



Review of Operations and Management's Discussion and Analysis

China Eastern Airlines Corporation Limited 21



Luo Chaogeng, President

A handwritten signature of Luo Chaogeng in white ink, written in a stylized Chinese calligraphic style. The signature is positioned below the portrait and above the main text block.

In 2004, we operated a total of 238 routes, of which 179 are domestic routes (including 15 routes to Hong Kong) and 59 are international routes (including 13 international cargo routes). We operated approximately 3,057 scheduled flights per week, serving a total of 88 foreign and domestic cities. In 2004, we added a total of 10 new aircraft, including the purchase of two Airbus A340-600 aircraft, five Airbus A320 aircraft and two Airbus A321 aircraft as well as one Airbus A300F freighter under wet lease in response to market demand. As of December 31, 2004, we operated a fleet of 103 aircraft, including 96 passenger jets each with a seating capacity of over 100 seats and 7 jet freighters.

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The following table sets forth details of our fleet as of December 31, 2004:

	Number of Aircraft Owned or under Capital Leases	As of December 31, 2004		Planned Additions*	
		Number of Aircraft under Operating Leases	Total Number of Aircraft	2005	2006
A340-600	5		5		
A340-300	5		5		
A330-300					7
A330-200					3
A300-600	7	3	10		
A321	2		2	2	
A320	25	10	35	5	
A319		10	10		3
MD-90	9		9		
MD-82		3	3		
B737-800				3	
B737-700	4	7	11		6
B737-300	3	3	6		
ERJ145				3	2
A300F		1	1		
MD-11F	6		6		
Total	66	37	103	13	21

* Except for three Boeing B737-800 to be acquired under operating leases, the other aircraft will be purchased by our group.

Review of Operating Results

The following discussion and analysis should be read together with our audited financial statements and the accompanying notes prepared in accordance with IFRS that are included elsewhere in this annual report. The financial data presented in this section are derived from our audited financial statements prepared in accordance with IFRS.

Turnover. Our turnover increased 47.4% from RMB14,277 million in 2003 to RMB21,039 million in 2004. This increase was primarily due to an increase of

our passenger and cargo revenues, which were net of the applicable PRC sales tax.

Traffic revenues from our passenger as well as cargo and mail transportation business increased 47.1% from RMB13,448 million in 2003 to RMB19,786 million in 2004. Compared to 2003, the average aircraft daily utilization increased by 1.7 hours to 9.7 hours in 2004.

Passenger revenues, which accounted for 77.6% of our total traffic revenues in 2004, increased 49.7% from RMB10,261 million in 2003 to RMB15,358 million in 2004. This increase was primarily due to the market

recovery following the end of severe acute respiratory syndrome (SARS) and the increase of our transportation capacity.

Our domestic passenger revenues, which accounted for 53.9% of our total passenger revenues, increased 48.1% from RMB5,592 million in 2003 to RMB8,284 million in 2004. This increase was principally a result of the growing market demand following the end of SARS and the expansion of our transportation capacity, including the launch of new routes and increase in the number of flights. Compared to 2003, our domestic passenger traffic increased by 40.8% in 2004, and our domestic passenger load factor increased from 64.8% in 2003 to 70.3% in 2004. As a result of the favorable condition in the domestic passenger market since the end of 2003, we increased capacity on our domestic routes by 29.7% in 2004. Our domestic passenger yield increased from RMB0.54 in 2003 to RMB0.57 in 2004 per passenger-kilometer. This increase was principally a result of the increased pricing level due to strong demand in the domestic transportation.

Hong Kong passenger revenues, which accounted for 14.2% of our total passenger revenues, increased 34.4% from RMB1,627 million in 2003 to RMB2,187 million in 2004. This increase was primarily due to the market recovery following the end of SARS and the increase in the number of business and leisure travelers. Hong Kong passenger traffic increased by 57.1% in 2004 over that of 2003. In order to meet market demand, we increased the passenger capacity on our Hong Kong routes by 31.6% in 2004. Our Hong Kong passenger load factor increased from 52.4% in 2003 to 62.6% in 2004, and our Hong Kong passenger yield decreased from RMB0.84 in 2003 to RMB0.72 in 2004 per passenger-kilometer. The decrease in passenger



yield on Hong Kong routes was primarily due to (1) an increase in the number of leisure travelers, (2) various promotions offered by us and (3) competition from other airlines.

