# Management Discussion and Analysis

## 1) OPERATING ENVIRONMENT

During the reporting period, despite a relatively fast economic development in the PRC as well as a continuous increase of social demand at large, the development of the iron and steel industry was not fully matched with the demand growth and there were evident structural incompatibilities. Raw materials, energy and transportation required for iron and steel production were still insufficient and their prices were increasing. As a result, the Company's production and operation were faced with a series of difficulties:

**Supply exceeded demand due to a rapid increase in iron and steel output:** The iron and steel industry as a whole produced approximately 350 million tonnes of crude steel in 2005, representing a year-on-year increase of 24.6%. In terms of additionally produced steel products during the year, plate belt accounted for nearly 50%, which exceeded the demand from industrialisation and urbanisation of the PRC at this stage.

**Substantial increase in prices due to a tight supply of major raw materials and fuel:** Approximately 75% of the Company's iron ore was supplied from overseas, while the global FOB price of iron ore surged by 71.5% in 2005. Approximately 90% of the Company's coal was supplied domestically, and prices of coking and thermal coal rose approximately 10% and 8%, respectively, in 2005 compared to the previous year.

**Abnormal price differentials among certain products due to volatile prices of steel products:** During the first quarter of 2005, prices of steel products continued to surge as a result of relatively tight supply in resources for the domestic steel market. Consolidated price index for steel products rose to 138 points at the end of March. Prices of steel products slumped continuously since April resulting in a drop of the consolidated price index of steel products to 94 points at the end of December, of which prices of medium-sized plate or hot-rolled thin plate of certain specifications were even lower than the average price of wires and corrugated steel. (Source: Metallurgical Information Research Centre)

## 2) PRODUCTION OPERATION

To achieve annual targets, the Company defined various objectives and implemented various measures thoroughly during the reporting period to achieve an improved performance in production and operation.

- **Adopted measures to tackle the difficulties in purchase of raw materials and fuel:** To fully capitalise on the favourable opportunities arising from the price fall of international marine transportation, measures such as co-transportation by river and sea were adopted to integrate logistics and reduce transportation costs. Through executing medium to long-term cooperation agreements with all of our coal suppliers, a steady supply in coal was assured.

- **Developed new technologies to increase the output of best-selling products:** Through cooperation with relevant departments and sections, the Company's State-level corporate technology centre has shouldered the research and development responsibility on three projects under the State 863 Projects, namely "Shock and Fire Resistant H-Shaped Steel for Construction", "Research and Development of High-efficiency, Low-cost Cold-forged Steel with Wire-softening Treatment in the Production Line" and "Materials and Critical Techniques for Train Wheels Used for High-speed Railroads". Core production technologies and various patents on respective projects have been certified by State-level standards. A total of 1,220,000 tonnes of new products such as cold-forged steel and whole train wheels were produced during the year.

- **Pushed forward measures on energy saving and consumption reduction for developing a recyclable economy and enhancing integrated resources utilisation:** Based on the concepts of sustainable development and a recyclable economy, the Company applied the facilities and techniques from the technological upgrades and environmental energy-saving projects, developed during the 11-5 Plan period, to generate electricity with coal gas and residual heat. As a result, we succeeded in enhancing environmental protection and integrated resources utilisation. In 2005, overall energy consumption was reduced to 731 kilogrammes standard coal per tonne, while fresh water consumed for every tonne of steel production went down to 11 tonnes. The ratio of self-supplied electricity rose to 40.31%, while the utilisation rate of recycled water improved to 93.59%.

- **Enhanced sales and marketing in response to volatile changes in the market:** By enhancing market forecasts and activities analysis, strengthening the coordination of production, sales and logistics; and planning and executing flexible sales and marketing tactics, the Company has ensured stable delivery of products and timely return of payments under challenging market conditions. In 2005, the Company enjoyed a approximately 2.76% share in the domestic steel products market, and approximately 560,000 tonnes of steel products were exported.

- **Carried out management innovation to enhance production and operation standards:** In order to adapt to the increasing scale of production, the Company strengthened its management on fundamentals and implemented the project of Total Normalised Productive Maintenance ("TnPM"). Business integration was initiated through a launch of the human resources information management system. Results from the Company's innovation in management were remarkable. There were further integrated reforms for the factory areas, while the environment was further improved.

- **Actively raised capital to satisfy production and construction needs:** During the reporting period, through strengthening its communication with major lending banks and leveraging its creditworthiness, the Company has succeeded in having the major lending banks raise its banking facilities, thereby assuring the funds for construction. At the same time, faced with continuous expansion in the production scale of existing factory areas and the need for increased liquidity, the Company timely issued one-year short-term commercial papers of RMB2 billion pursuant to the requirements of the People's Bank of China, which has effectively reduced capital costs.

