

# Management Discussion and Analysis

## Financial Results Overview

During the year, revenue of the Group amounted to approximately RMB48,264 million, representing an increase of approximately RMB6,529 million, or 15.6%, when compared with approximately RMB41,735 million of 2005. The profit of the Group attributable to shareholders amounted to approximately RMB2,081 million for the year, representing an increase of approximately RMB480 million, or 30.0%, when compared with approximately RMB1,601 million of 2005. Earnings per share was approximately RMB24.15 cents.

In 2006, after excluding the one-time expenses of approximately RMB252 million arising from the share reform schemes for Dongfeng Automobile Co., Ltd and Dongfeng Electronics Technology Co., Ltd., whose shares are listed on the A-share market in Mainland China, the adjusted profit of the Group attributable to shareholders amounted to approximately RMB2,333 million, representing an increase of approximately RMB732 million, or 45.7%, over 2005. In 2006, the adjusted earnings per share was RMB27.07 cents.

## Revenue

During the year, the total revenue of the Group amounted to approximately RMB48,264 million, representing an increase of approximately RMB6,529 million, or 15.6%, when compared with the figure in 2005 of approximately RMB41,735 million.

	2006		2005	
	Revenue from sales RMB million	Units sold	Revenue from sales RMB million	Units sold
<b>Passenger vehicles:</b>	<b>34,219</b>	<b>N/A</b>	27,915	N/A
Whole vehicles	<b>27,014</b>	<b>494,846</b>	21,798	351,219
External sales of engines and parts	<b>7,205</b>	<b>N/A</b>	6,117	N/A
<b>Commercial vehicles:</b>	<b>13,215</b>	<b>N/A</b>	12,989	N/A
Whole vehicles	<b>11,471</b>	<b>256,242</b>	11,193	243,582
External sales of engines and parts	<b>1,744</b>	<b>N/A</b>	1,796	N/A
<b>Others</b>	<b>830</b>	<b>N/A</b>	831	N/A
<b>Total</b>	<b>48,264</b>	<b>N/A</b>	41,735	N/A

Note: It should be noted that the revenue figures in the above table reflected the proportionate consolidated revenue of the Group. However, the related figures of the units of vehicles sold by the Group in the above table represented the actual units sold by the Dongfeng Motor Group, not adjusted on a proportionate consolidation basis, for the indicated periods.

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During the year, revenue of the Group from sales of passenger vehicles increased by approximately RMB6,304 million, or 22.6%, from approximately RMB27,915 million in 2005 to approximately RMB34,219 million. Of which, revenue from sales of whole passenger vehicles increased by approximately RMB5,216 million, or 23.9%, from approximately RMB21,798 million in 2005 to approximately RMB27,014 million. Despite oil price hikes, increase in consumption tax and auto price decline for intensifying market competition during the year, the revenue from sales of passenger vehicles recorded a significant increase of 23.9%. That was mainly attributable to a significant increase in the sales volume of vehicles. During the year, the total sales volume of whole passenger vehicles increased by 40.9% to 494,846 units from 351,219 units in 2005, higher than the industry growth rate of 30.0% for passenger vehicles. The market share in terms of sales volume of the Dongfeng Motor Group for the year increased to approximately 9.6% from approximately 8.8% in 2005. The newly released Peugeot 206, C-Triomphe, Civic, Sylphy, Geniss and C2 in 2006 gained wide acceptance in the market with encouraging sales performance. Meanwhile, the sales of various existing passenger vehicle series had not been affected by the above new model launches and remained encouraging during the year. During the year, because of the diversification of the product mix, the whole passenger vehicles of the Dongfeng Motor Group successfully extended its market share in high and medium as well as small passenger vehicles. The change of the product mix of the whole passenger vehicles (with gross profit margin of the Group increased to 17.9% from 14.5% in 2005) drove the revenue of the Group from sales of whole passenger vehicles to increase by approximately 23.9%.

Revenue of the Group from the sale of passenger vehicle engines and other auto parts increased by approximately 17.8% to RMB7,205 million for the year from RMB6,117 million in 2005. This overall increase in revenue of passenger vehicle engines and other auto parts was primarily due to the steady growth trend in the sales volume brought about by the enhancement in the engines of Dongfeng Honda Engine Co., Ltd.

