

Management Discussion and Analysis



The following discussion and analysis should be read in conjunction with the financial statements of the Group prepared under IFRS as set out on pages 43 to 99. The Group also prepares financial statements in accordance with PRC Accounting Rules and Regulations as set out on pages 100 to 182. IFRS differs in certain material respects from PRC Accounting Rules and Regulations. For a discussion of the material differences between IFRS and PRC Accounting Rules and Regulations relating to the Group, see supplementary information on pages 183 to 184 of this Annual Report.

OVERVIEW

From the fast growing economy in the PRC, growth in airline market has been carried on which was commenced in second half of 2003. The Group's business was benefited from the increasing traffic demand in which both the passenger volume and passenger load factor were improved. Nevertheless, the Group is facing pressure on its operation was due to the seasonal effects and the increase in jet fuel cost.

The continuing political tension in the Middle East led to high fuel prices which in turn caused an increase in the Group's jet fuel cost. The Group has implemented various measures to control the increase in operating expenses.

Pursuant to "Pricing Reform of Domestic Civil Aviation" as approved by the State Council of the PRC effective on 20 April, 2004, prices on domestic routes now fluctuate freely within a predetermined range. Instead of direct supervision by setting prices of air tickets through local price bureau, the government now provides guidance on domestic flights and domestic civil aviation is controlled by the government indirectly. Market-oriented pricing policy was introduced and pricing system has been adjusted as a result of the above pricing reform.

Certain financial information and operating data by geographic region

The following table sets forth certain financial information and operating data by geographic region for the years ended 31 December, 2003 and 2004:

	For the year ended 31 December,		2004 vs 2003 % Increase/ (decrease)
	2004	2003	
Traffic			
Revenue passenger kilometres (RPK) (million)			
– Domestic	29,121	21,294	36.8
– Hong Kong regional	1,203	778	54.6
– International	6,872	4,315	59.3
Total	37,196	26,387	41.0
Revenue tonne kilometres (RTK) (million)			
– Domestic	3,206	2,424	32.3
– Hong Kong regional	120	78	53.8
– International	1,337	1,059	26.3
Total	4,663	3,561	30.9
Passengers carried (thousand)			
– Domestic	25,002	18,259	36.9
– Hong Kong regional	1,394	1,019	36.8
– International	1,811	1,192	51.9
Total	28,207	20,470	37.8



Management Discussion and Analysis (Cont'd)

	For the year ended 31 December,		2004 vs 2003
	2004	2003	% Increase/ (decrease)
Cargo and mail carried (thousand tonnes)			
– Domestic	442	379	16.6
– Hong Kong regional	15	12	25.0
– International	88	73	20.5
Total	545	464	17.5
Capacity			
Available seat kilometres (ASK) (million)			
– Domestic	41,330	32,590	26.8
– Hong Kong regional	1,896	1,347	40.8
– International	10,543	6,930	52.1
Total	53,769	40,867	31.6
Available tonne kilometres (ATK) (million)			
– Domestic	4,773	3,772	26.5
– Hong Kong regional	211	150	40.7
– International	2,462	1,999	23.2
Total	7,446	5,921	25.8
Load factors			
Passenger load factor (RPK/ASK) (%)			
– Domestic	70.5	65.3	8.0
– Hong Kong regional	63.4	57.8	9.7
– International	65.2	62.3	4.7
Overall	69.2	64.6	7.1
Overall load factor (RTK/ATK) (%)			
– Domestic	67.2	64.2	4.7
– Hong Kong regional	56.9	52.2	9.0
– International	54.3	53.0	2.5
Overall	62.6	60.1	4.2

Management Discussion and Analysis (Cont'd)

