

RESEARCH AND DEVELOPMENT

In the first half of 2003, the Company continued to develop and improve the products of its new-generation ETD system, with the aim of providing participants in each segment of the value chain in the air travel and tourism industries with information technology solutions and services. With the technical support of the Company, China Eastern Airlines is speeding up the establishment of a revenue management system. The Company continues to improve its data services in a number of ways including the setting up of a complete databank and an efficient data dissemination channel as well as the development of data analysis products to meet the requirements of users such as airlines, travel agencies and airports.

In the first half of 2003, building on the new-generation APP front-ended system which was launched last year and continuous improvements since made to the system, the Company completed research and development of the APP subsidiary control systems on open platforms, such as an open flight data control system, an airline ground operation and management system, an open linkage engine, an APP operational analysis and management system and an airport passenger departure security information system. The development of products for the APP flight control system has achieved a substantial breakthrough.

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

Summary

The Group achieved a profit before tax of RMB149.3 million, representing a decrease of 36.6 per cent. compared to the first half of 2002. Earnings before interest, tax, depreciation and amortisation (EBITDA) amounted to RMB195.8 million, representing a decrease of 29.7 per cent. compared to the first half of 2002. Net profit was RMB135.6 million, which represents a decrease of 42.9 per cent. compared to the first half of 2002. The fall in profit was mainly attributable to the outbreak of SARS.

The turnover and results of the Group were mainly derived from its operations in China. The earnings per share of the Group was RMB0.15 for the first half of 2003.

Total Revenues

The total revenues of the Group in the first half of 2003 decreased by RMB63.0 million, or 13.3 per cent., to RMB411.8 million from RMB474.8 million in the first half of 2002. The decrease in total revenues was mainly attributable to the decrease in the Group's business volume. The reasons for the decrease in total revenues are as follows:

- ETD revenues represented 49.8 per cent. of the Group's total revenues in the first half of 2003 as compared to 54.2 per cent. in the first half of 2002. ETD revenues decreased by 20.3 per cent. to RMB205.0 million in the first half of 2003 from RMB257.3 million in the first half of 2002. The decrease was principally attributable to a decrease in the usage of the Company's ETD services by Chinese, foreign and regional commercial airlines due to the sharp fall in the number of air travellers following the SARS outbreak in China and Hong Kong and the attack on Iraq by US-British coalition forces.
- APP revenues accounted for 25.1 per cent. of the Group's total revenues in the first half of 2003 as compared to 24.0 per cent. in the first half of 2002. APP revenues decreased by 9.3 per cent. to RMB103.5 million in the first half of 2003 from RMB114.1 million in the first half of 2002. The decrease was also attributable to a reduction in the number of air travellers following the SARS outbreak and the attack on Iraq by US-British coalition forces. However, with the installation of APP front-ended systems at some domestic airports in the first half of 2003, there was an increase in the usage of APP services so that the impact described above was partially offset.
- Data network revenues accounted for 19.1 per cent. of the Group's total revenues in the first half of 2003 as compared to 17.4 per cent. in the first half of 2002. Data network revenues decreased by 4.7 per cent. to RMB78.5 million in the first half of 2003 from RMB82.4 million in the first half of 2002. The decrease was mainly attributable to the suspension by some travel agencies of the use of the Company's system services during the SARS outbreak.
- Other revenues increased by 18.9 per cent. from RMB20.9 million in the first half of 2002 to RMB24.8 million in the first half of 2003. The increase was mainly attributable to the rise in revenue from the Company's distribution of travel products.

Net Revenues

Net revenues decreased by 13.5 per cent. to RMB397.5 million in the first half of 2003 from RMB459.3 million in the first half of 2002.

Operating Expenses

Total operating expenses increased by RMB12.8 million, or 5.0 per cent., to RMB268.1 million in the first half of 2003 from RMB255.4 million in the first half of 2002. The reasons for the increase in operating expenses are as follows:

- depreciation and amortisation decreased by 9.9 per cent. primarily due to the fact that certain computer systems were already fully depreciated during the second half of 2002 and the first half of 2003;
- despite the decrease in the ETD and APP business volume, expenses on implementation of measures to ensure the reliability and enhance safety and stability in the operation of the data network had increased, as a result of which the network usage fee increased by 15.4 per cent.;
- personnel expenses increased by 31.2 per cent., primarily due to an increase in the number of employees in order to support the development of the Group's businesses;
- technological support and maintainance costs increased by 40.1 per cent. after the Company stepped up the research and development of new products and new technology in the first half of 2003;
- commission and promotion expenses increased by 33.2 per cent. due to the growth in new APP customers and the success of the Group's APP promotional programmes; and
- since the Group implemented a number of measures to save costs during the SARS outbreak, other operating costs decreased by 27.2 per cent.;

As a result of the above changes in net revenues and operating expenses, the operating profit of the Group decreased by RMB74.6 million, or 36.6 per cent., to RMB129.3 million in the first half of 2003 from RMB204.0 million in the first half of 2002.

