

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

The following discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes as set out in this interim report.

### CONSOLIDATED RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, information relating to certain income and expense items from our statements of income:

	<b>For the six months ended June 30,</b>	
	<b>Consolidated 2002</b>	Combined 2001 (Percent)
Turnover	<b>100%</b>	100%
Cost of goods sold	<b>79.1</b>	70.0
Gross profit	<b>20.9</b>	30.0
Other revenues	<b>3.1</b>	3.9
Expenses related to other revenues	<b>3.0</b>	3.7
Other revenues, net	<b>0.1</b>	0.2
Selling and distribution expenses	<b>3.1</b>	1.8
General and administrative expenses	<b>4.1</b>	5.2
Research and development expenses	<b>0.5</b>	0.9
Other expenses/(income), net	<b>0.2</b>	(0.3)
Operating profit	<b>13.1</b>	22.6
Finance costs	<b>3.4</b>	3.5
Operating profit after finance costs	<b>9.7</b>	19.1

## **SIX MONTHS ENDED JUNE 30, 2002 COMPARED WITH THE SIX MONTHS ENDED JUNE 30, 2001**

### **Revenues**

The total revenues of the Group for the six months ended June 30, 2002 (first half of the year) was RMB8,246 million, increased by 0.34% as compared with the same period last year.

Total revenues include sales of goods and other revenues. Sales of goods accounted for 96.2% and 97.0% of our total revenues for the first half of 2001 and 2002 respectively. Our sales of goods increased 1.12%, from RMB7,906.3 million in the first half of 2001 to RMB7,994.8 million in the first half of 2002. The increase was primarily due to increase in sales volume.

The external sales volume of our alumina increased by 21.9% from 1,477,500 tonnes for the first half of 2001 to 1,801,800 tonnes for the first half of 2002. The external sales volume of our primary aluminum increased by 10.94% from 299,800 tonnes for the first half of 2001 to 332,600 tonnes for the first half of 2002. The increased sales income from increase in sales volume basically offset the impact of decrease in product price on total sales. The average external sales price per tonne for our alumina decreased by 18.58% from RMB2,061.1 (exclusive of VAT) for the first half of 2001 to RMB1,678.2 (exclusive of VAT) for the first half of 2002. The average sales price for our primary aluminium decreased by 10.74% from RMB12,618.2 (exclusive of VAT) per tonne for the first half of 2001 to RMB11,262.5 (exclusive of VAT) per tonne for the first half of 2002. This price decrease was primarily due to the decrease in international alumina and primary aluminum spot prices for the first half of 2002 as compared with the same period last year. The amount of decrease in domestic product price was basically the same as that of the international product price.

### **Cost of Goods Sold**

The total cost of goods sold of the Group increased by 14.25% from RMB5,535 million for the first half of 2001 to RMB6,324 million for the first half of 2002. For the first half of 2002, despite the decrease in unit production cost of primary aluminum and alumina, the increase in sales volumes of these products has resulted in increase in total costs of good sold for alumina segment and primary aluminum segment by 21.9% and 6.14% respectively.

### **Selling and Distribution Expenses**

Our selling and distribution expenses increased by 77.95% from RMB139.7 million for the the first half of 2001 to RMB248.6 million for the first half of 2002. This was primarily due to an increase in sales volume which led to an increase in sales expenses by 23.7% compared with the same period last year, and for the first half of 2002, although the Group has integrated sales networks and rationalize the sales channels, sales expenses have increased by 54.2% compared with the same period last year as the Group paid partial expenses on transportation, packaging and loading on behalf of its customers as a means of sales promotion under the condition that the sales market for alumina has changed from excess demand in the same period last year to basic equilibrium on supply and demand.

## **General and Administrative Expenses**

General and administrative expenses decreased by 21% from RMB417.5 million for the first half of 2001 to RMB329.6 million for the first half of 2002, primarily because in the first half of 2002, the Group has recovered its accounts receivable prior to 1999, thereby written back this portion of bad debts provision and reduced the general and administrative expenses by RMB71.865 million.

