



Directors' Report

The Directors of the Company are pleased to present the Directors' Report and audited financial statements of the Company and the Group for the year ended 31 December 2006.

The Company's Business Activities

The Group is a leading train-borne electrical system provider and integrator in the PRC railway industry. We also engage in developing, manufacturing and selling train power converters, auxiliary power supply equipment and control systems for urban rail systems. Additionally, the Group designs, manufactures and sells electrical components for the PRC railway industry, the urban rail industry and non-railway applications.

There have been no significant changes in the nature of the Group's key operations during the reporting period.

Results and dividends

Results of the Group for the year ended 31 December 2006, prepared in accordance with the IFRSs, are set out on page 37 to page 90 of this annual report.

On 28 November 2006, the Company paid a special dividend of RMB0.23 per share, amounting to RMB167,538,000.

Based on the lower of the Company's net profit calculated under PRC GAAP and IFRSs, the Company has distributable profits (before the proposed final dividend) of RMB89,299,000 as at 31 December 2006. The Board of Directors of the Company proposed distribution of a cash dividend of RMB0.034 per share (including applicable tax) for the year. The dividend to be distributed is subject to approval by shareholders at the Annual General Meeting to be held on 15 June 2007.

The dividends shall be available to shareholders whose names are listed on the register of members at the close of business on 15 May 2007. The Company's share register will be closed from 16 May 2007 to 15 June 2007 (both days inclusive), during which no transfer of shares will be registered.

In respect of distribution of dividends, dividends for Domestic Shares will be distributed and paid in Renminbi, while dividends for H Shares will be declared in Renminbi, but paid in Hong Kong dollars. (The Hong Kong dollars shall be calculated at the average middle rate of Renminbi to Hong Kong dollars announced by the People's Bank of China five work days prior to the dividend declaration date by the Annual General Meeting on 15 June 2007).

Use of proceeds from the Company's initial public offering

The Company issued 414,644,000 H shares (including H shares issued via the exercise of the over-allotment option) in an initial public offering in December 2006. The issue price was HK\$5.30 per share, the proceeds amounted to approximately HK\$2,197,613,000 (equivalent to RMB2,209,968,000). The net proceeds from the initial public offering after deducting share issuing expenses amounted to RMB2,109,852,000. All proceeds were received by the Company by 28 December 2006.

The Company intends to put the the proceeds raised from its initial public offering to the following uses:

- (1) Investment in relation to train power converter, auxiliary power supply equipment and control systems;
- (2) Investment in relation to train operation safety equipment;
- (3) Investment in relation to importation of technology and development of a new generation of railway maintenance vehicles;
- (4) Investment in relation to large size power semi-conductor devices;
- (5) Investment in relation to sensors and related products;
- (6) Other areas, such as investment in the establishment of an export and overseas sales networks and implementation of ERP system; and
- (7) Supplementing working capital.

To the extent that the net proceeds are not immediately applied for the above purposes, it is the intention of the Directors to place such proceeds in interest bearing bank accounts or invest in short-term bonds as permissible under the applicable laws and regulations.

Financial Highlights

Property, plant and equipment

Details of the movements in the property, plant and equipment of the Company and the Group during the year are set out in note 13 to the financial statements.

Borrowings

Details of the Group's borrowings as at 31 December 2006 are set out in note 28 to the financial statements.

Share capital

Details of the movements in the share capital of the Company during the year are set out in note 29 to the financial statements.

Pre-emptive rights

There are no provisions for pre-emptive rights under the Companies Law of the PRC and in the Company's Articles of Association which oblige the Company to offer new shares on a pro-rata basis to existing shareholders.

Purchase, redemption or sale of listed securities of the Company

The H Shares of the Company were listed on the Main Board of the Stock Exchange of Hong Kong on 20 December 2006. During the year, there was no purchase, redemption or sale of any listed securities of the Company by the Company or any of its subsidiaries.



Reserves

Details of the movements in the reserves of the Company during the year are set out in note 30 to the financial statements and the consolidated statement of changes in equity.

Distributable reserves

As at 31 December 2006, calculated in accordance with relevant regulations, the Company's distributive reserves available for distribution amounted to approximately RMB89,299,000, of which approximately RMB36,865,000 has been proposed to be paid as final dividends for the year.

Charitable donations

The Group's total charitable donations for the year amounted to RMB1,120,000.

