

**GENERAL**

The following discussion and analysis should be read in conjunction with the combined financial information set out in Appendix I—"Accountants' Report," the additional financial information set out in Appendix II—"Additional Financial Information." Our audited combined financial information has been prepared in accordance with IFRS. IFRS differs in a number of significant respects from US GAAP. See Section I of Appendix II—"Additional Financial Information." Since China Telecommunications Corporation controlled the telecommunications operations and the related assets transferred to us prior to our restructuring and continues to control us after our restructuring, the financial data of the telecommunications operations transferred to us presented in this section and in the audited financial information included elsewhere in this prospectus have been combined in a manner similar to a pooling-of-interests. The assets and liabilities of the entities being combined are carried forward at their recorded historical amounts, and the book value of the assets and liabilities of each of these entities are added together and the revenue and expenses of the entities for the applicable periods are added together to prepare our combined financial information. Except for the income statement data for the six months ended June 30, 2002, the income statement data for the other periods include the results of the assets retained by China Telecom Group. The results of such assets will not be reflected in our combined income statement for future periods ending after December 31, 2001. Except for the balance sheet data as of December 31, 2001 and June 30, 2002, the balance sheet data includes data related to the assets retained by China Telecom Group. These assets will not be reflected in our balance sheet after December 31, 2001.

**Financial Overview**

We are the leading provider of wireline telecommunications services in four of the most economically developed regions in China, which are Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province. We provide wireline telephone, data and Internet and leased line services.

## FINANCIAL INFORMATION

The table below sets forth a breakdown of our operating revenue in terms of amount and as a percentage of our total operating revenue for the periods indicated:

	Year Ended December 31,						Six Months Ended June 30,			
	1999		2000		2001		2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
<b>Operating Revenue:</b>										
(RMB in millions, except percentage data)										
<b>Wireline telephone services:<sup>(1)</sup></b>										
Local:										
Installation fees . . .	442	0.7%	583	0.8%	780	1.1%	365	1.1%	467	1.3%
Monthly fees . . . . .	6,829	10.5	7,763	10.9	10,186	14.9	4,713	13.9	6,083	16.5
Local usage fees . . . . .	18,371	28.1	20,503	28.9	21,004	30.6	10,400	30.7	10,967	29.7
Sub-total . . . . .	25,642	39.3	28,849	40.6	31,970	46.6	15,478	45.7	17,517	47.5
Domestic long distance <sup>(2)</sup> . . . . .	15,220	23.3	17,190	24.2	14,676	21.4	7,611	22.5	7,148	19.4
International long distance <sup>(2)(3)</sup> . . . . .	6,043	9.2	5,177	7.3	3,392	4.9	1,766	5.2	1,601	4.3
Interconnections . . . .	4,779	7.3	4,869	6.9	3,814	5.6	2,009	5.9	2,272	6.2
Upfront connection fees . . . . .	5,923	9.1	6,322	8.9	6,290	9.2	3,205	9.5	3,058	8.3
Sub-total . . . . .	57,607	88.2	62,407	87.9	60,142	87.7	30,069	88.8	31,596	85.7
<b>Data and Internet services:</b>										
Internet . . . . .	435	0.7	1,144	1.6	2,150	3.1	907	2.7	1,665	4.5
Managed data . . . . .	1,429	2.2	1,750	2.5	1,477	2.2	709	2.1	846	2.3
Sub-total . . . . .	1,864	2.9	2,894	4.1	3,627	5.3	1,616	4.8	2,511	6.8
<b>Leased line services . . . . .</b>	4,549	7.0	4,268	6.0	2,862	4.2	1,391	4.1	1,555	4.2
<b>Other services<sup>(4)</sup> . . . .</b>	1,271	1.9	1,452	2.0	1,915	2.8	801	2.3	1,206	3.3
<b>Total operating revenue . . . . .</b>	<u>65,291</u>	<u>100.0%</u>	<u>71,021</u>	<u>100.0%</u>	<u>68,546</u>	<u>100.0%</u>	<u>33,877</u>	<u>100.0%</u>	<u>36,868</u>	<u>100.0%</u>

(1) Includes revenue from our registered subscribers, public telephones and prepaid calling card services. Revenue from prepaid calling card services is recognized as the services are provided to our customers.

(2) Includes revenue from our VoIP long distance services.

(3) Includes revenue from calls to Hong Kong, Macau and Taiwan.

