

## MANAGEMENT DISCUSSION AND ANALYSIS

The financial data below are extracted from the Group's audited financial statements prepared in accordance with HKASs. 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: RMB in millions

	2005	2004
<b>Revenue</b>		
Wireless communications	8,930.8	8,786.4
Wireline switch and access	2,752.6	2,598.6
Optical and data communications	3,353.0	2,335.3
Handsets	4,333.1	6,014.9
Telecommunications software systems, services and other products	2,206.4	1,484.9
<b>Total</b>	<b>21,575.9</b>	<b>21,220.1</b>
Cost of sales	(14,101.7)	(13,813.5)
<b>Gross profit</b>	<b>7,474.2</b>	<b>7,406.6</b>
Other revenue and gains	681.6	534.1
Research and development costs	(1,959.5)	(2,265.2)
Selling and distribution costs	(3,186.4)	(2,799.6)
Administrative expenses	(1,095.4)	(981.4)
Other operating expenses	(128.6)	(162.4)
<b>Profit from operating activities</b>	<b>1,785.9</b>	<b>1,732.1</b>
Finance costs	(175.9)	(140.4)
Share of profits and losses of jointly-controlled entities and associates	(4.2)	3.1
<b>Profit before tax</b>	<b>1,605.8</b>	<b>1,594.8</b>
Tax	(179.8)	(115.0)
<b>Profit before minority interests</b>	<b>1,426.0</b>	<b>1,479.8</b>
Minority interests	(138.3)	(207.3)
<b>Net profit from ordinary activities attributable to equity holders of the parent</b>	<b>1,287.7</b>	<b>1,272.5</b>
<b>Dividends</b>	<b>239.9</b>	<b>239.9</b>
<b>Earnings per share — basic</b>	<b>RMB1.34</b>	<b>RMB1.57</b>

## REVENUE

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

Unit: RMB in millions

Product segment	2005		2004	
	Revenue	Percentage of revenue	Revenue	Percentage of revenue
Wireless communications	8,930.8	41.4%	8,786.4	41.4%
Wireline switch and access	2,752.6	12.8%	2,598.6	12.2%
Optical and data communications	3,353.0	15.5%	2,335.3	11.0%
Handsets	4,333.1	20.1%	6,014.9	28.4%
Telecommunications software systems, services and other products	2,206.4	10.2%	1,484.9	7.0%
Total	21,575.9	100.0%	21,220.1	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 revenue for the periods indicated:

Unit: RMB in millions

Region	2005		2004	
	Revenue	Percentage of revenue	Revenue	Percentage of revenue
The PRC	13,874.3	64.3%	16,644.5	78.5%
Asia (excluding the PRC)	4,568.7	21.2%	2,459.9	11.6%
Africa	2,835.4	13.1%	1,513.1	7.1%
Other regions	297.5	1.4%	602.6	2.8%
Total	21,575.9	100.0%	21,220.1	100.0%

The Group's revenue in 2005 increased 1.7% to RMB21,575.9 million, as compared to RMB21,220.1 million in 2004. The increase was mainly attributable to growth in revenue from the optical and data communications segment and the telecommunications software systems, services and other products segment, which was partially offset by the decrease in revenue from handset sales. The Group's international business maintained rapid growth in 2005 with sales revenue rising 68.3% to RMB7,701.6 million as compared to RMB4,575.6 million in 2004, although the growth was partially offset by the decline in domestic sales revenue due to a decrease in capital expenditure of by domestic carriers and who were in the process of adjusting their investment structure.

The Group's revenue from the wireless communications business increased 1.6% to RMB8,930.8 million in 2005, as compared to RMB8,786.4 million in 2004. The increase was mainly attributable to solid increases in domestic and international sales of CDMA and domestic sales of GSM systems, partially offset by the declining PHS revenue resulting from the reduced investments in PHS network construction by domestic carriers who were in the process of re-aligning their investment structure.