Major customers and suppliers

The percentage of sales attributable to the Group's five largest customers during the year was approximately 37% of the Group's total sales.

ZELC is the largest customer of the Group, and the percentage of the Group's sales to ZELC during the year was approximately 11% of the Group's total sales. ZELC is owned as to 12.61% by the Parent Company, and is beneficially owned as to 98.74% by CSR.

CSR Sifang Locomotive and Rolling Stock Co., Ltd. is one of the Group's five largest customers, and is owned as to 84.13% by CSR.

CNR Datong Electric Locomotive Co., Ltd. is another one of the Group's five largest customers, and is owned as to 94.16% by CNR.

Kunming China Railway is also one of the Group's five largest customers, and is owned as to 1.06% by the Parent Company. Mr. Ma Yunkun, a Non-executive Director of the Company, is the chairman and general manager of Kunming China Railway.

Save as disclosed above, none of the Directors, their associates or those shareholders so far as is known to the Directors having over 5% in the share capital of the Company, has any interest in any one of the Group's five largest customers during the year.

Purchases from the Group's five largest suppliers during the year were in aggregate less than 30% of the Group's total purchases during the year.

Biographies of Directors

Details of the biographies of the Company's Directors are set out on page 12 to page 13 of this annual report.

Service contracts with Directors and Supervisors

The Company has entered into service contracts with all of its Directors and supervisors, of whom the executive Directors, non-executive Directors and supervisors shall retire at the end of the 2008 Annual General Meeting. Independent non-executive Directors shall retire at the end of the 2007 Annual General Meeting. On retirement and after being re-elected at the Company's Annual General Meeting, they will be eligible to continue in their original offices and under the terms of the original service contracts. Each such re-election will be for a tenure of three years or for a shorter period as decided by the shareholders at the Annual General Meeting.

Remuneration Information of Directors and Supervisors

Remuneration of Directors and supervisors must be approved by shareholders at the Annual General Meeting. Other emoluments are fixed by the Board of Directors according to the Directors' duties and responsibilities and the Company's performance. Details of Directors' and supervisors' emoluments are disclosed in note 8 to the financial statements.

Directors' and supervisors' interests in contracts

During the year none of the Directors had a material interest, whether directly or indirectly, in any contract of significance to the business of the Group to which the Company or any of its subsidiaries was a party.

Interests and short positions of Directors, supervisors and the Chief Executive in the shares of the Company

As at 31 December 2006, none of the Directors, supervisors, the chief executive of the Company or their respective associates had any personal, family, corporate or other interests or short positions in the shares, underlying shares and debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) required to be notified to the Company and the Stock Exchange of Hong Kong pursuant to Part XV of the SFO, or any interests or short positions in the shares required, pursuant to section 325 of the SFO, to be entered in the register referred to therein, or any personal, family, corporate or other interests or short positions required to be notified to the Company and the Stock Exchange of Hong Kong in other ways pursuant to the Model Code.

Directors' and supervisors' rights to acquire shares or debentures

At no time during the year were rights to acquire benefits by means of the acquisition of shares in or debentures of the Company or any other body corporate granted to any Directors, supervisors or their respective spouse or children under 18 years of age, or were any such rights exercised by them, or was the Company or any of its subsidiaries a party to any arrangement to enable the Directors to acquire such rights in any other body corporate.



Structure of share capital

The Company's share capital structure as at 31 December 2006 was as follows:

As at 31 December 2006

Shareholder	Type	Number of shares	% of issued share capital
ZELRI	Domestic share	589,585,699	54.38%
CSR Qishuyan	Domestic share	9,380,769	0.87%
New Leap	Domestic share	9,380,769	0.87%
ZELC	Domestic share	10,000,000	0.92%
Kunming China Railway	Domestic share	9,800,000	0.90%
Shares in public circulation	H shares	456,108,400	42.06%
Total		1,084,255,637	100%

Substantial shareholders

Interests and short positions in the shares and relevant underlying shares of the Company or any of its associated corporations pursuant to the disclosure requirements in Divisions 2 and 3 of Part XV of the SFO (interests and short positions in the shares and relevant underlying shares of the Company disclosed here were interests and short positions of the following persons other than Directors or Chief Executive of the Company) as at 31 December 2006 were as follows:

