



# Management Discussion and Analysis

The following discussion should be read in conjunction with the Group's consolidated financial statements and notes thereto set out in this Annual Report and other sections.

## SUMMARY

For the year ended 31st December 2006, the Group recorded a turnover of RMB17,111 million, representing an increase of 19.94% over that of 2005. The loss attributable to the equity holders of the Company was RMB331 million caused by the drop in the results of the automobile business.

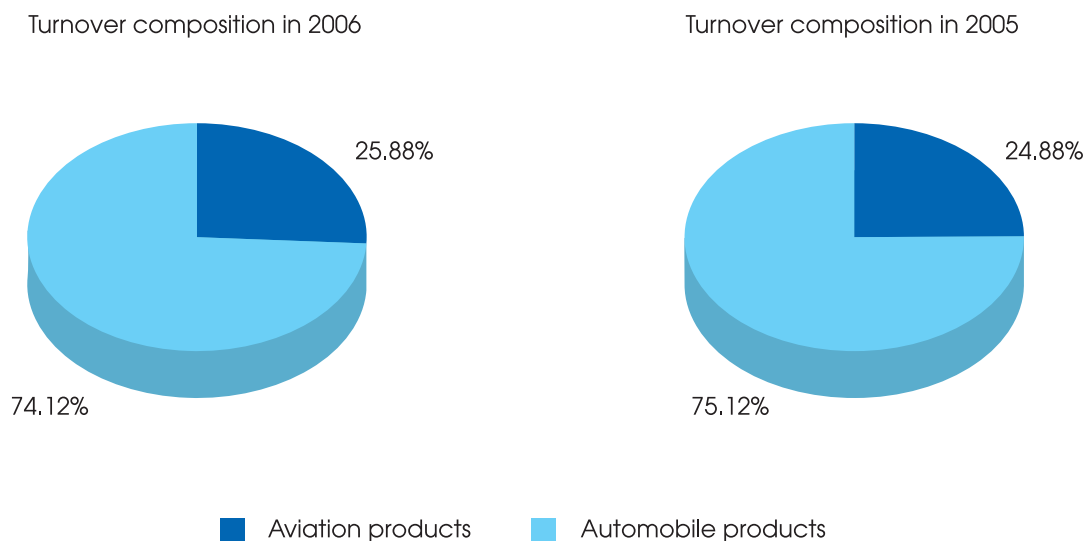
The following table shows the comparison between the years ended 31st December 2006 and 2005:

## CONSOLIDATED OPERATING RESULTS

RMB million	Year ended 31st December		Changes
	2006	2005	
Turnover	<b>17,111</b>	14,266	19.94%
Of which: automobile segment	<b>12,683</b>	10,716	18.36%
aviation segment	<b>4,428</b>	3,550	24.73%
Cost of sales	<b>(15,205)</b>	(12,395)	22.67%
Of which: automobile segment	<b>(11,443)</b>	(9,369)	22.14%
aviation segment	<b>(3,762)</b>	(3,026)	24.32%
Other revenues	<b>183</b>	209	(12.44%)
Selling and distribution expenses	<b>(1,157)</b>	(781)	48.14%
General and administrative expenses	<b>(1,178)</b>	(950)	24.00%
Operating (loss)/profit	<b>(246)</b>	348	N/A
Financial costs, net	<b>(272)</b>	(154)	76.62%
Share of results in associates before taxation	<b>45</b>	45	—
(Loss)/profit before taxation	<b>(473)</b>	240	N/A
Taxation	<b>(13)</b>	(52)	(75.00%)
Minority interests	<b>155</b>	(70)	N/A
Net (Loss)/profit attributable to the equity holders of the Company	<b>(331)</b>	118	N/A



## 1. Composition of turnover



The Group's turnover for 2006 was RMB17,111 million, representing an increase of 19.94% over RMB14,266 million of 2005. The turnover of automobile products amounted to RMB12,683 million, representing an increase of 18.36% over that of 2005 and accounting for 74.12% of the total turnover; and the turnover of aviation products amounted to RMB4,428 million, representing an increase of 24.73% over that of 2005 and accounting for 25.88% of the total turnover.

As shown in the charts above, aviation products accounted for a bigger proportion of the total turnover in 2006 with an increase about one percentage point over that of 2005. The proportion accounted by the sales revenue from the Group's aviation business in the total sales revenue is growing steadily year by year.

The Group operates mainly in mainland China where the majority of the turnover is derived from.