Net Financial Income

Net financial income in the first half of 2003 amounted to RMB15.0 million as compared to RMB25.5 million in the first half of 2002. The decrease was mainly attributable to the Company's decrease in interest income.

Net Profit

As a result of the above factors, the Group's net profit decreased by RMB101.9 million, or 42.9 per cent., from RMB237.5 million in the first half of 2002 to RMB135.6 million in the first half of 2003.

Liquidity and Capital Structure

For details of the cash flows of the Group for the first half of 2003, please refer to the unaudited condensed consolidated statement of cash flows and the explanatory notes relating thereto.

In the first half of 2003, the Group derived its working capital mainly from operating activities. Net cash inflow from operating activities amounted to RMB201.3 million.

During the first half of 2003, the Group had no short-term or long-term bank loans.

As at June 30, 2003, the cash and cash equivalents of the Group amounted to RMB2,124.2 million, of which 66 per cent. was denominated in Renminbi, 13 per cent. was denominated in US dollars and 21 per cent. was denominated in Hong Kong dollars.

Capital Expenditures

The total capital expenditures of the Group increased by a substantial amount of RMB219.1 million from RMB28.4 million in the first half of 2002 to RMB247.5 million in the first half of 2003.

The capital expenditures of the Group in the first half of 2003 mainly comprised the purchase of hardware, software and equipment under the Group's ETD business strategy as well as the purchase of software for ACS.

The total capital expenditures of the Group for the year 2003 is estimated to be approximately RMB432.0 million, which will be used principally for the development and promotion of the new-generation ETD products and services, the development of APP/ACS and other new businesses.

The capital expenditure programmes will be funded by the remaining balance of proceeds from the Company's initial public offering and internal cash flow from operating activities.

The Board anticipates that the capital available to the Group in 2003 will be sufficient to fully cover the amount required for its capital expenditure programmes and daily operations.

Use of Proceeds from Issuance of the H Shares

The H shares of the Company were listed on the Stock Exchange on February 7, 2001, and the net proceeds from the issuance of H shares amounted to approximately HK\$1,186.0 million. As at June 30, 2003, such amount has been used in the same manner as set out in the prospectus of the Company dated January 29, 2001. In particular:

- approximately RMB446.0 million (HK\$420.3 million) was used to finance a portion of the funding requirements of the ETD plan;
- approximately RMB131.0 million (HK\$123.5 million) was used to finance a portion of the expansion and upgrading of the APP system;
- approximately RMB8.4 million (HK\$7.9 million) was used to finance the expansion and upgrading of the ACS and other new businesses of the Company;
- approximately RMB26.8 million (HK\$25.3 million) was used for daily operating activities; and
- the balance of the net proceeds is currently deposited with banks.

The Board believes that the Company currently has sufficient capital for its operations, including future expansion of its businesses in the PRC and potential strategic acquisitions or investments which the Company may decide to pursue in the future.

Foreign Exchange Risk

The Group is exposed to foreign exchange risks related to its capital expenditures since a substantial portion of its capital expenditures involves payments for the purchase of imported equipment which are dominated in US dollars. Under the current foreign exchange system in the PRC, the Group is not able to hedge effectively against currency risks, except for cash and cash equivalents that are dominated in foreign currency.

Gearing ratio

As at June 30, 2003, the gearing ratio of the Group was 12.8 per cent. (June 30, 2002: 15.6 per cent.), which was computed by dividing the total amount of liabilities and minority interests, by the total assets of the Group as at June 30, 2003.

Contingent liabilities

As at June 30, 2003, the Group had no material contingent liabilities.

Employees

As at June 30, 2003, the total number of employees of the Group was 1,317. Personnel expenses amounted to RMB60.5 million for the first half of 2003, representing 22.6 per cent. of the total operating expenses of the Group in the first half of 2003.

The remuneration package of the Group's employees includes salary, bonus and other benefits. Where the relevant laws and regulations in the PRC permit the Group to do so, the Group offers salaries of different levels to different employees based on factors which include their performance, qualifications and duties.

In the first half of 2003, the Group continued to provide its employees with learning opportunities in the areas of air travel and tourism, computer technology and business management, as well as training in the latest developments in computer information technology, law and economics.

Looking Ahead for the Second Half of 2003

In the first half of 2003, despite the severe impact of the SARS outbreak on China's air travel and tourism industries, the Company's Board of Directors believes the momentum of the rapid development of the air travel and tourism industries, driven by the sustained economic growth in China, will remain fundamentally unchanged. In the second half of 2003, with the gradual restoration of air travellers' confidence, the introduction of the "Sky Revival" programme by the Civil Aviation Administration of China and the launch of marketing initiatives by various airlines, the number of air travellers is expected to pick up. In order to take advantage of the recovery of the air travel and tourism industries, the Group intends to implement a series of effective measures to overcome the impact of unfavourable factors and strive to minimize the losses caused by SARS.