## **Research and Development Expenses**

Our research and development expenses decreased by 46.12% from RMB70.867 million for the first half of 2001 to RMB38.181 million for the first half of 2002, primarily due to the centralization of research project management and emphasis the exchange between our plants of advanced technologies developed internally to avoid internal research projects repetitions.

## **Other Expenses/Income**

Our other income/expenses decreased from net income of RMB27.10 million for the first half of 2001 to net expenses of RMB18.92 million for the first half of 2002. This is primarily due to changes in exchange rate of RMB against Euro, which led to an exchange loss of RMB18.62 million in the first half of 2002, while the exchange gain amounted to RMB21.92 million over the same period last year.

## **Operating Income**

Our operating income decreased by 41.27% from RMB1,789.9 million for the first half of 2001 to RMB1,051.1 million for the first half of 2002. Our operating income as a percentage of sales of goods decreased from 22.6% for the first half of 2001 to 13.1% for the first half of 2002.

## **Finance Costs**

Our finance costs decreased by 2.41% from RMB279 million for the first half of 2001 to RMB272 million for the first half of 2002 primarily due to the decrease in total bank loans and interest rate.

## **Income Tax**

Our income tax expenses decreased by 60.2% from RMB472.1 million for the first half of 2001 to RMB187.7 million for the first half of 2002 primarily due to the decrease in our taxable profit for the first half of 2002.

For the first half of 2002, our effective income tax rate was 24.1%, which was lower than the statutory rate of 33.0%. This is primarily due to reduction in income tax as a result of income tax reduction policy for localization of state import equipments and also due to a 15% income tax for a subsidiary.

### **Minority Interests**

Minority interests decreased by 59.3% from RMB45.75 million for the first half of 2001 to RMB18.64 million for the first half of 2002 primarily as a result of the decreases in net income of our subsidiary, Shandong Aluminum Industry Co. Ltd., which had minority shareholders.

### **Net Income for the Period**

As a result of the foregoing, our net income decreased by 42.4% from RMB994.4 million for the first half of 2001 to RMB572.4 million for the first half of 2002.

### **DISCUSSION OF SEGMENT OPERATIONS**

We began accounting for our operations under alumina segment, aluminum segment and corporate and other services segment as of July 1, 2001. Although we had not divided our operations into these segments for the first half of 2001, for the purposes of the following discussion we have reconstructed our financial results for the first half of 2001 on a segmental basis. Consequently, we caution investors not to place undue reliance on historical segmental operating profit, operating expenses or operating income as measures of the economic efficiency of these segments.

Unless otherwise indicated, also included in these segments are other revenues derived from such activities as supplying electricity, gas, heat and water to affiliates, selling scrap and other materials, and providing services including transportation and research and development to third parties. Interest income and dividends from unlisted securities investments, included in other revenues, are not attributed to any segment. For additional data and information relating to our business segments and segmental presentation, see Note 2 to our condensed interim financial statements.

## FIRST HALF OF 2002 COMPARED WITH FIRST HALF OF 2001

### Alumina Segment

#### *Sales of Goods*

Our total alumina segment sales of goods was RMB4,777.8 million for the first half of 2002, representing an increase of 3.49% as compared with RMB4,616.5 million for the same period last year. The increase was primarily a result of increase in external sales volume of alumina, but our external sales price for alumina decreased because there is a global decline in international market prices for alumina, which basically offset the contribution of the increase in external sales volume to growth in total external sales.

Sales of alumina constituted 87.16% of the sales of our alumina segment for the first half of 2002. We sell alumina to our smelters as well as to external domestic smelters. Revenues from external sales of alumina for the first half of 2001 and 2002 were RMB3,029.1 million and RMB3,023.7 million respectively.

Revenues from sales of alumina to our smelters amounted to RMB1,140.4 million for the first half of 2002, representing an increase of 1.9% as compared with RMB1,118.9 million for the same period last year. The volume of internal sales increased 2.6%, from 661,260 tonnes for the first half of 2001 to 678,700 million tonnes for the first half of 2002. The percentage of internal sales volume of alumina in total sales volume decreased from 31% in the first half of 2001 to 27.36% in the first half of 2002. From July 1, 2001 onwards, we supply at our integrated plants based on market prices instead of cost in order to facilitate the review and analysis of our segmental results.

