

INDUSTRY OVERVIEW

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The PRC rail vehicle manufacturing industry has been directly affected by the development of the PRC Railway industry and the urban rail industry. This section sets forth the history, current situation and publicly-announced future development plans of each of the PRC Railway industry, the urban rail industry and rail vehicle manufacturing industry in China.

The Directors are of the view that the Company is a part of the PRC rail vehicle manufacturing industry rather than rail vehicle component industry. Rail vehicles comprise electrical systems and mechanical systems, and train-borne electrical systems the Group manufactures are essential electrical systems for rail vehicles. The Parent Company and the Company have cooperated with various domestic rail vehicle manufacturers in developing electric locomotives, diesel locomotives and EMUs for the PRC Railways and rail vehicles for urban rail systems.

THE PRC RAILWAY INDUSTRY

History and Current Situation

The railway industry has undergone more than a century of development in the PRC. The railways in China (excluding urban railways) comprise the PRC Railways, local railways and joint venture railways. As at the end of 2004, the PRC Railways accounted for 82.1% of the total operational length of the railways in China, while local railways accounted for 6.4% and joint railways accounted for 11.5%, and there were 16,066, 352 and 604 locomotives in service in the PRC Railways, local railways and joint venture railways, respectively. By the end of 2005, the total operational length of the railways in China was approximately 75,438 km, which ranked first in Asia and third in the world, next only to the US and Russia. The PRC Railway network covers all of China's provinces, autonomous regions and municipalities and connects to Hong Kong and six neighboring countries and regions. According to the *China Railway Yearbook 2005*, in 2004, the PRC railway industry ranked first in the world in terms of freight transportation volume, second in terms of freight turnover, fifth in terms of passenger transportation volume and first in terms of passenger turnover.

China is a vast and populous country. The inter-regional imbalance of economic development has led to frequent population and resource movements, which demand effective means of transportation. As a safe, fast and economic means of transportation with high transportation capacity, railway has become a primary mode of transportation in the PRC and plays a significant role in the national economy. According to the National Economic and Social Development

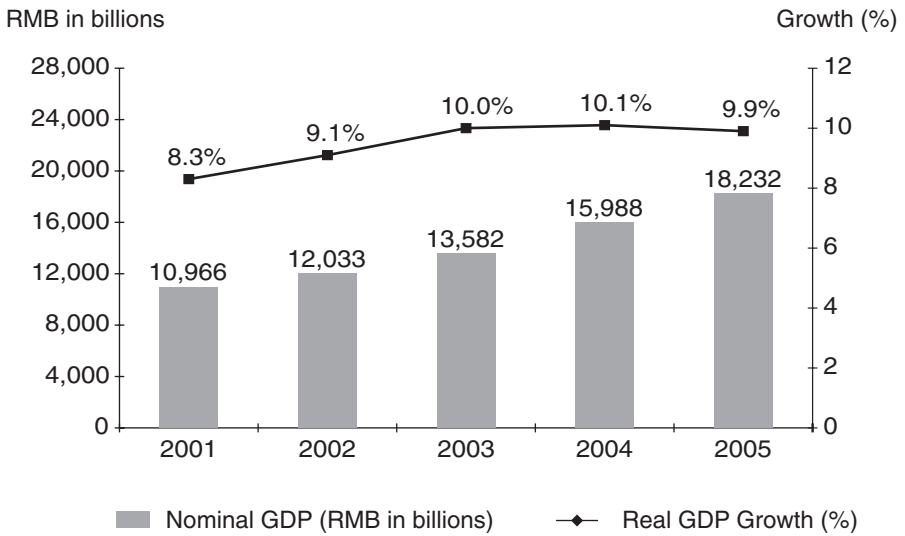
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Statistics Bulletin published by the National Bureau of Statistics of China, during the Tenth Five-year Plan period (2001-2005), railway transportation ranked second in terms of both freight turnover and passenger turnover among the four major means of transportation in the PRC, namely, railways, roads, waterways and aviation.

