Liu Shaoyong
President

The Group is one of the three largest air carriers in China based on tonne-kilometers and number of passengers carried in 2000, and is the primary air carrier serving Shanghai, China's largest economic, trading and financial center. In 2000, the Group operated 158 routes, including 126 domestic routes (among which, 13 routes to Hong Kong) and 32 international routes (including 12 international cargo routes). As at 31 December 2000, the Group operated about 1,750 scheduled flights per week, serving a total of 67 domestic and foreign cities. During 2000, the Group disposed of an aggregate of four MD82 and leased back two of them. The Group also acquired four A320 under finance leases, four A319 under operating leases and acquired two ATR-72 under short-term operating leases to serve feeder routes. In addition, the Group converted one MD11 passenger aircraft into a freight aircraft and wet leased one Boeing 747-200 cargo aircraft. As at 31 December 2000, the Group had a fleet of 73 aircraft, including 60 passenger jet aircraft with a capacity over 100 seats and four jet freighters.

In 2000, traffic volume of the Group totalled 2.137 billion tonne-kilometers, an increase of 15.73% over last year. The Group's revenues from its main business were RMB10.768 billion, an increase of 10.32% over last year. The average aircraft daily utilization rate was 8.7 hours, an increase of 0.6 hours over last year.

2000 Compared to 1999

In 2000, the economy in the Asian region continued to recover. The passenger traffic volume on the Group's Hong Kong, Japan and Korea routes increased significantly. The Group also expanded the Group's cargo operations substantially by opening new cargo routes and increasing the flight frequency on the Group's existing cargo routes. As a result, the Group's revenues increased by 10.4%. However, the Group's operating profit decreased from RMB 922 million in 1999 to RMB 778 million in 2000, or 15.6%, reflecting a 13.0% increase in operating expenses. During the same period, the Group's net interest expense decreased by 15.7% and the Group's other income increased by 97.9%. As a result, the Group's profit before taxation increased from RMB 128 million in 1999 to RMB 304 million in 2000, or 137.4%. Profit attributable to shareholders increased by 108.3% from RMB 84 million in 1999 to RMB 176 million in 2000.

Effective 1 January 2000, the Group changed the Group's accounting policy with respect to the recognition of major overhaul expenses for aircraft and engines owned as well as held under finance leases. In prior years, the costs of major aircraft and engines overhauls are estimated and charged to operating profit over the period between overhauls using the ratio of actual flying hours/cycles and estimated flying hours/cycles between overhauls. Differences between the estimated cost and the actual cost of the overhaul are included in the operating profit in the period of overhaul. In 2000 the Group adopted IAS 37 according to which major overhaul expenses for assets owned and assets held under finance leases are charged against the operating profit as and when incurred. The Group's consolidated financial statements have been restated to reflect this change of accounting policy. See Note 2 to the Group's financial statements prepared in accordance with IAS for a detailed discussion of the change of accounting policy.

Revenues. The Group's total revenues increased from RMB 10,163 million in 1999 to RMB 11,220 million in 2000, or 10.4%, reflecting increases in cargo and mail revenues as well as increases in passenger revenues from Hong Kong and international routes. These revenues are net of the applicable PRC sales tax and civil aviation infrastructure levies.

Passenger revenues, which accounted for 77.0% of the Group's total revenues in 2000, increased from RMB 8,031 million in 1999 to RMB 8,644 million in 2000, or 7.6%, reflecting increases in passenger revenues on Hong Kong and international routes partially offset by decrease in the Group's domestic passenger revenues.

The Group’s domestic passenger revenues, which accounted for 45.6% of the Group's passenger revenues, decreased from RMB 4,001 million in 1999 to RMB 3,946 million in 2000, or 1.4% primarily due to lower effective airfares as a result of increased competition in the Chinese domestic aviation market. To improve the Group's competitiveness, the Group replaced low traffic and low yielding domestic routes with new routes, and increased capacity on selected high traffic and high yielding domestic routes by increasing flight frequencies and capacity on these routes. As a result, the Group's domestic passenger traffic increased by 4.4% in 2000 and the Group's domestic passenger load factor increased from 55% in 1999 to 58% in 2000. However, the Group's domestic passenger yield decreased from RMB 0.71 in 1999 to RMB0.67 in 2000 per passenger-kilometer, primarily reflecting lower average airfares for the Group's flights originating or terminating at the Pudong International Airport. Pudong International Airport is further away from downtown Shanghai and less convenient than Hong Qiao International Airport. As a result, airlines including the Company reduced airfares to attract passengers to take flights terminating or originating from Pudong International Airport.