## 2. Selling and distribution expenses

The Group's selling and distribution expenses for 2006 amounted to RMB1,157 million, representing an increase of RMB376 million, or 48.14%, over that of 2005. The increase was mainly attributable to the increase of RMB90 million in after-sales service expenses for the Group's automobile and engine products during the year; the significant increase in transportation expenses as the sales volume of automobile products rose while oil price soared; and the increase of RMB67 million in advertisement expenses as the Group had to dedicate more investment in advertising to promote sales of the Group's automobile products in a competitive market.

## 3. General and administrative expenses

The Group's general and administrative expenses for 2006 amounted to RMB1,178 million, representing an increase of RMB228 million, or 24.00%, over that of 2005. The increase was mainly attributed to a growth of RMB135 million in investment on research and development and an increase of RMB69 million in remuneration of management and compensation for retirement pension.



## Management Discussion and Analysis

### 4. Operating (loss) / profit

The Group suffered an operating loss of RMB246 million for 2006, representing a decrease of RMB594 million from the profit of RMB348 million of 2005. The decrease was mainly due to the slip in the gross profit margin of the entire vehicle products as well as the increase expenses during the period.

### 5. Finance costs, net

The Group's net finance costs for 2006 amounted to RMB272 million, representing an increase of RMB118 million, or 76.62%, over that of 2005. The increase was mainly attributable to the fluctuation in exchange rates which resulted in an exchange loss of RMB14 million, representing a decrease of RMB72 million as compared to an exchange gain of RMB58 million in 2005.

### 6. Taxation

The Group's income tax for 2006 was RMB13 million, representing a decrease of RMB39 million from RMB52 million of 2005. Details are set out in note 9 to the financial statements.

### 7. Minority interests

The Group's minority interests for 2006 was a loss of RMB155 million, representing a decrease of RMB225 million from a profit of RMB70 million in 2005, which was mainly attributable to the loss incurred in certain non-wholly owned subsidiaries of the Group in 2006.

## ASSETS, LIABILITIES AND EQUITY

RMB million	As at 31st December		
	2006	2005	Changes
Current assets	<b>14,760</b>	12,668	2,092
Non-current assets	<b>10,051</b>	10,044	7
Total assets	<b>24,811</b>	22,712	2,099
Current liabilities	<b>15,659</b>	12,759	2,900
Non-current liabilities	<b>1,030</b>	1,243	(213)
Total liabilities	<b>16,689</b>	14,002	2,687
Share capital	<b>4,644</b>	4,644	0
Reserves	<b>(315)</b>	521	(836)
Proposed final dividends	<b>—</b>	49	(49)
Capital and reserves attributable to the Company's equity holders	<b>4,329</b>	5,214	(885)
Minority interests	<b>3,793</b>	3,496	297



As at 31st December 2006, the Group's total assets amounted to RMB24,811 million, total liabilities amounted to RMB16,689 million whereas minority interests and capital and reserves attributable to the Company's equity holders amounted to RMB3,793 million and RMB4,329 million respectively.

#### 1. Total assets

Total assets increased by RMB2,099 million over that of 2005 which was mainly attributable to the increase in current assets. Current assets of 2006 increased by RMB2,092 million over that of 2005, among which accounts receivable increased by RMB788 million which was mainly due to the increase in the sales revenue for 2006, while the credit policy of the Group has remained the same during the year; and inventories increased by RMB678 million which was mainly due to the increase in procurement of raw materials and finished products.

#### 2. Liabilities

Total liabilities increased by RMB2,687 million over that of 2005. Current liabilities increased by RMB2,900 million, among which trade payables and current borrowings increased by RMB1,222 million and RMB1,305 million respectively. Non-current liabilities decreased by RMB213 million mainly due to the decrease in long-term borrowings.

#### 3. Guaranteed and secured loans

As at 31st December 2006, the Group's total borrowings amounted to RMB6,672 million, of which RMB110 million was secured by properties, machinery, equipments and banks' acceptance bills, with a net book value of RMB243 million.

Guaranteed borrowings amounted to RMB4,543 million, of which RMB3,567 million was cross guaranteed amongst the subsidiaries of the Group, RMB145 million was guaranteed by third parties and RMB831 million was guaranteed by AVIC II and its subsidiaries.

#### 4. Capital and reserves attributable to the Company's equity holders

Capital and reserves attributable to the Company's equity holders in 2006 amounted to RMB4,329 million, representing a decrease of RMB885 million from that of 2005. Details are set out in the Consolidated Statement of Changes in Equity and note 36 and note 37 to the financial statements.

#### 5. Development costs

During the year 2006, research and development expenditures of the Group were RMB281 million representing an increase of RMB25 million over that of 2005.

#### 6. Exchange risks

Due to its operational need, the Group had a substantial amount of loans denominated in Euro and United States dollars. In addition, the Company has some deposits in Hong Kong dollars raised from the public offering in October 2003. Fluctuation in exchange rates of these currencies has brought about certain exchange risks to the Group. Details are set out in note 41(a)(i) to the financial statements.

