Management Discussion and Analysis

Turnover for 2005 was RMB 34,400 million (2004: RMB24,502 million), representing an increase of 40.4% over last year. Profit attributable to equity holders of the Company was RMB 1,672 million (2004: RMB 1,089 million), representing an increase of 53.5% over last year. Basic earnings per share was RMB 15.17 cents (2004: RMB 11.85 cents).

As at 31 December 2005, total assets of the Group were RMB55,165 million (2004: RMB47,110 million) and total liabilities were RMB33,979 million (2004: RMB32,778). Total equity was RMB21, 186 million (2004: RMB14,332 million), of which RMB14,880 million was attributable to the parent company equity holders (2004: RMB8,505 million).

The Group recorded satisfactory results for 2005 with the Power Equipment Division being the main driver of growth in profit, accounting for 75.8% of the operating profit for the year.

Business Review of Major Divisions

Set out below are the turnover and operating profits of individual business divisions:

	Turnover		Operating Profit	
(RMB million)	**2005**	**2004**	**2005**	**2004**
Power Equipment	19,491	11,393	2,555	1,220
Percentage of total	56.7%	46.5%	75.8%	51.0%
Electromechanical Equipment	11,041	8,675	706	772
Percentage of total	32.1%	35.4%	20.9%	32.2%
Transportation Equipment	3,143	4,029	20	307
Percentage of total	9.1%	16.4%	0.6%	12.8%
Environmental Systems	1,027	395	(20)	0
Percentage of total	3.0%	1.6%	-0.6%	0.0%
Financial business	0	0	385	212
Percentage of total	0.0%	0.0%	11.4%	8.9%
Other businesses	299	305	323*	87*
Percentage of total	0.9%	1.2%	9.6%	3.6%
Consolidated adjustments and write-offs	(601)	(295)	(599)*	(204)*
Percentage of total	(1.7%)	(1.2%)	(17.7%)	(8.5%)
Total	34,400	24,502	3,370	2,394

** Included in operating profit of other businesses was dividend income of RMB383 million (2004: RMB90 million) from the Company's subsidiaries, which has been eliminated by consolidation adjustments and write-offs.*

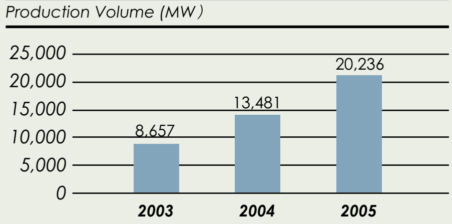
Power Equipment Division

Demand for electricity in China continued to exceed supply. In 2005, the Group has completed orders for power generation equipment with total capacity of over 20,000 MW, while outstanding orders for power generation equipment stood above 70,000 MW in total capacity by the end of the year. Turnover of the Power Equipment Division reached RMB19,491 million (2004: RMB11,393 million), representing an increase of 71.1% from last year. As a result of stringent controls over production costs, the Power Equipment Division recorded a moderate increase in gross profit margin to 21.8% (2004: 21.6%). Operating profit, in contrast, increased by 109.4% to RMB 2,555 million (2004: RMB 1,220 million), which was mainly due to growth in sales and the Group's control over operating expenses. In addition, the production volume, sales volume and profit from the Group's Power Equipment Division all reached new record levels.

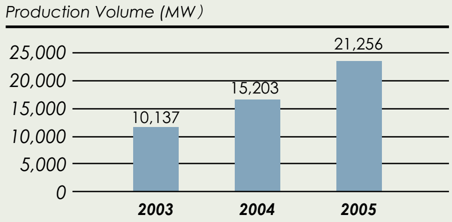
Through strengthening its Power Equipment Division and an integrated management strategy, the Group has reduced production and operating costs. Production capacity has been augmented through investments in fixed assets. Additionally, a new product development framework was established to enhance product capacity level. Through expanding provision of complete sets of power station equipment business and after sales services, the Group enlarged its business scope and added value to its products. In response to the sluggish domestic market, the Group has committed to explore overseas markets. In the meantime, it is actively involved in the development of new energy areas, such as nuclear power and wind power, with the objective to maintain the continuous development of our power station equipment business.

To accelerate the growth of the power transmission and distribution equipment business, the Group has expedited business restructuring, increased in resources for technical upgrade, established new product development framework, and engaged in business development for integrated projects. Turnover of the power transmission and distribution equipment business for 2005 was RMB1,808 million (2004: RMB 1,290 million),representing an increase of 40.2% from last year.