#### *Production Cost and Cost of Goods Sold*

The total alumina segment cost of goods sold increased 21.9% from RMB3,117.5 million for the first half of 2001 to RMB3,800.4 million for the first half of 2002. This is primarily due to increase in sales volumes of alumina segment by 22.71% over the same period last year.

Unit production costs of alumina excluding depreciation expenses decreased 5.4% from RMB1,166.7 per tonne for the first half of 2001 to RMB1,104.2 per tonne the first half of 2002, primarily due to the increase in outputs, decrease in labour cost and reduction in energy consumption through technological improvement.

#### *Operating Income*

Total operating income for the alumina segment decreased 39.03% from RMB1,137.5 million for the first half of 2001 to RMB694.0 million for the first half of 2002 primarily as a result of the decline in selling price for this segment. Our alumina segment operating income as a percentage of alumina segment sales of goods decreased from 24.6% for the first half of 2001 to 14.5% for the first half of 2002.

## **Primary Aluminum Segment**

### *Sales of Goods*

Our total primary aluminum segment sales of goods increased by 1.0% from RMB4,402.3 million for the first half of 2001 to RMB4,446.4 million for the first half of 2002.

Our revenue from the sales of primary aluminum for the first half of 2002 accounted for 84.25% of our total sales of goods of the segment. Sales of goods of primary aluminum decreased 0.97% from RMB3,782.6 million for the first half of 2001 to RMB3,746 million for the first half of 2002. The decrease in sales of goods of primary aluminum was due to decreases in primary aluminum sales prices, partially offset by increases in the sales volume of primary aluminum. The weighted average sales price for our primary aluminum decreased 10.74% from RMB12,618.2 (exclusive of VAT) per tonne for the first half of 2001 to RMB11,262.5 (exclusive of VAT) per tonne for the first half of 2002. Sales volume of primary aluminum increased 10.95% from 299,800 tonnes for the first half of 2001 to 332,600 tonnes for the first half of 2002.

### *Cost of Goods Sold*

The total cost of goods sold for our primary aluminum segment increased 6.14% from RMB3,509.8 million for the first half of 2001 to RMB3,725.3 million for the first half of 2002. The increase is primarily due to increase in sales volume of primary aluminum products.

Unit production costs of primary aluminum excluding depreciation expense increased by 2.48% from RMB8,673.1 per tonne for the first half of 2001 to RMB8,888.6 per tonne for the first half of 2002. The increase in costs was a result of integrated plants supplying alumina based on market prices instead of based on cost last year. If based on the calculation method of last year, the unit production cost of primary aluminum will be RMB8,447.6, representing a decrease of 2.6% over the same period last year.

### *Operating Income*

Primary aluminum segment operating income decreased 19.30% from RMB788.7 million for the first half of 2001 to RMB636.4 million for the first half of 2002. Our primary aluminum segment income as a percentage of primary aluminum segment sales of goods decreased from 17.9% for the first half of 2001 to 14.3% for the first half of 2002.

## **Corporate and Other Services Segment**

Our corporate and other services segment reflected our headquarters expenses, research and development services and product sales of our Research Institute to external customers. Operating income for the segment changed to a loss of RMB21.66 million for the first half of 2002.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of funding have been cash provided by operating activities, short-term and long-term borrowings, and our primary uses of funds have been production-related working capital, repayment of short-term and long-term borrowings and capital expenditures.

We have historically taken advantage of significantly lower interest rates on short-term debt to lower financing costs on our capital expenditures. Interest rates on short-term debt in China have generally been approximately 1% to 2% per annum lower than those on long-term debt. As a result, we have incurred substantial short-term borrowings. Our current liabilities as of June 30, 2002 exceeded our current assets by RMB1,629 million. As of June 30, 2002, our short-term debt amounted to RMB5,398 million (including the current portion of long-term debt of RMB1,025 million) accounted for 51.76% of our total debts to bank.

In addition, part of the cash flow and funding for our capital expenses have been in the form of loans from state-owned bank, commercial banks and other financial institutes. As of December 31, 2001, and June 30, 2002, we had RMB10,869 million and RMB10,428 million, respectively, of total outstanding obligations under these loans.