International passenger revenues, which accounted for 31.8% of our total passenger revenues, increased 60.7% from RMB3,042 million in 2003 to RMB4,887 million in 2004. This increase was mainly due to the market recovery following the end of SARS and the increasing demand as a result of the recovering global economy in 2004. As a result, international passenger traffic increased by 74.1% in 2004 compared to 2003. Our international passenger capacity increased by 58.2% in 2004 compared to 2003. Our international passenger load factor increased from 56.7% in 2003 to 62.4% in 2004. Our international passenger yield decreased from RMB0.53 in 2003 to RMB0.49 in 2004 per passenger-kilometer. This decrease was primarily due to the increase in the number of leisure travelers and competition.

We generate cargo and mail revenues from the transportation of cargo and mail on our designated cargo aircraft as well as from the carriage of cargo and mail on passenger aircraft. Revenues from cargo and

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Other operating revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading, aircraft cleaning, fueling and ground transportation of cargo and passenger luggage for airlines operating to or from Hong Qiao International Airport and Pudong International Airport. We are currently the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport. Other operating revenues increased 51.1% from RMB829 million in 2003 to RMB1,253 million in 2004, which is higher than the 39.0% growth rate achieved in 2003. This increase was mainly due to the increase in the number of flights following the end of SARS and the enhancement of our capability in carriage, storage and handling of cargo with the establishment of Shanghai Eastern Logistics Co., Ltd..

mail operations, which accounted for 21.1% of our total transportation revenues in 2004, increased 39.0% from RMB3,187 million in 2003 to RMB4,428 million in 2004. This increase was primarily due to the increasing demand for cargo transportation driven by the continuing rapid growth of China's economy following its accession to the World Trade Organization, the increase of our transportation capacity as well as the increase of our market share. Our cargo and mail traffic (as measured in revenue freight tonne-kilometers, or RFTKs) increased 44.6% from 1,297 million RFTKs in 2003 to 1,875 million RFTKs in 2004. This increase was primarily due to a significant increase in the capacity of our cargo transportation which resulted from the completion of the remodeling of MD-11 passenger aircraft into freighters, launch of new routes as well as an increase in the number of passenger flights which also carry cargo. Cargo yield decreased from RMB2.46 in 2003 to RMB2.36 in 2004 per cargo tonne-kilometer. This decrease was primarily due to intensified competition.



Other net operating income included rental income from operating sublease of aircraft and government subsidy net of loss on disposal of aircraft and engines. Our other operating income increased to RMB154 million in 2004 from RMB61 million in 2003. This increase was primarily due to a significant increase in rental income from operating sublease of aircraft.

Operating Expenses. Our total operating expenses increased 39.7% from RMB14,117 million in 2003 to RMB19,714 million in 2004. This increase was primarily due to increases in aviation fuel expenses, aircraft depreciation and operating lease expenses, take-off and landing charges, food and beverage expenses, salary costs, commission expenses and other expenses. Our total operating expenses as a percentage of our turnover decreased from 98.9% in 2003 to 93.7% in 2004.

Aviation fuel expenses increased 78.3% from RMB3,045 million in 2003 to RMB5,430 million in 2004. This increase was principally a result of our business expansion in 2004 and the increased international aviation fuel prices in 2004. In 2004, we consumed a total of 1,454,500 tonnes of aviation fuel, representing an increase of 42.1% compared to 2003. In 2004, the weighted average domestic and international fuel prices paid by our company compared to 2003 increased by approximately 24.4% and 30.6%, respectively.

Aircraft depreciation and operating lease expenses increased 28.8% from RMB2,851 million in 2003 to RMB3,672 million in 2004. This increase was primarily due to our fleet expansion. Other depreciation, amortization and operating lease expenses increased from RMB495 million in 2003 to RMB496 million in 2004.



The wages, salaries and benefits increased 28.8% from RMB1,449 million in 2003 to RMB1,866 million in 2004. This increase was primarily due to an increase in the number of staff resulting from the expansion of the Group and our main operations as well as an increase in staff's average salaries with the introduction of an incentive compensation plan that is linked to profit. The increase was also partially attributable to the introduction of an incentive plan for our pilots that links allowances to flying hours.

Take-off and landing charges increased 34.0% from RMB2,254 million in 2003 to RMB3,020 million in 2004, which accounted for 15.3% of our total operating expenses in 2004. This increase was primarily due to

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the expansion of our business and the increased number of flights.

