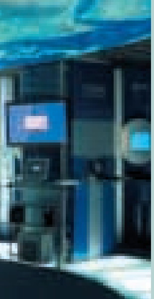
BREAKTHROUGH DEVELOPMENT FROM INTERNATIONAL STRATEGY

In 2004, the Group seized the opportunities from the recovery of the global telecommunications industry. Sales from the international market have significantly improved compared with the previous year. At the same time, the Group has made a significant breakthrough as a substantial cross-border telecommunications service provider and in developing new markets.

In December 2004, we were listed on the main board of Hong Kong Stock Exchange. The listing was in line with our globalization strategy and provides a better financial platform to the Group. We will also build a quality enterprise that is more transparent and responsible to shareholders in accordance with the demands of the international capital markets.

MANAGEMENT DISCUSSION AND ANALYSIS UNDER HONG KONG ACCOUNTING STANDARDS

The financial data below are extracted from the Group's audited financial statements prepared in accordance with Hong Kong accounting standards. The following discussion and analysis should be read in conjunction with the Group's financial statements audited by Ernst & Young and the accompanying notes as set out in this annual report.

Unit: in millions RMB

	2004	2003
Turnover		
Wireless communications	8,786.4	7,783.3
Wireline switch and access	2,598.6	2,257.9
Optical and data communications	2,335.3	2,211.0
Handsets	6,014.9	3,626.7
Telecommunications software systems, services and other products	1,484.9	1,157.2
Sub-total	21,220.1	17,036.1
Cost of sales	(13,813.5)	(11,226.1)
Gross profit	7,406.6	5,810.0
Other revenue and gains	534.1	252.0
Research and development costs	(2,265.2)	(1,535.7)
Selling and distribution costs	(2,799.6)	(1,981.5)
Administrative expenses	(981.4)	(869.0)
Other operating expenses	(162.4)	(213.9)
Profit from operating activities	1,732.1	1,461.9
Finance costs	(140.4)	(171.2)
Share of profits and losses of jointly-controlled entities and associates	3.4	(3.5)
Profit before tax	1,595.1	1,287.2
Tax	(115.3)	(198.6)
Profit before minority interests	1,479.8	1,088.6
Minority interests	(207.3)	(60.3)
Net profit from ordinary activities attributable to shareholders	1,272.5	1,028.3
Dividends	239.9	200.2
Earnings per share – basic	RMB1.57	RMB1.28

MANAGEMENT DISCUSSION AND ANALYSIS UNDER HONG KONG ACCOUNTING STANDARDS

Turnover

The following table sets out the revenue and the corresponding percentage of the total turnover attributable to the major product segments of the Group for the periods indicated:

Unit: in millions RMB

Product category	2004 Revenue	2004 Percentage of turnover	2003 Revenue	2003 Percentage of turnover
Wireless communications	8,786.4	41.4%	7,783.3	45.7%
Wireline switch and access	2,598.6	12.2%	2,257.9	13.2%
Optical and data communications	2,335.3	11.0%	2,211.0	13.0%
Handsets	6,014.9	28.4%	3,626.7	21.3%
Telecommunications software systems, services and other products	1,484.9	7.0%	1,157.2	6.8%
Total	21,220.1	100.0%	17,036.1	100.0%

The following table sets out the Group's revenue generated from sales in the PRC, Asia (excluding the PRC), Africa and other regions and the corresponding percentage of total turnover for the periods indicated:

Unit: in millions RMB

Region	2004 Revenue	2004 Percentage of turnover	2003 Revenue	2003 Percentage of turnover
The PRC	16,644.5	78.5%	15,076.4	88.5%
Asia (excluding the PRC)	2,459.9	11.6%	1,049.3	6.1%
Africa	1,513.1	7.1%	829.3	4.9%
Other regions	602.6	2.8%	81.1	0.5%
Total	21,220.1	100.0%	17,036.1	100.0%

The Group's turnover increased by 24.6% from RMB17,036.1 million in 2003 to RMB21,220.1 million in 2004, primarily due to revenue growth in the handsets and wireless communications segments. Revenue from sales in the PRC increased by 10.4% from RMB15,076.4 million in 2003 to RMB16,644.5 million in 2004. Revenue from international sales increased by 133.5% from RMB1,959.7 million in 2003 to RMB4,575.6 million in 2004.

