration of RMB1,200 million by shareholder Renxing Technology was approved by way of resolution at the general meeting of ZTE Microelectronics. Hengjian Xinxin and Huitong Rongxin were established on 9 September 2020 and 9 December 2019, respectively, and are dormant in business activities without any records of financial data for the two recent years. Please provide further look-through disclosure of the respective shareholding structures of Hengjian Xinxin and Huitong Rongxin and verify the source of the aforementioned cooperation funds of RMB2,600 million and whether the Company or its related parties had directly or indirectly funded such amount. Please also explain the principal considerations, commercial substance and justification of the equity transfer arrangements involving transfer from IC Fund to Renxing Technology and then from Renxing Technology to Hengjian Xinxin and Huitong Rongxin. The Independent Financial Adviser is asked to examine and furnish an unequivocal opinion.

I. Response

(I) Further penetrative disclosure of the shareholding structures of Hengjian Xinxin

and Huitong Rongxin

As at the date of this response, the shareholding structure information of Hengjian Xinxin and Huitong Rongxin after look-through has been disclosed in the draft restructuring report (revised version) as supplementary information.

(II) Source of the RMB2,600 million cooperation funds and whether ZTE or its related parties had directly or indirectly funded such amount.

According to the Cooperation Agreement and information, statements, bank evidences and undertakings furnished by Hengjian Xinxin, the RMB1,400 million cooperation funds provided by Hengjian Xinxin to Renxing Technology has been sourced from the capital contribution to Hengjian Xinxin made by its partners using self-raised funds in accordance with the Partnership Agreement for Guangdong Hengjian Xinxin Investment Partnership Enterprise (Limited Partnership). Among the partners, Guangdong Guanghengshun Investment Company Limited and Guangdong Hengjian Asset Management Company Limited are wholly-owned subsidiaries of Hengjiang Holding, which has a registered capital of RMB21,200 million; funds of partner Guangdong Henghang Industrial Investment Fund Partnership Enterprise (Limited Partnership) have been sourced from capital contribution of its partners Guangdong Advanced Manufacturing Sector Investment Fund Partnership Enterprise (Limited Partnership), among others, and Guangdong Advanced Manufacturing Sector Investment Fund Partnership Enterprise (Limited Partnership) in turn has sourced its funds from its partner Hengjian Holding.

According to the Cooperation Agreement and information, statements, bank evidences and undertakings furnished by Huitong Rongxin, Huitong Rongxin is a wholly-owned subsidiary of Huitong Jinkong, and the RMB1,200 million cooperation funds provided by Huitong Rongxin to Renxing Technology have been sourced from additional capital contribution to Huitong Rongxin from Huitong Jinkong, which has a registered capital of RMB22,700 million.

The respective capital contributions from Hengjian Xinxin and Huitong Rongxin do not involve financial assistance provided directly or indirectly by ZTE or its related parties.

(III) Principal considerations, commercial substance and justification of the equity transfer arrangements involving transfer from IC Fund to Renxing Technology and then from Renxing Technology to Hengjian Xinxin and Huitong Rongxin.

1. Transfer from IC Fund to Renxing Technology

On 23 November 2015, IC Fund entered into the Capital Increase Agreement, Shareholders' Agreement and Articles of Association (together the "Previous Transaction Documents") with ZTE, Sai Jia Xun and ZTE Microelectronics, pursuant to which the registered capital of ZTE Microelectronics would be increased from RMB100 million to RMB131,578,947, with the additional registered capital of RMB31,578,947 subscribed for by IC Fund at a price of RMB2,400 million. Following the completion of the aforesaid capital increase, IC Fund would hold 24% equity interests in ZTE Microelectronics.

