

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our consolidated financial statements together with the accompanying notes, included elsewhere in this annual report. The consolidated financial statements of the Group have been prepared in accordance with accounting principles generally accepted in Hong Kong ("HK GAAP"), which may differ in certain material respects from the generally accepted accounting principles in the United States of America ("U.S. GAAP"). A summary of the material differences is contained under the heading "Supplementary Information".

In 2005, the Group has changed certain of its accounting policies following the adoption of new / revised Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards (the together "HKFRSs") which are effective for accounting periods commencing on or after January 1, 2005. Certain financial information for 2004 has been restated and adjusted to reflect the adoption of the new / revised HKFRSs. A summary of the effects of adopting these new / revised HKFRSs is set out in Note 2(a) to the consolidated financial statements.

Overview

The Group is engaged principally in alumina refining and primary aluminum smelting operations. The Group organizes and manages its operations according to the following business segments:

- Alumina segment, which consists of mining and purchasing bauxite and other raw materials, refining bauxite into alumina, and selling alumina both internally to the Group's primary aluminum smelters and externally to customers outside the Group. This segment also includes the production and sales of alumina hydrate, alumina chemicals and gallium.
- Primary aluminum segment, which consists of procuring alumina and other raw materials, supplemental materials, smelting alumina to produce primary aluminum and selling substantially all primary aluminum products to external customers. In addition, this segment includes production and sales of carbon products and small amount of aluminum-fabricated products.
- Corporate and other services segment, which includes the headquarters' operations, research conducted by the Group's research institutes and provision of the Group's research and development services to third parties.

Results of Operations

The Group's net profit attributable to the equity holders of the Company amounted to RMB7,022 million for the year ended December 31, 2005, representing an increase of RMB630 million, from the previous year's net profit attributable to the equity holders of the Company of RMB6,392 million (restated).

Revenues

The Group's sales of goods increased by 14.85% from RMB32,313 million for the year 2004 to RMB37,110 million for the year 2005, representing an increase of RMB 4,797 million. The increase was primarily due to the increase in sales volume of alumina and primary aluminum and the increase in selling prices of the same.

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In 2005, the Group's external sales volume of primary aluminum reached 905,000 tonnes, representing an increase of 144,400 tonnes or 18.99% from 760,600 tonnes of 2004, which resulted to an increase of 6.15% in the total turnover. The increase was primarily attributable to the 33,800 tonnes primary aluminum produced by Shanxi Huaze an increase of 67,600 tonnes of primary aluminum due to the operation of the technological renovation project in Qinghai branch, and the increase of primary aluminum of 43,000 tonnes through technological renovation of existing production lines.

The external sales volume of alumina increased from 4,870,200 tonnes in 2004 to 5,365,000 tonnes in 2005, representing an increase of 494,800 tonnes or 10.16%, which in turn represents an increase of 4.95% in the total turnover. The increase was mainly attributable to the increase of output resulted from the commencement of production of the 800,000 tonnes alumina production lines in Shanxi, the 700,000 tonnes alumina production line in Henan and the 300,000 tonnes alumina productions line in Zhongzhou in 2005.

In 2005, the Group's average external selling price of alumina reached RMB3,268.32 per tonne (tax excluded, similarly thereafter), representing an increase of RMB38.66 per tonne from RMB3,229.66, which in turn represents an increase of 0.64% in the total turnover. Though the spot price for alumina in 2005 increased when compared with the previous year, for the purpose of ensuring a long-term stability of the alumina's selling price of the Group and justifying the sales structure, the Group captured on the favourable opportunity to continue to nurture, stabilize and consolidate the clientele and increased the percentage of long-term contracts appropriately. Thus there is no substantial increase in the Group's revenue.

Due to the increase of selling price of primary aluminum, the Group's average external selling price of primary aluminum increased by RMB507.69 per tonne from RMB13,756.33 per tonne in 2004 to RMB14,264.02 per tonne in 2005, which in turn represents an increase of 1.42% in turnover.