Revenue in the Group's wireless communications segment increased by 12.9% from RMB7,783.3 million in 2003 to 8,786.4 million in 2004, primarily due to increased international sales of CDMA and GSM systems and also due to increased sales of CDMA systems to China Unicom and increased sales of GSM systems to China Mobile and China Unicom. Such increased sales were partly offset by a slight decrease in the Group's revenue from sales of PHS systems.

Revenue in the Group's wireline switch and access segment increased by 15.1% from RMB2,257.9 million in 2003 to RMB2,598.6 million in 2004. This increase was primarily due to increased domestic sales of wireline switch and access equipment. Sales of wireline switch and access equipment in the international market also increased slightly.

Revenue in the Group's optical and data communications segment increased by 5.6% from RMB2,211.0 million in 2003 to RMB2,335.3 million in 2004. This increase was primarily attributable to increased sales of ADSL products and of certain optical transmission products, partially offset by a decline in sales of routers and other products. The growth in sales of ADSL products was due primarily to increased investment in broadband networks by major telecommunications services providers in China.

MANAGEMENT DISCUSSION AND ANALYSIS UNDER HONG KONG ACCOUNTING STANDARDS

Revenue in the Group's handsets segment increased by 65.9% from RMB3,626.7 million in 2003 to RMB6,014.9 million in 2004, primarily due to an increase in volume, which was partially offset by a decrease in average sales prices. In 2003, the Group sold approximately 4.5 million handsets while in 2004 sales rose to approximately 10 million handsets. Such growth principally resulted from the Group's expansion of marketing activities.

Revenue in the Group's telecommunications software systems, services and other products segment increased by 28.3% from RMB1,157.2 million in 2003 to RMB1,484.9 million in 2004, primarily due to an increase in services revenue.

Cost of sales and gross profit

The following tables set out (1) the cost of sales of the Group and cost of sales as a percentage of total turnover and (2) the Group's gross profit and gross profit margin for the periods indicated:

Unit: in millions RMB

Product category	2004		2003	
	Costs of sales	Percentage of product segment revenue	Costs of sales	Percentage of product segment revenue
Wireless communications	4,973.2	56.6%	5,424.8	69.7%
Wireline switch and access	1,105.6	42.5%	966.8	42.8%
Optical and data communications	1,768.6	75.7%	1,393.3	63.0%
Handsets	5,286.2	87.9%	2,970.9	81.9%
Telecommunications software systems, services and other products	679.9	45.8%	470.3	40.6%
Total	13,813.5	65.1%	11,226.1	65.9%

Unit: in millions RMB

Product category	2004		2003	
	Gross profit	Gross profit margin	Gross profit	Gross profit margin
Wireless communications	3,813.2	43.4%	2,358.6	30.3%
Wireline switch and access	1,493.0	57.5%	1,291.1	57.2%
Optical and data communications	566.7	24.3%	817.7	37.0%
Handsets	728.7	12.1%	655.8	18.1%
Telecommunications software system, services and other products	805.0	54.2%	686.8	59.4%
Total	7,406.6	34.9%	5,810.0	34.1%

The Group's gross profit increased 27.5% from RMB5,810.0 million in 2003 to RMB7,406.6 million in 2004, primarily due to the growth in the Group's turnover. The Group's gross profit margin increased slightly from 34.1% in 2003 to 34.9% in 2004. This increase resulted primarily from an increased gross profit margin for the wireless communications segment, which was largely offset by decreased gross profit margins for the handsets and optical and data communications segments.

