

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

## FINANCIAL RESULTS OVERVIEW

Due to a change in proportionate consolidation of some companies in the Dongfeng Motor Group during the year ended 31 December 2005, the financial information of 2005 is not directly comparable with that of 2004.

In 2005, operating revenue amounted to approximately RMB41,735 million, representing an increase of approximately RMB8,998 million or 27.5% compared with the 2004 figure of approximately RMB32,737 million. This was a result of the Group maintaining its established development tactics, taking full advantage of its scale, networks, business and services, making reasonable investments and implementing aggressive cost control measures by implementing effective competition strategy and marketing steps, so as to continue improving budget and evaluation management. The profit attributable to shareholders amounted to approximately RMB1,601 million, exceeding the forecast profit attributable to shareholders of not less than RMB1,520 million as disclosed at the time of the Company's public offering and listing of H shares on the Stock Exchange of Hong Kong at the end of 2005 by approximately 5.33%. Taking adjustments for proportionate consolidation and the dilutive effects on revenue into account, the profit attributable to the shareholders of the Group for 2005 grew year-on-year by approximately 21.3% [Note 1].

*Note 1:* Excluding net gain generated by dilution of interests in certain businesses and investments of RMB852 million and the changes in the consolidation ratio of certain jointly-controlled entities, the adjusted net profit for 2004 amounted to approximately RMB1,320 million, representing an increase of approximately RMB281 million or 21.3% when compared with the net profit of 2005.

In 2005, net cash inflows from operating activities of the Group was approximately RMB5,274 million, representing an increase of approximately RMB3,405 million or 182.18% compared with approximately RMB1,869 million in 2004, indicating a strong performance of cash flows generated from operating activities.

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## REVENUE

Total revenue of the Group for 2005 amounted to approximately RMB41,735 million, representing an increase of approximately RMB8,998 million or 27.5% compared with approximately RMB32,737 million for 2004, reflecting increases of approximately RMB12,586 million and RMB784 million in revenue from the sales of passenger vehicles to external customers and from other auto-related businesses of the Group respectively, and decreases of approximately RMB3,363 million and RMB1,009 million in revenue from sales of commercial vehicles, and engines and other auto parts, respectively.

Classes	2005		2004	
	<i>Revenue from sales of the Group RMB million</i>	<i>units sold by Dongfeng Motor Group</i>	<i>Revenue from sales of the Group RMB million</i>	<i>units sold by Dongfeng Motor Group</i>
Passenger vehicles	<b>21,798</b>	<b>351,219</b>	9,212	176,974
Commercial vehicles	<b>11,193</b>	<b>243,582</b>	14,556	245,702
Engines and auto parts	<b>6,676</b>	<b>N/A</b>	7,685	N/A
Others	<b>2,068</b>	<b>N/A</b>	1,284	N/A
Total	<b>41,735</b>	<b>594,801</b>	32,737	422,676

*Note:* It should be noted that the revenue figures in the above table reflected the proportionate consolidated revenue of the Group. However, the related figures of the units of vehicles sold by the Group in the above table represented the actual units sold by the Group, not adjusted on a proportionate consolidation basis, for the indicated periods.

Revenue of the Group from sales of passenger vehicles increased by approximately RMB12,586 million or 136.6%, from approximately RMB9,212 million in 2004 to approximately RMB21,798 million for 2005. The total sales volumes of passenger vehicles increased by 98.5% to 351,219 units in 2005 from 176,974 units in 2004, mainly due to: (1) revenue growth brought about by the increase of sales volume of vehicles; (2) new models such as the Nissan Teana, Dongfeng Honda CR-V and Dongfeng Peugeot 307, released by the Group in 2004, entering a peak sales period in 2005; and (3) the TIIDA, newly released in 2005, being widely recognized by the market.

