

Management's Discussion and Analysis of Financial Position and Operating Results

The following discussion and analysis are based on the Group's consolidated financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), and are designed to assist the readers in understanding the information provided in this report so as to fully comprehend the financial performance of the Group as a whole.



PROFIT FROM OPERATIONS AND PROFIT ATTRIBUTABLE TO EQUITY HOLDERS

In 2006, the Group's profit from operations was RMB2.518 billion, representing a decrease of 31.5% compared with 2005. The decrease was mainly due to an increase in costs of operations. Profit attributable to equity holders of the Company amounted to RMB2.688 billion, representing an increase of 11.7% compared with 2005. The increase in profit attributable to equity holders of the Company was mainly due to the gain on disposal of Dragonair.

The Group's consolidated financial statements prepared under IFRS have included the full operating results of all subsidiaries as well as the partial operating results of joint ventures through proportionate consolidation. During the reporting period, the share of profits of associates was RMB518 million, representing an increase of 130.1% over the corresponding period last year, primarily due to the share of profit of Cathay which became an associate of the Group in 2006.

EARNINGS PER SHARE

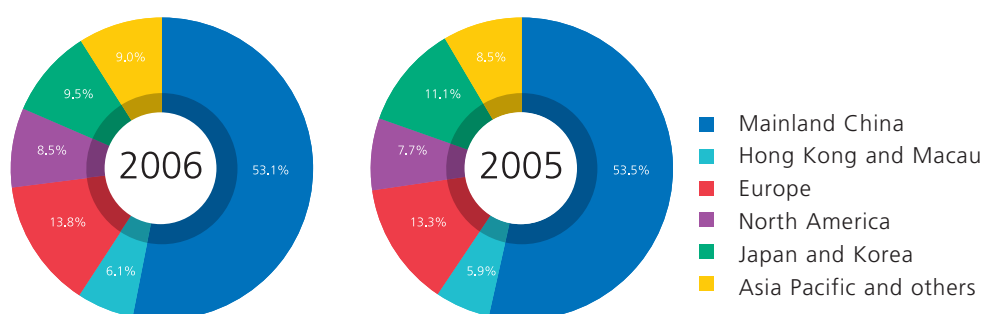
In 2006, the Group's earnings per share were RMB26.2 cents, representing an increase of 2.7% compared with RMB25.5 cents for 2005. This was mainly due to a profit growth for 2006.

REVENUE CONTRIBUTION BY BUSINESS SEGMENT

(RMB'000)	2006	2005	Change
Airline operations	43,708,683	37,380,669	16.9%
Engineering services	481,021	376,437	27.8%
Airport terminal services	496,741	320,477	55.0%
Others	250,161	213,383	17.2%
Operating revenue	44,936,606	38,290,966	17.4%

REVENUE CONTRIBUTION BY GEOGRAPHICAL SEGMENT

(RMB'000)	2006	2005	Change
Mainland China	23,868,328	20,490,055	16.5%
Hong Kong and Macau	2,770,579	2,269,256	22.1%
Europe	6,203,536	5,081,774	22.1%
North America	3,806,678	2,964,247	28.4%
Japan and Korea	4,256,753	4,250,255	0.2%
Asia Pacific and others	4,030,732	3,235,379	24.6%
Operating revenue	44,936,606	38,290,966	17.4%



OPERATING REVENUE

In 2006, the Group's operating revenue was RMB44.937 billion, representing an increase of 17.4% compared with 2005. The increase in the Group's operating revenue was mainly attributable to the rapid growth of the revenue from airline operations, which increased by 16.9% in 2006.

The Group's operating revenue principally included air traffic revenue and other operating revenue. Most of our operating revenue was from air traffic revenue, which represented 92.6% of the Group's operating revenue in 2006, while the other operating revenue represented only 7.4% of the total operating revenue. Among the air traffic revenue in 2006, 90.3% was generated from the provision of passenger services and 9.7% was from the provision of cargo and mail transport services.

The revenue generated from passenger traffic increased by 18.9% to RMB37.565 billion in 2006 from RMB31.584

billion in 2005. It was mainly attributable to the increase in traffic capacity, passenger load factor and profitability level. The Group's passenger traffic capacity in terms of available seat kilometres increased by 12.7% to 83.492 billion tonne kilometres in 2006 from 74.087 billion tonne kilometres in 2005. The Group's passenger load factor rose to 75.9% in 2006 compared with 74.0% in 2005. The Group's passenger yield increased by 3% to RMB0.5929 in 2006 from RMB0.5758 in 2005.

Revenue from cargo and mail traffic increased by 8.7% to RMB4.041 billion in 2006 from RMB3.716 billion in 2005. Such increase was primarily due to the improved traffic capacity. Cargo transport capacity in terms of available freight tonne-kilometres increased by 20.4% to 6.404 billion tonne kilometres in 2006 from 5.319 billion tonne kilometres in 2005. The overall load factor of cargo and mail traffic decreased to 54.3% in 2006 from 55.1% in 2005. The overall cargo yield decreased by 6.8% to RMB2.06 per tonne kilometre in 2006 from RMB2.21 per tonne kilometre in 2005.

