

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion and analysis should be read in conjunction with the Group's condensed interim financial statements together with the notes thereto as contained elsewhere in this interim report. The condensed interim financial statements have been prepared in accordance with accounting principles generally accepted in Hong Kong ("HK GAAP"), which may materially differ in certain respects from the generally accepted accounting principles in the United States ("U.S. GAAP"). A discussion of the material differences is set out in the Note 21 to the condensed interim financial statements.

OVERVIEW

The Group is engaged principally in alumina refining and primary aluminum smelting operations. The Group organises and manages its operations according to the following business segments:

- Alumina segment, which consists of mining and purchasing bauxite and other raw materials, refining bauxite into alumina, and selling alumina both internally to the Group's primary aluminum smelters and externally to customers outside the Group. To a lesser extent, this segment also includes the production and sales of alumina hydrate, alumina chemicals and gallium.
- Primary aluminum segment, which consists of procuring alumina and other raw materials, supplemental materials and electricity, smelting alumina to produce primary aluminum, and selling substantially all primary aluminum products to external customers. In addition, this segment includes production and sales of carbon products.
- Corporate and other services segment, which includes the headquarters' operations, research conducted by the Group's research institutes and provision of the Group's research and development services to third parties.

RESULTS OF OPERATIONS

The Group's profit amounted to RMB3,401 million for the six months ended June 30, 2004, representing an increase of RMB1,826 million or 116.0% from RMB1,575 million for the same period last year. The increase was mainly attributable to an increase in prices of the Group's principal products such as alumina and primary aluminum, as well as the increased sales volume of alumina.

REVENUES

The Group's total revenues amounted to RMB14,500 million for the six months ended June 30, 2004, representing an increase of RMB3,934 million or 37.2% from RMB10,566 million for the same period last year. Total revenues include sales of goods and other revenues. Sales of goods accounted for 97.9% and 98.0% of the Group's total revenues for the first half of 2003 and 2004, respectively. The Group's sales of goods increased by 37.4% from RMB10,340 million for the first half of 2003 to RMB14,205 million for the first half of 2004, representing an increase of RMB3,865 million. The increase was primarily due to the significant increase in the selling prices of the Group's principal products such as alumina and primary aluminum, while the growth in external sales volume of alumina was also a major contributor. For the first half of 2004, the Group's average external selling price for alumina reached RMB3,216.73 per tonne (tax excluded, similarly hereinafter), representing an increase of RMB991.83 per tonne or 44.6% from RMB2,224.90 per tonne for the same period last year. The Group's average external selling price for primary aluminum reached RMB14,287.54 per tonne, representing an increase of RMB2,059.48 per tonne or 16.8% from RMB12,228.06 per tonne for the same period last year. The Group's external sales volume of alumina increased by 14.6% from 1,974,200 tonnes for the first half of 2003 to 2,262,100 tonnes for the first half of 2004; the external sales volume of primary aluminum decreased by 24.6% from 369,200 tonnes for the first half of 2003 to 278,400 tonnes for the first half of 2004.

COST OF SALES

The Group's total cost of sales increased by 16.7% from RMB7,339 million for the first half of 2003 to RMB8,567 million for the first half of 2004. The increase was mainly attributable to an increase in sales volume of alumina, as well as the increased unit costs of primary aluminum and alumina due to the increased prices of raw materials and fuel. However, the increase in cost of sales was partially offset by the corresponding decrease in external sales volume and decreased production volume of primary aluminum, as the Company suspended some of its smelting pots due to the domestic power shortage in the first half of 2004, and the good sales performance of alumina during such period.

SELLING AND DISTRIBUTION EXPENSES

The Group's selling and distribution expenses increased by RMB56 million, or 23.1%, from RMB242 million for the first half of 2003 to RMB298 million for the first half of 2004. The increase was primarily due to the growth of 14.6% in the sales volume of alumina and the increased transportation costs resulting from the higher transportation prices.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased by 27.7% from RMB408 million for the first half of 2003 to RMB521 million for the first half of 2004. This was primarily due to the corresponding increase of RMB56 million in the taxation and surcharges levied by the government resulting from the increased revenue for the first half of 2004. In addition, the wages and welfare expenses of management staff increased by approximately RMB60 million due to the better operating results.

RESEARCH AND DEVELOPMENT EXPENSES

The Group's research and development expenses increased by 8.3% from RMB53.63 million for the first half of 2003 to RMB58.09 million for the first half of 2004, mainly due to the increased investment of the Group in research and development. After two years' efforts, the Company made significant achievements in research, promotion and application of certain key technologies. In the near future, the Company will focus on the research for improvement in alumina quality, development of new products and smooth running of smelting pots.

OTHER INCOME/EXPENSES

The Group's other net expenses/income changed from net income of RMB4 million for the first half of 2003 to net expenses of RMB19 million for the first half of 2004. This is primarily due to an interest waiver agreement entered into between the Company and the Construction Bank of China in the first half of 2003, under which an interest payment obligation of RMB44 million had been waived. In addition, the Company hedged certain amounts of primary aluminum on the SHFE in the first half of 2004. In view of the continuously increasing market price of aluminum ingots and the comparatively lower futures contracts price, the Company decided to sell spot goods at market price and closed the futures contracts. As a result, the Company incurred a loss of RMB33 million from futures contracts.

