





Li Fenghua, President

In 2003, we operated 210 routes, of which 166 were domestic routes (including 14 routes to Hong Kong) and 44 were international routes (including 11 international cargo routes). We operated approximately 3,090 scheduled flights per week, serving a total of 81 foreign and domestic cities. In 2003, we added 22 aircraft, including the purchase of three Airbus A340-600 aircraft and ten Airbus A320 aircraft and the acquisition of five Boeing B737-700 under operating leases. We also wet-leased two Airbus A300-600 aircraft and two

CRJ-200 aircraft from China Eastern Air Northwest Company and China Eastern Air Yunnan Company, respectively. We terminated the service of three aged Boeing B737-200 aircraft. As of December 31, 2003, we operated a fleet of 97 aircraft, including 89 passenger jet aircraft with a capacity of over 100 seats, two passenger aircraft for feeder routers and six jet freighters. During 2003, we also wet-leased a Boeing B747-200 freighter on short-term in order to meet the increased market demand.



The following table sets forth details of our fleet as of December 31, 2003:

	Number of Aircraft Owned or under Capital Leases	As of December 31, 2003		Planned Additions*	
		Number of Aircraft under Operating Leases	Total Number of Aircraft	2004	2005
A340-600	3		3	2	
A340-300	5		5		
A300-600	7	5	12		
A321				2	2
A320	20	10	30	5	5
A319		10	10		
MD-90	9		9		
MD-82		3	3		
B737-800					3
B737-700	4	7	11		
B737-300	3	3	6		
CRJ-200		2	2		
MD-11F	6		6		
Total	57	40	97	9	10

* Except for three Boeing B737-800 to be acquired under operating leases, the other aircraft will be purchased by our company.

Review of Operating Results

The following discussion and analysis should be read together with our audited financial statements and the accompanying notes prepared in accordance with IFRS that are included elsewhere in this annual report. The financial data presented in this section are derived from our audited financial statements prepared in accordance with IFRS.

Operating Revenues. Our total operating revenues increased from RMB13,079 million in 2002 to RMB14,277 million in 2003, or 9.2%, reflecting

increase in our domestic passenger and cargo revenues. These revenues were net of the applicable PRC sales tax and civil aviation infrastructure levies.

Revenues from our passenger and cargo and mail transportation business increased from RMB12,482 million in 2002 to RMB13,448 million in 2003, or 7.7%. Compared to 2002, the average aircraft daily utilization decreased by 0.6 hours to 8.0 hours in 2003.

Passenger revenues, which accounted for 76.3% of our total transportation revenues in 2003, increased



from RMB10,038 million in 2002 to RMB10,261 million in 2003, or 2.2%, reflecting increase in domestic passenger revenues driven by the recovery of the domestic passenger market during the second half of 2003. Passenger revenues in the second half of 2003 were RMB6,555 million, representing an increase of 21.3% from RMB5,405 million in the second half of 2002.

Our domestic passenger revenues, which accounted for 54.4% of our total passenger revenues, increased from RMB4,670 million in 2002 to RMB5,592 million in 2003, or 19.7%, primarily because we took advantage of the opportunities created by the recovery of the domestic passenger market during the second half of 2003 and attracted more customers. Domestic passenger revenues in the second half of 2003 were RMB3,651 million, representing an increase of 46.9% from RMB2,485 million in the second half of 2002. Compared to 2002, our domestic passenger traffic increased by 21.0% in 2003, and our domestic passenger load factor increased from 63.1% in 2002 to 64.8% in 2003. In response to the market demand, we increased capacity on our domestic routes by 17.9% in 2003. Our domestic passenger yield decreased slightly from RMB0.55 in 2002 to RMB0.54 in 2003 per passenger-kilometer, primarily due to competition in the domestic market.

