



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND OPERATING RESULTS

Shareholders are advised to read the following discussion and analysis in conjunction with the financial statements of the Group prepared in accordance with the International Financial Reporting Standards as set out on pages from 44 to 126 of this Annual Report.

BUSINESS REVIEW

The Group is the national flag carrier and a leading provider of air passenger, air cargo and airline related services in China. Taking advantage of its balanced network of extensive and complementary domestic and international routes as well as its dominant position in Beijing, the Group offers non-stop and transit services to its passengers from overseas, mainland China, Hong Kong and Macau. As at December 31, 2004, we operated an overall of 183,693 flights serving 72 domestic and 36 international and regional destinations. We offered an average of 3,426 scheduled passenger flights and 367 scheduled cargo flights weekly. We operated a fleet of 151 aircraft, including 124 Boeing aircraft, 26 Airbus aircraft, 1 business jet, the average age of our fleet was 8.1 years.

During the year, Chinese and global economy continued to improve, thereby bringing about a rapid surge of market demand for airline services in China, which greatly mitigated the



adverse effects of the outbreak of SARS in 2003. Meanwhile, the Group also faced certain challenges due to the soaring price of international jet fuel and intensified competition. Against this background, the Group seized the market opportunity by adopting a series of effective measures, resulting in great improvement in financial results and a more secured leading position in China aviation market. In 2004, we were appointed as the exclusive airline partner of 2008 Beijing Olympic Games, which significantly promoted the Company's brand recognition. In addition, the successful listing of our shares on Hong Kong and London stock exchanges laid a solid foundation for the Group's future development.

The Group operated certain airline business through its subsidiaries and operating results of each subsidiary have already been calculated into the consolidated financial statements. CNAC is the largest subsidiary of the Company and is listed on the Hong Kong Stock Exchange. CNAC is the controlling shareholder of Air Macau and the single largest shareholder of Dragonair. In 2003 and 2004, the operating revenues of CNAC accounted for 5.7% and 6.0% of the operating revenues of the Group in these years respectively.



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In 2004, Air China Cargo, a branch of the Company in 2003, was transformed into a joint venture in which the Group holds 51% equity interest, and its operating results has been included in the consolidated financial statements prepared in accordance with proportionate consolidation method under IFRS. In 2004, the Group accomplished acquisition of 48% of the equity interest of Shandong Aviation Group and 22.8% of the equity interest of Shandong Airlines Co., Ltd..

The Group's business, its financial position and operating results are mainly affected by such external factors as the development of Chinese economy and international trade, regulations of aviation industry, jet fuel price, special events, the seasonal nature of airline operation, performance of associates, financing costs, which were not within the control of the Group to a certain extent.

OPERATING RESULTS — 2004 COMPARED WITH 2003

The Group's net profit attributable to equity holders of the parent for 2004 was RMB2,386 million and that for 2003 was RMB160 million. Our operating revenue increased by 36.0% to RMB33,521 million in 2004 from RMB24,641 million in 2003. Our operating expenses increased by 29.9% to RMB29,036 million in 2004 from RMB22,357 million in 2003. As the increase in operation revenue exceeded that in operation expenses, the profit from operation increased by 96.4% to RMB4,485 million in 2004 from RMB2,284 million in 2003. Our finance costs decreased by 23.4% to RMB1,800 million in 2004 from RMB2,349 million in 2003. Share of profits less losses from associates increased by 130.9% to RMB561 million in 2004 from RMB243 million in 2003. Generally speaking, our profit before tax increased by 1,954.5% to RMB3,657 million in 2004 from RMB178 million in 2003. Net profit attributable to equity holders of the parent increased by 1,391.3% to RMB2,386 million in 2004 from RMB160 million in 2003.

OPERATING REVENUES

Our operating revenues principally included air traffic revenues and other operating revenues. Most of our operating revenues were from air traffic revenues, representing 92.0% of operation revenues in 2004, while the other operating revenues represented 8.0% of operating revenues. Among air traffic revenues in 2004, 89.7% was generated from passenger services and 10.3% was from cargo and mail services.