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OPERATING EXPENSES

(RMB'000)	2006	2005	Change
Jet fuel costs	15,716,174	11,777,129	33.4%
Take-off, landing and depot charges	5,136,388	4,442,585	15.6%
Depreciation	5,274,033	4,512,680	16.9%
Aircraft maintenance, repair and overhaul costs	1,812,647	1,341,773	35.1%
Employee compensation costs	4,313,883	3,406,825	26.6%
Air catering charges	1,320,123	1,242,933	6.2%
Others	8,845,654	7,893,225	12.1%
Total operating expenses	42,418,902	34,617,150	22.5%

The operating expenses of the Group primarily comprise jet fuel costs, take-off, landing and depot charges, depreciation, aircraft maintenance, repair and overhaul costs, employee compensation costs and air catering charges. In 2006, the Group recorded an aggregate operating expenses of RMB42.419 billion, representing an increase of 22.5% compared with RMB34.617 billion in 2005, primarily due to the increase of jet fuel costs.

Jet fuel costs increased by 33.4% to RMB15.716 billion in 2006 from RMB11.777 billion in 2005 and accounted for 37.0% of operating expenses compared with 34.0% in 2005. This increase was primarily due to a rise in jet fuel price and an increase in consumption of jet fuel as a result of the increased number of flights operated.

Take-off, landing and depot charges increased by 15.6% to RMB5.136 billion in 2006 from RMB4.443 billion in 2005, primarily due to the increased number of flights operated.

Depreciation expenses increased by 16.9% to RMB5.274 billion in 2006 from RMB4.513 billion in 2005, primarily due to the increased number of aircraft.

Aircraft maintenance, repair and overhaul costs increased by 35.1% to RMB1.813 billion in 2006 from RMB1.342 billion in 2005, primarily due to the substantial increase in overhaul expenses because of the increased number of aircraft under operating leases.

Employee compensation costs increased by 26.6% to RMB4.314 billion in 2006 from RMB3.407 billion in 2005, primarily due to the increase in the number of flight hours, number of employees and employees' basic income.

Air catering charges increased by 6.2% to RMB1.320 billion in 2006 from RMB1.243 billion in 2005, primarily due to an increase in the number of passengers carried.

Other operating expenses, including aircraft and engines operating lease expenses, other flight operating expenses, selling and marketing expenses and general and administrative expenses, increased by 12.1% to RMB8.846 billion in 2006 from RMB7.893 billion in 2005.

Expenses on operating leases of aircraft and engines increased from RMB1.531 billion in 2005 to RMB2.070 billion in 2006, mainly due to the increase in the number of leased aircraft, in particular the wet leases of aircraft from Dragonair and Shandong Airlines.

Other flight operating expenses decreased to RMB3.659 billion in 2006 from RMB3.745 billion in 2005. By excluding the loss on derecognition of property, plant and equipment, other flight operation actually increased to RMB3.589 billion in 2006 from RMB3.315 billion in 2005.

Selling and marketing expenses increased to RMB2.027 billion in 2006 from RMB1.775 billion in 2005, as a result of an increase in operating revenue.



PROFIT CONTRIBUTION BY BUSINESS SEGMENT

(RMB'000)	2006	2005	Change
Airline operations	2,281,754	3,367,949	(32.3%)
Engineering services	34,835	153,779	(77.3%)
Airport terminal services	175,445	123,679	41.9%
Others	25,670	28,409	(9.6%)
Profit from operations	2,517,704	3,673,816	(31.5%)

ANALYSIS OF ASSETS

As at 31 December 2006, the total assets of the Group amounted to RMB83.964 billion, representing an increase of 23.1% from 31 December 2005, of which current assets accounted for RMB10.702 billion, representing 12.7% of the total assets, while non-current assets accounted for RMB73.262 billion, representing 87.3% of the total assets. Among the current assets, cash and cash equivalents were RMB3.588 billion, increased by 59.6% compared with those recorded as at 31 December 2005, while accounts receivable increased by 2.6% to RMB2.835 billion compared with those recorded as at 31 December 2005. Among the non-current assets, the net book value of property, plant and equipment as at 31 December 2006 was RMB54.768 billion, representing an increase of 16.1% compared with those recorded as at 31 December 2005.

ASSETS MORTGAGE

As at 31 December 2006, the Group mortgaged certain aircraft with an aggregate net book value of approximately RMB34.214 billion (compared with RMB26.958 billion as at 31 December 2005) pursuant to certain bank loan and finance lease agreements. In addition, certain bank deposits of the Group in the sum of approximately RMB212 million (compared with approximately RMB177 million as at 31 December 2005) were pledged against the obligations in respect of certain bank loans, operating leases and financial derivatives of the Group. The Group also pledged certain number of shares in an associate with an aggregate market value of approximately RMB7.695 billion as at 31 December 2006 (no such pledge existed as at 31 December 2005).

