

MANAGEMENT DISCUSSION AND ANALYSIS

The financial data below are extracted from the Group's audited financial statements prepared in accordance with HKFRSs. The following discussion and analysis should be read in conjunction with the Group's financial statements audited by Ernst & Young and the accompanying notes as set out in this annual report.

FINANCIAL DATA

Unit: RMB in millions

	2006	2005
Revenue		
Wireless communications	9,186.9	8,930.8
Wireline switch and access	2,279.4	2,752.6
Optical and data communications	3,874.7	3,353.0
Handset	4,519.5	4,333.1
Telecommunications software systems, services and other products	3,171.2	2,206.4
Total revenue	23,031.7	21,575.9
Cost of sales	(15,250.5)	(14,101.7)
Gross profit	7,781.2	7,474.2
Other revenue and gains	792.1	681.6
Research and development costs	(2,832.7)	(1,959.5)
Selling and distribution costs	(3,274.6)	(3,186.4)
Administrative expenses	(1,097.6)	(1,095.4)
Other expenses	(191.5)	(128.6)
PROFIT FROM OPERATING ACTIVITIES	1,176.9	1,785.9
Finance costs	(153.7)	(175.9)
Share of profits and losses of jointly-controlled entities and associates	7.5	(4.2)
PROFIT BEFORE TAX	1,030.7	1,605.8
Tax	(127.1)	(179.8)
PROFIT BEFORE MINORITY INTERESTS	903.6	1,426.0
Attributable to:		
Minority interests	(136.6)	(138.3)
Equity holders of the parent	767.0	1,287.7
Dividends	143.9	239.9
Earnings per share — basic	RMB0.80	RMB1.34
Earnings per share — diluted	RMB0.80	N/A

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REVENUE ANALYSED BY PRODUCT AND GEOGRAPHIC REGION

The following table sets out the revenue and the corresponding percentage of the total revenue attributable to the major product segments of the Group for the periods indicated:

Unit: RMB in millions

Product segment	2006		2005	
	Revenue	Percentage of total revenue	Revenue	Percentage of total revenue
Wireless communications	9,186.9	39.9%	8,930.8	41.4%
Wireline switch and access	2,279.4	9.9%	2,752.6	12.8%
Optical and data communications	3,874.7	16.8%	3,353.0	15.5%
Handset	4,519.5	19.6%	4,333.1	20.1%
Telecommunications software systems, services and other products	3,171.2	13.8%	2,206.4	10.2%
Total	23,031.7	100.0%	21,575.9	100.0%

The following table sets out the Group's revenue generated from sales in the PRC, Asia (excluding the PRC), Africa and other regions and the corresponding percentage of total revenue for the periods indicated:

Unit: RMB in millions

Region	2006		2005	
	Revenue	Percentage of total revenue	Revenue	Percentage of total revenue
The PRC	12,801.8	55.6%	13,874.3	64.3%
Asia (excluding the PRC)	5,753.7	25.0%	4,568.7	21.2%
Africa	2,563.2	11.1%	2,835.4	13.1%
Other regions	1,913.0	8.3%	297.5	1.4%
Total	23,031.7	100.0%	21,575.9	100.0%

The Group's revenue in 2006 increased by 6.7% to RMB23,031.7 million, as compared to RMB21,575.9 million in 2005. The increase was mainly attributable to growth in revenue from the wireless communications segment, the optical and data communications segment, the handset segment, the telecommunications software systems, and the services and other products segment, which was partially offset by the decrease in revenue from sales of wireline switch and access products. The Group's international business confirmed to have rapid growth in 2006 with sales revenue rising by 32.8% to RMB10,229.9 million as compared to RMB7,701.6 million in 2005, although the growth was partially offset by the decline in domestic sales revenue due to a decrease in capital expenditure of domestic carriers who adjusted their investment structure.

The Group's revenue from the wireless communications business slightly increased by 2.9% to RMB9,186.9 million in 2006, as compared to RMB8,930.8 million in 2005. The increase was mainly attributable to solid increases in the international sales of GSM systems, partially offset by the declining PHS revenue resulting from declining investments in PHS network construction by domestic carriers.

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The Group's revenue from the wireline switch and access segment decreased by 17.2% to RMB2,279.4 million in 2006, as compared to RMB2,752.6 million in 2005. The setback was mainly attributable to the decline in sales revenue from both overseas and domestic markets.

The Group's revenue from the optical and data communications segment increased by 15.6% to RMB3,874.7 million in 2006, as compared to RMB3,353.0 million in 2005, mainly due to growth of domestic sales revenue for the optical and data communication segment, partially offset by the decline in international sales revenue.

