Business Review

"During 2006, our wafers shipped and sales increased from 1,347,302 8-inch wafers and US$1.2 billion in 2005 to 1,614,888 8-inch wafers and US$1.5 billion in 2006, representing a 20.2% and 25.1% increase, respectively."

In 2006, SMIC continued to grow its business despite a slowdown in the semiconductor industry in the early part of the year, thereby affirming SMIC's business strategy.

Overview of Business Developments

Our operations continue to remain strong. At the end of 2006, we had increased our monthly capacity to 182,250 8-inch wafers per month. During 2006, our wafers shipped and sales increased from 1,347,302 8-inch wafers and US$1.2 billion in 2005 to 1,614,888 8-inch wafers and US$1.5 billion in 2006, representing a 20.2% and 25.1% increase, respectively. According to a leading IC industry market research company, we held 7% of the foundry market in 2006, which represents a growth rate of approximately 24%, one of the highest growth rate among the top 10 foundries.

We generated US$769.6 million in cash from operations in 2006 which represents a 18.8% increase from 2005. However, our depreciation expenses remain among the highest in the foundry industry. Furthermore, because we are a new foundry with only five years of commercial operations and continued to expand our capacity to meet the increasing capacity demands of our customers, our depreciation expense as a percentage of revenues remain one of the highest in the foundry industry.

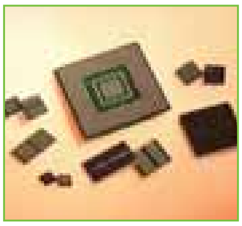
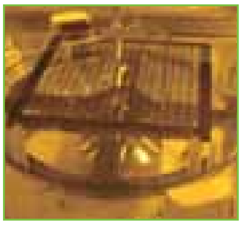
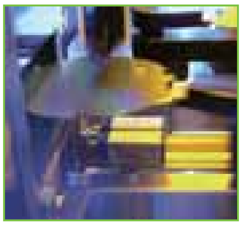
Despite these high depreciation expenses, we believe that we will become profitable by improving our product mix, thereby increasing our average selling price. In 2006, 49.6% of our wafer sales were from products that utilized advanced technology of 0.13 micron and below. Revenues generated from 0.13 micron and below technology nodes as a percentage of our logic revenues increased from 23.4% in 2005 to 26.8% in 2006. We expect that this upward trend will continue for the rest of 2007 as some of our fabless and IDM customers are migrating a significant portion of their products to the 0.13 micron and below technology nodes.

Customers and Markets

We target a diversified and global customer base, consisting of leading IDMs, fabless semiconductor companies, and systems and other companies and seek to maintain our leadership position in China.

Overall in 2006, we engaged 73 new customers, bringing the total number of our customers to 330. For 2006, our revenue by region was led by North America at 41.3%, then Europe at 30.0%, then Asia Pacific (excluding Japan) at 21.9%, and Japan at 6.8%. These customers participate in the consumer, communications or computer market segments. We intend to maintain a diversified customer mix in terms of end-market applications, processes, and geographical focus in order to manage our exposure to each market segment.



We seek to maintain our leadership position in the semiconductor industry in China by exploiting our first mover advantage to capture the growing China IC industry. According to Semico, semiconductor marketing and consulting research company. China's IC consumption has registered a compound annual growth rate of 33% since 2000, and reached US$58.4 billion in IC consumption in 2006. IC Insights, a provider of market research and analysis reports and services for the semiconductor industry, expects that by 2010, China's IC market is projected to more than triple and estimated to reach US$124 billion in terms of overall consumption. The main types of products driving this demand relate to communication ICs (i.e., 3G) and smart phones, digital television, MP3, wireless LAN, CPU and DSP.

At the same time, the gap between the domestic demand for integrated circuits in China and the domestic supply continues to increase. At present, China's domestic manufacturers can only meet less than 7% of its IC demand, representing a gap between domestic supply and demand, of almost US$38 billion. IC Insights expects that this gap will increase to almost US$112 billion by 2010.

