

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



**Mr. Xiao Yaqing**

Chairman of the Board and  
Chief Executive Officer



**Mr. Luo Jianchuan**

Executive Director and  
Senior Vice President



**Mr. Chen Jihua**

Executive Director,  
Vice President and  
Chief Financial Officer

The following discussion and analysis should be read in conjunction with our consolidated financial statements together with the accompanying notes, included elsewhere in this annual report.

### **Overview**

The Group is engaged principally in alumina refining and primary aluminum smelting operations. The Group organizes and manages its operations according to the following business segments:

- Alumina segment, which consists of mining and purchasing bauxite and other raw materials, refining bauxite into alumina, and selling alumina both internally to the Group's primary aluminum smelters and externally to customers outside the Group. This segment also includes the production and sales of chemical alumina (including alumina hydrate and alumina chemicals) and gallium.
- Primary aluminum segment, which consists of procuring alumina and other raw materials, supplemental materials and electricity power smelting alumina to produce primary aluminum and selling substantially all primary aluminum products to external customers. In addition, this segment includes production and sales of carbon products and small amount of aluminum-fabricated products.
- Corporate and other services segment, which includes the headquarters' operations, research conducted by the Group's research institutes and provision of the Group's research and development services to third parties.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)*



**Mr. Zhang Chengzhong**

Executive Director and  
Vice President



**Mr. Liu Xiangmin**

Vice President



**Mr. Ding Haiyan**

Vice President

### **Results of Operations**

The Group's net profit attributable to the equity holders of the Company amounted to RMB11,745 million for the year ended December 31, 2006, representing a year-on-year increase of RMB4,723 million and an increase by 67.26% from the previous year's net profit attributable to the equity holders of the Company of RMB7,022 million.

### **Revenues**

The Group's total revenue increased by RMB24,070 million from RMB37,826 million for the year 2005 to RMB61,896 million for the year 2006, representing an increase of 63.63%. The increase was primarily due to the increase in sales volume and selling prices of the Group's principal products, alumina and primary aluminum.

The Group's external sales volume of primary aluminum reached 1,823,100 tonnes, representing an increase of 918,100 tonnes or 101.44% from 905,000 tonnes of 2005. The growth was primarily attributable to the increase of production volume of primary aluminum resulting from commencement of production of the aluminum production line of Guizhou branch and the aluminum project of Shanxi-Huaze, acquisition and establishment of subsidiaries, improvement technological renovation of other production lines and the increase in trade sales. The increase of sales volume of primary aluminum contributed to an increase of RMB13,213 million in the revenue.

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

The external sales volume of alumina increased from 6,420,400 tonnes in 2005 (inclusive of trade volumes of 1,055,400 tonnes) to 6,799,400 tonnes in 2006 (inclusive of trade volumes of 1,183,700 tonnes), representing an increase of 379,000 tonnes or 5.9%. The increase was mainly attributable to the increase of output from the overall operation of production of the 800,000 tonnes alumina phase III production line in Shanxi, and the 700,000 tonnes alumina production line in Henan during 2006. The increase of the external sales volume of alumina contributed to an increase of RMB1,266 million in the revenue.

In 2006, due to the effect of the increase in the market price of primary aluminum, the Group's average external selling price of primary aluminum products reached RMB17,492 per tonne (excluding tax, hereinafter), representing an increase of RMB3,100 per tonne or 21.53% from RMB14,392 per tonne for the corresponding period, which contributed to an increase of RMB5,652 million in the revenue.

In 2006, the Group's average external selling price of alumina products reached RMB3,609 per tonne, representing an increase of RMB268 per tonne (or 8.02%) from RMB3,341 per tonne for the corresponding period, which contributed to an increase of RMB1,830 million in the revenue.

