MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Consolidated Financial Data

The summary consolidated financial data presented below as of and for the years ended December 31, 2002, 2003 and 2004 are derived from, and should be read in conjunction with, and are qualified in their entirety by reference to, the audited consolidated financial statements, including the related notes, included elsewhere in this annual report. The selected consolidated financial data as of December 31, 2000 and 2001, and for the period from April 3, 2000 (inception) through December 31, 2000 and for the year ended December 31, 2001 is derived from audited consolidated financial statements not included in this annual report. The summary consolidated financial data presented below has been prepared in accordance with United States generally accepted accounting principles.

	For the period from April 3, 2000 (inception) through December 31, 2000	For the year ended December 31,			
		2001	2002	2003	2004
	(in US$ thousands, except for per share and per ADS data)				
Income Statement Data:					
Sales	$—	$—	$50,315	$365,823	$974,665
Cost of sales(1)	—	—	105,238	363,241	721,401
Gross profit (loss)	—	—	(54,923)	2,582	253,264
Operating expenses:					
Research and development	—	9,326	37,459	32,070	78,167
General and administrative	929	16,870	17,782	27,912	46,015
Selling and marketing	—	751	4,371	9,447	8,130
Litigation settlement	—	—	—	—	23,153
Amortization of deferred stock compensation	—	712	1,769	5,900	15,416
Total operating expenses	929	27,659	61,381	75,329	170,881
Income (loss) from operations	(929)	(27,659)	(116,304)	(72,747)	82,383
Other income (expenses):					
Interest income	2,153	18,681	10,980	5,616	10,587
Interest expense	—	—	(176)	(1,425)	(13,698)
Foreign currency exchange gain	2	197	247	1,523	8,218
Other, net	—	187	2,650	888	2,441
Subsidy income	—	5,942	—	—	—
Total other income, net	2,155	25,007	13,701	6,602	7,547
Income (loss) before income tax	1,226	(2,652)	(102,603)	(66,145)	89,931
Income tax — current	—	—	—	—	186
Net income (loss)	1,226	(2,652)	(102,603)	(66,145)	89,745
Deemed dividend on preference shares(2)	—	—	—	37,117	18,839
Income (loss) attributable to holders of ordinary shares	$1,226	$(2,652)	$(102,603)	$(103,262)	$70,905
Income (loss) per share, basic	$0.02	$(0.03)	$(1.27)	$(1.14)	$0.01
Income (loss) per share, diluted	$0.02	$(0.03)	$(1.27)	$(1.14)	$0.00
Shares used in calculating basic income (loss) per share(3)(4)	80,000,000	80,000,000	80,535,800	90,983,200	14,199,164,517
Shares used in calculating diluted income (loss) per share(3)(4)	80,000,000	80,000,000	80,535,800	90,983,200	17,934,393,066

(1) Including amortization of deferred stock compensation for employees directly involved in manufacturing activities.

(2) Deemed dividend represents the difference between the sale and conversion prices of warrants to purchase convertible preference shares we issued and their respective fair market values.

(3) Anti-dilutive preference shares, options and warrants were excluded from the weighted average ordinary shares outstanding for the diluted per share calculation. For 2000, 2001, 2002 and 2003, basic income (loss) per share did not differ from diluted loss per share.

(4) All share information have been adjusted retroactively to reflect the 10-for-1 share split effected upon completion of the Global Offering.

