The following discussion should be read in conjunction with the Group's consolidated financial statements and notes thereto set out in this annual report and other sections.

OVERVIEW

For the year ended 31st December 2005, the Group recorded a profit before taxation of RMB240 million, representing an increase of 7.14% over that of 2004. The net profit attributable to the equity holders of the Company for the year amounted to RMB118 million, representing an increase of 66.20% over that of 2004, which was mainly attributable to the increase in earnings from the Group's investments in its associates engaging in aviation business and the exchange gains from borrowings denominated in foreign currencies caused by the appreciation of Renminbi.

For the year ended 31st December 2005, the basic and diluted earnings per share for profit attributable to the equity holders of the Company was RMB0.025.

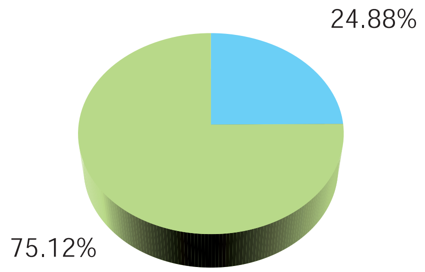
The following table shows the comparison between the years ended 31st December 2005 and 2004:

CONSOLIDATED OPERATING RESULTS

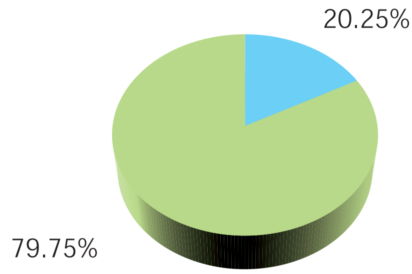
	Year ended 31st December		
RMB million	**2005**	2004	Changes
Turnover	**14,266**	12,877	10.79%
Of which: automobile segment	**10,716**	10,269	4.35%
aviation segment	**3,550**	2,608	36.12%
Cost of sales	**(12,395)**	(10,948)	13.22%
Of which: automobile segment	**(9,369)**	(8,846)	5.91%
aviation segment	**(3,026)**	(2,102)	43.96%
Other income	**209**	122	71.31%
Selling and distribution expenses	**(781)**	(573)	36.30%
General and administrative expenses	**(950)**	(1,026)	(7.41%)
Operating profit	**348**	453	(23.18%)
Financial costs, net	**(154)**	(237)	(35.02%)
Share of results of associates	**45**	8	462.50%
Profit before taxation	**240**	224	7.14%
Taxation	**(52)**	(86)	(39.53%)
Minority interests	**(70)**	(66)	6.06%
Net profit attributable to the equity holders of the Company	**118**	71	66.20%

1. Turnover

Turnover breakdown in 2005



Turnover breakdown in 2004



Automobile products   Aviation products

The Group's turnover for 2005 was RMB14,266 million, representing an increase of 10.79% over RMB12,877 million of 2004. The increase was mainly attributable to the increase in sales volumes of both aviation and automobile products as the Group had put more efforts in marketing during the year. The turnover of automobile products amounted to RMB10,716 million, representing an increase of 4.35% over that of 2004 and accounting for 75.12% of the total turnover; the turnover of aviation products amounted to RMB3,550 million, representing a significant increase of 36.12% over that of 2004 and accounting for 24.88% of the total turnover.

As shown in the charts above, the aviation products accounted for a bigger proportion of the total turnover with about 4.63 percentage points over that of 2004. With the rapid development in the aviation business the proportion of turnover of aviation products in the total turnover has been increasing.

The Group was mainly operating in the PRC, where a majority of the turnover had been generated.

2. Selling and distribution expenses

The Group's selling and distribution expenses for 2005 amounted to RMB781 million, representing an increase of RMB208 million (36.30%) over that of 2004. The increase was mainly attributable to the increase in loading and transportation expenses, after-sales service expenses and advertising expenses in automobile products brought by the increase of sales volume of vehicles, among which:

(1) The loading and transportation expenses increased by RMB64 million, representing a change of 23.49%. over the previous year;

(2) The after-sale service expenses increased by RMB31 million, representing a change of 107.39% over the previous year;

(3) The advertising expenses increased by RMB62 million, representing a change of 100.61% over the previous year.

3. General and administrative expenses

The Group's general and administrative expenses for 2005 amounted to RMB950 million, representing a decrease of RMB76 million (7.41%) from RMB1,026 million of 2004. Such decrease was mainly attributed to the decrease in research and development expenses and provisions for inventories.

