Management Discussion and Analysis of Financial Position and Operating Results

The following discussion should be read in conjunction with the Group's consolidated financial statements and notes thereto set out in this annual report and other sections.

OVERVIEW

For the year ended 31 December 2004, the Group recorded profit before taxation of RMB230 million, representing a decrease of 69.93% from that of 2003. Profit for the year amounted to RMB71 million, representing a decrease of 84.29% from that of 2003. The decrease in profit for the year was mainly attributable to the decrease in profit generated from the Group's automobile business.

For the year ended 31 December 2004, the Group's earnings per share was RMB0.015.

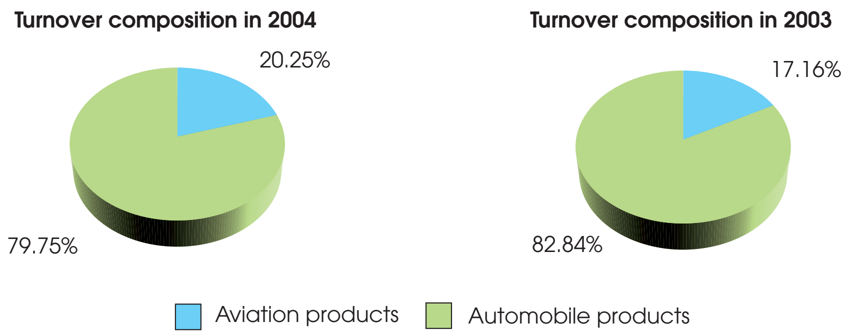
The following table shows the comparison between the years ended 31 December 2004 and 2003:

CONSOLIDATED OPERATING RESULTS

- Consolidated profit and loss

	Year ended 31 December		
RMB million	**2004**	2003	Change
Turnover	**12,877**	15,066	(14.53%)
of which: automobile segment	**10,269**	12,481	(17.72%)
aviation segment	**2,608**	2,585	0.89%
Cost of sales	**(10,948)**	(12,414)	(11.81%)
of which: automobile segment	**(8,846)**	(10,354)	(14.56%)
aviation segment	**(2,102)**	(2,060)	2.04%
Other revenues	**57**	85	(32.94%)
Selling and distribution expenses	**(573)**	(831)	(31.05%)
General and administrative expenses	**(1,026)**	(950)	8.00%
Other operating income	**—**	32	(100%)
Operating profit	**387**	988	(60.83%)
Finance costs, net	**(171)**	(210)	(18.57%)
Share of results of associates before taxation	**14**	(13)	207.69%
Profit before taxation	**230**	765	(69.93%)
Income tax	**(93)**	(61)	52.46%
Minority interests	**(66)**	(252)	(73.81%)
Profit for the year	**71**	452	(84.29%)

1. Composition of turnover



The Group's turnover for 2004 was RMB12,877 million, representing a decrease of 14.53% from RMB15,066 million in 2003. The decrease was mainly attributable to the decrease in both selling price and sales volume of automobile products during the year. The turnover of automobile products amounted to RMB10,269 million, accounting for 79.75% of the total turnover and representing a decrease of 17.72% from that of 2003; the turnover of aviation products amounted to RMB2,608 million, accounting for 20.25% of the total turnover and representing an increase of 0.89% over that of 2003.

As shown in the charts above, the aviation products component in the total turnover in 2004 increased by about 3 percentage points over that of 2003.

The Group was mainly operating in the PRC from where a majority of the turnover was generated.

2. Selling and distribution expenses

The Group's selling and distribution expenses for 2004 amounted to RMB573 million, representing a decrease of RMB258 million (31.05%) from that of 2003. The decrease was mainly attributable to the decrease in the transportation expenses, sales commissions, and after-sale service fees in respect of automobile products resulted from a drop in the sales volume of automobile products.

3. Administrative expenses

The Group's administrative expenses for 2004 amounted to RMB1,026 million, representing an increase of 8% over that of 2003.

4. Operating profit

The Group's operating profit for 2004 amounted to RMB387 million, representing a decrease of RMB601 million (60.83%) from that of 2003 which decrease was mainly due to the slip in the results of the automobile business.

5. Finance costs, net

The Group's net finance costs amounted to RMB171 million, representing a decrease of RMB39 million (18.57%) from that of 2003, among which net exchange losses decreased by RMB25 million (45.45%) due to the effect from fluctuation of exchange rates.

6. Taxation

The Group's income tax for the year was RMB93 million, representing an increase of 52.46% over RMB61 million in 2003. Details of taxation are set out in note 8 to the financial statements.