#### 7. Contingent liabilities and guarantees

As at 31st December 2006, the Group did not provide any guarantees for third party and did not have any significant contingent liabilities.

#### 8. Gearing ratio

As at 31st December 2006, the Group's gearing ratio was 26.89% (31st December 2005: 24.35%), which was arrived at by dividing the total borrowings by total assets as at 31st December 2006.



## CASH FLOW

### 1. Liquidity and capital resources

As at 31st December 2006, the Group's net cash and cash equivalents amounted to RMB3,156 million which was mainly derived from the followings:

- cash and bank deposits at the beginning of the year;
- funds generated from its operations; and
- new bank borrowings.

The Group's cash flow for the year 2006 and 2005 were as follows:

Unit: RMB million (except percentages)

Main items of cash flow	2006	2005	Change (amount)	Change (percentage)
Net cash flows generated from operating activities	910	1,506	(596)	(39.58%)
Net cash flows used in investing activities	(1,551)	(1,939)	388	(20.01%)
Net cash flows generated from financing activities	854	817	37	4.53%
Net increase in cash and cash equivalents	213	384	(171)	(44.53%)

### 2. Operating activities

Net cash flows generated from operating activities for the year amounted to RMB910 million, representing a decrease of RMB596 million from that of 2005. Details are set out in note 38(a) to the financial statements.

### 3. Investing activities

Net cash flows used in investing activities for the year amounted to RMB1,551 million, representing a decrease of RMB388 million from that of 2005, among which term deposits with an initial term of over three months increased by RMB246 million, representing an increase of RMB656 million when compared with the drop of RMB410 million in 2005.

### 4. Financing activities

Net cash flows generated from financing activities for the year amounted to RMB854 million, representing an increase of RMB37 million over that of 2005.

As at 31st December 2006, the Group's total borrowings amounted to RMB6,672 million, of which the current borrowings, current portion of long-term borrowings and non-current portion of long-term borrowings amounted to RMB5,401 million, RMB434 million and RMB837 million respectively.



The Group's long-term borrowings are repayable as follows:

Maturity	RMB million
Within one year	434
In the second year	233
In the third to fifth year	366
After the fifth year	238
Total	<u>1,271</u>

As at 31st December 2006, the Group's bank borrowings amounted to RMB6,099 million with an average interest rate of 5.29% per annum, representing 91.41% of the total borrowings. Other borrowings amounted to RMB573 million with an average interest rate of 1.42% per annum, representing 8.59% of the total borrowings.

As at 31st December 2006, the Group's borrowings denominated in foreign currencies amounted to RMB804 million, representing 12.05% of the total borrowings, of which borrowings denominated in United States dollars and Euros amounted to US\$60 million and Euro33 million respectively.

## SEGMENT INFORMATION

The Group's principal operations are divided into two segments, namely the automobile segment and the aviation segment.

### AUTOMOBILE SEGMENT

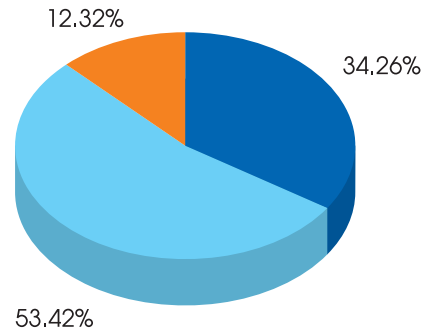
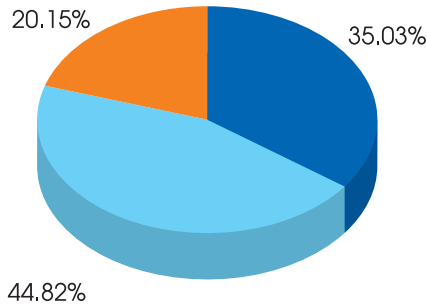
	Year ended 31 December							
	2006				2005			
RMB million	Sales Volume (units)	Sales revenue	Cost of sales	Gross margin (%)	Sales Volume (units)	Sales revenue	Cost of sales	Gross margin (%)
Automobile products in total	—	12,683	11,443	9.78%	—	10,716	9,369	12.57%
Entire vehicles in total	344,359	10,127	9,449	6.69%	331,045	9,395	8,297	11.69%
Mini-vans and mini-trucks	236,651	5,684	5,156	9.29%	239,578	5,724	4,947	13.57%
Sedans	107,708	4,443	4,293	3.38%	91,467	3,671	3,350	8.74%
Others	—	2,556	1,994	21.99%	—	1,321	1,072	18.85%



## Sales Revenue

Sales Revenue of Automobile Segment in 2006

Sales Revenue of Automobile Segment in 2005



■ Sedans      ■ Mini-vans and mini-trucks      ■ Other automobile products

The Group's sales of automobile products for 2006 amounted to RMB12,683 million, of which the sales of the entire vehicle products accounted for RMB10,127 million, representing an increase of RMB732 million, or 7.79% over that of 2005.