In 2005, subject to such factors as the cyclical nature of economic growth, higher oil prices and policy factors, the PRC commercial vehicles market as a whole weakened, resulting in a slight decrease in the demand for commercial vehicles. In 2005, the Dongfeng Motor Group's total sales volume of commercial vehicles recorded a slight decrease of 0.9% and

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the Group's revenue therefrom decreased by 23.1%, mainly due to the impact of macro-economic austerity measures and other factors. Sales volumes of heavy trucks decreased from 110,131 units in 2004 to 71,652 units in 2005. However, the Group maintained its competitive advantage in the domestic commercial vehicles market. In terms of commercial vehicle market sub-segments, the Dongfeng Motor Group was ranked the first, instead of the second in 2004, in heavy trucks market while maintaining its position among the top players in the medium trucks market in terms of market share in 2005, on the basis of statistics published by the China Association of Automobile Manufacturers. Dongfeng Motor Group's sales volumes of light trucks increased from 50,545 units in 2004 to 82,569 units in 2005, ranking the second instead of the third. An increase in the sales revenue from light trucks partly offset the decrease in sales revenue from heavy trucks.

In 2005, revenue from the sale of engines and other auto parts to external customers decreased by approximately 13.13% to approximately RMB6,676 million, from approximately RMB7,685 million in 2004. This overall decrease in revenue was primarily due to: (1) changes in product mix and sales structure; and (2) lower sales of engines and other auto parts for commercial vehicles. The decrease was partly offset by increased sales of engines to Guangzhou Honda Automobile Co., Ltd.

## **COST OF SALES AND GROSS PROFIT MARGIN**

In 2005, the total cost of sales of the Group was approximately RMB35,639 million, representing an increase of approximately RMB8,687 million compared with approximately RMB26,952 million in 2004. This increase was due to an increase in the sales volumes of passenger vehicles and other auto parts, and the rise in the price of raw materials, particularly steel, for automobile production.

The gross profit margin of the Group decreased to 14.6%, from 17.7% in 2004, primarily due to lower gross profit margins for commercial vehicles and passenger vehicles. However, the gross profit margin of the Group had improved to 16.2% in the second half of 2005, higher than that in the first half of 2005, as a result of taking a number of aggressive cost reduction measures, including raising the domestic production ratio, reducing the use of funds and cutting various costs and expenses.

## **OTHER INCOME**

Total other income of the Group in 2005 was approximately RMB1,007 million, representing an increase of approximately RMB439 million compared with approximately RMB568 million in 2004. The increase in other income was mainly attributable to the sales of other goods and materials and grants received from the government for the purpose of supporting the development of automotive technologies and automobile projects.

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In 2005, the gross profit margin on passenger vehicles decreased to 14.5%, from 18.8% in 2004, primarily due to the decrease in the selling prices of high-end passenger vehicles resulting from greater competition. The gross profit margin had improved to 17.1% in the second half of 2005, higher than that in the first half of 2005.

In 2005, the gross profit margin of commercial vehicles decreased to 7.4% from 8.3% in 2004, which was mainly attributable to changes in product structure and market conditions, and the general increase in the prices of raw materials, particularly steel.

## SELLING AND DISTRIBUTION COSTS

In 2005, the selling and distribution costs of the Group amounted to approximately RMB1,738 million, representing an increase of approximately RMB354 million when compared with approximately RMB1,384 million in 2004. This was due to higher selling and distribution costs resulting from increased sales volumes of vehicles and the marketing of many new models.

In 2005, the sales and distribution costs of the Group as a percentage of sales revenue decreased by 0.07% points to 4.16%, down from 4.23% in 2004, reflecting an effective control over the sales and distribution costs of the Group.

## ADMINISTRATIVE EXPENSES

In 2005, the total administrative expenses of the Group amounted to approximately RMB1,928 million, representing an increase of approximately RMB135 million when compared with approximately RMB1,793 million in 2004. This was due to increased business volume and proportionate consolidation. In 2005, the administrative expenses of the Group as a percentage of sales revenue decreased by 0.86% points to 4.62%, down from 5.48% in 2004, reflecting administrative expenses of the Group further under control.