7. Minority interests

The Group's minority interests for the year decreased by 73.81% from RMB252 million in 2003 to RMB66 million, which was mainly attributable to the substantial decrease in profits of the Group's certain non-wholly owned subsidiaries in 2004 from that of 2003.

- Assets, liabilities and equity

	As at 31 December		
RMB million	**2004**	2003	Changes
Current assets	**11,384**	13,150	(1,766)
Non-current assets	**8,432**	7,651	781
Total assets	**19,816**	20,801	(985)
Current liabilities	**10,151**	10,657	(506)
Non-current liabilities	**1,627**	2,125	(498)
Total liabilities	**11,778**	12,782	(1,004)
Share capital	**4,644**	4,644	—
Reserves	**452**	380	72
Proposed final dividends	**—**	49	(49)
Shareholders' equity	**5,096**	5,073	23
Minority interests	**2,942**	2,946	(4)

As at 31 December 2004, the Group's total assets amounted to RMB19,816 million, total liabilities amounted to RMB11,778 million whereas minority interests and shareholders' equity amounted to RMB2,942 million and RMB5,096 million respectively.

1. Total assets

Total assets decreased by RMB985 million from that of 2003 which was mainly attributable to the decrease of the current assets. Current assets of the year decreased by RMB1,766 million from that of 2003, among which accounts receivable decreased by RMB910 million which was mainly due to the decrease in the sales while the credit policy of the Group had remained the same during the year; term deposits with initial term of over three months decreased by RMB1,200 million which was mainly due to the fact that part of the proceeds generated from the initial public offering of the Company's H-shares which were previously deposited in banks as term deposits had been changed as current deposits and used in certain projects as planned in 2004.

2. **Liabilities**

Total liabilities decreased by RMB1,004 million (7.85%) from that of 2003, among which the current liabilities decreased by RMB506 million and the non-current liabilities decreased by RMB498 million which decrease was mainly attributable to the decrease in long-term borrowings.

3. **Guaranteed and secured loans**

As at 31 December 2004, the Group's total borrowings amounted to RMB5,356 million, of which RMB524 million was secured by properties, machinery and equipment, with a net book value of RMB424 million.

Guaranteed borrowings amounted to RMB3,763 million, of which RMB2,650 million was cross guaranteed amongst the subsidiaries of the Group, RMB167 million was guaranteed by third parties. Guarantees provided by AVIC II and its subsidiaries have been released except for a sum of RMB946 million the release of which is under way.

4. **Shareholders' equity**

Shareholders' equity in 2004 amounted to RMB5,096 million, representing an increase of RMB23 million over that of 2003. Details are set out in the statement of changes of the shareholders' equity and note 35 and note 36 to the financial statements.

5. **Development costs**

Due to the intense competition in the domestic automobile market, new vehicle models of advanced technology need to be launched in a more rapid pace. The Group had strengthened its research and development capability in automobile products during the year, thereby incurring research and development expenditure of RMB303 million for the year, to help the Group face the market competition, increase the gross margin and enhance the competitiveness of its products.

6. **Exchange risks**

The Group had a substantial amount of loans denominated in Euro, United States Dollar and Japanese Yen due to its operating needs, and the Company had some deposits in Hong Kong Dollar raised from the public offering. Fluctuation of exchange rates has brought about certain exchange risks to the Group. Details are set out in note 40(a(i)) to the financial statements.

7. Contingent liabilities and guarantees

As at 31 December 2004, the Group had not provided any guarantees for third party and did not have any significant contingent liabilities.

- Cash Flow

1. Liquidity and capital resources

As at 31 December 2004, the Group's cash and cash equivalents amounted to RMB2,558 million which was mainly derived from the following:

- cash and bank deposits at the beginning of the year;
- funds generated from its operations; and
- new bank borrowings

The Group's cash flows for the years 2004 and 2003 were as follows:

Unit: RMB million

Main items of cash flow	**2004**	2003	Fluctuation (amount)	Fluctuation (percentage)
Net cash flows generated from operating activities	**554**	385	169	43.90%
Net cash flows used in investing activities	**(185)**	(3,419)	3,234	(94.59%)
Net cash flows (used in)/generated from financing activities	**(395)**	3,145	(3,540)	(112.56%)
Net (decrease)/increase in cash and cash equivalents	**(26)**	111	(137)	(123.42%)

2. Operating activities

Net cash flows generated from operating activities for the year amounted to RMB554 million, representing an increase of RMB169 million over that of 2003. Details are set out in note 37(a) to the financial statements.

3. Investing activities

Net cash flows used in investing activities for the year amounted to RMB185 million, representing a decrease of RMB3,234 million from that of 2003, among which the increment of term deposits with initial term over three months dropped by RMB2,948 million from that in 2003.