Hong Kong passenger revenues, which accounted for 15.9% of our total passenger revenues, decreased from RMB1,911 million in 2002 to RMB1,627 million in 2003, or 14.9%, primarily due to the adverse effect on the traffic volume on our



Hong Kong regional routes by the outbreak and spread of a highly contagious form of atypical pneumonia, also known as severe acute respiratory syndrome, or SARS, in Hong Kong and other areas in China. Hong Kong passenger traffic decreased by 13.4% in 2003 over that of 2002. In order to increase our market share and in response to competition on our Hong Kong routes, we increased the passenger capacity on our Hong Kong routes by 1.2% in 2003. Our Hong Kong passenger load factor decreased from 61.2% in 2002 to 52.4% in 2003, and our Hong Kong passenger yield decreased from RMB0.86 in 2002 to RMB0.84 in 2003 per passenger-kilometer. The decrease in passenger load factor and passenger yield on Hong Kong routes was also attributable to competition from other airlines.

International passenger revenues, which accounted for 29.7% of our total passenger revenues, decreased from RMB3,457 million in 2002 to RMB3,042 million in 2003, or 12.0%. The decrease in international passenger revenues mainly reflected decreased international passenger traffic caused by





SARS. Starting from the end of 2002 until mid June 2003, most areas of China were affected by SARS. The SARS-related travel advice issued by the World Health Organization as well as governmental agencies and private companies of other countries significantly discouraged business travelers and tourists to travel to China. Other factors such as the Iraq war and the terrorist activities also affected the international traffic. As a result, international passenger traffic decreased by 22.7% in 2003 over that of 2002. Our international passenger capacity decreased by 5.9% in 2003 compared to 2002. Our international passenger load factor decreased from 68.9% in 2002 to 56.7% in 2003. However, our international passenger yield increased from RMB0.46 in 2002 to RMB0.53 in 2003 per passenger-kilometer primarily because the increase in customers who fly business class on our international routes and the appreciation of certain foreign currencies against Renminbi in 2003.

We generate cargo and mail revenues from the transportation 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 23.7% of our total transportation revenues in 2003, increased from RMB2,445 million in 2002 to RMB3,187 million in 2003, or 30.4%. The increase in our cargo revenues was primarily the result of our increased freight charges in response to the increased demand. The demand was driven by increased importation and exportation after China's admission to the World Trade Organization, or WTO. Our cargo and mail traffic (as measured in revenue freight tonne-kilometers, or RFTKs) increased from 1,023 million RFTKs in 2002 to 1,297 million RFTKs in 2003, or 26.7%. In response to the rapid growth in our cargo and mail operations, we successively remodeled three MD-11 passenger aircraft into freighters in the second half of 2003. Cargo yield increased from RMB2.39 in 2002 to RMB2.46 in 2003 per cargo tonne-kilometer primarily as a result of increased market demand.

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. We are currently the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport. Other operating revenues increased from RMB596 million in 2002 to RMB829 million in 2003, or 39.0%, which is higher than the 25.8% growth rate achieved in 2002. The increase in other operating revenues in 2003 was mainly due to



increase in our airport ground service revenues as a result of increased volume of imported and exported goods after China's admission to the WTO. It is also attributable to the increase in our commission revenues generated from our ticket handling services provided to other airlines.

Operating Expenses. Our total operating expenses increased from RMB12,242 million in 2002 to RMB14,058 million in 2003, or 14.8%, reflecting mainly increase in aviation fuel expenses, wages, salaries and benefits, other depreciation, amortization and operating lease expenses, aircraft maintenance expenses, commissions and take-off and landing charges. Our total operating expenses as a percentage of our total operating revenues increased from 93.6% in 2002 to 98.5% in 2003.

Aviation fuel expenses increased from RMB2,564 million in 2002 to RMB3,045 million in 2003, or 18.8%, primarily as a result of increased fuel prices and the expansion of our fleet. In 2003, we consumed a total of 1,023,700 tonnes of aviation fuel, representing an increase of 8.8% compared to 2002. In 2003, due to the Iraq war, the weighted

average domestic and international fuel prices paid by our company increased by approximately 10.6% and 3.6%, respectively.

Aircraft depreciation and operating lease expenses increased from RMB2,455 million in 2002 to RMB2,851 million in 2003, or 16.1%. Other depreciation, amortization and operating lease expenses increased from RMB400 million in 2002 to RMB495 million in 2003, or 23.7%, primarily due to the expansion of our fleet.