## 3) THE OPERATING RESULTS OF THE GROUP FOR THE REPORTING PERIOD PREPARED UNDER PRC ACCOUNTING STANDARDS ARE AS FOLLOWS:

- Analysis of principal operating income by segments and by products

The steel segment accounted for 95.45% of the Group's principal operating income. The steel segment also accounted for 91.10% of the Group's profit from principal operating activities.

Unit: RMB million

| Business segment | Principal operating income | Increase/ (decrease) compared to the previous year (%) | Cost of sales from principal operating activities | Increase/ (decrease) compared to the previous year (%) | Gross profit margin (%) | Increase/ (decrease) compared to the previous year (percentage points) |
|---|---|---|---|---|---|---|
| Iron and steel | 30,623 | 18.88 | 26,261 | 30.17 | 14.24 | -7.44 |
| **Product Segment** | | | | | | |
| Plate belt | 11,858 | 22.83 | 9,938 | 37.15 | 16.19 | -8.75 |
| Section steel | 7,551 | 17.49 | 6,253 | 27.61 | 17.19 | -6.57 |
| Wire rods | 9,200 | 8.54 | 8,545 | 23.22 | 7.12 | -11.06 |
| Train wheels and wheel rims | 1,534 | 63.89 | 1,118 | 28.80 | 27.12 | +19.86 |

- Geographical analysis of the Group's principal operating income:

Unit: RMB million

| Region | Percentage (%) | Principal operating income | Increase/(decrease) of principal operating income as compared to the previous year (%) |
|---|---|---|---|
| Anhui | 15 | 4,813 | -62 |
| Jiangsu | 28 | 8,731 | 92 |
| Shanghai | 18 | 5,931 | 73 |
| Zhejiang | 11 | 3,531 | 94 |
| Guangdong | 5 | 1,746 | 34 |
| Other PRC regions | 17 | 5,302 | 169 |
| Exports | 6 | 1,961 | 118 |

- During the reporting period, the Group's gross profit margin of principal operating activities was 14.93%, a decrease of 7.37 percentage points as compared to the corresponding period of the previous year. This was mainly attributable to the fall of the selling prices of steel products and the rise in purchasing costs of raw materials and fuel.

## 4) ASSETS AND LIABILITIES OF THE GROUP FOR THE REPORTING PERIOD PREPARED UNDER PRC ACCOUNTING STANDARDS ARE AS FOLLOWS:

- Assets

  During the reporting period, there were no material differences on the proportions of bills receivable, trade receivables, other receivables, inventories and long-term equity investments out of total assets when compared to the corresponding period of the previous year. The amount of net fixed assets accounted for 47.3% of total assets, a decrease of 9.5 percentage points over the corresponding period of the previous year, which was mainly due to an increase in the Company's total assets during the reporting period. Construction in progress accounted for 12.16% of total assets, an increase of 6.3 percentage points over the corresponding period of the previous year, which was mainly due to the construction of the Company's 5,000,000 tonnes thin plates production project in the new area and an increase in the number of construction in progress during the reporting period.

- Liabilities

  During the reporting period, short-term loans accounted for 0.29% of total assets, a decrease of 4.73 percentage points over the corresponding period of the previous year, which was mainly due to a decrease in loans as working capital as a result of the Company's issuance of short-term commercial papers. Long-term loans accounted for 22.05% of total assets, an increase of 8.91 percentage points from the corresponding period of the previous year, which was mainly due to an increase in long-term loans resulted from the construction of 5,000,000 tonnes thin plates production project in the new area.

## 5) EXPENSES AND INCOME TAX OF THE GROUP FOR THE REPORTING PERIOD PREPARED UNDER PRC ACCOUNTING STANDARDS ARE AS FOLLOWS:

During the reporting period, selling expenses increased by 25.51% over the corresponding period of the previous year, which was mainly due to increases in sales volume of steel products, transportation costs and loading and unloading costs. Administrative expenses decreased by 23.35% over the corresponding period of the previous year, which was mainly due to a reduction of RMB407 million in removal compensation and demolishment expenses, as well as no one-off staff medical insurance in year 2005. Financial expenses were reduced by 48.51% over the corresponding period of the previous year, which was mainly due to an increase in exchange gain and a decrease in exchange loss. There was no material difference on income tax when compared to the corresponding period of the previous year.