The PRC economy has grown significantly since the PRC government introduced economic reforms in the late 1970's. China's accession to the World Trade Organization, or WTO, in 2001 has further accelerated the reform of the PRC economy.

According to National Bureau of Statistics of China, China's real GDP grew at an average annual growth rate of approximately 9.5% during the 5-year period from 2001 to 2005, making China one of the fastest growing economies in the world. In 2005, China's nominal GDP was approximately RMB 18,232.1 billion, while real GDP grew approximately 9.9% from 2004.

China's GDP (2001-2005)



Source: National Bureau of Statistics of China

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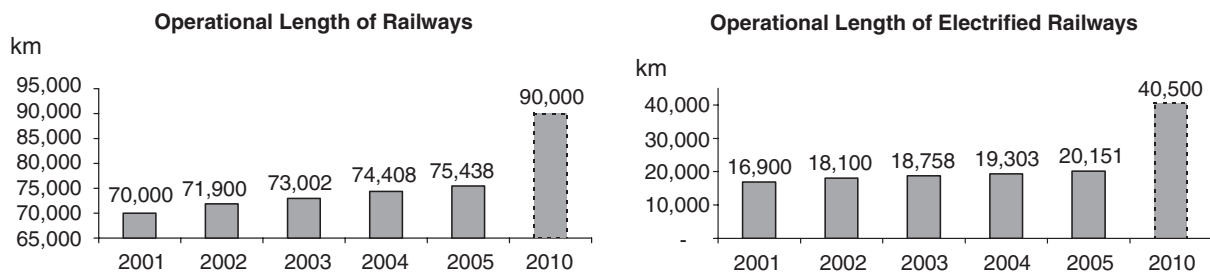
The economic growth in China has been a key driving force of the growth of the PRC Railway industry. During the last two decades, the railway network in China has continued to expand and railway passenger and freight transportation recorded steady increases, except for a decrease in passenger turnover and transportation in 2003 due to the outbreak of Severe Acute Respiratory Syndrome in China. The table below illustrates the growth trend of the railway freight and passenger transportation (excluding urban rail systems) during the Tenth Five-year Plan period in China:

	2001	2002	2003	2004	2005
Freight turnover (billion tonnes-km)	1,469	1,566	1,725	1,929	2,073
Passenger turnover (billion persons-km)	477	497	479	571	606
Freight transportation (million tonnes)	1,932	2,050	2,212	2,490	2,693
Passenger transportation (million persons)	1,052	1,056	973	1,118	1,156
Railway operational length (km)	70,000	71,900	73,002	74,408	75,438
Completed new railway length (km)	1,210	1,994	1,164	1,433	1,147
Electrified railway length (km)	16,900	18,100	18,758	19,303	20,151

Source: PRC Railway Statistics Bulletin 2001-2005 published by the MOR Statistics Centre.

Future Development

The MOR projected in its Mid and Long-Term Railway Network Plan that the PRC Railway industry is to sustain rapid growth. The charts below set forth the operational length of the railways and electrified railways (both excluding urban railways) in China from 2001 to 2005 and the projected operational lengths in 2010 forecasted by the MOR in its Eleventh Five-year Plan.



Source: PRC Railway Statistics Bulletin 2001-2005 published by the MOR Statistics Centre, and the MOR's Eleventh Five-year Plan published by the MOR

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The projected growth of the railways in China is attributed to a large extent to the following factors:

- the continuous growth of the country's economy and urbanisation, which will give rise to increasing demand for freight and passenger railway transportation;
- the PRC railway transportation system is operating at close to full capacity;
- although the operational length of the PRC railways was approximately 75,438 km as at the end of 2005, making it the longest in Asia and the third longest in the world, railway network density and per capita occupation of the PRC Railway network still lag behind other parts of the world; and
- railway transportation is a relatively safe, environmentally friendly and efficient means of transportation.

According to the Major Technology Policy of the Railway Industry (鐵路主要技術政策) and the Eleventh Five-year Plan promulgated by the MOR, the PRC Railway industry will feature network expansion, high speed passenger transportation, heavy-hauling freight transportation, safer operation and enhanced passenger comfort level.