The wages, salaries and benefits increased from RMB1,036 million in 2002 to RMB1,449 million in 2003, or 39.9%, mainly because our work force increased by approximately 5% compared to 2002, and in order to meet the requirements of our fleet expansion, most of our newly hired staff are pilots and cabin crew that are paid relatively high compared to our average salaries. In addition, in accordance with relevant government regulations and with reference to the policies implemented by enterprises in nearby regions, we formulated a staff housing allowance plan in 2003. The housing allowance standards under the new housing plan are higher than the standards to which we made references in 2000 in making provisions. Moreover, the number of employees who are qualified to receive housing allowance also increased in 2003. As a result, we recognized provisions of RMB340 million as of December 31, 2003, which amount is RMB260 million higher than the provisions of RMB80 million that we made in 2000. The increased amount of the provisions was fully charged to our income statement for our fiscal year ended December 31, 2003.



Take-off and landing charges increased from RMB1,988 million in 2002 to RMB2,254 million in 2003, or 13.4%, which accounted for 16.0% of our total operating expenses in 2003, primarily due to the mandatory increase in the take-off and landing charges for domestic flights by the CAAC, effective September 1, 2002, and a 20.1% increase in 2003 in our domestic flight take-offs and landings compared to 2002.

Aircraft maintenance expenses were RMB1,329 million in 2003, compared to RMB1,078 million in 2002, an increase of 23.3%. This increase is mainly due to increased number of aircraft and engines that were subject to overhaul in 2003, and increased maintenance of aircraft that were temporarily out of service during the period of SARS.

Commission expenses increased from RMB380 million in 2002 to RMB465 million in 2003, or 22.5%, primarily due to commission payments to China Eastern Air Northwest Company and China Eastern Air Yunnan Company that began to sell our passenger tickets since March 2003.

Food and beverage expenses decreased from RMB606 million in 2002 to RMB542 million in 2003, or 10.6%, primarily due to decreased provision of food and beverage during the period of SARS, and our effective control over purchases and provision of food and beverage, which is partially offset by the increased expenses resulted from the increased traffic volume on domestic routes.



Other operating expenses increased from RMB520 million in 2002 to RMB570 million in 2003, or 9.7%. 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. The increase was mainly attributable to increase in provision for obsolescence of flight equipment spare parts and maintenance expenses for our office building in Pudong.

Fixed assets. Our company had approximately RMB26.8 billion of fixed assets as of December 31, 2003, including aircraft and flight equipment with a value of approximately RMB23.8 billion. Fixed assets are initially recognized at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation.



Valuation of fixed assets is based on market conditions and global economic factors that we may not control. The determination of fair market value requires significant judgment, including judgment on valuations by our management and/or by independent professional appraisers. Our directors have reviewed the carrying value of our fixed assets as of December 31, 2003 and are of the opinion that the carrying amount is not materially different from the fair value of our fixed assets.

Net Losses. The net losses attributable to shareholders was RMB950 million for the fiscal year ended December 31, 2003.

Liquidity and Capital Resources

We finance our working capital requirements through a combination of funds generated from operations and bank loans. As a result, our liquidity would be adversely affected to the extent there is a significant decrease in demand for our services, or any delay in obtaining bank loans. As of December 31, 2002 and 2003, we had cash and cash equivalents of RMB1,945 million and RMB1,583 million, respectively. In 2002 and 2003, our net cash inflows generated from operating activities were RMB2,160 million and RMB3,267 million, respectively, while our net cash outflows used in investment activities were RMB4,543 million and RMB7,409 million, respectively. In the past two years, our primary cash requirements were for the acquisitions and upgrades of aircraft and flight equipment and debt repayments.

In 2002 and 2003, payment of advances on aircraft and flight equipment were RMB2,600 million and RMB1,296 million, respectively, while additions of aircraft and flight equipment were RMB1,004 million and RMB5,560 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) totaled RMB150 million and RMB92 million in 2002 and 2003, respectively. Our net cash inflow generated from financing activities was RMB3,764 million in 2003, primarily from short-term 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 a regulation issued in 2000 by the State Tax Bureau of China, lease payments made by Chinese airlines to foreign enterprises in respect of lease arrangements entered into prior to September 1, 1999 are exempt from the payment of any withholding tax. Withholding tax payable in respect of the lease arrangements entered into on or after September 1, 1999 are charged to our income statement as incurred.