- To expand the scale and increase the market share of its existing core businesses and increase customers' satisfaction by enhancing personalized services provided to commercial airlines; to improve its business operation model and promote new business development by focusing on the tourism-related products such as air-travel personal injury insurance and hotel reservation.

- To provide industry participants such as commercial airlines and airports with different options for expanding and diversifying their core and related businesses, and to provide air passengers with more choices to satisfy their increasingly sophisticated demand for personalised services, the Company intends to continue to implement a five-year expenditure programme, extensively employ new technology, strive to develop new-generation ETD and APP systems which boast internationally competitive core technologies, and improve product lines.
- To address the needs arising from the Group's business development by carrying out mainframe system backup and network improvement projects, enhancing the allocation of system resources, improving system performance, establishing a system infrastructure which will support the Group's product development strategies, and enhancing the security, reliability and interference resistance of the mainframes and the system network.
- To further reduce operating costs through the continuous use of advanced technical and managerial measures and to further increase the efficiency of capital utilization through a variety of measures.

Interim Dividend

The Board does not recommend the payment of an interim dividend for the first half of 2003.

Substantial Shareholders

As at June 30, 2003, pursuant to the register required to be maintained under Section 336 of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the "Ordinance"), the following substantial shareholders held an interest of 5 per cent. or more in their respective class of share capital of the Company:

Name of shareholder	Class	No. of shares interested	Percentage of respective class of share capital (per cent.)	Percentage of total issued share capital (per cent.)
J. P. Morgan Chase & Co. (1) Templeton Asset Management Limited (2)	H Shares	36,691,600	11.7	4.1
China TravelSky Holding Co.	H Shares	18,688,000	6.0	2.1
China Southern Air Holding Co. (3)	Domestic	198,496,500	34.4	22.3
China Eastern Air Holding Co. (4)	Domestic	116,460,500	20.2	13.2
China National Aviation Holding Co. (5)	Domestic	109,414,500	19.0	12.3
	Domestic	89,433,500	15.5	10.1

Save as disclosed herein, as at June 30, 2003, no other persons or companies held an interest or short positions of 5 per cent. or more in the issued share capital of the Company pursuant to the register required to be maintained under Section 336 of the Ordinance.

Note:

- (1) *Based on the Corporate Substantial Shareholder Notice from J. P. Morgan Chase & Co., as at June 30, 2003, J. P. Morgan Chase & Co. held approximately 11.7 per cent. of the H shares of the Company, representing approximately 4.1 per cent. of the total issued share capital of the Company.*
- (2) *Based on the Corporate Substantial Shareholder Notice from Templeton Asset Management Limited, as at June 30, 2003, Templeton Asset Management Limited held approximately 6.0 per cent. of the H shares of the Company, representing approximately 2.1 per cent. of the total issued share capital of the Company.*
- (3) *As at June 30, 2003, China Southern Air Holding Company directly held approximately 9.4 per cent. of the total issued share capital of the Company and also owned, among other things: (i) a 100 per cent. interest in China Northern Airlines Co.; and (ii) a 100 per cent. interest in Xinjiang Airlines Co.. Since China Northern Airlines Co. and Xinjiang Airlines Co. held approximately 2.8 per cent. and 1.0 per cent. of the total issued share capital of the Company respectively, China Southern Air Holding Company effectively had an aggregate interest of approximately 13.2 per cent. in the total issued share capital of the Company.*
- (4) *As at June 30, 2003, China Eastern Air Holding Company directly held approximately 7.7 per cent. of the total issued share capital of the Company and also owned, among other things: (i) a 100 per cent. interest in China Northwest Airlines Co.; and (ii) a 100 per cent. interest in Yunnan Airlines Co. Since China Northwest Airlines Co. and Yunnan Airlines Co. held approximately 2.6 per cent. and 2.0 per cent. of the total issued share capital of the Company respectively, China Eastern Air Holding Company effectively had an aggregate interest of approximately 12.3 per cent. in the total issued share capital of the Company; and*
- (5) *As at June 30, 2003, China National Aviation Holding Company owned, among other things: (i) a 100 per cent. interest in Air China; (ii) a 100 per cent. interest in China Southwest Airlines Co.; and (iii) a 100 per cent. interest in China National Aviation Corporation. Since Air China, China Southwest Airlines Co. and China National Aviation Corporation held approximately 6.5 per cent., 2.9 per cent. and 0.7 per cent. of the total issued share capital of the Company respectively, China National Aviation Holding Company effectively had an aggregate interest of approximately 10.1 per cent. in the total issued share capital of the Company.*

Interests of Directors and Supervisors in the Share Capital of the Company

As at June 30, 2003, none of the Directors, Supervisors or chief executives had any interest or short position in any shares, underlying shares and debentures of the Company or any of its associated corporations that is required to be recorded and kept in the register in accordance with Section 352 of the Ordinance, or any interest required to be notified to the Company and The Stock Exchange of Hong Kong Limited pursuant to the Model Code for Securities Transactions by Directors of Listed Companies.