

Management's Discussion and Analysis of Financial Conditions and Results of Operations



The following management's discussion and analysis should be read in conjunction with the financial statements together with the accompanying notes, included elsewhere in this annual report.

Overview

The Group is principally engaged in alumina refining and primary aluminum smelting operations. We organize and manage our operations according to the following business segments:

- Alumina segment, which consists of mining and purchasing bauxite and other raw materials, refining bauxite into alumina, and selling alumina both internally to the Group's primary aluminum smelters and externally to customers outside the Group. This segment also includes the production and sales of chemical alumina (including alumina hydrate and alumina chemicals) and gallium.

- Primary aluminum segment, which consists of procuring alumina and other raw materials, supplemental materials and electricity power, smelting alumina to produce primary aluminum and selling substantially all primary aluminum products to external customers. This segment also includes production and sales of carbon products and small amount of aluminum-fabricated products.
- Corporate and other services segment, which includes operations of the Company's headquarters, research conducted by the Group's research institutes and provision of the Group's research and development services to third parties.

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Results of Operations

The Group's earnings attributable to equity holders of the Company amounted to RMB10,245 million for the year ended December 31, 2007, representing a year-on-year decrease of RMB1,597 million or 13.49% from RMB11,842 million for the corresponding period last year. On April 24, 2007, the Group completed the mergers of Lanzhou Aluminum and Shandong Aluminum with the Company by way of share exchange. A total of 1.237 billion A Shares of the Company were issued. On December 28, 2007 the merger of Baotou Aluminum by way of share exchange was also completed and as a result, approximately 638 million A Shares of the Company were issued. As a result of the mergers, the total number of issued shares of the Company has reached 13.524 billion shares, thereby diluting the earnings per share to a certain extent.

Revenue

The Group's turnover increased by RMB11,353 million from RMB64,827 million in 2006 to RMB76,180 million in 2007, representing an increase of 17.51%. Such growth was primarily due to the increase in the external sales of primary aluminum of the Group.

The Group's external sales volume of primary aluminum reached 3,092,600 tonnes in 2007, representing an increase of 956,700 tonnes or 44.79% from 2,135,900 tonnes in 2006 (the Group has applied retrospective adjustment since 2006 for the merger of Baotou Aluminum). The growth was primarily attributable to the increase in sales volume of primary aluminum by 269,000 tonnes following the merger and establishment of Zunyi Aluminum and other subsidiaries in the second half of 2006 and increase in sales volume of primary aluminum by 234,100 tonnes resulting from the merger of Lanzhou Aluminum in the first half of 2007. Shanxi Huasheng

officially commenced production and operation at the end of April in 2006, resulting in an increase of sales volume by 119,400 tonnes. Such increase in the sale of primary aluminum was also attributable to the increased efficiency in production output through technological renovation of production lines and the increase in trade sales. The increased sales volume of primary aluminum led to an increase of RMB16,708 million in revenue.

The external sales volume of alumina decreased from 6,275,700 tonnes in 2006 (inclusive of the trading volume of 1,149,400 tonnes) to 6,030,900 tonnes in 2007 (inclusive of the trading volume of 1,275,200 tonnes), representing a decrease of 244,800 tonnes. Such decrease was mainly attributable to the shift of external sales volume of alumina to internal sales volume and the increase in trading volume of the Group's products as a result of the acquisition and establishment of Zunyi Aluminum and other subsidiaries in the second half of 2006, as well as the merger of Lanzhou Aluminum in 2007. The decrease of external sales volume of alumina resulted in a decrease in revenue by RMB817 million.

In 2007, due to the influence of the market price of primary aluminum, the Group's average external selling price of primary aluminum products reached RMB16,914 per tonne (excluding tax, hereinafter), representing a decrease of RMB549 per tonne or 3.14% from RMB17,463 per tonne in 2006. Such decrease in external selling price led to a decrease of RMB1,697 million in revenue.

In 2007, the Group's external selling price of alumina reached RMB2,912 per tonne, representing a decrease of RMB706 per tonne or 19.51% from RMB3,618 per tonne in 2006, which led to a decrease of RMB4.26 billion in the revenue.

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Cost of Sales

The Group's total cost of sales increased by RMB13,267 million or 30.20% from RMB43,931 million in 2006 to RMB57,198 million in 2007. Such increase was mainly attributable to the growth in external sales volume of products and the increase in unit cost of sales of alumina.

Selling and Distribution Expenses

The Group's selling and distribution expenses increased by RMB159 million or 15.47% from RMB1,028 million in 2006 to RMB1,187 million in 2007. This was primarily attributable to the increase in the fees of transportation, loading/unloading and packaging resulted from the growth in sales volume of products.

