

## Management Discussion and Analysis



### Civil Aviation Industry in China

In 2006, the rapid growth of business and tourism was driven by the continuous economic growth of China. The aviation market of China continued to demonstrate a fast-growing trend which made air transport the top priority among various means of high-speed transportation in the mainland. China's civil aviation industry is taking its step towards the golden era of rapid development. China will invest approximately RMB140 billion in airport infrastructure during the period under the "11th Five-Year Plan". In 2006, the PRC government entered into a contract for an order of more than 300 aircrafts with a view to creating favourable conditions for the development of the civil aviation industry. While the overall development of air transport in China was on an accelerating track, feeder air transport was also relatively well-prepared to speed up its development with particularly active progress made in regions such as southwest, northwest, northern China, Xinjiang, the Yangtze River Delta and the Pearl River Delta.

In face of the phenomenal fuel price hike over the past few years, the General Administration of Civil Aviation of China ("CAAC") has launched various relevant policies and ensured airlines could sustain their stable development under such price surge. As international fuel prices has already peaked and begun to drop, it is expected that the prices will gradually resume the normal level. As such, the most difficult time of the aviation industry will come to an end and the level of gross profit margin will turn around gradually. As for listed airlines which hold substantial foreign liabilities, the inevitable and stable appreciation of Renminbi in the long run is surely a piece of favourable news.



Domestic airlines will find themselves confronted by vigorous competition upon the gradual opening of both the domestic and the international air transport markets. With the opening of the domestic air transport market, airlines are allowed to operate more routes to expand their coverage. However, this also means that more competitors will contend for the popular routes which used to be relatively monopolised. Under such keen competition, it is expected that more frequent integrations and mergers will take place among airlines in order to lower operation costs and improve operating efficiency.

Under the strong auspices of the CAAC and Hainan Provincial Government, the trial run of the opening of aviation rights was launched in Hainan Province. In 2006, the CAAC confirmed the success in opening aviation rights in Hainan Province and loosened the midway division policy of aviation rights for the province. Meanwhile, Hainan Provincial Government also accelerated the opening of aviation rights by introducing various concessionary policies and launching extensive marketing campaigns to facilitate the opening. There was a tremendous increase in the number of international routes and flights in Hainan during 2006. The new foreign airlines operating international flights to and from Hainan achieved a significant breakthrough in the midway division policy of aviation rights.

On 30 March 2007, Office of the Release of Aviation Right in Hainan Province formally announced that the adjustment problem of aviation rights of Hainan routes had been solved. The international route network of Hainan achieved the objective of "opening to the south and north", which means establishing a channel from the sky over the Hainan peninsular to connect the international routes of Nanhai and Beibu Wan and releasing part of the northern routes to foreign airlines, which signifies that Hainan will have the most open sky in China.

The Group believed more foreign airlines will open the routes to Hainan as the aviation rights become more comprehensive. It will attract more foreigners for tourism or investment.



## Tourism in Hainan Province

The tourism market of Hainan Island is regaining its confidence after two years of adjustment. Given the implementation of concessionary policies in relation to the opening of aviation rights in Hainan and the enormous marketing effort for international markets, the number of international tourists visiting Hainan in 2006 increased approximately 42.8% as compared with 2005. As the nature of tourism of Hainan has transformed from sightseeing to leisure and relaxation, its tourist products has started to advance from low-end to middle-to-high-end ones. In particular, golfing on Hainan Island has become overwhelmingly popular. Besides, Hainan Island's wonderful "healthy and sunny" image has been effectively promoted through a number of large scale cultural and sports activities organised by the province such as Chinese Happiness Stanza and Round-the-Island Bike Tournament. As such, the reputation of Hainan has been immensely enhanced, which in turn facilitated the development of the tourism industry of Hainan Island in both the domestic and the international markets.