During the year, the sales volume of commercial vehicles of the Dongfeng Motor Group increased by approximately 5.2%, maintaining its leading position in the domestic commercial vehicles market; revenue of the Group increased by approximately RMB226 million, or 1.7%, from approximately RMB12,989 million in 2005 to approximately RMB13,215 million. Of which, revenue of the Group from sales of whole commercial vehicles increased by approximately RMB278 million from approximately RMB11,193 million in 2005 to approximately RMB11,471 million, increased by approximately 2.5% for the whole year, representing a turnaround from the approximately 15.2% drop in sales volume in the first half of the year. The increase was mainly resulted from a series of promotion activities launched by the Dongfeng Motor Group, bringing about the approximately 24.3% increase in sales volume of whole commercial vehicles of the Dongfeng Motor Group for the second half of the year as compared with the corresponding period in 2005. During the year, sales volume of the Dongfeng Motor Group's heavy trucks decreased from 71,652 units in 2005 to 66,778 units, while the sales volume increased by approximately 12.3% for the second half of the

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year as compared with the corresponding period in 2005. As the newly launched “Kinland” heavy trucks by the Dongfeng Motor Group was going through the adjustment process, its sales volume failed to meet the expected target. During the year, sales volume of medium trucks decreased from 55,883 units in 2005 to 50,426 units, while the sales volume increased by approximately 18.3% for the second half of the year as compared with the corresponding period in 2005. The Dongfeng Motor Group’s sales volume of light trucks during the year increased from 82,569 units in 2005 to 100,761 units, the growth in sales volume for the second half of the year was approximately 34.2% compared with the corresponding period in 2005.

## **COST OF SALES AND GROSS PROFIT MARGIN**

During the year, the total cost of sales of the Group was approximately RMB40,058 million, representing an increase of approximately RMB4,419 million when compared with approximately RMB35,639 million in 2005. The gross profit margin of the Group increased to 17.0% from 14.6% in 2005, primarily because the Group maintained the selling price at a reasonable level through launching various competitive new vehicle models to avoid price decrease, and on the other hand adopted cost reduction measures. The measures included increasing the localization ratio, controlling expenses in the sourcing, technical and management areas, and involving all the staff to cut expenses for the whole production process and the entire value chain, resulting in drop in the unit cost for various vehicle models to different extent. During the year, the gross profit margin of passenger vehicles increased to approximately 18.9% from approximately 15.8% in 2005, and the gross profit margin of whole passenger vehicles increased to approximately 17.9% from approximately 14.5% in 2005.

During the year, the gross profit margin of passenger vehicle engines and other auto parts increased to approximately 22.6% from approximately 20.4% in 2005. The rise in the price of key raw materials such as fuel and aluminum in the PRC during the year led to the increase of material costs to some extent. However, the cost savings resulting from RMB appreciation against Japanese Yen offset the effect of price increase of domestic raw materials. Coupled with the adoption of measures such as increasing the localisation ratio, optimising work processes and reducing costs, the gross profit margin of passenger vehicle engines and other auto parts increased during the year.

During the year, the gross profit margin of the Group’s commercial vehicles increased to approximately 12.0% from approximately 11.3% in 2005, and the gross profit margin of whole commercial vehicles increased to approximately 11.5% from approximately 10.5% in 2005. Under the unfavourable business environment for whole commercial vehicles, the Dongfeng Motor Group adopted a number of measures to boost sales and managed to get the Dongfeng Motor Group’s whole commercial vehicles business back on the track of growth.

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## OTHER INCOME

During the year, the total other income of the Group was approximately RMB736 million, representing a decrease of approximately RMB271 million when compared with approximately RMB1,007 million in 2005. The decrease in other income was mainly attributable to a decrease in grants by RMB293 million received from the government for the purpose of supporting the development of automotive technologies and automobile projects.

## SELLING AND DISTRIBUTION COSTS

During the year, the selling and distribution costs of the Group amounted to approximately RMB2,157 million, representing an increase of approximately RMB419 million when compared with approximately RMB1,738 million in 2005. This was due to higher transportation costs resulting from increased sales volume of vehicles of the Dongfeng Motor Group as well as higher advertising and exhibition costs and market expansion expenses arising from the marketing of several new models.