4. Operating profit

The Group's operating profit for 2005 amounted to RMB348 million, representing a decrease of RMB105 million (23.18%) from that of 2004, which was mainly due to the slip in the gross profit margin resulting from keen market competition, hence the drop in the total gross profit contribution of the products.

5. Finance costs, net

The Group's net finance costs for 2005 amounted to RMB154 million, representing a decrease of RMB83 million (35.02%) from that of 2004, which was mainly attributable to the increase of RMB88 million in the net exchange gains generated from borrowings denominated in foreign currencies due to the appreciation of Renminbi during the year.

6. Taxation

The Group's income tax for the year was RMB52 million, representing a decrease of RMB34 million (39.53%) from RMB86 million in 2004, which was mainly due to the utilization of certain tax losses previously not recognised. Details of which are set out in note 9 to the financial statements.

7. Minority interests

The Group's minority interests for the year increased by 6.06% from RMB66 million in 2004 to RMB70 million, which was mainly attributable to the increase in profits of the Group's certain non-wholly owned subsidiaries in 2005 from that of 2004.

CONSOLIDATED FINANCIAL POSITION

	As at 31st December		
RMB million	**2005**	2004	Changes
Current assets	**12,668**	11,384	1,284
Non-current assets	**10,044**	8,432	1,612
Total assets	**22,712**	19,816	2,896
Current liabilities	**12,759**	10,151	2,608
Non-current liabilities	**1,243**	1,627	(384)
Total liabilities	**14,002**	11,778	2,224
Share capital	**4,644**	4,644	—
Reserves	**521**	452	69
Proposed final dividend	**49**	—	49
Capital and reserves attributable to the Company's equity holders	**5,214**	5,096	118
Minority interests	**3,496**	2,942	554

As at 31st December 2005, the Group's total assets amounted to RMB22,712 million, total liabilities amounted to RMB14,002 million whereas minority interests and capital and reserves attributable to the equity holders of the Company amounted to RMB3,496 million and RMB5,214 million respectively.

1. **Total assets**

   Total assets increased by RMB2,896 million over that of 2004, with both current assets and non-current assets increasing. Current assets increased by RMB1,284 million over that of 2004, among which accounts receivable increased by RMB1,033 million which was mainly due to the increase in the sales volume while the credit policy of the Group had remained the same during the year; non-current assets increased by RMB1,612 million which was mainly due to the increase in investment in property, plant and equipment. Details are set out in note 15 to the financial statements.

2. **Total liabilities**

   Total liabilities increased by RMB2,224 million over that of 2004, which was mainly attributed to the increase of RMB2,608 million in current liabilities over that of 2004. The accounts payable increased by RMB1,851 million, which was due to the increase in purchase volume of automobile and aviation products caused by enlarged sales volume.

3. **Guaranteed and secured loans**

   As at 31st December 2005, the Group's total borrowings amounted to RMB5,529 million, of which RMB231 million was secured by properties, machinery and equipment, with a net book value of RMB407 million.

   Guaranteed borrowings amounted to RMB3,915 million, of which RMB3,119 million was cross guaranteed amongst the subsidiaries of the Group and RMB153 million was guaranteed by third parties. Guarantees provided by AVIC II and its subsidiaries have been substantially released except for a sum of RMB643 million, the release of which is underway.

4. **Capital and reserves attributable to the Company's equity holders**

   Capital and reserves attributable to the Company's equity holders in 2005 amounted to RMB5,214 million, representing an increase of RMB118 million over that of 2004 which is mainly due to the net profit realized during the year.

5. **Development costs**

   During 2005, research and development expenditures of the Group was RMB256 million, which has helped the Group to adapt to market competition and stabilize the gross margin of the products.

6. **Exchange risks**

   Due to its operational need, the Group had a substantial amount of loans denominated in Euro and United States dollars. In addition, the Company had some deposits in Hong Kong dollars raised from the public offering in October 2003. Fluctuation of exchange rates in these currencies has brought about certain exchange risks to the Group. Details are set out in note 40(a)(i) to the financial statements.

7. Contingent liabilities and guarantees

As at 31st December 2005, the Group has not provided any guarantees for third party and did not have any significant contingent liabilities.

