



Review of Operations and Management's Discussion and Analysis



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In 2002, the Group operated 228 routes, of which 179 were domestic routes (including 14 routes to Hong Kong) and 49 were international routes (including 7 international cargo routes). The Group operated about 3,130 scheduled flights per week serving a total of 77 domestic and foreign cities. During 2002 the Group purchased four Boeing 737-700 aircraft, and acquired two Airbus A319 aircraft and two Boeing 737-700 aircraft under operating leases. The Group also acquired one Boeing 747 freighter under a short term wet lease. As at 31 December 2002, the Group operated a fleet of 78 aircraft, including 75 passenger jet aircraft with a capacity of over 100 seats and three jet freighters.

Revenues

Our total revenues increased from RMB12,153 million in 2001 to RMB13,079 million in 2002, or 7.62%, due to an increase of RMB492 million in international passenger revenues and an increase of RMB232 million in cargo and mail revenues. These revenues were net of the applicable PRC sales tax and civil aviation infrastructure levies.

Passenger revenues, which accounted for 76.75% of our total revenues in 2002, increased from RMB9,587 million in 2001 to RMB10,038 million in 2002, or 4.70%, reflecting increased revenues from operations on international routes,

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including continuous revenue increase on Japanese and Korean routes.

Our domestic passenger revenues, which accounted for 46.52% of our passenger revenues, decreased from RMB4,701 million in 2001 to RMB4,670 million in 2002, or 0.67%, primarily because our company significantly lowered average airfares for our domestic flights in 2002. Our domestic passenger load factor increased from 58% in 2001 to 63.11% in 2002. Our revenue passenger-kilometers, or RPK, on domestic routes increased from 7,509 million passenger-kilometers in 2001 to 8,516 million passenger-kilometers in 2002, primarily because we expanded our fleet and put six Boeing B737 aircraft and two A319 aircraft into operation on our domestic routes in 2002. However, our domestic passenger yield decreased from RMB0.63 in 2001 to RMB0.55 in 2002 per passenger-kilometer, primarily due to increasing competition in the domestic transportation market, which prompted us to lower average airfares for our flights.

Hong Kong passenger revenues, which accounted for 19.04% of our passenger revenues, decreased from RMB1,921 million in 2001 to RMB1,911 million in 2002, or 0.53%, and our Hong Kong passenger yield decreased from RMB0.95 in 2001 to RMB0.86 in 2002 per passenger-kilometer, due to intensified

competition on Hong Kong routes with other airlines and responding reduction in our average airfares for our Hong Kong flights. Hong Kong passenger traffic increased by 10.13% in 2002 over that of 2001 as a result of passengers' preference for our flights due to our competitive prices and improved services. The passenger capacity on our Hong Kong routes increased by 1.12%. Our Hong Kong passenger load factor increased from 56.21% in 2001 to 61.21% in 2002.

International passenger revenues, which accounted for 34.44% of our passenger revenues, increased from RMB2,965 million in 2001 to RMB3,457 million in 2002, or 16.61%. The increase in international passenger revenues was mainly attributable to our increased capacity on our Japanese and Korean routes and our expanded share in the international transportation market. The increase also reflected increased business traffic on our European routes due to stable development in European economy. Passenger traffic on our international routes increased by 17.02% in 2002 over that of 2001. Our international passenger capacity increased by 16.49% in 2002, international passenger load factor increased slightly from 68.61% in 2001 to 68.93% in 2002. However, our international passenger yield decreased slightly from RMB0.47 in 2001 to

RMB0.46 in 2002 per passenger-kilometer primarily because our company lowered our average airfare on the Japanese routes in order to maintain our market share, which in turn resulted in a decrease in our international passenger yield since revenues derived from our Japanese routes accounted for 37% of our international passenger revenues.

We generate cargo and mail revenues from the transport of cargo and mail on our 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 18.69% of our total revenues, increased from RMB2,092 million in 2001 to RMB2,445 million in 2002, or 16.88%. The increase in cargo revenues was primarily the result of the increase in the volume of importation and exportation after China's accession to the WTO, and the positive effect on our cargo operations by the west coast port strike in the United States. Our revenue freight tonne-kilometres, or RFTK, increased from 950 million tonne-kilometers in 2001 to 1,023 million tonne-kilometers in 2002, or 7.66%, primarily because our company wet leased a B747 aircraft in the second half of 2002 in order to grasp the opportunities provided by increased market demand. Our cargo yield increased from RMB2.20 in 2001 to RMB2.39 in 2002 per cargo tonne-kilometer primarily



Opening Ceremony for China Eastern Airline's Beijing-Delhi route.

as a result of increased market demand and our responding increase in cargo freights.