During the year, the sales and distribution costs of the Group as a percentage of sales revenue increased slightly by approximately 0.3% points to approximately 4.5%, up from approximately 4.2% in 2005, reflecting an effective control over the sales and distribution costs of the Dongfeng Motor Group in spite of an increase in the sale volume of vehicles and the marketing of a number of new models.

## ADMINISTRATIVE EXPENSES

During the year, the total administrative expenses of the Group amounted to approximately RMB2,219 million, representing an increase of approximately RMB291 million when compared with approximately RMB1,928 million in 2005. This was due to the increased business volume. During the year, the administrative expenses of the Group as a percentage of sales revenue remained at the 2005 level of approximately 4.6%, reflecting administrative expenses of the Group under control.

## OTHER EXPENSES

During the year, other expenses of the Group was approximately RMB1,285 million, representing an increase of approximately RMB518 million when compared with approximately RMB767 million in 2005. This was mainly due to (1) research and development costs increased by approximately RMB186 million or 25.9% to approximately RMB905 million from approximately RMB719 million in 2005, as the Dongfeng Motor Group made greater investments in research and development; and (2) the Group recorded an exchange gain of approximately RMB9 million during the year while there was an exchange gain of approximately RMB252 million in 2005. Hence, an increase of

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RMB243 million of other expenses was recorded for the year. The exchange gain recorded in 2005 was due to the weakening of EURO, which was beneficial to the EURO loans of a jointly-controlled entity of the Company.

## LOSS ON DILUTION OF INTERESTS IN JOINTLY-CONTROLLED ENTITIES

During the year, the Group completed share reform schemes for two subsidiaries of a jointly-controlled entity, incurring one-time expenses of approximately RMB252 million. The shareholdings of these two listed companies indirectly held by the Company obtained the tradable right. The details are set out below:

- (1) Dongfeng Automobile Co., Ltd (“DFAC”), a subsidiary of Dongfeng Motor Co., Ltd., a jointly-controlled entity of the Company, approved a share reform scheme in its shareholders’ meeting on 30 October 2006. With the aggregate number of share capital of DFAC (2,000,000,000 shares) remained unchanged, Dongfeng Motor Co., Ltd granted shares to all tradeable shareholders whose names appeared on the register of members at a registration date specified by the share reform scheme according to their respective shareholdings on the basis of offering 3.3 shares for every 10 tradeable shares held. A total of 198,000,000 shares were transferred. The net book value of the consideration shares amounting to approximately RMB234 million attributable to the Group was recorded as an one-time expense.
- (2) Dongfeng Electronics Technology Co., Ltd. (“DFTC”), a subsidiary of Dongfeng Motor Co., Ltd., approved a share reform scheme in its shareholders’ meeting on 20 December 2006. With the aggregate number of share capital of DFTC (313,560,000 shares) remained unchanged, Dongfeng Motor Co., Ltd granted shares to all tradeable shareholders whose names appeared on the register of members at a registration date specified by the share reform scheme according to their respective shareholdings on the basis offering 4 shares for every 10 tradeable shares held. A total of 31,356,000 shares were transferred. The net book value of the consideration shares amounting to approximately RMB18 million attributable to the Group was recorded as an one-time expense.

## STAFF COSTS

During the year, the staff costs of the Group amounted to approximately RMB2,234 million, representing an increase of approximately RMB212 million when compared with approximately RMB2,022 million in 2005. It was because the increase in the sales volume of vehicles brought about a higher demand for labour and a general rise in salaries. In addition, the Group adopted a plan of stock appreciation rights as incentives to its senior management, and the amortised expenses during the year were RMB36 million.

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## DEPRECIATION CHARGES

With a view to expanding its business, the Group made greater investments in properties, plant and equipment. During the year, the Group's depreciation charges amounted to approximately RMB1,479 million, representing an increase of approximately RMB173 million when compared with approximately RMB1,306 million in 2005.

## FINANCE COSTS

During the year, the finance costs of the Group amounted to approximately RMB411 million, representing a decrease of approximately RMB67 million when compared with approximately RMB478 million in 2005. Such a decrease is mainly attributable to the bank loans obtained in 2005 for financing the repurchase of shareholdings held by asset management companies being fully repaid within a month after the listing with the proceeds therefrom.