Cost of Sales

The Group's total cost of sales increased by RMB3,319 million or 15.44 % from RMB 21,503 million (restated) in 2004 to RMB24,822 million in 2005. The increase was mainly attributable to a growth in sales volume of alumina and primary aluminum, and the increased unit production costs of primary aluminum and alumina caused by the increase in raw material prices. The growth in sales volume of alumina and primary aluminum and the increase in production cost caused an increase of 10.17% and 4.25%, respectively, in its cost of sales.

Selling and Distribution Expenses

The Group's selling and distribution expenses increased by RMB39 million from RMB648 million in 2004 to RMB687 million in 2005, up 6.02%, which was primarily attributable to the increase in transportation and loading fee due to the growth of sales volume of primary aluminum.

General and Administrative Expenses

General and administrative expenses increased by RMB302 million from RMB1,221 million in 2004 to RMB1,523 million in 2005, up 24.73%. The increase was mainly due to increase in operational and related expenses of RMB128 million due to the commencement of the operation of a subsidiary, Shanxi Huaze and a new subsidiary engaged in mining operation. The charges related to taxation imposed by the PRC tax authorities increased by RMB56 million due to the expanded business. Rental expenses increased by RMB45 million as result of the new lease of the Company's headquarters. The continued efforts to strengthen the internal control system and information system of the Group increased the office and other expenses by RMB34 million. The Group's insurance premiums increased by RMB10 million as the Group spent more on property insurance.

Research and Development Cost

The Group's cost expenditure for research and development decreased by RMB20 million or 15.04% from RMB133 million in 2004 to RMB113 million in 2005. In 2005, the expenses used for research and development was RMB269 million, which was basically the same amount as in 2004. The decrease of expenditure for research and development of RMB20 million in 2005 was primarily due to the decrease on expenditure for the Group's new R&D projects.

Net Other Revenue

The Group's net other revenue in 2005 included a net gain of RMB116 million, an increase of RMB15 million or 14.85% from RMB101 million in 2004. This was attributable to the fact that Chalco International Trading, a subsidiary of the Company, hedged some of the primary aluminum contracts in the futures market, resulting in a profit of RMB5.76 million upon closing the futures contracts in 2005 while a loss of RMB25.49 million was recorded in 2004.

Operating Profit

As a result of the foregoing, the Group's operating profit increased by RMB1,171 million from RMB8,910 million in 2004 (restated) to RMB10,081 million in 2005, up 13.14%. The Group's operating profit as a percentage of sales of goods was 27.57% in 2004 and 27.17% in 2005.

Finance Costs

The Group's finance costs increased by RMB257 million, from RMB110 million in 2004 (restated) to RMB367 million in 2005 (interest expenses: RMB405 million, foreign exchange gains: RMB38 million). The increase was primarily due to commencement of production upon completion of a majority of the construction projects in progress in 2005, so that no interest was capitalized, which led to an increase of RMB284 million in interest expenses. Furthermore, owing to the appreciation of RMB, foreign exchange gain increased by RMB27 million.

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Total interest expense increased by RMB189 million from RMB520 million in 2004 to RMB709 million in 2005, of which capital expenditure was RMB304 million and cost expense was RMB405 million. The increase was attributable to the increased interest expense of RMB120 million from the increased long-term loan of RMB2,299 million; an increase in interest rates resulted in increased interest expenses of RMB41 million; increased working capital as a result of commencement of operation of new production lines; increased interest expense of approximately RMB28 million due to the issue of short-term bonds of RMB1,943 million and repayment of partial short-term loan of RMB1,070 million.

Income Taxes

The Group's income tax expenses increased by RMB334 million or 15.46% from RMB2,161 million (restated) in 2004 to RMB2,495 million in 2005. The

increase of income tax of approximately RMB221 million was mainly attributable to the increased profit of the Company. Tax credit on certain qualified capital expenditures in 2005 was reduced, and resulted in an increase of tax expenses by approximately RMB135 million. However, a tax charge of RMB22 million on Shandong Aluminum Industry Co., Ltd., a subsidiary of the Company, was waived upon the approval by the relevant tax authority of a tax concession for integrated utilization of resources.