General and Administrative Expenses

The Group's general and administrative expenses increased by RMB323 million from RMB2,466 million in 2006 to RMB2,789 million in 2007. Such increase was mainly attributable to the increase of RMB78 million in related tax charges other than income tax payable to the PRC tax authorities as a result of expanded business scale. The increase was also attributable to the increased expenses on depreciation for management equipment and administration costs by approximately RMB106 million, and the increased loss on assets disposal.

The Group's research and development expenses increased by RMB112 million from RMB116 million in 2006 to RMB228 million in 2007.

Other Gains, Net

The Group's other net gains decreased by RMB251 million to RMB131 million in 2007 from RMB382 million in 2006. Such decrease was mainly attributable to the account of an estimated gain of RMB236 million from negative goodwill as a result of the acquisitions of subsidiaries in the year of 2006, whereas there was no such activity in the year.

As a result of the foregoing reasons, the operating profit of the Group decreased by RMB2,759 million, or by 15.62%, from RMB17,668 million in 2006 to RMB14,909 million in 2007. The Group's operating profit of 2007 represented 19.57% of the sales, representing a decrease by 7.68% from 27.25% in 2006.

Finance Costs

The Group's finance costs increased by RMB101 million or 15.86% from RMB637 million in 2006 to RMB738 million in 2007. Such increase was primarily attributable to the increase of interest expenses arising from the increment of bank loans and interest rate.

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Income Taxes

The Group's income tax expenses decreased by RMB1,631 million or 36.98% from RMB4,411 million in 2006 to RMB2,780 million in 2007. Out of that sum, (i) approximately RMB800 million was due to a year-on-year decrease in the Group's profit; (ii) a decrease of RMB421 million due to the preferential policies on reduction and exemption of enterprise income tax for the purchase of domestically manufactured production equipment obtained by two subsidiaries of the Group, namely, Shanxi Huasheng and Lanzhou branch respectively in April and June 2007 and; (iii) a decrease of RMB384 million was due to the preferential policies on reduction and exemption of enterprise income tax for the purchase of domestically manufactured production equipment obtained in December 2007 by the Shanxi branch and the Guizhou branch of the Group. The total tax deduction due to the preferential policies for purchase of domestically manufactured production equipment amounted to RMB805 million, resulting in the decrease of income tax expenses of RMB737 million as compared with 2006.

In 2007, the average tax rate of the Group was 19.30%, which was lower than the average tax rate of 25.76% in the corresponding period last year and the statutory tax rate of 33% due to the decrease of consolidated tax rate resulted from the acquisition and establishment of Zunyi Aluminum and the merger of Lanzhou Aluminum and Baotou Aluminum with the Company, respectively. Lanzhou Aluminum and Baotou Aluminum are located in the western region of the PRC, which enjoy a tax rate of 15%. Such decrease was also attributable to the preferential policies enjoyed by the Group during the year in respect of the reduction and exemption of enterprise income tax for the purchase of domestically manufactured production equipment.

Minority Interests

Minority interests increased by RMB512 million from RMB872 million in 2006 to RMB1,384 million in 2007, primarily due to the increase in the minority interests after the acquisition of subsidiaries.

Discussion of Segment Operations

Alumina Segment

Sales of Goods

The total sales in the alumina segment of the Group was RMB35,130 million in 2007, representing a decrease of RMB3,139 million or 8.20% from RMB38,269 million in 2006. Such decrease was mainly attributable to a lower selling price of alumina products.

The external sales revenue in the alumina segment decreased by RMB4,784 million or 18.69% to RMB20,818 million in 2007 from RMB25,602 million in 2006. Such decrease was mainly attributable to a decrease in the selling price of alumina and the external sales volume.

Revenues from the sales of alumina to the Group's aluminum smelters increased by RMB1,644 million, or by 12.98%, from RMB12,667 million in 2006 to RMB14,312 million in 2007. Such increase in internal sales was primarily due to the increase in the total demand for alumina as raw material for production of the Group's aluminum smelters following the merger of aluminum production enterprises.

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Operating Profit

As a result of the foregoing reasons, the Group's total operating profit in the alumina segment decreased by RMB5,693 million, or 41.08% from RMB13,859 million in 2006 to RMB8,166 million in 2007. The operating profit of alumina segment contributed to 23.25% of the sales of goods in 2007, representing a decrease of 12.96% from 36.21% in 2006.

Primary Aluminum Segment

Sales of Goods

The Group's total sales of goods for the primary aluminum segment increased by RMB15,313 million or 39.88% from RMB38,394 million in 2006 to RMB53,707 million in 2007, mainly due to the acquisition and establishment of smelters in the second half of 2006 and the merger by absorption of aluminum enterprises with the Group in 2007, which led to an increase in sales volume, as well as the output expansion of the existing smelters due to technological renovation.