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The Group's revenue from the wireline switch and access segment increased 5.9% to RMB2,752.6 million in 2005, as compared to RMB2,598.6 million in 2004. The growth was mainly attributable to increased sales of certain products that were reclassified to this segment from "telecommunications software systems, services and other products" during the year to more accurately reflect product classifications based on actual applications. The growth was also attributable to the growth in international sales revenue of the wireline switch and access business, though this was partially offset by the decline in sales revenue from the domestic market.

The Group's revenue from the optical and data communications segment increased 43.6% to RMB3,353.0 million in 2005, as compared to RMB2,335.3 million in 2004. The growth was mainly attributable to considerable growth in the international sales coupled with solid increase in domestic market share for optical products, while growth in sales revenue was also recorded for wireless access data products.

The Group's revenue from the handsets business amounted RMB4,333.1 million in 2005, down from RMB6,014.9 million in 2004. The decrease was mainly attributable to substantial reductions in PHS investment by domestic carriers in 2005, resulting in a notable decrease in the Group's sales of PHS handsets as compared to the previous year. On the other hand, the Group recorded its first sales revenue from 3G handsets in 2005.

The Group's revenue from the telecommunications software systems, services and other products segment increased 48.6% to RMB2,206.4 million in 2005, as compared to RMB1,484.9 million in 2004, benefiting mainly from sales growth in new innovative products such as fixed terminals and IPTVs. Meanwhile, sales revenue generated by software products as a separate item dropped as most of these products were bundled with system equipment in sales during the year. Moreover, certain products originally in this segment that registered sales growth were reclassified during the year such that their sales revenue was accounted for under the segment of "wireline switch and access" to more accurately reflect product classifications based on actual applications.

### COST OF SALES AND GROSS PROFIT

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

Unit: RMB in millions

Product segment	2005		2004	
	Cost of Sales	Percentage of product segment revenue	Cost of Sales	Percentage of product segment revenue
Wireless communications	5,021.6	56.2%	4,973.2	56.6%
Wireline switch and access	1,260.9	45.8%	1,105.6	42.5%
Optical and data communications	2,697.7	80.5%	1,768.6	75.7%
Handsets	3,575.0	82.5%	5,286.2	87.9%
Telecommunications software systems, services and other products	1,546.5	70.1%	679.9	45.8%
Total	14,101.7	65.4%	13,813.5	65.1%

Unit: RMB in millions

Product segment	2005		2004	
	Gross Profit	Gross profit margin	Gross Profit	Gross profit margin
Wireless communications	3,909.2	43.8%	3,813.2	43.4%
Wireline switch and access	1,491.7	54.2%	1,493.0	57.5%
Optical and data communications	655.3	19.5%	566.7	24.3%
Handsets	758.1	17.5%	728.7	12.1%
Telecommunications software systems, services and other products	659.9	29.9%	805.0	54.2%
Total	7,474.2	34.6%	7,406.6	34.9%

The Group's gross profit rose slightly to RMB7,474.2 million in 2005 from RMB7,406.6 million in 2004. The Group's gross profit margin dropped slightly to 34.6% from 34.9% in 2004 due primarily to the decrease in the gross profit margin of the optical and data communications segment, the telecommunications software systems and services, wireline switch and access products, which was largely offset by the increase in the gross profit margin of handset products.

Gross profit margin of the Group's wireless communications business rose slightly to 43.8% in 2005 from 43.4% in 2004 as the increase in the sales of higher-margin CDMA systems as percentage to revenue was largely offset by declining gross profit margin for GSM. Growth in international sales of CDMA systems, which generally commanded a higher gross profit margin, more than offset the slight decline in its domestic sales, resulting in an improved overall gross profit margin for the product. The gross profit margin of GSM system products lost considerable ground due to intense competition in the global market.

Gross profit margin in the Group's wireline switch and access segment dropped to 54.2% in 2005 from 57.5% in 2004 as a result of increasing market competition and the reclassification of certain lower-margin products to this segment from "telecommunications software systems, services and other products" during the year.