The Group's revenue from the handsets business amounted RMB4,519.5 million in 2006, representing a 4.3% increase from RMB4,333.1 million in 2005. The increase was mainly attributable to the growth in revenue generated from the sales of 3G and CDMA handsets, although this was partially offset by reduced sales of the Group's GSM and PHS handsets.

The Group's revenue from the telecommunications software systems, services and other products segment increased by 43.7% to RMB3,171.2 million in 2006, as compared to RMB2,206.4 million in 2005, benefiting mainly from stronger sales in video communication products, terminal products and overseas telecommunications services.

COST OF SALES AND GROSS PROFIT ANALYSED BY PRODUCT

The following tables set out (1) the cost of sales and cost of sales as a percentage of the total revenue and (2) the Group's gross profit and gross profit margin for the periods indicated:

Unit: RMB in millions

Product segment	2006		2005	
	Cost of Sales	Percentage of product segment revenue	Cost of Sales	Percentage of product segment revenue
Wireless communications	5,276.6	57.4%	5,021.6	56.2%
Wireline switch and access	1,361.5	59.7%	1,260.9	45.8%
Optical and data communications	2,959.8	76.4%	2,697.7	80.5%
Handset	3,364.5	74.4%	3,575.0	82.5%
Telecommunications software systems, services and other products	2,288.1	72.2%	1,546.5	70.1%
Total	15,250.5	66.2%	14,101.7	65.4%

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Unit: RMB in millions

Product segment	2006		2005	
	Gross profit	Gross profit margin	Gross profit	Gross profit margin
Wireless communications	3,910.3	42.6%	3,909.2	43.8%
Wireline switch and access	917.9	40.3%	1,491.7	54.2%
Optical and data communications	914.9	23.6%	655.3	19.5%
Handset	1,155.0	25.6%	758.1	17.5%
Telecommunications software systems, services and other products	883.1	27.8%	659.9	29.9%
Total	7,781.2	33.8%	7,474.2	34.6%

The Group's gross profit rose to RMB7,781.2 million in 2006 from RMB7,474.2 million in 2005, although its gross profit margin for 2006 dropped slightly to 33.8% from 34.6% in 2005 due primarily to the decrease in the gross profit margin of wireless communication products, wireline switch and access products and telecommunications software systems, services and other products, which was offset by improved gross profit margin for handsets and optical and data communications products.

Gross profit margin of the Group's wireless communications business dropped to 42.6% in 2006 from 43.8% in 2005 mainly as a result of declined gross profit margin for CDMA systems, partially offset by improved gross profit margin for PHS systems and GSM systems.

Gross profit margin in the Group's wireline switch and access segment dropped to 40.3% in 2006 from 54.2% in 2005 as a result of lower prices for the segment in line with shrinking market demand.

Gross profit margin in the Group's optical and data communications business rose to 23.6% in 2006 from 19.5% in 2005, mainly due to improved gross profit margin for DSL products, routers, router switches and other data communications products.

Gross profit margin in the Group's handsets segment rose to 25.6% in 2006 from 17.5% in 2005 in tandem with rising gross profit margin for 3G and PHS handsets. International sales of 3G handsets increased further as the Group made further inroads in the international market. Gross profit margin for PHS handsets improved despite decreased in sales in 2006 as compared to 2005 owing to reduced investments by carriers, due to effective cost reductions resulting from ongoing upgrades in technology and production processes. In addition, the gross profit margin of CDMA handsets and GSM handsets also enjoyed slight improvement in tandem with reduced production costs.

Gross profit margin in the Group's telecommunications software systems, services and other products segment decreased to 27.8% in 2006 from 29.9% in 2005. The decrease was mainly attributable to increase in the sales of low-margin items such as video communication products and network terminal products which resulted in lower gross profit margin for the segment.

Other Revenue and Gains

Other revenue and gains of the Group increased by 16.2% to RMB792.1 million in 2006 from RMB681.6 million in 2005. The increase was mainly attributable to the increase in VAT rebate income.

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Research and Development Costs

The Group's research and development costs increased by 44.6% to RMB2,832.7 million in 2006 from RMB1,959.5 million in 2005, mainly attributable to increased R&D investment in customised products for overseas strategic markets and advanced technologies such as 3G, WIMAX and IMS. The increase was also due to the capitalisation of certain development expenses in 2005. Research and development costs accounted for 12.3% of the revenue from principal operations in 2006, as compared to 9.1% in 2005.

Selling and Distribution Costs

The Group's selling and distribution costs in 2006 amounted to RMB3,274.6 million, representing a 2.8% increase as compared to RMB3,186.4 million in 2005. Selling and distribution costs accounted for 14.2% of revenue from principal operations in 2006, as compared to 14.8% in 2005.

