

MANAGEMENT DISCUSSION AND ANALYSIS

OPERATING INFORMATION

The following table sets forth certain operating statistics relating to our IM community and value-added services as of the dates and for the periods presented:

	For the 16-day period ended 31 December 2004	For the 15-day period ended 30 September 2004 (in millions)	For the 16-day period ended 31 December 2003
Registered IM user accounts (at end of period)	369.7	355.3	256.1
Active user accounts	134.8	119.3	81.5
Peak simultaneous online user accounts (for the quarter)	9.4	7.3	4.9
Average daily user hours	114.6	79.2	51.4
Average daily messages ⁽¹⁾	1,580.2	1,210.7	681.8
Fee-based Internet value-added services registered subscriptions (at end of period)	8.3	6.9	6.9
Fee-based mobile and telecommunications value-added services registered subscriptions (at end of period) ⁽²⁾	8.8	12.5	13.1

Notes:

- (1) Average daily messages include messages exchanged between PCs only and exclude messages exchanged with mobile handsets.
- (2) Includes registered subscriptions for services provided directly by the Group or through mobile operators. Substantially all the decline in fee-based subscriptions was due to the discontinuation of the 161 Mobile Chat fee sharing arrangement at the end of December 2004.



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Year Ended 31 December 2004 Compared to Year Ended 31 December 2003

The following discussion covers the results for the two years ended 31 December 2004. Our results, however, fluctuate from quarter to quarter. You should read the following discussion together with the quarterly discussion below.

Revenues. Revenues increased by 55.6% from RMB735.0 million for the year ended 31 December 2003 to RMB1,143.5 million for the year ended 31 December 2004, as a result of a significant increase in revenues from both Internet value-added services and mobile and telecommunications value-added services. The following table sets forth our revenues by lines of business for the years ended 31 December 2003 and 2004:

	Year ended 31 December			
	2004		2003	
	Amount RMB'000	% of total revenues	Amount RMB'000	% of total revenues
Internet value-added services	439,041	38.4%	229,690	31.3%
Mobile and telecommunications value-added services	641,190	56.1%	467,369	63.6%
Online advertising	54,801	4.8%	32,841	4.4%
Others	8,501	0.7%	5,057	0.7%
Total revenues	<u>1,143,533</u>	<u>100.0%</u>	<u>734,957</u>	<u>100.0%</u>

Revenues from our Internet value-added services increased by 91.1% from RMB229.7 million for the year ended 31 December 2003 to RMB439.0 million for the year ended 31 December 2004. Revenues from our various community services and interactive entertainment, in particular avatars, increased as our user adoption grew. In addition, we continued to grow our membership subscriptions through various promotional activities. Several new products and services, particularly online games and “cyber hard disk”, and the development of new fee collection channels also contributed to the increase in revenues from Internet value-added services.



Revenues from our mobile and telecommunications value-added services increased by 37.2% from RMB467.4 million for the year ended 31 December 2003 to RMB641.2 million for the year ended 31 December 2004. Although some of our mature products and services, such as Mobile QQ, were affected by the “cleaning up” of inactive customer accounts undertaken by mobile operators, revenues from mobile chat services and mobile content services continued to grow. In addition, revenues from newly

launched services, such as mobile voice value-added services comprising ringback tones and mobile IVR, contributed to the increased revenues. Revenues from 2.5G-related services also increased significantly due to the increased popularity of 2.5G services offered by mobile operators.

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Revenues from online advertising increased by 66.9% from RMB32.8 million for the year ended 31 December 2003 to RMB54.8 million for the year ended 31 December 2004. The increase in revenues reflected our growing customer base and our increased advertising generated by the QQ.com portal. Moreover, revenues from online advertising for the year ended 31 December 2003 were negatively affected due to the outbreak of the SARS epidemic.