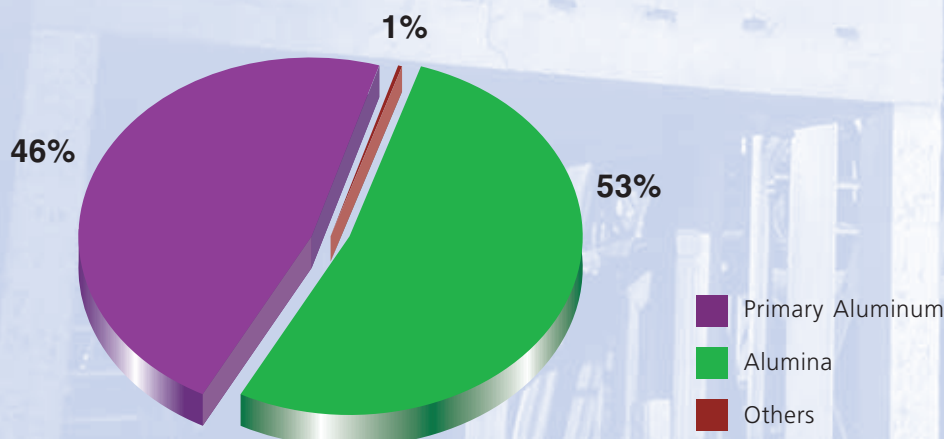
In 2006, the sales of chemical alumina and other products increased by approximately RMB2 billion from the previous year.

### Cost of Sales

The Group's total cost of sales increased by RMB16,351 million or representing an increase of 64% from RMB25,543 million in 2005 to RMB41,894 million in 2006. The increase was mainly attributable to the growth in external sales volume and the increased unit cost of sales of alumina.

### Selling and Distribution Expenses

The Group's selling and distribution expenses increased by RMB238 million from RMB720 million in 2005 to RMB958 million in 2006, representing an increase of 33.05%, which was primarily attributable to the increase in transportation fee, loading fee and packing fee due to the growth of sales volume of primary aluminum.



# *Management's Discussion and Analysis of Financial Condition and Results of Operations* (Continued)

## **General and Administrative Expenses**

General and administrative expenses increased by RMB603 million from RMB1,490 million in 2005 to RMB2,093 million in 2006, representing an increase of 40.46%. The increase was mainly attributable to the increase in expenses of approximately RMB344 million as a result of acquisitions and the establishment of subsidiaries. The related tax charges other than income tax imposed by the PRC tax authorities increased by RMB215 million due to the expanded business generating taxable transactions. The continued efforts to strengthen the internal control system and information system of the Group increased the expenses by approximately RMB44 million.

## **Research and Development Expenses**

In 2006, the Group's cost expenditure for research and development slightly increased by RMB1 million from RMB113 million in 2005 to RMB114 million.

## **Other Income and Other Gains or losses, net**

The Group's other income and other gains or losses, net in 2006 were a gain of RMB565 million, an increase of RMB444 million or 366.94% from a gain of RMB121 million in the previous year. This was attributable to the fact that the Group hedged some of the primary aluminum contracts in the futures market, resulting in an increase of RMB81 million in other revenues. Increase of RMB236 million was mainly due to the recognition of excess of interest in the net fair value of net assets acquired over cost on acquisitions of businesses completed during the year.

## **Operating Profit**

As a result of the foregoing, the Group's operating profit increased by RMB7,321 million from RMB10,081 million in 2005 to RMB17,402 million in 2006, representing an increase of 72.62%. The Group's operating profit as a percentage of sales of goods was 26.65% in 2005 and 28.11% in 2006.

## ***Management's Discussion and Analysis of Financial Condition and Results of Operations*** (Continued)

### **Finance Costs**

The Group's finance costs increased by RMB349 million or 96% from RMB367 million in 2005 to RMB716 million in 2006. The increase was primarily attributable to the ceasing of interest capitalization due to the commencement of production of Shanxi Huaze's aluminum smelting and power project, Shanxi alumina project of 800,000 tonnes and Henan alumina project of 700,000 tonnes. This led to an increase of RMB243 million in interest expense, and finance costs of RMB158 million contributed by the entities acquired during the year and exchange losses.

### **Income Tax Expense**

The Group's income tax expense increased by RMB1,899 million or 76.11% from RMB2,495 million in 2005 to RMB4,394 million in 2006, which was mainly attributable to the increased profit of the Group. In 2006, the Group's average tax rate was 26.18%, which was slightly higher than the average tax rate of 25.61% in prior year. The Group's income tax rate is lower than the statutory tax rate of 33.0%. This is mainly because of the preferential tax rate of 15% for the three branches of the Company in Guizhou, Guangxi and Qinghai and Zunyi Aluminum Company Limited, an acquired subsidiary, which are located in the western region of the PRC.