Administrative Expenses

The Group's administrative expenses in 2006 amounted to RMB1,097.6 million, representing a 0.2% increase from RMB1,095.4 million in 2005, although administrative expenses accounted for 4.8% of revenue from principal operations in 2006, as compared to 5.1% in 2005.

Other Expenses

Other expenses of the Group increased by 48.9% to RMB191.5 million in 2006 from RMB128.6 million in 2005. The increase mainly reflected increase in the bad debt provision which was partially offset by the decrease in exchange losses and goodwill impairment.

Profit from Operating Activities

The Group's profit from operating activities decreased by 34.1% from RMB1,785.9 million in 2005 to RMB1,176.9 million in 2006, while the profit margin from operating activities dropped to 5.1% in 2006 from 8.3% in 2005, which was mainly attributable to the increase in research and development costs, selling and distribution costs and other expenses.

Finance Costs

The Group's finance costs decreased by 12.6% to RMB153.7 million in 2006 from RMB175.9 million in 2005, mainly as a result of reduction in expenses in line with decreased in factoring of accounts receivable of the Group. The decrease was partially offset by higher financing costs caused by increased interest-bearing bank loans.

Tax

The Group's tax expenses decreased by 29.3% to RMB127.1 million in 2006 from RMB179.8 million in 2005 and its effective tax rate increased to 12.3% in 2006 from 11.2% in 2005, mainly attributable to the increase in effective tax liabilities of certain subsidiaries of the Group.

Minority Interests

The Group's minority interests in 2006 decreased by 1.2% to RMB136.6 million from RMB138.3 million in 2005. Minority interests as a percentage of profit before minority interests increased to 15.1% in 2006 from 9.7% in 2005, mainly as a result of increase in contribution to the Group's profit from subsidiaries in which minority shareholders of the Group had larger shareholdings.

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Gearing Ratio and the Basis of Calculation

The Group's gearing ratio for 2006 was 18.8%, which is an increase of 12.8 percentage points from 6.0% in 2005, mainly attributable to the increase in interest-bearing loans. The gearing ratio represented total interest-bearing loans as a percentage of the total capital.

Liquidity and Capital Resources

In 2006, the Group's development funds were financed mainly by the proceeds from cash generated from its operations and bank loans. The Group's cash requirements related primarily to production and operating activities, repayment of due liabilities, capital expenditure, interest and dividend payments and other unforeseeable cash requirements.

Cash and cash equivalents of the Group as of 31 December 2006 amounted to RMB4,142.1 million.

CASH FLOW DATA

Unit: RMB in millions

	2006	2005
Net cash outflow from operating activities	(2,106.3)	(285.9)
Net cash outflow from investing activities	(1,115.2)	(1,067.3)
Net cash inflow/(outflow) from financing activities	1,975.6	(735.0)
Net decrease in cash and cash equivalents	(1,245.9)	(2,088.2)
Cash and cash equivalents at the end of the year	4,142.1	5,397.2

Operating Activities

Net cash outflow from the Group's operating activities amounted to RMB2,106.3 million in 2006 as compared to net cash outflow of RMB285.9 million in 2005, consisting mainly of an increase of RMB2,412.9 million in trade and bills receivables (including approximately RMB2,273.4 million due in less than six months) and an increase in contract receivable of RMB1,144.3 million as telecommunications system construction project works were completed ahead of progress bill payments as a result of more favourable business terms offered by the Group to customers. Operating profit before working capital changes decreased from RMB2,222.9 million in 2005 to RMB1,863.1 million in 2006 because of an increase in research and development expenses and selling and distribution costs during the year. The aforesaid reduction in cash was partially offset by an increase in trade and bills payables due to delay in payment resulting from higher credit limit granted to the Group by its suppliers. Prepayments and other receivables increased by RMB309.5 million owing to an external loan granted by the Group in 2006. In 2006, the Group's receivables turnover rate was 3.7 as compared to 4.0 in 2005. Inventory turnover rate was 6.5 as compared to 7.1 in 2005. Payables turnover rate was 2.3 as compared to 2.7 in 2005.

Investing Activities

Net cash outflow from the Group's investing activities in 2006 amounted to RMB1,115.2 million, as compared to net cash outflow of RMB1,067.3 million in 2005. The cash outlay in 2006 was mainly used in business and production expansion, comprising RMB1,135.7 million for the purchase of machinery and equipment, testing instruments, computers and replacements of and additions to office equipment and RMB43.9 million for the purchase of software and other intangible assets.