## STAFF COSTS

In 2005, the staff costs of the Group amounted to approximately RMB1,727 million, representing an increase of approximately RMB132 million when compared with approximately RMB1,595 million in 2004. This was due to an increase in the sales volume of vehicles resulting in a higher demand for labour.

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## DEPRECIATION CHARGES

With a view to expanding its business, the Group made greater investments in buildings, machinery and equipment for production purposes. In 2005, Group depreciation charges, amounted to approximately RMB1,306 million, representing an increase of approximately RMB276 million compared with the 2004 figure of approximately RMB1,030 million.

## RESEARCH AND DEVELOPMENT COSTS

In 2005, the Group made higher investments in research and development. The research and development costs incurred by the Group in 2005 increased by approximately RMB241 million, or 50.4%, to approximately RMB719 million, from approximately RMB478 million in 2004.

## NET FINANCE COSTS

The net finance costs of the Group for 2005 amounted to approximately RMB478 million, representing an increase of approximately RMB236 million compared with approximately RMB242 million in 2004. Such an increase is mainly attributable to a higher demand for capital resulting from bank loans obtained for financing the repurchase of its shareholdings held by the Asset Management Companies and increase investment in property, plant and equipment for production purpose.

The interest-bearing liabilities of the Company in 2004 and 2005 primarily resulted from obtaining bank loans for financing the repurchase of shareholdings held by asset management companies, which were fully repaid within a month after the listing with the proceeds therefrom. The increase of net finance costs should be an increase specific to this stage by judging from the business development of the Group and its estimated cash flows.

## INCOME TAX

The income tax expenses of the Group for 2005 amounted to approximately RMB474 million, representing an increase of approximately RMB166 million compared with approximately RMB308 million for 2004. This increase is mainly due to a higher taxable income and an increase in deferred income taxes.

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## THE GROUP'S NET PROFIT

Based on the above reasons, the net profit of the Group decreased by approximately RMB997 million to approximately RMB1,601 million from approximately RMB2,598 million in 2004. Taking adjustments for proportionate consolidation and the dilutive effects on revenue into account, the profit attributable to the shareholders of the Group in 2005 recorded a year-on-year increase of approximately 21.3% [Note 2].

*Note 2:* Excluding net gain generated by dilution of interests in certain businesses and investments of RMB852 million and the changes in the proportionate consolidation ratio of certain jointly-controlled entities, the adjusted net profit for 2004 amounted to approximately RMB1,320 million, representing an increase of approximately RMB281 million or 21.3% when compared with the net profit of 2005

The audited consolidated earnings per share decreased to approximately RMB25.86 cents in 2005 from approximately RMB28.38 cents in 2004. Taking adjustments for proportionate consolidation and the dilutive effects on revenue into account, the earnings per share of the Group for 2005 grew year-on-year by approximately 79.3% [Note 3].

*Note 3:* Excluding net gain generated by dilution of interests in certain businesses and investments of RMB852 million and the changes in the proportionate consolidation ratio of certain jointly-controlled entities, the adjusted net profit for 2004 amounted to approximately RMB1,320 million. The adjusted earnings per share for 2004 was RMB14.42 cents. The earnings per share for 2005 grew by 79.3% when compared with the adjusted earnings per share for 2004.

## LIQUIDITY AND SOURCE OF CAPITAL

The Group raises funds through operations, bank loans and listings to meet its working capital requirements. The funds raised by the Group are mainly used for operating activities, capital expenditure and repayment of short and long term loans.