### **Minority Interest**

Minority interest increased by RMB418 million from RMB224 million in 2005 to RMB642 million in 2006, primarily due to the increase in the minority interest as a result of the acquisition of subsidiaries and establishment of joint ventures, and the increase in profits of the Company's subsidiaries.

### **Net Profit for the Year Attributable to Equity Holders of the Company**

As a result of the foregoing, the Group's net profit attributable to equity holders of the Company increased by RMB4,723 million an increase of 67.26% from RMB7,022 million in 2005 to RMB11,745 million in 2006.

# *Management's Discussion and Analysis of Financial Condition and Results of Operations* (Continued)

## **Discussion of Segment Operations**

### **Alumina Segment**

#### **Sales of Goods**

The Group's total sales of goods of the alumina segment increased by RMB9,566 million, representing an increase of 34.1% from RMB28,046 million in 2005 to RMB37,612 million in 2006.

Revenues from the external sales of alumina segment in 2006 increased by RMB4,155 million or 18.18% from RMB22,854 million in 2005 to RMB27,009 million in 2006, mainly due to the increase in external sales volume and selling price of the Group's alumina.

Revenues from the sales of alumina to the Group's smelters rose by RMB5,411 million from RMB5,192 million in 2005 to RMB10,603 million in 2006, primarily due to the increased total demand of alumina for production as a result of the increased output of the Group's aluminum.

#### **Operating Profit**

The Group's total operating profit of alumina segment increased by RMB3,030 million, or 29.38% from RMB10,312 million in 2005 to RMB13,342 million in 2006.

### **Primary Aluminum Segment**

#### **Sales of Goods**

The Group's total sales of goods for the primary aluminum segment increased by RMB19,129 million or 135.39% from RMB14,128 million in 2005 to RMB33,257 million in 2006, mainly due to the increase of the Group's primary aluminum sales volume and selling price.

#### **Operating Profit**

The primary aluminum segment recorded an operating profit of RMB4,476 million in 2006, representing an increase of RMB4,244 million as compared with RMB232 million in 2005.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations* (Continued)

### **Corporate and Other Services Segment**

The Group's corporate and other services segment reflected the expenses of the Group's corporate segment, research and development services and product sales of the Group's research institute to external customers. This segment recorded an increase in operating loss from RMB48.44 million in 2005 to a loss of RMB54.49 million in 2006.

### **Working Capital and Liabilities**

As of December 31, 2006, the Group's current assets amounted to RMB25,728 million, representing an increase of RMB8,765 million as compared with RMB16,963 million in 2005.

- As of December 31, 2006, the Group's cash and cash equivalents amounted to RMB12,803 million, representing an increase of RMB5,205 million as compared with RMB7,598 million as of December 31, 2005.
- As of December 31, 2006, the Group's inventories amounted to RMB9,036 million, representing an increase of RMB1,801 million as compared with RMB7,235 million as of December 31, 2005. The Group's turnover rate of inventory in 2006 was 5.15, representing an increase of 1.17 as compared with the 3.98 in the previous year. This was resulted from the effective management on inventory.
- The Group's net accounts receivable amounted to RMB2,026 million, representing an increase of RMB1,065 million as compared with RMB961 million as of December 31, 2005. Of the accounts receivable, bills receivable and trade receivables increased by RMB858 million and RMB206 million from RMB712 million and RMB250 million as of December 31, 2005 to RMB1,570 million and RMB456 million respectively. The turnover rate of accounts receivable was basically the same as compared to 8.7 in the previous year.

As of December 31, 2006, the Group's current liabilities amounted to RMB21,561 million, representing an increase of RMB6,623 million as compared with RMB14,938 million at the end of 2005. Of the current liabilities, the total loans increased by RMB1,380 million to RMB5,113 million from RMB3,733 million in 2005; short-term bonds amounted to RMB4,985 million, representing an increase of RMB3,014 million as compared to the corresponding period in 2005; and the account payable, current income taxes payable and other current liabilities increased by RMB238 million, RMB705 million and RMB1,286 million, respectively.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)*

- The Company issued short-term bonds of RMB3 billion at par in May 2006 and short-term bonds of RMB1,933 million with nominal value of RMB2 billion at discount in December 2006 for repayment of certain short-term borrowings and for working capital purposes.
- As a result of the foregoing, the Group's net current assets amounted to RMB4,167 million as of December 31, 2006. This represented an increase of RMB2,142 million as compared to the net current assets of RMB2,025 million as of December 31, 2005.