(4) Includes primarily revenue from the provision of value-added telecommunications services and the sales and maintenance of certain customer-end equipment.

Our revenue is mainly affected by the number of our subscribers, the level of usage of our services and the levels and structure of our tariffs. Our revenue increased by 8.8% from 1999 to 2000. It decreased by 3.5% from 2000 to 2001, primarily caused by the government-mandated tariff adjustments we implemented in our service regions between January and March of 2001. Our revenue increased by 8.8% in the six months ended June 30, 2002 as a result of the expansion of our subscriber base. As we implemented the tariff adjustments in the first half of 2001, we do not expect these adjustments to contribute to any further revenue decline on a period-to-period basis for periods after 2002. We cannot predict with accuracy or assure you on the timing, likelihood or likely magnitude of tariff adjustments generally or the extent or potential impact on our business of future tariff adjustments.

## FINANCIAL INFORMATION

Revenue from our local telephone services increased by 12.5% and 10.8% in 2000 and 2001, respectively, and further increased by 13.2% in the six months ended June 30, 2002, primarily as a result of the rapid expansion of our customer base. The number of our telephone access lines in service increased from 31.9 million as of December 31, 1999 to 53.2 million as of June 30, 2002. The wireline penetration rate in our service region was 24.2% as of June 30, 2002. We expect increase in penetration will continue to drive the growth of our revenue from local telephone services.

Revenue from our domestic and international long distance services decreased by 14.6% and 34.5% respectively, in 2001, primarily due to the tariff adjustments in 2001 and increased use of lower-priced VoIP long distance services. Revenue from our domestic and international long distance services further decreased by 6.1% and 9.3%, respectively, in the six months ended June 30, 2002. We expect the usage of our VoIP services as a percentage of our total domestic and international long distance usage to continue to increase. In addition, revenue from our international long distance services is expected to continue to decline due to intensified competition.

Revenue from our Internet services increased rapidly by 163.0% and 87.9% in 2000 and 2001, respectively, and further increased by 83.6% in the six months ended June 30, 2002 due to our expanding subscriber base and increasing on-line usage. We expect revenue from Internet services to continue to grow as a result of the rapid increase in the number of broadband Internet access subscribers. Revenue from our managed data services and leased line services in 2001 was lower than that in 2000, primarily due to the 2001 tariff adjustments. As the 2001 tariff adjustments substantially affected the revenue in the first half of 2001, the increase in revenue from managed data and leased line services in the first six months of 2002 was due to increased usage of such services.

The following table sets forth a breakdown of our operating expenses in terms of amount and as a percentage of our total operating revenue for the periods indicated:

	Year Ended December 31,						Six Months Ended June 30,			
	1999		2000		2001		2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)										
<b>Operating Expenses:</b>										
Depreciation and amortization . . . . .	14,903	22.8%	17,386	24.5%	19,451	28.4%	9,365	27.6%	10,030	27.2%
Network operations and support <sup>(1)</sup> . . . . .	11,353	17.4	14,057	19.8	16,477	24.0	7,830	23.1	7,973	21.6
Selling, general and administrative <sup>(1)</sup> . . . .	5,490	8.4	6,896	9.7	6,986	10.2	3,308	9.8	3,170	8.6
Personnel . . . . .	6,294	9.6	7,794	11.0	6,207	9.1	2,986	8.8	3,393	9.2
Interconnection charges and other expenses . . . . .	889	1.4	1,264	1.7	1,327	1.9	741	2.2	1,404	3.8
<b>Total operating expenses . . . . .</b>	<b>38,929</b>	<b>59.6%</b>	<b>47,397</b>	<b>66.7%</b>	<b>50,448</b>	<b>73.6%</b>	<b>24,230</b>	<b>71.5%</b>	<b>25,970</b>	<b>70.4%</b>

(1) Does not include personnel expenses.

Our total operating expenses increased from RMB38,929 million in 1999 to RMB50,448 million in 2001, representing a compound annual growth rate of 13.8%. The

## FINANCIAL INFORMATION

increase in our total operating expenses from 1999 to 2001 was primarily due to increased depreciation and amortization expenses and network operations and support expenses associated with increased capital expenditures and network expansion as a result of the rapid growth of our business and the steady expansion of our customer base in recent years. Our total operating expenses increased by 7.2% from RMB24,230 million in the six months ended June 30, 2001 to RMB25,970 million in the six months ended June 30, 2002, but decreased as a percentage of total operating revenue and was less than the 13.0% increase in our total operating profit in the same period. We expect the amount of total operating expenses to continue to increase as our networks and operations continue to expand.