PRC Railway network expansion

The MOR will continue to construct new railway lines and upgrade existing lines to meet the increasing demand for railway transportation. A total of 17,000 km of new railways is scheduled to be constructed during the Eleventh Five-year Plan period (2006-2010), including 7,000 km of dedicated passenger railway lines. In addition, a total of 15,000 km of existing railways will be upgraded to be electrified railways during the Eleventh Five-year Plan period. In 2010, the total operational length of railways in China is expected to reach approximately 90,000 km, with double-line railways (複線鐵路) and electrified railways each accounting for more than 45% of the total operational length. In 2020, the total operational length of railways in China is expected to reach approximately 100,000 km, with double-line railways and electrified railways each accounting for more than 50% of the total operational length.

High speed passenger transportation

Since 1997, the MOR has implemented five speed increases on PRC Railway lines, bringing the maximum operational speed of 7,700 km railway lines up to 160 km/h. The MOR is in the process of implementing a sixth speed increase. According to the MOR's Eleventh Five-year Plan (2006-2010), approximately 13,000 km major main lines (railway lines connecting certain large cities) will achieve a maximum operational speed of 200 km/h.

Heavy-hauling freight transportation

The average hauling capacity of freight trains in the PRC was 3,038 tonnes per train as at the end of 2005. According to the Major Technology Policy of the Railway Industry, freight trains operating on major lines are expected to achieve an average hauling capacity of 5,000 tonnes and trains operating on dedicated coal transportation lines are expected to reach a maximum hauling capacity of 20,000 tonnes.

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Safety and enhanced passenger comfort level

As stated in the Major Technology Policy of the Railway Industry, the MOR attaches great importance to safe operation of trains with a particular focus on the safety of passenger railway transportation.

With the economic development, passengers demand higher levels of comfort in travel and higher service quality. Important measures to improve passenger comfort levels include installation of on-board information displays and entertainment systems, air-conditioners and equipment designed to reduce noise and shock.

URBAN RAIL INDUSTRY IN THE PRC

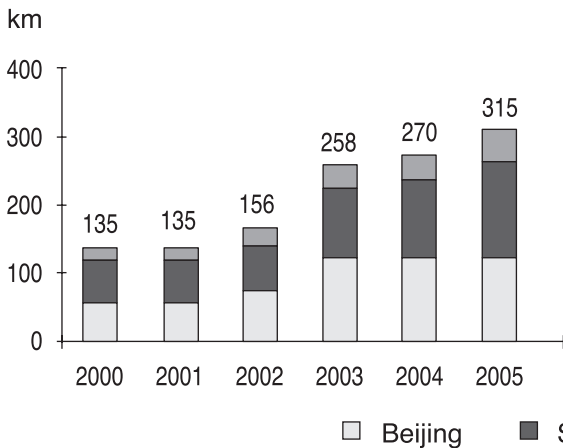
History and Current Situation

In October 1969, the PRC's first subway, the 21 km Beijing subway line, commenced operation. By the end of 2005, the total length of urban rail systems in operation in the PRC reached 400 km (including approximately 300 km of subway lines).

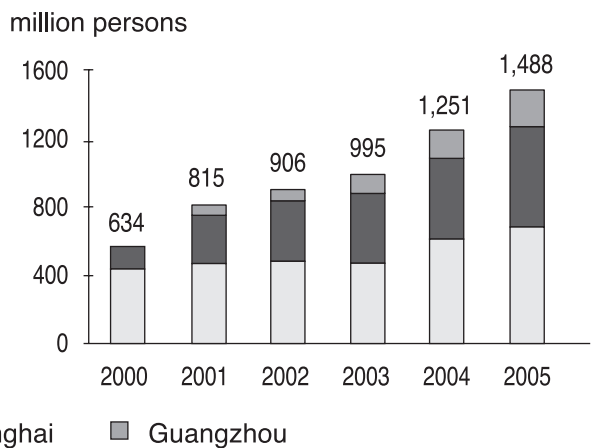
Urban rail transportation has the advantage of having high transportation capacity and being punctual, creating less pollution and taking up less land compared to other means of urban transportation. As a result, urban rail systems have been adopted by a number of large and medium-sized cities in the PRC as a primary solution to relieve pressure on the public transportation system.