Pursuant to the Company's strategic planning for ZTE Microelectronics, the pertinent terms under the Previous Transaction Documents and negotiations between the Company and IC Fund, IC Fund agreed to the repurchase of 24% equity interests in ZTE Microelectronics held by IC Fund by Renxing Technology, a wholly-owned subsidiary of the Company by way of cash and the Equity Transfer Agreement was signed on 10 September 2020. The aforesaid equity transfer was conducted pursuant to the agreement among IC Fund, ZTE and Renxing Technology under the Previous Transaction Documents and in view of the long-term strategic planning for ZTE Microelectronics of ZTE as its majority shareholder, and was determined through friendly negotiations among the parties under the framework of the Previous Transaction Documents. It represents the bona fide intentions of the parties and is commercially justifiable.

2. Transfer from Renxing Technology to Hengjian Xinxin and Huitong Rongxin

Given the Company's relatively high gearing ratio as well as substantial funding requirements for R&D and business development and in order to fulfill the Company's objective of repurchasing 24% equity interests in ZTE Microelectronics by cash, following friendly negotiations among between Company and Hengjian Xinxin and Huitong Rongxin, Hengjian Xinxin and Huitong Rongxin agreed to provide cooperation funds of RMB1,400 million and RMB1,200 million, respectively, to Renxing Technology, a wholly-owned subsidiary of the Company, to finance part of the consideration to be paid by Renxing Technology to IC Fund for the acquisition of 24% equity interests in ZTE Microelectronics, and the Company and Renxing Technology entered into the Cooperation Agreement with Hengjian Xinxin and Huitong Rongxin on 10 September 2020. In accordance with the Cooperation Agreement, Hengjian Xinxin and Huitong Rongxin have the right to recoup the cooperation funds from Renxing Technology by way of debt-to-equity conversion arrangements for or otherwise.

Following further negotiations, Renxing Technology reached an agreement with Hengjian Xinxin and Huitong Rongxin in connection with the conversion of the aforesaid cooperation funds into equity interests in ZTE Microelectronics and entered into the Equity Transfer Agreement on 20 October 2020, pursuant to which Renxing Technology agreed to transfer 10.1349% equity interests in ZTE Microelectronics to Hengjian Xinxin for a consideration of RMB1,400 million and 8.6870% equity interests in ZTE Microelectronics to Huitong Rongxin for a consideration of RMB1,200 million. The RMB2,600 million cooperation funds provided by Hengjian Xinxin and Huitong Rongxin under the aforesaid Cooperation Agreement shall be offset against the consideration for the equity transfer, so as to facilitate the recoup of the cooperation funds by Hengjian Xinxin and Huitong Rongxin from Renxing Technology.

In view of the above, the aforesaid transaction arrangements have been based on respective previous cooperation documents and determined through friendly negotiations. They represent the bona fide intentions of the parties and are commercially justifiable.

II. Examination opinion of the intermediary agencies

Upon examination, the Independent Financial Adviser is of the view that:

1. The shareholding structure information of Hengjian Xinxin and Huitong Rongxin after look-through has been disclosed in the draft restructuring report (revised version) as supplementary

information, which is true.

2. The cooperation funds provided by Hengjian Xinxin and Huitong Rongxin to Renxing Technology have been sourced from the capital contributions of their respective partners or shareholders by way of legal and compliant means such as loans and capital contributions. The sources of funds do not involve financial assistance provided directly or indirectly by ZTE or its related parties;

3. The transfer of 24% equity interests in ZTE Microelectronics from IC Fund to Renxing Technology has been determined through friendly negotiations between relevant parties pursuant to the Previous Transaction Documents. It represents the bona fide intentions of the parties and is commercially justifiable. The transfer of partial equity interests in ZTE Microelectronics to Hengjian Xinxin and Huitong Rongxin by Renxing Technology has been determined through friendly negotiations between relevant parties pursuant to relevant terms under previous cooperation documents. It represents the bona fide intentions of the parties and is commercially justifiable.

