You should read the whole document before you decide to invest in our Offer Shares, and should not just rely on key or summarised information. You should read this section in conjunction with our audited combined financial statements, including notes thereto, as set forth in "Appendix I — Accountants' Report." Our financial statement data for the six months ended June 30, 2003 are unaudited, but contain all adjustments necessary to fairly state this information in the opinion of our management. The financial statements have been prepared in accordance with IFRS. The financial information in this section has been extracted without material adjustment from "Appendix I — Accountants' Report."

The following discussion and analysis contains forward-looking statements that reflect our current views with respect to future events and financial performance. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of any number of factors, including those set forth in the sections headed "Risk Factors" and "Forward-Looking Statements."

OVERVIEW

We are the national flag carrier and a leading provider of air passenger, air cargo and airline-related services in China. Leveraging our well-balanced route network, with complementary and extensive domestic and international routes, and our leading position in Beijing, we provide convenient direct and transfer services to international, domestic, Hong Kong and Macau passengers. As of June 30, 2004, we operated flights on 296 routes and with services to 69 domestic and 34 international and regional destinations. We are also the leading provider of cargo services, utilising our five freight aircraft and bellyhold space on 130 passenger aircraft. Our cargo service through bellyhold space leverages our extensive passenger service route network. We operate cargo flights between Beijing and Shanghai and seven countries and regions, including the United States, Germany, Japan and Hong Kong.

Our predecessor is Air China International Corporation. Under the CAAC's consolidation plan in 2002, encouraged by the PRC government, Air China International Corporation merged with China Southwest Airlines and Zhejiang Airlines, and as a result, our operating and financial reports include data of these two entities. Prior to the Global Offering, CNACG transferred to us its approximately 69% equity interest of CNAC. CNAC holds a 43.29% equity interest in Dragonair, a 51.0% equity interest in Air Macau and 60.0% equity interests in both Beijing Air Catering Co., Ltd. and Southwest Air Catering Company Limited immediately prior to the Global Offering. We also hold a 51.0% equity interest in Air China Cargo and a 25.0% equity interest in Shenzhen Airlines and a 60.0% equity interest in Ameco.

FACTORS AFFECTING OUR PERFORMANCE

Our business, financial position and results of operations, as well as the period-to-period comparability of our financial results, are significantly affected by a number of factors, many of which are beyond our control, including:

- China's economic development and international trade;
- Chinese and international regulation of the airline industry;
- jet fuel prices;

- extraordinary events;
- seasonality;
- performance of associates; and
- finance costs.

China's Economic Development and International Trade

Historically, China's air traffic growth has been positively correlated with the country's economic growth. Between 1993 and 2003, China's real gross domestic product grew at a compound annual growth rate of 8.5% while China's total air traffic volume in RTKs grew at a compound annual growth rate of 12.8% over the same period. Our financial results have been, and are expected to continue to be, materially affected by China's economic development, per capita disposable income, international trade volume as well as global economic conditions. Moreover, China's international trade volume is affected by China's participation in the World Trade Organization and regional trade initiatives such as (i) the Closer Economic Partnership Agreement between the mainland of China and Hong Kong and (ii) the Framework Agreement on Comprehensive Economic Co-Operation between China and the Association of South East Asian Nations.

Chinese and International Regulation of the Airline Industry

Changing government regulation of the Chinese airline industry has impacted and will continue to impact our operating results. The PRC government has in recent years gradually and orderly deregulated many aspects of China's domestic airline industry and allowed international air passenger, cargo and airline-related service providers greater access to China's aviation market. Recent reform measures include easing market-entry restrictions for regional feeder airlines and privately funded airlines (which may include low-cost carriers), granting additional third-, fourth- and fifth-freedom traffic rights and raising the foreign ownership ceiling of Chinese airlines. While we believe that we will be able to compete effectively in an increasingly deregulated industry, deregulation may result in additional competition and impact our results of operations in future periods.

Although the PRC government has implemented reforms in the past decade, many aspects of the Chinese airline industry remain highly regulated. Regulations and policies issued or implemented by the CAAC encompass many aspects of the industry. Changes to these regulations and policies could affect our financial results. For example, the PRC government may set guidelines limiting our ability to increase or decrease our domestic airfares or impose levies or surcharges for which we are not allowed to charge customers. Moreover, due to value-added taxes and other charges, the average cost of jet fuel in China is higher than international market prices.

We are also subject to certain operational and environmental laws in each country and region where we fly.

Jet Fuel Prices

Jet fuel is an important element of all airlines' cost structure and therefore a change in jet fuel costs would significantly affect airlines' results of operations. Jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuations in supply and demand. Since the beginning of 2004, jet fuel prices have been rising, which has increased the operating costs of airlines.

Extraordinary Events

Extraordinary events beyond our control such as terrorist attacks and outbreaks of contagious diseases could also affect our financial results. Although the September 11, 2001 terrorists attacks in the United States did not affect our business as severely as compared with certain European or North American carriers, the occurrence or threat of such terrorist attacks have had, and may continue to have, an adverse impact on the airline industry resulting in depressed demand for passenger services, higher insurance premiums and increased security costs. Moreover, an outbreak of contagious diseases such as SARS could severely affect our operations. Our airline operations were adversely affected during the peak of the SARS outbreak in the months of April, May and June 2003 when our passenger traffic dropped significantly. These extraordinary events may take place in the future and may have short-term or long-term impacts on the airline industry.

Seasonality

Our passenger revenues and profitability are affected by the seasonality of the Chinese airline industry. We generate a substantial portion of our passenger revenues during the second half of each year, with demand for our passenger services at its highest during the months of July, August, September and October of each year. Our passenger revenues are typically higher in the second half as compared to the first half of each year. Seasonality may affect our passenger revenues and profitability from quarter to quarter.

Performance of Associates

Our operating results are impacted by the performance of our long-term investments in our associates. Although we have substantial shareholdings in certain associates, we do not control their operations and therefore do not have control over their financial performance. Contributions from our associates have had a positive impact on our financial results, representing 21.9%, 41.0%, 136.4% and 17.7%, respectively, of our profit before tax in 2001, 2002, 2003 and the six months ended June 30, 2004. In 2003, while our operation was greatly affected by the outbreak of SARS, our share of profit from associates represented substantially all of our profit before tax. Moreover, we may seek to acquire, or make investments in, other airlines and airline-related businesses that complement our passenger and cargo services. Such acquisitions may impact our results of operations and financial condition. See the section headed ''Business — Affiliates and Investees.''

Finance Costs

Our finance costs include interest expense, foreign exchange gains/losses and fuel derivatives gains/losses, each of which has experienced significant fluctuations in each of the reported periods, thereby affecting our net income each year. Interest expenses generally vary in accordance with our liabilities under long- and short-term loans and finance leases, which in turn vary in accordance with our annual working capital requirements and our ongoing capital needs. In addition, our interest expense is affected by prevailing interest rates, as a significant amount of our debt is short-term debt, which is subject to refinancing within one year. For a discussion of risks related to interest rates, derivative instruments and foreign currency, see the section headed ''Financial Information — Market Risk and Risk Management.''

BASIS OF PRESENTATION

The Accountants' Report has been prepared in accordance with IFRS.

We have an extensive operating history in China through our predecessors and historically have been the principal Chinese airline providing international and domestic airline services. Our original predecessor was the Beijing Administrative Bureau of the CAAC, which began providing air passenger services in the 1950s. In connection with the airline industry reforms in China, our immediate predecessor was established in 1988 under the name Air China International Corporation to assume the airline operations of the Beijing Administrative Bureau of the CAAC. Our predecessor became the principal subsidiary of CNAHC in 2002, which retained the rights to use the "Air China" name and logo pursuant to the industry consolidation plan of merging the nine major Chinese airlines into three major airline groups. Consequently, the airline operations of China Southwest Airlines and Zhejiang Airlines were merged into Air China International Corporation.

We have accounted for the Restructuring as a reorganisation of companies under common control in a manner similar to a pooling-of-interests since the businesses acquired were operated by wholly owned subsidiaries of CNAHC and the equity interests were owned directly or indirectly by CNAHC prior to the Restructuring. Accordingly, we have prepared the combined balance sheets to present our assets and liabilities, and the combined income statements and combined cash flow statements to present our results of operations and cash flows as if the Restructuring had occurred on January 1, 2001.

A portion of our revenues is derived from our consolidated subsidiaries such as Air China Cargo, CNAC and Air Macau. Our long-term investments in airline affiliates such as Dragonair and Shenzhen Airlines have contributed to our profit from associates. We consolidate Air China Cargo, in which we hold a 51.0% equity interest as of June 30, 2004, and CNAC, in which we hold an approximately 69% equity interest. We also consolidate Air Macau, which is 51.0%-owned by CNAC. We record the revenues of CNAC and Air Macau under the "Hong Kong and Macau" and "International" geographic segments. We account for Dragonair, in which we hold effectively an indirect 29.9% equity interest, and Shenzhen Airlines, in which we effectively hold a 25.0% equity interest, in our combined financial statements as long-term investments under the equity method. Similarly, upon the completion of our proposed acquisitions, we plan to account for our investments in Shandong Aviation Group and Shandong Airlines as long-term investments under the equity method.

DISTRIBUTION TO CNAHC AND CNACG

In accordance with the "Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment," which was issued by the Ministry of Finance and became effective from August 27, 2002, and the Restructuring Agreement, we are required to make a distribution to CNAHC in the amount equal to the net profit attributable to shareholders generated during the Relevant Profit Period by the businesses and operations (excluding those of CNAC) contributed to us by CNAHC pursuant to the Restructuring. Pursuant to the Restructuring Agreement, the special audit for CNAHC will be completed by April 30, 2005 to ascertain the level of the net profit as mentioned above for the Relevant Profit Period. The net profit for the Relevant Profit Period will be determined based on audited accounts prepared under PRC GAAP. It was agreed that we will make the payment to CNAHC in stages before December 31, 2005.

In addition, pursuant to the Restructuring Agreement, we are required to make a distribution to CNACG in the amount equal to the net profit attributable to shareholders generated by the businesses and operations contributed to us by the CNAC Group during the Relevant Profit Period (but excluding an amount equal to approximately 69% of the dividends that had been declared by CNAC during the Relevant Profit Period). It was agreed that the special audit for CNAC Group will be completed by April 30, 2005 to ascertain the level of net profit as mentioned above for the Relevant Profit Period. The net profit for the Relevant Profit Period will be determined based on audited accounts prepared under PRC GAAP. It was agreed that we will make the payment to CNACG in stages before December 31, 2005.

OPERATING REVENUES

Our operating revenues are derived mainly from air traffic revenues, which include revenues generated by passenger and cargo and mail services. Operating revenues also include other revenues. In 2001, 2002, 2003 and the six months ended June 30, 2004, approximately 79.4%, 79.3%, 77.2% and 79.4%, respectively, of our operating revenues came from passenger revenues and approximately 14.5%, 16.1%, 17.8% and 16.6%, respectively, of our operating revenues came from cargo and mail revenues. Other revenues represented 6.1%, 4.6%, 5.0% and 4.0%, respectively, of our operating revenues for the same periods. In our combined financial statements, we present air traffic revenues net of applicable business taxes, other surcharges and contributions to the CAAC Infrastructure Development Fund (prior to January 1, 2004).

Air Traffic Revenues

Passenger Revenues

We generate passenger revenues mainly from our international, domestic and Hong Kong and Macau flights. We recognise passenger revenues from ticket sales when the service is provided to the passenger or when the ticket expires unused. We also generate passenger revenues from codesharing arrangements, under which revenues are allocated between us and our codeshare partners based on existing contractual agreements and airline industry standard formulas.

Passenger revenues are mainly affected by capacity in ASKs, load factor and passenger yield. Capacity is determined or affected by fleet size, routes, flight scheduling and aircraft utilisation rate. Load factor is determined by demand, competition, airline reputation, seasonality and aircraft types. Passenger yield is affected by, among other things, ticket price, exchange rates, the composition of different class seats sold and the mix of long-haul, medium-haul and short-haul flights.

The following table sets forth, for the periods indicated, additional information about our passenger services:

	Year Ended December 31,			Six Months Ended June 30,	
	2001	2002	2003	2003	2004
Passenger revenues (RMB in millions)[1]	16,508.9	18,209.4	17,930.2	6,387.3[2]	11,507.8
RPKs (in millions)	28,686.0	34,092.1	33,477.0	12,359.2	21,141.2
ASKs (in millions)	46,348.3	51,910.3	50,732.6	20,964.0	30,815.8
Passenger load factor	61.9%	65.7%	66.0%	59.0%	68.6%
Passenger yield[3] (RMB per RPK)	0.58	0.53	0.54	0.52	0.54
Daily aircraft utilisation (block hours per day per aircraft)	9.0	9.2	8.6	7.4	10.0

(1) Excludes Air Macau's revenue contribution.