Name of substantial shareholder	Number of shares held	Capacity	% of domestic share share capital	% of H Share share capital	% of issued share capital
ZELRI	589,585,699 ^(L)	Beneficial owner	93.86%	—	54.38%
CSR ^(Note 1)	618,347,237 ^(L)	controlling shareholder	98.43%	—	57.03%
Macquarie Bank Limited	54,084,000 ^(L)	Beneficial owner	—	11.86%	4.99%
National Social Security Fund Council	36,647,300 ^(L)	Beneficial owner	—	8.03%	3.38%
UBS AG	27,644,600 ^(L)	Beneficial owner	—	6.06%	2.55%
Prime Capital Management (Cayman) Limited	25,000,000 ^(L)	Beneficial owner	—	5.48%	2.31%

Note:

- (1) ZELRI is owned as to 51% by CSR. CSR is a state-owned enterprise. CSR is directly interested as to 100% in the registered capital of CSR Qishuyan, directly and indirectly interested as to 100% in the registered capital of New Leap and directly and indirectly interested as to 98.74% in the registered capital of ZELC. Accordingly, CSR is deemed under the SFO to be interested in the Shares held by each of ZELRI, CSR Qishuyan, New Leap and ZELC.



Connected transactions

Transactions conducted between the Group and the following parties shall constitute continuing connected transactions after the listing of the H shares of the Company on Stock Exchange of Hong Kong under the Listing Rules.

The Directors of the Company, including the independent non-executive Directors of the Company, have reviewed and confirmed that the continuing connected transactions set out below have been entered into:

- (1) in the ordinary and usual course of business of the Group;
- (2) either on normal commercial terms or on terms no less favourable to the Group than terms available to or from independent third parties; and
- (3) in accordance with the terms of the agreements governing the relevant transactions, and on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

Details of the Group's continuing connected transactions are as follows:

1) Continuing connected transactions exempted from reporting, public announcement and independent shareholders' approval requirements

The following transactions constituted continuing connected transactions for the Company under Rule 14A.33(3) of the Listing Rules and thus are exempted from the reporting, announcement and independent shareholders' approval requirements under Chapter 14 of the Listing Rules.

- (a) On 1 January 2005, ZELC (as lessor) signed a lease with the Company (as lessee) for leasing a property and certain equipment. ZELC agreed to let to the Company a total area of 4,779.18m² of factory premises and relevant equipment for a term of three years from 1 January 2005 to 31 December 2007. The annual lease rental was RMB126,700 (excluding management fees and utility charges). The Company has paid ZELC RMB126,700 up to 31 December 2006.
- (b) On 28 July 2006, Times Electronics (as lessor) signed a lease with NERCC (as lessee) for leasing a property. Times Electronics agreed to let to NERCC a total area of 3,116m² of factory premises for a term of six months from 1 July 2006 to 31 December 2006. The lease rental was RMB175,000. Rental receivable by Times Electronics from NERCC was RMB175,000 up to 31 December 2006.
- (c) On 20 January 2006, the Parent Company (as a franchise grantor) signed a trademark licence agreement with the Company. The Parent Company agreed to franchise a trademark "TEG & device" to the Company and its subsidiaries on a non-exclusive basis for the period up to the validity period from 2012 to 2015 (subject to renewal) with effect from 1 January 2006. The Company has paid the Parent Company franchise fees of RMB10,000 up to 31 December 2006.

2) Continuing connected transactions exempted from independent shareholders' approval requirement but subject to reporting and public announcement requirements ("Exempt Transactions")

The following transactions constituted continuing connected transactions for the Company under Rule 14A.34 of the Listing Rules and thus are exempted from the requirement to obtain independent shareholders' approval, but were subject to the reporting and announcement requirements. The Company had already reported to the Stock Exchange of Hong Kong and the Stock Exchange of Hong Kong has granted a waiver from strict compliance with the announcement requirement under Rule 14A.47 of the Listing Rules.

- (a) The Company signed a lease on 29 March 2006 as the lessor with the Parent Company (the lessee). The Company agreed to let to the Parent Company four stories of research administrative building with a total area of 6,960m² for a term of three years from 1 January 2006 to 31 December 2008. The annual lease rental was RMB1,867,184. The Company had received from the Parent Company RMB1,867,184 up to 31 December 2006.
- (b) The Parent Company signed an equipment leasing agreement on 25 March 2006 as the lessor with the Company. A supplementary agreement was signed on 30 May 2006. The Parent Company agreed to lease certain testing equipment to the Company for three years from 1 January 2006 to 31 December 2008. The annual lease rental was RMB 9,025,072. The Company had paid the Parent Group rental of RMB2,256,268 up to 31 December 2006.