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### Business Review

#### Overview of Aeronautical Business

In 2006, the Group's production and operation indicators slightly decreased due to the strategic restructuring and organizational adjustment of airlines, reformation of the Hainan tourism markets, as well as the diffluent effect on passenger flow arising from the commencement of operation of the Guangdong-Hainan Railway and the increasing popularity of Sanya Phoenix Airport.

Aviation traffic throughput for 2006 and the comparison figures for last year are set out below:

	2006	2005	Change (%)
<b>Aircraft movement</b>	<b>61,738</b>	<b>68,879</b>	<b>-10.4%</b>
In which: Domestic	58,905	66,383	-11.26%
Hong Kong/Macau	1,646	1,562	5.38%
International	1,187	934	27.1%
<b>Passenger Throughput (Ten thousand persons)</b>	<b>666.8</b>	<b>702.7</b>	<b>-5.1%</b>
In which: Domestic	639.71	680	-5.93%
Hong Kong/Macau	13.06	14	-6.7%
International	14.03	8.7	61.3%
<b>Cargo Throughput (Tones)</b>	<b>97,641.1</b>	<b>94,728.9</b>	<b>3.1%</b>
In which: Domestic	93,775	91,217.7	2.8%
Hong Kong/Macau	1,614.6	1,938	-16.7%
International	2,251.5	1,573.2	43.1%

It is estimated that the Group's international flights and international passenger throughput will sustain stable growths in 2007. Under unfavourable market environment, the Group's revenue from aviation business for 2006 was RMB230,756,000, representing a decrease of 7.1% as compared to last year. Details are set out as follows:

	Amount (RMB'000)	Change to last year (%)
Passenger charges	89,005	-6.7
Aircraft movement fees and related charges	41,044	-2.9
Airport fees	80,564	-5.6
Ground handling service fees	20,143	-20.7
<b>Total revenue from aeronautical businesses</b>	<b>230,756</b>	<b>-7.1</b>

#### Particulars of Commencement of New International Routes

Capitalising on the opening of aviation rights in Hainan Province, the passenger throughput of both international and regional routes of Meilan Airport continued to grow steadily in 2006. During the year, the Group successfully introduced the first foreign low-cost airline, Tiger Airways Pte Ltd. from Singapore, to operate a daily flight between Haikou and Singapore. In the meantime, Hong Kong Dragon Airlines Limited, also successfully operates the first "Hong Kong – Haikou – Sanya – Hong Kong" route, representing a breakthrough in the midway division policy of aviation rights. Currently, there are 11 domestic and foreign airlines operating 9 international/regional routes covering places such as Hong Kong, Macau, Singapore, Thailand, Malaysia, Korea and Japan departing from/arriving at Hainan Meilan International Airport.

### **Zealous Introduction of Low-cost Airlines**

In 2006, the boom of domestic low-cost airlines was attributable to the opening of aviation rights and the flourishing growth of tourism. The Group promptly activated the research project of "Introducing Low-Cost Airlines" as an endeavour to attract these airlines to establish external depots in Haikou. At present, domestic and foreign low-cost airlines such as Spring Airlines, East Star Airlines, OKAIR and Tiger Airways Pte Ltd. from Singapore are operating routes to and from Haikou with satisfactory track record.

From 25 to 27 March 2007, the Group successfully organized the forum of Regional New Route Asia 2007 Forum. Haikou was the first city in China to organise the meeting of international routes. Taking advantage of such valuable opportunity, the Group aggressively promoted the policy of the release of aviation rights of Hainan, the subsidy measures of the routes, together with abundance of travel resources in Hainan, which aroused the interests of the airlines in Asia Pacific and Europe regions. The Group believed that the success of the forum could further promote the progress of the release of the aviation rights in Hainan province. It will not only enhance the reputation of the Meilan Airport, but also attract more airlines to open routes to Haikou.