Hong Kong passenger revenues, which accounted for 21.7% of the Group's passenger revenues, increased from RMB 1,718 million in 1999 to RMB 1,873 million in 2000, or 9.0%, reflecting primarily the increased Hong Kong passenger traffic. Hong Kong passenger traffic increased by 7.9% in 2000 over that of 1999 as a result of higher passenger demand. The passenger capacity on the Group's Hong Kong routes increased by 6.6%. Our Hong Kong passenger load factor increased slightly from 60% in 1999 to 61% in 2000 and the Group's Hong Kong passenger yield increased slightly from RMB 0.98 in 1999 to RMB 0.99 in 2000 per passenger-kilometer.

International passenger revenues, which accounted for 32.7% of the Group's passenger revenues, increased from RMB 2,312 million in 1999 to RMB 2,826 million in 2000, or 22.2%, reflecting increased international passenger traffic and increased yield per passenger-kilometer. International passenger traffic increased by 7.9% in 2000 over that of 1999 as a result of higher passenger demand. In particular, passenger traffic on the Group's Japanese routes increased substantially because the Group's competitors have moved their flights to and from Japan to Pudong International Airport which is further away from downtown Shanghai and relatively less convenient than Hong Qiao International Airport. The Group’s passenger traffic on Korean and European routes also increased substantially due to increased Chinese tourists travelling to Korea and Europe. The Group’s international passenger capacity increased slightly by 1.6% in 2000. The Group’s international passenger load factor increased from 64% in 1999 to 67% in 2000 due to increased demand. International passenger yield increased from RMB 0.40 in 1999 to RMB 0.45 in 2000 per passenger-kilometer primarily as a result of increased airfares.

The Group generates cargo revenues from the transport of cargo and mail on the Group's designated cargo aircraft as well as from the carriage of cargo and mail on passenger aircraft. Revenues from cargo and mail operations, which accounted for 18.9% of the Group's total revenues, increased from RMB 1,730 million in 1999 to RMB 2,124 million in 2000, or 22.8%. The increase in cargo revenues was primarily the result of higher cargo traffic. The Group’s cargo and mail traffic (as measured in cargo TKs) increased from 689 million TKs in 1999 to 904 million TKs in 2000, or 31.2%, primarily due to the increase of the Group's international cargo and mail traffic. To meet the increased cargo and mail traffic demand, the Group converted one additional MD-11 passenger aircraft into a freight aircraft and wet-leased one Boeing 747 freight aircraft in 2000. In 2000, the Group opened new cargo routes to Hong Kong and New York and increased the flight frequency on routes to other major destinations such as Chicago, Seoul and Paris. Cargo yield decreased from RMB 2.51 in 1999 to RMB 2.35 in 2000 per cargo tonne-kilometer primarily as a result of increased competition on the Group's international cargo routes and the Group's increased cargo traffic on long-haul routes which generally have lower yield.

Other operating revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading, aircraft cleaning and ground transportation of cargo and passenger luggage for airlines operating to or from Hong Qiao International Airport and Pudong International Airport. Other operating revenues increased from RMB 440 million in 1999 to RMB 568 million in 2000, or 29.2%, primarily due to a substantial increase of cargo handling income and the receipt of fuel surcharges partially offset by the decreases of commission income and airport ground service income. As a result of the substantial increase of fuel prices, the Group's cargo customers are required by the CAAC to pay the Group fuel surcharges in 2000. The Group currently is the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport.

Operating Expenses. The Group's total operating expenses increased from RMB 9,241 million in 1999 to RMB 10,442 million in 2000, or 13.0%, primarily due to increases in aircraft fuel expenses, other depreciation and operating lease expenses, commissions, wages, salaries and benefits expenses and other expenses. Operating expenses as a percentage of revenues increased from 90.9% in 1999 to 93.1% in 2000.