3) **Non-exempt continuing connected transactions (“Non-exempt Transactions”)**

The following transactions constituted non-exempt continuing connected transactions for the Company and thus are subject to reporting, announcement and independent shareholders’ approval requirements under Rule 14A.45 to 14A.48 of the Listing Rules. The Stock Exchange of Hong Kong has granted a waiver from strict compliance by the Company with the announcement and independent shareholders’ approval requirements in respect of these transactions.

- (a) On 4 December 2006, the Company signed a general service agreement with the Parent Company. The Parent Company agreed to provide members of the Group general services for the period from 20 December 2006 (the Company’s listing date) to 31 December 2008. The Company had paid RMB 6,780,836 service fee to the Parent Company up to 31 December 2006.
- (b) On 4 December 2006, the Company signed a mutual supply agreement with the Parent Company. The Company and its subsidiaries will supply certain electrical components to Parent Company, while the Parent Company and its subsidiaries also agreed to supply mechanical and electro-mechanical parts and components to the Company. The agreement is valid for three years from 20 December 2006 (the Company’s listing date) to 31 December 2008.

Up to 31 December 2006, the amount payable by the Company to the Parent Company for mutual provision of services for the year amounted to RMB140,659,704 (excluding amount payable to Shiling by the Company). The amount paid by the Parent Company to the Company for mutual provision of services for the year amounted to RMB37,900,059.

- (c) On 4 December 2006, the Company signed a mutual supply agreement with CSR. The Company and its subsidiaries will sell train-borne electrical systems and electrical components of different segments to the CSR Group while the CSR Group) also agreed to supply certain parts and components for the production of train-borne electrical systems to the Group. The agreement is valid for three years from 20 December 2006 (the Company’s listing date) to 31 December 2008.

Up to 31 December 2006, the amount due by the Company to the CSR Group for mutual services it provided to the Company amounted to RMB21,958,573. The amount due by the CSR Group to the Company for mutual supplies services provided to the CSR Group amounted to RMB260,886,171.



- (d) On 4 December 2006, Kunming China Railway and the Company entered into a mutual supply agreement under which the Company agreed to supply and procure its subsidiaries to supply certain electrical control systems for large railway maintenance vehicles to Kunming China Railway and its subsidiaries (together the “Kunming China Railway Group”) and Kunming China Railway also agreed to supply and procure its subsidiaries and associates to supply certain parts and components in relation to large railway maintenance vehicles to the Group from 20 December 2006 (the Company’s listing date) to 31 December 2008. Kunming China Railway, as licensee, entered into a technology license agreement with a European company, as licensor, in relation to the license of the technology for large railway maintenance vehicles. As part of the consideration for the technology license, Kunming China Railway agreed to procure parts and components from the licensor in an amount equal to a fixed percent of its sales income from certain types of large railway maintenance vehicles (“procurement percentage”). Kunming China Railway has in turn formed a consortium with the Parent Company (implemented by the Group) and three other companies to manufacture large railway maintenance vehicles. With respect to each type of large railway maintenance vehicle, the parties would agree on what percentage they will each receive from the sales income (“revenue percentage”). For the type of product Kunming China Railway is obligated to procure parts and components from the licensor, each party of the consortium would also be obligated to procure parts and components from the licensor (through Kunming China Railway) in an amount equal to the sales income from relevant type of products multiplied by procurement percentage and revenue percentage.

For the year ended 31 December 2006, fees payable to the Kunming China Railway Group by the Group amounted to approximately RMB23,816,498. Fees payable to the Group by the Kunming China Railway Group amounted to approximately RMB108,581,997.

- (e) As the Parent Group holds 50% equity interest in Shiling and the Company has not completed the acquisition of 50% interest in Shiling in 2006, Shiling is considered as a connected party of the Company. According to the subsisting contracts for 200 km/h EMU projects and the OEM and packaging services of certain city railway projects, the Company will continue to purchase certain imported electronic parts and components from Shiling in 2006-2007.

Up to 31 December 2006, the amount due by the Company to Shiling for supply services it provided to the Company amounted to RMB49,712,849.