	As of December 31,				
	2000	2001	2002	2003	2004
	(in US$ thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$94,290	$178,920	$91,864	$445,276	$607,173
Short-term investments	—	—	27,709	27,165	20,364
Accounts receivable, net of allowances	—	—	20,110	90,539	169,188
Inventories	—	4,749	39,826	69,924	144,018
Total current assets	102,949	235,196	185,067	680,882	955,418
Land use rights, net	—	48,913	49,354	41,935	39,198
Plant and equipment, net	14,284	478,950	1,290,910	1,523,564	3,311,925
Total assets	117,233	763,059	1,540,078	2,290,506	4,384,276
Total current liabilities	115,965	249,071	263,655	325,430	730,330
Total long-term liabilities	—	—	405,432	479,961	544,462
Total liabilities	115,965	249,071	669,087	805,391	1,274,792
Stockholders' equity	$1,268	$513,988	$870,991	$1,485,115	$3,109,484

	For the year ended December 31,				
	2000	2001	2002	2003	2004
	(in US$ thousands, except percentages and operating data)				
Cash Flow Data:					
Net income (loss)	$1,226	$(2,652)	$(102,603)	$(66,145)	$89,745
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:					
Depreciation and amortization	10	1,445	84,537	233,905	456,961
Net cash provided by (used in) operating activities	904	3,360	(48,802)	114,270	518,662
Purchases of plant and equipment	(9,774)	(459,779)	(761,704)	(453,097)	(1,838,773)
Net cash used in investing activities	(17,774)	(501,779)	(751,144)	(454,498)	(1,826,787)
Net cash provided by financing activities	111,120	583,152	712,925	693,497	1,469,764
Net increase (decrease) in cash and cash equivalents	$94,290	$84,630	$(87,056)	$353,412	$161,896
Other Financial Data:					
Gross margin	—	—	(109.2%)	0.7%	26.0%
Operating margin	—	—	(231.2%)	(19.9)%	8.5%
Net margin	—	—	(203.9%)	(18.1)%	9.2%
Operating Data:					
Wafers shipped (in units):					
Logic(1)	—	—	26,419	188,316	597,533
Total(2)	—	—	82,486	476,451	943,463
Average selling price (in US$):					
Logic(1)	—	—	$794	$896	$1,066
Total(2)	—	—	$558	$733	$979

(1) Excluding copper interconnects and DRAM wafers.

(2) Including logic, DRAM, copper interconnects and all other wafers.

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

Sales. Sales increased by 166.4% from US$365.8 million for 2003 to US$974.7 million for 2004, primarily as a result of the increase in the Company's manufacturing capacity and ability to use such capacity to increase sales. The number of wafers the Company shipped increased by 98.0%, from 476,451 8-inch wafer equivalents to 943,463 8-inch wafer equivalents, between these two periods. The average selling price of the wafers the Company shipped also increased by 33.5% from US$733 per wafer to US$979 per wafer, while the average selling price of the logic wafers the Company shipped increased by 19.0% from US$896 per wafer to US$1,066 per wafer. The percentage of wafers shipped that used 0.18 micron and below process technology also increased from 43.6% to 68.5% between these two periods.

Cost of sales and gross profit (loss). Cost of sales increased by 98.6% from US$363.2 million for 2003 to US$721.4 million for 2004. This increase was primarily due to the significant increase in sales volume, manufacturing labor expenses and depreciation. Other factors included an increase in the amount of direct and indirect materials purchased corresponding to the increase in wafers shipped. In addition, deferred stock compensation expenses relating to employees involved in the manufacturing of wafers increased to US$11.6 million in 2004 from US$5.5 million in 2003, primarily due to additional stock options granted and restricted share units awarded to new and existing employees involved in this activity. The Company amortizes the deferred stock compensation expense using the straight-line method over the applicable vesting periods, which is typically four years.

The Company had gross profit of US$253.3 million for 2004 compared to gross profit of US$2.6 million in 2003. Gross margins improved to 26.0% in 2004 from 0.7% in 2003. The increase in gross margins was primarily due to an increase in the average selling price per wafer, a shift in production to more logic and less DRAM wafers, migration towards more advanced and higher margin process technology and a lower average cost per wafer resulting from the ability to leverage fixed costs over a greater number of wafers manufactured.