(2) Unaudited.

(3) Calculated by dividing the passenger revenues (excluding Air Macau's passenger revenues) by the passenger traffic measured in RPKs.

We have historically recorded passenger revenues net of contribution to CAAC's Infrastructure Development Fund, which is collected by the CAAC on behalf of the Ministry of Finance to help finance the cost of improving China's commercial aviation facilities. Historically, the PRC government assessed each Chinese airline's contribution to the fund based on specified percentages of domestic and international air service revenues. The PRC government temporarily suspended the collection of this fund after the SARS outbreak in 2003. Effective on April 1, 2004, the PRC government resumed collection of this fund under a new rule that assesses an airline's contribution to the fund based on usage of domestic routes and domestic segments of international routes, geographic area and length of the routes and aircraft weight. We believe that the amount of our contribution to the fund as a percentage of our operating revenues will decrease under the new rule. In each of 2001, 2002 and 2003 and the six months ended June 30, 2004, our contribution to the fund amounted to approximately RMB761.1 million, RMB813.1 million, RMB247.2 million and RMB112.7 million, respectively. Beginning on January 1, 2004, we record contribution to CAAC's Infrastructure Development Fund under "Other flight operation expenses."

Cargo Revenues

We also generate cargo revenues from the transport of cargo and mail on dedicated cargo aircraft as well as from the carriage of cargo and mail in the bellyhold space of passenger aircraft. In order to give management operational independence and flexibility to grow the air cargo business, we formed Air China Cargo in 2003 and hold a 51.0% equity interest. Prior to the formation of Air China Cargo in 2003, our cargo operations were operated by us as a part of our airline operations. We recognise cargo and mail revenues when the transportation is provided.

Other Revenues

We also generate revenues from other services such as MRO, ground, in-flight catering, general aviation services, import and export services, government grants and ancillary businesses. We recognise other revenues when services are rendered.

General aviation services income includes, among other things, sales of souvenirs, commission income on sales of passenger tickets and cargo space, sales of cargo transportation quotas in Taiwan by Air Macau, income received from certain hotels and shops in respect of Air China's frequent flyer programme, income received from other airlines for use of first- and business-class lounges at Beijing Capital International Airport, income on transportation of goods in the airport and other general airline-related miscellaneous revenues.

Import and export service income represents handling fees earned by AIE, our subsidiary, for the provision of services to other airlines companies to import materials and equipment used in the aircraft repair and maintenance work from overseas suppliers. The amount of handling fees earned depends on the type of materials or equipment being purchased on behalf of customers.

The PRC government has historically provided subsidies and other forms of assistance to us in connection with our provision of charter flights for government-related travel services. In 2000, the PRC government subsidised the purchase of an aircraft and during the six months ended June 30, 2004 the PRC government provided an aircraft to us. In accordance with IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance," we recorded the aircraft purchased in 2000 and the aircraft injected in the six months ended June 30, 2004 as fixed assets with the corresponding amount of the government grant recorded as deferred income at the date of the delivery of the aircraft. As such, the aircraft purchased in 2000 and the aircraft injected during the six month months ended June 30, 2004 are recorded as deferred income in 2000 and during the six months ended June 30, 2004, respectively. The deferred income is recognised as income over the expected useful life of the aircraft on a straight-line basis. Accordingly, we recognised deferred income of RMB57.9 million in each of 2001, 2002 and 2003 and RMB28.9 million for the six months ended June 30, 2004. The PRC government has also provided fixed cash subsidies. We received fixed cash subsidies of RMB50.0 million in each of 2001, 2002 and 2003 and RMB25.0 million for the six months ended June 30, 2004. The deferred income and fixed cash subsidies are recorded under "Government grants" of "Other operating revenues" in our combined financial statements.

In connection with the Restructuring, CNAHC, our parent company, has agreed to undertake obligations to provide government charter flights. CNAHC intends to subcontract these services to us. We expect to be compensated for such services at hourly rates, which may be adjusted periodically, based on the total cost plus reasonable margins. As a result, such direct government grants to us will be discontinued in the future.

Operating Expenses

Substantially all of our operating expenses are related to our passenger and cargo airline operations. Our major operating expenses are jet fuel, take-off, landing and depot charges, depreciation, aircraft maintenance, repair and overhaul, employee compensation, other flight operations expenses and selling and marketing expenses.

Jet Fuel

Jet fuel costs represented the largest percentage of our operating expenses, accounting for approximately 24.6%, 22.9%, 24.3% and 28.1%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004. Therefore a change in jet fuel costs would significantly affect our results of operations.

In 2001, 2002, 2003 and the six months ended June 30, 2004, our weighted jet fuel cost per barrel was approximately RMB369.9 (US$44.7), RMB340.6 (US$41.2), RMB377.1 (US$45.6) and RMB439.9 (US$53.1), respectively. Over each of these periods, we procured approximately 70% and 30%, respectively, of our jet fuel requirements from domestic and international suppliers.

Domestic jet fuel prices, which are regulated by the PRC government, are set by reference to average Singapore jet fuel prices published by Platts. The PRC government normally adjusts the domestic jet fuel prices every one or two months, and most recently in August 2004. International jet fuel prices are typically set by reference to New York crude oil prices. Both Singapore jet fuel prices and New York crude oil prices have been at high levels in 2004 compared to prior periods. Higher weighted jet fuel cost per barrel could adversely affect our results of operations and our profitability.

International jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuations in supply and demand. We have historically entered into derivative contracts, such as swaps and options contracts, to limit our exposure to jet fuel price volatility.

Jet fuel consumption is affected by the number of hours flown and fuel consumption per hour flown. We expect that jet fuel consumption will increase due to overall increase in hours flown, partially offset by decrease in the fuel consumption per hour flown as we introduce our Aviation Fuel Consumption Planning System and newer aircraft to our fleet.

For relationship between historical crude oil prices and jet fuel prices, on both domestic and international markets, see the section headed "Industry Overview — Jet Fuel."

Take-off, Landing and Depot Charges

Take-off, landing and depot charges mainly relate to the fees airports charge for the right to take off and land, ground services charges and navigation services charges as well as fees related to cargo processing and use of airport facilities at airports we serve. Take-off, landing and depot charges represented approximately 15.2%, 15.5%, 15.4% and 15.7%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

Depreciation

Depreciation expenses primarily relate to depreciation of aircraft and flight equipment and other fixed assets. Depreciation expenses represented approximately 16.7%, 15.0%, 15.1% and 12.7%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

Aircraft Maintenance, Repair and Overhaul

Aircraft maintenance, repair and overhaul expenses include maintenance, repair and overhaul expenses for our aircraft and engines, line maintenance fees, technical handling fees and taxes related to pre-flight maintenance and maintenance materials costs. Aircraft maintenance, repair and overhaul expenses represented approximately 8.0%, 11.0%, 9.6% and 9.5%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

Employee Compensation Costs

Employee compensation costs include wages and salaries, awards, social security costs and retirement benefits. The increase of employee compensation costs in recent years is mainly due to changes to our employee compensation system which increased overall salary costs. Employee compensation costs represented approximately 8.5%, 9.4%, 10.6% and 9.7%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

Other Flight Operations Expenses

Significant items of other flight operations expenses include aircraft and engine insurance premiums, maintenance costs of rotables and pilot training costs. Other flight operations expenses represented approximately 9.9%, 10.3%, 9.4% and 9.1%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

Selling and Marketing Expenses

Selling and marketing expenses include reservation expenses, sales commissions on passenger ticket and cargo sales, sales office expenses, sales incentives and advertising and promotional expenses. Selling and marketing expenses represented approximately 5.9%, 5.6%, 4.7% and 4.9%, respectively, of our operating expenses in 2001, 2002, 2003 and the six months ended June 30, 2004.

RESULTS OF OPERATIONS

Six Months Ended June 30, 2004 Compared with Six Months Ended June 30, 2003

Our net profit attributable to shareholders was RMB788.4 million in the six months ended June 30, 2004, as compared to a net loss of RMB1,252.5 million in the same period in 2003. We recorded increases in our revenues, passenger traffic in RPKs, passenger capacity in ASKs, load factor and passenger yield in the six months ended June 30, 2004 compared to the same period in 2003, primarily due to the SARS outbreak in 2003 which decreased demand for passenger air travel. Operating profit was RMB1,826.5 million in the six months ended June 30, 2004, as compared to an operating loss of RMB835.7 million in the six months ended June 30, 2003, as operating revenues increased 66.0% while operating expenses increased 34.0% over the same period. Our profit before tax increased to RMB1,260.8 million in the six months ended June 30, 2004 from a loss before tax of RMB1,931.5 million in the six months ended June 30, 2003, primarily due to our increased operating profit and profit from associates of RMB2,662.2 million and RMB334.6 million, respectively, and our decreased finance costs of RMB195.6 million.

Operating Revenues

Operating revenues increased 66.0% to RMB15,311.0 million in the six months ended June 30, 2004 from RMB9,225.9 million in the six months ended June 30, 2003, primarily due to an increase in passenger revenues. Passenger revenues increased 78.4% to RMB12,151.9 million in the six months ended June 30, 2004 from RMB6,809.9 million in the six months ended June 30, 2003, due to increases in revenues in all our geographic segments. Passenger traffic in RPKs increased 71.1% to 21,141.2 million RPKs in the six months ended June 30, 2004 from 12,359.2 million RPKs in the six months ended June 30, 2003. Load factor increased 9.6 percentage points to 68.6% in the six months ended June 30, 2004 from 59.0% in the six months ended June 30, 2003. Passenger yield increased by 3.8% to RMB0.54 per RPK in the six months ended June 30, 2004 from RMB0.52 per RPK in the six months ended June 30, 2003.

The following table sets forth additional information for our passenger services in the six months ended June 30, 2004:

	Six Months Ended June 30, 2004			
	International	Domestic	Hong Kong and Macau	Total
	(in millions, except percentages and yield data)			
Passenger revenues:				
Air China (excludes Air Macau) (RMB)	4,127.3	6,935.2	445.3	11,507.8
Change from the six months ended June 30, 2003	*99.2%*	*72.1%*	*56.2%*	*80.2%*
Contribution from Air Macau (RMB)	371.3	—	272.8	644.1
Change from the six months ended June 30, 2003	*53.0%*	—	*51.7%*	*52.4%*
Total passenger revenues (RMB)	4,498.6	6,935.2	718.1	12,151.9
Change from the six months ended June 30, 2003	*94.4%*	*72.1%*	*54.5%*	*78.4%*
Passenger operating data(1):				
RPKs	8,652.6	11,835.4	653.2	21,141.2
Change from the six months ended June 30, 2003	*84.5%*	*63.2%*	*56.0%*	*71.1%*
ASKs	12,955.0	16,761.3	1,099.5	30,815.8
Change from the six months ended June 30, 2003	*59.5%*	*39.8%*	*28.9%*	*47.0%*
Passenger load factor	66.8%	70.6%	59.4%	68.6%
Change from the six months ended June 30, 2003	*9.1 pts*	*10.1 pts*	*10.3 pts*	*9.6 pts*
Passenger yield(2) (RMB per RPK)	0.48	0.59	0.68	0.54
Change from the six months ended June 30, 2003	*9.1%*	*5.4%*	—	*3.8%*

(1) Excludes the operating data of Air Macau.

(2) Calculated by dividing passenger revenues (excluding Air Macau's passenger revenues) by passenger traffic measured in RPKs.

International passenger revenues increased 94.4% to RMB4,498.6 million in the six months ended June 30, 2004 from RMB2,314.3 million in the six months ended June 30, 2003 primarily due to increased demand for international flights in 2004 compared to the reduced demand experienced following the SARS outbreak in 2003. The increase in international passenger revenues was also due to the recovery of the demand on our Japan and Korean routes in the six months ended June 30, 2004. Passenger capacity in ASKs increased by 59.5%, and passenger load factor increased to 66.8% in the six months ended June 30, 2004 from 57.7% in the same period in 2003. International passenger yield increased 9.1% to RMB0.48 per RPK in the six months ended June 30, 2004 from RMB0.44 per RPK in the six months ended June 30, 2003.

Domestic passenger revenues increased 72.1% to RMB6,935.2 million in the six months ended June 30, 2004 from RMB4,030.8 million in the six months ended June 30, 2003 due to increased passenger traffic and higher average domestic airfares. Domestic passenger traffic increased due to increased demand for our domestic flights in 2004 compared to 2003 in which we experienced reduced demand for most domestic flights during the SARS outbreak. We increased our average domestic airfares following the new domestic airfare policy adopted by the NDRC and the CAAC in March 2004 that widened the permitted range in which Chinese airlines are permitted to price airfares. Our passenger capacity in ASKs increased by 39.8% and passenger load factor increased to 70.6% in the six months ended June 30, 2004 from 60.5% in the six months ended June 30, 2003. Domestic passenger yield increased 5.4% to RMB0.59 per RPK in the six months ended June 30, 2004 from RMB0.56 per RPK in the six months ended June 30, 2003, primarily due to the recovery of our domestic passenger services compared to 2003 and the implementation of our yield management on certain of our domestic routes.