Operating revenue increased by 36.0% to RMB33,521 million in 2004 from RMB24,641 million in 2003, mainly due to revenue growth from passenger services. Revenue from passenger services increased by 45.4% to RMB27,665 million in 2004 from RMB19,030 million in 2003. The capacity of passenger traffic in ASKs increased by 27.9% to 64,894 million ASKs in 2004 from 50,733 million ASKs in 2003. Passenger load factor increased to 71.9% in 2004 from 66.0% in 2003. Income per RPK increased by 3.7% to RMB0.56 in 2004 from RMB0.54 in 2003. In 2004, the daily utilization of aircraft averaged at 10.2 hours, increased by 1.5 hours when compared to 2003.

Revenue generated from international passenger services accounted for 39.7% of the total revenue from passenger services of the Group in 2004, representing an increase of 62.6% to RMB10,835 million in 2004 from RMB6,663 million in 2003, and the main reason was an apparent recovery of the demand for international airline services in 2004 from the SARS outbreak in 2003 and the increased input of capacity in international routes by the Group. The passenger traffic capacity (in ASKs) of international routes of the Group increased by 41.5% to RMB27,897 million kilometers in 2004 from RMB19,709 million kilometers in 2003. The passenger load factor increased to 70.4% in 2004 from 64.8% in 2003. Level of passenger yield from international routes increased to RMB0.51 per RPK in 2004 from RMB0.47 per RPK in 2003.



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Revenue generated from domestic passenger services accounted for 55.1% of the Group's total revenue from passenger services in 2004, increasing by 38.3% to RMB15,340 million in 2004 from RMB11,093 million in 2003, primarily due to the increase of passenger load factor and yield of domestic services. The passenger traffic capacity (in ASKs) of domestic airline of the Group increased by 19.5% to RMB34,627 million kilometers in 2004 from RMB28,983 million kilometers in 2003. Passenger load factor increased to 73.6% in 2004 from 67.4% in 2003. Passenger yield in domestic services increased to RMB0.60 per RPK in 2004 from RMB0.57 per RPK in 2003.

Passenger traffic revenue from Hong Kong and Macau accounted for 5.2% of the Group's passenger traffic revenue in 2004, increasing by 17.0% to RMB1,490 million in 2004 from RMB1,274 million in 2003, primarily due to the uprising of passenger load factor in Hong Kong and Macau services. The passenger traffic capacity (in ASKs) of Hong Kong and Macau services of the Group increased by 16.1% to RMB2,371 million kilometers in 2004 from RMB2,042 million kilometers in 2003. Passenger load factor increased to 64.5% in 2004 from 58.1% in 2003. Passenger yield from Hong Kong and Macau services decreased to RMB0.67 per RPK in 2004 from RMB0.68 per RPK in 2003.

Revenue from cargo and mail operations decreased by 27.8% to RMB3,170 million in 2004 from RMB4,392 million in 2003, primarily due to the fact that Air China Cargo, which is engaged in cargo operations, had changed into a joint venture in 2004 of proportionally consolidation from a branch of the Company. The cargo traffic capacity (in AFTKs) increased by 20.2% to RMB4,843 million kilometers in 2004 from RMB4,028 million kilometers in 2003. The overall load factor of cargo traffic



decreased to 53.3% in 2004 from 54.8% in 2003. The overall cargo yield increased to RMB1.99 per RFTK in 2004 from RMB1.87 per RFTK in 2003.

Other operating revenue increased by 120.3% to RMB2,686 million in 2004 from RMB1,219 million in 2003, primarily due to the increase in bellyhold income.

OPERATING EXPENSES

Operating expenses increased by 29.9% to RMB29,036 million in 2004 from RMB22,357 million in 2003, primarily due to increases in jet fuel costs, take-off, landing and depot charges and aircraft maintenance, repair and overhaul expenses, and employee compensation costs. Operating expenses as a percentage of operating revenues decreased to 86.6% in 2004 from 90.7% in 2003.

Jet fuel expenses increased by 54.0% to RMB8,354 million in 2004 from RMB5,425 million in 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 average jet fuel cost for each barrel increased by 25.7% to RMB474 in 2004 from RMB377 in 2003.