CONSOLIDATED CASH FLOW

1. Liquidity and capital resources

As at 31st December 2005, the Group's cash and cash equivalents amounted to RMB2,942 million which was mainly derived from the following:

- cash and bank deposits at beginning of the year;
- funds generated from its operations; and
- new bank borrowings

The Group's cash flows for the years 2005 and 2004 were as follows:

Unit: RMB million

Main items of cash flow	2005	2004	Change (amount)	Change (percentage)
Net cash flows generated from operating activities	**1,506**	554	952	171.84%
Net cash flows used in investing activities	**(1,939)**	(185)	(1,754)	948.11%
Net cash flows generated from/(used in) financing activities	**817**	(395)	1,212	(306.84%)
Net increase/(decrease) in cash and cash equivalents	**384**	(26)	410	(1,576.92%)

2. Operating activities

Net cash flows generated from operating activities for the year amounted to RMB1,506 million, representing an increase of RMB952 million over that of 2004. Details are set out in note 37(a) to the financial statements.

3. Investing activities

Net cash flows used in investing activities for the year amounted to RMB1,939 million, representing an increase of RMB1,754 million over that of 2004, among which the purchase of property, plant and equipment increased by RMB825 million and the decrease in term deposits with initial term of over three months dropped by RMB791 million from that in 2004.

4. Financing activities

Net cash flows generated from financing activities for the year amounted to RMB817 million, which was mainly generated from the contributions from minority shareholders of certain subsidiaries in 2005.

As at 31st December 2005, the Group's total borrowings amounted to RMB5,529 million, of which current borrowings, current portion of long-term borrowings, non-current portion of long-term borrowings amounted to RMB4,097 million, RMB400 million and RMB1,032 million respectively.

The Group's non-current borrowings are repayable as follows:

Maturity	RMB million
Within one year	400
In the second year	376
In the third to fifth year	582
After the fifth year	74
Total	1,432

As at 31st December 2005, the Group's bank borrowings amounted to RMB5,342 million with an average interest rate of 4.80%, representing 96.62% of the total borrowings. Other borrowings amounted to RMB187 million with an average interest rate of 0.42%, representing 3.38% of the total borrowings.

As at 31st December 2005, the Group's borrowings denominated in foreign currencies amounted to RMB642 million, representing 11.61% of the total borrowings, of which borrowings denominated in United States dollars and Euro amounted to US$41 million and Euro33 million respectively.

- Gearing Ratio

As at 31st December 2005, the Group's gearing ratio was 24.35% (2004: 27.03%), which was arrived at by dividing the total borrowings by total assets as at 31st December 2005.

SEGMENT INFORMATION

The Group's principal operations are divided into two segments, namely the automobile segment and the aviation segment.

AUTOMOBILE SEGMENT

Major statistics of automobile operation

	Year ended 31st December							
	2005				2004			
RMB million	Sales volume (units)	Sales revenue	Cost of sales	Gross margin	Sales volume (units)	Sales revenue	Cost of sales	Gross margin
Automobile products in total	—	10,716	9,369	12.57%	—	10,269	8,846	13.86%
Entire vehicles in total	331,045	9,395	8,297	11.69%	297,603	8,765	7,614	13.13%
Mini-vans and mini-trucks	239,578	5,724	4,947	13.57%	244,666	6,334	5,533	12.65%
Sedans	91,467	3,671	3,350	8.74%	52,937	2,431	2,081	14.40%
Others	—	1,321	1,072	18.85%	—	1,504	1,232	18.09%

Review on China's Automobile Market in 2005

In 2005, to ensure the successful implementation of the Automobile Industry Development Policy, the Chinese government has promulgated a series of measures on automobile trading, import and export, taxation, administration on second-hand automobiles, safety and environmental protection. All these had played an important role in propelling the long-term and ordered development of the automobile market in China. In 2005, the Chinese automobile industry generally maintained stable development. A total of 5,707,700 and 5,758,200 vehicles were produced and sold, representing an increase of 12.56% and 13.54% respectively when compared with that of 2004. The sales volume of sedans reached 2,787,400 units, representing an increase of 24.31% over that of 2004. The economy sedans market was quite active with a sales volume of 1,777,400, accounting for 63.77% of the total sales volume of sedans; the mini-vans market has kept a moderate development with a sales volume of 831, 500 units, representing an increase of 9.87%; and the output and sales volume of mini-trucks has also maintained certain increase.

(Source: China Automobile Industry Newsletter of Production and Sales, first issue of 2006)

Review on the Group's Automobile Business In 2005

During 2005, facing intense competition, the Group took active marketing measures to optimize the sales network and enhance promotion, and has successfully reversed the declining sales volume of vehicles in 2004 back to an upward trend. In 2005, the Group sold 331,045 vehicles, representing an increase of 11.24% when compared with that of 2004. Among that the sales volume of sedans was 91,467, representing an increase of 72.78% over that of 2004; The sales volume of mini-vans and mini-trucks dropped slightly to 239,578 due to the delay in upgrading some old models; of that, a total of 20,254 mini-vans and mini-trucks were exported, representing an increase of 69.38% when compared with that of 2004, which has become a highlight in the Group's automobile business in 2005.