We generally operate with a working capital deficit. As of December 31, 2003, our current liabilities exceeded our current assets by RMB9,941 million, while our current liabilities exceeded our current assets by RMB7,437 million as of December 31, 2002. The increase in working capital deficit in 2003 was due to increase in short-term bank loans and the portion of long-term bank loans payable within one year. Short-term loans outstanding totaled RMB4,527 million and RMB4,632 million as of December 31, 2002 and 2003, respectively. Long-term loans outstanding totaled RMB6,495 million and RMB11,223 million as of December 31, 2002 and 2003, respectively. Long-term loans payable within two years, from three to five years and beyond five years were RMB4,689 million, RMB4,164 million and RMB2,370 million, respectively, as of December 31, 2003, as compared to RMB2,971 million, RMB2,368 million and RMB1,156 million, respectively, as of December 31, 2002. The total lease obligations outstanding under our finance leases as of December 31, 2002 and 2003 were RMB8,184 million and RMB7,101 million, respectively. Our lease obligations payable within two years, from three to five years and beyond five years were RMB2,679 million, RMB4,039 million and RMB383 million, respectively, as of December 31, 2003, as compared to RMB3,082 million, RMB4,005 million and RMB1,097 million, respectively, as of December 31, 2002.

We have, and in the future may continue to have, substantial debts. As of December 31, 2002 and 2003, our long-term debt to equity ratio was 1.8 and 2.6, respectively. The interest expenses associated with these debts might impair our future

profitability and cause our earnings to be subject to a higher degree of volatility. We expect that cash from operations and 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. We have entered into credit facility agreements with Chinese banks to meet our future working capital needs. We have arranged, and we believe that we will continue to be able to arrange, short-term bank loans with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. However, 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

Our aircraft orders as of December 31, 2003 included commitments to acquire two Airbus A340-600 aircraft, four Airbus A321 aircraft, ten Airbus A320 aircraft and three Boeing B737-800 aircraft to be delivered in 2004 and 2005. We expect our capital expenditures for aircraft and related equipment, including deposits, through 2005 to be in aggregate approximately RMB7,669 million, including RMB5,130 million in 2004 and RMB2,539 million in 2005, in each case subject to contractually stipulated increases or any increase relating to inflation. We generally finance our purchase of aircraft through operating leases and bank loans secured by our



assets. As of December 31, 2003, the total value of our mortgaged assets increased by 197.5%, from RMB3,272 million as of December 31, 2002 to RMB9,735 million as of December 31, 2003. 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 expenditures in 2004. In addition, we plan to increase our investment on technology upgrade and other projects in response to technological development in the aviation industry. We plan to finance our 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

We have debts denominated in U.S. dollars, Japanese yen or Euro in addition to our debts denominated in RMB. We generate a significant amount of 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. Pursuant to current foreign exchange regulations in China, we may retain our foreign currency earnings subject to the approval of the State Administration of Foreign Exchange, which are generally sufficient to satisfy our foreign currency liabilities payable within one year. We have also designated certain personnel to manage the foreign currency risks through derivative financial products such as forward foreign exchange contracts

and interest rate swaps. We use interest rate swaps to reduce risks related to changes in market interest rates. As of December 31, 2003, the notional amount of the outstanding interest rate swap agreements was approximately US\$164 million, compared to US\$96 million as of December 31, 2002. These interest rate swap agreements will expire between 2004 and 2010. In addition, we use forward contracts to reduce risks related to changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. These currency forward contracts will expire between 2004 and 2010.

Pursuant to IFRS, our monetary assets and liabilities denominated in foreign currencies are required to be translated into Renminbi at the year end at exchange rates announced by People's Bank of China. The net exchange gains or losses are recognized and reflected in the income statement for the relevant year. Any fluctuation of the exchange rates between Renminbi and foreign currencies may materially adversely affect our financial condition and results of operations. The exchange rate between Renminbi and Japanese yen or Euro had experienced a significant level of fluctuation over the past two years. For example, due to the appreciation of Japanese yen and Euro against the Renminbi in 2003, we had a net exchange loss of RMB70 million in 2003, compared to a net exchange loss of RMB38 million in 2002 due to the appreciation of Japanese yen against Renminbi.