OPERATING PROFIT

The Group's operating profit increased by 105.5% from RMB2,333 million for the first half of 2003 to RMB4,794 million for the first half of 2004. The Group's operating profit as a percentage of sales of goods increased from 22.6% for the first half of 2003 to 33.7% for the first half of 2004.

FINANCE COSTS

The Group's finance costs decreased by RMB36 million, or 15.8%, from RMB228 million for the first half of 2003 to RMB192 million for the first half of 2004, primarily due to the decrease in the Group's short-term bank loans.

INCOME TAX

The Group's income tax expense increased from RMB463 million for the first half of 2003 to RMB1,036 million for the first half of 2004, mainly attributable to the increased profit of the Group. For the first half of 2004, the Group's effective income tax rate was 22.5% on average, which was lower than the statutory tax rate of 33%. This was mainly due to the fact that the Company's three branches, namely, Guizhou branch, Guangxi branch and Qinghai Branch, are situated in the western region of China, and thereby were entitled to a preferential income tax rate of 15% in connection with the state's policy to develop the western region. In addition, a subsidiary in Shandong province is taxed at a preferential rate of 15.0%. Furthermore, under the state's industry policies, some of the Group's plants are entitled to preferential income tax treatment for the purchase of domestically-produced equipment in technological renovation projects.

MINORITY INTERESTS

Minority interests increased from RMB69 million for the first half of 2003 to RMB165 million for the first half of 2004 primarily as a result of the increase in the profit of the Company's domestically listed subsidiary, Shandong Aluminum Industry Co., Ltd., which has minority interests.

PROFIT FOR THE PERIOD

As a result of the foregoing, the Group's net profit for the period increased by 116.0% from RMB1,575 million for the first half of 2003 to RMB3,401 million for the first half of 2004.

DISCUSSION OF SEGMENT OPERATIONS

Alumina Segment

Sales of Goods

The Group's total sales of goods of the alumina segment increased by RMB4,232 million, or 59.4%, to RMB11,356 million for the first half of 2004 from RMB7,124 million for the first half of 2003.

The Group sold alumina to the Company's smelters and external domestic smelters. Revenue from the external sales of alumina for the first half of 2004 rose by RMB3,703 million or 65.5% as compared with the same period last year. The increase was mainly due to the significant increases both in the external selling prices and the external sales volume of alumina of the Group as compared with the same period last year.

Revenue from sales of alumina to the Group's smelters increased by RMB529 million or 35.9% in the first half of 2004 as compared with the same period last year. The increase was mainly due to the increase in the revenues caused by the increased selling prices of alumina which was, however, partially offset by the reduction in material consumption of the Group's smelters.

Cost of Goods Sold

For the first half of 2004, the total cost of goods sold of the Group's alumina segment increased by RMB1,316 million or 27.6% as compared with the same period last year. The increase was mainly due to the increase in the external sales volume of alumina products, as well as the increased unit production cost of alumina owing to the increased prices of raw materials and fuel. However, such increase in the prices of raw materials and fuel was partially offset by the decreased materials consumption, which was attributable to the gradual effects of technological renovations as well as the improved technological and economic indexes of the Group's plants.

Operating Profit

Total operating profit for the alumina segment increased by 125.2% from RMB2,161 million for the first half of 2003 to RMB4,867 million for the first half of 2004, primarily as a result of a 59.4% increase in the sales of goods of this segment. Such increase was partially offset by the increased costs of sales. The operating profit of the alumina segment as a percentage of sales of goods of the Company increased from 30.3% for the first half of 2003 to 42.9% for the same period of 2004.

Primary aluminum Segment

Sales of Goods

The Group's total sales of goods for the primary aluminum segment increased by RMB150 million, or 3.2%, to RMB4,806 million for the first half of 2004 as compared with the same period last year. Such increase was mainly attributable to the increased average selling price for primary aluminum. However, such increase was partially offset by the correspondingly decreased sales volume and the decreased production volume of primary aluminum, as the Company suspended some of its smelting pots due to the domestic power shortage, and the good sales performance of alumina in the first half of 2004.

Cost of Goods Sold

The total cost of goods sold for the Group's primary aluminum segment increased by 9.9% from RMB4,019 million for the first half of 2003 to RMB4,418 million for the same period of 2004. This was mainly attributable to the increase of 18.2% in unit production cost of primary aluminum due to the significant upsurge in the prices of raw materials and fuel such as alumina and electricity. However, the Group adopted an analytical management measure on production to prevent unnecessary consumption, leading to a reduction in material consumption which partially offset the impact of the increased prices of raw materials and fuel. In addition, the increased cost was also partially offset by the decreased sales volume of primary aluminum during such period.