Gross profit margin in the Group's wireless communications segment increased from 30.3% in 2003 to 43.4% in 2004, due to increased gross profit margins from sales of PHS, GSM and CDMA systems. Gross profit margin for PHS systems was lower in previous years due to intense competition for market share. As the market has matured and competition has eased, gross profit margin for PHS systems has increased accordingly. Gross profit margin for CDMA systems increased as a result of the combined effect of lower unit costs of sales and increased international sales. Gross profit margin for GSM systems increased as a result of the higher contribution from international sales, on which profit margins are also generally higher.

Gross profit margin in the Group's wireline switch and access segment remained largely unchanged in 2004 at approximately 57.0% as an improvement in gross profit margin for the Group's circuit-switch products was offset by a larger decrease in gross profit margin for its narrow-band access systems.

Gross profit margin in the Group's optical and data communications segment decreased from 37.0% in 2003 to 24.3% in 2004, primarily due to a decline in gross profit margins from domestic sales of the Group's ADSL products.

Gross profit margin in the Group's handset segment decreased from 18.1% in 2003 to 12.1% in 2004 due to decreased gross profit margins for PHS and GSM handsets, partially offset by increased gross profit margin for CDMA handsets. Gross profit margins for PHS and GSM handsets declined as a result of lower unit prices in 2004 as compared to 2003 due to intense competition. This decline in gross profit margin principally took place in the second half of the year due in part to additional provisions for handset inventory obsolescence. Gross profit margin for CDMA handsets increased due to an improvement in gross profit margin from domestic sales and also due to increased international sales. In addition, we ceased sales of CDMA handsets purchased from third party suppliers, which relieved the pressure on pricing.

Gross profit margin in the Group's telecommunications software systems, services and other products segment decreased from 59.4% in 2003 to 54.2% in 2004, primarily due to a decrease in profit margins for certain other products, which was partially offset by an increase in gross profit margin for software systems.

Other revenue and gains

The other revenue and gains of the Group increased by 111.9% from RMB252.0 million in 2003 to RMB534.1 million in 2004. This increase is primarily attributable to value-added tax rebates received by Shenzhen ZTE Software Company, Limited ("ZTE Software") (which began operations in September 2003) and, to a significantly lesser extent, gains on disposal of short-term investments by ZTE (H.K.) Limited in 2004.

Research and development costs

The Group's research and development costs increased by 47.5% from RMB1,535.7 million in 2003 to RMB2,265.2 million in 2004. This increase was primarily due to the Group's expansion and an increase in the number of research and development employees and associated costs. The Group's research and development headcount increased from 6,321 as of 31 December 2003 to 8,287 as of 31 December 2004. The additional employees are mainly engaged in the research and development of 3G mobile communications, handsets and data communications products.

Selling and distribution costs

The Group's selling and distribution costs increased by 41.3% from RMB1,981.5 million in 2003 to RMB2,799.6 million in 2004, primarily as a result of increases in staff and welfare expenses, sales commissions and entertainment expenses which resulted generally from the Group's expanded operations, particularly overseas. Staff and welfare expenses increased primarily due to an increase in the number of sales and marketing employees from 4,717 as of 31 December 2003 to 7,973 as of 31 December 2004. Sales commissions increased due to the increase in international sales, a portion of which is undertaken though sales agents who are paid commissions. Entertainment expenses also increased significantly because of the expansion of international sales.

MANAGEMENT DISCUSSION AND ANALYSIS UNDER HONG KONG ACCOUNTING STANDARDS

Administrative expenses

The Group's administrative expenses increased by 12.9% from RMB869.0 million in 2003 to RMB981.4 million in 2004, primarily due to increased salaries, welfare benefits and social security insurance, which were in turn principally due to the increase in the number of administrative employees from 1,684 as of 31 December 2003 to 3,246 as of 31 December 2004.

Other operating expenses

The Group's other operating expenses decreased by 24.1% from RMB213.9 million in 2003 to RMB162.4 million in 2004, primarily due to a decrease in the provision for bad and doubtful debts and a decrease in losses on disposal of fixed assets. The decrease in the provision for bad and doubtful debts was due to the Group's recovery of some of the aged receivables for which provisions had been made although the ageing of trade and bills receivables generally increased in 2004. However, the decrease in provision was partially offset by an increase in foreign exchange losses and losses on the transfer of intangible assets.