Pursuant to Chapter 14A.38 of the Listing Rules, the board of directors engaged the auditors of the Company to perform certain agreed upon procedures in respect of the continuing connected transactions of the Group. The auditors have reported their factual findings on these procedures to the board of directors. The independent non-executive directors have reviewed the continuing connected transactions and the report of the auditors and have confirmed that the transactions have been entered into by the Group in the ordinary course of its business, on terms no less favourable than terms available to and from independent third parties, in accordance with the terms of the agreements governing such transactions that are fair and reasonable and in the interest of the shareholders of the Company as a whole and have not exceeded the limit disclosed in the Company’s prospectus dated 8 December 2006.

Mechanism for protecting minority interests

In order to protect minority interests, the Company has (inter alia) established and operated the following governance measures:

- (i) Directors who have interests shall announce their respective interests, and waive their rights to attend Board Meetings and abstain from voting in respect of the connected transactions they are interested in. Accordingly, Messrs. Liao Bin and Tian Lei waived their rights to attend the Board Meetings and abstained from the related voting in respect of connected transactions between the Company and the Parent Group. Mr. Ma Yunkun waived his rights to attend the Board Meeting and abstained from the related voting in respect of connected transactions between the Company and Kunming China Railway.
- (ii) An independent professional management team of the Group shall be responsible to negotiate and review the terms of transactions to be conducted with the suppliers and customers (including the Parent Group and CSR Group). The members of the management team shall include the staff of the Group with relevant techniques and sales expertise, and the scope of functions of the management team will ensure its ability to make independent business judgments. The management team shall report to the Board of Directors, while the Board of Directors shall be accountable to the Company and the shareholders taken as a whole.
- (iii) The Company's auditors shall provide quarterly reports to the independent non-executive Directors on all transactions conducted between the Company and the Parent Group/CSR Group/Kunming China Railway.
- (iv) When making purchases, the Group shall make efforts to obtain offers or quotations from a number of independent suppliers, and select successful offers (where applicable) based on objective standards such as the price and quality of products, delivery schedule and services.
- (v) Subject to (i) above, Board Meetings attended by all independent non-executive Directors shall decide whether the Group shall conduct special transactions with the Parent Group or CSR Group.
- (vi) The terms for supply and purchase arrangements entered into between the Group and the Parent Group or CSR Group shall be subject to quarterly reviews by the independent non-executive Directors, and opinions regarding such transactions shall be disclosed to shareholders by way of announcements. The Company shall make announcements to shareholders in a timely manner. Independent non-executive Directors may request an independent party having at least 10 years experience in the locomotive manufacturing industry to participate in assessing the terms of the sales and purchases agreements, and to provide their discoveries to the independent non-executive Directors.



Non-competition and indemnity agreements:

The Company has signed non-competition and indemnity agreements with the Parent Group and the CSR Group on 30 November 2006. The Parent Group and the CSR Group promised not to carry on businesses that are in competition with the Company's businesses respectively.

Independent directors of the Company have reviewed compliance of the non-competition and indemnity agreements by the Parent Group and the CSR Group for 2006, and reviewed relevant information provided by the Parent Group and the CSR Group. Independent directors of the Company were of the opinion: the Parent Group and CSR Group had complied with the relevant terms of the non-competition and indemnity agreements in 2006. The Parent Group and the CSR Group carried on their own businesses independently of the Company's businesses, each owning different technology applications and have different customers, which will not result in any competition with the Company. The Directors are able to operate and manage the Company's businesses independently on the premises of the Company's and shareholders' interests as a whole.

Sufficiency of public shareholdings

According to publicly available information and as far as the Directors were aware, public shareholders held at least 42.06% of the Company's issued share capital as at the date of this report.

Post Balance Sheet Event

Details of the Group's post balance sheet events are set out in note 37 to the financial statements.

Taxation

For the year ended 31 December 2006, no foreign shareholder who is not resident of the PRC is liable to individual or enterprise income tax, capital gains tax, stamp duty or estate duty of the PRC in relation to their holding of H shares of the Company. Shareholders are urged to consult their tax advisers regarding the applicable PRC, Hong Kong and other tax consequences of owning and disposing of H shares.

Auditors

The financial statements for the year have been audited by Ernst & Young, and a resolution will be tabled at the upcoming Annual General Meeting to re-appoint Ernst & Young as the Company's auditors.