Hong Kong and Macau passenger revenues increased 54.5% to RMB718.1 million in the six months ended June 30, 2004 from RMB464.8 million in the six months ended June 30, 2003 primarily due to increased demand for our Hong Kong flights in 2004 compared to 2003 in which we experienced reduced demand for our Hong Kong and Macau passenger services following the SARS outbreak. Our passenger capacity in ASKs increased by 28.9%, with a 10.3 percentage point increase in passenger load factor to 59.4% in the six months ended June 30, 2004 from 49.1% in the six months ended June 30, 2003. During the same period, contribution from our subsidiary, Air Macau, also increased 51.7% to RMB272.8 million in the six months ended June 30, 2004 from RMB179.8 million in the six months ended June 30, 2003.

Revenues from cargo and mail operations increased 35.3% to RMB2,546.4 million in the six months ended June 30, 2004 from RMB1,882.4 million in the same period in 2003, primarily due to an increase in cargo traffic and cargo freight rates. Cargo capacity in AFTKs increased 32.8% to 2,315.8 million AFTKs in the six months ended June 30, 2004 from 1,743.8 million AFTKs in the same period in 2003 as a result of the addition of one Boeing 747-400F freighter and increased bellyhold space. Cargo volume in RFTKs increased 21.5% to 1,225.2 million RFTKs in the six months ended June 30, 2004 from 1,008.7 million RFTKs in the six months ended June 30, 2003. Cargo load factors decreased in each geographic segment and overall cargo load factor decreased to 52.9% in the six months ended June 30, 2004 from 57.8% in the six months ended June 30, 2003, primarily because the higher load factor on passenger flights limited higher utilisation of bellyhold space on passenger aircraft. Cargo yield increased 9.7% to RMB1.92 per RFTK in the six months ended June 30, 2004 from RMB1.75 per RFTK in the same period in 2003.

Other operating revenues increased 14.8% to RMB612.7 million in the six months ended June 30, 2004 from RMB533.6 million in the six months ended June 30, 2003, primarily due to increases in revenues from aircraft engineering, air catering and ground services, partially offset by the decrease in gains on disposal of property, plant and equipment.

Operating Expenses

Operating expenses increased 34.0% to RMB13,484.5 million in the six months ended June 30, 2004 from RMB10,061.6 million in the six months ended June 30, 2003, primarily due to increases in jet fuel costs, take-off, landing and depot charges and aircraft maintenance, repair and overhaul expenses.

The following table sets forth additional information relating to our operating expenses in the six months ended June 30, 2004:

	Six Months Ended June 30, 2003 (unaudited)	Six Months Ended June 30, 2004	Percentage Change between Periods	Percentage of Operating Revenues for the Six Months Ended June 30, 2004
	(RMB in millions, except percentages)			
Operating expenses:				
Jet fuel	2,383.0	3,784.9	58.8%	24.7%
Take-off, landing and depot charges	1,506.6	2,114.3	40.3	13.8
Depreciation	1,667.4	1,715.4	2.9	11.2
Aircraft maintenance, repair and overhaul	922.6	1,280.6	38.8	8.4
Employee compensation costs	1,096.1	1,310.6	19.6	8.5
Air catering charges	360.1	534.9	48.5	3.5
Aircraft and jet engines operating lease expenses	420.7	514.5	22.3	3.4
Other operating lease expenses	84.3	88.3	4.7	0.6
Other flight operation expenses	898.5	1,222.0	36.0	8.0
Selling and marketing expenses	495.8	666.2	34.4	4.3
General and administrative expenses	226.5	252.8	11.6	1.7
Total operating expenses	**10,061.6**	**13,484.5**	**34.0%**	**88.1%**

Jet fuel expenses increased 58.8% to RMB3,784.9 million in the six months ended June 30, 2004 from RMB2,383.0 million in the six months ended June 30, 2003, primarily due to the increased consumption of jet fuel as a result of the increased number of flights operated and higher domestic and international jet fuel prices. Our weighted jet fuel cost per barrel increased 10.5% to RMB439.9 (US$53.1) in the six months ended June 30, 2004 from RMB397.9 (US$48.1) in the six months ended June 30, 2003.

Take-off, landing and depot charges increased 40.3% to RMB2,114.3 million in the six months ended June 30, 2004 from RMB1,506.6 million in the six months ended June 30, 2003, primarily due to the increased number of flights operated.

Depreciation expenses increased 2.9% to RMB1,715.4 million in the six months ended June 30, 2004 from RMB1,667.4 million in the six months ended June 30, 2003, primarily due to the acquisition of nine aircraft during the period between July 1, 2003 and June 30, 2004.

Aircraft maintenance, repair and overhaul expenses increased 38.8% to RMB1,280.6 million in the six months ended June 30, 2004 from RMB922.6 million in the six months ended June 30, 2003, primarily due to increased line maintenance requirements as a result of increased block hours.

Employee compensation costs increased 19.6% to RMB1,310.6 million in the six months ended June 30, 2004 from RMB1,096.1 million in the six months ended June 30, 2003, primarily due to higher pilot and crew compensation resulting from increased number of flight hours, which resulted in additional flight and cabin crew work shifts and higher hourly rates. The increase was in part due to changes to our compensation system which increased overall salary costs.

Air catering charges increased 48.5% to RMB534.9 million in the six months ended June 30, 2004 from RMB360.1 million in the six months ended June 30, 2003, primarily due to an increase in the number of passengers carried.

Aircraft and jet engines operating lease expenses increased 22.3% to RMB514.5 million in the six months ended June 30, 2004 from RMB420.7 million in the six months ended June 30, 2003, primarily due to the net addition of five aircraft acquired through operating leases.

Other operating lease expenses increased 4.7% to RMB88.3 million in the six months ended June 30, 2004 from RMB84.3 million in the same period in 2003, primarily due to increased rental rates for our terminal stations and sales offices in the first half of 2004 compared to the lower rental rates negotiated after the SARS outbreak.

Other flight operation expenses increased 36.0% to RMB1,222.0 million in the six months ended June 30, 2004 from RMB898.5 million in the six months ended June 30, 2003. The increase was primarily due to the CAAC Infrastructure Development Fund of RMB112.7 million being included in the other flight operation expenses in the six months ended June 30, 2004, to reflect the change in the charge basis in accordance with the related new policy promulgated by the PRC government, whereas the CAAC Infrastructure Development Fund of RMB247.2 million in 2003 was netted off against gross air traffic revenue in the six months ended June 30, 2003. In addition, the increase in the other flight operation expenses was mainly due to increased training costs and general cabin expenses resulting from an increased number of flight hours.

Selling and marketing expenses increased 34.4% to RMB666.2 million in the six months ended June 30, 2004 from RMB495.8 million in the six months ended June 30, 2003, primarily due to increased sales commissions generated by increased ticket sales.

General and administrative expenses increased 11.6% to RMB252.8 million in the six months ended June 30, 2004 from RMB226.5 million in the six months ended June 30, 2003 mainly due to the fact that there was a loss on disposal of fixed assets of RMB15.9 million and increased office supplies, maintenance and utilities charges of approximately RMB10.0 million in the six months ended June 30, 2004.

Finance Costs

Net finance costs decreased 19.9% to RMB789.4 million in the six months ended June 30, 2004 from RMB985.0 million in the six months ended June 30, 2003, primarily due to a decrease in interest expense as a result of the repayment of certain bank loans and finance lease obligations.

Share of Profit Less Losses from Associates

Share of profit less losses from associates represented a profit of RMB223.7 million in the six months ended June 30, 2004, as compared to a loss of RMB110.9 million in the six months ended June 30, 2003, primarily due to Dragonair's profit contribution of RMB123.3 million in the six months ended June 30, 2004 as compared to our share of its losses, amounting to RMB155.6 million in the six months ended June 30, 2003.

Income Tax

Our income tax charge was RMB391.4 million in the six months ended June 30, 2004, as compared to an income tax credit of RMB535.3 million in the six months ended June 30, 2003, primarily due to the recognition of deferred tax assets on tax losses in the six months ended June 30, 2003.

2003 Compared to 2002

Our net profit attributable to shareholders decreased 68.1% to RMB159.6 million in 2003 from RMB499.6 million in 2002. Operating profit decreased 30.5% to RMB2,284.3 million in 2003 from RMB3,284.4 million in 2002, as operating revenues decreased 1.4% from 2002 to 2003, while operating expenses increased 3.0% over the same period. Our profit before tax decreased 82.9% to RMB178.3 million in 2003 from RMB1,039.8 million in 2002, primarily due to the decreased operating profit (which decreased by RMB1,000.1 million in 2003) and profit from associates (which decreased by RMB183.4 million in 2003), partially offset by a decrease in finance costs of RMB428.0 million.

Operating Revenues

Operating revenues decreased 1.4% to RMB24,641.4 million in 2003 from RMB24,983.7 million in 2002, primarily due to a decrease in passenger revenues. The decrease in passenger revenues was partially offset by an increase in cargo revenues. Passenger revenues decreased 4.0% to RMB19,030.2 million in 2003 from RMB19,815.2 million in 2002, primarily due to a decrease in international and Hong Kong and Macau passenger revenues, partially offset by an increase in domestic passenger revenues in the second half of 2003. The decrease in passenger revenues in 2003 was primarily due to decreased passenger traffic because of the SARS outbreak, which also reduced the passenger revenue contribution from Air Macau, which decreased 31.5% to RMB1,100.0 million in 2003 from RMB1,605.8 million in 2002. Passenger traffic in RPKs decreased slightly in 2003. Load factor increased 0.3 percentage points to 66.0% in 2003 from 65.7% in 2002. Passenger yield increased by 1.9% to RMB0.54 per RPK in 2003 from RMB0.53 per RPK in 2002.

The following table sets forth additional information relating to our passenger services for 2003:

	Year Ended December 31, 2003			
	International	Domestic	Hong Kong and Macau	Total
	(in millions, except percentages and yield data)			
Passenger revenues:				
The Company (excludes Air Macau) (RMB)	6,025.1	11,092.6	812.5	17,930.2
Change from 2002	*(14.2)%*	*9.4%*	*(22.6)%*	*(1.5)%*
Contribution from Air Macau (RMB)	638.0	—	462.0	1,100.0
Change from 2002	*(32.3)%*	—	*(30.3)%*	*(31.5)%*
Total passenger revenues (RMB)	6,663.1	11,092.6	1,274.5	19,030.2
Change from 2002	*(16.4)%*	*9.4%*	*(25.6)%*	*(4.0)%*
Passenger operating data[1]:				
RPKs	12,765.1	19,525.2	1,186.7	33,477.0
Change from 2002	*(10.1)%*	*5.9%*	*(18.8)%*	*(1.8)%*
ASKs	19,708.5	28,982.6	2,041.5	50,732.6
Change from 2002	*(1.6)%*	*(0.6)%*	*(25.2)%*	*(2.3)%*
Passenger load factor	64.8%	67.4%	58.1%	66.0%
Change from 2002	*(6.1) pts*	*4.2 pts*	*4.6 pts*	*0.3 pts*
Passenger yield[2] (RMB per RPK)	0.47	0.57	0.68	0.54
Change from 2002	*(4.1)%*	*3.6%*	*(5.6)%*	*1.9%*

(1) Excludes the operating data of Air Macau.

(2) Calculated by dividing passenger revenues (excluding Air Macau's passenger revenues) by passenger traffic measured in RPKs.

International passenger revenues decreased 16.4% to RMB6,663.1 million in 2003 from RMB7,966.7 million in 2002. We experienced reduced demand for most of our international flights across most geographic segments following the SARS outbreak during the months of April, May and June of 2003. Passenger capacity in ASKs decreased by 1.6%, with a 6.1 percentage point decrease in passenger load factor to 64.8% in 2003 from 70.9% in 2002. International passenger yield decreased 4.1% to RMB0.47 per RPK in 2003 from RMB0.49 per RPK in 2002.

Domestic passenger revenues increased 9.4% to RMB11,092.6 million in 2003 from RMB10,135.4 million in 2002. Although the SARS outbreak in the first half of 2003 adversely affected our passenger traffic in RPKs, load factor and passenger yield, resulting in decreased domestic passenger revenues, our recovery in the second half of 2003 substantially offset the loss in the first half of 2003. Passenger traffic in RPKs increased by 5.9% as of a result of a 0.6% decrease in passenger capacity in ASKs and an increase in load factor of 4.2 percentage points to 67.4% in 2003 from 63.2% in 2002. Domestic passenger yield increased 3.6% to RMB0.57 per RPK in 2003 from RMB0.55 per RPK in 2002.