As shown in the charts above, there was a change in the composition of the Group's automobile products in 2006 from that of 2005: sedans accounted for 35.03% of the sales of the automobile products, representing an increase of 0.77 percentage points over 34.26% of 2005; mini-vans and mini-trucks accounted for 44.82% of the sales of automobile products, representing a decrease of 8.60 percentage points from 53.42% of 2005; other automobile products accounted for 20.15% of the sales of the automobile products, representing an increase of 7.82 percentage points when compared with 12.33% of 2005, which is mainly caused by the rapid increase in the sales of engines sold to external parties of the Group.

## Cost of Sales

Cost of sales of the Group's automobile products for 2006 amounted to RMB11,443 million, among which the cost of sales of the entire vehicle product increased to RMB9,449 million from RMB8,297 million in 2005. The increase was mainly attributable to the increase in the sales volume of the entire vehicle product during the year and the increase in expenses relating to depreciation on new production lines and the amortization of vehicle molds.

## Gross Margin

Gross margin of the Group's automobile products for 2006 was 9.78%, representing a decrease of approximately 2.79 percentage points from that of 2005. The gross margin of economy sedans and mini-vans and mini-trucks suffered a great drop. During the year, the Group cut the price of economy sedans and mini-sized automobiles to boost the sales volume as such segment was facing pressure from the market. At the same time, the automobile production lines in Jiujiang and Shenzhen were completed and commenced production which has caused the increase in depreciation and amortization expenses whereas sales volume did not reach the expected level given the relatively low utilization rate of the production capacity. All these factors resulted in a drop in the gross margin of the Group's automobile products.





### Review on China's Automobile Market in 2006

In 2006, a total of approximately 7,280,000 and 7,220,000 vehicles in China were produced and sold respectively, representing an increase of 27% and 25% respectively as compared to that of 2005. Among that the sales of sedans amounted to 3,828,900, representing an increase of 36.89% over that of 2005. The increment was improved by 12.58 percentage points when compared with that of 2005. Within all the sedan models, the sales volume of models with emission from 1L to 1.6L amounted to 2,078,100, accounting for 54.28% of the total sales volume of sedans, which was promoted by the government's favorable policies on encouraging low emission vehicles. It is noted that the independent brand sedans had an outstanding sales volume of 982,800, accounting for 25.67% of the total sales volume of sedans. During 2006, mini-vans and mini-trucks experienced a stable increase with a sales volume of 917,900 and 270,400 respectively, representing an increase of 10.40% and 21.12% respectively when compared with those of the corresponding period of 2005.

*(Source: China Automobile Industry Newsletter of Production and Sales, first issue of 2007)*

### Review on the Group's Automobile Business In 2006

The automobile business of the Group experienced rigorous challenges during 2006. The Group sold 344,359 vehicles in 2006, representing an increase of 4.02% as compared with that of 2005, among which the sales volume of sedans was 107,708, representing an increase of 17.76% over that of 2005 and the sales volume of mini-vans and mini-trucks dropped to 236,651, representing a decrease of 1.22% from that of 2005. The decrease was mainly due to the drop in domestic sales of mini-vans and mini-trucks despite an increase in the export sales. For the year ended 31st December 2006, the sales revenue of the Group's automobile products recorded RMB12,683 million, representing an increase of 18.36% over that of 2005. The increase was mainly attributable to the climbing sales volume in sedans which have a relatively higher price than that of mini-vans and mini-trucks and the rise in sales volume of sedan engines sold to third parties. However, the results of the whole automobile segment suffered a loss of RMB620 million during the year due to the great drop in the gross margin of the entire vehicles products and the rise of expenses during the period.

### Launch of New Products

In 2006, the Group launched six new vehicle models, including sedans as Hafei Saibao V series, Changhe two compartment Liana and Changhe Ideal II, mini-vans as Changhe Furuida and Hafei Minyi M408 and mini-trucks Hafei Minyi. At the same time, three new upgraded models, namely new Beidouxing (1.4L), new Saima and new Lobo (1.3L) were launched. The above new models present favourable sales situation after their respective launching. The sales volume of Changhe Suzuki Beidouxing (1.4L) broke 30,000 in 2006; 23,000 Changhe Furuida were sold during the eight months after launching and the highest sales volume per month went beyond 5,000; Hafei Saibao V has also gained favorable comments from the market. At present, the Group has established a multi-strain series structure in its automobile products, including mini-vans, mini-trucks, mini-sedans, economy sedans and middle-class sedans, which set a foundation for the development of the Group's automobile business in 2007.