## 6) OPERATING RESULTS

As at the end of 2005, in accordance with PRC Accounting Standards, the Group's principal operating income rose 20% from the corresponding period of the previous year, which was mainly due to an increase in sales volume of steel products of the Company. Profit generated from principal operating activities dropped 20.79% from the corresponding period of the previous year, which was mainly due to an increase in procurement costs for raw materials and fuel. Net profit dropped 20.36% from the corresponding period of the previous year, which was mainly due to a decrease in profit generated from principal operating activities.

## 7) CASH FLOWS OF THE GROUP FOR THE REPORTING PERIOD PREPARED UNDER PRC ACCOUNTING STANDARDS ARE AS FOLLOWS:

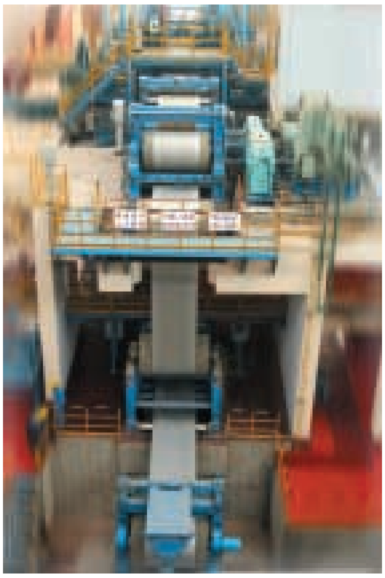
In 2005, the Group realised a net profit of RMB2,848 million, a difference of RMB3,323 million when compared to the net increase of cash flow amounting to RMB6,171 million generated from operating activities, which was mainly due to depreciation on fixed assets and a decrease in receivables from operations, as well as an increase in payables from operations. The amount of net increase in cash flow generated from operating activities was not very different from that of the corresponding period of the previous year. The amount of net cash outflow from investing activities increased by RMB4,642 million from the corresponding period of the previous year, which was mainly due to acquisition and construction of fixed assets and investments. The amount of net cash inflow from financing activities increased by RMB5,788 million from the corresponding period of the previous year, which was mainly due to securing of bank loans and the issuance of short-term commercial papers.

## 8) MAJOR SUPPLIERS AND CUSTOMERS

In 2005, the Group's purchase from the five largest suppliers amounted to RMB5,663 million, accounting for 23% of the Group's total purchase amount for the year. The Group's sale to the five largest customers amounted to RMB4,207 million, representing 13% of the total sales revenue of the Group for the year. Of the above-mentioned major suppliers, Holding is a controlling shareholder of the Company. Other than that, none of the directors, supervisors, their connected parties and other shareholders (to the knowledge of the Board of Directors holding 5% or more of the Company's shares) held any beneficial interest in the Group's five largest suppliers or customers.

## 9) THE OPERATIONS AND RESULTS OF THE GROUP'S MAJOR SUBSIDIARIES AND ASSOCIATES

- Ma Steel International Trade and Economics Corporation, a wholly-owned subsidiary with a registered capital of RMB50 million, is mainly engaged in the import of machinery and raw materials and export of steel products. Net profit for the period amounted to RMB55 million. As at the end of the reporting period, it had total assets amounting to RMB1,316 million.



- Design & Research Institute of Maanshan Iron & Steel Company Limited has a registered capital of RMB20.49 million, in which the Company holds direct and indirect stakes of 58.96% and 7.86%, respectively. It is mainly engaged in metallurgical, construction and planning and design of environmental protection projects. Net profit for the period amounted to RMB35 million. As at the end of the reporting period, it had total assets amounting to RMB82 million.

- Maanshan Iron & Steel (HK) Limited has a registered capital of HK$4.8 million, in which the Company holds direct and indirect stake of 80% and 20%, respectively. It is mainly engaged in the trading of steel and iron ores and provision of transportation services. Net profit for the period amounted to RMB4 million. As at the end of the reporting period, it had total assets amounting to RMB22 million.

- Anhui Masteel K. Wah New Building Materials Co., Ltd. has a registered capital of US$4.29 million, in which the Company holds a direct stakes of 70%. It is mainly engaged in the production, sale and transportation of slag products and provision of related consultation services. Net profit for the period was RMB7 million. As at the end of the reporting period, it had total assets amounting to RMB102 million.

- Ma Steel (Wuhu) Processing and Distribution Co., Ltd. has a registered capital of RMB35 million, in which the Company holds direct and indirect stake of 70% and 30%, respectively. It is mainly engaged in the processing and sale of metallic products, processing of motor vehicle spare parts and sale of construction materials and chemical products. Net profit for the period amounted to RMB14 million. As at the end of the reporting period, it had total assets amounting to RMB626 million.