In cities such as Beijing, Shanghai and Guangzhou, the operational length and passenger transportation volume of urban rail have experienced a sustained growth from 2000 to 2005, as illustrated in the charts below:

Operational Length



Passenger Transportation Volume



Sources: *Beijing, Shanghai and Guangzhou's City Yearbooks 2001-2005, Statistics Bureau of Guangzhou City*

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Future Development

According to the PRC Ministry of Construction's statistics, as at the end of 2005, urban rail lines were under construction or planned to be constructed in approximately 20 cities in China including Beijing, Shanghai, Guangzhou, Tianjin, Dalian, Shenyang and Harbin. The total operational length of urban rail lines in the PRC is expected to reach 1,500 km in 2010.

RAIL VEHICLE MANUFACTURING INDUSTRY IN THE PRC

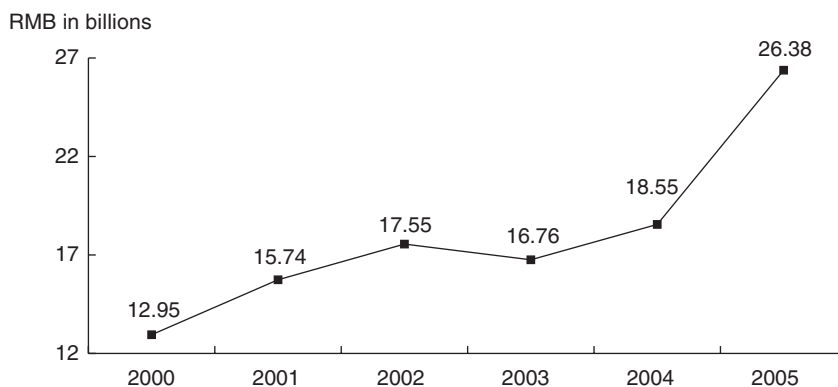
History and Current Situation

The PRC rail vehicle manufacturing industry started in the 1950s and has developed into an industry that possesses proprietary technologies and produce a full range of rail vehicles including locomotives (diesel and electric), EMUs, passenger cars, freight cars, trains for urban rail systems and large railway maintenance vehicles. Rail vehicles comprise electrical systems and mechanical systems. Electrical systems include primarily train-borne electrical systems, motors and traction transformers.

As at the end of 2004, there were 16,066, 352 and 604 locomotives in service in the PRC Railways, local railways and joint venture railways, respectively. Among the 16,066 locomotives in service in the PRC Railways, there were approximately 4,849 electric locomotives, 11,135 diesel locomotives and 82 steam locomotives, most of which were designed and manufactured by PRC rail vehicle manufacturers. The rail vehicles include, among others, Dongfeng DF series diesel locomotives, Shaoshan SS series electric locomotives and high speed EMUs such as Blue Arrow, Central-China Star and China Star. China Star recorded a travelling speed of 321.5 km/h, the highest measured speed in PRC railway history.

Due to the sustained growth of the PRC economy, continuous extension of the PRC Railway network and rapid growth of the transportation industry, the MOR's investment on procurement and upgrade of rail vehicles has steadily increased from 2001 to 2005 except for the slight decrease in 2003. The chart below illustrates the MOR's investment on procurement of rail vehicles (excluding large railway maintenance vehicles) from 2001 to 2005.