4. **Financing activities**

Net cash flows generated from financing activities for the year amounted to RMB395 million, representing a decrease of RMB3,540 million from that of 2003. The main reason was that the Company was listed on 30 October 2003, while in 2004 the Company did not have any such financing activities.

As at 31 December 2004, the Group's total borrowings amounted to RMB5,356 million, of which current borrowings, non-current borrowings due within one year and non-current borrowings due over one year amounted to RMB3,898 million, RMB516 million and RMB942 million respectively.

The Group's non-current borrowings are repayable as follows:

Maturity	RMB million
Within one year	516
In the second year	419
In the third to fifth year	511
After the fifth year	12
Total	1,458

As at 31 December 2004, the Group's bank borrowings amounted to RMB5,311 million with an average interest rate of 4.71%, representing 99.16% of the total borrowings. Other borrowings amounted to RMB45 million with an average interest rate of 1.75%, representing 0.84% of the total borrowings.

As at 31 December 2004, the Group's borrowings denominated in foreign currencies amounted to RMB749 million, representing 13.98% of the total borrowings, of which borrowings denominated in United States dollars, Euro and Japanese Yen amounted to US$25 million, Euro33 million and Yen2,198 million respectively.

- Gearing Ratio

As at 31 December 2004, the Group's gearing ratio was 27.03% (2003: 26%), which was arrived at by dividing the total borrowings by total assets as at 31 December 2004.

SEGMENT INFORMATION

The Group's principal operations are divided into two segments, namely the automobile segment and the aviation segment.

Management Discussion and Analysis of Financial Position and Operating Results

AUTOMOBILE SEGMENT

Major statistics of automobile operation

	Year ended 31 December							
	2004				2003			
RMB million	Sales volume (units)	Sales revenue	Cost of sales	Gross margin (%)	Sales volume (units)	Sales revenue	Cost of sales	Gross margin (%)
Automobile products in total	—	10,269	8,846	13.86%	—	12,481	10,354	17.04%
Entire vehicles in total	297,603	8,765	7,614	13.13%	326,814	10,700	8,874	17.07%
Mini-vans and mini-trucks	244,666	6,334	5,533	12.65%	253,466	6,779	5,620	17.10%
Economy sedans	52,937	2,431	2,081	14.40%	73,348	3,921	3,254	17.01%
Others	—	1,504	1,232	18.09%	—	1,781	1,480	16.90%

Review on China's Automobile Market in 2004

In 2004 there were relatively more new policies and regulations promulgated for the China automobile industry which were to direct the growth of the automobile industry in a fast and harmonious manner and to solve the emerging conflicts between the automobile sector and the energy sector and those between the automobile sector and the environment. In 2004 the automobile industry in China ended the "blowout" style growth in the past two years and stepped into a steady development stage through market adjustment. The national volume of production and sales in 2004 were 5,070,500 and 5,071,100 respectively, representing an increase of 14.11% and 15.50% over that of 2003 respectively. Among that the volume of production and sales of sedans amounted to 2,316,300 and 2,326,500 respectively, representing an increase of 11.99% and 15.17% over that of 2003 respectively; the volume of production and sales of mini-vans were 757,800 and 742,100 respectively, representing an increase of 11.68% and 6.71% over that of 2003 respectively; the increase in sales of mini-trucks was at a speed of 24.96%. (Source: China Automobile Industry Newsletter of Production and Sales)

In 2004, the sales revenue in China's automobile industry has maintained the growth momentum, but the overall profitability of the automobile products dropped due to a general decrease in vehicle selling prices and increase in domestic raw material prices, such as steel.

Review on the Group's Automobile Business In 2004

Facing the rise in material prices of automobile products and the intense competition in the automobile market, the management of the Group had further integrated its business and sped up enterprise reformation process to build a solid foundation for the development of the Group's automobile business in future.

1. *Integration of the Group's business achieved remarkable results*

   The integration of subsidiaries in automobile business and engine business took effect through the acquisition of the entire equity interest in Hafei Auto by Dongan Motor. Through setting up Automobile Business Department, adjustments have been made to the Company's administration as well as the management of the subsidiaries engaging in automobile business and there has been in place the centralization of decision making, planning and development, purchasing, marketing and international cooperation, thereby achieving the goal of resources sharing and cost cutting.

2. *Achievements in products' research and development*

   Several new vehicle models had been put into production last year. A new model of "Zhongyi" series, "Xinyi", had been launched in 2004. The design of the double-row truck of "Zhongyi" series had been completed, which will soon be put into production in small quantities. The new sedan "Saibao" has been launched in early 2005. The research and development of new sedan "Liana" had made good progress, and it has been scheduled to be launched in 2005. The development of other new models and improved models has progressed as planned.