Cost of revenues. Cost of revenues increased by 81.3% from RMB229.5 million for the year ended 31 December 2003 to RMB416.2 million for the year ended 31 December 2004. The increase principally reflected the increases in the amount of telecommunications operators' revenue share and imbalance fees, bandwidth and server custody fees and staff costs directly attributable to our services and products. As a percentage of revenues, cost of revenues increased from 31.2% in the year ended 31 December 2003 to 36.4% in the year ended 31 December 2004 mainly due to the increase in the amount of imbalance fees as a result of the increased volume of traffic imbalance. Staff costs also increased in advance of our revenues as we recruited additional staff to support our growing product and service offerings. The following table sets forth our cost of revenues by lines of business for the year ended 31 December 2003 and 2004:

	Year ended 31 December			
	2004		2003	
	Amount RMB'000	% of segment revenues	Amount RMB'000	% of segment revenues
Internet value-added services	143,133	32.6%	75,489	32.9%
Mobile and telecommunications value-added services	243,927	38.0%	141,916	30.4%
Online advertising	17,514	32.0%	10,499	32.0%
Others	11,642	136.9%	1,644	32.5%
Total cost of revenues	<u>416,216</u>		<u>229,548</u>	

Cost of revenues for our Internet value-added services increased by 89.6% from RMB75.5 million for the year ended 31 December 2003 to RMB143.1 million for the year ended 31 December 2004. The amount of fees retained by mobile operators for their share of revenues and imbalance fees increased as the fees collected through that channel increased for the full year. However, in the fourth quarter of 2004, these fees decreased as a result of a gradual diversification of some of our collection channels into non-mobile based channels and smaller imbalance fees as we reduced the traffic imbalance volume. As we offered an increasing variety of Internet value-added services in 2004, we had to increase our bandwidth and server capacity, content subscription and support staff.

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Cost of revenues for our mobile and telecommunications value-added services increased by 71.9% from RMB141.9 million for the year ended 31 December 2003 to RMB243.9 million for the year ended 31 December 2004. The increase mainly reflected the increase in the amount of fees retained by mobile operators for their share of revenues and imbalance fees. Imbalance fees grew as the traffic imbalance grew and as certain mobile operators increased the amount of imbalance fees. Staff costs also increased as we increased the number of staff to support our various new products and services. As we enriched our content offering, content subscription charges increased.

Cost of revenues for our online advertising increased by 66.8% from RMB10.5 million for the year ended 31 December 2003 to RMB17.5 million for the year ended 31 December 2004. The increase mainly reflected increased amount of sales commissions paid to advertising agencies and increased bandwidth charges as we increased the volume of advertising contracts.

Other operating income/(expenses), net. We recorded other operating income of RMB11.0 million for the year ended 31 December 2004 relating to a financial subsidy of RMB7.2 million received from the local government and fair value gains on financial instruments of RMB3.8 million. The financial subsidy was granted to us as part of the local government's efforts to promote development of the high-tech software business.



Selling and marketing expenses. Selling and marketing expenses increased by 93.8% from RMB56.0 million for the year ended 31 December 2003 to RMB108.5 million for the year ended 31 December 2004. The increase principally reflected increased promotional and advertising activities relating to the launch of and promotional efforts relating to several new products and new distribution channels, such as Vnet, E-sales and banks. For the year ended 31 December 2004, we increased our outsourcing as we expanded our customer support activities. In addition, we incurred higher level of travel and entertainment costs relating to our marketing efforts as we participated in trade shows and exhibitions more actively.

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General and administrative expenses. General and administrative expenses increased by 51.8% from RMB112.0 million for the year ended 31 December 2003 to RMB170.1 million for the year ended 31 December 2004. The increase primarily reflected the increase in research and development costs as a result of an increase in the number of research and development staff and technical personnel supporting our overall business, including in particular online gaming, web portal and IM functionalities. Staff cost also increased significantly as a result of a higher number of staff and increased salary. The increase in our office lease rental payments relating to our new Shenzhen headquarters was mostly offset by the reductions in office maintenance expenses incurred at our previous offices.