	For the year ended 31 December,		2004 vs 2003 % Increase/ (decrease)
	2004	2003	
Yield			
Yield per RPK (RMB)			
– Domestic	0.58	0.57	1.8
– Hong Kong regional	0.92	0.96	(4.2)
– International	0.46	0.47	(2.1)
Overall	0.57	0.57	–
Yield per RTK (RMB)			
– Domestic	5.53	5.40	2.4
– Hong Kong regional	9.83	10.35	(5.0)
– International	3.31	2.90	14.1
Overall	5.01	4.76	5.3
Fleet			
Total number of aircraft in service at year end (Note)			
– Boeing	137	108	26.9
– Airbus	46	24	91.7
– McDonnell Douglas	35	–	N/A
– Others	13	–	N/A
Total	231	132	75.0
Overall utilisation rate (hours per day)			
– Boeing	10.0	8.6	16.3
– Airbus	9.2	7.9	16.5
– Others	8.4	–	N/A
Overall	9.9	8.5	16.5
Cost			
– Operating cost per ASK (RMB)	0.43	0.42	2.4
– Operating cost per ATK (RMB)	3.10	2.87	8.0

Note: As approved by the Company's shareholders in an extraordinary general meeting on 31 December, 2004, the Company acquired the airline operations and certain related assets of China Northern Airlines Company and Xinjiang Airlines Company. Accordingly, a total of 78 aircraft were added at 31 December, 2004.



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2004 COMPARED WITH 2003

The Group recorded a net loss of RMB48 million for 2004, as compared to a net loss of RMB358 million for 2003. The Group's operating revenue increased by RMB6,504 million or 37.2% from RMB17,470 million in 2003 to RMB23,974 million in 2004. Passenger load factor increased by 4.6 percentage point from 64.6% in 2003 to 69.2% in 2004. Passenger yield (in passenger revenue per RPK) remain steady and at RMB 0.57 in both years. Average yield (in traffic revenue per RTK) increased by 5.3% from RMB4.76 in 2003 to RMB5.01 in 2004. Operating expenses increased by RMB6,051 million or 35.6% from RMB17,014 million in 2003 to RMB23,065 million in 2004. As operating revenue increased more than operating expenses, operating profit increased by 99.3% from RMB456 million in 2003 to RMB909 million in 2004. The Group's net non-operating expenses decreased by 30.1%, from RMB967 million in 2003 to RMB676 million in 2004, mainly attributable to a decrease in unfavourable movement in foreign exchange differences of RMB105 million and a decrease in interest expense of RMB133 million. Overall, the Group recorded a net loss of RMB48 million in 2004, as compared to a net loss of RMB358 million in 2003.



OPERATING REVENUE

Substantially all of the Group's operating revenue is attributable to airline and airline related operations. Traffic revenue in 2004 and 2003 accounted for 97.4% and 97.1% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 90.4% and 9.6% respectively of total traffic revenue in 2004. The balance of the Group's operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.



Operating revenue increased by 37.2% from RMB17,470 million in 2003 to RMB23,974 million in 2004. This increase was primarily due to a 40.6% rise in passenger revenue from RMB15,010 million in 2003 to RMB21,100 million in 2004 resulting from increased traffic volume. The total number of passengers carried increased by 37.8% to 28.2 million passengers in 2004. RPKs increased by 41.0% from 26,387 million in 2003 to RMB37,196 million in 2004, primarily as a result of an increase in passengers carried. Passenger yield remained constant at RMB0.57.

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Domestic passenger revenue, which accounted for 79.9% of the total passenger revenue in 2004, increased by 37.8% from RMB12,242 million in 2003 to RMB16,869 million in 2004. Domestic passenger traffic in RPKs increased by 36.8%, mainly due to an increase in passengers carried. Passenger yield remained steady in 2004 and at RMB0.58.

Hong Kong passenger revenue, which accounted for 5.3% of total passenger revenue, increased by 47.2% from RMB750 million in 2003 to RMB1,104 million in 2004. For Hong Kong regional flights, passenger traffic in RPKs increased by 54.6%, while passenger capacity in ASKs increased by 40.8%, resulting in a 5.6 percentage point increase in passenger load factor from 2003. Passenger yield decreased from RMB0.96 in 2003 to RMB0.92 in 2004 mainly due to intensified competition among airlines.

International passenger revenue, which accounted for 14.8% of total passenger revenue, increased by 55.0% from RMB2,018 million in 2003 to RMB3,127 million in 2004. For international flights, passenger traffic in RPKs increased by 59.3%, while passenger capacity in ASKs increased by 52.1%, resulting in a 2.9 percentage point rise in passenger load factor from 2003. Passenger yield decreased by 2.1% from RMB0.47 in 2003 to RMB0.46 in 2004 mainly resulted from the increases in traffic derived from long haul routes which generally had a lower yield than short haul routes.