3. *Construction of new production lines has made good progress*

   The Group started to establish a production line mainly for sedans with engine capacity over 1.6 litres in Shenzhen, which is under construction as planned.

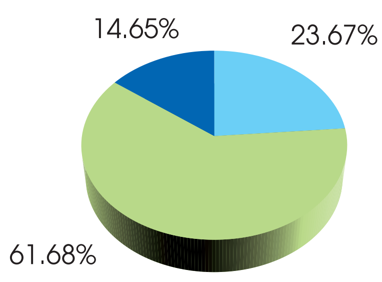
   The Jiujiang Production lines in Jiangxi province for vehicles and vehicle engines have been constructed as planned. The lines have been fitted and are currently under test. They are expected to be completed and put into use by the end of 2005.

   Upon completion of all the above mentioned projects, the Group's automobile business will be further strengthened in that its production capability will be increased and the range of automobile products will be expanded, and a solid foundation will be built for the future development of the Group.

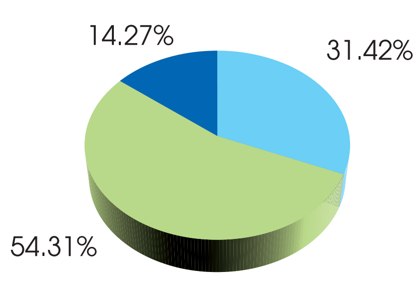
SALES REVENUE

Composition of sales revenue from automobile segment

Sales revenue from automobiles segment in 2004



Sales revenue from automobiles segment in 2003



Economy sedans Mini vans and trucks Other automobile products

Management Discussion and Analysis of Financial Position and Operating Results

The Group's sales of automobile products for 2004 amounted to RMB10,269 million, of which the sales of vehicles accounted for RMB8,765 million, representing a decrease of RMB1,935 million from that of 2003. The decrease was mainly attributable to the sharp decrease in sales volume of economy sedans of relatively high unit price coupled with the drop in automobile products' prices. The main reason for the drop in the sales volume of the economy sedans was due to the intense competition in the automobile market. In 2005, the Group will take measures to strengthen its brand awareness, sales network and sales strategy according to the market trend.

As shown in the charts above, there was a change in the composition of the Group's automobile products in 2004 from that of 2003. The sales of economy sedans in 2004 accounted for 23.67% of the sales from automobile segment, representing a decrease of 7.75 percentage points from 31.42% in 2003; the sales of mini-vans and mini-trucks in 2004 accounted for 61.68% of the sales from automobile segment, representing an increase of 7.37 percentage points from 54.31% in 2003; the sales of other automobile products in 2004 accounted for 14.65% of the sales from automobile segment, which was almost the same as that in 2003.

COST OF SALES

Cost of sales of the Group's automobile products for 2004 amounted to RMB8,846 million, of which cost of sales of vehicles decreased to RMB7,614 million in 2004 from RMB8,874 million in 2003. The decrease was mainly attributable to the drop in the sales volume during the year as compared with that of 2003.

GROSS MARGIN

Gross margin of the Group's automobile products for 2004 was 13.86%, representing a decrease of approximately 3.18 percentage points from that of 2003. The decrease was mainly attributable to the price cut made by many automobile manufacturers, including the Group, in order to retain and increase market share in the highly competitive domestic automobile market. In addition, prices of raw materials such as steel soared in 2004. Despite the effective measures taken by the Group to lower the costs, the extent of decrease in cost was insufficient to offset the drop in sales revenue, resulting in the decrease in the gross margin.

AVIATION SEGMENT

Major statistics of aviation operation

	Year ended 31 December							
	2004				2003			
RMB million	**Sales volume (units)**	**Sales revenue**	**Cost of sales**	**Gross margin**	Sales volume (units)	Sales revenue	Cost of sales	Gross margin
Aviation products in total	**75**	**2,608**	**2,102**	**19.40%**	67	2,585	2,060	20.31%
Helicopters	**26**	**1,142**	**962**	**15.76%**	22	885	694	21.58%
Trainers	**46**	**561**	**462**	**17.65%**	35	555	459	17.30%
General purpose aeroplanes	**3**	**59**	**57**	**3.39%**	10	43	48	-11.63%
Aviation parts and components	**—**	**684**	**507**	**25.88%**	—	959	748	22.00%
Others	**—**	**162**	**114**	**29.63%**	—	143	111	22.38%

Review on China's Civil Aviation Market in 2004

The PRC economic growth maintained its rapid pace in 2004, which in turn boosted the growth of the civil air transportation industry. According to the statistics published by CAAC on 17 February 2005, as at the end of 2004, there were 133 cities in China which had established regular flights, with an annual passenger handling capacity of 241 million in person-trips (among which the number of domestic and international passengers were 217 million and 24.19 million respectively), representing an increase of 38.8% over that of the year 2003, an annual freight handling capacity of 5.52 million tons (of which domestic freight constituted 3.81 million tons and international freight took up 1.71 million tons), representing an increase of 22.3% over that of the year 2003, and 2.66 million aircraft movements, representing an increase of 25.8% over that of the year 2003.