We believe that by establishing our company as a key foundry partner to local semiconductor companies at an early stage of their development, we will be well positioned to take advantage of the potential semiconductor growth in China. In 2006, our Mainland Chinese customers represented an area of growth as we engaged 43 new customers. Among the new products we manufactured for these companies include the first 3G baseband chips for TD-SCDMA and WCDMA, mobile phone application processor, digital satellite receiver chip for set-top box, China-standard (CDMB-T/H) digital terrestrial receiver chip for TV and PCTV, video processor for HDTV and MP3/MP4 multimedia consumer electronics. We expect that the percentage of revenue from our Mainland Chinese customers will increase in 2007 as more of these customers commence commercial production. We are also working closely with our customers to migrate their products to more advanced technology nodes in order for the customers to reap benefits of economies of scale at these technology nodes.

We generate our sales primarily from fabricating semiconductors. We also derive a relatively small portion of our sales from the mask-making and wafer probing services that we perform for third parties separately from our foundry services.

Capacity Expansion Plans

We intend to maintain our strategy of expanding capacity and improving our process technology to meet both the capacity requirements and the technological needs of our customers. In 2006, our capital expenditures were approximately US$889.9 million and we recorded depreciation and amortization costs of US$896.1 million. We currently expect that our capital expenditures in 2007 will be approximately US$720 million.

We plan to use this capital expenditure mainly to ramp up our fabs in Beijing, Shanghai, and Tianjin. We are scheduling that by the end of 2007, our monthly capacity will be 193,000 8-inch wafer equivalents. In addition, we have entered into management contracts to provide management services to wafer fabs in Chengdu and Wuhan.

Research and Development

The semiconductor industry is characterized by rapid changes in technology, frequently resulting in obsolescence of process technologies and products. As a result, our research and development efforts are essential to our overall success. We spent approximately US$94.1 million in 2006 on research and development expenses, which represented 6.4% of our sales. We employ over 500 research and development personnel, combining experienced semiconductor engineers with advanced degrees from leading universities around the world with top graduates from the leading universities in China. We believe this combination has enabled us to quickly bring our technology in line with the semiconductor industry roadmap and ensures that we will have skilled personnel to lead our technology advancement in the future. We are also developing our 65 nanometer technology with one of the top fabless companies in the world.

Joint Ventures

We have established numerous joint ventures in order to expand our service offerings to our customers. In July 2004, we entered into an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd. Toppan SMIC Electronics (Shanghai) Co. Ltd. is a joint venture in Shanghai for the manufacture of on-chip filters and micro-lenses for image sensors and began mass production in January of 2006.

Our assembly and testing facility in Chengdu, China with United Test and Assembly Center Ltd. began pilot production in the fourth quarter of 2005. We have begun to provide full-turn-key services in 2006, and will continue ramping up in 2007.

We also planned to invest in a wafer reclamation project in Shanghai to produce solar power modules. One of the keys to this wafer reclamation project will be the supply of polysilicon. We are currently discussing the possibility of establishing a facility to manufacture polysilicon to meet the needs of our solar power project as well as the needs of other solar power companies.

Material Litigation

Overview of TSMC Litigation:

Beginning in December 2003 through August 2004, the Company became subject to several lawsuits brought by Taiwan Semiconductor Manufacturing Company, Limited (“TSMC”) relating to alleged infringement of certain patents and misappropriation of alleged trade secrets relating to methods for conducting semiconductor fab operations and manufacturing integrated circuits.

On January 31, 2005, the Company entered into a settlement agreement, without admission of liability, which provided for the dismissal of all pending legal actions without prejudice between the two companies (the “Settlement Agreement”). The terms of the Settlement Agreement also included:

- The Company and TSMC agreed to cross-license each other’s patent portfolio for all semiconductor device products, effective from January 2005 through December 2010.