The Group's weighted average effective tax rate was 25.61% in 2005, which was lower than the statutory tax rate of 33.0%. This was mainly because three branches of the Company situated in Guizhou, Guangxi and Qinghai in the western region of the PRC are entitled to a preferential income tax rate of 15.0%.

Minority Interest

Minority interest decreased from RMB244 million in 2004 to RMB224 million in 2005 primarily due to a loss recorded in the Company's newly operated subsidiary, Shanxi Huaze, where its indicative production technology has not yet been stabilized, resulting in higher production cost, and operation expenses of RMB42 million.

Net Profit for the Year

As a result of the foregoing, the Group's net profit attributable to the equity holders of the Company for the year increased by RMB630 million (9.86%) from RMB6,392 million in 2004 (restated) to RMB7,022 million in 2005.



Discussion of Segment Operations

Alumina Segment

Sales of Goods

The Group's total sales of goods of the alumina segment increased by RMB3,322 million, an increase of 13.44% from RMB24,724 million in 2004 to RMB28,046 million in 2005, this was mainly due to the increased sales volume and selling price of the Group's alumina.

Revenues from the external sales of alumina in 2005 rose by RMB2,356 million, an increase of 11.49% from RMB20,498 million in 2004 to RMB22,854 million in 2005, mainly a result of increased external sales volume and selling price of alumina, which increased the sales revenue of 7.80% and 1.01%, respectively.

Revenues from the sales of alumina to the Group's smelters rose by RMB966 million from RMB4,226 million in 2004 to RMB5.192 million in 2005, primarily a result of the increased output of the Group's aluminum, which increased the alumina supplied by the Group's alumina factory to its smelters for production.

Cost of Goods Sold

The total cost of goods sold in the alumina segment of the Group increased by RMB2,165 million or 15.05% from RMB 14,387 million in 2004 to RMB16,552 million in 2005. The increase was mainly attributable to the sales volume of alumina products which increased by 10.16% over the previous year and an increased unit production cost. The unit production cost of alumina products in 2005 increased when compared with 2004 mainly

due to the increase in price in raw materials, resulting in the increase of its unit production cost of 14.36% year on year. In addition, the unit production cost decreased by 4.27% as consumption rate decreased and output increased, offsetting the influences imposed by the rising prices of certain raw materials. The decrease of consumption rate is mainly due to technological renovation carried out in each production plant, resulting in an improvement of its technical economic indicator over 2004.

Operating Profit

As a result of the foregoing, the Group's total operating income of alumina segment increased by 10.49% from RMB9,333 million in 2004 to RMB10,312 million in 2005. The ratio of operating income of the alumina segment to the Group sales of goods decreased from 37.75% in 2004 to 36.77% in 2005.

Primary Aluminum Segment

Sales of Goods

The Group's total sales of goods for the primary aluminum segment increased by RMB2,408 million or 20.55% from RMB 11,720 million in 2004 to RMB 14,128 million in 2005, mainly due to the increase of the Group's primary aluminum external sales volume from 760,600 tonnes in 2004 to 905,000 tonnes in 2005, up 144,400 tonnes and, caused an increase of 16.94% in the sales of goods. The revenue from sales increased by 3.92% because of the growth in selling price, the decrease of sales volume of other products like carbon also offset the growth of the sales of certain products. The ratios of sales volume of the Group to the sales of primary aluminum segment for 2004 and 2005 were 81.23% and 92.19% respectively.

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Cost of Goods Sold

The total cost of goods sold in respect of the Group's primary aluminum segment increased by 18.16% from RMB11,240 million in 2004 to RMB13,281 million in 2005, mainly due to the increase in the external sales volume and unit production cost of primary aluminum. The production cost of primary aluminum products increased because of the increased electricity cost and production cost of alumina. However, the increased output of primary aluminum products diluted the fixed production expenses which in turn offset the partial impact resulted from the increase in raw materials expenses.

Operating Profit

The primary aluminum segment recorded an operating profit of RMB232 million, up RMB276 million as compared with the loss of RMB44 million in 2004. This was mainly attributable to a growth in the selling price and sales volume of primary aluminum.