MOR New Rail Vehicle Procurement

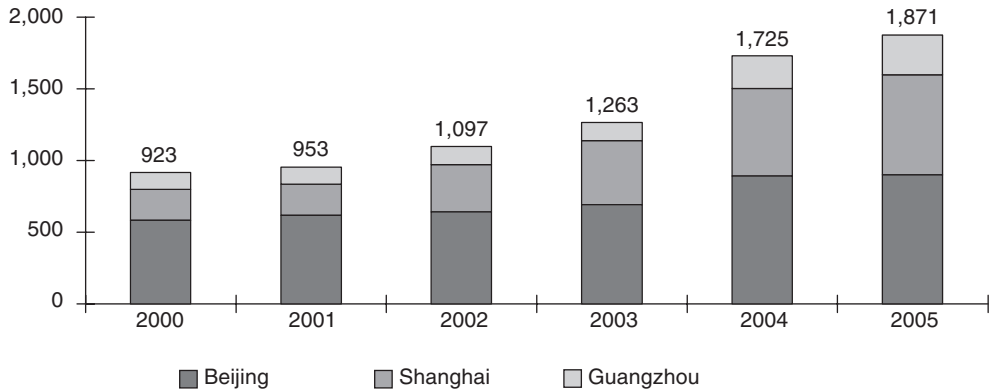


Source: PRC Railway Statistics Bulletin (鐵道統計公報) 2001-2005 released by the MOR Statistics Centre

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Commensurate with the growth of the operational length and passenger transportation volume of the PRC urban rail lines (see “Urban Rail Industry in the PRC — History and Current Situation”) is the growth of urban rail vehicle procurement. The following chart sets forth the number of trains for urban rail systems procured by operators in Beijing, Shanghai and Guangzhou from 2000 to 2005.

Procurement of Trains for Urban Rail Systems



Source: *Beijing, Shanghai and Guangzhou's City Yearbooks 2001-2005*

Future Development

In light of the current policies and development plans of the PRC Government, the PRC rail vehicle manufacturing industry expects the following development trends:

Further development of high speed and heavy-hauling technologies

According to the Major Technology Policy of the Railway Industry and the MOR's Eleventh Five-year Plan, the PRC Railway industry will feature, among other things, high speed passenger transportation and heavy-hauling freight transportation, which will in turn necessitate research and development of high speed and heavy-hauling technologies, in particular AC train power converter and control technology in substitution for DC train power converter and control technology. See “The PRC Railway Industry — Future Development” for more details.

The PRC rail vehicle manufacturing industry has made significant progress in developing AC train power converter and control technologies. In 1996, ZELRI and ZELC developed and manufactured the first AC propulsion locomotive, the AC4000 type in the PRC. In order to accelerate the growth of the PRC Railway transportation, the MOR started to acquire, through PRC manufacturers, the technologies relating to high speed EMUs (including 200 km/h EMUs and 300 km/h EMUs) and heavy-hauling freight locomotives from leading foreign rail transportation equipment suppliers. The acquired advanced technologies were further transferred by the MOR to domestic manufacturers. The MOR expects to, through such action, expedite the development of high speed and heavy-hauling technologies in the PRC rail vehicle manufacturing industry.

Growing demand for rail vehicles

Prospective investment in and expansion of the PRC railway network, combined with the projected speed increase, will evidently lead to growing demand for locomotives and EMUs. See “The PRC Railway Industry — Future Development” for more details. For example, the proposed Beijing-Shanghai high speed railway is expected to cost RMB168 billion in total, RMB26.2 billion of which is expected to be invested on procurement of EMUs. The same factors will also cause the demand for large railway maintenance vehicles to grow as (i) the speed increase will require higher quality railway track, which in turn will require more frequent maintenance of railway track and (ii) the increased length of the railway network will demand more large railway maintenance vehicles. In addition, according to the Release Notice of the Management Rules of Railway Train Operation Safety Equipment (關於發佈《鐵路機車行車安全裝備管理規則》的通知) (Tieyun [2006] No. 88) issued by the MOR in 2006, the service life of train operation safety equipment is six to eight years. Enforcement of this standard should ensure a stable future demand for train operation safety equipment.

According to the MOR’s Eleventh Five-year plan, by 2010, there will be approximately 19,000 locomotives, 1,000 EMUs, 45,000 passenger cars and 700,000 freight cars in service in the PRC Railways, and large railway maintenance vehicles will be utilised for major maintenance works on approximately 85,000 km of the PRC Railway lines.