Aircraft fuel expenses increased from RMB 1,685 million in 1999 to RMB 2,327 million in 2000, or 38.1%. Fuel expenses increased primarily as a result of the increased domestic and international fuel prices. In 2000, the weighted average domestic and international fuel prices paid by us increased by approximately 31.5% and 54.2%, respectively.

Aircraft depreciation and operating lease expenses increased slightly from RMB 2,119 million in 1999 to RMB 2,185 million in 2000, or 3.1%. Other depreciation and operating lease expenses increased from RMB 235 million in 1999 to RMB 304 million in 2000, or 29.4%, primarily reflecting the addition of buildings, facilities and equipment and other assets at Pudong International Airport. Take-off and landing charges increased slightly from RMB 1,539 million in 1999 to RMB 1,572 million in 2000, or 2.2%. Aircraft maintenance expenses were RMB 820 million in 2000, compared to RMB 790 million in 1999, an increase of 3.8%.

Commission expenses increased from RMB 526 million in 1999 to RMB 645 million in 2000, or 22.7%, primarily due to increased ticket sales and the increase of average rate of commission paid. Commission expenses include agency fees paid to sales and travel agents and other airlines for ticket sales made on behalf of the Group.

Wages, salaries and benefits increased from RMB 724 million in 1999 to RMB 798 million in 2000, or 10.2%. This increase was attributable primarily to the increase in the number of employees at the Group's cargo operations and the salary increase for the employees the Group inherited from the former China General Aviation Corporation.

Food and beverage expenses increased from RMB 465 million in 1999 to RMB 499 million in 2000, or 7.3%, due to the increased number of passengers. Office and administration expenses increased slightly from RMB 720 million in 1999 to RMB 724 million in 2000.

Other operating expenses increased from RMB 440 million in 1999 to RMB 568 million in 2000, or 29.2%. Other operating expenses included provision for obsolescence of flight equipment spare parts, maintenance expenses of other fixed assets, computer and telecommunication expenses and other expenses. The increase was attributable to a provision of RMB 80 million staff housing cash allowance in 2000 and a provision of RMB 76 million in 2000 for staff quarters under construction which are to be sold at a discount to eligible employees. See Note 34 to the Group's financial statements prepared in accordance with IAS for a discussion of the accounting treatment of the Group's housing benefits to its employees.

Net Interest Expense and Net Other Income. Net interest expenses decreased from RMB 966 million in 1999 to RMB 814 million in 2000, or 15.7%, primarily due to the expiration of two finance leases in the second quarter of 2000 and the early termination of one finance lease in the middle of 2000 . Other income increased from RMB 172 million in 1999 to RMB 341 million in 2000, primarily as a result of a net foreign exchange gain of RMB 120 million as compared to a net foreign exchange loss of RMB 111 million in 1999. The net foreign exchange gain resulted primarily from the depreciation of the Japanese yen against the Renminbi in 2000.

Provision for Taxation. The Group had an effective tax rate of 32.7% in 2000, compared to 21.2% in 1999. The effective tax rate in 1999 was lower primarily because deferred tax asset attributable to provision for loss on sale of staff quarters was not recognized and such provision charged to profit and loss account increased from RMB 30 million in 1999 to RMB 76 million in 2000.

Liquidity and Capital Resources

The Group finances its working capital requirements through a combination of funds generated from operations and short-term bank loans. The Group had cash and cash equivalents as at 31 December 1999 and 2000 of RMB 1,315 million and RMB 1,423 million, respectively. Net cash provided by operating activities in 1999 and 2000 was RMB 1,811 million and RMB 2,130 million, respectively. During the last two years, the Group's primary cash requirements have been for additions of and upgrades on aircraft and flight equipment and payments on related indebtedness.