Operating expenses and loss from operations. Operating expenses increased by 126.8% from US$75.3 million for 2003 to US$170.9 million for 2004 due to the increase in research and development expenses, general and administrative expenses, amortization of deferred stock compensation and the litigation settlement.

Research and development expenses increased by 143.7% from US$32.1 million for 2003 to US$78.2 million for 2004. This increase in research and development expenses resulted primarily from non-recurring startup engineering costs associated with the ramp-up of Fab 4 and the commencement of commercial production at Fab 7, 90 nanometer research and development activities and an increase in depreciation and amortization expenses.

Furthermore, as a part of the settlement with TSMC, the Company has allocated US$23.2 million of the total settlement amount to litigation settlement costs in 2004.

General and administrative expenses increased by 64.9% to US$46.0 million for 2004 from US$27.9 million for 2003, primarily due to an increase in personnel and legal fees.

Selling and marketing expenses decreased by 13.9% from US$9.4 million for 2003 to US$8.1 million for 2004, primarily due to a decrease in engineering material costs relating to sales activities.

In addition, the Company's deferred stock compensation expenses relating to employees involved in research and development, general and administrative and selling and marketing increased from US$5.9 million to US$15.4 million between these periods, primarily due to additional stock options granted and restricted share units awarded to new and existing employees involved in these activities. The Company amortizes the deferred stock compensation expense over the applicable resting periods, which is typically four years.

As a result, the Company's income from operations increased to US$82.4 million in 2004 from a loss of US$72.7 million in 2003. Operating margin was 8.5% and negative 19.9%, respectively, for these two years.

Other income (expenses). Other income (expenses) increased 14.3% from US$6.6 million in 2003 to US$7.5 million in 2004. This increase was primarily attributable to the increase in interest income from US$5.6 million in 2003 to US$10.6 million in 2004. This interest income was primarily derived from bank deposits on the proceeds received from the Global Offering. The foreign currency exchange gains increased from US$1.5 million in 2003 to US$8.2 million in 2004.

Net income (loss). Due to the factors described above, the Company had net income of US$89.7 million in 2004 compared to a net loss of US$66.1 million for 2003.

Deemed dividends on preference shares. In 2004, the Company recorded aggregate deemed dividends on preference shares of US$18.8 million, representing the difference between the sale and conversion price of a warrant to purchase Series D convertible preference shares issued in the first quarter of 2004 and their respective fair market values.

In 2003, the Company recorded deemed dividends on preference shares of US$35.2 million, representing the difference between the sale and conversion prices of warrants to purchase Series C convertible preference shares the Company issued in the third and fourth quarters of 2003 and their respective fair market values. The Company also recorded deemed dividends on preference shares of US$1.9 million in 2003, representing the difference between the sale and conversion prices of a warrant to purchase Series D convertible preference shares the Company issued in the fourth quarter of 2003 and their respective fair market values. All of these warrants expired unexercised upon the completion of the Global Offering.

Bad debt provision. The Company determines its bad debt provision based on the Company's historical experience and the relative aging of receivables. The Company provides bad debt provision based on the age category of receivables. A fixed percentage of the total amount receivable is applicable to receivables in each past due age category, ranging from 1% for the shortest past due age category to 100% for the longest past due age category. Any receivables deemed non-collectible will be written off against the relevant amount of provision. The Company's bad debt provision made (reversed) in 2002, 2003, and 2004 amounted to US$0.2 million, US$(0.1 million) and US$1.0 million, respectively. The Company reviews, analyzes and adjusts bad debt provisions on a monthly basis.

Debt Arrangements

Set forth in the table below are the aggregate amounts, as of December 31, 2004, of the Company's future cash payment obligations under the Company's existing debt arrangements on a consolidated basis:

	Payments due by period				
Debt obligations	**Total**	**Less than 1 year**	**1–2 years**	**3–5 years**	**After 5 years**
	(consolidated) (in US$ thousands)				
Short-term debt	$91,000	$91,000	$—	$—	$—
Long-term debt					
Secured long-term loans	736,448	191,986	265,267	279,195	—
Total debt obligations	$827,448	$282,986	$265,267	$279,195	$—

As of December 31, 2004, the Company's outstanding long-term liabilities primarily consisted of US$736.5 million in secured bank loans, which are repayable in installments commencing in March 2005, with the last payment in March 2009.