Gross profit margin in the Group's optical and data communications business dropped to 19.5% in 2005 from 24.3% in 2004, as gross profit margin for optical communications products decreased as gross profit margin for optical communications products and the price of DSL products experienced a notable decrease amid intense market competition in 2005.

Gross profit margin in the Group's handsets segment rose to 17.5% in 2005 from 12.1% in 2004 in tandem with rising gross profit margin for CDMA handsets and PHS handsets. International sales of CDMA handsets increased further as the Group made further inroads in the international market. Gross profit margin for PHS handsets improved despite decreased sales in 2005 as compared to 2004 owing to reduced investments by carriers, due to effective cost reductions resulting from ongoing upgrades in technology and production processes. Nevertheless, such growth was partially offset by decreased gross profit margin for GSM handsets owing to rapid price concessions in an intensely competitive domestic GSM market.

Gross profit margin in the Group's telecommunications software systems, services and other products segment dropped to 29.9% in 2005 from 54.2% in 2004. This decline was mainly attributable to increased sales of low-margin products coupled with decreased sales revenue from high-margin products such as software and services.



### OTHER REVENUE AND GAINS

Other revenue and gains of the Group increased 27.6% to RMB681.6 million in 2005 from RMB534.1 million in 2004. The increase was mainly attributable to the increase in government subsidies for technology projects and VAT subsidy income.

### RESEARCH AND DEVELOPMENT COSTS

The Group continued to commit resources to research and development with additional investments in certain areas, although there was a change in the structure of investment. In accordance with HKASs, the development costs of certain products were capitalised by the Group. Moreover, the efficiency of research and development was improved with the Group's active measures in consolidating the core technical platform for research and development, contributing to the decrease in costs for the period. Research and development costs accounted for 9.1% of revenue from principal operations in 2005, as compared to 10.7% in 2004.

### SELLING AND DISTRIBUTION COSTS

The Group's selling and distribution costs in 2005 amounted to RMB3,186.4 million, representing an increase of 13.8% comparing to RMB2,799.6 million in 2004. The increase was mainly attributable to the increase in overseas travel and transport expenses and staff costs due to growing international sales and the development of overseas sales platforms, which was partially offset by a significant reduction in sales commission expenses. Selling and distribution costs accounted for 14.8% of revenue from principal operations in 2005, as compared to 13.2% in 2004.

### ADMINISTRATIVE EXPENSES

The Group's administrative expenses in 2005 amounted to RMB1,095.4 million, representing an increase of 11.6% comparing to RMB981.4 million in 2004. The increase was mainly attributable to the expansion in operation of its subsidiaries. Administrative expenses accounted for 5.1% of revenue from principal operations in 2005, as compared to 4.6% in 2004.

### OTHER OPERATING EXPENSES

Other operating expenses of the Group decreased 20.8% to RMB128.6 million in 2005 from RMB162.4 million in 2004. The decrease mainly reflected reductions in bad debt provisions as a result of the revised method for bad debt provision for the Group's accounts receivable in accordance with requirements of Hong Kong Accounting Standard HKAS 39 (see note 2.2 to the financial statements prepared in accordance with HKASs), although such reductions were partially offset by the increase in goodwill impairment and exchange losses.

### PROFIT FROM OPERATING ACTIVITIES

The Group's profit from operating activities increased 3.1% from RMB1,732.1 million in 2004 to RMB1,785.9 million in 2005, while the profit margin from operating activities rose to 8.3% in 2005 from 8.2% in 2004, which was mainly attributable to the decline in research and development costs, which were partially offset by the increases of selling and distribution costs and administrative expenses.

### FINANCE COSTS

The Group's finance costs increased 25.3% to RMB175.9 million in 2005 from RMB140.4 million in 2004, mainly as a result of additional expenses associated with increased factoring of accounts receivable of the Group to shorten turnover of working capital. The increase was partially offset by lower financing costs as the balance of interest-bearing bank loans declined.