Corporate and Other Services Segment

The Group's corporate and other services segment reflected the expenses of the Group's corporate segment, research and development services and product sales of the Group's research institute to external customers. This segment recorded a decrease in operating loss from RMB76.91 million in 2004 to a loss of RMB48.44 million in 2005.

Working Capital, Liabilities and Capital Commitments

As of December 31, 2005, the Group's current assets amounted to RMB16,963 million, representing an increase of RMB2,606 million over RMB14,357 million in 2004.

- the Group's inventories amounted to RMB7,235 million, representing an increase of RMB2,003 million over RMB5,232 million of the end of 2004. The increase was mainly attributable to the increased working capital resulting from the commencement of operation of additional production lines, namely the 280,000 tonnes aluminum smelting project of Shanxi Huaze and the 800,000 tonnes alumina project in Shanxi as well as the increase in the price of raw materials, resulting in the increase in the cost of inventories.
- the Group's net account receivables amounted to RMB961 million, representing a decrease of RMB1,004 million as compared with RMB1,965 million at the end of 2004, mainly due to faster cash receipts during the selling process. Of the account receivables, bills receivables and trade receivables decreased RMB812 million and RMB192 million, respectively, over the end of 2004.

As of December 31, 2005, the Group's current liabilities amounted to RMB14,938 million, representing an increase of RMB1,745 million as compared with RMB13,193 million at the end of 2004, which consists of the closing balance of RMB1,971 million of the corporate short-term bonds issued by the Group, increased payables of RMB603 million and the increase of RMB280 million of long-term loans due and repayable within one year, leading to an increase of total current liabilities of RMB2,854 million. In addition, short-term loans decreased by RMB1,070 million offset the increase of current liabilities.

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The PRC government implemented measures to reform its financial system in 2005 by increasing the channels for enterprises to obtain finances among banks. The Group is pleased to be among the first batch of enterprises to have been granted the qualification to issue corporate short-term bonds and, accordingly, has been granted a revolving credit of RMB5,000 million. Such grants qualified the Group to obtain finances among banks and widen the financing channels of the Group.

In June 2005, the Group successfully issued RMB2,000 million short-term bonds of par value RMB100 each at an issue price of RMB97.16, and accordingly an aggregate of RMB1,943 million has been raised and effective interest rate was approximately at 3.33%. The bonds are due a year from the date of issue. In addition, due to the lower financing cost of short-term bond issue as compared to bank loans for the corresponding period, the issuance has lowered the interest expense by approximately RMB33 million. The Group has plans to issue the remaining short-term bonds of RMB3,000 million in the first half of 2006.

As a result of the foregoing, the Group's net current assets amounted to RMB2,025 million as of December 31, 2005. This represented an increase of RMB862 million over the net current assets as of the end of 2004 which amounted to RMB1,163 million.

The Group's long-term loans amounted to RMB9,691 million as of December 31, 2005, an increase of RMB2,299 million over RMB7,392 million as of December 31, 2004, which was primarily attributable to the increased financing for the long-term loans as a result of the increased capital expenditure of the Group.

The Group's gearing ratio as stated in the financial report increased to 32.05% as of December 31, 2005 from 30.18% as of December 31, 2004, up 1.87 percentage point, which was mainly attributable to the increased long-term loans of the Group.

By virtue of the Group's credit standing and availability of domestic capital, the Group is of the opinion that there will be no significant difficulties in receiving bank loans in the future. The Group will finance its working capital expenditure and related expenditures through its operating activities and bank loans. The Company will also finance its capital by ways of issuing additional shares and the offer of short-term bonds where necessary. In addition, the Group has established standby credit facilities with domestic banks for an aggregate of RMB37.672 billion to finance the capital shortfall related to its alumina and primary aluminum projects and for relevant working capital purposes. The Group believes that its working capital is sufficient for its existing need.