Aircraft maintenance expenses were RMB1,396 million in 2004, compared to RMB1,329 million in 2003, an increase of 5.0%. This increase was mainly due to the increased aircraft maintenance performed as a result of the increase in the number of our flights in 2004.

Commission expenses increased 66.0% from RMB465 million in 2003 to RMB772 million in 2004. This increase was primarily due to the increase in revenues of our domestic and international businesses.

Food and beverage expenses increased 39.9% from RMB542 million in 2003 to RMB758 million in 2004. This increase was primarily due to an increase in the number of travelers which was partially offset by a decrease of the average cost of food and beverage as a result of our cost-control initiatives.

Office and administration expenses increased by 26.5% from RMB1,058 million in 2003 to RMB1,338 million in 2004. This increase was primarily due to an increase in

pilot and aircrew training expenses, overseas expenses as well as travel expenses.

Other operating expenses increased 53.8% from RMB628 million in 2003 to RMB966 million in 2004. Other operating expenses mainly included SITA ticket reservation system charges, SITA departure control system charges, civil aviation infrastructure levy, provision for obsolescence of flight equipment spare parts, maintenance expenses and loss on disposal of other fixed assets, insurance costs, investment income and expenses relating to the newly-established Shanghai Eastern Logistics Co., Ltd.. This increase was mainly attributable to increases in SITA ticket reservation system charges, SITA departure control system charges, civil aviation infrastructure levy as well as expenses relating to the newly-established Shanghai Eastern Logistics Co., Ltd..

Non-operating Income. Non-operating income was RMB133 million in 2004, which was due to the rescission of certain related party lease arrangements between China Eastern Northwest Company and us. For more details, please see note 38(c)(ii) to the financial statements.

Net Profits. As a result of the foregoing, net profit attributable to shareholders was RMB514 million in 2004 compared to a loss of RMB950 million in 2003.

Fixed Assets. Our company had approximately RMB30,220 million of fixed assets as of December 31, 2004, including aircraft and flight equipment with a value of approximately RMB27,169 million. Fixed assets are initially recognized at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation.

Valuation of fixed assets is based on market conditions and global economic factors that we may not control. The determination of fair value requires significant judgment, including judgment on valuations by our management and/or by independent professional appraisers. Our directors have reviewed the carrying value of our fixed assets as of December 31, 2004 and are of the opinion that the carrying amount is not materially different from the fair value of our fixed assets.

Liquidity and Capital Resources

We finance our working capital requirements through a combination of funds generated from operations and short-term bank loans. As a result, our liquidity would be adversely affected to the extent there is a significant decrease in demand for our services, or any delay in obtaining bank loans. As of December 31, 2003 and 2004, we had cash and cash equivalents of RMB1,583 million and RMB2,114 million, respectively. In 2003 and 2004, our net cash inflows generated from operating activities were RMB3,163 million and RMB3,266 million, respectively, while our net cash outflows used in

investment activities were RMB7,305 million and RMB2,433 million, respectively. In the past two years, our primary cash requirements were the funds for the acquisitions and upgrades of aircraft and flight equipment and debt repayments.

In 2003 and 2004, payment of advances on aircraft and flight equipment were RMB1,296 million and RMB2,410 million, respectively, while additions of aircraft and flight equipment were RMB5,560 million and RMB1,207 million, respectively. We financed the additions to our aircraft and flight equipment primarily through lease arrangements, bank loans, and funds generated from operations. Funds generated from disposal of old aircraft and flight equipment and other fixed assets and equipment (including by way of exchange) totaled RMB92 million and RMB668 million in 2003 and 2004, respectively. Our net cash outflow generated from financing activities was RMB312 million in 2004, primarily from bank loans.

Pursuant to certain of our finance or operating leases, we are required to indemnify the lessors against any

withholding or similar taxes that may be imposed on the lessors by taxing authorities in China with regard to payments made under these leases. Pursuant to a regulation issued in 2000 by the State Tax Bureau of China, lease payments made by Chinese airlines to foreign enterprises in respect of lease arrangements entered into prior to September 1, 1999 are exempt from the payment of any withholding tax. Withholding tax payable in respect of the lease arrangements entered into on or after September 1, 1999 are charged to our income statement as incurred.