As of June 30, 2002, the Group's long-term loans comprise Renminbi denominated loans of RMB 4,663 million with variable interest rates ranging from interest free to 11.16% per annum; Renminbi denominated loans of RMB168 million with fixed interest rate of 5.94% per annum; an US dollar denominated loan of an amount equivalent to RMB 4.77 million with interest rate of 0.25% per annum; Euro dollar denominated loans of an amount equivalent to RMB182 million with interest rates ranging from 2.8% to 9.4% per annum; and Danish Krone denominated loans of an amount equivalent to RMB13.34 million with fixed interest rates ranging from 0.3% to 9.2% per annum. Short-term loans amounted to RMB4,372 million and long-term loans due within one year amounted RMB1,025 million were loans with variable interest rates ranging from 4.8% to 7.56% per annum.

As of June 30, 2002, the net book value of fixed assets pledged as security for short-term and long term loans of the Group amounted to RMB732 million and RMB1,814 million, respectively.

Our leverage ratio, or our total loans divided by the aggregate of our total loans plus owners' equity, has improved from 43.54% as of December 31, 2001 to 41.51% as of June 30, 2002, primarily as a result of retained earnings and the Over-allotment. Our interest coverage ratio (EBIT divided by total finance costs excluding interest capitalized in construction in progress) was 6.41 times as at June 30, 2001 and 3.86 times as at June 30, 2002.

In addition to internally generated funds and a portion of the proceeds from the Global Offering, we may rely on bank borrowings to finance our capital expenditure plans. In view of our credit and the availability of funds in China, we currently do not foresee significant difficulties in obtaining bank borrowings. We plan to fund our capital and related expenditures principally through cash provided by operating activities, short-term and long-term loans and the net proceeds we received from the Global Offering. We have also obtained conditional undertakings from certain PRC state-owned banks to establish standby credit facilities for an aggregate of RMB11,400 million to fund any capital shortfall related to alumina and primary aluminum projects and related working capital purposes. We believe that our working capital is sufficient for our present needs.

## **CASH AND CASH EQUIVALENTS**

As of June 30, 2002, our cash and cash equivalents, including foreign currencies deposits, was RMB2,906 million, comprising US\$71.062 million and HK\$91.304 million.

### **Net Cash Flow from Operating Activities**

Net cash provided by operating activities decreased by 73.23% from RMB979.0 million for the first half of 2001 to RMB262.4 million for the first half of 2002. The decrease was primarily the result of a decrease in alumina and primary aluminum prices in 2001, but the increase in sales volumes for alumina and primary aluminum has partially offset the effect. Of the cash from operating activities for the first half of 2002, RMB1,261.5 million was used as working capital, RMB298.1 million was used for interest payment, RMB169.6 million was used to pay income tax.

### **Cash Flows from Investing Activities**

In the first half of both 2001 and 2002, majority of the net cash from investing activities were used for capital expenditures. Our cash outlays for capital expenditure projects amounted to RMB1,354.3 million and RMB1,380.2 million in the first half of 2001 and 2002, respectively.

### **Cash Flows from Financing Activities**

Cash flows from financing activities were net outflow of RMB300.8 million in 2002. This consisted primarily of net proceeds of RMB204.8 million from the Over-Allotment bank deposits pledged of RMB100.2 million and net loan settlement of RMB605.8 million.

### **Foreign Exchange Rate Risk**

We conduct our business primarily in Renminbi. Certain loan balances of the Company were denominated in Euro dollars. The discussion on gain/loss recognised during the period in respect of exchange rate fluctuation has been covered in "Other expenses / (income), net" in this section.

The Renminbi is not a freely convertible currency. Limitations on foreign exchange transactions imposed by the PRC government could cause future exchange rates to vary significantly from current or historical exchange rates. The fluctuations in Renminbi exchange rates will affect our ability to perform our foreign exchange denominated obligations. Such fluctuations will also affect our ability to pay dividends in Hong Kong Dollars or to pay dividends in respect of American depository receipts in United States Dollars. We believe that the Company is or will be able to obtain sufficient foreign exchange for the performance of such obligations.