

2. an amount equivalent to 4.5% of the annual aggregate wages of the employees of the Group in the previous year as its contribution under the supplemental pension scheme organised by the SA Group. The scheme will pay pension benefits to retired employees of the Group. In addition, the Company shall pay a management fee to the SA Group for administering the supplemental pension scheme; and
3. fixed annual fees for providing post-retirement medical and other welfare benefits to the current and future retirees of the Group from the effective date of the Services Agreement to 31 December, 2006.

The Independent Non-executive Directors of the Company have confirmed to the Board of Directors of the Company that they have reviewed the connected transactions described in (B) through (E) above and have concluded that:

- (a) the transactions have been entered into by the Group in the ordinary and usual course of its business;
- (b) the transactions have been entered into either (A) on normal commercial terms (by reference to transactions of a similar nature made by similar entities within the PRC) or (B) (where there is no available comparison) on terms that are fair and reasonable so far as the shareholders of the Company are concerned; and
- (c) the transactions have been performed either (A) in accordance with the terms of the agreement governing each such transaction or (B) (where there is no such agreement) on terms no less favourable than terms available from third parties.

Wet-lease Agreements relating to Zhongyuan's Aircraft

On 16 August, 2000 the Company and Zhongyuan Airlines (Zhongyuan") entered into four wet-lease agreements (the "Wet-lease Agreements") dated as of 4 August, 2000 whereby Zhongyuan agreed to wet lease to the Company one Boeing 737-37K aircraft with Chinese registration mark B-2935, one Boeing 737-37K aircraft with Chinese registration mark B-2936, one Boeing 737-300 aircraft with Chinese registration mark B-2574 and one Boeing 737-300 aircraft with Chinese registration mark B-2575 (the "Aircraft"). Under the Wet-lease Agreements, Zhongyuan will supply aircraft crew members and be responsible for the maintenance of the Aircraft and insurance for the respective Aircraft (the "Services").

1. Merger and Restructuring Agreement relating to Zhongyuan

The SA Group and Henan Transportation Department entered into the Merger and Restructuring Agreement dated as of 4 August, 2000 whereby all the equity of Zhongyuan will be transferred to the SA Group and all the liabilities of Zhongyuan will be assumed by the SA Group by way of administrative allocation without compensation. The completion of the merger is currently pending for approval of relevant PRC authorities. Under the Merger and Restructuring Agreement, Henan Transportation Department will allow the SA Group to use an office building which is in the process of construction and to use a piece of land; such use by the SA Group will not be in competition with the aviation business of the Company. Under the demerger agreement dated as of 25 March, 1995, as amended, the "non-compete agreement" between the SA Group and the Company, the SA Group undertook not to conduct or participate or hold any interest in, either directly or indirectly, any business, activity or entity in or outside China that competes or is likely to compete with the commercial interests of the Company, provided that the SA Group (1) may hold shares of the Company and (2) may continue to hold and control the existing affiliates of the SA Group, including, without limitation, the Southern Airlines (Group) Import and Export Trading Company, and may continue to operate the businesses of such affiliates; and (3) may continue to operate the businesses of such affiliates, as well as of Minhang Express Delivery Company Limited, which provides services in connection with the transportation of cargo and mail.

2. Background to the Wet Lease Agreements between the Company and Zhongyuan

The Aircraft are being leased to Zhongyuan under the following four lease agreements respectively (the "Head Lease Agreements" and each a "Head Lease Agreement"):

- i. Lease agreement dated 3 February, 1995 between BQCHY Industrial Inc. (as lessor) and Zhongyuan (as lessee) in respect of one Boeing 737-37K aircraft with Chinese registration mark B-2935, such agreement to expire on 15 January, 2007;
- ii. Lease agreement dated 3 February, 1995 between BQCHY Industrial Inc. (as lessor) and Zhongyuan (as lessee) in respect of one Boeing 737-37K aircraft with Chinese registration mark B-2936, such agreement to expire on 15 January, 2007;
- iii. Aircraft lease agreement dated 22 March, 1999 between Zhongyuan 99A Limited (as lessor) and Zhongyuan (as lessee) in respect of one Boeing 737-300 aircraft with Chinese registration mark B-2574, such agreement to expire on 6 April, 2011; and
- iv. Aircraft lease agreement dated April 1, 1999 between Zhongyuan 99A Limited (as lessor) and Zhongyuan (as lessee) in respect of one Boeing 737-300 aircraft with Chinese registration mark B-2575, such agreement to expire on 6 April, 2011.