Review on the Group's Aviation Business in 2004

The Group is the largest helicopter manufacturer and a major aircraft manufacturer in the PRC. Government departments and non-military departments are the main customers for the Group's helicopters and trainers. The police department had ordered helicopters from the Group following the Chinese People's Armed Police Force. The target customers for regional jets and general purpose aeroplanes are airline companies. As China's civil aviation market grows at a rapid pace with a great prospect, aeroplanes manufactured by the Group will play an active role for both air passenger transportation and air freight transportation of China.

1. *Helicopter*

In 2004, the first model HC-120 helicopter manufactured by the Group had successfully completed its first flight, which marked the successful transformation of the Group from a manufacturer of parts and components to a manufacturer of model EC-120 helicopter, and took domestic helicopter industry closer to the international standard.

In 2004, the model H-425 helicopter, which was developed and manufactured by the Group had been awarded an airworthiness certificate by CAAC, which means that it has been permitted to enter into China domestic civil aviation market. It is the most advanced civil helicopter developed by China herself.

In 2004, the Group's general purpose transporting helicopter, model Z-8F, completed its first flight. Model Z-8F helicopter is an improved model of Z-8 series, which can be operated in extreme conditions such as very hot or very cold weather. Model Z-8F helicopter has its competitive edge in its better reliability, higher economical performance and higher level of comfort.

In 2004, Hafei Aviation, a subsidiary of the Group, entered into a sales contract with Nanjing Municipal Public Security Bureau for the sale of one model Z-9 police helicopter. It was the first time for model Z-9 police helicopter to be deployed by national municipal police system, and this sale would have a high promotion value in expanding both the areas of usage and the potential market for domestic helicopters.

2. *Regional Jet*

In early 2004, Harbin Embraer entered into a contract with China Southern Airlines Co., Ltd. for the sale of six units of model ERJ-145 regional jets. As at the date of this report, all those six regional jets have been delivered.

In March 2005, Harbin Embraer entered into a contract with China Eastern Airlines Jiangsu Co., Ltd. for the sale of five units of model ERJ-145 regional jets. These regional jets will be delivered in 2005 and 2006.

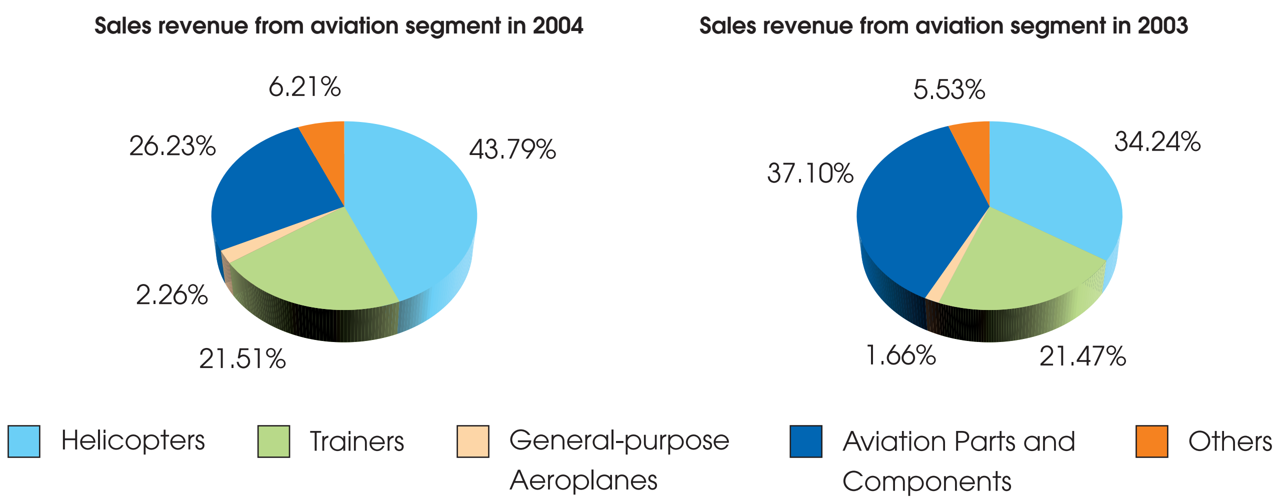
3. *Trainer and General Purpose Aeroplane*