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We generally operate with a working capital deficit. As of December 31, 2004, our current liabilities exceeded our current assets by RMB12,502 million, while our current liabilities exceeded our current assets by RMB9,941 million as of December 31, 2003. The increase in our current liabilities in 2004 was due to increase in short-term bank loans and the portion of long-term bank loans payable within one year. Short-term loans outstanding totaled RMB4,632 million and RMB6,189 million as of December 31, 2003 and 2004, respectively. Long-term loans outstanding totaled RMB11,223 million and RMB10,736 million as of December 31, 2003 and 2004, respectively. Long-term loans payable within two years, from three to five years and beyond five years were 5,580 million, RMB3,216 million and RMB1,940 million, respectively, as of December 31, 2004, as compared to RMB4,689 million, RMB4,164 million and RMB2,370 million, respectively, as of December 31, 2003. The total lease obligations outstanding under our finance leases as of December 31, 2003 and 2004 were RMB7,101 million and RMB8,662 million, respectively. Our lease obligations payable within two years, from three to five years and beyond five years were RMB2,889 million, RMB3,756 million and RMB2,017 million, respectively, as of December 31, 2004, as compared to RMB2,679 million, RMB4,039 million and RMB383 million, respectively, as of December 31, 2003.

We have, and in the future may continue to have, substantial debts. As of December 31, 2003 and 2004, our long-term debt to equity ratio was 2.6 and 2.5, respectively. The interest expenses associated with these debts might impair our future profitability. We expect that cash from operations and bank borrowings will be sufficient to meet our operating cash flow requirements, although events that materially affect our operating results can also have a negative impact on



liquidity. We have entered into credit facility agreements with Chinese banks to meet our future working capital needs. We have arranged, and we believe that we will continue to be able to arrange, short-term bank loans with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. However, our ability to obtain financing may be affected by our financial position and leverage, as well as by prevailing economic conditions and the cost of financing generally. If we are unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or to expand our operations could be impaired.

Capital Expenditures

Our aircraft orders as of December 31, 2004 included commitments to acquire 31 aircraft to be delivered in 2005 and 2006. We expect our capital expenditures for aircraft and related equipment, including deposits, through 2006 to be in aggregate approximately RMB8,791 million, including RMB6,945 million in 2005 and RMB1,350 million in 2006, in each case subject to contractually stipulated increases or any increase relating to inflation. We generally finance our purchase of aircraft through operating leases and bank loans secured by our assets. As of December 31, 2004, the total value of our mortgaged assets increased by 33.9%, from RMB9,735

million as of December 31, 2003 to RMB13,033 million as of December 31, 2004. Construction of our facilities at the Pudong International Airport and the purchase of maintenance equipment and other property and equipment will continue to require additional capital expenditures in 2005. We plan to finance our other capital commitments through a combination of funds generated from operations, existing credit facilities, bank loans, leasing arrangements and other external financing arrangements.

Foreign Currency Transactions

We have debts denominated in U.S. dollars, Japanese yen or Euro in addition to our debts denominated in Renminbi. We generate a significant amount of foreign currency revenues, including U.S. dollar, Japanese yen, Euro, Korean won, Hong Kong dollar, Singapore dollar, Australian dollar, and Thailand baht revenues, from ticket sales made in overseas offices. Pursuant to current foreign exchange regulations in China, we may retain our foreign currency earnings subject to the approval of SAFE, which are generally sufficient to satisfy our foreign currency liabilities payable within one year. We have also designated certain personnel to manage the foreign currency risks through derivative financial products such as forward foreign exchange contracts and interest rate swaps. We use interest rate swaps to reduce risks related to changes in market interest rates. As of December 31, 2004, the notional amount of the outstanding interest rate swap agreements was approximately US\$437 million, compared to US\$164 million as of December 31, 2003. These interest rate swap agreements will expire between 2006 and 2013. In addition, we use currency forward contracts to reduce risks related to

changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. As of December 31, 2004, the notional amount of the outstanding currency forward contracts was approximately US\$226 million, compared to US\$237 million as of December 31, 2003. These currency forward contracts will expire between 2006 and 2010.

Pursuant to IFRS, our monetary assets and liabilities denominated in foreign currencies are required to be translated into Renminbi at the year end at exchange rates announced by the People's Bank of China. The net exchange gains or losses are recognized and reflected in the income statement for the relevant year. Any fluctuation of the exchange rates between Renminbi and foreign currencies may materially adversely affect our financial condition and results of operations. The exchange rate between Renminbi and Japanese yen or Euro had experienced a significant level of fluctuation over the past two years. We had a net exchange gain of RMB40 million in 2004, compared to a net exchange loss of RMB70 million in 2003.