In the last two decades, the vehicles used in PRC urban rail lines were mainly imported from overseas suppliers. In 1999, the PRC Government required that an average of not less than 70% of the rail vehicles and related electro-mechanical equipment as measured by value used in every urban rail project must be sourced within the PRC. The demand for trains for urban rail systems in 2010 is expected to be approximately 2,500 to 3,000, in addition to demand for replacement trains of the existing lines.

Government support for development of proprietary technologies

The PRC Government has shown strong support and encouragement to innovations and development of proprietary technologies, which was highlighted during the National Science and Technology Conference (全國科技大會) held in December 2005. In 2006, the PRC State Council released the Outline of the Mid and Long-term National Plan for the Development of Science and Technology (2006-2020) (國家中長期科學和技術發展規劃綱要) and the Notice of Ancillary Policy to the Outline of the Mid and Long-term National Plan for the Development of Science and Technology (2006-2020) (關於實施《國家中長期科學和技術發展規劃綱要(2006-2020)》若干配套政策的通知), which provided a number of incentives for China’s science and technology development. Pursuant to the outline and related notice, the PRC Government entities are required to give preference to domestic innovations and domestically developed proprietary technologies in terms of government procurement and financial support. A variety of tax incentives, including an annual tax credit amounting to 150% of the year’s research and development expense and a two year exemption from and two year preferential rate of enterprise income tax, are available for “high and new technology enterprises” in national high and new technology zones.

Increasing competition from foreign competitors

The MOR started to import locomotives from leading foreign manufacturers in late 2004 with an intention to expedite the development of the PRC rail vehicle manufacturing industry. These imports are expected to increase competition from foreign competitors in the PRC rail vehicle manufacturing industry.

Related PRC Regulatory Environment

The MOR is the governmental body overseeing the PRC Railway industry. The MOR formulates the overall strategies and policies as well as technical standards and policies for the PRC Railway industry. The MOR mandates that any vehicle type (including imported types) for use on the PRC Railway network must be tested and approved by the MOR and a production license must be obtained from the MOR before commercial production commences. In order to obtain a production license, an applicant has to submit to the MOR required documents relating to technology, production and quality assurance. In addition, the applicant's products must pass key components tests, type test and related technical inspections. All railway vehicles, equipment and related components have to be manufactured in accordance with strict standards and technical specifications set by the MOR. Vehicles for use on the PRC Railway network can only be delivered to customers after they are tested and certified by the MOR. The MOR is responsible for formulating technical standards for PRC Railway industry and has designated 12 enterprises and institutes to lead in setting those standards (including ZELRI, which has been designated to lead in setting technical standards for train power converters and control systems). The MOR also sets safety standards for the PRC Railway industry and technical specifications for train operation safety equipment used in the PRC Railway network.

The MOR sets a guidance price when a new type of vehicle or equipment for PRC Railway network is commercially launched. The MOR sets guidance prices by reference to the prices of similar products, the cost structure of locomotive works and negotiations on the profit margin.

For trains for urban rail systems, the Government has explicitly encouraged purchases of domestic equipment. According to the Implementation Plan of Localisation of Urban Rail Transportation (國家計委關於印發城市軌道交通設備國產化實施方案) (Ji Jiyuce [1999] No. 428) issued by the State Development Planning Commission, the predecessor of the NDRC, the localisation rate (as measured by the ratio of the value of domestic rail vehicles and related electro-mechanical equipment to the value of all rail vehicles and related electro-mechanical equipment in a project) of all urban rail projects shall be at least 70%. The State Development Planning Commission also requires that certain equipment can be procured only from a specified list of manufacturers. The Company is one of the designated manufacturers of train power converters and control systems.

The manufacturers in the PRC rail vehicle manufacturing industry are subject to environmental laws and regulations including, among other things, (i) The Environmental Protection Law of the PRC (中華人民共和國環境保護法); (ii) The Water Pollution Prevention Law of the PRC (中華人民共和國水污染防治法); (iii) Regulations on Pollutant Emission Permits (排污許可證條例) promulgated by the State Environmental Protection Administration of China and (iv) Cleaner Production Promotion Law (中華人民共和國清潔生產促進法).