- TSMC covenanted not to sue the Company for trade secret misappropriation as alleged in TSMC's legal actions as it related to 0.15μm and larger processes subject to certain conditions ("TSMC Covenant"). The TSMC Covenant did not cover 0.13μm and smaller technologies after 6 months following execution of the Settlement Agreement (July, 31, 2005). Excluding the 0.13μm and smaller technologies, the TSMC Covenant remains in effect indefinitely, terminable upon a breach by the Company.

- The Company is required to deposit certain Company materials relating to 0.13μm and smaller technologies into an escrow account until December 31, 2006 or under certain circumstances for a longer period of time.

- The Company agreed to pay TSMC an aggregate of $175 million in installments of $30 million for each of the first five years and $25 million in the sixth year.

Accounting under the Settlement Agreement:

Restatement of 2004 and 2005 Financials

As a result of review of the accounting treatment for the Settlement Agreement, the Company determined that errors were made in the identification and classification of the components of payment. The Company previously recorded $23.2 million of the settlement amount as an expense in 2004 and $134.8 million of intangible assets associated with the patent license portfolio and covenant not to sue. The Company determined that the payment was made solely for the right to use the licensed patent license portfolio both prior and subsequent to the settlement date.

This determination impacted the allocation of the settlement amount to its various components, which resulted in the Company decreasing the amount of expense recognized in its 2004 financial statements from $23.2 million to $16.7 million in 2004 and increasing a deferred cost associated with patent license portfolio from $134.8 million to $141.3 million. This correction also impacted the amount of expense recorded in periods subsequent to the settlement date given the higher asset value being recorded and the shorter amortization period of the patent license portfolio as compared to the covenant not to sue.

In addition, the Company corrected the classification of the payment for the patent license portfolio from an intangible asset to a deferred cost and has also reclassified the amortization of the deferred asset from amortization of intangible to a component of cost of sales.

See Note 31 to Notes to the Consolidated Financial Statements included with this Annual Report for a more detailed description of the impact of the effects of correcting these errors. See also the section titled "Current Accounting" below for a description of the accounting treatment for the Settlement Agreement set forth in the Company's financial statements that are included with this Annual Report.

Current Accounting

In accounting for the Settlement Agreement, the Company determined that there were several components of the Settlement Agreement – settlement of litigation, covenant not to sue, patents licensed by us to TSMC and the use of TSMC's patent license portfolio both prior and subsequent to the settlement date.

The Company does not believe that the settlement of litigation, covenant not to sue or patents licensed by us to TSMC qualify as accounting elements. In regard to the settlement of litigation, the Company cites the following:

- The settlement agreement reached between TSMC and SMIC clearly stated that there was no admission of liability by either party;

- The settlement agreement required all parties to bear their own legal costs;

- There were no other damages associated with the Settlement Agreement;

- There was a provision in the Settlement Agreement for a grace period to resolve any misappropriation issues had they existed;

- Albeit a complaint had been filed by TSMC on trade secret infringement, TSMC has never identified which trade secrets it claimed were being infringed upon by the Company;

- The Settlement Agreement was concluded when the litigation process was still at a relatively early stage and the outcome of the litigation was therefore highly uncertain.

The TSMC covenant not to sue for alleged trade secrets misappropriation does not qualify as a separable asset in accordance with either SFAS 141 or SFAS 142 as TSMC had never specified the exact trade secrets that it claimed were misappropriated, the Company's belief that TSMC's trade secrets may be obtained within the marketplace by other legal means and the Company never obtained the legal right to use TSMC's trade secrets.

In addition, the Company did not attribute any value to the patents licensed to TSMC under the Settlement Agreement due to the limited number of patents held by the Company at the time of the Settlement Agreement.

As a result, the Company determined that only the use of TSMC's patent license portfolio prior and subsequent to the settlement date were considered elements of an arrangement for accounting purposes. In attributing value to these two elements, the Company first discounted the payment terms of the US$175 million settlement amount using an annual 3.4464% interest rate to arrive at a net present value of US$158 million. This amount was then allocated to the pre-and post-settlement periods based on relative fair value, as further described below.