## Management Discussion and Analysis

The independent innovation of the Group's automobile products made fruitful achievements. A series of automobile models have received many awards in China and abroad:

Four new vehicle models, namely Hafei Saima, Lobo, Saibao, Changhe Ideal, two engine models 4G1 and 4G9 and gearboxes were awarded "Intergration and Innovation Award" and "Introducing, Digestion and Reinnoation Awards" in the Ceremony for 2006 China Automobile Independent Innovation Achievements;

Hafei Minyi achieved the "State Key New Products Certification" granted by the Ministry of Science and Technology, Ministry of Commerce, General Administration of Quality Supervision, Inspection and Quarantine and State Environment Protection Administration;

Hafei Saibao V was granted as the "Most Influencial Sport Sedan" in China Automobile Fengyun Award; Changhe Liana was ranked first among the economy passenger cars in the 2006 USA survey on automobile quality in initial stages; Changhe Beidouxing picked the award of "Energy-saving King" with the lowest oil consumption among the models with emissions over 0.8 liter promulgated by State Development and Reform Commission; Hafei Lobo was the champion in the CCTV Cup Oil-saving Match for Automobiles with emission of 1.1 liters; and Changhe Furuida was awarded the "2006 Most Satisfactory Mini-sized Vehicle of China Customers".

### Marketing

In 2006, the Group put more efforts on marketing, further optimized its sales networks and strengthened the capability of its sales agencies. The Group insisted on customer centralization and continued to improve its after-sales service system through Hafei Auto's "Sunflower" action and Changhe Auto's "Care All The Way" services. The images of the Company as well as its products have been enhanced by multi-ways and multi-levels' promotions, such as outdoor advertisement, advertisement on TV, on internet, through broadcast and on newspapers, to further enhance the market competitiveness of the brands of the Group's



automobile products. In 2006, Hafei was awarded as the "2006 Most Competitive Brand" by the Ministry of Commerce and Changhe was awarded the title of "2006 Ten Most Favorable Brands of the Customers in China Automobile Industry". Hafei Auto and Changhe Auto, among the first several enterprises, were both granted the title of "Export Base of Automobiles and Parts and Components in China" by Ministry of Commerce and National Development and Reform Commission.

### Production Location and International Cooperation

After the adjustment and restructure in 2006, the Group completed the separation of its automobile business from its aviation business, which helped the Group to specialize management for different business. In November, the Shenzhen production base of Hafei Auto was put into production and in December, the production line of 4G9 engines, jointly invested with Mitsubishi, was completed. The cooperation between Changhe Auto and Suzuki was further enhanced and they completed the third increase in the capital of Changhe Suzuki. The cooperation between Hafei Auto and



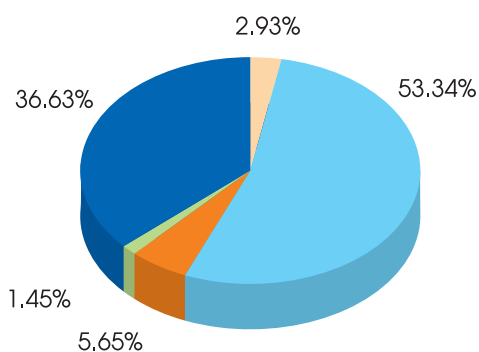
Malaysia NAZA company on technologies and export of spare parts have made a breakthrough, creating a new model of international cooperation for Chinese automobile companies.

## AVIATION SEGMENT

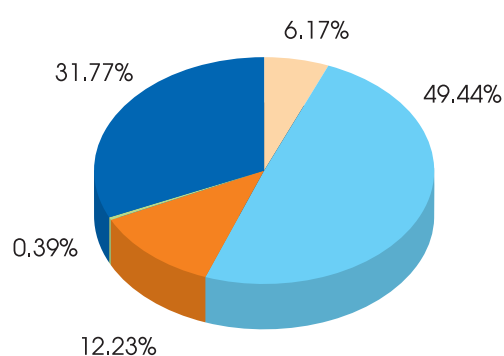
RMB million	Years ended 31st December							
	2006				2005			
	Sales volume Units	Sales revenue	Cost of sales	Gross margin	Sales volume Units	Sales revenue	Cost of sales	Gross margin
Aviation products in total	163	4,428	3,762	15.04%	101	3,550	3,026	14.76%
Helicopters	96	2,362	2,111	10.63%	49	1,755	1,591	9.34%
Trainers	63	250	197	21.20%	50	434	346	20.28%
General aeroplanes	4	64	58	9.38%	2	14	21	(50.00%)
Aviation parts and components	—	1,622	1,349	16.83%	—	1,128	924	18.09%
Others	—	130	47	63.85%	—	219	144	34.25%