Operating Profit

Operating profit of the primary aluminum segment decreased by 73.2% from RMB484 million for the first half of 2003 to RMB130 million for the same period of 2004. The operating profit of the Group's primary aluminum segment as a percentage of that segment's sales of goods decreased from 10.4% for the first half of 2003 to 2.7% for the same period of 2004.

Corporate and Other Services Segment

The Group's corporate and other services segment reflected the expenses for the Company's headquarters as well as research and development services and profit from product sales of the Group's research institute provided to external customers. This segment recorded an operating loss of RMB21 million for the six months ended June 30, 2004.

WORKING CAPITAL, LIABILITIES AND CAPITAL COMMITMENTS

As of June 30, 2004, the Group's current assets amounted to RMB12,479 million, representing an increase of RMB3,840 million from RMB8,639 million as of the December 31, 2003. The increase was mainly attributable to (1) the increase of RMB1,758 million in bank deposit derived from the proceeds of RMB3,301 million from the issue of 550,000,000 new H shares; and (2) an increase of RMB1,779 million in inventories due to the expanded production and trade scale.

As of June 30, 2004, the Group's current liabilities amounted to RMB10,449 million, representing a slight increase of RMB178 million from RMB10,271 million as of December 31, 2003.

As of June 30, 2004, the Group's net current assets amounted to RMB2,030 million, representing an increase of RMB3,663 million as compared with the net current liabilities amounting to RMB1,633 million as at the end of last year. In addition to the above-mentioned reasons, the increase in the net current assets was due to the gradual adjustment to the proportion of long-term and short-term loans. The Group has historically taken advantage of the lower interest rates of short-term borrowings to finance capital expenditures. In order to maintain a healthy capital structure, currently the Company has ceased to use short-term borrowings to finance its new capital expenditure projects. At the same time, the Company has gradually repaid certain short-term borrowings upon maturity.

As of June 30, 2004, the Group's long-term loans amounted to RMB6,068 million, representing an increase of RMB655 million from RMB5,413 million as of December 31, 2003, which was mainly due to an increase in the Company's capital expenditure.

The Group's gearing ratio (the ratio of total liabilities to the sum of total liabilities and owner's equity) decreased to 29.9% as of June 30, 2004 from 34.9% as of December 31, 2003, which is mainly attributable to an increase in retained profit and the proceeds from the issue of new H shares.

In view of the Group's credibility and the availability of funds in China, the Group does not foresee any significant difficulties in obtaining bank loans. The Company plans to finance its capital expenditure projects and related expenditures principally through cash generated from operating activities and long-term borrowings. The Group will also, if necessary, issue new shares or debentures in the future and use the proceeds from such issue to finance its capital expenditures. The Group has also established standby credit facilities with domestic banks for an aggregate of RMB25,200 million to finance any funding shortfall related to its alumina and primary aluminum projects and for relevant working capital purposes. The Group believes that its working capital is sufficient for the present needs.

CAPITAL COMMITMENTS

As of June 30, 2004, the Group's capital commitments amounted to RMB19,172 million, which mainly consisted of the Company's proposed investment in the new or upgrading alumina and primary aluminum production lines. With the enhanced macro-control policies, approvals for new aluminum projects are strictly controlled. As the Company's new aluminum projects, namely Shanxi aluminum and power joint venture project and Qinghai aluminum project, have already been approved by the PRC government, the state's macro-control policy will not have a material impact on the Company.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents of the Group as of June 30, 2004 (including foreign currency-denominated deposits) totaled RMB4,340 million, comprising US\$59 million and HK\$250,000.

Net Cash Flow from Operating Activities

Net cash from operations increased by 21.4% from RMB2,297 million for the first half of 2003 to RMB2,789 million for the same period of 2004. The increase was primarily due to the increase in the sales revenues in the first half of 2004. Of the cash from operations in the first half of 2004, RMB207 million was used for interest payment and RMB1,095 million was used to pay PRC income tax.

Net Cash Flows from Investing Activities

Net cash outflow of the Group from investing activities amounted to RMB1,663 million and RMB3,808 million for the first half of 2003 and 2004, respectively, used primarily for capital expenditure projects. During the first half of 2004, the capital expenditures were mainly for the alumina projects in Henan Branch, Zhongzhou Branch, Shanxi Branch, as well as the aluminum and power joint venture project in Shanxi Province, etc.

Net Cash Flows from Financing Activities

Net cash inflows from financing activities amounted to RMB2,763 million for the first half of 2004, which are mainly derived from the proceeds from the issue of new H shares.

Foreign Exchange Rate Risk

The Group conducts its business primarily in Renminbi.

Renminbi is not a freely convertible currency. The restrictions on foreign exchange imposed by the PRC government may result in material differences between the future exchange rate and the current exchange rate or historical exchange rate. The fluctuations in Renminbi exchange rates may affect the Group's ability to perform its foreign currency-denominated obligations. Such fluctuations may also affect the Group's ability to pay dividends in Hong Kong Dollars or to pay dividends in respect of American depositary receipts in United States Dollars. However, the Group believes that it is able to obtain sufficient foreign exchange for the performance of such obligations.