



I am pleased to present our annual report for the year ended 31 December 2006 to the shareholders.

### OPERATING RESULTS

Total revenues for the year ended 31 December 2006 increased by 96.3 % to RMB2,800.4 million, compared with the same period last year. Revenues from our Internet value-added services increased by 132.0% to RMB1,825.3 million, revenues from our mobile and telecommunications value-added services increased by 35.3% to RMB700.1 million and revenues from online advertising increased by 136.4% to RMB266.7 million.

The Group's audited profit for the year ended 31 December 2006 was RMB1,063.8 million, an increase of 119.2% compared with the results for the year ended 31 December 2005. Basic and diluted earnings per share for the year ended 31 December 2006 were RMB0.603 and RMB0.585 respectively.



## BUSINESS REVIEW AND OUTLOOK

During 2006, the China Internet market continued to grow at a rapid pace. According to China Internet Network Information Center (“CNNIC”), China’s Internet population grew by 23.4% in 2006 to reach 137 million. This growth rate was higher than the 18.1% registered in 2005. In particular, the number of broadband Internet users increased at a higher rate of 41.1% to reach 91 million, representing a broadband penetration of 66%. Broadband penetration is important as it allows the users to enjoy richer Internet services such as online games, video and other multimedia applications. Despite the strong growth, Internet penetration in China was only at 10.5%, a rate that is much lower than many other countries and that represents strong potential for future growth. We see both opportunities and challenges in this dynamic market. In 2006, we experienced a strong year of growth in our businesses, reaping the fruits of our investments in research and development as well as new products in 2005. On the other hand, we also faced intensifying competition as well as increase in “spam” messages and user account thefts in our IM service. In order to manage these challenges and to stay ahead in this market, we are committed to continue investing in research and development to enhance our existing products and launch new products. We are also determined to use every means to fight against spamming and user account theft. We believe our strategy of focusing on our users’ experience and building sustainable franchises will pay off for us over the long run.

The fourth quarter of the year was a challenging quarter for us as we came off the strong summer holidays season in the third quarter, and as measures to enhance user account security negatively impacted our Internet value-added services. The first quarter of 2007 would present better seasonality for our Internet value-added services as a result of the Chinese New Year holidays and winter holidays for students. On the other hand, we expect our account security measures will continue in the foreseeable future.

In our core IM platform, enhancing user security remained our number one priority. During the quarter, we strengthened our dedicated team of account security staff who have been designing various mechanisms to detect and prevent account thefts. We had launched our QQ Security Doctor to allow our users to more easily detect and eliminate Trojan horses and viruses on their computers aimed to steal user account passwords. We have also put in various restrictions on transfer of virtual items such that virtual items in stolen accounts would not be easily transferred. Although some of the measures we took had negative impact on our revenues, particularly on item-based revenues, we are committed to continuing these measures to foster a safer environment for our users.

In our Internet value-added services, our online identities businesses, Qzone and QQ Pet were relatively flat as organic growth in the businesses evened out weak seasonality and account security measures. On the other hand, QQ show declined as it was partially hard-hit by weak seasonality and account security measures and as the product became mature. For 2007, we will continue to improve the speed and stability of Qzone, and develop more significant new features for QQ Pet and QQ Show.





With respect to online games, weak seasonality affected our revenues across the board. In addition, our mini casual game was negatively impacted by account security measures as certain restrictions were placed on the purchase and consumption of virtual items. We had also commissioned a system upgrade to our QQ Game which caused certain disruption to the monetization of the service. We expect such impacts would be somewhat alleviated in the future as the system upgrade progressed smoothly. Having said that, we will continue to maintain a relatively modest level of monetization in our mini casual game to provide a balanced environment for its large user base which we believe is an important franchise for our entire online game business. In MMOG, QQ Fantasy continued to face intense competition from increasing number of free-to-play games. To counter such pressure, we had been introducing more in-game activities and developing expansion packs. In addition, we are preparing for the launch of our light MMOG, QQ SanGuo, toward the summer season. Apart from QQ SanGuo, we currently have one internally developed and one licensed 3D MMOG scheduled for launch in 2008. In advanced casual game, R2Beat started to contribute more revenue as we increased the number of items for sale while QQ Tang declined as a result of weak seasonality. In the course of 2007, we will continue to roll out expansion packs for both R2Beat and QQ Tang. In addition, we are looking to launch one or more new games toward the second half of this year.

In our wireless business, our revenues benefited from the relaxation of the one-month free trial policy by China Mobile and achieved growth despite continued industry volatility. During the quarter, we entered into a cooperation memorandum with China Mobile to jointly develop a technical platform to implement interoperation between China Mobile's Fetion (mobile chat) handset users and our QQ users through the offering of "Fetion QQ". Our current service contracts on mobile chat services with China Mobile were also extended for another six months at which time Fetion QQ is expected to be launched. As we look forward, we expect the wireless industry to remain volatile and uncertain in the foreseeable future as regulatory scrutiny keeps increasing in response to consumer complaints. We are committed to strengthening our cooperation with operators and regulators, and continuing to improve the user experience for our services. In addition, we believe wireless Internet presents significant opportunity over the long run as more and more users access the Internet via their handsets. According to CNNIC, the number of users who access the Internet via handsets has reached 17 million by the end of 2006. We will focus on investing in wireless Internet technology and our wireless portal to position ourselves for such growth.

Our advertising business was relatively flat compared to a seasonally strong third quarter. We have continued to sign up new advertisers as traffic in our IM and portal platforms grew. In addition, we have placed a lot of emphasis on improving the foundation of our advertising business by professionalizing our advertising sales team and improving our advertising delivery technology. In 2007, we will focus on increasing the monetization of our QQ.com portal given it has already become the number one portal in China in terms of traffic since June 2006, according to Alexa.com. We will invest in branding campaigns for QQ.com to raise its profile and increase our purchase of strategic content to further improve its appeal for users. Although the first quarter of 2007 will be a weak season, we strive to grow our advertising business at a rate above industry average in the entire year of 2007.



## DIVIDEND

The Board has recommended the payment of a final dividend of HKD0.12 per share (2005: HKD0.08) for the year ended 31 December 2006. The dividend will be payable on 30 May 2007 to shareholders whose names appear on the Register of Members of the Company on 16 May 2007.

## APPRECIATION

Last but not least, I would like to express my deepest gratitude to our staff for their contribution, commitment and hard work and to our Board for its guidance and support throughout the year. I would also like to thank all our shareholders and investors for their support and confidence in our Group.

**Ma Huateng**

*Chairman*

Hong Kong, 21 March 2007