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Take-off, landing and depot charges increased by 22.6% to RMB4,230 million in 2004 from RMB3,450 million in 2003, primarily due to the increased number of flights operated.

Depreciation expenses increased by 2.5% to RMB3,463 million in 2004 from RMB3,377 million in 2003, primarily due to the acquisition of eleven aircraft from August to September in 2004.

Aircraft maintenance, repair and overhaul expenses increased by 32.0% to RMB2,836 million in 2004 from RMB2,149 million in 2003, primarily due to increased line maintenance requirements as a result of increased block hours.

Employee compensation costs increased by 22.8% to RMB2,921 million in 2004 from RMB2,379 million in 2003, primarily due to the increase of flight hours.

Air catering charges increased by 39.0% to RMB1,172 million in 2004 from RMB843 million in 2003, primarily due to an increase in the number of passengers carried by the Group.

Aircraft and jet engines operating lease expenses increased by 17.7% to RMB1,071 million in 2004 from RMB910 million in 2003, primarily due to the addition of nine aircraft acquired through operating leases.

Other operating lease expenses increased by 2.7% to RMB187 million in 2004 from RMB182 million in 2003, primarily due to higher rental rates for our terminal stations and sales offices as compared to the lower rental rates for the same negotiated after the SARS outbreak.

Other flight operation expenses increased by 27.7% to RMB2,698 million in 2004 from RMB2,112 million in 2003, primarily due to a change in the accounting method of the CAAC

Infrastructure Development Fund, whereby it is no longer offset by revenues but is released to costs directly in 2004.

Selling and marketing expenses increased by 31.1% to RMB1,387 million in 2004 from RMB1,058 million in 2003, primarily due to higher sales commissions as a result of increased ticket sales.

General and administrative expenses increased by 51.8% to RMB715 million in 2004 from RMB471 million in 2003, primarily due to higher travelling expenses resulting from increased business volume and donation for Olympic Games and loss on property, plant and equipment retirement.

FINANCE COSTS

Net finance costs decreased by 23.4% to RMB1,800 million in 2004 from RMB2,349 million in 2003, of which interest expenses decreased by 18.6% to RMB1,824 million in 2004 from RMB2,241 million in 2003, primarily due to the repayment of certain bank loans and a decrease in finance lease obligations. Interest income increased by 78.9% to RMB34 million in 2004 from RMB19 million in 2003, primarily due to an increase in bank deposits.

SHARE OF PROFITS LESS LOSSES FROM ASSOCIATES

In 2004, share of profits less losses from associates was RMB561 million, as compared to that of RMB243 million in 2003, primarily due to the significant increase of the profits of our associates Dragonair, Jardine Airport Services Limited ("JASL") and Menzies Macau Airport Services Limited.



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INCOME TAX

The Company is subject to the PRC income tax at a rate of 33%. The income tax of the Group increased to RMB1,108 million in 2004 from RMB90 million in 2003, primarily due to the increase of the profit before taxation in 2004.

LIQUIDITY AND CAPITAL RESOURCES

We financed our working capital needs through consolidated capital from operating activities and bank loans. As at December 31, 2003 and 2004, the total amount of cash and cash equivalents of the Group were RMB2,620 million and RMB9,734 million respectively. In 2003 and 2004, the Group generated net cash from operating activities of RMB5,425 million and RMB6,151 million respectively, whilst the Group's net cash outflow from investing activities in the same period reached RMB4,360 million and RMB4,974 million respectively, primarily due to the amounts utilized for purchase and improvement of aircraft and aviation equipment. In 2004, the Group's net cash inflow from financing activities amounted to RMB5,620 million, primarily due to the new issues of shares by the Company at the end of the year; while in 2003, the Group recorded a net cash outflow from financing activities of RMB2,207 million, primarily due to the repayment of certain bank loans.

Similar to other Chinese airlines, we have been operating with a net current liabilities position. As at December 31, 2003 and 2004, the net current liabilities of the Group were RMB12,384 million and RMB6,860 million respectively. The decrease of net current liabilities was primarily due to the increase of current assets as a result of the new issue of shares by the Company.