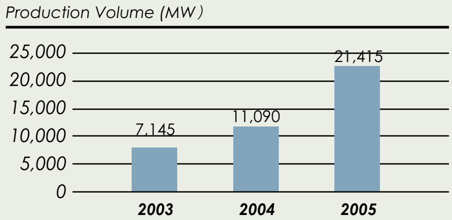
Changes in Production Volume of Power Station Boilers over the Past Three Years



Changes in Production Volume of Turbine Generators over the Past Three Years



Changes in Production Volume of Turbines over the Past Three Years



In 2005, the Group has completed orders for power generation equipment with total capacity of over 20,000 MW, while outstanding orders for power generation equipment stood above 70,000 MW in total capacity by the end of the year.

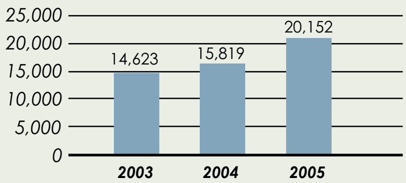
The Group managed to achieve a record-breaking production volume of 20,000 elevators

Electromechanical Equipment Division

For 2005, turnover of the Electromechanical Equipment Division was RMB11,041 million (2004: RMB8,675 million), representing an increase of 27.3%, which was mainly attributable to the growth in sales of heavy machinery and contributions from certain printing and packaging equipment manufacturing company acquired in 2004. Operating profit recorded a slight decline at RMB706 million (2004: RMB772 million), which was mainly due to rising prices of raw materials and commencement of production of new heavy machinery products. Accordingly, gross profit margin declined to 17.6% (2004: 22.1%). Following the maturity of production and technology for new heavy machinery products and implementation of stringent cost control measures, the gross profit margin of this division is expected to increase gradually.

Changes in Production Volume of Elevators over the Past Three Years

Production Volume (Units)



The Group managed to achieve a record-breaking production volume of 20,000 elevators, and maintained the division's sales revenue and operating profit at high levels against the backdrop of the government's macro economic control on fixed assets investments and property development in 2005. The PRC's average number of elevators per capita is only one third of the rest of the world, which means enormous markets with great potential especially for new elevators and for elevators upgrade and modification. However, intense competition has evidently diminished product differentiation. Anyway, with further enhancement of its operation and sales systems; successful recruitment of more industry talents; another step improvement of service function; more extensive utilization of information technology as well as acquisition of technology and continuous application of new proprietary technology, production, sales and operation efficiency of the elevator business will remain at high levels, and the group will maintain its leading position in elevator market.

Heavy machinery business maintained a relatively high growth rate while sales increased from RMB1,274 million in 2004 to RMB2,348 million in 2005, representing a growth of approximately 84.3%. The Group has achieved rapid growth in heavy machinery business in recent years as its products are for the assembling of heavy equipment. The heavy machinery market of the PRC will see further growth in the coming few years. The Group will further enhance its production capacity of large-scale casting and forging pieces, through increasing investment in fixed assets. The Group will also strengthen its product development capability through cooperating with academic researchers, so as to expand the product line and elevate the technology level of our heavy machinery products. It is expected that the heavy machinery business of the Group will further grow in both size and scale.

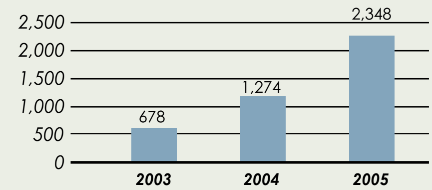
Sales and profitability of printing and packaging equipment business maintained at a relatively high level in the PRC. Under the rapidly developing PRC economy, demand for printing and packaging equipment, especially in the upper market, will continue to grow. The Company aims to promote the growth of this business by leveraging on effective resource consolidation and technical synergy with entities acquired overseas. It is expected that the printing and packaging equipment business will remain at a relatively high growth rate.

The Company's machine tools business shows a rising trend in terms of production and sales. In the coming few years, large-scale, precision, dedicated and digitally-controlled machine tools and relevant accessories will become the mainstream and key products in the market. This will also be the major trend for future development. Through acquisitions, the Group has expanded the production scale and product range of its machine tools business; elevated the technology standard of its products, advanced technical specification of products through synergistic exchanges with both domestic and foreign enterprises, and tapped into industry talents from domestic and overseas sources to support product development. It is expected that the sales and profit of the Group's machine tools business will maintain substantial growth momentum in the coming few years.

In the coming few years, large-scale, precision, dedicated and digitally-controlled machine tools and relevant accessories will become the mainstream and key products in the market

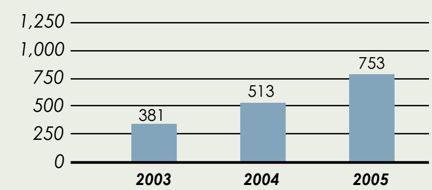
Changes in sales amount of Heavy Machinery over the Past Three Years

(RMB million)



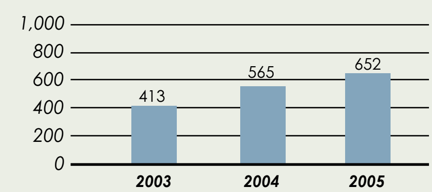
Changes in sales amount of Printing and Packaging Equipment over the Past Three Years