In December 2001, Semiconductor Manufacturing International (Shanghai) Corporation ("SMIC Shanghai"), the Company's wholly foreign-owned enterprise, entered into a long-term loan agreement with a syndicate of Chinese banks for US$432.0 million. The drawdown period of the facility is 18 months starting from the loan agreement date. As of December 31, 2004, we had drawn down the full amount. The interest rates on the loan ranged from 2.82% to 4.34% in 2004. Interest is due on a semi-annual basis. The principal amount is repayable starting in March 2005 in five semi-annual installments of US$86.4 million each. The interest expenses incurred in 2004, 2003 and 2002 were US$14.0 million, US$12.3 million and US$6.6 million, respectively, a significant portion of which was capitalized as additions to assets under construction.

As part of the same long-term loan arrangement, SMIC Shanghai has a line of credit in Renminbi equivalent to US$48.0 million. As of December 31, 2004, SMIC Shanghai had fully drawn down this line of credit. The principal amount is repayable starting in March 2005 in five semi-annual installments of US$9.6 million each. The interest rate on the loan was 5.02% in 2004. The interest expenses incurred in 2004, 2003 and 2002 were US$2.5 million, US$2.4 million and US$0.4 million, respectively, a significant portion of which was capitalized as additions to the assets under construction.

These long-term loan agreements contained certain financial covenants which were superseded by the financial covenants set forth in SMIC Shanghai's long-term agreements from January 2004 as described below.

In January 2004, SMIC Shanghai entered into two long-term loan agreements with four Chinese banks for US$256.5 million and Rmb 235.7 million (equivalent to approximately US$28.5 million), respectively. The drawdown period of these facilities ends on the earliest of (i) twelve months after the date of the first drawdown, (ii) March 28, 2005 and (iii) the date on which the loans have been fully drawn down. As of December 31, 2004, SMIC Shanghai had drawn down the full amount of the US dollar facility while the Rmb facility has yet to be drawn. The interest rates on the loan ranged from 2.75% to 4.34% in 2004. The principal amount of the US dollar facility is repayable starting in March 2006 in seven semi-annual installments of US$36.6 million each. The interest expense incurred in 2004 in connection with the US dollar facility was US$3.9 million.

The financial covenants contained in the two long-term loan agreements from January 2004 supersede the financial covenants contained in the long-term loan agreement from December 2001. Any of the following would constitute an event of default for SMIC Shanghai beginning in March 2005, when the first payment of the loan from December 2001 is repayable:

- Total liability — borrowings from shareholders, including principal and interest/Total assets > 65%
- Current assets — inventory/Current liabilities < 100%;
- Total liability/EBITDA > 2.98;
- (Funds available for loan repayment in current year + Funds available for loan repayment in prior year); and
- Repayment amount during current year < 2.5.

Any of the following would constitute an event of default for SMIC Shanghai during the term of either of the two long-term loan agreements:

- Incurrence of any losses in 2005;
- Incurrence of losses in 2006 in excess of US$21.9 million;
- Incurrence of cumulative losses in 2007 in excess of US$62.6 million;
- Incurrence of any losses in 2008; or
- Incurrence of research and development costs in any given year in excess of 15% of revenue for that year.

These five-year bank loans will be used to expand the capacity of the fabs in Shanghai and are collateralized by the Shanghai fabs and equipment.