In May 2004, Hafei Aviation delivered one model Y-12E aeroplane to Sichuan Sanxing General Aviation Co., Ltd.. In June, the State Oceanic Administration of China selected model Y-12IV aeroplane again as its maritime surveillance law enforcement aeroplane. At the fifth China International Aviation and Aerospace Exhibition held in Zhuhai, Hafei Aviation entered into a contract for the sale of 20 units of model Y-12 aeroplanes series. At the beginning of 2005, Hongdu Aviation entered into a contract for the sale of 40 units of model K-8 trainers. The signing of these contracts has provided a stable market for the development of the Group's trainers and general purpose aeroplanes in future.

4. *Cooperation with International Partners in Aviation Business*

In 2004, the Group made substantial progress in the cooperation with international partners in aviation business. The Group entered into an agreement with Italy AgustaWestland on the joint production of model A-109E light twin-engine helicopter. The construction of model HC-120 helicopter final assembly line in Hafei Aviation was completed, and the first helicopter made on this line had completed its first flight. The Group will play an important role in the implementation of the framework agreement on cooperation in advanced medium general purpose helicopter project signed between AVIC II and Eurocopter. Besides, the Group entered into a framework agreement with Airbus on cooperation in research and development of aviation products, and had actively pursued the sub-contract on parts and components to be signed with Boeing.

SALES REVENUE



The Group's sales of aviation products for 2004 amounted to RMB2,608 million, representing an increase of RMB23 million (0.89%) over that of 2003. The sales of aviation products remained stable with a slight increase. Sales of aircrafts amounted to RMB1,762 million, representing an increase of RMB279 million (18.81%) over RMB1,483 million of 2003. The increase was mainly attributable to the increase in sales volume of helicopters.

Sales of aviation parts and components amounted to RMB684 million, representing a decrease of RMB275 million (28.68%) from RMB959 million of 2003. The decrease was mainly attributable to the adjustment of production arrangement of AVIC II, the largest customer of the Group's aviation products. As a result, the delivery of the Group's aviation parts and components produced for AVIC II has been postponed to future years.

As shown in the charts above, there was a change in the composition of the Group's aviation products in 2004 from that of 2003: helicopter accounted for 43.79% of the sales of aviation products, representing an increase of 9.55 percentage points over 34.24% of 2003; trainers accounted for around 21.51% of the sales of aviation products, with no significant change when compared with that of 2003; general purpose aeroplanes accounted for around 2.26% of the sales of aviation products, with no significant change when compared with that of 2003; aviation parts and components accounted for 26.23% of the sales of aviation products, representing a decrease of 10.87 percentage points from 37.10% of 2003; and other aviation products accounted for 6.21% of the sales of aviation products, with no significant change when compared with that of 2003.

COST OF SALES

Cost of sales of the Group's aviation products for 2004 increased by RMB42 million to RMB2,102 million from RMB2,060 million of 2003, representing an increase of 2.04%. Cost of sales for aviation products increased slightly in pace with the growth of sales volume.

GROSS MARGIN

Gross margin of the Group's aviation products for 2004 was 19.40%, representing a decrease of approximately one percentage point from that of 2003, and the change was insignificant.

ORDERS FOR AVIATION PRODUCTS

As at the date of this report, the Group has received orders for 45 units of helicopters, 40 units of trainers, 20 units of general purpose aeroplanes and 10 units of regional jets. The Group is endeavoring to seek for more orders for aviation products.

PROSPECT AND STRATEGY

Automobile business

Prospect on automobile market in China 2005

Year 2005 is the last year of the transition period after China's accession to the World Trade Organisation (WTO). The Board of Directors believes that, in 2005, the macro-economy of China will continue to grow at a stable pace, and it is estimated that the GDP will increase by around 8% as compared with that of 2004. On that basis, the Group believes that the total demand for automobiles in 2005 will grow steadily. According to the forecast by the China State Information Center, the impact on mini-sized vehicles imposed by austerity measures will be slight, and the demand for mini-sized vehicles will rise slowly and gradually with an annual increase of around 10%, while the demand for sedans will increase at an annual rate between around 10% and 12%.

The automobile market will feature the following characters:

1. The call for energy saving and environment protection for automobile products will be higher. The continuously rising price of oil in the international market and the emphasis which the Chinese government and our society put on energy saving and environment protecion will drive the market towards low engine capacity vehicles. The "Automobile Industry Development Policy" and "Fuel Consumption Line on Passengers Car" published in 2004 present new legal requirements for vehicles on the ability of energy saving and environment protection.