Profit from operating activities

The Group's profit from operating activities increased by 18.5% from RMB1,461.9 million in 2003 to RMB1,732.1 million in 2004, while the profit margin from operating activities decreased from 8.6% in 2003 to 8.2% in 2004. This decrease in operating profit margin was mainly caused by the increase in selling and distribution costs and research and development costs as a percentage of turnover, which was largely offset by the slight increase in gross profit margin.

Finance costs

The Group's finance costs decreased by 18.0% from RMB171.2 million in 2003 to RMB140.4 million in 2004, primarily due to the repayment of bank loans and the consequent reduction in interest expenses.

Tax

The Group's tax expenses decreased by 41.9%, from RMB198.6 million to RMB115.3 million in 2004 and its effective tax rate decreased from 15.4% in 2003 to 7.2% in 2004, primarily due to an increase in the proportion of profit before tax contributed by subsidiaries that enjoy a lower tax rate or other tax benefits.

Minority interests

The Group's minority interests increased by 243.8% from RMB60.3 million in 2003 to RMB207.3 million in 2004, primarily due to the rapid growth in the net profit of ZTE Software, which began operations in September 2003. Minority interests as a percentage of profit before minority interests increased from 5.5% in 2003 to 14.0% in 2004.

Liquidity and capital resources

In 2004, the Group mainly funded its growth from cash generated from its operations and bank loans. The Group's cash requirements relate primarily to production and operating activities, repayment of liabilities as they become due, capital expenditure, interest and dividend payments and unexpected cash requirements.

The cash and cash equivalents as of 31 December 2004 were RMB7,509.2 million.

Cash flow data

Unit: in millions RMB

	2004	2003
Net cash inflow from operating activities	1,240.0	682.5
Net cash outflow from investing activities	(620.6)	(448.4)
Net cash inflow from financing activities	3,314.2	554.0
Net increase in cash and cash equivalents	3,933.6	788.1

Operating activities

The Group had a net cash inflow from operating activities of RMB1,240.0 million in 2004 compared to RMB682.5 million in 2003, primarily because of a decrease of RMB901.0 million in amounts due from customers for contract work, an increase of 22% in operating profit before working capital changes from RMB1,978.7 million in 2003 to RMB2,413.8 million in 2004 and an increase in other payables and accruals, which were partially offset by an increase in trade and bills receivables, an increase in inventories and a decrease in amounts due to customers for contract work. Amounts due from customers for contract work decreased in 2004 because the seasonal effects of telecommunications systems contracts decreased in 2004 with more contracts being completed over the year compared to the number of contracts in progress. Amounts due to customers for contract work decreased because advance payments received by the Group for telecommunications systems contracts declined. Trade and bills receivables and inventories generally increased in line with the increase in the Group's sales. In 2004, the Group's receivables turnover was 3.8 compared to 4.0 in 2003, the Group's inventory turnover was 9.1 compared to 9.4 in 2003 and the Group's payables turnover was 3.1 compared to 2.9 in 2003.

Investment activities

The net cash outflow from the Group's investment activities in 2004 was RMB620.6 million as compared to RMB448.4 million in 2003. This cash was mainly used in the expansion of the Group's operations and scale of production, of which RMB497.9 million was applied in the acquisition of equipment and facilities, testing apparatus, computers and additional office equipment, and RMB58.2 million was applied to the construction of the Group's Shenzhen research and development center.

Financing activities

In 2004, the Group's net cash inflow from financing activities amounted to RMB3,314.2 million, which was generated from the receipt of proceeds of the global offering of H shares completed in December 2004, partially offset by a net reduction in loans.

Capital expenditure

The following table sets out the Group's capital expenditure for the periods indicated. The following capital expenditure was funded out of the proceeds of the Company's initial and subsequent offerings of A shares, long-term bank loans, cash generated from operating activities and government grants.