Net cash used in investing activities in 1999 and 2000 was RMB 598 million and RMB 1,156 million, respectively. In 1999 and 2000, payment of advances on aircraft and flight equipment were RMB 494 million and RMB 630 million, respectively, while additions of aircraft and flight equipment were RMB 799 million and RMB 237 million, respectively. The Group finances the additions to the Group's aircraft and flight equipment primarily through lease arrangements, bank loans, funds generated from operations and by trading old aircraft for new ones. Funds generated from disposal of old aircraft and flight equipment and other fixed assets and equipment (including by way of exchange) totaled RMB 1,415 million and RMB 325 million in 1999 and 2000, respectively. The Group also received RMB 302 million and RMB 276 million as return of advances on aircraft and flight equipment in 1999 and 2000, respectively. Additions of construction in progress, which include primarily facilities at the Pudong International Airport, were RMB 659 million and RMB 540 million in 1999 and 2000, respectively.

Net cash used in financing activities was RMB 1,707 million and RMB 846 million in 1999 and 2000, respectively, and was primarily used for repayments of long-term and short-term loans as well as principal repayments on finance lease obligations.

Pursuant to the Group's certain finance or operating leases, the Group is required to indemnify the lessors against any withholding or similar taxes that may be imposed on the lessors by taxing authorities in China with regard to payments made under these leases. The State Council of China, China's highest authority of state administration, has confirmed that no withholding or similar tax would be imposed in respect of any payments made under any aircraft lease entered into prior to the end of 1996. In addition, the Group has obtained exemptions from these taxes for leases entered into prior to 1 September 1999 under Chinese tax regulations, which provide that lease payments under certain types of capital leases may be exempted from withholding or similar taxes if the cost of the lease financing is lower than the prevailing market borrowing rates at the time of the execution of these leases. However, the Group cannot assure that the Group will be able to obtain any exemption in respect of leases entered into after 1 September 1999 or be able to obtain it in a timely manner. In the event any such exemption was not available, payments under those leases could be subject to a withholding tax of up to 20% of the total amount of such payments or in appropriate cases the interest component of such payments, and the Group could be required to absorb the total effect of these tax payments.

The Group generally operates with a working capital deficit. As at 31 December 2000, the Group's current liabilities exceeded the Group's current assets by RMB 858 million. The Group has generally been able to arrange short-term bank loans with domestic and foreign banks in China as necessary to meet the Group's working capital requirements. The Group believes that it can obtain these short-term bank loans when required because of the Group's continuing relationships with various lenders, although the Group cannot assure that it will be able to continue to do so in the future. Short-term loans outstanding (including current portion of long-term loans) totaled RMB 606 million and RMB 600 million as at 31 December 1999 and 2000, respectively. Long-term loans outstanding totaled RMB 4,706 million and RMB 4,804 million as at 31 December 1999 and 2000, respectively. Long-term loans payable within two years, from three to five years and beyond five years are RMB 867 millions, RMB 2,048 million and RMB 1,890 million, respectively, as at 31 December 2000, as compared to RMB 994 million, RMB 1,660 million and RMB 2,052 million, respectively, as at 31 December 1999. The total lease obligations outstanding under the Group's finance leases as at 31 December 1999 and 2000 were RMB 11,557 million and RMB 11,308 million, respectively. The Group's lease obligations payable within two years, from three to five years and beyond five years are RMB 3,154 million, RMB 4,078 million and RMB 4,076 million, respectively, as at 31 December 2000, as compared to RMB 2,160 million, RMB 4,911 million and RMB 4,486 million, respectively, as at December 31, 1999. The Group expects that cash from operations and short-term bank borrowings will be sufficient to meet the Group's operating cash flow requirements, although events that materially affect the Group's operating results could also have a negative impact on liquidity. The Group has, and in the future may continue to have, substantial indebtedness. As at 31 December 1999 and 2000, the Group's long-term debt to equity ratio was 2.37 and 2.36, respectively. As a result, the interest expenses associated with these indebtedness might impair the Group's future profitability and cause the Group's earnings to be subject to a higher degree of volatility.