Hong Kong and Macau passenger revenues decreased 25.6% to RMB1,274.5 million in 2003 from RMB1,713.1 million in 2002. The decrease in our Hong Kong and Macau revenues was primarily due to a 22.6% decrease in passenger revenues from our Hong Kong and Macau routes and a 30.3% decrease in passenger revenue contributions from Air Macau. Demand for our Hong

Kong and Macau passenger services, and those of Air Macau, was adversely affected by the outbreak of SARS during the months of April, May and June of 2003. Our passenger load factor increased 4.6 percentage points to 58.1% in 2003 from 53.5% in 2002 and we reduced capacity in ASKs (which decreased 25.2% between 2002 and 2003), resulting in a decrease in passenger traffic in RPKs (which decreased 18.8% between 2002 and 2003). Hong Kong and Macau passenger yield decreased 5.6% to RMB0.68 per RPK in 2003 from RMB0.72 per RPK in 2002, primarily due to the impact of SARS and declining airfares.

Revenues from cargo and mail operations increased 9.0% to RMB4,392.5 million in 2003 from RMB4,031.5 million in 2002, primarily due to an increase in cargo traffic. Cargo volume in RFTKs increased 4.2% to 2,206.2 million RFTKs in 2003 from 2,117.7 million RFTKs in 2002. Cargo capacity in AFTK increased 1.5% to 4,028.2 million AFTKs in 2003 from 3,967.4 million AFTKs in 2002 primarily as a result of the addition of a Boeing 747-400 cargo aircraft and increase in available bellyhold space. The ratio of the cargo aircraft capacity and bellyhold space capacity remained unchanged in 2003. Cargo yield increased to RMB1.87 per RFTK in 2003 from RMB1.81 per RFTK in 2002.

Operating Expenses

Operating expenses increased 3.0% to RMB22,357.1 million in 2003 from RMB21,699.3 million in 2002, primarily due to increases in jet fuel expenses and employee compensation costs, partially offset by decreases in aircraft maintenance, repair and overhaul expenses and selling and marketing expenses. Operating expenses as a percentage of operating revenues increased to 90.7% in 2003 from 86.9% in 2002.

The following table sets forth additional information relating to our operating expenses in 2003:

	Year Ended December 31,		Percentage Change between Periods	Percentage of Operating Revenues in 2003
	2002	2003		
	(RMB in millions, except percentages)			
Operating expenses:				
Jet fuel	4,978.7	5,425.1	9.0%	22.0%
Take-off, landing and depot charges	3,359.6	3,449.8	2.7	14.0
Depreciation	3,251.6	3,377.5	3.9	13.7
Aircraft maintenance, repair and overhaul	2,384.9	2,149.3	(9.9)	8.7
Employee compensation costs	2,030.5	2,379.1	17.2	9.7
Air catering charges	919.2	842.7	(8.3)	3.4
Aircraft and jet engines operating lease expenses	712.0	910.1	27.8	3.7
Other operating lease expenses	143.4	182.0	26.9	0.7
Other flight operation expenses	2,237.4	2,112.4	(5.6)	8.6
Selling and marketing expenses	1,220.1	1,057.6	(13.3)	4.3
General and administrative expenses	461.9	471.5	2.1	1.9
Total operating expenses	**21,699.3**	**22,357.1**	**3.0%**	**90.7%**

Jet fuel expenses increased 9.0% to RMB5,425.1 million in 2003 from RMB4,978.7 million in 2002, primarily due to higher domestic and international jet fuel prices in 2003. Our weighted jet fuel cost per barrel increased 10.7% to RMB377.1 (US$45.6) in 2003 from RMB340.6 (US$41.2) in 2002.

Take-off, landing and depot charges increased 2.7% to RMB3,449.8 million in 2003 from RMB3,359.6 million in 2002, primarily due to the CAAC's mandatory increase in unit take-off and landing charges for domestic flights, which became effective on September 1, 2002, partially offset by a decreased number of international and Hong Kong and Macau flights as a result of the SARS outbreak.

Depreciation expenses increased 3.9% to RMB3,377.5 million in 2003 from RMB3,251.6 million in 2002, primarily due to our acquisition of six additional aircraft.

Aircraft maintenance, repair and overhaul expenses decreased 9.9% to RMB2,149.3 million in 2003 from RMB2,384.9 million in 2002, primarily due to a decrease in the aircraft utilisation rate due to the SARS outbreak and the related extension of the maintenance cycle of most aircraft and reduction of maintenance costs through more internal controls over maintenance procedures.

Employee compensation costs increased 17.2% to RMB2,379.1 million in 2003 from RMB2,030.5 million in 2002. Our employee compensation costs increased in 2003 compared to 2002 primarily due to changes to our employee compensation system which increased overall salary costs and an increase in the number of flight hours, which resulted in additional flight and cabin crew work shifts.

Air catering charges decreased 8.3% to RMB842.7 million in 2003 from RMB919.2 million in 2002, primarily due to a decrease in number of meals served reflecting decreased passenger traffic during the SARS outbreak as well as the decreased unit cost of providing such meals.

Aircraft and jet engines operating lease expenses increased 27.8% to RMB910.1 million in 2003 from RMB712.0 million in 2002, primarily due to the net addition of nine aircraft acquired through operating leases.

Other operating lease expenses increased 26.9% to RMB182.0 million in 2003 from RMB143.4 million in 2002.

Other flight operation expenses decreased 5.6% to RMB2,112.4 million in 2003 from RMB2,237.4 million.

Selling and marketing expenses decreased 13.3% to RMB1,057.6 million in 2003 from RMB1,220.1 million in 2002, primarily due to lower sales commissions resulting from decreased ticket sales and lower sales office expenses as a result of the SARS outbreak.

General and administrative expenses remained relatively unchanged at RMB471.5 million in 2003 compared to RMB461.9 million in 2002.

Finance Costs

Net finance costs decreased 15.4% to RMB2,349.1 million in 2003 from RMB2,777.1 million in 2002, mainly reflecting the combined effect of lower interest expense resulting from scheduled repayment of a portion of our long-term debt and finance lease obligations.

Share of Profit Less Losses from Associates

Share of profit less losses from associates decreased 43.0% to RMB243.1 million in 2003 from RMB426.5 million in 2002, primarily due to the decrease in investment income from Dragonair. Dragonair's profit before taxation from its airline operations decreased substantially in 2003 as a result of the SARS outbreak. The decrease in investment income from Dragonair was partially offset by an increase in investment income from Shenzhen Airlines, which was less affected by SARS.

Income Tax

Income tax decreased 75.7% to RMB89.8 million in 2003 from RMB369.1 million in 2002, primarily reflecting a decrease in profit before tax.

2002 Compared to 2001

Our net profit attributable to shareholders decreased 47.3% to RMB499.6 million in 2002 from RMB948.3 million in 2001. Operating revenues increased 9.9% from 2001 to 2002, while operating expenses increased 11.6% over the same period, resulting in a 0.1% decrease in operating profit to RMB3,284.4 million in 2002 from RMB3,286.1 million in 2001. Our profit before tax decreased 35.4% to RMB1,039.8 million in 2002 from RMB1,609.7 million in 2001, primarily due to an increase in net finance costs, which was partially offset by an increase in share of profits less losses from associates.

Operating Revenues

Operating revenues increased 9.9% to RMB24,983.7 million in 2002 from RMB22,736.4 million in 2001, due to increases in both passenger and cargo revenues. Passenger revenues increased 9.8% to RMB19,815.2 million in 2002 from RMB18,049.9 million in 2001. Passenger revenues increased primarily due to an increase in passenger traffic in RPKs, passenger capacity in ASKs and load factor (which increased by 3.8 percentage points to 65.7% in 2002 from 61.9% in 2001). However, passenger yield decreased 8.6% to RMB0.53 per RPK in 2002 from RMB0.58 per RPK in 2001. Competition depressed airfares on many of our routes, especially our domestic, Japan and Korea, and Hong Kong and Macau routes. The increase in passenger revenues in 2002 was also partly due to the increase in passenger revenue contributions from Air Macau, which increased 4.2% to RMB1,605.8 million in 2002 from RMB1,541.0 million in 2001, reflecting Air Macau's improved airline operations in 2002.

The following table sets forth additional information relating to our passenger operations for 2002:

	Year Ended December 31, 2002			
	International	Domestic	Hong Kong and Macau	Total
	(in millions, except percentages and yield data)			
Passenger revenues:				
The Company (excludes Air Macau) (RMB)	7,023.8	10,135.4	1,050.2	18,209.4
Change from 2001	*23.1%*	*4.8%*	*(7.5)%*	*10.3%*
Contribution from Air Macau (RMB)	942.9	—	662.9	1,605.8
Change from 2001	*(2.5)%*	*—*	*15.4%*	*4.2%*
Total passenger revenues (RMB)	7,966.7	10,135.4	1,713.1	19,815.2
Change from 2001	*19.4%*	*4.8%*	*0.2%*	*9.8%*
Passenger operating data(1):				
RPKs	14,197.1	18,432.7	1,462.3	34,092.1
Change from 2001	*20.1%*	*19.5%*	*1.2%*	*18.8%*
ASKs	20,034.7	29,144.5	2,731.1	51,910.3
Change from 2001	*12.2%*	*13.0%*	*1.7%*	*12.0%*
Passenger load factor	70.9%	63.2%	53.5%	65.7%
Change from 2001	*4.7 pts*	*3.4 pts*	*(0.3) pts*	*3.8 pts*
Passenger yield(2) (RMB per RPK)	0.49	0.55	0.72	0.53
Change from 2001	*2.1%*	*(12.7)%*	*(8.9)%*	*(8.6)%*

(1) Excludes the operating data of Air Macau.

(2) Calculated by dividing passenger revenues by passenger traffic measured in RPKs.

International passenger revenues increased 19.4% to RMB7,966.7 million in 2002 from RMB6,670.2 million in 2001, primarily due to a 20.1% increase in passenger traffic in RPKs, a 12.2% increase in passenger capacity in ASKs and a 4.7 percentage point increase in load factor, which increased to 70.9% in 2002 from 66.2% in 2001. Passenger yield increased 2.1% to RMB0.49 per RPK in 2002 from RMB0.48 per RPK in 2001. Revenues on our European, North American and Japanese and Korean segments increased. European revenues increased as a result of increased demand, which contributed to the significant increase in passenger traffic, load factor and airfares for that segment. The increase in North American passenger revenues was primarily due to higher airfares.

Domestic passenger revenues increased 4.8% to RMB10,135.4 million in 2002 from RMB9,669.5 million in 2001. Domestic passenger revenues increased primarily because passenger traffic in RPKs increased by 19.5%, passenger capacity in ASKs increased by 13.0% and passenger load factor increased by 3.4 percentage points to 63.2% in 2002 from 59.8% in 2001. However, market competition resulted in a decrease of airfares. Our domestic passenger yield decreased 12.7% to RMB0.55 per RPK in 2002 from RMB0.63 per RPK in 2001.

Hong Kong and Macau passenger revenues increased slightly by 0.2% to RMB1,713.1 million in 2002 from RMB1,710.2 million in 2001. This slight increase was primarily due to a 15.4% increase in passenger revenue contributions from Air Macau, partially offset by a 7.5% decrease in passenger revenues from our Hong Kong and Macau routes. The decrease in passenger revenues from our Hong Kong and Macau routes was primarily due to lower average fares as a result of increased competition. Hong Kong and Macau passenger yield decreased 8.9% to RMB0.72 per RPK in 2002 from RMB0.79 per RPK in 2001.

Revenues from cargo and mail operations increased 22.2% to RMB4,031.5 million in 2002 from RMB3,298.3 million in 2001, primarily due to an increase in cargo traffic and cargo freight rates. Cargo traffic in RFTKs increased 17.6% to 2,117.7 million RFTKs in 2002 from 1,801.5 million RFTKs in 2001. Cargo yield increased slightly to RMB1.81 per RFTK in 2002 from RMB1.76 per RFTK in 2001, primarily due to increased cargo freight rates. The increase in cargo freight rates was partly due to the then ongoing labour strike at the shipping ports in western United States, which contributed to higher demand for air cargo services, thereby driving up cargo freight rates.

Other operating revenues decreased 18.1% to RMB1,137.0 million in 2002 from RMB1,388.2 million in 2001, primarily due to the one-time aircraft operating lease transaction that generated RMB460.0 million in revenues in 2001, partially offset by the gain of RMB161.7 million from the disposal of property, plant and equipment in 2002.