Cargo and mail revenue, which accounted for 9.6% of the Group's total traffic revenue and 9.4% of total operating revenue, increased by 14.8% from RMB1,955 million in 2003 to RMB2,244 million in 2004. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 24.8% from RMB505 million in 2003 to RMB630 million in 2004. The increase was primarily due to the general growth in income from various auxiliary operations.





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OPERATING EXPENSES

Substantially all of the Group's operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repair and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group's flight operations (collectively, "flight operations expenses") include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses

associated directly with repairs and maintenance in respect of the Group's aircraft (collectively, "repairs and maintenance expenses") include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group's aircraft and traffic servicing operations (collectively "aircraft and traffic servicing expenses") include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group's operating expenses result from promotional and marketing activities (collectively, "promotional and marketing expenses") such as sales commissions, fees for use of the CAAC's reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

Total operating expenses in 2004 amounted to RMB23,065 million, representing an increase of 35.6% or RMB6,051 million over 2003, primarily due to the combined effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue decreased from 97.4% in 2003 to 96.2% in 2004.

Flight operations expenses, which accounted for 45.2% of total operating expenses, increased by 47.4% from RMB7,070 million in 2003 to RMB10,418 million in 2004, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses, labour costs for flight personnel and inclusion of CAAC Infrastructure Development Fund of RMB466 million in operating expenses which is an usage charge since 2004 but was a turnover-based levy and deducted against the traffic revenue in 2003. Jet fuel costs, which accounted for 58.1% of flight operations expenses, increased by 56.5% from RMB3,867 million in 2003 to RMB6,050 million in 2004 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 8.4% from RMB1,536 million in 2003 to RMB1,665 million in 2004, primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 38.2% from RMB510 million in 2003 to RMB705 million in 2004, primarily due to increased passenger carried. Aircraft insurance costs decreased by 5.6% from RMB196 million in 2003 to RMB185 million in 2004, primarily because of a decrease in insurance premiums prescribed by the PRC insurance company. Labour costs for flight personnel increased by 40.9% from RMB728 million in 2003 to RMB1,026 million in 2004, largely due to the increase in flying hours.

Maintenance expenses which accounted for 15.0% of total operating expenses, increased by 33.6% from RMB2,589 million in 2003 to RMB3,459 million in 2004. The increase was primarily attributable to an 32.9% increase in aircraft overhaul charges from RMB2,377 million in 2003 to RMB3,158 million in 2004, as resulted from fleet expansion in recent years.

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Aircraft and traffic servicing expenses, which accounted for 15.2% of total operating expenses, increased by 26.6% from RMB2,767 million in 2003 to RMB3,503 million in 2004. The increase primarily resulted from an 25.7% rise in landing and navigation fees from RMB2,563 million in 2003 to RMB3,222 million in 2004, due to an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 8.4% of total operating expenses, increased by 31.1% from RMB1,480 million in 2003 to RMB1,940 million in 2004. The increase was due to 44.4% increase in labour costs from RMB225 million in 2003 to RMB325 million in 2004, as more payments of performance bonus were made because of the increased traffic volume.

General and administrative expenses, which accounted for 5.7% of the total operating expenses, increased by 25.6% from RMB1,053 million in 2003 to RMB1,323 million in 2004. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 10.5% of total operating expenses, increased by 18.4% from RMB2,038 million in 2003 to RMB2,413 million in 2004. This increase was primarily as a result of the additions of aircraft during 2004.

OPERATING PROFIT

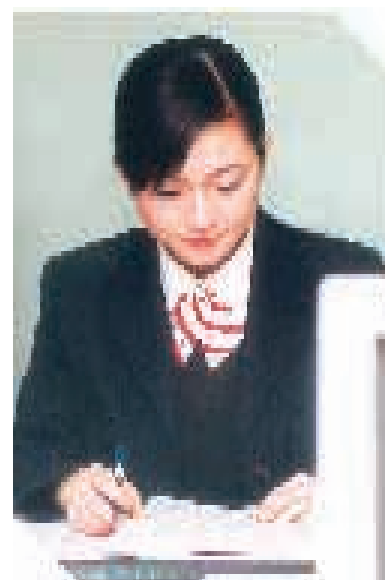
Operating profit increased by 99.3% from RMB456 million in 2003 to RMB909 million in 2004. This was mainly because operating revenue increased by RMB6,504 million or 37.2% from 2003 and operating expenses increased by RMB6,051 million or 35.6% over the same period.