Other operating revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading, aircraft cleaning, fueling 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 RMB474 million in 2001 to RMB596 million in 2002, or 25.79 %, which is much higher than the 5% growth rate achieved in 2001. The increase in other operating revenues in 2002 was mainly due to increased volume of importation and exportation after China's accession to the WTO. The increased freight

handling fees charged by China Cargo Airlines Limited for its new storage house in Pudong International Airport opened in 2001 also contributed to the increase of our other operating revenues.

Operating Expenses

Our total operating expenses increased from RMB11,278 million in 2001 to RMB12,242 million in 2002, or 8.50%, primarily due to increase in take-off and landing charges, aircraft maintenance expenses, wages, salaries and benefits, as well as office and administration expenses.

Aircraft fuel expenses decreased from RMB2,613 million in 2001 to RMB2,564 million in 2002, or 1.89%. Fuel expenses decreased primarily as a result of decreased fuel prices in 2002. In 2002, the weighted average domestic and

international fuel prices paid by our company decreased by approximately 11% and 3%, respectively. The weighted average fuel prices paid by our company decreased about 7%.

Aircraft depreciation and operating lease expenses increased from RMB2,404 million in 2001 to RMB2,455 million in 2002, or 2.15%. Other depreciation and operating lease expenses increased from RMB358 million in 2001 to RMB400 million in 2002, or 11.78%, primarily due to expansion of our fleet.

Take-off and landing charges increased from RMB1,703 million in 2001 to RMB1,988 million in 2002, or 16.73%, primarily due to increased flights and an approximate 5% increase in the average number of take-off and landing, as well as the mandatory increase in the takeoff and landing charges for domestic flights by CAAC, effective September 1, 2002.

Aircraft maintenance expenses increased from RMB967 million in 2001 to RMB1,078 million in 2002, or 11.48%, primarily due to increased number of aircraft subject to overhaul in 2002.

Commission expenses decreased from RMB487 million in 2001 to RMB380 million in 2002, or 22.04%, primarily because revenues received by our company from sales and travel agents for

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tickets of domestic flights are net of commissions.

Wages, salaries and benefits increased from RMB773 million in 2001, which included a one-time write-back of approximately RMB96 million as a result of the curtailment of our company's obligations to provide medical benefits to retirees, to RMB1,036 million in 2002, or 34.02%. This increase was primarily attributable a 7% increase in the number of our employees in 2002 as a result of the expansion of our fleets and establishment of our Ningbo branch in mid-2001. Moreover, our company increased wage and benefit expenses due to an approximate 6.44% increase in hours flown in 2002, as well as an increase in the average salaries of important employees to maintain stable human resources in a competitive market.

Food and beverage expenses increased from RMB567 million in 2001 to RMB606 million in 2002, or 6.83%, primarily due to our expanded operations and additions of flights as a result of a 11.24% increase in passenger traffic.

Office and administration expenses increased from RMB849 million in 2001 to RMB1,044 million in 2002, or 22.95%. The increase was attributable to an increase in our training expenses in 2002 to prepare for further expansion of our

fleet in 2003. It was also due to the expansion in our general operations, including the opening of our local office in Delhi, and increase in expenses relating to our overseas sales. In addition, due to the appreciation of Euro and Japanese yen, the expenses of our overseas offices, if translated into RMB, also increased.

Other operating expenses decreased from RMB562 million in 2001 to RMB520 million in 2002, or 7.51%. Please see note 1 to Financial Highlights. Other operating expenses included provision for obsolescence of flight equipment spare parts, maintenance expenses of other fixed assets, computer and telecommunications expenses and other expenses.

Fixed assets

Our company had approximately RMB20.5 billion of fixed assets as at December 31, 2002, including aircraft and flight equipment with a value of approximately RMB17.8 billion. Fixed assets are initially recognised at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less accumulated depreciation.

In view of recent volatility in the global aviation industry and change in market values for aircraft, on December 31, 2002, our company performed a valuation on its the fixed assets pursuant to the

requirements of IFRS. As a result of the revaluation, our company recognised a net revaluation surplus of RMB137 million in the revaluation reserve and a charge of RMB172 million to the income statement.