Operating Expenses

Operating expenses increased 11.6% to RMB21,699.3 million in 2002 from RMB19,450.3 million in 2001, primarily due to increases in aircraft maintenance, repair and overhaul expenses, take-off, landing and depot charges and employee compensation costs. Operating expenses as a percentage of operating revenues increased to 86.9% in 2002 from 85.5% in 2001.

The following table sets forth additional information relating to our operating expenses in 2002:

	Year Ended December 31, 2001	Year Ended December 31, 2002	Percentage Change between Periods	Percentage of Operating Revenues in 2002
	(RMB in millions, except percentages)			
Operating expenses:				
Jet fuel	4,786.8	4,978.7	4.0%	19.9%
Take-off, landing and depot charges	2,948.1	3,359.6	14.0	13.4
Depreciation	3,242.6	3,251.6	0.3	13.0
Aircraft maintenance, repair and overhaul	1,555.9	2,384.9	53.3	9.5
Employee compensation costs	1,643.9	2,030.5	23.5	8.1
Air catering charges	856.0	919.2	7.4	3.7
Aircraft and jet engines operating lease expenses	547.4	712.0	30.1	2.9
Other operating lease expenses	149.1	143.4	(3.8)	0.6
Other flight operation expenses	1,934.3	2,237.4	15.7	9.0
Selling and marketing expenses	1,156.6	1,220.1	5.5	4.9
General and administrative expenses	629.6	461.9	(26.6)	1.9
Total operating expenses	**19,450.3**	**21,699.3**	**11.6%**	**86.9%**

Jet fuel increased 4.0% to RMB4,978.7 million in 2002 from RMB4,786.8 million in 2001, primarily due to higher consumption of jet fuel as a result of increased flight operations, partially offset by lower domestic and international jet fuel prices. Our weighted jet fuel cost per barrel decreased 7.9% to RMB340.6 (US$41.2) in 2002 from RMB369.9 (US$44.7) in 2001.

Take-off, landing and depot charges increased 14.0% to RMB3,359.6 million in 2002 from RMB2,948.1 million in 2001, primarily due to the increase in number of flights, the CAAC's mandatory increase in unit takeoff and landing charges for domestic flights effective on September 1, 2002, higher costs of security checks at certain North American and European airports following the September 11, 2001 terrorist attacks and higher rates for cargo services charged by Pudong International Airport in Shanghai.

Depreciation expenses increased slightly to RMB3,251.6 million in 2002 from RMB3,242.6 million in 2001.

Aircraft maintenance, repair and overhaul expenses increased 53.3% to RMB2,384.9 million in 2002 from RMB1,555.9 million in 2001. This increase was primarily due to engine-related projects undertaken in 2002, including the overhaul of the engines of certain of China Southwest Airline's aircraft, overhaul of all JT9D-7R4G2 engines of Boeing 747-200Fs and testing and maintenance of Pratt & Whitney 4000 engines of Boeing 747-400s and Boeing 767-300s pursuant to the United States Federal Aviation Administration's airworthiness order.

Employee compensation costs increased 23.5% to RMB2,030.5 million in 2002 from RMB1,643.9 million in 2001, primarily due to changes to our compensation system which increased overall salary costs. The increase was partly due to higher pilot and crew compensation resulting from increased number of flight hours, which resulted in additional work shifts of flight and cabin crew.

Air catering charges increased 7.4% to RMB919.2 million in 2002 from RMB856.0 million in 2001, primarily due to an increase in number of passengers carried.

Aircraft and jet engines operating lease expenses increased 30.1% to RMB712.0 million in 2002 from RMB547.4 million in 2001, primarily due to the net addition of five additional aircraft acquired through operating leases.

Other flight operation expenses increased 15.7% to RMB2,237.4 million in 2002 from RMB1,934.3 million in 2001. The increase was primarily due to increases in charges for equipment insurance and insurance surcharges for third-party liabilities following the September 11, 2001 terrorists attacks and increased maintenance costs for rotables.

Selling and marketing expenses increased 5.5% to RMB1,220.1 million in 2002 from RMB1,156.6 million in 2001, primarily due to higher sales commissions paid as a result of increased ticket sales.

General and administrative expenses decreased 26.6% to RMB461.9 million in 2002 from RMB629.6 million in 2001. The decrease was primarily due to a loss on disposal of fixed assets of RMB181.2 million in 2001.

Finance Costs

Net finance costs increased 36.9% to RMB2,777.1 million in 2002 from RMB2,029.2 million in 2001. The increase was primarily due to an increase in exchange loss partially offset by a decrease in interest expense as a result of the repayment of certain bank loans and finance lease obligations.

Share of Profit Less Losses from Associates

Share of profit less losses from associates increased 20.9% to RMB426.5 million in 2002 from RMB352.8 million in 2001, primarily due to the increase in investment income from Dragonair as a result of favourable market conditions for passenger and cargo services on certain of its routes.

Income Tax

Income tax decreased 33.2% to RMB369.1 million in 2002 from RMB552.7 million in 2001, primarily reflecting a decrease in profit before tax.

LIQUIDITY AND CAPITAL RESOURCES

We finance our working capital needs through our cash inflows from operating activities and short-term borrowings. We also actively manage our trade payables as well as receivables to enhance working capital efficiency. In 2001, 2002 and 2003 and the six months ended June 30, 2004, our net cash inflow from operating activities was RMB5,538.3 million, RMB4,069.1 million, RMB5,510.6 million and RMB2,032.1 million, respectively. Net cash inflow from operating activities has been primarily used to pay debts and purchase aircraft.

Set forth below is a summary of our cash flow for the periods indicated:

	Year Ended December 31,			Six Months Ended June 30,	
	2001	**2002**	**2003**	**2003**	**2004**
	RMB	**RMB**	**RMB (in millions)**	**RMB (unaudited)**	**RMB**
Net cash inflow from operating activities	5,538.3	4,069.1	5,510.6	79.8	2,032.1
Net cash outflow from investing activities	(1,719.1)	(2,075.7)	(4,360.0)	(1,884.5)	(1,205.8)
Net cash outflow from financing activities	(2,462.7)	(2,316.3)	(2,207.4)	(409.1)	(703.1)
Cash and cash equivalents at the end of the year/period in cash flow statement	3,969.0	3,646.1	2,589.4	1,432.4	2,712.7

Net cash flows from operating activities consists of operating profit before change in working capital, and change in working capital. Net cash inflow from operating activities increased RMB1,952.3 million to RMB2,032.1 million in the six months ended June 30, 2004 from RMB79.8 million in the same period in 2003. The reason for the net cash inflow from operating activities was primarily because cash inflow from operating profit before working capital changes increased RMB2,714.2 million from the recovery of air traffic business after the SARS outbreak in 2003, partially offset by an overall cash outflow of RMB1,002.3 million in changes of working capital and a decrease of RMB235.9 million in interest payments as a result of the decrease in RMB-denominated bank loans outstanding and an increase in U.S. dollar denominated loans outstanding which carried lower interest rates. Net cash inflows from operating activities increased 35.4% to RMB5,510.6 million in 2003 from RMB4,069.1 million in 2002. Operating profit before change in working capital decreased 8.4% to RMB5,840.0 million in 2003 from RMB6,375.9 million in 2002, due in part to the SARS outbreak and the adverse business environment after the September 11, 2001 terrorist attacks in the United States. The decrease of our working capital contributed cash inflow of RMB1,947.3 million in 2003 and RMB283.3 million in 2002 primarily due to the increase in trade payables, bills payables, other payables and accruals, and air traffic liabilities totalling approximately RMB806.9 million, RMB900.8 million, RMB41.7 million and RMB276.9 million in 2003, respectively, compared to the increase in trade payables and bills payables of approximately RMB587.9 million and RMB206.3 million, respectively, and a decrease in other payables and accruals, and air traffic liabilities of RMB557.1 million and RMB87.7 million in 2002, respectively. The general increase in current liabilities in 2003, such as trade payables, bills payables and other payables and accruals, was primarily due to the extension of the settlement period negotiated by us as a result of the adverse impact of SARS on our business operations in 2003. Net cash inflows from operating activities decreased 26.5% to RMB4,069.1 million in 2002 from RMB5,538.3 million in 2001. Operating profit before change in working capital decreased 7.3% to RMB6,375.9 million in 2002 from RMB6,874.7 million in 2001, due to a decrease in our net profit by RMB448.7 million in 2002. While the cash inflow as a result of working capital changes in 2002 was only RMB283.3 million, such inflow amounted to RMB1,580.0 million in 2001, primarily due to a large increase of other payables and accruals of RMB666.9 million in 2001, and an increase of air traffic liabilities of RMB174.9 million in 2001 compared to a decrease of other payables and accruals of RMB557.1 million in 2002.

Net cash outflow from investing activities decreased RMB678.7 million to RMB1,205.8 million in the six months ended June 30, 2004 from RMB1,884.5 million in the same period in 2003. The reason for the decrease in cash outflow was mainly caused by cash inflow from the increase in release of pledged bank deposits of RMB1,096.7 million, offset by purchase of aircraft increased by RMB730.3 million primarily resulting from the purchase of two additional new aircraft, and cash proceeds received from disposal of fixed assets decreased by RMB183.5 million. Net cash outflow from investing activities increased 110.0% to RMB4,360.0 million in 2003 from RMB2,075.7 million in 2002. The increase was primarily due to the purchase of fixed assets, consisting of six aircraft, the increase in advance payments for aircraft and related equipment by RMB784.1 million for the purpose of expanding our aircraft fleet, and the increase in pledged deposits by RMB854.0 million in 2003. Net cash outflow from investing activities increased 20.7% to RMB2,075.7 million in 2002 from RMB1,719.1 million in 2001. Although the purchase of fixed assets decreased in 2002 primarily due to the decrease in the number of new aircraft purchased in 2002 (four aircraft) as compared to that in 2003 (six aircraft), our net cash outflow increased, primarily due to the decrease of income from the sale of fixed assets compared with 2001 and a decrease of advance payments for aircraft and related equipment in 2001 compared to an increase in 2002.

Net cash outflow from financing activities increased RMB294.0 million to RMB703.1 million in the six months ended June 30, 2004 from RMB409.1 million in the same period in 2003. The reason for the increase in cash outflow was mainly due to the increase in repayment of bank and other loans by RMB1,909.0 million primarily resulting from the improvement of cash flow as a result of the increase in revenues earned in the six months ended June 30, 2004, offset by cash contributions received from minority shareholders of Air China Cargo of RMB1,078.0 million.

Financing activities resulted in net cash outflows of RMB2,462.7 million, RMB2,316.3 million, RMB2,207.4 million and RMB703.1 million in 2001, 2002, 2003 and the six months ended June 30, 2004, respectively. The net cash outflows of 2001, 2002 and 2003 were primarily as a result of making scheduled repayments of bank borrowings and finance lease obligations in excess of proceeds from new bank borrowings.

As of December 31, 2003 and June 30, 2004, as provided in our combined cash flow statement, we had RMB 2,589.4 million and RMB2,712.7 million in cash and cash equivalents, respectively.

As of December 31, 2003 and June 30, 2004, our aggregate outstanding balance of finance lease obligations and long-term debts was approximately RMB28,751.7 million and RMB26,859.8 million, respectively. Such indebtedness was primarily denominated in U.S. dollars and to a lesser extent by Japanese yen, and bore interest primarily at fixed rates at a weighted average of 6.1%. As of December 31, 2003 and June 30, 2004, we had short-term borrowings (including bills payable) of approximately RMB8,320.9 million (mostly denominated in U.S. dollars) with a weighted average interest rate of 2.9% and RMB7,941.3 million with a weighted average interest rate of 2.8%, respectively.

As of October 31, 2004, we had total credit facilities amounting to RMB71,700 million with major Chinese banks, of which RMB44,427 million was drawn down. Consistent with our experience of Chinese lending practice, we have in place agreed credit limits under the relevant credit facilities, although the terms of any lending thereunder are not set and remain to be agreed prior to any advance. In addition, we finance our acquisition of aircraft and other fixed assets through operating cash flows, bank loans and leases.

Similar to many other Chinese airlines, we have been operating, and expect to continue to do so in the foreseeable future, with a net current liabilities position. As of December 31, 2001, 2002 and 2003 and June 30, 2004, we had net current liabilities of RMB11,142.3 million, RMB11,620.9 million, RMB12,383.8 million and RMB11,732.2 million, respectively. Although our net current liabilities position is comparable to some other Chinese airlines, it is relatively high when compared to some other Asian airlines such as Cathay Pacific. We have maintained a relatively high net current liabilities position due to our use of Renminbi-denominated short-term loans, which typically have lower interest rates compared to Renminbi-denominated long-term loans, to satisfy our working capital requirements and to repay a portion of our long-term loans. Historically, we have repaid and re-financed a significant portion of such short-term loans by rolling over the loans on an annual basis.