Operating Profit

The Group's operating profit from the primary aluminum segment increased by RMB2,421 million from RMB5,001 million in 2006 to RMB7,422 million in 2007. The operating profit of primary aluminum segment as a percentage of product sales for 2007 was 13.82%, up 0.79% over 13.03% in 2006.

Corporate and Other Services Segment

The Group's corporate and other services segments reflected the expenses of the Group's corporate segment and the research and development services of the Group's research institute to external customers. This segment recorded an increase in operating loss by RMB18 million from RMB59 million in 2006 to a loss of RMB77 million in 2007.

Working Capital and Liabilities

As of December 31, 2007, the Group's current assets amounted to RMB26,211 million, representing a decrease of RMB912 million as compared with RMB27,123 million at the end of 2006.

- As of December 31, 2007, the Group's bank balances and cash amounted to RMB7,803 million, representing a decrease of RMB5,180 million as compared with RMB12,983 million as of December 31, 2006, mainly due to redemption of matured short-term bonds of RMB3,000 million and RMB2,000 million at par, respectively.
- As of December 31, 2007, the Group's inventories amounted to RMB13,474 million, representing an increase of RMB3,528 million as compared with RMB9,946 million at the end of 2006. The Group's turnover days of inventory was increased by 4 days to 74 days in 2007 from 70 days in 2006. This was resulted from the increased reserve of minerals of RMB1,210 million, and the increase of inventory of RMB1,470 million as a result of the merger of Lanzhou Aluminum.

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- As of December 31, 2007, the Group's net accounts receivable amounted to RMB2,976 million, representing an increase of RMB694 million as compared with RMB2,282 million at the end of 2006. Out of that amount, notes receivable and net trade receivables increased by RMB669 million and RMB24 million from RMB1,735 million and RMB548 million at the end of 2006 to RMB2,404 million and RMB572 million, respectively. The turnover days of the Group's trade receivables were 5 days, which is in line with the 5 turnover days in 2006.
- As of December 31, 2007, the Group's current liabilities amounted to RMB18,832 million, representing a decrease of RMB4,840 million as compared with RMB23,672 million at the end of 2006. Of the current liabilities, the short-term loans decreased by RMB532 million, the accounts payable increased by RMB382 million, the income tax payable and other current liabilities decreased by RMB1,223 million and RMB825 million respectively.
- The Group issued short-term bonds at face value in the principal amount of RMB3,000 million in June 2007 in order to supplement the Company's working capital.

As a result of the foregoing reasons, the Group's net current assets amounted to RMB7,379 million as of December 31, 2007, representing an increase of RMB3,928 million from RMB3,451 million at the end of 2006.

As of December 31, 2007, the gearing ratio of the Group was 1.39, representing an increase of 0.24 as compared with 1.15 at the end of 2006. The quick ratio of the Group was 0.67, representing a decrease of 0.05 as compared with 0.72 at the end of 2006.

Long-term liabilities

As of December 31, 2007, the Group's long-term liabilities amounted to RMB14,489 million, representing an increase of RMB5,485 million as compared to RMB9,004 million at the end of 2006. Of the long-term liabilities, the long-term borrowings increased by RMB3,333 million to RMB12,139 million from RMB8,806 million at the end of 2006; and bonds payable amounted to RMB2,029 million, mainly resulting from the issue of corporate bonds at par in the principal amount of RMB2,000 million in June 2007 by the Company, as approved by the National Development and Reform Commission of the PRC, to finance Phase III of Guangxi alumina project, the expansion and environment control works of the Guizhou alumina project, Shandong project relating to output expansion of alumina with the use of imported bauxite and Lanzhou Aluminum 3 × 300 kilovolts self-contained power plant.

Capital Expenditures, Capital Commitments and Investment Undertakings

As of December 31, 2007, the Group's accumulated capital investment of fixed assets amounted to RMB16,842 million, which consisted mainly of the investment of (i) RMB2,559 million in Phase III of the Guangxi Alumina Project; (ii) RMB2,606 million in the Lanzhou Branch self-contained power plant project; (iii) RMB2,533 million in the 268,000-tonne project for improvement of pre-baked aluminum smelting pot; (iv) RMB1,814 million in Phase IV of the Guizhou alumina project for the expansion; (v) RMB1,024 million in the alumina project for expansion and environment treatment; (vi) RMB834 million in the construction of the self-contained power plant in Henan; (vii) RMB617 million in the Chongqing 800,000 tonnes alumina construction project; (viii) RMB384 million in the Qingdao 120,000 tonnes recycled aluminum alloy project, etc.