As at December 31, 2003 and 2004, the short-term loans of the Group were RMB9,237 million and RMB8,806 million respectively, while the long-term loans were RMB12,820 million and RMB12,897 million respectively in the same

period. As at December 31, 2004, our bank and other loans due within 1 year, 1 to 2 years, 3 to 5 years and over 5 years were RMB8,806 million, RMB3,064 million, RMB6,215 million and RMB3,618 million respectively. As of December 31, 2003 and 2004, our liabilities under finance leases were RMB13,699 million and RMB12,281 million respectively. As of December 31, 2004, our liabilities under finance leases due within 1 year, 1 to 2 years, 3 to 5 years and over 5 years were RMB1,705 million, RMB1,944 million, RMB6,722 million and RMB1,910 million respectively.

As at December 31, 2004, the equity attributable to shareholders of the Group was RMB16,548 million, representing an increase of RMB9,655 million when compared with RMB6,893 million in the previous year, primarily due to the issuance by the Company of 2,550,618,182 H Shares with a par value of RMB1.00 each at an offer price of HKD 2.98 per share.

CAPITAL EXPENDITURES

As of December 31, 2004, the Group had contracted for 27 passenger aircraft to be delivered from 2005 to 2006. The Group's total investment in aircraft is expected to be RMB7,511 million (The plan of the Company is to change the contracts for 5 B737-700 under operating leases and if commercial terms are not applicable, the total investments for aircraft will be adjusted to RMB9,023 million), including prepayments for purchasing aircraft in 2006 and afterwards of RMB4,682 million. Other investment in capital expenditure items is estimated to be RMB1,899 million, which mainly involves improvement of first class and business class cabins, the Company's ancillary projects in No. 3 Terminal of Beijing International Airport, and some long-term investment projects. Some capital expenditures projects of the Company are generally subject to Chinese government approval, and are subject to



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adjustments depending on approval time, the prevailing market conditions, financing and other relevant factors.

FINANCIAL RISK MANAGEMENT POLICY

The Group is exposed to the fluctuations in jet fuel price during its ordinary operations. 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 counterparties and within approved limits. The Group recorded a gain of RMB170 million and RMB41 million from the derivative instruments from jet fuel used by us in 2003 and 2004, respectively.

A substantial portion of the Group's debt, part of its operating revenues and expenses and capital expenditures are denominated in certain major foreign currencies and consequently subject to fluctuations in exchange rates. The Group recorded exchange losses of RMB297 million and RMB55 million in 2003 and 2004, respectively. In order to reduce our foreign currency risk, we have pursued a strategy for certain major foreign currencies, to make the match 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.

ASSETS MORTGAGE

As at December 31, 2004, the Group mortgaged several aircraft and flight equipment with an aggregate carrying amounts of approximately RMB28,585 million (2003: RMB29,732 million)

pursuant to certain borrowing and lease agreements, details of which are set out in notes 16, 33 and 34 to the financial statements.

As at December 31, 2004, the Group's bank deposits amounting to RMB117 million (2003: RMB1,246 million) were pledged against borrowing and leasing arrangements and financial derivatives.

COMMITMENTS AND CONTINGENT LIABILITIES

As at December 31, 2004, the Group's capital commitments amounted to approximately RMB15,820 million, mostly regarding the purchase of certain aircraft and relevant equipment to be delivered in 2005 and 2006.

As at December 31, 2004, the Group committed to make a capital contribution of approximately RMB422 million to its joint venture.

As at December 31, 2004, the Group entered into operating lease agreements with respect to certain office premises, aircraft and related equipment pursuant to which we committed to make lease payments in aggregate amounts of at least RMB1,140 million within 1 year, RMB3,216 million within 2 to 5 years, and RMB1,000 million after 5 years.

Details of the commitments are set out in note 42 to the financial statements.

The Group's primary contingent liabilities as at December 31, 2004 are set out in note 41 to the financial statements.

GEARING RATIO

As at December 31, 2004, the gearing ratio (represented by total liabilities divided by total assets) of the Company was approximately 73%, representing a decrease of 12 percentage points from approximately 85% as at December 31, 2003.