## INCOME TAX

The income tax expenses of the Group during the year amounted to approximately RMB428 million, representing a decrease of approximately RMB46 million when compared with approximately RMB474 million in 2005. The effective tax rate decreased to 16.0% from 21.3% in 2005. The decrease in income tax expenses was mainly due to the prior year's tax losses of the Company and one of jointly-controlled entities of the Company, which partly offset the income tax payable and the decrease in deferred taxation due to the receipt of dividends from subsidiaries of the Dongfeng Motor Group during the year.

## NET PROFIT

Based on the above reasons, the net profit of the Group increased by approximately RMB480 million or 30.0% to approximately RMB2,081 million from approximately RMB1,601 million in 2005.

In 2006, after excluding the one-time expenses of approximately RMB252 million arising from the share reform schemes for DFAC and DFTC, which their respective shares listed in A share market in Mainland China, the adjusted net profit of the Group amounted to approximately RMB2,333 million, representing an increase of approximately 45.7% over the net profit in 2005.

## DIVIDENDS

The board of directors recommends to distribute a dividend of RMB4 cents per share in respect of the earnings in 2006.

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## LIQUIDITY AND SOURCES OF CAPITAL

The Group raises funds through operations, bank loans and listing of shares to meet its working capital requirements. The funds raised by the Group are mainly used for operating activities, capital expenditure and repayment of short and long term loans.

	<b>2006</b>	2005
	<b>RMB million</b>	RMB million
Net increase in cash flows generated from operating activities	<b>4,561</b>	4,322
Net decrease in cash flows generated from investing activities	<b>(3,930)</b>	(4,269)
Net increase/(decrease) in cash flows generated from financing activities	<b>(558)</b>	1,055
Net increase in cash and cash equivalents	<b>73</b>	1,108

During the year, net cash inflows of the Group from operating activities amounted to approximately RMB4,561 million. This principally represents: (1) profit before tax amounting to approximately RMB2,679 million; (2) an increase of approximately RMB2,488 million in trade receivables, bills receivable and prepayments, deposits and other receivables; (3) an increase of approximately RMB4,027 million in trade, bills and other payables and accrued liabilities; (4) depreciation and impairment of approximately RMB1,531 million; and (5) a decrease of approximately RMB877 million in inventories.

During the year, net cash used in investing activities of the Group amounted to approximately RMB3,930 million. This is mainly attributable to the purchase of property, plant and equipment to the value of approximately RMB2,787 million, generally relating to the expansion of capacity and development of new products. During the year, the above outlays together with an increase of approximately RMB25 million in unsecured time deposits was partly offset by proceeds of approximately RMB87 million from the disposal of obsolete property, plant and equipment.

During the year, net cash outflow from financing activities of the Group amounted to approximately RMB558 million, mainly reflecting the offsetting of borrowings of approximately RMB11,894 million by repayment of borrowings of approximately RMB12,047 million.

During the year, the increase in cash and cash equivalents (excluding the time deposits with original maturity of three months or more) of the Group amounted to approximately RMB73 million. As at 31 December 2006, cash and cash equivalents of the Group amounted to approximately RMB5,659 million, and cash and bank balances (including the time deposits with original maturity of three months or more) amounted to approximately RMB7,437 million.

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As at 31 December 2006, the Group's gearing ratio, measured on the basis of total borrowings as a percentage of total shareholders' equity is approximately 56.0%, representing an improvement from the 2005 level of 66.8%. On 12 December 2006, the Group completed the issue of the first tranche of its short term debentures with an aggregate face value of RMB1,900 million, and the term of maturity was one year. All the proceeds were used to repay the short-term bank borrowings. The successful issue of the short term debentures ear-marked a more diversified capital structure of the Group.

In 2006, the Group's turnover days of inventory was 54 days, which was almost equivalent to 55 days in 2005, reflecting the Dongfeng Motor Group's prudent inventory management.

The Group's turnover days of account receivable (including bills receivable) increased to 56 days from 44 days in 2005, and the turnover days of account receivable (excluding bills receivable) decreased slightly to 12 days from 13 days in 2005, which was mainly due to the Dongfeng Motor Group's strengthening its collection management of account receivable in 2006. The turnover days of bills receivable increased to 44 days from 31 days in 2005, as a result of the Dongfeng Motor Group using promissory notes from trustworthy banks for facilitating transactions. The Dongfeng Motor Group adopts stringent policies for the management of bills receivable and only accepts applications by clients with credibility, while the credit risks related to bank promissory notes are assumed by the clients' banks.