Finance income, net. Finance income, net increased by 369.7% from RMB2.0 million for the year ended 31 December 2003 to RMB9.4 million for the year ended 31 December 2004. The increase was mainly due to the interest income generated from placing the cash proceeds from our initial public offering into interest-earning financial assets. Increases in interest rates in general that occurred in 2004 also contributed to the increase.

Income tax expenses. We recorded profit taxes of RMB22.5 million for the year ended 31 December 2004 compared to RMB16.0 million for the year ended 31 December 2003. The increase in profit taxes mainly reflected the increase in our profit before tax. Starting from 2003, Tencent Technology has been selling software to Tencent Computer under our structure contracts. Upon obtaining a formal approval from the local tax bureau in the PRC, the cost of the software, which is amortised as expenses at Tencent Computer over its estimated contractual useful lives, will be allowed for income tax deduction claims in ascertaining the assessable profits of Tencent Computer. Accordingly, these intra-group arrangements have given rise to a potential temporary difference between the accounting base in our consolidated financial statements and the tax base in the financial statements of Tencent Computer. The related potential deferred tax assets, estimated to be in the amount RMB98.1 million as at 31 December 2004 based on the enacted 15% tax rate applicable to enterprises based in Shenzhen, have not been recognised in our consolidated financial statements because there is no reasonable certainty that Tencent Computer will obtain the necessary approval from the local tax bureau. Management has lodged an application with the relevant authorities in 2004, but there has not been any affirmative confirmation obtained.

Net profit. As a result of the factors discussed above, net profit increased by 38.6% from RMB322.2 million for the year ended 31 December 2003 to RMB446.7 million for the year ended 31 December 2004. Net margin was 39.1% for the year ended 31 December 2004 compared to 43.8% for the year ended 31 December 2003.

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Fourth Quarter of 2004 Compared to Third Quarter of 2004

The following discussion covers the results of the two quarters ended 31 December 2004. The quarterly results, however, are not necessarily indicative of our results for the full year. You should read the following discussion together with the annual discussion above.



The following table sets forth the comparative figures for fourth quarter ended 31 December 2004 and the third quarter ended 30 September 2004:

	Three months ended	
	31 December 2004 RMB'000	30 September 2004 RMB'000
	(Unaudited)	
Revenues	314,481	300,986
Cost of revenues	(114,037)	(114,652)
Gross profit	200,444	186,334
Other operating income, net	9,564	1,457
Selling and marketing expenses	(31,501)	(27,472)
General and administrative expenses	(58,019)	(49,647)
Profit from operations	120,488	110,672
Finance income, net	4,053	3,425
Profit before tax	124,541	114,097
Income tax expenses	(6,407)	(6,122)
Net profit	118,134	107,975

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Revenues. Revenues increased by 4.5% from RMB301.0 million for the third quarter of 2004 to RMB314.5 million for the fourth quarter of 2004. The following table sets forth our revenues by lines of business for the third quarter of 2004 and the fourth quarter of 2004:

	Three months ended			
	31 December 2004		30 September 2004	
	Amount RMB'000	% of total revenues	Amount RMB'000	% of total revenues
Internet value-added services	125,149	39.8%	109,393	36.4%
Mobile and telecommunications value-added services	168,664	53.6%	173,655	57.7%
Online advertising	17,744	5.6%	15,995	5.3%
Others	2,924	1.0%	1,943	0.6%
Total revenues	<u>314,481</u>	<u>100.0%</u>	<u>300,986</u>	<u>100.0%</u>



Revenues from our Internet value-added services increased by 14.4% from RMB109.4 million for the third quarter of 2004 to RMB125.1 million for the fourth quarter of 2004. The increase mainly reflected the healthy growth in our Internet value-added services, including the continuing success of avatars and the growth in our fairly new products and services, such as online games and “cyber hard disk” online data storing services. In addition, revenues from various newly launched products also contributed to our revenue growth. The increase was partially offset by a decrease in some of the more mature services, such as online dating and QQXing.