### Sales Revenue

Sales Revenue of Aviation Segment in 2006



Sales Revenue of Aviation Segment in 2005



■ Helicopters   
 ■ Trainers   
 ■ General aeroplanes   
 ■ Aviation parts and components   
 ■ Others

The Group's sales revenue of aviation products for 2006 was RMB4,428 million, representing an increase of RMB878 million, or 24.73%, over that of 2005, in which the sales of aeroplanes and helicopters amounted to RMB2,676 million, representing an increase of RMB473 million, or 21.47%, over RMB2,203 million of 2005. The increase was mainly attributable to the increase in sales volume of helicopters during the year.

The Group's sales revenue from aviation parts and components amounted to RMB1,622 million, representing an increase of RMB494 million, or 43.79%, over RMB1,128 million of 2005. The increase was mainly attributable to the growth in sales volume of aviation parts and components sold to AVIC II Group.

As shown in the charts above, the composition of the Group's aviation products in 2006 was different from that of 2005: the sales of helicopters accounted for 53.34% of the total sales revenue of aviation products, representing an increase of



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3.90 percentage points over 49.44% of 2005; the sales of trainers accounted for 5.65% of the total sales revenue of aviation products, representing a decrease of 6.58 percentage points from that of 2005; the sales of general aeroplanes accounted for 1.45% of the total sales revenue of aviation products, showing a slight increase when compared with that of 2005; the sales of aviation parts and components accounted for 36.63% of the total sales revenue of aviation products, representing an increase of 4.86 percentage points over 31.77% of 2005; and sales of other aviation products accounted for 2.93% of the total sales revenue of aviation products, representing a decrease of 3.24 percentage points from that of 2005.



### Cost of Sales

Cost of sales of the Group's aviation products for 2006 was RMB3,762 million, representing an increase of RMB736 million, or 24.32%, over RMB3,026 million in 2005. The increase in the cost of sales goes in tandem with the growth in the sales revenue of aviation products.

### Gross Margin

Gross margin of the Group's aviation products for 2006 was 15.03%, which was comparable with that of 2005, representing a modest increase of 0.27 percentage points over that of 2005.

### Review on China's Aviation Market in 2006

With the rapid growth in China's GDP, the structure adjustments in transportation and the continuous improvement of people's living standards, a large potential market for helicopters and civil aeroplanes has been formed, which presents a wider horizon for the development of China's civil aviation industry. World's famous aviation manufacturers, such as Airbus, Embraer and Boeing, have adjusted their production schemes to



cooperate with Chinese aviation manufacturers, enlarged the proportion of their products being made in China, established production lines and set up joint ventures in China. This situation has provided a good opportunity for the Group to participate in international cooperation so as to enhance its own capabilities.

### Review on the Group's Aviation Business in 2006

The Group is the largest helicopter manufacturer and a major aeroplane manufacturer in China. In 2006, with continuous rapid growth of China's economy, increase in orders from the Chinese government for helicopters and increase in sales of aviation parts and components, the Group's aviation business kept its high-speed growth. In 2006, the sales revenue of the Group's aviation products was RMB4,428 million, representing an increase of 24.73% as compared to that of 2005, and the results of the Group's aviation segment was RMB404 million, representing an increase of 46.91% as compared to that of 2005.



The Group's Z-8, Z-9 and Z-11 helicopters have led to the establishments of a series and showed a good developing trend. In 2006, the Group sold 96 helicopters with sales revenue of RMB2,362 million, representing an increase of 34.59% over that of 2005. Changhe Agusta entered into contract with Beijing Police Bureau for the sale of two CA109 helicopters, which will serve in the 2008 Beijing Olympic Games.

Sales volume of the Group's trainers is climbing, however, sales revenue from the Group's trainers showed a decline from that of 2005, because according to the delivery schedule set out in contracts, the delivery of exported trainers, which receive a relatively higher price than that sold to domestic market, recorded a smaller quantity in 2006 that resulted in the decrease in the total sales revenue of the Group's trainers. The Group will endeavor to exploit new overseas markets for its trainers so as to secure more export sales contracts.

As to general aeroplanes, the Group entered into contracts for the sales of nine Y-12 series in 2006 and the newly upgraded Y-12E aeroplanes also has attracted export sales contracts. Since the Chinese government has put much efforts in supporting the development of a modernized agricultural industry, the Group has also grasped this opportunity to exploit the market for its agricultural and forest aeroplanes.