(RMB million)

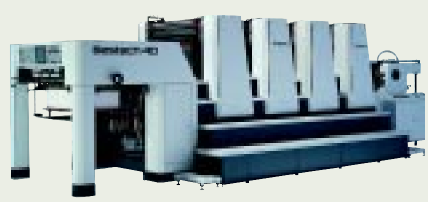


Changes in sales amount of Machine tools over the Past Three Years

(RMB million)



Under the rapidly developing PRC economy, demand for printing and packaging equipment, especially in the upper market, will continue to grow



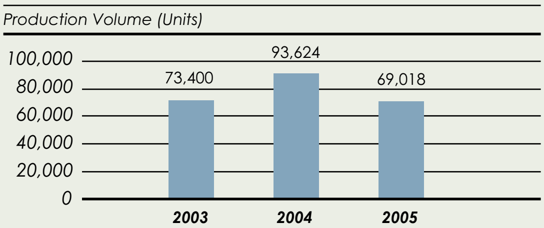
As a result of macro economic control, demand for heavy trucks in the PRC has diminished, contributing to a rather substantial decline in the sales and operating profit of the Group's diesel engine business

Sales from metropolitan rail transportation equipment for 2005 was small as such sales are largely subject to the progress of railway construction.

Transportation Equipment Division

In 2005, turnover and operating profit of the Transportation Equipment Division dropped 22.0% and 93.5% from the previous year respectively. As a result of macro economic control, demand for heavy trucks in the PRC has diminished, contributing to a rather substantial decline in the sales and operating profit of the Group's diesel engine business. Nevertheless, as the PRC is committed to more water, transportation and energy projects and environmental conservation projects and has embarked upon a series of large-scale infrastructure and engineering projects, the diesel engine market still holds substantial potential in the long run. As such, the Group intends to improve the operating efficiency of this business by enhancing research and development capability and broadening the scale of the market

Changes in Production Volume of Diesel Engines over the Past Three Years

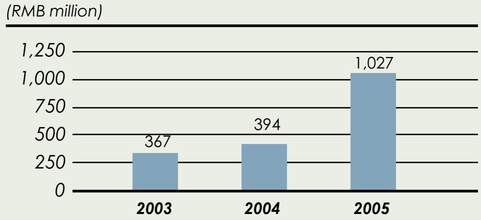


Sales from metropolitan rail transportation equipment for 2005 was small as such sales are largely subject to the progress of railway construction. Although the Company's metropolitan railcar and system business was new and has a less established foundation, sales for railcars, railcar signal systems, railcar station equipments and power supply systems are expected to grow along with the progression of metropolitan rail transportation projects. The Company will, through analysis and absorption of acquired technology, and mastering of proprietary and innovative technologies, for railcars design and production, through establishment of production base via fixed assets investment, and through implementation of integrated metropolitan rail transportation system projects, enlarge the business scale and increase the value of its products. It is expected that the Metropolitan Rail Transportation Equipment business will experience faster development.

Environmental Systems Division

The Environmental Systems Division is a new business segment of the Group with tremendous potential. Turnover of this Division recorded an impressive growth of 160.0% over the previous year, mainly attributable to the growth of environmental desulphurisation business and acquisition of a solar cell manufacturing business in the second half of 2005. Due to our continuous investment into the development and research of these new businesses, the Division has recorded an operating loss for 2005. During the year, operating revenue of the Group's power station desulphurisation and denitration business surpassed RMB100 million for the first time. The Company will acquire new technologies and gradually expand its business scale. The Group has also entered into the business of complete solid waste incineration systems through participating in a solid waste incineration BOT project. Building on its research and development efforts, the Company aims to further develop the sewage treatment business. Moreover, the Group entered quickly into the production and sales of solar cells through acquiring an existing business. This business provides one of the world's fastest growing clean energy and has a huge potential. It is anticipated that the global production capacity of photovoltaic cells will rapidly exceed 4,000 MW in 2010. The Group has planned to inject fixed assets into the acquired solar cell manufacturing company to expand its production lines and business scale. As such, robust development is expected for the Group's solar cell business in the next few years. Overall, environmental business is a key industry encouraged and supported by the Government. The accelerated economic development and urbanization of the PRC is expected to present immense development opportunities for the environmental protection equipment, environmental protection engineering, and related industries.

Changes in sales amount for Environmental Systems business over the Past Three Years



The Group has also entered into the business of complete solid waste incineration systems through participating in a solid waste incineration BOT project.

the Group entered quickly into the production and sales of solar cells through acquiring an existing business

Financial Business Division

Operating profit of financial business for 2005 showed a marked increase. This was primarily attributable to the consolidation of revenue from Shanghai Electric Group Finance Company Ltd., which became a subsidiary of the Group in July 2004. In 2004, only revenue from the second half of the year of this subsidiary was consolidated into the Group.