BQCHY Industrial Inc. bears no ownership relationship with Zhongyuan. Zhongyuan 99A Limited is beneficially owned by Zhongyuan.

Upon and after entering into each of the four Wet Lease Agreements, Zhongyuan will remain as the lessee under the respective Head Lease Agreements. Under the respective Head Lease Agreements, Zhongyuan is required to obtain waivers or consents from certain financing parties related to the Head Lease Agreements with respect to the transactions under the Merger and Restructuring Agreement.

3. Terms of the Wet Lease Agreements

Zhongyuan agreed to wet lease to the Company one Boeing 737-37K aircraft with Chinese registration mark B-2935, one Boeing 737-37K aircraft with Chinese registration mark B-2936, one Boeing 737-300 aircraft with Chinese registration mark B-2574 and one Boeing 737-300 aircraft with Chinese registration mark B-2575. Under the Wet Lease Agreements, Zhongyuan will supply aircraft crew members and be responsible for the maintenance of the Aircraft and insurance for the respective Aircraft.

Each of the four Wet Lease Agreements dated as of 4 August, 2000 between Zhongyuan and the Company contains, among other things, the terms set forth below. The Company has been operating the Aircraft since 4 August, 2000. Irrespective of whether or not the parties have entered into the Merger and Restructuring Agreement, Zhongyuan and the Company are allowed to enter into the four Wet Lease Agreements.

Under the four Wet Lease Agreements, in consideration of Zhongyuan's wet lease of the Aircraft and provision of the Services to the Company, the Company agreed to pay to Zhongyuan an aggregate monthly rent of RMB20,000,000 arrears on the 10th day of each month throughout the wet lease period, that is, a monthly rent of RMB5,000,000 for each Aircraft and the Services for each Aircraft.

The amount of the consideration was determined having regard to the prevailing market level of rent payable for the wet leases of Boeing 737-300 aircraft and Boeing 737-37K aircraft and the provision of services which are subjects of the four Wet Lease Agreements.

4. Reasons for the Transactions

The Company's principal business is that of civil aviation. The directors of the Company believe that the transactions under the Wet Lease Agreements would enable the Company to expand its aviation business and increase the size of its operation to achieve further market share. At present, the Company has no definite plan with respect to the Aircraft at the expiration of the Wet Lease Agreements; Zhongyuan, the SA Group and the Company will take such steps as appropriate to ensure compliance with the non-compete agreement between the SA Group and the Company.

5. Connected Transactions Disclosure

As the SA Group is the 65.2% controlling shareholder of the Company and as Zhongyuan will become a wholly owned subsidiary of the SA Group upon the conclusion of the Merger and Restructuring Agreement, the transactions under the four Wet Lease Agreements will constitute connected transactions under Chapter 14 of the Listing Rules. The directors (including the independent non-executive directors) of the Company, having considered the terms of each of the four Wet Lease Agreements, are of the opinion that the terms of the said agreements are fair and reasonable so far as the independent shareholders of the Company are concerned. As the aggregated consideration involved does not exceed 3% of the net tangible assets of the Company at 31 December, 1999, the transactions under the four Wet Lease Agreements are not subject to shareholders' approval but are disclosed as required in this Annual Report.

6. Additional Wet-lease Agreement

The Company entered into another wet lease agreement with Zhongyuan in November 2000 to lease another Boeing 737-300 aircraft on a short term basis. Under this wet lease agreement, Zhongyuan will supply aircraft crew members and be responsible for the maintenance of the aircraft and insurance for the aircraft.

Donations

During the year, the Group made donations for charitable purposes amounting to RMB2.2 million (1999: RMB2.6 million).

Designated Deposits and Overdue Time Deposits

As at 31 December, 2000, the Group's deposits placed with financial institutions or other parties did not include any designated deposits, or overdue time deposits against which the Group failed to receive repayments.

Material Litigation

The Group was not involved in any material litigation or dispute in 2000.

Auditors

A resolution is to be proposed at the forthcoming Annual General Meeting of the Company for the reappointment of KPMG as the Company's international auditors and appointment of KPMG Huazhen as the PRC auditors of the Company.

By Order of the Board of Directors

Yan Zhi Qing

Chairman of the Board of Directors

Guangzhou, the PRC
17 April, 2001