

## Management Discussion and Analysis



**Opening of aviation industry  
will bring opportunities to the  
Group.**

## CIVIL AVIATION INDUSTRY IN CHINA

The outbreak of SARS in the first half of 2003 tremendously affected the civil aviation industry in China. The passenger traffic for civil aviation in April 2003 amounted to 1,218 million, representing a decrease of 6.9% as compared to the corresponding period last year. Passenger traffic continued to decrease during the Labour Day golden week holiday. The passenger traffic of numerous PRC airports hit their record low in May. As part of the government subsidy for the affected industry, on 11 May 2003, the State Administration of Taxation issued an emergency notice for the exemption of business tax, city maintenance construction fee and additional education fee for tourist transportation business and tourism for the period from 1 May 2003 to 31 December 2003. Meanwhile, domestic airlines adopted different measures in minimizing losses, including the combination of flights, delay of opening new flights, suspension of investment projects and reduction of expenditures, etc. With the successful combat against SARS by the mid of the year, the domestic civil aviation industry recorded remarkable rebound and growth for the second half of the year during which period the passenger traffic of the PRC civil aviation recorded a substantial increase particularly during the National Day golden week holiday and the Chinese New Year.



In 2003, the civil aviation industry reform in the PRC was intensified and airport localization policies were proactively implemented. According to the related programs approved by the PRC State Council, all civil aviation management bureaus at provincial, autonomous district and centrally administrated municipalities level will be removed and the management of all 93 nationwide airports will be transferred to the regional government. The government's functions of administrative monitoring of the airport and of operational management of the airport is required to be separated. Such policy encourages marketization and independent operation of the airports in the PRC and paves the way for Meilan Airport to be involved in the management of more airports and become a regional airport management company in the PRC.

As a pilot project, the PRC government has adopted certain policies in respect of the opening of aviation industry in Hainan to foreign airlines in 2003 and earlier 2004. Under such policies, foreign airlines are able to arrange direct flights to Hainan and/or via Hainan to other countries with right to load and unload passengers and cargos in Hainan and not being restricted to the bilateral equality principle adopted in the international air traffic industry. Further, foreign airlines have been granted the access via Hainan to other PRC cities that are open to international flights with the exceptions of Beijing, Shanghai and Guangzhou, subject to certain frequency conditions. Those new policies will facilitate foreign airlines to extend their existing or proposed international flights en route from other PRC cities to Hainan or stopping over Hainan and bring more business opportunities to Meilan Airport.

## TOURISM IN HAINAN PROVINCE

Hainan island is one of the major tourist destinations in the PRC attracting both domestic and international visitors. In 2003, the number of individual visits reached 12,341,000, representing a decrease of 1.7% when compared with the previous year. Realized income from tourism decreased by 1.9%, amounted to RMB9,355 million.

The total number of foreign tourists visiting China in 2003 dropped by 7.1% and the number of domestic tourists recorded a decrease of 0.9% when compared with previous year. Total revenue of international and domestic tourism decreased by 12.4%. Apparently, the tourism business of Hainan province in 2003 maintained to be conspicuous. Despite the negative growth in 2003, the image of "epidemic-free area" and "healthy island" was strongly imprinted into the mind of the public and stimulated immense consumption demand.

Meanwhile, the tourism attractions in Hainan such as the flourishing economy, established conference/events hosting business and numerous festivities were enhanced in breadth and depth during 2003. The hosting of the New-silk-road Model Competition, the 2nd Annual Boao Forum for Asia (BOA), the 53rd Miss World Final and the 4th Hainan Island Festival, etc. earned overwhelming attention and reputation for the island, which further expedited its tourism development.

## BUSINESS REVIEW

### OVERVIEW OF AERONAUTICAL BUSINESS

The impact of the SARS outbreak led to a year-on-year decrease in passenger throughput and cargo throughput for the first half of the year, while aircraft movements stayed in line with the previous year. Passenger throughput, aircraft movements and cargo throughput recorded a drastic decrease in the second quarter of 2003. For the six months ended 30 June 2003, aeronautical revenue recorded negative growth, representing a year-on-year decrease of 16.9%. The Group has made announcements regarding the adverse effects brought forth by the SARS outbreak to the Group's business operation on 29 April 2003 and 21 May 2003.

## Management Discussion and Analysis

In the second half of 2003, the SARS epidemic subsided and a strong rebound for the tourism industry in the PRC was observed. The Group successfully captured the business opportunities during the National Day golden week holiday and Chinese New Year and maintained an annual growth rate of 7.7% in passenger throughput. Aircraft movement increased by 2.6% while the corresponding increase of cargo throughput (including non-transportation aircraft movement, such as training, etc.) was 6.4%.