Capital Expenditures and Capital Commitments

In 2005, the Group completed property, plant and equipment, and land use rights investments amounting to RMB8,418 million, which mainly consisted of the investment in the 280,000-tonnes alumina smelting project of Shanxi Huaze, an associated company of the Company, together with the 800,000-tonnes alumina project in Shanxi, the 700,000-tonnes alumina project in Henan and the 300,000-tonnes alumina project in Zhongzhou as well as the Company's project in technological renovation etc. As of December 31, 2005, the Group's capital commitments of property, plant and equipment amounted to RMB9,026 million, of which those contracted but not provided for amounted to RMB561 million and those authorized and not contracted amounted to RMB8,465 million.

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In March 2005, the Group acquired a 28% equity interest in Lanzhou Aluminum at a consideration of RMB768 million (including transaction costs) and became the largest shareholder of Lanzhou Aluminum. Under the Articles of Association of Lanzhou Aluminum, the board of Lanzhou Aluminum comprises 9 directors, of which 6 are Non-independent Directors and 3 are Independent Directors, and among its existing 9 Directors, 5 Directors are appointed by the Company, representing the majority of its Board.

Lanzhou Aluminum is an A Share listed company (Stock code: 600296) that is listed on the Shanghai Stock Exchange. Its principal business is the production and sales of primary aluminum products. As of December 31, 2005, Lanzhou Aluminum's total assets amounted to RMB4,443 million and its issued share capital and reserves amounted to RMB2,882 million. The Company produced 166,100 tonnes of primary aluminum in 2005, and its sales revenue, operating profit and net profit amounted to RMB2,755 million, RMB130 million and RMB112 million, respectively. The acquisition of Lanzhou Aluminum further enhanced the Group's output and production capacity and its market share of primary aluminum in the domestic market.

Cash and Cash Equivalents

Cash and cash equivalents of the Group as of December 31, 2005 totaled RMB7,598 million, comprising foreign currency deposits of US\$7,184,000, HK\$2,639,000 and 94,000 Euro.

Cash Flow from Operating Activities

Cash from operations increased by RMB325 million or 3.93% from RMB8,265 million for the year of 2004 to RMB8,590 million for the year of 2005. The increase was primarily the result of the increase of the Group's profit and the expanded scale of production which increased the operating capital and offset partial cash flow.

Cash Flows from Investing Activities

Net cash outflow from investing activities in 2005 was RMB8,821 million, which was slightly lower than the RMB9,056 million of 2004. This was mainly due to the decrease of expenses for additional plants and equipment and facilities by RMB986 million when compared with the previous year, accompanied with the Group's Investment of RMB768 million in Lanzhou Aluminum and the increased investment of RMB117 million in a controlled company, Guangxi Guixi Huayin Aluminum Co., Ltd.

Cash Flows from Financing Activities

Net cash inflows from financing activities amounted to RMB1,605 million in 2005, which was a decrease of RMB2,813 million from the RMB4,418 million of 2004. This was mainly due to the income received from the issuance of the Company's H shares of RMB3,301 million in 2004, the issuance of the Company's short-term bonds of RMB1,943 million and the increased dividend payment of RMB884 million over the previous year.

Foreign Exchange Rate Risk

The Group conducts its business primarily in Renminbi.

Renminbi is not a freely convertible currency. The restrictions on foreign exchange imposed by the PRC government may result in material differences between future exchange rate and current exchange rate or historical exchange rate. The changes in the exchange rate of Renminbi will impact the ability of the Group to carry out operations relating to foreign exchange. Those changes will also impact the ability of the Group to pay dividends in HK dollars and to pay dividends of American Depositary Shares in US dollars. The Company believes that it is able and will be able to obtain sufficient foreign exchange to implement the above-mentioned obligations.

Impact of Appreciation of Renminbi

The Group believes that, since the price of domestic alumina is determined with reference to the price of imported alumina, the appreciation of Renminbi will affect prices of the domestic spot market of alumina.

However, the appreciation of Renminbi will not have a significant impact on the Group's operations because the Group's import and export volume and foreign currency loans are minimal. From the perspective of production costs, the appreciation of Renminbi will, to some extent, enhance the competitiveness of the Company in the international market.