Harbin Embraer, delivered six ERJ-145 regional jets in 2006 and entered into an agreement with Hainan Airlines Group on the sales of 50 ERJ-145 regional jets, which will be delivered from September 2007 to 2010.

## Research and Development on Aviation Products

The Group has participated in the research and development of L15 advanced trainer, which performed its first flight successfully in March 2006 and was presented at the 6th China International Aviation & Aerospace Exhibition as a third-generation advanced trainer independently developed and manufactured by China. N-5B agricultural aeroplane successfully performed its maiden flight at the end of 2006, which provides a new choice for the general aeroplane market.

## International Cooperation

The Group has steadily developed its international cooperation on helicopters, from simply subcontract production of parts and components to joint manufacture of helicopters with international partners. Through cooperation with the world's well-known helicopter manufacturers, such as Eurocopter, Agusta and Sikorsky, the Group has participated in the manufacture of helicopters HC120, A109E, S92 and S300. As to international cooperation on aircrafts, the Group has solidified and expanded production shares in programmes with Airbus, Embraer and Boeing. In addition, Hafei Aviation and Hongdu Aviation have taken 10% interests respectively in Tianjin Zhongtian Aviation Industry Investment Co., Ltd. which engages in the assembly of Airbus A320 series in China.



## Orders for Aviation Products

As at the date of this report, the Group has received orders for 100 helicopters, 30 trainers, 27 general aeroplanes and 50 regional aeroplanes. The Group is endeavor to getting more orders for aviation products.



## OUTLOOK AND STRATEGIES

In 2007, the Company believes that China's economy will sustain a moderate and stable growth, which is expected to drive the growth of the automobile industry and the aviation industry in China.

## AUTOMOBILE BUSINESS

### Outlook of China's Automobile Market in 2007

At present, the retaining volume of automobiles is still low in China and the potential consumption for automobile products is great. With the increase of growth in China's economy and the improvement of the residents' income, the demands for automobiles from private sector will keep increasing. According to the forecast by China Automobile Industry Association, the total output of China's automobile manufacturers in 2007 is expected to reach 8,500,000, representing an increase of 16.76% over that of 2006. The growth in sedans is expected to reach 25% which will outperform the industry growth.

Under the policy of establishing an economized society and encouraging energy-saving, low emission and environment-protecting sedans, low emission economy sedans, which feature "safe, environmental-friendly, energy-saving, economical and practical" are being more favoured by the consumers. Under the support of the government's policies, sedans with independent brands will have more and more influence and become a highlight in China automobile market.

### Outlook of the Group's Automobile Business

The models developed, manufactured and sold by the Group are mainly low-emission automobiles (mostly among 0.8L to 1.4L) with independent intellectual property rights and low oil consumptions. Those automobiles feature "safe, environmental-friendly, energy-saving, economical and practical" and are in line with the policy direction of the China's automobile industry and the development of the world automobile industry.

The Group will continue the strategy of developing "safe, environmental-friendly, energy-saving, economical and practical" low-emission vehicles, adhering to the principle of enhancing the mini-sized vehicles and sedans and pushing forward the independent research and development and the international cooperation. The Group will further study the market and commit to conduct effective work in respect of marketing, research and development of new products, structural adjustment and cost control.



## Marketing

To ensure the increase of sales volume in 2007, the Group will improve its marketing and advertisement to promote brand awareness. The Group will also engage senior marketing personnels by offering high salaries to expand marketing concept and push forward the reform on marketing system. The Group will speed up the exploitation of second and third tier market to develop sales of mini-vans and mini-trucks in rural areas and middle and small towns. At the same time, the Group will also further exploit the international market to guarantee the stable increase of export of automobiles.





## Development of New Products

In 2007, the Group will launch three new models, namely Hafei Luzun, Changhe Landy, Changhe Furuida single and double seat truck, and other upgraded models, among which Hafei Luzun and Changhe Landy will be put into market in the first half of 2007 and Changhe Furuida will be put into market in the second half of 2007. The Group will also actively promote the development of diesel engines and high-quality petrol engines as well as the upgrading of current engine models.

## Integration and Improvement on Management

The Company plans to change Changhe Auto Hefei Branch, which engages in the manufacturing of Changhe series sedans and mini-vans and mini-trucks, into Hefei subsidiary with independent legal status to gain more supports from the local government and speed up the development of automobiles with independent brands. The Group will also integrate current resources to improve the utilization efficiency in stages of research and development of new products, out-source, logistics and sales service. Meanwhile, the Group will strengthen lean manufacturing and cost control to improve the efficiency and turn over the falling of profit under the rising of sales volume.