### **Overview of Non-Aeronautical Business**

In 2006, with the help of the advanced business development experience of foreign airports, the Group established and optimised its business development model which incorporated the concept of "operating resources utilisation in line with market demand and future development" to suit the development requirement of the airport. By actively promoting business outsourcing, stable development was achieved in the non-aviation business. The non-aeronautical revenue was RMB103,619,000, representing an increase of 19.8% as compared to last year. The main reason is that, as a result of the inauguration of Terminal Expansion Phase II, the business of Duty Free Shoppers Hong Kong Limited ("DFS") has been fully commenced with the expansion of commercial areas, which recorded an increase in the franchise income from the DFS. Details are set out as follows:

	<i>Amount</i> <i>(RMB'000)</i>	<i>Change to</i> <i>last year</i> <i>(%)</i>
Retail business	9,509	-6.4
Franchise revenue	27,769	73.8
Leasing of commercial areas in the airport terminal	17,942	8.9
Tourism and travelling revenue	20,485	5.3
Advertising revenue	12,008	31.1
Car parking fees	5,101	-4.2
Other revenue	10,805	8.8
<b>Total revenue from non-aeronautical businesses</b>	<b>103,619</b>	<b>19.8</b>

## Management Discussion and Analysis

### **Commercial Development**

In 2006, the cooperation between the Group and the world famous catering company, Select Service Partner (“SSP”), and DFS was ready to operate with full force. The transformation of the Group from self-operation to franchise operation has completed and put into place a unified and professional commercial management of airports. Through entering into a contract with minimum-guaranteed rental, the Group was assured of fixed revenue in times of falling turnover while obtaining pro rata additional revenue in times of growing turnover. As such, operation risks were minimised by effectively curbing losses in association with reduction in production output.

### **Tourism and Travelling**

Hainan Meilan International Airport Traveling Company Limited (“Meilan Travelling”) provides a wide range of services such as transport between Meilan Airport and Haikou City, hotel reservation, air ticket sales and travel reception. It also actively organises more and more short tour packages. Due to a reduction in passenger and cargo throughput, the Group outsourced its tourism and travelling business to Luckyway Travelling in 2006 to ensure stable income of the Group. In addition to the franchise fee paid by Luckyway Travelling, the Group received additional income from a pro rata share of its operating profit. In 2006, the Group’s revenue from tourism was RMB20,485,000, in addition RMB 583,000 was franchise fee paid by Luckyway Traveling.

### **Car Parking**

Car parking charges is another income contributor for the Group’s non-aviation business. The turnover in 2006 amounted to RMB5,101,000.

### **Advertising Business**

In 2006, leveraging on hosting significant events such as Boao Asia Forum and Forum on Agricultural Cooperation between Mainland and Taiwan in Hainan, the Group entered into advertising contracts with more than 30 clients such as Merrill Lynch (Asia Pacific) Limited, Shanghai Brawman Group and PetroChina Company Limited through the deployment of more promotional resources and efforts and the building up of an extensive sales network. For the year ended 31 December 2006, revenue from advertising business reached RMB12,008,000, equivalent to an approximately 31.1% growth over 2005.

### **Retail Business**

Revenue from retail business was RMB9,509,000 for the year ended 31 December 2006, which represented a 6.4% decrease over that of last year. The main reason is that the domestic duty free shop was outsourced to DFS since April, 2005, and the Company obtained franchise income from DFS. For the first three months of 2005, retail income comprised revenue from both domestic and international duty free shops. For the period from April 2005 to December 2006, retail income only represented the revenue from international duty free shop.

### **Franchise Revenue**

For the year ended 31 December 2006, income from franchise was RMB27,769,000, representing an increase of 73.8% over the previous year. The main reason is that, as a result of the inauguration of Terminal Expansion Phase II, the business of DFS has been fully commenced with the expansion of commercial areas, which recorded an increase in the franchise income from DFS.

## **Financial Review**

### **Structure of Assets**

As at 31 December 2006, the total assets of the Group amounted to RMB1,870,351,000, representing an increase of 8.9% as compared to last year. The increase was mainly attributable to the increase in the shareholders’ equity due to the operating results in 2006.

