

V. MANAGEMENT DISCUSSION AND ANALYSIS

(1) Business review:

In accordance with IFRS, the Company recorded a profit attributable to shareholders of Rmb715,727,000 for the six months ended 30 June 2004, representing an increase of 15.37% over the same period last year. Basic earnings per share was Rmb0.242. In accordance with the PRC Accounting Rules and Regulations, the Company recorded a net profit of Rmb695,985,000 for the six months ended 30 June 2004, an increase of 12.19% as compared to the corresponding period last year. Earnings per share was Rmb0.235.

Since the beginning of the year, uncertainties and unhealthy factors hindering the development of the PRC iron and steel industry have been preliminarily contained as a result of the government's macroeconomic control and market mechanism at work. The Company has seized the favourable market conditions by fine-tuning its sales strategies, improving production operations and accelerating trial runs for production of new products during the first half of the year. The goal was to maintain the Company's production and operation at a high standard.

1. Strengthening production operation and increasing production capacity. During the first half of the year, the Company produced 2,585,500 tonnes of steel products, up 22.90% over the same period last year; cold rolled sheets amounted to 910,800 tonnes, up 10.09%; galvanized sheets and colour coating sheets amounted to 172,000 tonnes; wire rods amounted to 349,900 tonnes, up 38.15%; thick plates amounted to 550,500 tonnes with no change from the same period last year; and large and continuous rolling mill products amounted to 602,400 tonnes, up 26.48%. The Steel Smelting Plant of the Company produced 1,566,200 tonnes of steel, an increase of 18.22% as compared to the same period last year.
2. Perfecting sales strategies by dealing with direct users. Based on the principle of mutual benefits and both parties win, long-term partnerships were established with direct users in a bid to secure the Company's sales channels. During the first half of the year, the number of orders placed by direct users reached 65% of the Company's total number of orders, representing an increase of 14% as compared to the same period last year. The Company sold 2,454,100 tonnes of steel products during the first half of 2004.
3. Tapping into additional overseas markets and increasing export. During the first half of the year, the Company exported 322,900 tonnes of products, up 265.20% in comparison to the same period last year.

4. Speeding up trial runs and the production of new product. The Company boosted its competitiveness in the market by translating technological advantage of renovated items into product advantage.
5. Continuing scientific and technological research and development. During the first half of the year, the Company has set up 44 research projects, developed and produced 278,000 tonnes of new products, and produced 1,020,000 tonnes of specialized, distinctive and high quality products. All such efforts have laid a foundation for enhancing the competitiveness of the products manufactured by the Company.

(2) Changes in profit structure, principal businesses and their structure and the profitability of principal businesses as compared with the previous reporting period:

The sales of galvanized steel sheet and colour coating steel sheet during the reporting period amounted to 151,500 tonnes. A profit of Rmb60,791,000 from principal businesses was realised. The profitability of consolidated principal businesses has no significant changes as compared to the previous reporting period.

(3) Products represented 10% or more of the revenue from principal businesses or of the profit from principal businesses of the Group are as follows (under IFRS):

Products	Income from principal activities <i>Unit: Rmb'000</i>	Cost of principal activities <i>Unit: Rmb'000</i>	Gross profit margin (%)	Percentage change of income from principal activities compared with the same period of the previous year	Percentage change of cost of principal activities compared with the same period of the previous year	Gross profit margin compared with the same period of the previous year
				Increase (+) /decrease (-) (%)	Increase (+) /decrease (-) (%)	Increase (+) /decrease (-) (%)
Cold rolled sheets	3,700,428	3,489,509	5.70	20.28	32.50	-60.48
Thick plates	2,126,542	1,498,835	29.51	20.99	15.70	12.20
Wire rods	1,093,513	848,638	22.39	92.37	69.71	86.11
Large steel products	1,907,043	1,665,955	12.64	42.36	51.88	-30.24
Including: connected transactions	1,398,252	1,240,778	11.26	93.74	87.27	37.31

The pricing policy for connected transactions:

Not less than the average of the selling prices between the Company and independent third parties during the previous month.

Rationale for and continuity of connected transactions:

The production of steel highly depends on the continuous supply of raw material. The Company relies on Angang Holding and its subsidiaries for the supply of most of its raw materials and sells part of its products to Angang Holding and its subsidiaries. Therefore, it is expected that such connected transactions will continue in the future operation of the Company.