Traffic throughput for 2003 and the previous year are set out below:

	2003	2002	Change (%)
<b>Aircraft movements</b>	<b>64,136</b>	<b>62,498</b>	<b>2.6</b>
Domestic	62,996	60,839	3.5
Hong Kong/Macau	1,027	1,471	(30.1)
International	113	188	(39.9)
<b>Passenger throughput (Ten thousand persons)</b>	<b>602.9</b>	<b>560</b>	<b>7.7</b>
Domestic	592.6	544.7	8.8
Hong Kong/Macau	9.1	13.7	(33.6)
International	1.2	1.6	(25)
<b>Cargo throughput (tonnes)</b>	<b>81,401.9</b>	<b>76,479.8</b>	<b>6.4</b>
Domestic	80,065.2	74,627.2	7.3
Hong Kong/Macau	1,138.1	1,548.3	(26.5)
International	198.6	304.3	(34.7)

International flights decreased by 39%. The reason for the substantial decrease in international flights in 2003 was mainly due to the significant reduction in the number of tourists from Hong Kong and Macau during the outbreak of SARS from April to June 2003. The relevant flights of numerous airlines were either suspended or reduced.



Benefited from the overall increase in traffic flow in 2003, the Company's revenue from aeronautical business for the year reached RMB214.84 million, representing an increase of 2.5% as compared to last year:

	Amount (RMB'000)	YoY Change (%)
Passenger charges	84,620	(17)
Aircraft movement fees and related charges	38,297	120
Airport fee	71,668	7.6
Ground handling service fees	20,254	(13)
<b>Total revenue from Aeronautical Business</b>	<b>214,839</b>	<b>2.5</b>

### OVERVIEW OF NON-AERONAUTICAL BUSINESS

Despite the adverse impacts of the outbreak of SARS in 2003, the Group attained encouraging results in respect of its non-aeronautical business. The revenue from non-aeronautical business amounted to RMB93.09 million, representing an increase of 26% as compared to last year. The sources of revenue are set out as follow:

	Amount (RMB'000)	YoY Change (%)
Leasing of commercial areas in the airport terminal	15,964	30
Franchise revenue	24,493	14
Advertising revenue	6,192	21
Duty-free merchandise business	11,450	160
Tourism transportation revenue	21,977	107
Car parking fees	2,963	102
Management fee income	2,472	259
Other revenue	7,583	2.9
<b>Total revenue from non-aeronautical business</b>	<b>93,094</b>	<b>26</b>





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Hainan Meilan Airport Travelling Company Limited ("Meilan Travelling") provides a wide range of services such as transportation between Hainan Meilan International Airport and Haikou City, hotel reservation, air ticket sales and tour package reservations. Under the adverse impacts of the outbreak of SARS during the first half of 2003, the operation of Meilan Travelling was suspended. However, with the unparalleled effort and dedication of all staff members, the annual results of Meilan Travelling was outstanding and was ranked 57th in 2002's Top 100 PRC Travelling Companies.

Commercial sales also receded due to the outbreak of SARS. The Company utilized new innovative ideas and enhanced its business foundation management during the difficult period by establishing business analysis systems, arranging business development plans and extending reach to the advertising business. By exploring new business realms, the management endeavored to nurture new growth momentums. Proactive communication with internationally renowned brands led to the successful introduction of SSP, one of the largest international airport food and beverages catering services operators owned by the COMPASS Group. During the period under review, the non-aeronautical business of the Group was greatly improved, which further motivated future business development and the establishment of the international brand building of Hainan Meilan International Airport.

Car parking charges is another income source for the Group's non-aeronautical businesses. The turnover for 2003 amounted to RMB2.96 million.

The Group also generated revenue by leasing out advertising space at the airport terminal. For the year ended 31 December 2003, income from advertising was RMB6.19 million, representing an increase of 21%. As Hainan Meilan International Airport begins accommodating international flights, the number of domestic and international corporations placing advertisements in the airport terminal will increase and ultimately, revenue from advertising business will be further boosted in the future.

## SANYA AIRPORT

The management income generated from the provision of operation and management services to Sanya Phoenix International Airport Company Limited reached RMB2.47 million in 2003.

In 2003, Sanya Phoenix Airport successful completed the hosting ceremony for Miss World Contest and took the lead in benefiting from the opening of the aviation industry in Hainan Province. Renovation works at Sanya Phoenix Airport were completed in 2003 and the airport's transportation capacity was increased substantially.

## FINANCIAL REVIEW

### STRUCTURE OF ASSETS

As at 31 December 2003, the total assets of the Group amounted to RMB1,610.7 million, a decrease of 7.7% as compared to the previous year. The decrease was mainly attributable to the optimization of the capital structure, and reduction of the borrowings by RMB186 million. In addition, final dividend of 2002 and interim dividend of 2003 were paid and amounted to approximately RMB98.43 million.