Based on this approach, US$16.7 million was allocated to the pre-settlement period, reflecting the amount that the Company would have paid for use of the patent license portfolio prior to the date of the Settlement Agreement. The remaining US$141.3 million, representing the relative fair value of the licensed patent license portfolio, was recorded on the Company's consolidated balance sheets as a deferred cost and is being amortized over a six-year period, which represents the life of the licensed patent license portfolio. The amortization of the deferred cost is included as a component of cost of sales in the consolidated statements of operations.

Valuation of Deferred Cost:

The fair value of the patent license portfolio was calculated by applying the estimated royalty rate to the specific revenue generated and expected to be generated from the specific products associated with the patent license portfolio.

The selected royalty rate was based on the review of median and mean royalty rates for the following categories of licensing arrangements:

a) Existing third-party license agreements with SMIC;

b) The analysis of comparable industry royalty rates related to semiconductor chip/integrated circuit ("IC") related technology; and

c) The analysis of comparable industry royalty rates related to semiconductor fabrication.

On an annualized basis, the amounts allocated to past periods was lower than that allocated to future periods as the Company assumed increases in revenues relating to the specific products associated with the patent license portfolio.

As the total estimated fair value of the patent license portfolio exceeded the present value of the settlement amount, the Company allocated the present value of the settlement amount based on the relative fair value of the amounts calculated prior and subsequent to the settlement date.

Recent TSMC Legal Developments:
On August 25, 2006, TSMC filed a lawsuit against the Company and certain subsidiaries (SMIC (Shanghai), SMIC (Beijing) and SMIC (Americas) in the Superior Court of the State of California, County of Alameda for alleged breach of the Settlement Agreement, alleged breach of promissory notes and alleged trade secret misappropriation by the Company. TSMC seeks, among other things, damages, injunctive relief, attorneys' fees, and the acceleration of the remaining payments outstanding under the Settlement Agreement.

In the present litigation, TSMC alleges that the Company has incorporated TSMC trade secrets in the manufacture of the Company's 0.13 micron or smaller process products. TSMC further alleges that as a result of this claimed breach, TSMC's patent license is terminated and the covenant not to sue is no longer in effect with respect to the Company's larger process products.

The Company has vigorously denied all allegations of misappropriation. Moreover, TSMC has not yet proven, nor produced evidence of, any misappropriation by the Company. At present, the claims rest as unproven allegations, denied by the Company. The Court has made no finding that TSMC's claims are valid, nor has it set a trial date.

On September 13, 2006, the Company announced that in addition to filing a response strongly denying the allegations of TSMC in the United States lawsuit, it filed on September 12, 2006, a cross-complaint against TSMC seeking, among other things, damages for TSMC's breach of contract and breach of implied covenant of good faith and fair dealing.

On November 16, 2006, the High Court in Beijing, the People's Republic of China, accepted the filing of a complaint by the Company and its wholly-owned subsidiaries, SMIC (Shanghai) and SMIC (Beijing), regarding the unfair competition arising from the breach of bona fide (i.e. integrity, good faith) principle and commercial defamation by TSMC ("PRC Complaint"). In the PRC Complaint, the Company is seeking, among other things, an injunction to stop TSMC's infringing acts, public apology from TSMC to the Company and compensation from TSMC to the Company, including profits gained by TSMC from their infringing acts.

Under the provisions of SFAS 144, the Company is required to make a determination as to whether or not this pending litigation represents an event that requires a further analysis of whether the patent license portfolio has been impaired. We believe that the lawsuit is at a very early stage and we are still evaluating whether or not the litigation represents such an event. The Company expects further information to become available to us which will aid us in making a determination. The outcome of any impairment analysis performed under SFAS 144 might result in a material impact to our financial position and results of operations.

Outlook for 2007

Our main focus in 2007 will be to expand our technology offerings and wafer capacity in a fiscally disciplined manner. Continuous improvement in performance and yield enables expansion of our product mixture in more advanced nodes of 90 nanometer and finer line technologies. Our capital expenditure target for 2007 of approximately US$720 million is based on anticipated customer demand for our services this year and beyond.