Our relatively high net current liabilities position exposes us to liquidity risk. As of June 30, 2004, we had substantial debt due within one year, including repayment of RMB7,214.2 million and RMB2,087.7 million of outstanding short-term and long-term bank and other loans, respectively. Our liquidity in the future will primarily depend on our ability to maintain adequate cash inflow from operations to meet our debt obligations as they become due and on our ability to maintain adequate external financing to meet our committed future capital expenditures. Our operating cash flows could be adversely affected by numerous factors, including increased competition, decreased demand for airline passenger and cargo services, or higher jet fuel prices. Our ability to obtain external financing depends on numerous factors, including our financial performance, relationships with lenders and credit history. Since we are subject to a high degree of financial leverage, an adverse change in our operating cash flows could adversely affect our financial position and hence weaken our ability to obtain additional debt and operating and finance leases and to renew our short-term debt facilities as they become due and payable.

We intend to continue to assess our level of indebtedness and net current liabilities position and seek to achieve a low cost of capital while ensuring appropriate leverage for our operations. We plan to monitor interest rate movements and intend to reduce the use of short-term debt and pursue other financing methods such as equity-based sources of funding, or fixed rate corporate debentures where appropriate if the interest rate environment deteriorated. We also intend to lower our level of indebtedness and reduce our net current liabilities position by further focusing on improving our cash generating capabilities and pursuing a prudent capital expenditure plan. For example, we plan to convert the purchase commitment of six Boeing 737-700s into operating lease arrangements to reduce our capital expenditures. We plan to broaden our external sources of funding, including equity offerings, long-term fixed-rate bank loans and corporate bonds. We believe that the net proceeds to the Company of the Global Offering will help reduce our financial leverage.

Many of our aircraft finance and operating leases contain undertakings and restrictive covenants. Any failure to comply with such undertakings or restrictive covenants in the future, or to obtain waivers for any breach, may result in the acceleration of all of the relevant indebtedness and, through cross-default provisions, other indebtedness. Any such developments would have a material adverse effect on our results of operations and financial condition as they would involve indebtedness of an aggregate amount of at least RMB12,862 million (consisting solely of finance lease obligations) as of June 30, 2004 (which represents approximately 27.37% of our total liabilities as of June 30, 2004) plus the related indemnities and expenses. Other than the items described in Notes 4(i), (ii), (iii), (v) and (vi) to the Pro Forma Statement of Net Assets as set forth in the section headed "Financial Information — Pro Forma Statement of Net Assets," there has been no significant change in the capitalisation or indebtedness of our Group since June 30, 2004, the date to which the Accountants' Report set out in Appendix I to this Prospectus has been prepared. Our RMB-denominated short-term loans do not contain restrictive or financial covenants.

Taking into account the net proceeds to the Company of the Global Offering on the basis of an Offer Price of HK$2.35 per Offer Share (being the minimum of the indicative price range) (see the section headed "Future Plans and Use of Proceeds") and available bank facilities, the Directors are of the opinion that the Group has sufficient working capital for the next 12 months following the date of this Prospectus.

INDEBTEDNESS

The table below sets forth our indebtedness as of September 30, 2004:

	Notes	As of September 30, 2004 Repayable Within One Year	Repayable After One Year	Total
		RMB	RMB (in millions)	RMB
Bank and other loans	(1)	8,589.8	13,401.9	21,991.7
Finance lease obligations	(2)	1,602.8	10,654.6	12,257.4
Bills payable		536.3	—	536.3
Total		10,728.9	24,056.5	34,785.4

	As of September 30, 2004 Total Indebtedness
	RMB (in millions)
Indebtedness denominated in U.S. dollars (US$2,472.8 million)	20,466.4
Indebtedness denominated in Japanese yen (JPY44,028.1 million)	3,280.9
Indebtedness denominated in Renminbi	11,038.1
Total	34,785.4

(1) The Group's bank loans of RMB14,225.5 million were secured by certain of the Group's assets (consisting of aircraft and related equipment and bank deposits) in the amount of approximately RMB17,039.7 million as of September 30, 2004. Certain commercial banks have guaranteed approximately RMB10,026.3 million of the Group's bank loans to which certain major PRC state-owned banks have provided counter-guarantees in the amount of RMB6,684.8 million.

(2) The Group's finance lease obligations of RMB12,257.4 million were secured by certain of the Group's assets (consisting of aircraft and bank deposits) in the amount of approximately RMB12,478.3 million as of September 30, 2004. Certain commercial banks have guaranteed approximately RMB17,305.8 million of the Group's finance lease obligations to which certain major PRC state-owned banks have provided counter-guarantees of RMB4,210.9 million.

As of September 30, 2004, CNAHC guaranteed certain of the Group's finance lease obligations and bank loans in an aggregate amount of RMB7,506 million, and Air China International Corporation guaranteed RMB15 million of the Group's bank loans. Subsequent to September 30, 2004, certain of the aforesaid guarantees provided by CNAHC in an aggregate amount of RMB4,081.5 million were released and the bank loans of RMB15 million guaranteed by Air China International Corporation have been repaid and the related guarantees have been released accordingly. The Company will ensure that no guarantees will be required to be given by CNAHC in our future financing arrangements (including aircraft leasing and financing).

As of September 30, 2004, certain of the Group's bank deposits in the amount of approximately RMB38.4 million were pledged against the Group's aircraft operating leases and financial derivatives.

Except as disclosed above, as of September 30, 2004, the Group did not have any outstanding mortgages, charges, pledges, debentures, loan capital, bank loans and overdrafts, debt securities or other similar indebtedness, finance leases or hire purchase commitments, acceptance liabilities or acceptance credits or any guarantees.

Except for as disclosed above, the Directors have confirmed that there has been no material change in the indebtedness and commitments of the Group since September 30, 2004.

Except for the fact that the Group's associates had guarantees provided to banks in respect of the bank loans granted to third parties in the amount of approximately RMB85 million as of September 30, 2004, there have been no material adverse changes on other contingent liabilities compared with those described in Section 5(r) of "Appendix I — Accountants' Report" to the Prospectus.

CAPITAL EXPENDITURE PLAN

As of September 30, 2004, our Company entered into contracts with respect to 41 passenger aircraft, of which our Company has entered into purchase commitments to purchase 32 aircraft and operating lease arrangements with respect to nine aircraft. As of the same date, contracts were entered into with respect to the purchase of five freighters. Since operating leases are accounted for through recognition of lease payments as cost in our income statement, we have not included the contractual commitments under operating leases in our capital expenditure plan. In addition to the aircraft contracted for, we plan to purchase an additional six aircraft for which we have not entered into contracts or obtained necessary government approvals as of September 30, 2004.

The table below sets forth additional information regarding (i) the number of aircraft or freighters contracted for as of June 30, 2004 (the latest balance sheet date included in the Prospectus), (ii) the number of aircraft or freighters contracted for between July 1, 2004 and September 30, 2004 and (iii) the method of procurement.

Aircraft and freighters contracted for as of June 30, 2004:

Air China Limited

	Number of Aircraft
Boeing 737-300:	
Operating lease	2
Boeing 767-300ER:	
Operating lease	2
Boeing 737-700:	
Operating lease	2
Purchase	8[(1)]
Airbus 319:	
Purchase	17
Sub-total	31

(1) Although we have contracted to purchase such aircraft, we plan to convert the purchase commitment of six aircraft into operating lease arrangements.

Air China Cargo

	Number of Freighters
Boeing 747-400F:	
Purchase	2
Turpolev TU 204:	
Purchase	3
Sub-total	5
Total	36

Aircraft contracted for between July 1, 2004 and September 30, 2004:

Air China Limited

	Number of Aircraft
Boeing 737-300:	
Operating lease	3
Boeing 737-700:	
Purchase	7
Total	**10**

The budgeted capital expenditures of our Company and Air China Cargo are summarised in the following table:

	Budgeted Capital Expenditures			
	2004	2005	2006	Total
	RMB	RMB	RMB	RMB
		(in millions)		
Air China Limited:				
Aircraft	4,730	4,339	6,114	15,183
Others	688	1,420	1,406	3,514
Total	5,418	5,759	7,520	18,697
Air China Cargo:				
Freighter	888	1,682	1,621	4,191
Others	70	70	70	210
Total	958	1,752	1,691	4,401

We plan to spend RMB15,183 million to expand and upgrade our passenger aircraft fleet through 2006. As of September 30, 2004, we contracted to purchase 32 aircraft, with committed capital expenditures of RMB9,440 million, of which RMB1,817 million was paid and RMB7,623 million was outstanding. Of the 32 aircraft we are committed to purchase, we plan to convert the purchase commitment of six aircraft into operating lease arrangements, which should reduce our total committed capital expenditures. The budgeted capital expenditures also include the committed capital expenditures for three aircraft contracted for and delivered prior to June 30, 2004. The remaining budgeted capital expenditures are designated for our planned purchase of an additional six aircraft and prepayment of aircraft to be delivered in 2007. We plan to enter into purchase commitments (with respect to the six aircraft) upon the receipt of necessary government approvals.

We have also budgeted a total of RMB3,514 million through the end of 2006 for other capital expenditure plans, including:

- purchase of spare parts and engines;
- investments in necessary facilities and equipment for our use of the new Terminal 3 of Beijing Capital International Airport;
- improvement of the first- and business-class cabins and in-flight and entertainment systems of some long-haul aircraft; and
- incremental capital contribution to Ameco for Ameco's expansion of MRO services.

The total of the above budgeted capital expenditures through 2006 is estimated to be RMB18,697 million. We plan to finance our aircraft procurement principally through operating cash flows, with the remaining amount through the net proceeds of the Global Offering and, to a lesser extent, debt borrowings. We plan to finance our other capital expenditure requirements through a combination of cash flows from operations and, to the extent necessary, debt borrowings.

To modernise its fleet and strengthen its capacity, Air China Cargo plans to spend RMB4,191 million to purchase five freighters through 2006. As of September 30, 2004, Air China Cargo had obtained all necessary government approvals and had entered into contracts to purchase five freighters, with a total contractual commitment of RMB3,236 million, of which RMB82 million was paid and RMB3,154 million was outstanding. The remaining budgeted capital expenditures are for the down payment of freighters Air China Cargo plans to acquire in 2007. The total amount of capital expenditures planned for Air China Cargo through 2006 is estimated to be RMB4,401 million. Air China Cargo plans to finance these planned capital expenditures through a combination of cash flow from operations and debt borrowings.

We may adjust our capital expenditure plan based on our future results of operations, cash flows and overall financial condition, financing costs, the condition of financial markets in general and other relevant factors. Our capital expenditures are generally subject to receipt of necessary approvals from the PRC government.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The following table sets forth our obligations and commitments to make future payments under contracts and commitments as of June 30, 2004:

	As of June 30, 2004				
	Payment Due by Period				
	Total	Less than 1 Year	1-3 Year(s)	4-5 Years	After 5 Years
	RMB	RMB	RMB (in millions)	RMB	RMB
Short-term bank and other loans	7,214.2	7,214.2	—	—	—
Long-term bank and other loans	13,998.2	2,087.7	5,140.2	3,179.0	3,591.3
Finance lease obligations	12,861.6	1,644.0	4,118.8	2,912.2	4,186.6
Bills payable	727.1	727.1	—	—	—
Operating lease commitments	5,301.5	1,143.0	1,784.2	1,161.3	1,213.0
Aircraft purchase commitments	8,751.7	4,519.1	4,232.6	—	—
Other capital commitments	343.6	343.6	—	—	—
Total contractual obligations	**49,197.9**	**17,678.7**	**15,275.8**	**7,252.5**	**8,990.9**

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are defined as those that reflect significant judgements and uncertainties and could potentially result in materially different results under different assumptions and conditions.

The Accountants' Report attached as Appendix I to this Prospectus has been prepared in accordance with IFRS. Our principal accounting policies are set forth in Section 3 to the Accountants' Report. IFRS requires that we adopt the accounting policies and make estimates that our Directors believe are most appropriate in the circumstances for the purposes of giving a true and fair view of our results and financial condition. However, different policies, estimates and assumptions in critical areas could lead to materially different results. The critical accounting policies adopted and estimates made in preparation of these financial statements are identified as follows:

Property, Plant and Equipment

As of June 30, 2004, we had a carrying value of approximately RMB42.4 billion of property, plant and equipment including RMB37.8 billion in aircraft and flight equipment. In accounting for property, plant and equipment, we must make estimates about the expected useful lives of the assets, the expected residual values of the assets, and the potential for impairment based on the fair value of the assets and the cash flows generated.