DEBT STRUCTURE OF THE GROUP

(RMB'000)	Bank, other loans and corporate bonds		Obligations under finance leases	
	31 December 2006	31 December 2005	31 December 2006	31 December 2005
Within one year	11,139,021	10,401,170	2,354,905	1,954,873
In the second year	2,649,697	2,747,158	1,996,954	1,949,802
In the third to fifth years, inclusive	5,581,186	4,699,653	6,061,709	6,071,492
After five years	4,471,094	5,376,068	3,189,192	57,377
Total	23,840,998	23,224,049	13,602,760	10,033,544

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A significant portion of the Group's debts is repayable within one year. The Group will ensure the repayment of debts when due and by way of bank loans, its own capital and other means. The Group is not exposed to any liquidity risk for the reasons set out in the section headed "Liquidity and Capital Resources" and "Objectives and Policy of Financial Risk Management" below.

GEARING RATIO

As at 31 December 2006, the Group's gearing ratio, which represents total liabilities divided by total assets, was 62.2%, representing a decrease of 6.2 percentage points from 68.4% as at 31 December 2005.

INTEREST EXPENSE

In 2006, interest expense of the Group increased from RMB1.79 billion in 2005 to RMB1.98 billion, primarily due to the increase in borrowings as a result of business expansion.

INTEREST COVER

In 2006, earnings before finance revenue (including interest income, net exchange gains, net gain on fuel derivatives and dividend income from available-for-sale investments), finance costs, enterprise income tax, gain on disposal of an associate, share of profits and losses of associates, depreciation and amortisation ("EBITDA") as computed under IFRS, divided by finance costs, were 4.15 times, compared with 4.62 times in 2005. The decrease in interest cover was attributable to the decrease in EBITDA.

COMMITMENTS AND CONTINGENT LIABILITIES

As at 31 December 2006, capital commitments of the Group increased substantially from RMB38.51 billion in 2005 to approximately RMB42.94 billion, primarily used for the purchase of certain aircraft and relevant flight equipment to be delivered in the coming years and the construction of certain properties.

As at 31 December 2006, the Group had contingent liabilities in respect of bank and other guarantees and other matters arising in the ordinary course of business. Details of contingent liabilities of the Group are set out in note 44 to the Group's 2006 annual consolidated financial statements.

LIQUIDITY AND CAPITAL RESOURCES

The Group finances its operations through cash inflow from operating activities and bank loans. Like many other airline groups in the PRC, the Group has been operating with a net current liabilities position. As at 31 December 2006 and 31 December 2005, the net current liabilities of the Group were RMB15.251 billion and RMB16.006 billion respectively. The decrease in net current liabilities was primarily due to the faster growth of current assets as compared with the previous period.

In 2006, the Group's net cash inflow from operating activities increased by 2.7% to RMB6.212 billion from RMB6.048 billion in 2005. Net cash outflow from investing activities during the year decreased by 2.8% to RMB12.148 billion from RMB12.5 billion in 2005. The Group recorded a net cash inflow from financing activities of RMB7.309 billion, primarily due to the issuance of A shares and the additional issue of H shares to Cathay. The major sources of finance of the Group are bank loans and finance leases. As at 31 December 2006, the Group had obtained bank facilities with an aggregate amount of up to RMB66.090 billion from a number of banks in the PRC.

On 29 August 2006, the Company successfully issued short-term commercial papers in the amount of RMB2 billion.

CAPITAL EXPENDITURE

In 2006, the capital expenditure of the Company amounted to RMB15.368 billion. Among the capital expenditure of the Company, the total investment in aircraft was RMB8.420 billion, including prepayments of RMB2.831 billion for the purchases of aircraft.

Other capital expenditure amounted to RMB6.948 billion, which mainly involved the improvement of first class and business class cabins of certain aircraft, investment in the ancillary project in the Third Terminal of Beijing Capital International Airport as well as in certain long-term investment projects.



OBJECTIVES AND POLICY OF FINANCIAL RISK MANAGEMENT

The Group is exposed to the fluctuations in jet fuel price in its daily operation. International jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuation in supply and demand. The Group's strategy for managing its jet fuel price risk aims to protect itself against sudden and significant price increases. To the extent as permitted by the relevant laws in the PRC, the Group has been engaging in fuel hedging transactions since March 2001. The hedging instruments used were mainly derivatives of Singapore Kerosene together with Brent crude oil and New York crude oil, which are closely linked to the price of jet fuel. In 2006, the Group applied hedging to 44% of the procured jet fuel, and the net gain on fuel derivatives was RMB113 million, representing a decrease of 49.1% compared with RMB222 million in 2005.

Foreign currency denominated liabilities constitute a large proportion of the Group's liabilities. As at 31 December 2006, loans denominated in US dollar and Hong Kong dollar amounted to RMB13.522 billion and RMB1.224 billion respectively. Appreciation of the Renminbi has benefited the Company with exchange gains. In 2006, the net exchange gains of the Group were RMB984 million (while the net exchange gains of the Group in 2005 were RMB918 million). The Group basically maintains a balance of its foreign currency denominated incomes and expenditures. To achieve a balance in income and expenditure denominated in foreign currency so as to minimize the risk of exchange rate fluctuation, the Group will consider using exchange rate derivatives in future.

Information on financial risk management objectives and policies in other aspects of the Group's operations are set out in note 47 to the Group's 2006 annual consolidated financial statements.