As of December 31, 2006, the Group's liquidity ratio was 1.19, representing an increase of 0.05 as compared to 1.14 as of December 31, 2005. The quick ratio of the Group was 0.77, representing an increase of 0.12 as compared to the 0.65 in the previous year.

### **Capital Expenditures, Capital Commitments and Investment Undertakings**

In 2006, the Group completed property, plant and equipment investments amounted to RMB8,091 million, which consisted mainly of the investment in Phase III of Guangxi alumina project, 600,000 tonnes Bayer alumina project of Shandong Aluminum, an integrated aluminum project of Shanxi Huaze of 280,000 tonnes, expansion project of 700,000 tonnes of Henan Branch, Guizhou alumina project for energy saving and consumption reduction, and projects on environmental conservation and energy saving.

As of December 31, 2006, the Group's capital commitment of property, plant and equipment amounted to RMB8,200 million, of which those contracted but not provided for amounted to RMB2,167 million and those authorized and not contracted amounted to RMB6,033 million. The Group's external investment undertaking amounted to RMB880 million, mainly attributable to the establishment of Guangxi Huayin alumina project and Zunyi Alumina through joint venture. The Group's investment in construction and upgrade of technology as well as external investment and acquisition improved the Group's capacity and output of alumina and primary aluminum.



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The Group's gearing ratio (total borrowings/(total borrowings + total equity - minority interest)) decreased to 29.58% as of December 31, 2006 from 32.05% as of December 31, 2005, representing a decrease of 2.47 percentage points, which was mainly attributable to the H shares placement of the Company and increased profit.

The Group's capital expenses and external investment are mainly financed by operating activities, long-term and short-term loans and additional shares placement. In light of the Group's creditability and various domestic and overseas financing methods, the Group believes that there will be no difficulty in financing capital investments.

### **Cash and Cash Equivalents**

Cash and cash equivalents of the Group as of December 31, 2006 amounted to RMB12,802 million, comprising foreign currency deposits of AUD31.95 million, US\$30.67 million and HK\$9.42 million. Cash and cash equivalents above include RMB3,000 million of time deposits.

### **Cash Flows from Operating Activities**

Cash from operations increased by RMB4,634 million or 53.95% from RMB8,590 million in 2005 to RMB13,224 million in 2006. The increase was primarily the result of the Group's increased profit.

### **Cash Flows from Investing Activities**

Net cash outflow from investing activities in 2006 was RMB10,244 million, increasing by RMB1,423 million compared with RMB8,821 million in 2005. This was mainly due to the increase in capital expenditure of the Group.

### **Cash Flows from Financing Activities**

Net cash outflow from financing activities amounted to RMB775 million in 2006, which was a decrease of RMB2,380 million as compared with an inflow of RMB1,605 million in 2005. This was mainly due to the Group's placement of new H shares for net proceeds of approximately RMB4,390 million, the issuance of short-term bonds for net proceeds of RMB4,913 million, repayment of short-term bonds of RMB2 billion, additional bank loans of RMB2,879 million, bank loan repayments of RMB6,438 million and dividend payments of RMB4,611 million.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)*

### **Foreign Exchange Rate Risk**

The Group conducts its business primarily in Renminbi.

Renminbi is not a freely convertible currency. The restrictions on foreign exchange imposed by the PRC government may result in material differences between future exchange rate and current exchange rate or historical exchange rate. The changes in the exchange rate of Renminbi will impact the ability of the Group to carry out operations relating to foreign exchange. Those changes will also impact the ability of the Group to pay dividends in HK dollars and to pay dividends of American Depository Shares in US dollars. The Group believes that it is able and will be able to obtain sufficient foreign exchange to implement the above-mentioned obligations.

### **Impact of Appreciation of Renminbi**

The Group believes that, since the price of domestic alumina is determined with reference to the price of imported alumina, the appreciation of Renminbi will affect prices of the domestic spot market of alumina.

However, the appreciation of Renminbi will not have a significant impact on the Group's operations because the Group's import and export volume and foreign currency loans are minimal in 2006. From the perspective of production costs, the appreciation of Renminbi will, to some extent, decreased the competitiveness of the Group in the international market.