As of December 31, 2004, the Company had an aggregate of US$253 million in bank loans available to it through short-term loan facilities from seven different banks. As of December 31, 2004, the Company had drawn down on US$91.0 million. Approximately 27%, 38% and 35% were made available to Semiconductor Manufacturing International (Beijing) Corporation ("SMIC Beijing"), Semiconductor Manufacturing International (Tianjin) Corporation ("SMIC Tianjin") and the Company, respectively.

The Company has accepted promissory notes from employees exercising options to purchase either ordinary shares or Series A convertible preference shares under the Company's 2001 employee stock option plans (the "Stock Option Plans"). At December 31, 2004, 2003 and 2002, the Company had notes receivable from employees related to the early exercise of employee stock options in the aggregate amount of $391,375, $36,026,073 and $36,994,608, respectively. In 2004, the Company collected $35,245,774 through the repayment of notes receivable by certain employees and the sale of the notes receivable to a third party bank. The notes are full recourse and are secured by the underlying ordinary shares and preference shares. The notes are due at various dates from year 2006 to 2008 and payable at varying rates from 3.02% to 4.28% per annum.

Capitalized Interest

Interest cost incurred on funds used to construct plant and equipment during the active construction period is capitalized, net of government subsidies received. The interest capitalized is determined by applying the borrowing interest rate to the average amount of accumulated capital expenditures for the assets under construction during the period. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful life of the assets. Capitalized interest of US$7.5 million, US$7.1 million and US$0.4 million net of government subsidies of US$nil, US$7.2 million and US$7.2 million in 2004, 2003 and 2002, respectively, has been added to the cost of the underlying assets during the year and is amortized over the respective useful life of the assets. In 2004, 2003 and 2002, the Company recorded amortization expenses relating to the capitalized interest of US$1.7 million, US$0.3 million and US$nil, respectively.

Commitments

As of December 31, 2004, the Company had commitments of US$7.0 million to purchase land use rights for the living quarters at SMIC Beijing, US$127.0 million for facilities construction obligations for the Beijing, Tianjin and Shanghai fabs and US$419.0 million to purchase machinery and equipment for the Beijing, Tianjin and Shanghai fabs.

Major Acquisition

In September 2003, the Company entered into agreements with Motorola, Inc. ("Motorola") and its wholly owned subsidiary, Motorola (China) Electronics Limited ("MCEL"), providing for the Company's acquisition of the assets constituting a fab in Tianjin, the assumption of certain obligations, the transfer of certain technology to the Company from Motorola, the Company's exchange of certain licenses with Motorola, the provision by Motorola of US$30 million in cash to the Company and the Company's issuance to Motorola and MCEL of the Company's Series D convertible preference shares and warrants to purchase Series D convertible preference shares in exchange for the foregoing. Upon completion of these transactions, which occurred in January 2004, Motorola, together with MCEL, became the beneficial owner of more than 10% of the ordinary shares of the Company ("Ordinary Shares") outstanding and issuable upon conversion of outstanding preference shares and Motorola became entitled to appoint a director to the Board (a "Director"). Motorola's right to appoint a Director terminated upon the completion of the Global Offering.

In connection with this acquisition, the Company entered into certain intellectual property agreements with Motorola. Under these agreements, the Company and Motorola each granted to the other a five-year license to certain specified patents. The Company also agreed to license from Motorola certain intellectual property relating to certain CMOS process technology. In connection with the closing of the transactions described above, the Company also entered into a semiconductor foundry agreement with Motorola to provide wafer fabrication and associated services to Motorola. Under this agreement, Motorola has agreed to use good faith efforts to purchase a minimum number of wafers per month over a fifteen-month period, provided that the Company meets applicable production and quality standards. In addition to the agreements described above, the Company, Motorola and MCEL have entered into several ancillary agreements relating to the acquisition. These agreements relate to, among other things, transition services to be provided to the Company by MCEL to assist in transitioning the Tianjin fab's operations to the Company and long-term services to be provided between the Company and MCEL. The Company and MCEL have also executed a real property transfer agreement providing for the transfer of MCEL's real property rights associated with the Tianjin fab to the Company. Motorola has also agreed to guarantee the indemnification obligations of MCEL under the asset purchase agreement.