Revenues from our mobile and telecommunications value-added services decreased by 2.9%, from RMB173.7 million for the third quarter of 2004 to RMB168.7 million for the fourth quarter of 2004. The “cleaning up” of inactive customer accounts undertaken by mobile operators and the slowdown of mobile content industry in general negatively impacted our mobile IVR services, some of our mobile news and information content services and our music and picture/image downloading services. These decreases, however, were partially compensated by increased revenues from our ringback tones and mobile chat services.

Revenues from online advertising increased by 10.9%, from RMB16.0 million for the third quarter of 2004 to RMB17.7 million for the fourth quarter of 2004. The increase reflected the continued growth of our online advertising business offered through our IM platform and the QQ.com portal.

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Cost of revenues. Cost of revenues decreased by 0.5%, from RMB114.7 million in the third quarter of 2004 to RMB114.0 million in the fourth quarter of 2004. The decrease principally reflected the decrease in the amount of telecommunications operators' revenue share and imbalance fees. Content subscription costs, however, increased as we offered richer content. Expenses associated with our bandwidth capacity and servers also increased as we supported more bandwidth intensive services. In addition, staff costs increased as we recruited additional staff to support our broader range of products and services. As a percentage of revenues, cost of revenues decreased from 38.1% in the third quarter of 2004 to 36.3% in the fourth quarter of 2004. The following table sets forth our cost of revenues by lines of business for the third quarter of 2004 and the fourth quarter of 2004:

	Three months ended			
	31 December 2004		30 September 2004	
		% of		% of
	Amount	segment	Amount	segment
	revenues	revenues	revenues	
	RMB'000		RMB'000	
Internet value-added services	37,827	30.2%	38,570	35.3%
Mobile and telecommunications value-added services	68,144	40.4%	67,682	39.0%
Online advertising	5,216	29.4%	5,105	31.9%
Others	2,850	97.5%	3,295	169.6%
	<u>114,037</u>		<u>114,652</u>	
Total cost of revenues	<u>114,037</u>		<u>114,652</u>	

Cost of revenues for our Internet value-added services decreased by 1.9% from RMB38.6 million for the third quarter of 2004 to RMB37.8 million for the fourth quarter of 2004. The decrease mainly reflected the lower amount of fees paid to mobile operators for their share of revenues and imbalance fees as we gradually diversified some of our collection channels into non-mobile based channels and we incurred smaller imbalance fees as the volume of traffic imbalance decreased. These decreases were partially offset by increased expenses associated with our bandwidth capacity and servers as we supported more bandwidth intensive services and increased staff costs as we recruited additional staff to develop and support our new products and services.

Cost of revenues for our mobile and telecommunications value-added services increased by 0.7% from RMB67.7 million for the third quarter of 2004 to RMB68.1 million for the fourth quarter of 2004. Content sharing costs and staff costs continued to increase as we offered a broader range of products. However, the amount of fees retained by mobile operators for their share of revenues and imbalance fees decreased due to smaller imbalance fees as the volume of traffic imbalance decreased.

Cost of revenues for our online advertising increased slightly by 2.2% from RMB5.1 million for the third quarter of 2004 to RMB5.2 million for the fourth quarter of 2004. Sales commission paid to advertising agencies increased mainly due to our increased online advertising business volume.

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Other operating income, net. We recorded other operating income of RMB9.6 million in the fourth quarter of 2004 relating to a financial subsidy of RMB7.2 million received from the local government and fair value gains on financial instruments of RMB2.4 million. The financial subsidy was granted to us as part of the local government's efforts to promote development of the high-tech software business.

Selling and marketing expenses. Selling and marketing expenses increased by 14.7% from RMB27.5 million for the third quarter of 2004 to RMB31.5 million for the fourth quarter of 2004. The increase principally reflected increased promotional and advertising activities relating to our broader products and services portfolio and the higher staff costs relating to our expanded marketing staff. As a percentage of revenues, selling and marketing expenses increased from 9.1% in the third quarter of 2004 to 10.0% in the fourth quarter of 2004.