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Financing Activities

Net cash inflow from the Group's financing activities in 2006 amounted to RMB1,975.6 million, as compared to net cash outflow of RMB735.0 million in 2005, representing mainly new loans amounting to RMB1,945.3 million.

Capital Expenditure

The following table sets out the Group's capital expenditure for the periods indicated. The following capital expenditure was funded out of the proceeds of the Company's initial public offering of H shares, long-term bank loans, cash generated from operating activities and government grants.

Unit: RMB in millions

Capital expenditure	2006	2005
Purchases of fixed assets and additions to construction in progress	1,135.7	803.8

The Group's capital expenditure in 2006 amounting to RMB1,135.7 million was mainly used to complete the construction of the ZTE research and development center in Shenzhen and purchase other equipment and facilities.

INDEBTEDNESS

Unit: RMB in millions

	At 31 December 2006	2005
Secured bank loans	394.7	47.7
Unsecured bank loans	2,230.3	632.0

Unit: RMB in millions

	At 31 December 2006	2005
Short-term bank loans	945.7	599.7
Long-term bank loans	1,679.3	80.0

Credit facilities available to the Group included long-term and short-term bank loans, which were mainly used as working capital. Within the Group's long-term loans, RMB loans were subject to fixed interest rates while USD loans were subject to floating interest rates. To control the risk associated with RMB appreciation, the Group's borrowings were mainly denominated in USD, apart from certain RMB loans.

The Group's bank loans in 2006 increased as a result of reduction in factoring of accounts receivable and the borrowing of bank loans to provide additional working capital.

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CONTRACTUAL OBLIGATIONS

Unit: RMB in millions

	As at 31 December 2006			
	Total	Less than one year	Two to five years	More than five years
Bank loans	2,625.0	945.7	1,409.5	269.8
Operating lease obligations	201.4	118.3	81.5	1.6

CONTINGENT LIABILITIES

Unit: RMB in millions

	As at 31 December	
	2006	2005
Factored trade receivables	107.2	438.5
Guarantees given to banks in respect of performance bonds	5,200.6	2,823.8
Total	5,307.8	3,262.3

CAPITAL COMMITMENTS

The Group had the following capital commitments as of the dates indicated:

Unit: RMB in millions

	As at 31 December	
	2006	2005
Land and buildings		
Contracted, but not provided for	796.0	231.6
Investment in associates		
Contracted, but not provided for	80.3	21.1

Details of the Subsidiaries, Jointly-controlled Entities and Associates of the Group

Details of the subsidiaries, jointly-controlled entities and associates of the Group as at 31 December 2006 are set out in notes 18, 19 and 20 to the financial statements prepared in accordance with HKFRSs.

Prospects for New Business

Details of the prospects for new business of the Group are set out in the section headed "Chairman's Statement" in the Annual Report.

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Employees

Details of the number of employees, remuneration, remuneration policy, bonus and training programs of the Group as at 31 December 2006 are set out in the sections headed “Directors, Supervisors, Senior Management and Employees” and “Corporate Governance Structure” in the Annual Report.

Charges on Assets

Details of charges on the Group’s assets as at 31 December 2006 are set out in note 32 to the financial statements prepared under HKFRSs.

Plans for Significant Investments or Acquisition of Capital Assets

Details of the Group’s significant investments and their performance and prospects as at 31 December 2006 are set out in the section headed “Report of the Board of Directors” in the Annual Report.

Details of plans for significant investments or acquisition of capital assets are set out in the section headed “Report of the Board of Directors” in the Annual Report.

Market Risks

Interest rate risks:

The interest rate risk of the Group was mainly associated with the Company’s interest bearing long-term liabilities. The Group controlled its interest rate risk mainly by rescheduling the maturity period of its debts.

Foreign exchange risks:

The foreign exchange risk of the Group arose mainly from exchange differences in the conversion to RMB (the functional currency of the Group) of sales and purchases settled in currencies other than RMB. The Group attempts to include terms relating to exchange risk avoidance or allocation when entering into purchase and sales contracts. The Group endeavoured to enhance its internal management standards and actively managed its foreign exchange position. Matching of currencies and amounts received or incurred was conducted. Where matching was not practicable, derivative products such as foreign exchange forward contracts were employed to lock up exchange rates in varying proportions based on the maturity periods of the outstanding foreign exchange positions, so as to minimise the impact of exchange rate fluctuations on the principal business of the Group. With a strong emphasis on the research of exchange risk management policies, models and strategies, the Group has formulated a foreign exchange risk management policy that takes into account the business characteristics of the Company and international standards in risk management with ongoing improvements, and has gained considerable experience in exercising exchange risk management through the extensive use of exchange-related derivative products.