Foreign Exchange Rate Fluctuation Risk

The Company's revenue, expense, and capital expenditures are primarily transacted in U.S. dollars. However, since the Company has operations consisting of manufacturing, sales and purchasing activities outside of the U.S., the Company enters into transactions in other currencies. The Company is primarily exposed to changes in exchange rate for the Euro, Japanese Yen, and Rmb.

To minimize these risks, the Company purchases foreign-currency forward exchange contracts with contract terms normally lasting less than six months to protect against the adverse effect that exchange rate fluctuations may have on foreign-currency denominated activities. These forward exchange contracts are principally denominated in Rmb, Japanese Yen or Euros and do not qualify for hedge accounting in accordance with SFAS No. 133.

Outstanding Foreign Exchange Contracts

As of December 31, 2004, the Company had outstanding foreign currency forward exchange contracts with notional amounts of US$61.0 million. Notional amounts are stated in the U.S. dollar equivalents at spot exchange rates as of the respective dates. As of December 31, 2004, the fair value of foreign currency forward exchange contracts was approximately a loss of US$0.3 million, which is recorded in accrued expenses and other current liabilities. We had US$133.0 million of foreign currency exchange contracts outstanding as of December 31, 2003, all of which matured during the first ten months of 2004.

The Company had US$43.1 million of foreign currency exchange contracts outstanding as of December 31, 2002, all of which matured during the first nine months of 2003.

The Company does not enter into foreign currency exchange contracts for speculative purposes.

	As of December 31, 2004 Expected maturity date (in US$ thousands)	
	2005	**Fair Value**
Forward Exchange Agreement		
(Receive JPY/Pay US$)		
Contract Amount	**28,111**	**211.25**
Average Contractual Exchange Rate	**109.073**	**103.72**
(Receive Euro/Pay US$)		
Contract Amount	**27,313**	**(117.29)**
Average Contractual Exchange Rate	**1.2499**	**1.3628**
(Receive US$/Pay Rmb)		
Contract Amount	**5,610**	**(377.30)**
Average Contractual Exchange Rate	**6.6326**	**8.2764**
Total Contract Amount	**61,034**	**(283.34)**

Interest Rate Risk

The Company's exposure to interest rate risks relates primarily to the Company's long-term debt obligations, which the Company generally assumes to fund capital expenditures and working capital requirements. The table below presents annual principal amounts due and related weighted average implied forward interest rates by year of maturity for the Company's debt obligations outstanding as of December 31, 2004. The Company's long-term debt obligations are all subject to variable interest rates. The interest rates on the Company's U.S. dollar-denominated loans are linked to the LIBOR rate, while the Company's Rmb-denominated loans have interest rates linked to the rates determined by the People's Bank of China. As a result, the interest rates on the Company's loans are subject to fluctuations in the underlying interest rates to which they are linked. The Company has not entered into any interest rate hedging contracts.

	As of December 31,			
	2005	**2006**	**2007**	**2008**
	(Forecast) (in US$ thousands, except percentages)			
Redeemable promissory notes				
Average balance	—	—	—	—
Average interest rate	—	—	—	—
US$ denominated				
Average balance	515,662	269,602	109,921	36,640
Average interest rate	5.2%	5.6%	5.9%	6.3%
Rmb denominated				
Average balance	28,800	9,593	—	—
Average interest rate	5.3%	5.8%	—	—
Weighted average forward interest rate	5.2%	5.6%	5.9%	6.3%

As of December 31, 2004, the Company did not have any material contingent liabilities.

Pre-emptive Rights

There are no provisions for pre-emptive rights in the articles of association of the Company (the "Articles") requiring the Company to offer new shares to the existing shareholders in proportion to their shareholdings.