Note:

- 1. Including: during the reporting period, the total amount of connected transactions in relation to the sales of products from the Company to its controlling shareholders and subsidiaries was Rmb1,398,252,000;*
- 2. Increase in income from cold rolled sheets over the previous year was mainly due to an increase in cold rolled sheets sales, increase in the proportion of high value-added products and a rise in products price. The increase in production cost was due to the increase in sales and the rise in the cost of raw materials; the decline in gross profit margin was due to the larger cost increase than the revenue increase;*
- 3. The increase in revenue of thick plates over the previous year was due to an improvement in the sales structure and an increase in product price; increase in the operating cost was due to an increase in the procurement cost; the increase in gross profit was due to improvement of sale structure;*
- 4. The significant increase in revenue from wire rod over the previous year was due to an increase in sales and an increase in the ratio of value-added products sales and a rise in product price; the increase in principal operation cost was due to an increase in sales volume and an increase in the price of raw materials; the increase in gross profit margin was due to an increase in the ratio of value-added products sales; and*
- 5. The significant increase in revenue from large steel products over last year was due to an increase in sales volume, an increase in the ratio of high value-added products sales and a rise in product price; increase in the operating cost was due to an increase in sales volume and an increase in the cost of raw materials; the decline of gross profit margin was due to an increase in cost which was larger than the increase in product revenue.*

(4) Distribution of revenue from principal operations of the Group by geographical locations (under PRC Accounting Rules and Regulations)

Regions	Income from principal operations <i>Rmb'000</i>	Income from principal operations in the corresponding period last year <i>Rmb'000</i>	Change (+)/(-) of income from principal operations compared with previous year (%)
Northeast China	4,929,306	2,835,222	73.86
Northern China	730,643	644,242	13.41
Eastern China	1,738,730	2,058,542	-15.54
Southern China	732,235	—	—
Central south China	302,694	1,040,410	-70.91
Northwest China	122,374	136,391	-10.28
Southwest China	82,605	63,128	30.85
Export sales	1,251,268	195,455	540.18
Total	9,889,855	6,973,390	41.82

(5) Operation of companies invested by the Company (under PRC Accounting Rules and Regulations)

Unit: Rmb'000

Companies invested by the Company	Scope of operations	Net profit	Investment revenue contributed in the period	Proportion of net profit of the Company
Jointly controlled entity	Production of rolled hot dip galvanized and galvanized steel products and sales of self-manufactured products and the provision of after-sales service	-63,285	-31,642	-4.5%
Processing company	Processing, sales, storage and delivery of steel products	218	65	0.01%

(6) Problems and difficulties in operation

During the first half of the year, the Company experienced pressure from fluctuation in steel products' price in the domestic market and competition stretching to the upstream enterprises. The Company also experienced pressure from relatively large fluctuation in the price of raw materials.

During the first half of the year, the Company's average steel products' price (comparable products) increased by 20.21% as compared with the corresponding period last year. The price of raw materials increased by 41.99% as compared with the corresponding period last year.

(7) The investment of the Company

- The Company issued 890,000,000 H Shares and 300,000,000 A Shares in July 1997 and November 1997, respectively, raising approximately a total of Rmb2,633,000,000. In March 2000, the Company issued convertible debentures in the amount of Rmb1,500,000,000, raising a total of Rmb1,480,000,000 in the PRC. The Company has raised a total of Rmb4,113,000,000 which has been completely applied in relevant projects, the details are as follows:

Unit: Rmb'000

Projects undertaken	Proposed investment	Changes in use of proceeds	Actual investment	Actual/ (estimated) benefits	Whether progressing as scheduled and estimated return
Construction of steel smelting plant	2,400,000	No	1,540,992	50,000	Yes
Renovation of the combined pickling and continuous rolling line	700,000	No	645,434	45,000	Yes
Construction of the jointly invested galvanized steel production line	Total project investment: 1,494,000	No	Total project investment: 977,385	-31,642	No
	The Company's total investment: 250,000		The Company's total investment: 248,305		
Renovation of the Cold Rolling Plant 1700 cross cutting lines	60,000	No	60,000	8,000	Yes
Renovation of cold rolling line	1,950,000	No	1,585,710	48,000	Yes
Cold Rolling Plant's renovation of No. 2 and 3 cross cutting lines	100,000	No	32,960	15,000	Yes
Distribution centre for the Cold Rolling Plant	180,000	No	0	15.66% (estimated)	No
Total	5,640,000		4,113,401		

2. Progress on uncompleted projects financed by proceeds

The main reason for the delayed completion of the cutting and distribution center in the Cold Rolled Plant was that the project's operation plans required further analysis.

3. Progress on investment by non-publicly raised funds

- (1) The Company has planned to invest a total of Rmb2,640,000,000 for the setting up of galvanized steel sheet production lines and colour coating steel sheet production lines. As of 30 June 2004, Rmb1,452,736,000 has been injected.

(8) Analysis of the Group's financial position

Prepared under IFRS (unaudited)

1. Items of income statements and cash flow statements

Unit: Rmb'000

Items	For the six months ended 30 June		Change (+)/(-) (%)
	2004	2003	
Turnover	9,883,321	6,947,111	42.26
Cost of principal operations	8,476,186	5,735,614	47.78
Profit from principal operations	1,407,135	1,211,497	16.14
Profit attributable to shareholders	715,727	620,352	15.37
Net decrease in cash and cash equivalents	1,483,696	22,041	6,631.53

Notes:

- (1) Increase in turnover was due to an increase in sales volume, the ratio of high value-added products sales and products' price;
- (2) Increase in cost of principal operation was due to the increase in sales volume and a rise in the cost of raw materials procurement;
- (3) Increase in profit from principal operations was due to an increase in sales volume and ratio of high value-added products sales;
- (4) Increase in profit attributable to shareholders was due to the net profit generated from operational activities; and
- (5) Decrease in the net increase of cash and cash equivalents was due to the payment of cash dividends during the reporting period, the increase in procurement expenditure and payment of bill on maturity.