1. *The automobile business strategy was improved to form an integrated strategy of independent development and international cooperation.*

   The Group improved the automobile business strategy by re-defining the vision, goal, direction and ways of development. The cooperation with Suzuki was extended from the initial step of introducing mini-van models to manufacturing sedan models and K series engines, thus forming a closer tie in the strategic cooperation between Changhe Auto and Suzuki. Hafei Auto has also actively pushed forward the cooperation with international automobile groups while making great efforts to develop proprietary brands.

2. *The new production lines were established and put into use, with more rational coverage of the Group's automobile production plants.*

   Hafei Auto has set up branches in Shenzhen and Weihai. The plant of Shenzhen branch has been completed and is expected to commence production in the first half of 2006. Weihai branch is under smooth construction and is expected to become a mini-sized vehicles export base of the Group. Furthermore, automobile and engine production lines of Changhe Suzuki in Jiujiang has also been completed and commenced production. After completion of all the projects, the Group will cover Northeast China, Central China, East China and South China in a more rational and market-oriented manner.

3. *The new models were launched as planned, thus enriching the products series of the Group.*

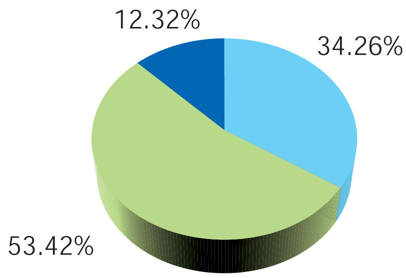
   In 2005, two new sedan models, Hafei Saibao and Changhe Liana, and four upgraded models, Hafei Saima, Hafei Lobo, Changhe Beidouxing and Changhe Ideal were launched to the market. Changhe Suzuki K14B engine was formally put into batch production while Dongan 4G9 engine was also launched to production. The development of other new models progressed as planned. The automobile business of the Group has formed a multi-brand series comprising sedans, mini-vans and mini-trucks. Automobile engines cover 0.8 litres to 2.0 litres,thus providing the driving force for the development in the automobile business.

4. *Business integration has improved the marketing and cost control ability.*

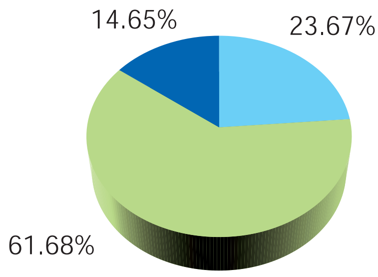
   After the Automobile Business Department of AviChina was set up, the automobile business of the Group was further integrated by the centralization of purchasing, developing and marketing. The strengthening of the marketing team and the integration of marketing network begin to show their effects on cost control. The automobile customer service Beijing hotline 800-810-2357 of the Company has been put online in addition to the existing service hotline of Hafei Auto and Changhe Auto.

SALES REVENUE

Breakdown of sales revenue of automobile segment in 2005



Breakdown of sales revenue of automobile segment in 2004



Economy sedans
Mini-vans and mini-trucks
Other automobile products

The Group's sales of automobile products for 2005 amounted to RMB10,716 million, of which sales of vehicles accounted for RMB9,395 million, representing an increase of RMB630 million (7.19%) from that of 2004. In 2005, the Group took active marketing measures to strengthen promotion and to optimize the sales network. The sales volume of the Group's automobile products swung back to an increase.

As shown in the charts above, the composition of the Group's automobile products in 2005 was slightly different from that of 2004: economy sedans accounted for 34.26% of the sales of automobile products, representing an increase of 10.59 percentage points over 23.67% of 2004; mini-vans and mini-trucks accounted for 53.42% of the sales of automobile products, representing a decrease of 8.26 percentage points from 61.68% of 2004 and continued to be a major part of automobile products of the Group; other automobile products accounted for 12.32% of the sales of the automobile products, declining by 2.33 percentage points when compared with that of 2004.

COST OF SALES

Cost of sales of the Group's automobile products for 2005 amounted to RMB9,369 million, of which cost of sales of vehicles increased to RMB8,297 million from RMB7,614 million in 2004. The increase was mainly attributable to the rise in the sales volume of vehicles during the year as compared with that of 2004.