Q3: ZTE Microelectronics derives its sales revenue mainly from chip products and technology services, for 2018, 2019 and the six months ended 30 June 2020, the sales revenue of ZTE Microelectronics from chip products and technology services amounted to RMB5,184 million, RMB5,004 million and RMB6,025 million, respectively, and sales to its top five customers in aggregate accounted for 93.27%, 96.62% and 98.94%, respectively, out of which revenue from sales by ZTE Microelectronics to the Company (including its subsidiaries) accounted for 88.82%, 88.35% and 95.10%, respectively. In addition, the sample cases selected for the appraisal, including the acquisition of 85.53% equity interests in Beijing Haowei Technology Co. Ltd. (北京豪威科技有限公司) by Will Semiconductor (韋爾股份), acquisition of 100% equity interests in AutoChips (傑發科技(合肥)有限公司) by NavInfo (四維圖新), acquisition of 59.99% equity interests in ISSI (北京矽成半導體有限公司) by Ingenic Semiconductor (北京君正), all involve the acquisition of controlling interests in the target companies. Will the Company please: (1) state whether the sales operations of ZTE Microelectronics are significantly dependent on the Company (including its subsidiaries), whether the differences between intra-group sales and sales to third parties have been considered in relation to comparability in selecting the comparable companies under the market approach to valuation, and further state the effect thereof on the reasonableness of the valuation of the Target Assets; (2) further analyse the comparability between the Transaction (acquisition of minority interests in the target company) and the selected cases, and state whether the intention of acquiring of controlling interests in these cases and its probable effect on their appraised values has been taken into consideration in the course of appraisal. The Independent Financial Adviser and the Appraiser are asked to furnish their unequivocal opinions.

I. Response

(I) Whether the sales operations of ZTE Microelectronics are significantly dependent on the Company (including its subsidiaries), whether the differences between intra-group sales and sales to third parties have been considered in relation to comparability in selecting the comparable companies under the market approach to valuation, and the effect thereof on the reasonableness of the valuation of the Target Assets

1. The commercial cooperation relationship between ZTE Microelectronics and ZTE is determined by the characteristic of having a high level of concentration of the downstream communication industry in which they operate

On a global basis, there are four major communication equipment manufacturers, forming a highly concentrated sector. As the chip is the one of the core components of communication equipment, all major communication equipment manufacturers have designated chip manufacturers with whom they are engaged in stable long-term cooperation, while manufacturers of core chips for communication equipment are generally focused on core customers, hence forming close working relationships and equity holding relationships. Accordingly, it is a characteristic of the industry that a single customer would account for a rather high percentage share.

The Company has continued to increase its investment in core chip technologies in order to maintain its competitive edge. As a majority-owned subsidiary of the Company, ZTE Microelectronics is the Company's operating arm for chip design and development. The core chip technologies and products of ZTE Microelectronics provide an important assurance for the overall competitiveness of the Company's communication business. The relationship between the two is a mutually beneficial one based on market-oriented commercial principles, which is consistent with the relationships of the comparable companies with their respective customers and therefore is comparable.

2. ZTE accounts for a substantial share of ZTE Microelectronics sales as the latter is currently focused on communication chips to seize opportunities presented by the generational change in communication technologies

ZTE Microelectronics has developed more than 100 types of proprietary chips which have been successfully put to commercial applications, covering the "access, bearer and terminal" segments of the communication network. With global mobile communication technologies evolving from 4G to 5G, the world is currently undergoing a stage of 5G commercial network construction and expedited industrial. To seize the historic opportunity for development in the 5G market, ZTE Microelectronics is focusing its resources on the development of communication chips including key 5G chips, which is why sales during the reporting period were mainly directed towards ZTE, while less effort was made to develop other customers. The market development strategy of ZTE Microelectronics is consistent with that of the comparable companies. As both are based on market-oriented commercial principles, they are comparable.

3. Sales to ZTE by ZTE Microelectronics priced according to market-based principles

The gross profit margin of ZTE Microelectronics sales of chips to ZTE has been maintained at around 30%, which is close to the gross profit margin of listed IC design companies such as Giga Device and Will Semiconductor for the past three years, and is generally within the reasonable range for the industry. During the reporting period, ZTE Microelectronics sales to ZTE were priced according to market-based principles, and this was consistent with the sales pricing of comparable companies. As both are based on market-oriented commercial principles, they are comparable.