Unit: in millions RMB

Capital expenditure	2004	2003
Purchases of fixed assets and additions to construction in progress	**647.0**	500.0

The Group's capital expenditures in 2004 exceeded the estimated amount of RMB400.0 million in capital expenditures disclosed in the prospectus for its H share offering. This was due to the Group proceeding with certain capital expenditure projects which were not originally intended to be implemented in 2004. The Group decided to proceed with these projects on the basis of the smooth progress of the H share offering process and the expected proceeds therefrom.

For the year ending 31 December 2005, the Group expects to incur approximately RMB900 million in capital expenditures relating primarily to the completion of construction of the Company's research and development center in Shenzhen and the acquisition of other equipment and facilities. The actual amounts spent may vary from the budgeted amounts of capital expenditure for a variety of reasons, including changes in market conditions and other factors.

There is no guarantee that any of the planned capital expenditures outlined above will proceed as planned. As the Group continues to expand, it may incur additional capital expenditures. In the future, the Group may consider additional debt or equity financing, depending on market conditions, the Group's financial performance and other relevant factors. The Group can provide no assurance that it will be able to raise additional capital, should that become necessary, on terms acceptable to the Group or at all.

Indebtedness

Unit: in millions RMB

	As at 31 December	
	2004	2003
Secured bank loans	**361.6**	404.9
Unsecured bank loans	**1,085.4**	1,332.0

Unit: in millions RMB

	As at 31 December	
	2004	2003
Short-term bank loans	**421.7**	977.9
Long-term bank loans	**1,025.3**	759.0

The banking facilities available to the Group comprise long-term and short-term loans from banks. Long-term loans are principally applied by the Group for capital expenditure projects. Short-term loans are principally applied by the Group for working capital purposes. The Group's long-term loans bear interest at fixed rates. The Group's borrowings are denominated principally in Renminbi and also in US dollars.

In 2004, the Group's bank loans have decreased, primarily due to the increase in sales receipts and increase in available cash balances.

Contractual obligations

Unit: in millions RMB

	As at 31 December 2004			
	Total	Less than one year	Two to five years	More than five years
Bank loans	1,447.0	421.7	1,025.3	–
Operating lease obligations	149.3	74.4	67.5	7.4

Contingent Liabilities

Unit: in millions RMB

	2004	2003
Bills discounted with recourse	440.9	975.2
Trade debtors factored with recourse	691.7	–
Guarantees given to banks in connection with facilities granted to third parties	–	12.8
Guarantees given to banks in respect of performance bonds	1,626.1	1,114.3
Total	2,758.7	2,102.3

Capital Commitments

The Group had the following capital commitments as of the dates indicated:

Unit: in millions RMB

	As at 31 December	
Land and buildings	2004	2003
Contracted, but not provided for	282.4	3.3
Authorised, but not contracted for	–	296.7

Details of the subsidiaries, jointly-controlled entities and associates of the Group

Details of the subsidiaries, jointly-controlled entities and associates of the Group as at 31 December 2004 are set out in notes 18, 19 and 20 to the financial statements prepared in accordance with Hong Kong accounting standards.

Market risks

Interest rate risk: The Group's interest rate risk principally arises from its interest-bearing long-term liabilities. The Company controls its interest rate risk mainly by adjusting the maturities of its debts.

Foreign exchange risk: Since the Renminbi is now closely pegged to the US dollar, the Group faces foreign exchange exposure mainly from fluctuations in the exchange rates for currencies other than the US dollar. For overseas purchases and international sales transactions not denominated in US dollars, the Group adopts clauses in purchase contracts designed to transfer or share the exchange rate exposure. The Group also seeks to control foreign exchange risk by the use of derivatives such as futures and options.

Internal controls

The Group has established an internal control system and risk management mechanisms and will conduct verification and make improvements on a periodic basis to ensure their effectiveness and efficiency. The internal control process is aimed at, among other things, ensuring that the Group's assets are safeguarded while improving operating efficiency.