## TAX

The Group's tax expenses increased 56.3% to RMB179.8 million in 2005 from RMB115.0 million in 2004 and its effective tax rate increased to 11.2% in 2005 from 7.2% in 2004, reflecting mainly the increase in overseas tax expenses from the Group's growing international sales.

## MINORITY INTERESTS

The Group's minority interests decreased 33.3% to RMB138.3 million from RMB207.3 million in 2004. This was primarily attributable to the decrease in minority shareholdings in certain subsidiaries. Minority interests as a percentage of profit before minority interests decreased to 9.7% in 2005 from 14.0% in 2004.

## GEARING RATIO AND THE BASIS OF CALCULATION

The Group's gearing ratio for 2005 was 6.0%, down 7.0% from 13.0% in 2004. The decrease was mainly attributable to the decrease in interest-bearing loans and the increase in equity. The gearing ratio represented outstanding amounts under total interest-bearing loans as a percentage of total capital.

## LIQUIDITY AND CAPITAL RESOURCES

In 2005, the Group's development funds were financed mainly by the proceeds from the Company's H share offering, cash generated from its operations and bank loans. The Group's cash requirements related primarily to production and operating activities, repayment of due liabilities when due, capital expenditure, interest and dividend payments and other unforeseeable cash requirements.

Cash and cash equivalents of the Group as of 31 December 2005 amounted to RMB5,397.2 million.

## CASH FLOW DATA

Unit: RMB in millions

	2005	2004
Net cash inflow/(outflow) from operating activities	(285.9)	1,240.0
Net cash inflow/(outflow) from investing activities	(1,067.3)	(620.6)
Net cash inflow/(outflow) from financing activities	(735.0)	3,314.2
Net increase/(decrease) in cash and cash equivalents	(2,088.2)	3,933.6
Cash and cash equivalents at the end of the year	5,397.2	7,509.2

## OPERATING ACTIVITIES

Net cash outflow from the Group's operating activities amounted to RMB285.9 million in 2005 compared to net cash inflow amounted to RMB1,240.0 million in 2004, consisting mainly of an increase of RMB1,937.1 million in amounts due from customers for contract work and a decrease in contract work amounts payable of RMB1,585.3 million as telecommunications system construction project works were completed ahead of progress bill payments as a result of more favourable business terms offered by the Group to customers; a decrease in operating profit before working capital changes from RMB2,413.8 million in 2004 to RMB2,222.9 million in 2005 because of increased selling and distribution costs and administrative expenses during the year, but partially offset by an increase in trade and bills payable due to delay in payment resulting from higher credit limit granted to the Group by its suppliers; and an increase in prepayments and other receivables of RMB526.4 million owing to an external loan granted by the Group in 2005. In 2005, the Group's receivables turnover rate was 4.0 compared to 3.8 in 2004. Inventory turnover rate was 7.1 compared to 9.1 in 2004. Payables turnover rate was 2.7 compared to 3.1 in 2004.

## INVESTING ACTIVITIES

Net cash outflow from the Group's investing activities in 2005 amounted to RMB1,067.3 million, as compared to RMB620.6 million in 2004. The cash outlay in 2005 was mainly used in business and production expansion, comprising RMB641.9 million for the purchase of machinery and equipment, testing instruments, computers and replacements of and additions to office equipment, RMB161.9 million for the construction of the research and development centre in Shenzhen and RMB206.8 million for the purchase of software and other intangible assets.

## FINANCING ACTIVITIES

Net cash outflow from the Group's financing activities in 2005 amounting to RMB735.0 million, as compared to net cash inflow of RMB3,314.2 million in 2004, was mainly used in the repayment of bank loans of RMB869.0 million.

## 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 public offering of H shares, long-term bank loans, cash generated from operating activities and government grants.