GROSS MARGIN

Gross margin of the Group's automobile products for 2005 was 12.57%, representing a decrease of approximately 1.29 percentage points from that of 2004. The decrease was mainly attributable to the decrease in gross margin for economy sedans in 2005. During the year, the Group had made several price cuts to boost the sales volume of economy sedans and maintain its market share. Despite the effective measures taken by the Group to lower costs, the extent of decrease in cost was insufficient to offset the drop in sales revenue caused by the cut in prices, which resulted in a decrease in gross margin during that year.

AVIATION SEGMENT

Major statistics of aviation operation

	Year ended 31st December							
	2005				2004			
RMB million	**Sales volume (units)**	**Sales revenue**	**Cost of sales**	**Gross margin**	Sales volume (units)	Sales revenue	Cost of sales	Gross margin
Aviation products in total	**101**	**3,550**	**3,026**	**14.76%**	75	2,608	2,102	19.40%
Helicopters	**49**	**1,755**	**1,591**	**9.34%**	26	1,142	962	15.76%
Trainers	**50**	**434**	**346**	**20.28%**	46	561	462	17.65%
General-purpose aeroplanes	**2**	**14**	**21**	**-50.00%**	3	59	57	3.39%
Aviation parts and components	**—**	**1,128**	**924**	**18.09%**	—	684	507	25.88%
Others	**—**	**219**	**144**	**34.25%**	—	162	114	29.63%

Review on the Group's Aviation Business in 2005

The Group is the largest helicopter manufacturer and a major aeroplane manufacturer in the PRC. In 2005, with sustained rapid growth of China's economy, increased orders from the Chinese government for helicopters and increase in sales of aviation parts and components, the Group's aviation business has made significant achievements. In 2005, the revenue from the Group's aviation products exceeded RMB3,500 million, representing an increase of 36.12% when compared with that of 2004, taking up 24.88% of the total revenue of the Group.

1. *The Group had made achievements in exploiting the market for its aviation products.*

   In 2005, the Group took active measures to exploit both domestic and overseas markets and has successfully increased the sales volume of aviation products. For the whole year, the Group sold 49 helicopters, and sales revenue increased by 53.68% when compared with that of 2004. The Group entered into sales contracts of 67 K-8 trainers, and ensured the stable growth in the export orders for trainers. Harbin Embraer entered into contracts with China Eastern Airlines to sell five ERJ145 regional jets and three aircraft have been delivered during the year.

2. *The Group had strengthened its cooperation with international partners.*

   In the presence of the premier of China and the prime minister of France, AVIC II, the controlling shareholder of the Company, entered into a cooperation contract with Eurocopter on the advanced medium-sized general-purpose helicopter, which marked another significant achievement in the two parties' cooperation following the success of EC-120 program. According to the plan of AVIC II, the Group will play a key role in the execution of this cooperation contract.

   Jiangxi Changhe-Agusta Helicopter Co., Ltd., a joint venture between Changhe Aviation and Agusta, was established to manufacture model CA109, an advanced and popular twin-engine helicopter.

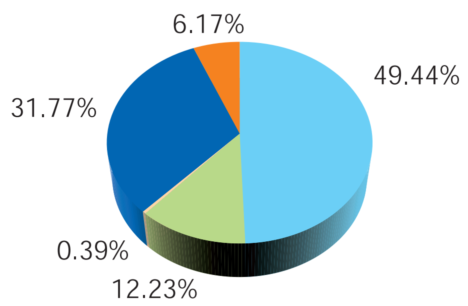
   Hafei Aviation entered into contracts with Boeing and Airbus respectively on subcontracting the aviation parts and components. Its subcontract of Bell430 has also run smoothly during the year and the first delivery was made at the beginning of 2006.

3. *The research, development and certification of new models and upgrading of models progressed smoothly.*

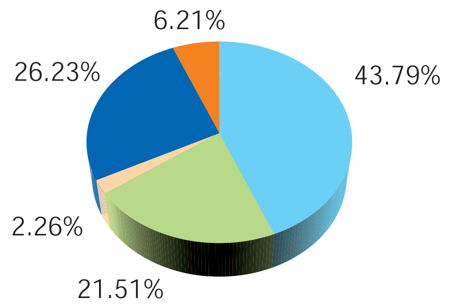
The Group invested and participated in the research and development of a new advanced trainer, which performed its first flight at the beginning of 2006. General-purpose aeroplane model N-5A is actively applying for the airworthiness certificate from the US Federal Aviation Administration, which is essential for this model to enter into overseas markets including USA. Those models could enrich the aeroplane series of the Group to create room for the Group's aviation business in the future.