2. There are still margins for the drop in prices of medium and high grade vehicles. The Group believes that the State's austerity measures, the abolishment of import quota, the downward adjustment of the tariffs on automobile products and the increase in the stock of automobile products will further drive the prices of the medium and high grade vehicles downwards.

3. Mini-sized vehicles will have a niche market for further development. The continuous development of Chinese economy, the rising of average income level and the expanding of cities in scale and quantities will lead to the increase of demand for private vehicles. Under the guidance of the State's policy favouring economic vehicles with a low engine capacity, mini-sized vehicles and economy sedans which are "safe, environment friendly, energy saving, economical and practical" will be the leading products with great growth potential in the China automobile market.

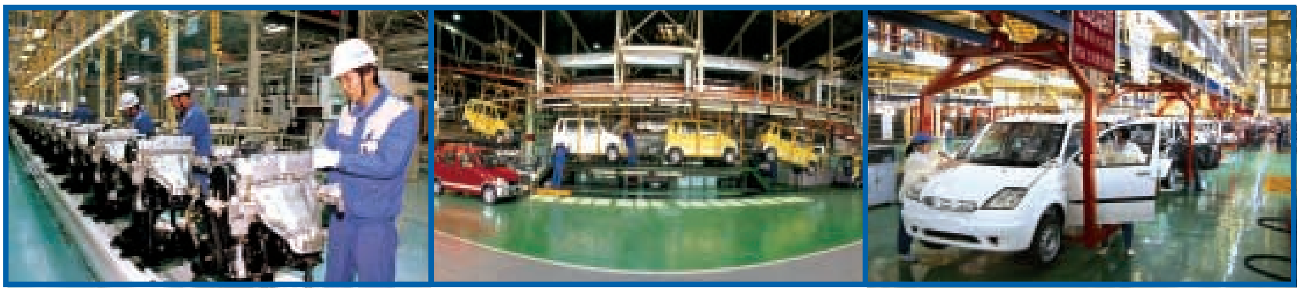
Advantages and strategies of the Group's automobile business

After years of experience and the business integration in 2004, the Group's automobile business has the following advantages:

1. The Group has strong research and development capability and advanced production lines. After technology transfer, improving models, joint research and development of new models with partners, the Group has now acquired the capability to develop mini-sized vehicles and economy sedans on its own. Accordingly, the production lines of vehicles and engines have been upgraded to a high level which could match those of large automobile groups or joint ventures, to manufacture mini-vans, mini-trucks and economy sedans.

2. The Group owns a good sales network and reputable brand names for mini-sized vehicles in China. The brand names, such as "Songhuajiang" and "Changhe", are popular and widely accepted in the Chinese automobile market.

3. The locations of the Group's automobile plants give the Group certain geographical advantages. In the Northeastern part of China, there are production lines for sedans, mini-sized vehicles and vehicle engines; in Hefei, east of China and Jingdezhen, central China, there are production lines for entire vehicles; in Jiujiang also in the Southern China, production lines for entire vehicles and engines are under construction. Reasonable utilization of these production facilities will expand the catchment area of the Group's automobile business, shorten the transportation distance and enhance the development of the automobile business.



4. The vehicles manufactured by the Group comply with the State's policies favouring energy saving and environmental friendly vehicles. Currently, the Group focuses on developing, manufacturing and selling mini-sized vehicles with small engine capacity between 0.8 liters and 1.1 liters. These vehicles fully comply with the State's requirements on environment protection. These automobile products have the features of being safe, environmental friendly, energy saving, economical and practical, and are well positioned in following the State's policies and the development trend of the world's automobile industry.

In 2005, the Group will maintain its business strategies of giving priority to mini-sized vehicles, strengthening its position in sedan market, sharing resources by way of joint venture and cooperation with international partners, perfecting development strategy, optimizing resources allocation and enhancing marketing with a view to achieving growth in automobile business. The Group will take the following strategic measures, including:

1. To further integrate the automobile business. The centralization of decision making, planning and development, purchasing, marketing, and international cooperation of automobile business will be implemented to realize the optimal allocation of resources.

2. To strengthen its marketing network. Active marketing strategies will be established to promote the overall quality of the marketing team and the capabilities of the employees. We will rearrange the existing network and after-sale service network. The Group will enhance the awareness of its brand names for sedans through active advertising campaigns.

3. To launch new vehicle models steadily as planned. In 2005, the Group will launch new models such as Saibao and Liana according to market situation.

4. To consolidate its core competence. In respect of the production, research and development, the Group will capitalize on its comparative advantages and focus on energy saving vehicles with low engine capacity.