Valuation of fixed assets is based on market conditions and global economic factors which may not be necessary under our company's control. The determination of fair market value requires significant judgment, including judgment on valuations performed by management and/or independent professional valuers.

The revaluation deficit on fixed assets as recognised in 2002 is a non-cash charge and has no impact on our company's cash flows. It is not an indication of any impairment on our company's fleet.

Net Interest Expense and Net Other Income

Net interest expenses decreased from RMB814 million in 2001 to RMB731 million in 2002, or 10.19%. The decrease was mainly due to the decreased principal amount and interests relating to aircraft finance leases as a result of expiration of three aircraft leases in 2002. Net other income increased from RMB128 million in 2001 to RMB226 million in 2002, or 77.40%. Please see note 1 to Financial Highlights. The increase in other income reflects net proceeds from sale of two A310 aircraft in 2002.

Liquidity and Capital Resources

Our company finances its working capital requirements through a combination of funds generated from operations and short-term bank loans. We had cash and cash equivalents as at December 31, 2001 and 2002 of RMB1,331 million and RMB1,945 million, respectively. Net cash provided by operating activities in 2001 and 2002 was RMB2,499 million and RMB2,160 million, respectively. During the last two years, our primary cash requirements had been for additions of and upgrades on aircraft and flight equipment and payments on related indebtedness.

Net cash used in investing activities in 2001 and 2002 was RMB2,554 million and RMB4,543 million, respectively. In 2001 and 2002, payment of advances on aircraft and flight equipment were RMB992 million and RMB2,600 million, respectively, while additions of aircraft and flight equipment were RMB1,024 million and RMB1,004 million, respectively. We financed the additions to our aircraft and flight equipment primarily through lease arrangements, bank loans, and funds generated from operations. Funds generated from disposal of old aircraft and flight equipment and other fixed assets and equipment (including by way of exchange) totalled RMB73 million and RMB150 million in 2001 and 2002,

respectively. We also received RMB62 million and RMB21 million as return of advances on aircraft and flight equipment in 2001 and 2002, respectively.

Net cash used by our company in financing activities in 2001 was RMB17 million, mainly for repayments of short-term bank loans and finance lease obligations. Net cash generated from financing activities was RMB2,956 million in 2002, primarily from short-term bank loans.

Pursuant to certain of our finance or operating leases, we are 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. Pursuant to certain PRC regulations, except for two Boeing B737-700 aircraft under operating leases entered into by our company in 2002, all of our other current leases have been exempted from withholding or similar taxes under Chinese tax regulations. Although we cannot assure that we will be able to obtain any exemption in respect of future leases, the amount of withholding taxes are generally subject to and limited by bilateral taxation treaties.

We generally operate with a working capital deficit. As at December 31, 2002, our current liabilities exceeded our

current assets by RMB7,437 million. The increase in working capital deficit in 2002 was the result of increased short-term bank loans. Short-term loans outstanding totalled RMB1,288 million and RMB4,527 million as at December 31, 2001 and 2002, respectively. Long-term loans outstanding totalled RMB5,301 million and RMB6,495 million as at December 31, 2001 and 2002, respectively. Long-term loans payable within two years, from three to five years and beyond five years were RMB2,971 million, RMB2,368 million and RMB1,156 million, respectively, as at December 31, 2002, as compared to RMB917 million, RMB2,518 million and RMB1,866 million, respectively, as at December 31, 2001. The total lease obligations outstanding under our finance leases as at December 31, 2001 and 2002 were RMB9,871 million and RMB8,184 million, respectively. Our lease obligations payable within two years, from three to five years and beyond five years were RMB3,082 million, RMB4,005 million and RMB1,097 million, respectively, as at December 31, 2002, as compared to RMB4,166 million, RMB3,091 million and RMB2,614 million, respectively, as at December 31, 2001. We expect that cash from operations and short-term bank borrowings will be sufficient to meet our operating cash flow requirements, although events that materially affect our operating results can also have a negative impact on liquidity.

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We have, and in the future may continue to have, substantial indebtedness. As at December 31, 2001 and 2002, our long-term debt to equity ratio was 2.01 and 1.81, respectively. Please see note 2 to Financial Highlights. The interest expenses associated with these indebtedness might impair our future profitability and cause our earnings to be subject to a higher degree of volatility. Our ability to obtain financing may be affected by our financial position and leverage, as well as by prevailing economic conditions and the cost of financing generally. If we are unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or to expand our operations could be impaired.