### COST STRUCTURE

In 2003, the total operating costs of the Group were RMB90.33 million, representing an increase of 28% compared to last year. The increase in expenses were attributable to the followings:

- Acquisition of certain businesses from the parent company, the increase of operating costs generated from the rise of income was RMB8.9 million.
- Appreciation of asset valuation in August 2002 and acquisition of the rights of using the land at a consideration of RMB94.38 million in December 2002 led to the increase of depreciation and amortization of RMB4 million.
- Adoption of new and increased remuneration scheme to enhance the staff's commitment and recruit more professionals to join the Group. The relevant total costs was increased by RMB2.7 million.

Administrative expenses of the Group in 2003 was RMB52.96 million, representing an increase of 122.5%, which was mainly attributable to the following reasons:

- Listing of the Group, restructuring of the airport and promotion of the international airport status lead to an additional increase of the administrative expenses (e.g. announcement, printing of annual reports, lawyer's fee, auditor's fee, consultation fee of CPH, traveling expenses, entertainment expenses, remuneration of senior management, remuneration of directors and supervisors, etc) The increase in cost was RMB14 million.
- Adoption of new remuneration package increased the staff's remuneration, which enhanced the staff's commitment and helped to recruit more professionals to join the Group. Administrations over the salary, benefit and insurance for the year was increased by RMB5.5 million.

## CASHFLOW

In 2003, the Group's net cash flow from operating activities was RMB88.79 million, representing an increase of 3.9%. The primary reason for the increase was the reduction of operating expenses. During the year, the Group's investment cash outflow was RMB183.77 million, which was contributed by the short-term investment, acquisition of equity interest in Meilan Travel and construction of phase II expansion project and a new customs and inspection joint operations building.

## PLEDGE OF THE GROUP'S ASSETS

The Group pledged its rights to revenues to secure a long-term bank loan of RMB128 million from China Development Bank.

## GEARING RATIO

As at 31 December 2003, the current assets of the Group was approximately RMB721.07 million, the total assets was approximately RMB1,610.7 million, the current liability was approximately RMB76.71 million and the total liability was approximately RMB216.21 million.

The Group's gearing ratio, representing the ratio of the total bank borrowing to the total asset, was 7.9%, a decrease of 10.1% in comparison to that of the previous year. The main reason for the improvement was the repayment of part of the long-term borrowing.

## EXPOSURE TO FOREIGN EXCHANGE RISK

Except the purchase of certain equipment, goods and raw materials denominated in US Dollar, the Group's businesses were denominated in RMB. As at 31 December 2003, all of the Group's assets and liabilities are denominated in RMB, only cash and cash equivalents of approximately RMB9.63 million (31 December 2002: RMB208.27 million) was denominated in HK Dollar. The fluctuation of the exchange rate of RMB to foreign currency may have an impact on the Group's results.

## FINANCIAL INSTRUMENTS

As at 31 December 2003, financial instruments of the Group were mainly comprised of bank loans, cash and bank deposits. The purpose of those financial instruments is to finance the operation needs. Besides, the Group has other direct finance instruments in relation to daily operations, such as accounts receivable and accounts payable. In addition, the Group also made some short term investments in money market instruments with an aim to earn interest and gain from investment holding.

## CONTINGENT LIABILITY

As at 31 December 2003, the Group or the Company did not have any significant contingent liabilities.

## PURCHASE, SALES OR REDEMPTION OF SHARES

As at 31 December 2003, the Group or the Company has not purchased, sold or redeemed any of the Company's shares.

## EMPLOYMENT, TRAINING AND DEVELOPMENT

As at 31 December 2003, the Group had a total of 568 employees, representing an increase of 87 employees as compared to that of 2002. Total staff costs accounted for about 7% of total turnover, representing an increased of 49% as compared to the previous year. The reason of the increase in cost was mainly contributed by the implementation of the new staff remuneration scheme, which significantly increased the staff's salary and benefits, aiming at strengthening the staff's commitment and recruiting more qualified staff. Employees are remunerated based on their performance, experience and prevailing industry practices. Their compensation policies and packages are subject to review on a regular basis. Bonuses and commissions may be awarded to employees as incentives based on their performance. All the benefits are the rewards for the effort contributed by individuals.

## RETIREMENT PENSION

The Company and its respective subsidiaries have participated in the employee retirement scheme operated by the relevant local government of the PRC. The relevant local government shall be responsible for the pension of the retired employees. The Group has to make contribution at a rate of 18% and 20% of the salary of the employees of permanent residence in the PRC before and after 1 January 2003 respectively. For the year ended 31 December 2003, the contribution for the pension was amounted to approximately RMB3.62 million (2002: RMB1.56 million).