The following table sets forth a breakdown of our property, plant and equipment along with information about estimated useful lives and residual values of these groups of assets:

	Depreciation Life	Residual Value
Aircraft and flight equipment	10 – 20 years	Nil – 5%
Buildings	15 – 35 years	5%
Machinery, transportation equipment and office equipment	4 – 20 years	5%

Our policy is that the carrying value of the property, plant and equipment are reviewed for impairment when events or circumstances indicate the carrying value may not be recoverable. Factors that would indicate potential impairment may include, but are not limited to, significant decreases in the market value of the property, plant and equipment, a significant change in an asset's physical condition, and operating or cash flow losses associated with the use of the property, plant and equipment. Impairment losses are recognised in the income statement.

There are inherent risks in estimating future cash flows used in the impairment test. If cash flows do not materialise as estimated, there is a risk the impairment charges recognised to date may be inaccurate, or further impairment charges may be necessary in the future.

Revenue Recognition

We recognise passenger revenues either when transportation is provided or when the ticket expires unused rather than when a ticket is sold. The value of sold but unused tickets is included in the current liabilities as air traffic liabilities. Management performs periodic evaluations of air traffic liabilities, and any adjustments made as a result of such evaluations, which can be significant, are included in the results of operations for the periods in which the evaluations are completed. These adjustments result from differences between the estimates of certain revenue transactions and the related sales price, and are impacted by various factors, including a complex pricing structure and interline agreements throughout the industry, which affect the timing of revenue recognition. Revenues earned under codeshare arrangements are allocated between the codeshare partners based on the existing contractual agreements and are recognised as air traffic revenues when the transportation is provided. Except for certain cargo codeshare arrangements where the costs incurred in running the codeshare routes are shared among the codeshare partners, costs incurred in other codeshare routes are borne by the respective carriers.

Maintenance and Overhaul Costs

Following the adoption of IAS 37 (revised 2003) "Provisions, Contingent Liabilities and Contingent Assets," major overhaul expenses for owned assets and assets under capital leases are no longer accrued but charged against operating profits as and when incurred. In respect of major overhauls for aircraft and engines under operating leases, the estimated costs of such overhauls are accrued and charged to operating profits over the estimated period between overhauls using the ratios of actual flying hours/cycles and estimated flying hours/cycles between overhauls. The amount of overhaul costs charged to the operating profits is impacted by management's estimates of the expected overhaul costs and estimated flying hours/cycles, which are largely based on past experience of overhauls of the same or similar models of aircraft and engines.

Frequent Flyer Programme

We utilise a number of estimates in accounting for our frequent flyer programme which we believe are consistent with industry practice.

For Air China Companion Club accounts with sufficient mileage credits to claim the lowest level of free travel, we record a liability for the estimated incremental costs associated with providing travel awards, which include costs for catering, fuel and insurance payable by us.

The liability is computed based on several assumptions that require significant management judgement to estimate and formulate. There are uncertainties inherent in estimates. Therefore, an incorrect assumption impacts the amount and/or frequent flyer programme expenses. The most significant assumptions in accounting for the Air China Companion Club are described below:

Number of Miles Not Redeemed for Travel

Members may not reach the mileage threshold necessary for a free ticket and outstanding miles may not always be redeemed for travel. Therefore, based on the number of Air China Companion Club accounts and the miles in the accounts, we estimate how many miles will never be used (''breakage''), and do not record a liability for those miles. Our estimates of breakage consider the activity in our member accounts, account balances and other factors. We believe our breakage assumptions are reasonable. However, actual breakage could differ significantly from our estimates given the dynamic nature of the programme and our inability to predict our members' future behaviour.

Number of Miles Used per Award

We estimate how many miles will be used per award. If actual miles used exceed or fall below our estimates, we may need to adjust the liability and corresponding expense. Our estimates are based on the current requirements in our Air China Companion Club and historical redemptions on other airlines.

Costs Incurred to Carry Passengers

When we fly passengers on award tickets, we incur incremental costs such as food, fuel and insurance. We estimate such costs (excluding any contribution to overhead and profit) and accrue a liability. If the passenger travels on an award ticket on another airline with which we have a frequent flyer programme co-operation agreement, we are normally required to pay the other airline for carrying the passenger. The costs of the other airline are based on negotiated agreements and are often substantially higher than the costs we would incur to carry that passenger. We estimate how much we will pay to other airlines for future travel awards based on historical redemptions and settlements with other carriers and accrue a liability accordingly. The costs actually incurred by us or paid to other airlines may be higher or lower than the costs that were estimated and accrued, and we may need to adjust our liability and corresponding expense.

We review all Air China Companion Club estimates periodically and change our assumptions if facts and circumstances indicate that a change is necessary. Any such change in our assumptions could significantly affect our financial position and results of operations.

Inventories

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any provision for obsolescence, and are expensed when consumed in operations. Cost is determined on the weighted average basis. Work in progress represents material cost, labour cost and overhead cost capitalised for the provision of aircraft engineering services and is stated at the lower of cost as calculated on a weighted average basis and net realisable value. Net realisable value is determined on the basis of anticipated sales proceeds less estimated selling expenses.

We have a perpetual inventory system to regularly review the condition of our inventories. Specific provisions are made against (1) obsolete inventories, (2) inventories relating to aircraft no longer in use, and (3) inventories without air worthiness certificates issued by either the U.S. Federation Aviation Administration or the CAAC.

MARKET RISK AND RISK MANAGEMENT

Jet Fuel Price Risk

We are exposed to the fluctuations in jet fuel price. International jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuations in supply and demand. Our strategy for managing our jet fuel price risk aims to provide us with protection against sudden and significant price increases. To meet these objectives, we will continue to use instruments such as swaps, options and collars with approved counter-parties and within approved limits.

In 2001, 2002, 2003 and the six months ended June 30, 2004, our weighted jet fuel cost per barrel was approximately RMB369.9 (US$44.7), RMB340.6 (US$41.2), RMB377.1 (US$45.6) and RMB439.9 (US$53.1), respectively. We have historically procured approximately 70% and 30%, respectively, of our jet fuel requirements from domestic and international suppliers.

Domestic jet fuel prices, which are regulated by the PRC government, are set by reference to the average Singapore jet fuel prices published by Platts. The PRC government adjusts the domestic jet fuel prices from time to time, most recently in August 2004. International jet fuel prices are typically set by reference to New York crude oil prices. Both Singapore jet fuel prices and New York crude oil prices have been at high levels in 2004 than compared to prior periods. Higher weighted jet fuel cost per barrel could adversely affect our results of operations and our profitability.

In each of 2003 and the six months ended June 30, 2004, a hypothetical increase of US$1 per barrel in the price of jet fuel through the respective periods, with all other variables constant, would have increased our operating expenses by 0.51% (or RMB114.5 million) and 0.54% (or RMB72.6 million), respectively.

Derivative Instrument Risk

We enter into derivative transactions for both crude oil and jet fuel. The majority of our derivative transactions are crude oil derivatives such as swaps, capped swaps, knock-out swaps, collars and capped collars. We recorded a derivatives loss of RMB104.8 million, a gain of RMB85.2 million, a gain of RMB169.9 million and a gain of RMB76.6 million in 2001, 2002 and

2003 and the six months ended June 30, 2004, respectively. The fair values of derivative instruments as of December 31, 2003 and June 30, 2004 are as follows:

	As of December 31, 2003		As of June 30, 2004	
	Assets	Liabilities	Assets	Liabilities
	RMB	RMB	RMB	RMB
	(in millions)			
Swaps and collars expiring:				
Within six months	8.0	(2.4)	60.0	(0.2)
Over six months to 21 months	26.0	(3.6)	17.0	(0.8)
Total	**34.0**	**(6.0)**	**77.0**	**(1.0)**

See "Appendix I — Accountants' Report."

Since most of our derivative instruments relate to crude oil derivatives, our Fuel Management Committee (chaired by our President and includes the general manager of various departments) has primary oversight of such transactions. Our Fuel Management Committee is responsible for establishing the derivative strategies, monitoring the implementation of our risk management policies and evaluating the performance of derivative instruments. Our Fuel Risk Management Group, which includes a group leader, risk control manager and traders, is responsible for implementing of the policies set by the Fuel Management Committee, determining the timing, price, and types of derivative products and executing derivative transactions.

Interest Rate Risk

We are subject to market risks due to fluctuations in interest rates and refinancing of short-term debt. Our net profit is affected by changes in interest rates due to the impact such changes have on interest income and interest expense from short-term deposits and other interest-bearing financial assets and liabilities. A significant portion of our interest-bearing financial liabilities, including finance leases, with maturities above one year has predominantly fixed interest rates and is denominated in U.S. dollars and Japanese yen. Our short-term deposits and other interest-bearing financial assets and short-term liabilities are predominantly denominated in Renminbi, U.S. dollars, Hong Kong dollars and Japanese yen. The PBOC regulates the interest rates of our Renminbi-denominated borrowings. Changes in such interest rates could impact our finance costs. From time to time, we may enter into interest rate swaps designed to mitigate exposure relating to interest rate risks. No such contract was outstanding as of December 31, 2003.

Our indebtedness includes bank and other loans, bills payable as well as obligations under finance leases. As of June 30, 2004, we had bank and other loans of RMB21,212.4 million, bills payable of RMB727.1 million and finance lease obligations of RMB12,861.6 million. All such borrowings bear fixed interest rates except for bank loans and finance lease obligations aggregating RMB14,465.0 million that bear floating interest rates. Assuming that there is no change in the level of borrowings at June 30, 2004, and all other variables remain constant, a hypothetical increase in interest rates by 1% per annum for floating rate bank loans and finance lease obligations would result in an interest expense increase of approximately RMB72.3 million for the six months ended June 30, 2004.

The table below sets forth information regarding our interest rate sensitive financial instruments as of June 30, 2004:

	As of June 30, 2004							
	Expected Maturity Date for the Twelve Months Ending June 30,							
	2005	2006	2007	2008	2009	Thereafter	Total	Fair Value
	(RMB equivalents in millions, except percentages)							
Short-Term Debt:								
Debt in RMB								
Floating rate	3,366.2	—	—	—	—	—	3,366.2	3,366.2
Average interest rate	4.1%						4.1%	4.1%
Debt in U.S. dollars								
Floating rate	4,555.2	—	—	—	—	—	4,555.2	4,555.2
Average interest rate	1.9%						1.9%	1.9%
Loans in HK$								
Floating rate	19.9	—	—	—	—	—	19.9	19.9
Average interest rate	1.7%						1.7%	1.7%
Long-Term Debt:								
Debt in RMB								
Floating rate	722.2	2,069.7	622.3	522.3	472.6	1,424.2	5,833.3	5,833.3
Average interest rate	5.5%	5.2%	5.7%	5.9%	5.9%	6.0%	5.6%	5.6%
Debt in U.S. dollar								
Fixed rate	2,725.1	2,662.8	2,671.5	2,422.4	2,582.3	3,797.7	16,861.8	16,861.8
Average interest rate	7.3%	7.2%	7.2%	7.0%	6.9%	6.7%	7.1%	7.1%
Floating rate	90.4	390.0	180.4	14.8	14.8	—	690.4	690.4
Average interest rate	1.5%	1.4%	2.1%	1.8%	1.8%	—	1.6%	1.6%
Debt in Japanese yen								
Fixed rate	194.0	190.2	472.1	31.0	31.0	2,556.0	3,474.3	3,474.3
Average interest rate	4.7%	2.1%	3.3%	3.1%	3.1%	3.1%	3.1%	3.1%
Total	11,673.0	5,312.7	3,946.3	2,990.5	3,100.7	7,777.9	34,801.1	34,801.1

Foreign Currency Risk

A substantial portion of our debt, part of our operating revenues and expenses and capital expenditures are denominated in certain major foreign currencies and consequently subject to fluctuations in exchange rates. As a result of the significant fluctuation of Japanese yen against Renminbi, we recorded a foreign exchange gain of RMB871.9 million in 2001 and incurred foreign exchange loss of approximately RMB360.7 million and RMB297.0 million in 2002 and 2003, respectively. We recorded a foreign exchange gain of RMB42.3 million in the six months ended June 30, 2004. Our finance leases and a portion of our long-term loans are denominated in U.S. dollars and Japanese yen. Our exposures are primarily from the exchange rate fluctuations of the U.S. dollar and Japanese yen against Renminbi and such fluctuation could result in an accounting profit or loss. In order to reduce our foreign currency risk, we have pursued a strategy of reducing, for certain major foreign currencies, the mismatch between our revenues and payments denominated in such currencies. We are also currently evaluating proposals to hedge our foreign currency exposure by entering into hedge transactions.

As of June 30, 2004, we had the equivalent of RMB3,474.3 million in Japanese yen-denominated debt. Assuming that there is no change in the level of Japanese yen-denominated borrowings after June 30, 2004, and all other variables remain constant, a hypothetical 1% appreciation in Japanese yen will result in a foreign exchange loss of an equivalent of RMB34.7 million for the six months ended June 30, 2004.