- Ma Steel (Guangzhou) Processing and Distribution Co., Ltd. has a registered capital of RMB120 million, in which the Company holds a direct stake of 66.67%. It is mainly engaged in the production, processing and sale of steel products, as well as provision of storage, transportation and after-sales services. Net profit for the period amounted to RMB15 million. As at the end of the reporting period, it had total assets amounting to RMB435 million.

- Anhui Masteel Holly Packing Co. Ltd. has a registered capital of RMB30 million, in which the Company holds a direct stake of 71%. It is mainly engaged in the production, sale and agency of steel products and other product packaging materials and provision of on-site packaging services. Net profit for the period amounted to RMB78 million. As at the end of the reporting period, it had total assets amounting to RMB161 million.

- Maanshan Iron and Steel (Australia) Proprietary Limited, a wholly-owned subsidiary, has a registered capital of AU$22 million. It is mainly engaged in investment and trading. Net profit for the period amounted to RMB5 million. As at the end of the reporting period, it had total assets amounting to RMB136 million.

## 10) INVESTMENTS

In 2005, the Group invested a total of RMB5,379 million construction in progress, an increase of 12.93% from the previous year.

- Projects which have already commenced operation:

Unit: RMB million

| Project name | Total investment |
|---|---|
| The new No. 2 Coke Furnace | 215 |
| The Second H-Beam Production Line | 930 |
| The No. 2 Galvanisation Production Line (undergoing heat-load trial production stage) | 670 |

- Projects under construction

Unit: RMB million

| Project name | Total investment | Project progress |
|---|---|---|
| The Capacity Enhancement of Train Wheel Rolling System | 320 | Entering facilities installation stage |
| Integrated Raw Materials Plot | 850 | Commencing construction and installation of partial steel structures |
| New Area Iron-making System | 3,500 | Cast of Blast Furnace A capped; commencing construction and installation of steel structures in the vestibule of core belt; undergoing installation of the cast for Blast Furnace B |
| New Area Steel-making System | 3,200 | Construction of Converters Nos. 1, 2 and 3 completed; commencing hoisting high-level frame for converters |
| New Area Hot-rolled Broad Belt System | 3,600 | Installation of steel structure in core factory of core belt line completed; undergoing construction of foundation facilities |
| New Area Pickled Cold Wire and Hot Galvanising Line | 4,700 | Undergoing hoisting of steel structures in core factory of cold wire line and construction of foundation facilities for galvanising line |
| New Area Power Generating Plant Using Integrated Resources | 1,850 | Under foundation construction stage |

During the reporting period, in order to provide equipment support, technical support, sales support and assurance of raw materials supply for the newly operating projects, the Group carried out five external investments as follows:

- A contribution of RMB234 million was made to establish a joint venture Ma'anshan BOC-Ma Steel Gases Company Limited(馬鞍山馬鋼比歐西氣體有限責任公司)with BOC (China) Holding Company Limited(比歐西(中國)投資有限公司), a wholly-owned subsidiary of the BOC Group of the United Kingdom, in which the Company holds a direct stake of 50%. The company is mainly engaged in the production and sales of gas products in gaseous or liquid form, as well as the preparation of other industrial gas products projects.

- A contribution of RMB0.9 million in the form of physical assets and monetary funds was made to establish a joint venture 馬鞍山馬鋼華陽設備診斷工程公司 with 上海華陽檢測儀器有限公司, in which the Company holds a direct stake of 90%. The company is mainly engaged in technical consultation for equipment diagnosis, equipment diagnosis service and equipment diagnosis projects.

- A contribution of AU$21,737,900 was made to establish a wholly-owned subsidiary Maanshan Iron and Steel (Australia) Proprietary Limited, which is mainly engaged in investment and trading.

- A contribution in the form of physical assets, land assets and cash to establish a joint venture 馬鞍山港口(集團)有限責任公司 with State-owned Assets Administration Office of Maanshan City, 中國長江航運集團總公司 and 安徽長江鋼鐵有限責任公司, in which the Company holds a direct stake of 45%. The Company plans to contribute a capital amounting to RMB112.5 million, in which an amount of RMB104.8 million had been contributed as capital as at the end of the reporting period. The company is mainly engaged in stevedoring of materials at the ports, freight agency, multimodal transportation and storage services.

- The establishment of a joint venture Masteel (Jinhua) Processing Co., Ltd. in Jinhua, Zhejiang Province with 香港怡德實業有限公司 and 香港遠東實業投資有限公司, in which the Company holds a direct stake of 75%. The Company plans to contribute a capital amounting to RMB90 million, in which an amount of RMB63 million had been contributed as capital as at the end of the reporting period. The Company is mainly engaged in the production, processing and sales of steel plates, wires and section steel products, as well as the provision of storage and after-sales services.