SALES REVENUE

Breakdown of sales revenue of aviation segment in 2005



Breakdown of sales revenue of aviation segment in 2004



The Group's sales in aviation products for 2005 amounted to RMB3,550 million, representing an increase of RMB942 million (36.12%) over that of 2004, which was mainly attributable to the increase in the sales volume of aviation products during the year. Sales of aircraft and helicopters amounted to RMB2,203 million, representing an increase of RMB441 million (25.03%) over RMB1,762 million of 2004. The increase was mainly attributable to the increase in sales volume of helicopters during the year.

Sales of aviation parts and components amounted to RMB1,128 million, representing an increase of RMB444 million (64.91%) from RMB684 million of 2004. The increase was mainly attributable to the significant increase in the sales volume of parts and components sold to the AVIC II Group during the year, as a result of the rapid growth in aviation business of AVIC II Group, the largest customer of the Group's aviation products.

As shown in the charts above, the composition of the Group's aviation products in 2005 was different from that of 2004: the sales of helicopters accounted for 49.44% of the sales of aviation products, representing an increase of 5.65 percentage points over 43.79% of 2004; the sales of trainers accounted for approximately 12.23% of the sales of aviation products, representing a decrease of 9.28 percentage points when compared with that of 2004; the sales of general-purpose aeroplanes accounted for about 0.39% of the sales of aviation products, showing a slight decrease when compared with that of 2004; the sales of aviation parts and components accounted for 31.77% of the sales of aviation products, representing an increase of 5.54 percentage points from 26.23% of 2004; and other aviation products accounted for 6.17% of the sales of aviation products, with no significant change when compared with that of 2004.

COST OF SALES

Cost of sales of the Group's aviation products for 2005 increased by RMB924 million to RMB3,026 million from RMB2,102 million of 2004, representing an increase of 43.96%. Cost of sales for aviation products increased significantly as a result of the rapid growth in the sales volume during the year.

GROSS MARGIN

Gross margin of the Group's aviation products for 2005 was 14.76%, representing a decrease of approximately 4.64 percentage points from that of 2004. The decrease was mainly attributable to the rise in prices of raw materials used in helicopters and some aviation parts and components and the increase in accessories equipped on helicopters. The gross margin of helicopter decreased by 6.42 percentage points during the year.

ORDERS FOR AVIATION PRODUCTS

As at the date of this report, the Group has received orders for 66 helicopters, 60 trainers, 7 general-purpose aeroplanes and 7 regional jets. The Group is endeavoring to getting more orders for aviation products.

PROSPECT AND STRATEGY

AUTOMOBILE BUSINESS

Prospect on automobile market in China

The Board believes that, in 2006, the China's economy will continue its stable and moderate growth, leading to a steady growth in automobile industry in China. A forecast made by the State Information Center suggests that, in 2006, the total output and sales volume of China's automobile manufacturers will increase by 10% to 15%, and the sales volume for the whole year is expected to reach 6.5 million. The growth in economy sedans will enjoy an above average growth within the industry.

Under China's policy to build a conservation-minded society and to encourage the manufacture and utilization of energy-saving, environmental-friendly and low-emission vehicles, the State Council issued the "Decision on Implementing the Interim Regulation on Promoting the Adjustment of Industrial Structures", the State Development and Reform Commission issued the "Guiding Catalogue for the Adjustment of Industrial Structure" and six ministries of the State Council jointly issued a "Notice on Encouraging the Use of Energy-saving, Environment-friendly and Low-emission Vehicles". Those guidelines encourage manufacturers to develop safe, environment-friendly, energy-saving and low-emission economy passenger cars for private use, encourage residents to purchase such types of vehicles and require the local governments to abolish all existing restrictions in respect of road access and taxi operation against such vehicles before the end of March 2006. All these have provided an unprecedented opportunity for the development of low-emission economy vehicles. In addition, customers are expected to prefer low-emission economy vehicles with low fuel consumption as the price of crude oil in international market remains at a high level, the price of fuel oil in Chinese market keeps rising and the newly revised consumption tax effects.