NON-OPERATING INCOME/(EXPENSES)

Interest expense decreased by 16.1% from RMB824 million in 2003 to RMB691 million in 2004, mainly reflecting the combined effect of scheduled debt repayments and the replacement of certain RMB denominated bank loans of higher interest rates with US\$ denominated bank loans of lower interest rates.

Interest income increased by 69.2% from RMB13 million in 2003 to RMB22 million in 2004. This was mainly attributable to an increase in average cash balances.

During 2004, the Group recorded a net exchange loss of RMB59 million (2003: RMB164 million) mainly from its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealised translational exchange loss.





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TAXATION

On 17 October, 2003, the Company's registered address was moved to Guangzhou Economic & Technology Development Zone, Guangzhou, China. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document "Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043", the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective from 1 October, 2003. As a result, the Company's income tax rate has been changed from 33% to 15% beginning from that date.

In 2003, the Group recorded an income tax credit of RMB324 million resulting from reduction in net deferred taxation liability balance of RMB392 million. In 2004, income tax expense of RMB78 million was recorded.

MINORITY INTERESTS

Minority interests increased by 18.7% from RMB171 million in 2003 to RMB203 million in 2004, primarily reflecting the increased net profits earned by certain of the Group's airline subsidiaries for the year.

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As at 31 December, 2004, the Group's borrowings totalled RMB35,196 million, representing an increase of RMB16,736 million from RMB18,460 million last year. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen, Hong Kong dollars and Renminbi, with a significant portion being fixed interest rate borrowings. Of such borrowings, RMB13,662 million, RMB4,489 million, RMB6,705 million, RMB3,608 million and RMB6,732 million will be repayable in 2005, 2006, 2007, 2008, 2009 and thereafter respectively. As at 31 December, 2004, cash and cash equivalents of the Group totalling RMB3,083 million, of which 24.2% were denominated in foreign currencies, increased by 48.2% from RMB2,080 million last year.

Net debts (total borrowings net of cash and cash equivalents) increased by 96.1% to RMB32,113 million.

As at 31 December, 2004, the Group's shareholders' equity amounted to RMB11,848 million, representing a decrease of RMB48 million from RMB11,896 million last year.

Net debt/equity ratio of the Group at 31 December, 2004 was 2.71 times, as compared to 1.38 times last year.

FINANCIAL RISK MANAGEMENT POLICY

In the normal course of business, the Group is exposed to fluctuations in foreign currencies and jet fuel prices. The Group's exposure to fluctuations in foreign currencies is a result of its debts which are denominated in foreign currencies. Depreciation or appreciation of the RMB against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, by entering into forward foreign exchange contracts with certain authorised PRC banks. The Group is required to procure a majority of its jet fuel domestically at PRC spot market prices. There are currently no effective means available to manage the Group's exposure to the fluctuations in domestic jet fuel prices.

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CHARGES ON ASSETS

As at 31 December, 2004, certain aircraft of the Group with an aggregate carrying value of approximately RMB23,562 million (2003: RMB14,576 million) were mortgaged under certain loan and lease agreements.

COMMITMENTS AND CONTINGENCIES

At 31 December, 2004, the Group had capital commitments of approximately RMB26,871 million. Of such amounts, RMB25,347 million related to the acquisition of aircraft and related flight equipment and RMB824 million related to the Group's facilities and equipment to be constructed and installed at the new Guangzhou Baiyun International Airport. The remaining amount of RMB700 million was related to the Group's other airports and office facilities and equipment, overhaul and maintenance bases and training facilities.

As at 31 December, 2004, the Group committed to make a capital contribution of approximately RMB181 million and RMB83 million to its subsidiaries and to its jointly controlled entities respectively.

Details of the capital and investing commitments are set out in note 30 to the financial statements prepared under IFRS.

Major contingent liabilities of the Group at 31 December, 2004 are set out in note 31 to the financial statements prepared under IFRS.