In view of the above, the higher percentage of intra-group sales recorded by ZTE Microelectronics is attributable to the characteristics of the downstream communication industry and the operating strategy for the current stage, and such sales have been priced according to market-based principles. The differences with the comparable companies in relation to intra-group sales and sales to third parties are the result of their respective market-oriented commercial backgrounds. As both are based on market-oriented principles, they are comparable. The business characteristics of ZTE Microelectronics and the comparable companies under their respective market-oriented commercial backgrounds have been taken into full consideration in the appraisal, and adjustments have been made according to selected significant indicators, such as profitability, asset quality, solvency, growth of operations, ability in upstream consolidation, ability in downstream consolidation and R&D competence. Therefore the adoption of the market approach to valuation is justified.

(II) Further analysis of the comparability between the Transaction (acquisition of minority interests in the target company) and the selected cases, and whether the intention of acquiring of controlling interests in these cases and its probable effect on their appraised values has been taken into consideration in the course of appraisal.

1. Analysis of comparability of selected cases for the appraisal

The comparable cases selected for the appraisal are comparable to the Transaction, as illustrated in the following:

Item	Comparability
Consistency in type	The Transaction on the one hand and the comparable cases on the other both involve equity acquisition
Recency of transaction	The dates of announcement of CSRC approval for the selected transaction cases are within 4 years from the valuation benchmark date and the acquirers in such cases are A share listed companies of the PRC
Similarity in the target company's business	The respective target companies in the Transaction and in the comparable cases are listed under the sector categories of "semiconductor products" and "IC" in the WIND database, which are principally engaged in the R&D, design and sales of chips
Similarity in the size of the target company's results	The respective estimated annualised net profit amounts for the Transaction and for the comparable cases for the year in which the valuation benchmark date falls or nearing the valuation benchmark date range between RMB200 million and RMB600 million
Adjustment of differences between the Transaction and the comparable cases through reasonable means	In respect of differences between the Transaction and the comparable cases in terms of the nature of equity interests transacted and financial indicators, qualitative or quantitative analyses have been carried out and valuation ratios have been adjusted on the basis of reasonable comparison

2. Adjustments to have been made to valuation ratios in the appraisal to reflect the controlling interest premium applicable to the comparable cases

The subject matter of the Transaction is the acquisition of minority interests in the target company, while the subject matter of transactions in the comparable cases is the transfer of controlling equity interests. In view of the difference, a controlling interest premium based on the valuation difference between cases for the transaction of controlling interest and cases for the transaction of non-controlling interest has been calculated for the purpose of the appraisal, and the controlling interest premium rate has been calculated at 20%. The appraised value of the target has been downwardly adjusted in accordance with such controlling interest premium rate.

II. Examination opinion of the intermediary agencies

Upon examination, the Independent Financial Adviser and the Appraiser are of the view that:

1. The higher percentage of intra-group sales recorded by ZTE Microelectronics is attributable to the characteristics of the downstream communication industry and the operating strategy for the current stage, and such sales have been priced according to market-based principles. The differences with the comparable companies in relation to intra-group sales and sales to third parties are the result of their respective market-oriented commercial backgrounds. As both are based on market-oriented principles, they are comparable. The business characteristics of ZTE Microelectronics and the comparable companies under their respective market-oriented commercial backgrounds have been taken into full consideration in the appraisal, and adjustments have been made according to selected significant indicators, such as profitability, asset quality, solvency, growth of operations, ability in upstream consolidation, ability in downstream consolidation and R&D competence. Therefore the adoption of the market approach to valuation is justified.

2. The comparable cases selected for the appraisal are comparable to the Transaction. The appraisal has been adjusted to reflect the impact of the controlling interest premium on valuations in the comparable cases.

By Order of the Board
Li Zixue
Chairman

Shenzhen, the PRC
1 December 2020

As at the date of this announcement, the Board of Directors of the Company comprises three executive directors, Li Zixue, Xu Ziyang, Gu Junying; three non-executive directors, Li Buqing, Zhu Weimin, Fang Rong; and three independent non-executive directors, Cai Manli, Gordon Ng, Zhuang Jianshen