	<b>2005</b>	2004
	<b>RMB million</b>	RMB million
Net cash flows generated from operating activities	<b>5,274</b>	1,869
Net cash used in investing activities	<b>(4,203)</b>	(2,928)
Net cash generated from/(used in) financing activities	<b>37</b>	(936)
Net increase/(decrease) in cash and cash equivalents	<b>1,108</b>	(1,995)

For the year ended 31 December 2005, net cash inflows from operating activities amounted to RMB5,274 million, representing an increase of approximately RMB3,405 million. This principally represents: (1) profit before tax amounting to approximately RMB2,221 million; (2)

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an increase of approximately RMB1,749 million in trade, bills and other payables and accrued liabilities; (3) depreciation and impairment of approximately RMB1,357 million; and (4) a decrease of approximately RMB513 million in inventories.

For the year ended 31 December 2005, net cash used in investing activities of the Group amounted to approximately RMB4,203 million, representing an increase of 43.55%. This is mainly attributable to the purchase of property, plant and equipment to the value of approximately RMB4,051 million, generally relating to expansion of capacity and development of new products. During the year, an increase of approximately RMB738 million in unsecured time deposits has been partly offset by proceeds of approximately RMB467 million from the disposal of obsolete property, plant and equipment.

For the year ended 31 December 2005, net cash from financing activities of the Group amounted of the Group to approximately RMB37 million, mainly reflecting the offsetting of the net proceeds from share issues of approximately RMB3,959 million and borrowings of approximately RMB10,338 million by repayment of borrowings of approximately RMB10,456 million, the payment for the repurchase of share capital of approximately RMB2,306 million and the payment of a dividend of approximately RMB1,390 million.

As at 31 December 2005, the net increase in cash and cash equivalents of the Group amounted to approximately RMB1,108 million, representing an increase of approximately RMB3,103 million. As of 31 December 2005, cash and cash equivalents of the Group amounted to approximately RMB5,586 million.

The Dongfeng Motor Group's turnover days of inventory decreased by 18 days to 55 days as compared with 73 days in 2004. Such decrease was mainly due to: (1) the Dongfeng Motor Group's enhancement of its inventory management; (2) the increase of the portion of product localisation and the reduction of auto parts' purchase time lag; and (3) the decrease of import order size of knock-down parts.

The Dongfeng Motor Group's turnover days of account receivable decreased by 9 days to 44 days as compared with 53 days in 2004. Such decrease was mainly due to the Dongfeng Motor Group's enhancement of its collection management of account receivable.

## CHANGES IN SHAREHOLDINGS

1. In 2004, Dongfeng Automobile Co., Ltd, which was a 70% owned subsidiary of Dongfeng Motor Co., Ltd., a joint venture company of the Company, acquired 51% equity interests of Zhengzhou Nissan Automobile Co., Ltd.. The Company had 17.85% indirect equity interests of Zhengzhou Nissan Automobile Co., Ltd. through Dongfeng Motor Co., Ltd. with effect from 1 March 2005.

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2. In 2005, the Company and Dongfeng Motor Co., Ltd. entered into the Agreement regarding the Increase of Registered Capital of Dongfeng Motor Finance Co., Ltd. with the partners of their joint venture company, pursuant to which, the parties shall make additional capital contribution to Dongfeng Motor Finance Co., Ltd respectively. Upon additional capital contribution, the Company maintained its direct shareholding percentage in Dongfeng Motor Finance Co., Ltd unchanged while Dongfeng Motor Co., Ltd's shareholding percentage in Dongfeng Motor Finance Co., Ltd increased to 55% from 40%. Dongfeng Motor Finance Co., Ltd was proportionately consolidated into the Group from 40% to 47.5% since then.
3. In 2005, the Company acquired 9% equity interests of Dongfeng Honda Auto Parts Co., Ltd from other shareholders. Dongfeng Honda Auto Parts Co., Ltd was owned as to 44% from 35% by the Company since then.

## RISK FACTORS

The Dongfeng Motor Group's business, financial condition and results of operations are subject primarily to such external factors as global economic activities, the price of raw materials, exchange rate fluctuations, policies on taxes and duties, regulation in the motor industry and finance costs, which are not wholly within the Dongfeng Motor Group's control.