Unit: RMB in millions

Capital expenditure	2005	2004
Purchases of fixed assets and additions to construction in progress	803.8	647.0

The Group's capital expenditure in 2005 amounting to RMB803.8 million was mainly used to complete the construction of the ZTE research and development center in Shenzhen and purchase other equipment and facilities.

## INDEBTEDNESS

Unit: RMB in millions

	As at 31 December	
	2005	2004
Secured bank loans	47.7	361.6
Unsecured bank loans	632.0	1,085.4

Unit: RMB in millions

	As at 31 December	
	2005	2004
Short-term bank loans	599.7	421.7
Long-term bank loans	80.0	1,025.3

Credit facilities available to the Group included long-term and short-term bank loans. Long-term loans were mainly used for capital expenditures, while short-term loans were mainly used as working capital. The Group's long-term loans were subject to interest at fixed rates. The Group's borrowings were mainly denominated in RMB, with some loans which were denominated in US dollars.

The Group's bank loans in 2005 decreased as a result of the increase in available cash balances as the proceeds from the H share offering were applied in the Group's operations and increase in cash receipt from sales.

## CONTRACTUAL OBLIGATIONS

Unit: RMB in millions

	Total	As at 31 December 2005		
		Less than one year	Two to five years	More than five years
Bank loans	679.7	599.7	80.0	—
Operating lease obligations	183.4	97.0	79.1	7.3

## CONTINGENT LIABILITIES

Unit: RMB in millions

	As at 31 December 2005	As at 31 December 2004
Discounted bills	—	440.9
Factored trade receivables	438.5	691.7
Guarantees given to banks in respect of performance bonds	2,823.8	1,626.1
<b>Total</b>	<b>3,262.3</b>	<b>2,758.7</b>

## CAPITAL COMMITMENTS

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

Unit: RMB in millions

	As at 31 December 2005	As at 31 December 2004
<b>Land and buildings</b>		
Contracted, but not provided for	231.6	282.4
<b>Investment in an associate</b>		
Contracted, but not provided for	21.1	—

## 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 2005 are set out in notes 18, 19 and 20 to the financial statements prepared in accordance with HKASs.

## PROSPECTS FOR NEW BUSINESS

Details of the prospects for new business of the Group are set out section headed "Report of the Board of Directors" on pages 54 to 65 in this annual report.



### EMPLOYEES

Details of the number of employees, remuneration, remuneration policy, bonus and training programs of the Group as at 31 December 2005 are set out in the section headed "Directors, Supervisors, Senior Management and Employees" on pages 25 to 35 and the section headed "Corporate Governance" on pages 38 to 52 in this Annual Report.

### CHARGES ON ASSETS

Details of charges on the Group's assets as at 31 December 2005 are set out in note 31 to the financial statements prepared under HKASs.

### PLANS FOR MATERIAL INVESTMENTS OR ACQUISITION OF CAPITAL ASSETS

Details of the Group's material investments and their performance and prospects as at 31 December 2005 are set out section headed "Report of the Board of Directors" on pages 54 to 65 in this annual report.

Details of plans for material investments or acquisition of capital assets are set out section headed "Report of the Board of Directors" on pages 54 to 65 in this annual report.

### MARKET RISKS

#### Cash flow interest rate risk

The Group's exposure to cash flow interest rate risk is minimal.

#### Foreign currency risk

The Group has transactional currency exposures. Such exposures arise from sales or purchases by operating units in currencies other than the units' functional currency. Approximately 35% (2004: 22%) of the Group's sales are denominated in currencies other than the functional currency of the operating units making the sale, whilst almost 70% (2004: 65%) of costs are denominated in the unit's functional currency.

The Group attempts to include terms relating to foreign currency exchange risk avoidance or allocation when entering into purchase and sales contracts. The Group takes rolling forecasts on foreign currency revenue and expenses, and matches the currency and amount received or incurred, so as to alleviate the impact to the business due to exchange rate fluctuation.