## Cost Structure

In 2006, total operating costs of the Group were RMB125,250,000, representing an increase of RMB26,110,000 or 26.3% over last year. The main reason was that, as a result of the inauguration of Terminal Expansion Phase II, the depreciation expenses increased accordingly. The administrative expenses were RMB61,528,000, representing a decrease of RMB644,000 or 1% as compared to last year.

## Capital Structure

The Group maintained an appropriate mix of equity and debt to ensure an efficient capital structure to reduce costs of capital. As at 31 December 2006, the total liabilities of the Group which amounted to approximately RMB207,496,000, representing an increase of 16.97% as compared to last year. The main reason is that the construction payable for the Phase II expansion of terminal building has increased approximately by RMB66,000,000.

## Cash Flows

For the year ended 31 December 2006, the Group's net cash flow from operating activities was RMB173,860,000, representing an increase of 43%, which was primarily due to the airport construction fee of RMB113,000,000 received for the period between September 2004 and December 2005. During the year, the Group's net cash outflow for investing activities was RMB47,228,000, which was mainly attributable to the capital injection from the Group for the expansion of the terminal building.

## Financial Resources

As at 31 December 2006, financial resources of the Group mainly comprised bank loans, cash and bank deposits. The purpose of those financial instruments is to finance the Group's operations. Besides, the Group had other financial instruments in relation to daily operations, such as accounts receivable and accounts payable.

## Gearing Ratio

As at 31 December 2006, the current assets of the Group was approximately RMB616,809,000, the total assets was approximately RMB1,870,351,000, the current liability was approximately RMB163,016,000 and the total liability was approximately RMB207,496,000. As at 31 December 2006, the ratio between total liabilities and total assets of the Group was 11.1%(31 December 2005: 10.3%).

## Exposure to Foreign Exchange Risk

Except the purchase of certain equipment and services which was denominated in US Dollar, the Group's businesses were denominated in RMB. The dividends of H shares of the shareholders was declared in RMB and paid in HK Dollar. As at 31 December 2006, except that cash and cash equivalents of approximately RMB753,000 were denominated in HK Dollar and US Dollar, all of the Group's assets and liabilities were denominated in RMB. The fluctuation of the exchange rate of RMB to foreign currency may cause a limited impact on the Group's results of operations.

## Pledge of the Group's Assets

The Group pledged its rights to revenues, including the rights of the airport construction management fee, to secure a long-term bank loan of RMB53,000,000 from China Development Bank.

## Contingent Liability

As at 31 December 2006, the Group or the Company did not have any significant contingent liabilities.

## Purchase, Sales or Redemption of Shares

As at 31 December 2006, neither the Group nor the Company has purchased, sold or redeemed any of the Company's shares.

## Management Discussion and Analysis

### Employment, Training and Development

As at 31 December 2006, the Group had a total of 676 employees, representing a decrease of 15 employees as compared to last year. This was mainly due to the refinement of corporate structure and the optimisation of employees. Total staff costs accounted for approximately 11% of total turnover, representing an increase of 5.5% as compared to last year. The reason for the increase in cost was mainly due to the cost arising from the promotion of employees. Employees are remunerated based on their performance, experience and prevailing industry practices. The Group will review the remuneration policy and its related combination on a regular basis. Performance-based bonuses and commissions may be awarded to employees.

### Retirement Pension

The Company and its respective subsidiaries have participated in the employee retirement scheme operated by the relevant local government of the PRC. The relevant local government shall be responsible for the pension of the retired employees. The Group has to make contribution at a rate of 20% of the salary of the employees with permanent residence in the PRC. For the year ended 31 December 2006, the contribution for the pension amounted to approximately RMB4,000,000 (2005: RMB3,530,000).

### Other Information

Save as disclosed above, in 2006, the Group had no material change in other information in relation to those matters set out in paragraph 32 of Appendix 16 to the Rules Governing the Listing of Securities on the Stock Exchange ("Listing Rules").