## 11) FINANCIAL POSITION AND EXCHANGE RISKS

For the year ended 31 December 2005, the total amount of loans borrowed by the Group was RMB8,762 million, including loans for working capital of RMB2,267 million and construction loans of RMB6,495 million. Except for foreign currency loans amounting to US$209 million and 2 million Euro, all other loans were denominated in RMB. Except for a foreign currency loan amounting to US$208 million which carried interests at LIBOR plus a fixed percentage, all other loans carried interests calculated at fixed interest rates. Movements of the Group's bank loans followed the developments in our production and construction projects. No overdue payments have been recorded so far. On 30 December 2005, the Group issued one-year short-term commercial papers in an aggregate amount of RMB2,000 million.

As at 31 December 2005, in accordance with PRC Accounting Standards, the Group's gearing ratio (total liabilities/total assets) stood at 51.08%. Under the Hong Kong Accounting Standards, the Group's gearing ratio (total liabilities/total assets) stood at 52.09%.

At the present stage, other than internal resources, all capital requirements for the Group's 11-5 Master Plan were financed through bank loans. As at the end of the reporting period, bank commitments to provide banking facilities to the Group amounted to approximately RMB29,090 million.

As at 31 December 2005, the Group's cash and balances with financial institutions amounted to RMB3,255 million. Bills receivable amounted to RMB1,932 million (of which bank bills receivable due within three months amounted to RMB1,432 million). Deposits received for the coming month constituted a substantial part of the cash and balances with financial institutions and bank acceptance bills.

The Group's import of raw materials was settled in US dollar, while import of equipment and spare parts was settled in Euro or Japanese Yen, and export of products was settled in US dollar. Given that the US dollar to RMB exchange rate continued to depreciate, an exchange gain was resulted from the Company's US dollar-denominated debts. Moreover, since the amount of payments denominated in US dollar on imported iron ore is larger than that of income from export, the appreciation of RMB exchange rate is favourable to the Company. Taking into consideration of the volatility on the exchange rate of Japanese Yen, the Company entered into a selective forex forward contract with HSBC in July 2005 to lock the risks arising from payments in Japanese Yen. Taking into consideration of the volatile characteristics on the exchange rate of Euro, the Company is actively seeking relevant risk management solutions, so as to ensure the construction projects under the 11-5 Plan will not be materially affected by the volatility of exchange rates.

### 12) CHANGES IN THE PRODUCTION OPERATION ENVIRONMENT FOR 2006

In 2006, the PRC economy will still maintain steady and relatively fast pace of growth, which will provide certain opportunities for the development of the iron and steel industry. However, overall speaking the oversupply problem and the structural imbalance between products may become more apparent. The Company will firmly position itself in the existing market and actively develop new products, explore new customers and expand into new markets. Our capability to withstand market risks will be strengthened through optimising product mix, reducing costs and enhancing efficiency.

The National Development and Reform Commission (the "NDRC") promulgated "The Iron and Steel Industry Development Policies" (the "Policies") on 20 July 2005, in an effort to enhance the overall technological standards of the domestic iron and steel industry, to carry forward structural adjustments, and to strengthen the competitiveness of the iron and steel industry in the international arena. The Policies lay down the policy guidelines in relation to the development plan, strategies, technology, organisational structure, investment and raw materials for iron and steel enterprises. The promulgation and implementation of the Policies will create a more favourable market environment for the Company's development and will also pose more stringent standards to the Company's environment protection efforts.

The Ministry of Finance and the State Administration of Taxation also published policies in 2005 in relation to the cancellation of Export VAT Refund Policy for primary steel products such as pig iron, steel billet and steel ingot, as well as a reduction in tax rebates rate for export of steel products and the imposition of value-added tax as stipulated on all domestic steel products sold by iron and steel enterprises to domestic processing and export enterprises for manufacturing export products, for which no more tax reduction or exemption will be granted. In view of the proportion of the Company's current exports being lower than 10%, such measures will therefore have insignificant impact on the Company.

### 13) LONG-TERM STRATEGIES OF THE COMPANY

Between 2006 and 2010, the Company will implement its 11-5 Master Plan for technological reforms and structural adjustments. By the end of 2007, a production capability of 5,000,000 tonnes of thin plates will be launched mainly for products either with a shortage in the PRC or applicable in automobiles and home appliances industries.

By that time, the overall profitability of the Company will be significantly enhanced. The Company's integral competitiveness and its capabilities to withstand market risks will strengthen significantly.