## AVIATION BUSINESS

### Prospect for Aviation Market

China's civil aviation market is in a flourishing period. As China's GDP is growing, several industries, such as transportation, emergency rescue, electrical projects, firefighting, police enforcement and tourism, have presented their demands for helicopters. However, at present, China only has one hundred helicopters for civil usage, therefore, there is a large potential demand. According to relevant expectations, the demands for civil helicopters in China will rise up to 2300 by the year 2018. The growth in China's tourism, aviation transportation and the market of agricultural and forest aeroplanes will also boost the demands for trainers, general aeroplanes and regional aeroplanes. Both Airbus and Boeing have predicted in their respective forecasts on aviation market that the demand from mainland China for aircrafts would be very huge in the future.

### Outlook and Strategy for the Group's Aviation Business

As the largest helicopter manufacturer and a major aeroplane manufacturer in China, the Group's aviation products will continue to benefit from the expansion of China's civil aviation market in the following years. In the coming years, both the production and sales volume of the Group's helicopters will keep growing due to the increase in orders from the Chinese government and the expansion of application areas of helicopters for civil usage. The fast growth in aviation business of both AVIC II Group and AVIC I Group results in an increase in demand for aviation parts and components manufactured by the Group. In addition, as the Group has made advancement in the subcontract production for the world's renowned aviation manufacturers, such as Airbus and Boeing, sales volume of the Group's aviation parts and components is expected to grow steadily in following years. With the gradual opening of civil aviation market and low altitude airspace by Chinese government, demands for light general aeroplanes are ascending. This will also provide a huge room for the development of the Group's general aeroplanes.





## Management Discussion and Analysis

### Research and Promotion

In addition to the current helicopter and aircraft models, the Group will strengthen the development of new products and promote the research of new models and upgrade of current models based on domestic and overseas customers' demands and the developing trend of the market so as to attract more customers. In 2007, the Company will present at the 2007 Asian Aerospace International Expo and Congress to promote the Group's aviation products, especially achievements gained during the 50-year development of China's helicopter industry and to further exploit international market.

### Improvement on Management

The Group will push forward the reform on organization and management, ensure the construction of new production lines, improve and boost the batch production capabilities for aviation products and put more efforts on coordinating the out-source from foreign suppliers with the production progress in China so as to secure a balanced production and timely deliveries of the Group's aviation products. The Group will also actively promote lean production and Six Sigma management to enhance operation efficiency of its aviation subsidiaries.

### International Cooperation

As the world's major aviation enterprises are adjusting their production location and giving Chinese manufacturers more and more share in their production chains, the Group will take this opportunity to enlarge its subcontract production and push forward the cooperation with international renowned aviation companies, such as EADS and Agusta.

## USE OF PROCEEDS

According to the plan for use of proceeds, the proceeds used as at 31st December 2006 amounted to RMB895 million in total, out of which RMB700 million was used for the research and development of new vehicle models and new vehicle engines; RMB195 million was used for the research and development of new advanced trainers; and the rest was deposited with the banks in China as short term deposits which would also be used by the Company as planned.

## EMPLOYEES

As at 31st December 2006, the Group had 27,469 employees. The Group has provided appropriate emoluments, benefits and trainings to its employees.

### Employees breakdown by functions

	Number of employees	Percentage to total employees (%)
Vehicles and engines	16,504	60%
Aviation	10,187	37%
Other activities	778	3%
Total	<u>27,469</u>	<u>100%</u>



For the year ended 31st December 2006, a total staff costs of RMB997 million were incurred by the Group in connection with its employees, representing an increase of RMB204 million when compared with RMB793 million of 2005.

## REMUNERATION OF EMPLOYEES

The Group's remuneration scheme is determined on fair and reasonable principles which are similar to those available in the market. Remuneration of employees comprises of basic salary, contribution to a housing fund, and contributions to pension plans. The Group will also, in its discretion, pay year-end bonus to employees according to their respective performance.

## TRAINING FOR EMPLOYEES

The Group expects a high level of knowledge and skill in respect of the automobile manufacturing industry and the aviation manufacturing industry from its employees. Therefore, implementation of comprehensive employee training is the key to the Group's continuous development. Accordingly, the Group will continuously review its existing employee training scheme in order to provide comprehensive and systematic training to its employees.

The Group provides special training courses, seminars on strategic management, human resources management, and financial management for its senior management. Trainings relating to all kinds of professional skills and management techniques are also provided to all professional departments of the Group's headquarters and the business departments of its subsidiaries. On-the-job trainings covering corporate culture, management concept and management standardization are also provided to new employees.

The Group also provides overseas training to the management officers and technicians through cooperation with international partners. The employees, through training, are able to continuously acquire new knowledge to improve their capabilities. This will in turn enhance the Group's competitiveness in the ever-changing market.