5. To control costs mainly through reducing purchase costs. Every management department will set out specific measures to reduce costs to promote sales of products.

AVIATION BUSINESS

Prospect for Aviation Products Market

The rapid growth of the Chinese economy, structural adjustments in the communication and transportation sectors, advancement and continuous improvement of people's living standard will all help forming a large potential market for helicopters and civil aeroplanes and provide room for development of the civil aviation manufacturing industry. Regional jet transportation and aviation freight transportation will become new growing areas in China domestic market. World renowned aviation product manufacturers are adjusting their manufacturing facilities one after another, and have entered into China's market through sino-foreign joint ventures and cooperation, thus providing good opportunities for further development of the Chinese aviation industry.

Prospect and Strategies for the Group's Aviation Business

Being the largest helicopter manufacturer and a major aircraft manufacturer in China, the Group possesses strong research capabilities and advanced manufacturing technologies. The Group will take the favourable opportunities to develop aviation products and increase the investment in aviation business in the next few years. The Group will expand its helicopter production capacity, develop domestic and overseas markets, and actively seek to enter into the global supply chain of aviation products. It will strengthen its cooperation with international partners and upgrade the business to a new level generally. In particular,

1. The Group will expand into new markets. The Group will actively develop markets for new models of helicopters such as H-425, HC-120, Z-11MB1 and A-109E, further develop the markets for current models Z-8 and Z-9, and put more efforts in marketing the regional jets, general purpose aeroplanes and trainers to new customers.

2. The Group will further strengthen its cooperation with international partners in the research and manufacture of helicopters. It is expected that new contracts will be signed in 2005 which will enrich the Group's series of helicopter products. With the cooperation in manufacturing of model A-109E helicopter the Group will expand the scope of cooperation with international partners in aviation products. The Group will actively pursue the agreements with Boeing and Airbus and will endeavor to turn them into executable sub-contracts of work-package. The Group will diligently execute sub-contract production of Bell 430 parts and components.

3. In the light of market situation, the Group will quicken its pace in research and development of new models and improvement of current models, and to obtain the relevant certificates. The Group will speed up research and development on medium general purpose helicopter in cooperation with international partners. Good progress has been made in research and development of a new model of advanced trainer and its first flight is expected to be performed by the end of 2005. The Group is actively applying for the airworthiness certificate for N-5 series agricultural aeroplane to enter into the US market.

Capitalizing on the State's policy in supporting reforms on large and medium-sized corporations and revitalizing the traditional industrial bases in Northeast China, the Group will further promote enterprises reforms, adjust corporate structure, optimize human resources, and enhance the Company's productivity.

USE OF PROCEEDS

According to the plan for use of proceeds, the proceeds used as at 31 December 2004 amounted to RMB662 million in total, out of which RMB530 million was used for the research and development of new vehicle models and new vehicle engines; RMB132 million was used for the research and development of new advanced trainers; and the rest was deposited in banks in China as short term deposits which will also be used by the Company as planned.

EMPLOYEES OF THE GROUP

As at 31 December 2004, the Group had 32,122 employees.

Employees analysed by functions

	Number of employees	Percentage to total employees (%)
Vehicles and engines	17,262	53.74%
Civil aviation	14,346	44.66%
Other activities	514	1.60%
Total	32,122	100.00%

For the year ended 31 December 2004, staff costs of RMB874 million in aggregate were incurred by the Group for its employees.

REMUNERATION OF EMPLOYEES

The Group's remuneration scheme is determined by the remuneration committee on fair and reasonable principles which are similar to those available in the market. Remuneration of employees comprises of basic salary, contribution to a housing fund, and contributions to pension plans. The Group will also, in its discretion, pay year-end bonus to employees according to their respective performance.

TRAINING FOR EMPLOYEES

The Group expects a high level of knowledge and skill in respect of the automobile manufacturing industry and the aviation manufacturing industry from its employees. Therefore, implementation of comprehensive employee training is a key to the Group's continuous development. Accordingly, the Group will continuously review its existing employee training scheme in order to provide comprehensive and systematic training to its employees.

The Group provides special training courses, seminars on strategic management, human resources management, and financial management for its senior management. Trainings relating to all kinds of professional skills and management techniques are also provided to all professional departments of the Group's headquarter and the business departments of its subsidiaries. On-the-job trainings covering corporate culture, management concept and management standardization are also provided to new employees.

The Group also provides overseas training to the management officers and technicians through cooperation with international partners. The employees, through the training, are able to continuously acquire new knowledge to improve their capabilities. This will in turn enhance the Group's competitiveness in the ever-changing market.