Share of Profits and Losses of Associates

Share of profits of associates for 2005 remained at a similar level to last year at RMB247 million (2004: RMB247 million).

Finance Costs

Finance costs for 2005 amounted to RMB67 million (2004: RMB117 million), representing a decrease of 42.7% from the corresponding period last year. The decrease in finance costs was primarily due to repayment of bank borrowings.

Profit Attributable to Equity Holders of the Company

As a result of the foregoing, profit attributable to equity holders of the Company for 2005 increased by 53.5% from last year to RMB1,672 million (2004: RMB 1,089 million). Earnings per share attributable to equity holders of the company was RMB15.17 cents (2004: RMB11.85 cents).

Cash Flow

As at 31 December 2005, the Group had cash, bank balances and deposits in central bank of RMB12,969 million (of which RMB1,313 million were pledged deposits) (2004: RMB13,163 million of which RMB1, 003 million were pledged deposits), representing a decrease of RMB194 million from the beginning of the year. This was mainly attributable to the purchase of raw materials for production and capital investments. During the year, the Group had net cash outflow from operating activities of RMB1,111 million (2004: RMB5,935 million of net cash inflow), net cash outflow from investing activities of RMB2,031 million (2004: RMB7,887 million), and net cash inflow from financing activities of RMB2,230 million (2004: RMB2,143 million).

Cash inflow from financing activities primarily represents proceeds from the listing of our H shares in Hong Kong on 28 April 2005. The net proceeds amounted to RMB4,678 million after deducting certain expenses and payments in respect of the listing.

We anticipate to record further cash outflow as the Power Equipment Business stabilizes and capital investment increases.

Assets and Liabilities

As at 31 December 2005, the Group has total assets of RMB55,165 million (2004: RMB47,110 million), an increase of RMB8,055 million, or 17.1%, compared to that of the beginning of the year. Total current assets increased by RMB6,683 million from the beginning of the year to RMB43,863 million (2004: RMB37,180 million), accounting for 79.5% of the total assets. Total non-current assets were RMB11,302 million (2004: RMB9,930 million), representing an increase of RMB1,372 million from the beginning of the year and accounting for 20.5% of the total assets.

As at 31 December 2005, total liabilities of the Group were RMB33,979 million (2004: RMB32,778 million), which represented an increase of 3.7% compared with the beginning of the year. Total current liabilities increased by 3.7% from the beginning of the year to RMB33,262 million (2004: RMB32,080 million), while total non-current liabilities increased by 2.7% to RMB717 million (2004: RMB698 million).

As at 31 December 2005, total net current assets of the Group was RMB10,601 million (2004: RMB5,100 million), representing an increase of RMB5,501 million from the beginning of the year. Liquidity ratio increased from 1.16 to 1.32.

Source of Funding and Indebtedness

As at 31 December 2005, the Group had aggregate bank and other borrowings and debentures of RMB1,001 million (2004: RMB805 million), an increase of RMB196 million from the beginning of the year. Borrowings and debentures repayable within one year was RMB932 million which represented an increase of RMB282 million. Borrowings and debentures repayable after one year was RMB69 million, representing a decrease of RMB86 million compared with the beginning of the year.

As of 31 December 2005, all bank and other borrowings and debentures of the Group were interest-bearing at fixed rates. Except for secured bank loans of USD409,000 (2004: Nil), equivalent to RMB3,309,000, and EUR2,400,000 (2004: Nil), equivalent to RMB22,992,000, which are denominated in foreign currencies, all other borrowings are in Renminbi.

As at 31 December 2005, gearing ratio of the Group, which represents the ratio of debentures and interest-bearing bank and other borrowings to total equity plus debentures plus interest-bearing bank and other borrowings, was 4.5%, a reduction from 5.3% at the beginning of the year.

Pledge of Assets

As at 31 December 2005, bank deposits of RMB1,313 million (2004: RMB1,003 million) of the Group have been pledged to banks. In addition, certain bank loans of the Group are secured by mortgages over the Group's certain land use rights, buildings and machinery, with an aggregate net book value of approximately RMB153 million as at 31 December 2005 (2004: RMB115 million).

Contingent Liabilities

Please refer to note 44 to the consolidated financial statements for details.

Capital Commitment

Please refer to note 46 to the consolidated financial statements for details.

Foreign Exchange Risks

During the report period, the Group exported certain products as well as imported equipment, spare parts and materials. The exports and imports substantially hedged the risks of transactions in foreign currencies. As at 31 December 2005, cash and bank balances of the Group included HK$2,159 million, US$28 million and other foreign currencies equivalent to RMB54 million in total. Apart from this, the Group was not exposed to any material foreign exchange risks.