2. Items of balance sheets

Unit: Rmb'000

Items	As at 30 June 2004	As at 31 December 2003	Change (+)/(-) (%)
Total assets	13,726,456	14,845,674	-7.54
Shareholders' funds	8,940,151	8,815,385	1.42
Long-term loans	1,842,733	1,892,733	-2.64
Cash at banks and in hand	1,723,280	2,606,976	-33.90
Bills receivable	1,547,955	2,097,812	-26.21
Inventories	2,252,831	1,440,283	56.42
Construction in progress	232,430	1,122,923	-79.30
Bills payable	209,856	1,259,594	-83.34
Short-term bank loans	670,267	420,267	59.49

Notes:

1. Increase in shareholders' interests was due to net profit generated from operation;
2. Decrease in long-term loans and the increase in long-term debt due within one year was due to part of the long-term loans being changed into long-term debt due within one year;
3. Decrease in cash in banks and in hand and total assets was due to payment of cash dividends during the reporting period, bills payable on maturity and cash payment for procurement;
4. Decrease in bills receivable was due to increase in cash payment to the Company for goods purchased;
5. Increase in inventories was due to expansion of production and increase of sales and new production lines as well as the development of international markets and increase of export in transit;
6. Decrease in construction in progress was due to completion of construction and the conversion of which into fixed assets;
7. Decrease in bills receivable was due to payment of bills on maturity; and
8. Increase in short-term bank loans was due to borrowings incurred by jointly controlled entities during the reporting period and the inclusion of the current portion of the long-term liabilities.

(9) Business plan for the second half of 2004

1. To further increase export, to secure export channels and boost competitiveness of the Company's products on the international markets;
2. To strengthen operational and sales management, improve market analysis and maintain the stability and smoothness of sales channels;
3. To strengthen capital management to enhance the efficiency of capital utilisation;
4. To further tap cost saving potential and increase cost effectiveness;
5. To further drive technological improvement so as to achieve pre-determined targets and productivity, and to make the most use of the Company's technological and equipment advantages; and
6. To push forward scientific research and technological innovation in order to raise the Company's core competitive edge and long-term development capability.

(10) Liquidity, financial resources and capital structure of the Group (under IFRS)

1. As at 30 June 2004, the Group had long-term loans of Rmb1,843,000,000 with annual interest rates of 5.49% to 5.76%. The term of the loans range from 2 to 10 years and the loans were mainly used for plant construction.
2. As at 30 June 2004, the Group had cash, cash equivalents and bank deposits of Rmb1,723,000,000. At the end of 2003, the Group had cash, cash equivalents and bank deposits of Rmb2,607,000,000.

As at 30 June 2004, the total assets less current liabilities of the Group amounted to Rmb10,780,000,000, compared with Rmb10,713,000,000 at the end of 2003. The shareholders' fund of the Group amounted to Rmb8,940,000,000 as at 30 June 2004 compared with Rmb8,815,000,000 at the end of 2003.

(11) Charges of assets

The Company's jointly controlled entity has created charges over certain land use rights, construction in progress, properties, buildings, machinery and equipment in favour of the Bank of China as securities for a loan. The Company had pledged 50% of its equity interests in the jointly controlled entity to the Bank of China.

(12) Commitments and contingent liabilities

As at 30 June 2004, the Group had capital commitment of Rmb1,233,000,000, which was primarily the expenses of construction projects. As at 30 June 2004, the Group did not have any contingent liabilities.

(13) Foreign currency risk

The Company does not have any significant foreign currency risk exposure arising from its sales and purchases of raw materials for production as these transactions are mainly carried out in Renminbi except a small portion of export sales conducted in foreign currencies.

(14) Gearing ratio

In accordance with IFRS, the shareholders' funds to liabilities ratio of the Group as at 30 June 2004 was 1.87 times, compared with 1.46 times as at 31 December 2003 (which is calculated by dividing shareholders' funds over liabilities).

(15) Employees

As of 30 June 2004, the Company had 7,645 employees.

The Company implemented the salary distribution system for the senior management in which salary linked to the respective positions and annual remuneration linked to the respective risk subjected. For employees holding key technical positions and key production positions, salaries are linked to positions and option award remuneration. For employees holding research and development positions, salaries are linked to position and bonus was distributed according to new product developed and profits. Other staff, are paid by wages in accordance with the positions they hold.

In the second half of the year, the Company will provide additional trainings to staff in new positions and at the same time continue strengthening the training of management staff.