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As of December 31, 2007, the Group's capital commitment of fixed assets amounted to RMB27,355 million, of which those contracted but not provided for amounted to RMB8,698 million and those authorized and not contracted amounted to RMB18,657 million.

As of December 31, 2007, the Group's external investment commitment amounted to RMB550 million, mainly attributable to the establishment of the joint venture Zunyi Alumina Project. The Group's investment in construction projects, renovation as well as external investment and acquisition had constantly improved the Group's capacity and output of alumina and primary aluminum.

Business combination

The Company issued 631.93 million A Shares and completed the merger of 72% equity interest in Lanzhou Aluminum held by shareholders other than the Company by way of share exchange on April 24, 2007. The total purchase cost of the transaction was RMB4,324 million which was determined by reference to the proportionate interests in the fair value of Lanzhou Aluminum as of April 24, 2007. The fair value of the assets was RMB2,400 million. As a result of such merger, the Company recorded an increase of RMB632 million in its share capital and an increase of RMB3,632 million in the capital reserve and a goodwill of RMB1,924 million had been recognized.

On December 28, 2007, the Company issued 637,880,000 A Shares to shareholders of Baotou Aluminum in order to acquire 100% of the equity interest of Baotou Aluminum by way of share exchange.

Acquisition of minority interests

The Company issued 604.80 million A Shares and completed the merger of its subsidiary, Shandong Aluminum, by acquiring 28.57% equity interests from the minority shareholders of Shandong Aluminum on April 24, 2007. As a result of the merger of the minority interests of Shandong Aluminum by way of share exchange, the Company recorded an increase of RMB605 million in share capital and was entitled to a net asset value of RMB1.230 billion as at the date of completion of the acquisition.

On November 23, 2007, the Company paid RMB497 million in cash to acquire 49% minority interest in Hewan Power Plant. The acquisition should be entitled to a net asset value of RMB400 million as at the date of completion of the acquisition.

The Group's capital expenses and external investment are mainly financed by operating activities, long-term and short-term debts and issuance of shares and bonds. In light of the Group's credit standing and various domestic and overseas financing methods, the Group believes that there will not be any difficulty in financing capital investments and external acquisitions.

Cash and Cash Equivalents

Cash and cash equivalents of the Group as of December 31, 2007 amounted to RMB7,707 million, including foreign currency deposits denominated in Hong Kong dollars, US Dollars, Euro dollars and Australian dollars which were respectively translated to RMB128.28 million, RMB41.07 million, RMB32.41 million and RMB11.39 million.

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Cash Flow from Operating Activities

Net cash from operating activities decreased by RMB3,970 million or 28.06% from RMB14,147 million in 2006 to RMB10,177 million in 2007. Such decrease was primarily due to a slight decrease in the Group's profit.

Cash Flow from Investing Activities

Net cash outflow from investing activities decreased by RMB3,520 million or 32.87% from RMB10,708 million in 2006 to RMB7,188 million in 2007. Such decrease was mainly attributable to increased capital expenditures by the Group which offset the reduced external cash investment, the treatment of fixed deposits over 3 months as investment activities and maturity of deposits at year end, thus leading to a reduced cash outside as compared with last year.

Cash Flow from Financing Activities

Net cash outflows from financing activities amounted to RMB5,265 million in 2007, representing an increased outflow by RMB3,994 million from RMB1,271 million in 2006. This was mainly due to the proceeds raised from increased share capital which increased the cash inflow by RMB4,390 million in 2006 by the Group, whereas there was no such activity in the year.

Risk of Foreign Exchange Rate

The Group conducts its business primarily in Renminbi.

Renminbi is not a freely convertible currency. The restrictions on foreign exchange imposed by the PRC government may result in material differences between future exchange rate and current exchange rate or historical exchange rate. The changes in the exchange rate of Renminbi will impact the ability of the Group to carry out operations relating to foreign exchange and will also impact the ability of the Group to pay dividends in HK dollars and to pay dividends of American Depository Shares in US dollars. The Company believes that it is able and will be able to obtain sufficient foreign exchange to implement the above-mentioned obligations.

Impact of Appreciation of Renminbi

The Group believes that, since the domestic spot price of alumina is determined with reference to the price of imported alumina, Renminbi appreciation has imposed certain impact on the spot price of alumina in the PRC.

Renminbi appreciation will not have a significant impact on the operation of the Company. The supply of raw materials and product sales of the Group are conducted in the PRC and its export of primary aluminum and loans in the form of other foreign currency is relatively minimal. From the perspective of cost competitiveness of the products, Renminbi appreciation will reduce the Group's competitiveness in international markets and raise the competitiveness of imported alumina.