Capital Expenditures

In 2002, in order to develop our company's operation in the Jiangsu aviation market and to increase the market share of China Eastern Airlines Jiangsu Co., Ltd, or China Eastern Jiangsu, a non-wholly owned subsidiary of our company, in the local market, on December 19, 2002, our company provided financial assistance, upon normal commercial terms, to China Eastern Jiangsu by way of investing an additional RMB400 million cash in China Eastern Jiangsu as capital contribution towards its registered capital. The other two shareholders of China Eastern

Jiangsu, i.e., Jiangsu Provincial Aviation Industry Group and Jiangsu Guoxin Asset Management, Co., Ltd., also made their capital contributions in proportion to their respective shareholding interests in China Eastern Jiangsu. The registered capital of China Eastern Jiangsu was thereby increased from US\$47 million to RMB1,000 million. The percentage shareholding interests in China Eastern Jiangsu following such increase in its registered capital remained unchanged, with our company, Jiangsu Provincial Aviation Industry Group and Jiangsu Guoxin Asset Management Co. Ltd. holding 55%, 24% and 21%, respectively, of its enlarged registered capital. Jiangsu Provincial Aviation Industry Group and Jiangsu Guoxin Asset Management Co. Ltd. are both third parties independent of our company, its subsidiaries or any of their chief executives, directors or substantial shareholders or any associates of any of them. In addition, in August 2002, our company, jointly with Wuhan Municipal State-owned Assets Management Committee Office and two other independent third parties, established China Eastern Airlines Wuhan Limited and invested RMB240 million in the joint venture. Our company holds 40% equity interest in China Eastern Airlines Wuhan Limited. Our company also invested RMB295 million in May 2002 in an investment holding company, i.e., Shanghai Eastern Airlines Investment Co.,

Ltd., and holds 98% equity interest. Other major equity investments of our company in 2002 include an additional contribution to the registered capital of Eastern Airlines Industrial Co., Ltd. in the amount of RMB21 million and an acquisition of 45% equity interest in Eastern Airline Advertising Services Co. for RMB15 million.

Our aircraft orders as at December 31, 2002 included commitments to acquire five Boeing B737 aircraft, 20 A320 Airbus aircraft and five A340 Airbus aircraft to be delivered between 2003 and 2005. We expect our capital expenditures for aircraft and related equipment, including deposits, through 2005 to be in aggregate approximately RMB14,544 million, including RMB6,967 million in 2003, RMB3,782 million in 2004, and RMB3,795 million in 2005, in each case subject to contractually stipulated increases of contracts or any increase in certain product indexes. Construction of our 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 2003. We plan to finance our aircraft acquisitions, our investment in the joint ventures and other capital commitments through a combination of funds generated from operations, existing credit facilities, bank loans, leasing arrangements and other external financing arrangements.

Foreign Currency Transactions

All of our finance lease obligations are denominated in U.S. dollars, Japanese yen or Euro, and certain of our other expenses are denominated in currencies other than Renminbi. We generate foreign currency revenues, including U.S. dollar, Japanese yen, Euro, Korean won, Hong Kong dollar, Singapore dollar, Australian dollar, and Thailand baht revenues from ticket sales made in overseas offices. Our revenues in foreign currencies to some extent hedge against part of our payments in foreign currencies. Our company has designated certain personnel to manage the foreign currency risks relating to other foreign currency obligations, using such methods like forward contract, swap transaction, option and through other derivative financial products to effectively control the interest and exchange rate risks.

Our company adopts Renminbi as its base currency. Therefore all of our assets and liabilities denominated in foreign currencies are translated into Renminbi amount in our financial statements. We adjust the numbers at the end of each fiscal year in accordance with the change in the exchange rates, and recognise the net exchange gains or losses in that period. Changes in certain foreign currency exchange rates in which our revenues or debts are denominated can

have a material impact on our financial performance. For example, our net exchange gain was RMB126 million in 2001 due to the depreciation of Japanese yen against Renminbi. However, we had a net exchange loss of RMB38 million in 2002 due to the appreciation of Japanese yen against Renminbi. Our company operates a couple of Japanese routes and has stable revenues in Japanese yen in each year. We believe our revenues denominated in Japanese yen will be sufficient to pay the principal amount and interests of our debts denominated in Japanese yen in each year.