Prospect and Strategies for the Group's Automobile Business

The vehicles manufactured by the Group are all compliant with China's policy to develop energy-saving and environmental-friendly vehicles. Currently, most of the models developed, manufactured and sold by the Group are mini-sized, low emission (0.8 litres to 1.4 litres) and low fuel consumption vehicles. These models, with features including "safe, environment-friendly, energy-saving, economical and practical", and fully compliant with the China's policy on environmental protection, the State's guidelines on the development of automobile industry and the development trend of the world's automobile industry. Automobile products of the Group have the following advantages:

1. Brand recognition: Models, including Hafei Zhongyi, Hafei Minyi, Hafei Lobo and Changhe Ideal are all energy-saving, environment-friendly and low-emission vehicles with proprietary intellectual property rights. Therefore, these models could obtain support and encouragements from the Chinese government.

2. Independent research and development: In low-emission vehicles, the Group is capable of independently developing mini-sized vehicles and the matching engines as well as developing sedans jointly with other partners. The Group is also the leading manufacturer of engines with low fuel consumption, low emission and light weight.

3. Export: Chinese motor vehicles manufacturers are very competitive in overseas markets because of their low costs structure and economy of scale. In 2005, the Group has exported vehicles to 30 countries and regions. The Group has set up production lines of cooperative projects in certain key regions. The Group's export competitive advantage has been gradually established.

The Group will continue its strategy of developing "safe, environment-friendly, energy-saving, economical and practical" low-emission vehicles, adhere to the principles of giving priority to mini-sized vehicles while enlarging the share in sedan market share, employ a balanced effort in independent research and development as well as cooperation with international partners, and further improve its operation in the automobile business as well as rationalize the manufacturing locations. On that, the Group will evolve into a leading mini-sized vehicle manufacturing group in China with comparative competitive advantages. In 2006, the Group will increase marketing efforts, strengthen the research and development in low-emission vehicles and vehicles using alternative power source by cooperating with international partners and enhance its cost control so as to achieve a stable growth in both the output and sales volume of automobile products.

1. To focus on marketing: The Group will put more efforts on the building of marketing networks and the integration of sales channels to improve its marketing capability and enlarge the sales volume of major mini-sized vehicles. The Group will start automobile financing business, improve enterprises and brands recognition including Hafei Saibao and Changhe Liana sedans.

2. To further strengthen the cooperation with international partners: Changhe Auto will expand its cooperation with Suzuki to other areas, speed up the research and development, introduce new models and improve its technology level and management methods through interaction with Suzuki. Hafei Auto will actively pursue the cooperation with international automobile groups.

3. To strengthen independent research and development capabilities and further promote development of low-emission and energy-saving vehicles: In 2006, the Group will launch several new low-emission models and other upgraded models developed or introduced by Hafei Auto and Changhe Auto.

4. To further reduce costs: The Group will keep up with the integration of its automobile business, the centralization of purchasing and lean manufacturing to cut costs and increase its competitiveness.

To further integrate the Group's automobile business, the resolution on the acquisition of all its equity interest in Hafei Auto by Dongan Motor was passed at the extraordinary general meeting of the Company on 22 March 2005. However, certain conditions to the completion of this transaction have not been fulfilled because of the promulgation of the "Guidelines on the A Share Reform in Listed Companies" issued by the Chinese government. Therefore, the agreement on the transaction has been voided since 31st March 2006 and this transaction could not be completed due to unforeseeable circumstances. The Company is considering proposals on the A Share reform to be conducted by its A Share listed subsidiaries to comply with requirements of Chinese authorities. In order for the Company to respond to the current intensive competition in the Chinese automobile market, the Company plans to place the state owned interests in Changhe Auto held by Changhe Aviation and the state owned interests in Hafei Auto held by Harbin Aviation Group under its direct control to better define the business and management relationships as well as clearly separate the aviation business of the Group from automobile business.

AVIATION BUSINESS

Prospect for Aviation Products Market

With the rapid growth in China's GDP, changes in transportation modes and the continuous improvement of people's living standards, a large potential market for helicopters and civil aeroplanes and a wide opened growth platform for the Chinese civil aviation industry are formed. The World Tourism Organization forecasts that, by 2020, China will become the largest tourists destination and the forth largest source of tourists. This means China's airports need to handle about 210 million tourists every year, which creates huge demands for aviation products in China. In order to take full advantage of this situation, world famous aviation manufacturers, such as Boeing, Airbus and Embraer, have adjusted their production schemes to cooperate with Chinese aviation manufacturers, enlarged the proportion of their products being made in China, establish production lines and set up joint ventures in China. Through the cooperation with international partners, Chinese aviation manufacturers can gradually upgrade their technical levels and strengthen their capabilities in production to keep pace with the development of international civil aviation manufacturers and take their business to a new level.