General and administrative expenses. General and administrative expenses increased by 16.9% from RMB49.6 million for the third quarter of 2004 to RMB58.0 million for the fourth quarter of 2004. The increase was mainly attributable to increased research and development expenses as we increased our research and development staff with an emphasis on online gaming, web portal and IM functionalities. Staff cost also increased as we recruited heavily to support our future growth. As a percentage of revenues, general and administrative expenses increased from 16.5% in the third quarter of 2004 to 18.4% in the fourth quarter of 2004.

Income tax expenses. We recorded profit taxes of RMB6.4million for the fourth quarter of 2004 compared to RMB6.1 million for the third quarter of 2004. The effective tax rate applicable for the fourth quarter of 2004 was 5.1%, only slightly lower than that for the third quarter of 2004.

Net profit. As a result of the factors discussed above, net profit increased by 9.4% from RMB108.0 million for the third quarter of 2004 to RMB118.1 million for the fourth quarter of 2004. Net margin for the period was 37.6% for the fourth quarter of 2004 compared to 35.9% for the third quarter of 2004.



LIQUIDITY AND FINANCIAL RESOURCES

In connection with the initial public offering, a total of 420,160,500 shares of HKD0.0001 each were issued at HKD3.70 each and were fully paid up in cash on 16 June 2004. In addition, on 8 July 2004, a total of 63,024,000 additional shares were issued at HKD3.70 each after the exercise of an over-allotment option in full and were fully paid up in cash. Our financial position significantly improved in the year ended 31 December 2004 as we received gross proceeds of RMB1,905.2 million from the initial public offering.

As of 31 December 2004, we had cash and cash equivalents of RMB859.8 million compared to RMB325.6 million as of 31 December 2003. A large portion of our cash has been held in deposits and investments denominated in U.S. dollars. As we have not used any means to hedge our exposure to foreign exchange risk, we may experience a loss as a result of any foreign currency exchange rate fluctuations in connection with our deposits and investments.

We had no interest-bearing borrowings as at 31 December 2004.

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OUTLOOK

In our core IM platform, we aim to continue to enrich the platform's functionalities to provide not only IM services, but also a whole range of value-added services to facilitate the interaction among our users and to provide entertainment to them. In the past year, we strengthened our IM platform, as demonstrated in the rapid growth in both our active user accounts and peak simultaneous users, and we will continue to focus on this area.

In our Internet value-added services, we intend to continue to grow our QQ Membership service by offering additional functionalities, such as an expanded version of our mail service, as well as performing targeted marketing to increase its still very low penetration among our users. We intend to further enrich the product offerings of our avatar service, which has been a significant revenue growth driver for us in recent quarters. We also intend to further extend the leadership of our QQ Game Portal, and to monetize such leadership by increasing fee-based subscriptions and game item purchases for the casual games. In addition, we plan to promote our advanced casual game, QQ Tang, aggressively and beta test our new MMOG in the next few months. We are targeting to generate new revenues from these games in the later part of 2005.



To further strengthen our email product offering, we agreed to acquire the developer of Foxmail, a leading email client software in China, in March 2005. We plan to leverage the technology and technical personnel acquired in the transaction to enhance its QQ email client, and to launch a compelling web mail service in future.

In view of the negative impacts on our mobile and telecommunications value-added services caused by the termination of 161 Mobile Chat fee sharing arrangement with China Mobile as well as the change in billing policy of our MMS revenue, we will strive to lessen such negative impacts by actively promoting our Mobile QQ and other existing services, enriching our 2.5G offerings and taking advantage of the growth potential of the PHS market.

In our online advertising business, we will continue to optimize our IM advertising to strike a better balance between growing advertising revenue and reducing disturbance to our IM users. We intend to attract more advertisers to QQ.com by developing more content targeted for various vertical industries, and strengthening its brand recognition as a premier destination portal for the young generation in China. We will also start advertising business in our QQ Game Portal. We expect to see strong growth in our online advertising business in 2005.