OFF-BALANCE SHEET TRANSACTIONS

Other than the information disclosed in the Accountants' Report attached as Appendix I to this Prospectus, we do not have any outstanding derivative financial instruments, off-balance sheet guarantees, interest rate swap transactions or foreign currency forward contracts.

TAXATION

We are subject to the Chinese enterprise income tax at a rate of 33% and are responsible for settling our tax liability with the respective tax bureaus. We are also subject to income tax on profits arising in, or derived from, jurisdictions where our subsidiaries are domiciled or have base of operations. See Note 4(i) of the Accountants' Report attached as Appendix I to this Prospectus.

RECENT ACCOUNTING PRONOUNCEMENTS

For more information on recent accounting pronouncements see ''Appendix I — Accountants' Report.''

WORKING CAPITAL

Taking into account the net proceeds to the Company from the Global Offering on the basis of an Offer Price of HK$2.35 per Offer Share (being the minimum of the indicative price range) (see the section headed ''Future Plans and Use of Proceeds'') and available bank facilities, the Directors are of the opinion that the Group will have sufficient working capital for the next 12 months following the date of this Prospectus.

RULES 13.11 TO 13.16 OF THE HONG KONG LISTING RULES

Rules 13.11 to 13.16 of the Hong Kong Listing Rules set out certain specific instances which give rise to a disclosure obligation on the part of an issuer. These include instances where the issuer gives an advance or provides a guarantee to another company or the issuer providing financial assistance to an associated company or a jointly controlled entity upon meeting certain conditions. Our directors have confirmed that they are not aware of any circumstances that would give rise to a disclosure requirement under Rules 13.11 to 13.16 of the Hong Kong Listing Rules.

PROFIT FORECAST FOR THE YEAR ENDING DECEMBER 31, 2004

We forecast that, in the absence of unforeseen circumstances and on the bases and assumptions set out in ''Appendix III — Profit Forecast,'' our combined profit before taxation and combined profit after taxation and minority interests but before extraordinary items for the year ending December 31, 2004 will not be less than RMB3,506 million and RMB2,290 million, respectively, under IFRS. We are currently not aware of any extraordinary items that have arisen or are likely to arise in respect of the year ending December 31, 2004 that would affect the prospective financial information presented. On the basis of the prospective financial information and the number of shares outstanding during the financial year, adjusted, as if the Global Offering had occurred at January 1, 2004 of 9,050,618,182 Shares (assuming the Joint Global Coordinators (on behalf of the International Underwriters) do not exercise the Over-allotment Option), the pro forma fully diluted forecast earnings per Share will not be less than RMB0.25, representing (upon conversion into Hong Kong dollars at the PBOC Rate of HK$1.00 to RMB1.0638 prevailing on October 29, 2004) a price/earnings multiple of 9.8 times and 12.9 times if the Offer Price is HK$2.35 per Share and HK$3.10 per Share, respectively.

The texts of the letters from the reporting accountants, Ernst & Young, and from the Joint Sponsors in respect of the profit forecast are set out in "Appendix III — Profit Forecast."

DIVIDEND POLICY

Our Board of Directors will declare dividends, if any, in Renminbi with respect to H Shares on a per share basis and will pay such dividends in Hong Kong dollars. Any dividend distribution shall be subject to Shareholders' approval. Under PRC Company Law and our Articles of Association, all of our Shareholders have equal rights to dividends and distributions. The holders of H Shares will share proportionately on a per share basis in all dividends and other distributions declared by our Board of Directors. The decision to recommend payment of any dividend and the amount of such dividend will depend upon:

- our results of operations and cash flows;
- our financial position;
- our Shareholders' interests;
- general business conditions;
- our future prospects;
- statutory and regulatory restrictions on the payment of dividends by us; and
- other factors that our Board of Directors deems relevant.

We will pay dividends out of our after-tax profits only after we have made the following allowances and allocations:

- recovery of accumulated losses, if any;
- allocations to the statutory common reserve fund equivalent to 10% of our after-tax income, as determined under PRC GAAP;
- allocations to the statutory common welfare fund equivalent to between 5% and 10% of our after-tax income, as determined under PRC GAAP; and
- allocations to a discretionary common reserve fund as approved by the Shareholders in a Shareholders' meeting.

The minimum and maximum allocations to the statutory funds are 15% and 20% of our after-tax income, as determined under PRC GAAP. When the statutory common reserve fund reaches and is maintained at or above 50% of our registered capital, no further allocations to this fund will be required.

Under PRC law, dividends may be paid only out of distributable profits. Distributable profits means our after-tax profits as determined under PRC GAAP or IFRS, whichever is lower, less any recovery of accumulated losses and allocations to statutory funds that we are required to make. Any distributable profits that are not distributed in a given year are retained and available for distribution in subsequent years. However, we normally will not pay any dividends in a year in which we do not have any distributable profits.

PRO FORMA STATEMENT OF NET ASSETS

The following unaudited pro forma statement of net assets is extracted without material adjustment from "Appendix II — Pro Forma Financial Information" to this Prospectus:

	Audited Combined Net Assets of the Group as of June 30, 2004	Adjustment — Net Proceeds of Global Offering	Total Pro Forma Net Assets of the Group	Pro Forma Net Assets per Share
	RMB (in thousands)			RMB
	(Note 1)	(Note 2)		(Note 3) and (Note 4)
Based on an Offer Price of HK$2.35 per share				
Non-current assets				
Lease prepayments	70,007	—	70,007	
Goodwill included as part of interests in associates	1,205,390	—	1,205,390	
Other investments	21,930	—	21,930	
Others	46,211,986	—	46,211,986	
	47,509,313	—	47,509,313	
Current assets				
Cash and cash equivalents	3,758,507	5,970,356	9,728,863	
Pledged deposits	138,617	—	138,617	
Others	5,825,623	—	5,825,623	
	9,722,747	5,970,356	15,693,103	
Current liabilities				
Bills payable	(727,118)	—	(727,118)	
Tax payable	(51,005)	—	(51,005)	
Obligations under finance leases	(1,644,035)	—	(1,644,035)	
Bank and other loans	(9,301,850)	—	(9,301,850)	
Others	(9,730,958)	—	(9,730,958)	
	(21,454,966)	—	(21,454,966)	
Non-current liabilities				
Obligations under finance leases	(11,217,580)	—	(11,217,580)	
Bank and other loans	(11,910,523)	—	(11,910,523)	
Others	(2,416,335)	—	(2,416,335)	
	(25,544,438)	—	(25,544,438)	
Total net assets	10,232,656	5,970,356	16,203,012	
Represented by:				
Net intangible assets	1,205,390	—	1,205,390	0.13
Net tangible assets	9,027,266	5,970,356	14,997,622	1.66
	10,232,656	5,970,356	16,203,012	1.79

	Audited Combined Net Assets of the Group as of June 30, 2004	Adjustment — Net Proceeds of Global Offering	Total Pro Forma Net Assets of the Group	Pro Forma Net Assets per Share
		RMB (in thousands)		RMB
	(Note 1)	(Note 2)		(Note 3) and (Note 4)
Based on an Offer Price of HK$3.10 per share				
Non-current assets				
Lease prepayments	70,007	—	70,007	
Goodwill included as part of interests in associates	1,205,390	—	1,205,390	
Other investments	21,930	—	21,930	
Others	46,211,986	—	46,211,986	
	47,509,313	—	47,509,313	
Current assets				
Cash and cash equivalents	3,758,507	7,905,610	11,664,117	
Pledged deposits	138,617	—	138,617	
Others	5,825,623	—	5,825,623	
	9,722,747	7,905,610	17,628,357	
Current liabilities				
Bills payable	(727,118)	—	(727,118)	
Tax payable	(51,005)	—	(51,005)	
Obligations under finance leases	(1,644,035)	—	(1,644,035)	
Bank and other loans	(9,301,850)	—	(9,301,850)	
Others	(9,730,958)	—	(9,730,958)	
	(21,454,966)	—	(21,454,966)	
Non-current liabilities				
Obligations under finance leases	(11,217,580)	—	(11,217,580)	
Bank and other loans	(11,910,523)	—	(11,910,523)	
Others	(2,416,335)	—	(2,416,335)	
	(25,544,438)	—	(25,544,438)	
Total net assets	10,232,656	7,905,610	18,138,266	
Represented by:				
Net intangible assets	1,205,390	—	1,205,390	0.13
Net tangible assets	9,027,266	7,905,610	16,932,876	1.87
	10,232,656	7,905,610	18,138,266	2.00

Notes:

(1) The financial information at June 30, 2004 is extracted from the combined balance sheet of the Group set out in "Appendix I — Accountants' Report" to this Prospectus.

(2) The adjustment to the pro forma statement of net assets reflects the estimated proceeds from the Global Offering, net of related expenses, to be received by the Company. This has been shown on the basis of both the upper and lower limits of the range of Offer Price, being HK$3.10 and HK$2.35 per Share. The translation of Hong Kong dollars into Renminbi was at HK$1.00 to RMB1.0638, being the PBOC Rate on October 29, 2004.

(3) The number of Shares is based on a total of 9,050,618,182 Shares issued and outstanding during the entire year, adjusted as if the Global Offering had occurred at January 1, 2004, excluding any shares that might be issued under the Over-allotment Option.

(4) The calculation of the unaudited pro forma net tangible asset per Share has not taken into account the following subsequent events after the balance sheet date of June 30, 2004, which, when happened, will increase/decrease the unaudited pro forma net tangible assets per Share:

(i) On September 9, 2004, CNAHC made a cash contribution amounting to RMB561 million to the Group which forms part of the Company's paid-in capital of RMB6,500 million upon its incorporation.

(ii) Upon incorporation of the Company, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB886 million to the Company which forms part of the Company's paid-up capital of RMB6,500 million.

(iii) As a result of the completion of (i) the stock purchase agreement entered into by a wholly owned subsidiary of CNAC with Air China International Corporation in relation to the acquisition of 60% of the equity interest in Beijing Air Catering Co., Ltd. (''BACL''), (ii) the stock purchase agreement entered into by a wholly owned subsidiary of CNAC with Air China International Corporation in relation to the acquisition of 60% of the equity interest in Southwest Air Catering Company Limited (''SWACL''), and (iii) the stock transfer agreement entered into between Air China International Corporation and Hong Kong Southwest Air Catering Limited (''HKSACL''), the minority shareholder of SWACL, in respect of the disposal of 15% of the equity interest in SWACL by Air China International Corporation to HKSACL, the Group will make a payment of approximately RMB378 million to CNAHC, representing the total considerations paid by CNAC, through its wholly owned subsidiary, and HKSACL for the acquisitions of the entire shareholding interests held by the Group in BACL and SWACL pursuant to the Restructuring. This payment to be made to CNAHC will be accounted for as a special distribution to CNAHC by the Group.

(iv) Upon completion of the acquisitions of (i) a 48% equity interest in Shandong Aviation Group Corporation and (ii) a 22.8% equity interest in Shandong Airlines Co., Ltd., details of which are set out in Section 11(g) of ''Appendix I — Accountants' Report'' to this Prospectus, an estimated goodwill amount of approximately RMB183 million (unaudited) will result from the above acquisitions.

(v) In accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) ''Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment'' notice issued by the Ministry of Finance (English title is a direct translation of Chinese title of the notice), which became effective from August 27, 2002, and pursuant to the Restructuring Agreement, after the Company's incorporation, we are required to make a distribution to CNAHC which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with PRC GAAP, generated during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC.

In addition, in accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) ''Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment'' notice issued by the Ministry of Finance, and pursuant to the Restructuring Agreement, after the Company's incorporation, we are required to make a distribution to CNACG, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with PRC GAAP, generated during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those directly contributed by CNAHC) contributed to the Group by the CNAC group, less the 2003 final dividend and 2004 interim dividend amounts already paid by CNAC to CNACG.

(vi) Subsequent to June 30, 2004 and up to the date of the Prospectus, distribution totalling approximately RMB15 million was declared by a subsidiary of the Company.

NO MATERIAL ADVERSE CHANGE

There was no interruption in our business that may have or have had a significant effect on our financial position of the Group in the last 12 months. Our Directors confirm that other than the items described in Notes 4(iii), (v) and (vi) to the Pro Forma Statement of Net Assets (see the section headed ''Financial Information — Pro Forma Statement of Net Assets''), there has been no material adverse change in our financial or trading position or prospects since June 30, 2004.

CURRENT TRADING AND PROSPECTS

Since June 30, 2004, our sales have been higher than in previous months due to the seasonal nature of the airline business in line with Directors' expectations. See the section headed ''Financial Information — Seasonality.'' In addition, load factors and yields for this period are both higher than those experienced during the same period in 2003. The Directors view the future prospects during the current financial year of the Company with confidence and believe that the Group is well placed to continue to develop its business in line with its strategy. See the section headed ''Business — Overview — Strategy.''