Prospect and Strategies for the Group's Aviation Business

The Group is the largest helicopter manufacturer and a major aeroplane manufacturer in the PRC. Benefiting from the stable growth of Chinese macro-economy, the Group's aviation business now enters into a fast development stage. In the next few years, both the output and sales volume of the Group's aviation products, especially helicopters, will increase substantially due to the increased purchase orders from the Chinese government. Sales volume of aviation parts and components will also enjoy a steady growth due to the following factors: (i) the fast growth in aviation business of both AVIC II Group and AVIC I Group results in an increased demand for aviation parts and components manufactured by the Group; and (ii) as the Group has made significant advancement in the subcontract production for the world renowned aviation manufacturers, such as Boeing and Airbus, sales volume of aviation parts and components will increase accordingly.

The Group will seize this excellent opportunity, increase investment in the aviation business in the next few years, enlarge the proportion of the aviation business in the Group's portfolio and increase the contribution of its aviation business. In 2006, the Group will:

1. Increase investments in developing aviation business to strengthen its capability in batch production of its current models and improve coordination on the domestic and foreign auxiliary products to ensure a balanced production and the timely delivery of aviation products;

2. Develop new markets: The Group will strengthen relationships with the Chinese government and current customers, while actively seeking new customers for the helicopter products. The Group will emphasize on the export markets for its trainers and general purpose aeroplane as well as pursue new customers for its regional jets;

3. Further strengthen its cooperation with international partners: The Group will further promote the cooperation with EADS in aviation business, especially in the research and development of general purpose helicopters, strengthen the cooperation with Agusta in the production and sale of helicopters and enlarge the proportion it shares in the subcontract production for the world famous aircraft manufacturers, such as Boeing and Airbus, from which the revenue is expected to grow year by year; and

4. Deploy extra efforts in the research and development for aviation products: The Group will emphasize on developing medium-size general purpose helicopter through international partnership to bring in new and improved models. In 2006, aeroplanes model N-5B aeroplanes will perform its first flight and model N-5A will obtain the airworthiness certificate from the US Federal Aviation Administration. The research and development of other serial models will also be carried out as planned.

The Company will also utilize fully the State's policy in supporting reforms on large and medium-sized corporations and revitalizing the traditional industrial bases in Northeast China, continue to promote corporation reforms, adjust the corporate structure, optimize human resources, and enhance productivity.

USE OF PROCEEDS

According to the plan for use of proceeds, the proceeds used during the year ended 31st December 2005 amounted to RMB895 million in total, out of which RMB700 million was used for the research and development of new vehicle models and new vehicle engines; RMB195 million was used for the research and development of new advanced trainers; and the rest was deposited in banks in China as short-term deposits which will also be used by the Company as planned.

EMPLOYEES OF THE GROUP

As at 31st December 2005, the Group had 28,907 employees. The Group provided appropriate remuneration, benefits and trainings to its employees. There were no significant changes in the remuneration policies of the Group during the year.

Employees breakdown by functions

	Number of employees	Percentage to total employees
Vehicles and engines	16,952	58.64%
Civil aviation	10,842	37.51%
Other activities	1,113	3.85%
Total	28,907	100.00%

For the year ended 31st December 2005, a total staff costs of RMB793 million were incurred by the Group for its employees, representing a decrease of RMB81 million when compared with RMB874 million of 2004.

REMUNERATION OF EMPLOYEES

The Group's remuneration scheme is determined by the remuneration committee on fair and reasonable principles which are similar to those available in the market. Remuneration of employees comprises of basic salary, contributions to housing funds and contributions to pension plans. The Group will also, in its discretion, pay year-end bonus to employees according to their respective performance.

TRAINING FOR EMPLOYEES

The Group expects a high level of knowledge and skills in the automobile manufacturing industry and the aviation manufacturing industry from its employees. Therefore, implementation of comprehensive employee training is a key to the Group's continuous development. Accordingly, the Group will continuously review its existing employee training scheme in order to provide a comprehensive and systematic training to its employees.

The Group provides special training courses, seminars on strategic management, human resources management, and financial management for its senior management. Trainings relating to all kinds of professional skills and management techniques are also provided to all professional departments in the Group's headquarters and the business departments of its subsidiaries. On-the-job trainings covering corporate culture, management concept and management standardization are also provided to new employees.

The Group also provides overseas training to the management officers and technicians through cooperation with international partners. The employees, through the training, are able to continuously acquire new knowledge to improve their capabilities. This will in turn enhance the Group's competitiveness in the ever-changing market.