The Group's aircraft orders as at 31 December 2000 included commitments to acquire three Airbus 320 aircraft and six Airbus 319 aircraft to be delivered between 2001 and 2002. The Group expects its capital expenditures for aircraft and related equipment, including deposits, through 2003 to be in aggregate approximately RMB 8,074 million, including RMB 2,161 million in 2001, RMB 1,708 million in 2002 and RMB 4,205 million in 2003, in each case subject to contractually stipulated increases related to inflation and any discounts available upon delivery of the aircraft. Construction of the Group's facilities at the Pudong International Airport and the purchase of maintenance equipment and other property and equipment will continue to require additional capital expenditure in 2001. The Group has entered into an agreement to acquire Air Great Wall at an aggregate consideration of approximately RMB 300 million. The acquisition has been submitted to the CAAC for its approval. The acquisition is expected to be approved by the end of 2001 and the consideration will be paid on an instalment basis. The Group plans to finance the Group's aircraft acquisitions, the Group's acquisition of Air Great Wall and other capital commitments through a combination of funds generated from operations, existing credit facilities, bank loans, leasing arrangements and other external financing arrangements.

In the past, the Group has obtained, with the assistance of the CAAC, guarantees from the Bank of China and other Chinese banks in respect of payments under the Group's foreign loan and finance lease obligations. While the Group believes that the Group will continue to be able to obtain bank guarantees in the future, the Group cannot assure that the Group will be able to do so. The unavailability of guarantees from Bank of China or other acceptable banks or the increased cost of these guarantees could adversely affect the Group's ability to borrow internationally or enter into international aircraft lease financings on acceptable terms. The Group's ability to obtain financing may also be affected by the Group's financial position and leverage, as well as by prevailing economic conditions and the cost of financing generally. If the Group was unable to obtain financing for a significant portion of the Group's capital requirements, the Group's ability to acquire new aircraft or to expand its operations could be impaired.

Foreign Currency Transactions

All of the Group's finance lease obligations and aircraft operating leases are denominated in U.S. dollars, Japanese yen and German deutschemarks, and certain other expenses of the Group are denominated in currencies other than Renminbi. Although the Group generates foreign currency revenues, including Japanese yen, Hong Kong dollar and U.S. dollar revenues, from ticket sales made in overseas offices, the Group may generate a deficit or surplus of revenues in foreign currencies over payments in these currencies from period to period. The resulting foreign currency exchange rate exposure can have an adverse effect on the Group's results of operations if, for example, the value of the Renminbi weakens against the U.S. dollar or the relevant foreign currencies and the effective cost of the Group's aircraft financing and other foreign currency-denominated liabilities increase. The Group is not able to hedge effectively against the devaluation of the Renminbi, other than by retaining the Group's foreign exchange-denominated earnings and receipts to the extent permitted by the Chinese State Administration of Foreign Exchange. The Group’s results of operations may also be affected by changes in the value of currencies other than the Renminbi, depending on the currencies of the Group's foreign currency-denominated receipts and obligations. In 2000, the Group had a net foreign exchange gain of RMB 120 million as compared to a net foreign exchange loss of RMB 111 million in 1999 primarily as a result of the depreciation of the Japanese yen against the Renminbi in 2000.

Employees

As at 31 December, 2000, the Group had approximately 13,000 employees, a substantial majority of them are working in the PRC. The Group normally pays a basic salary and a performance bonus to each of its employees. The Group has not experienced any significant difficulty in recruiting employees or any significant turnover in the number of its employees or any labour dispute with its employees. Apart from the basic salary and performance bonus, the details of the staff housing benefits have been set out in note 34 of financial statements prepared under IAS.

Charges on Asset and Contingent Liabilities

For the acquisition of aircraft, the Company generally pledges its assets, including the aircraft and its long-term bank deposits, to secure its obligations under finance leases and bank loans for these acquisitions. As at 31 December 1999 and 2000, the total carrying value of assets pledged was RMB 5,832 million and RMB 5,396 million, respectively.

As at 31 December 2000, the Group had provided a guarantee to a bank in respect of bank facilities granted to Nanjing Lu Kou International Airport Company, a third party, amounting to RMB 150 million. In addition, the Group had provided a guarantee to Citic Securities Co. Ltd. in respect of a 3-year company debenture issued by Jiangsu Aviation Property Group Co. Ltd., the holding company of Lu Kou International Airport, amounting to RMB 160 million.