The following table sets forth our total operating revenue, operating expenses and operating profit in terms of amount and as a percentage of our total operating revenue for the periods indicated:

	Year Ended December 31,						Six Months Ended June 30,			
	1999		2000		2001		2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)										
Operating revenue . . . .	65,291	100.0%	71,021	100.0%	68,546	100.0%	33,877	100.0%	36,868	100.0%
Operating expenses . . .	38,929	59.6%	47,397	66.7%	50,448	73.6%	24,230	71.5%	25,970	70.4%
Operating profit . . . . .	26,362	40.4%	23,624	33.3%	18,098	26.4%	9,647	28.5%	10,898	29.6%
Cash flows from operations . . . . .	37,379	—	38,255	—	32,761	—	17,863	—	17,449	—

Our operating profit decreased from RMB26,362 million in 1999 to RMB18,098 million in 2001, but increased from RMB9,647 million in the six months ended June 30, 2001 to RMB10,898 million in the six months ended June 30, 2002. During these periods, our total operating expenses increased as a result of the expansion of our networks and customer base and the increased usage of our services. The decrease in our operating profit from 2000 to 2001 was also attributable to the negative impact of the 2001 tariff adjustments.

## FINANCIAL INFORMATION

### Overview of Our Services

The customer base and usage volume for most of our services grew significantly in recent years. The following table shows our selected operating data as of the dates and for the periods indicated. Please see the Section headed “Business” for a detailed discussion of these operating data.

	As of or for the Year Ended December 31,			As of or for the Six Months Ended June 30,	
	1999	2000	2001	2001	2002
<b>Local Telephone:</b>					
Access lines in service (in millions) . . . . .	31.9	39.8	48.5	44.3	53.2
Wireline penetration rate . . . . .	15.7%	18.3%	22.1%	20.3% <sup>(1)</sup>	24.2%
Total minutes (in billions) <sup>(2)</sup> . . . . .	111.8	141.9	171.5	82.5	98.4
<b>Domestic Long Distance:</b> <sup>(3)</sup>					
Total outgoing call minutes carried (in billions) . . . . .	22.88	26.97	30.63	15.05	16.34
<b>International Long Distance:</b> <sup>(3)(4)</sup>					
Total outgoing call minutes carried (in billions) . . . . .	1.28	1.42	1.41	—	0.61
<b>Managed Data (bandwidth leased in thousands):</b>					
DDN (x64Kbps) . . . . .	70.5	103.1	158.6	125.8	168.3
Frame relay (x128Kbps) . . . . .	6.1	11.2	20.4	14.6	25.1
ATM (x2Mbps) . . . . .	0.6	1.3	7.8	3.2	10.0
<b>Dial-up Internet Access:</b>					
Number of subscribers (in millions) <sup>(5)</sup> . . . . .	1.44	5.17	9.63	7.40 <sup>(6)</sup>	10.26
Total on-line minutes (in billions) . . . . .	5.61	22.22	45.55	21.67	20.34
<b>Dedicated Internet Access:</b>					
Number of subscribers (in thousands) . . . . .	2.52	5.23	5.13	5.17	4.32
<b>Broadband Access:</b>					
Number of DSL subscribers (in thousands) . .	—	5.60	300.57	88.21	662.90
Number of FTTx+LAN subscribers (in thousands) . . . . .	—	4.30	87.57	19.32	151.59
Number of other broadband access subscribers (in thousands) . . . . .	—	—	8.40	2.11	9.99
<b>Leased Digital Circuits:</b>					
Total bandwidth (x2Mbps) (bandwidth leased in thousands) . . . . .	53.5	65.1	84.3	74.8	91.9

- (1) The population number used to determine the wireline penetration rate as of June 30, 2001 is calculated based on the average of the population as of December 31, 2000 and the population as of December 31, 2001 in our service regions.
- (2) Minutes reported were converted from pulses through a statistical sampling of actual calling pattern. See “Business—Wireline Telephone Services—Local Telephone Services—Service Usage.”
- (3) Includes calls originated from wireline and mobile networks.
- (4) Includes calls to Hong Kong, Macau and Taiwan.
- (5) Excludes inactive subscribers, who have registered accounts with us but have not used our Internet access services.
- (6) Calculated as the total number of subscribers minus the estimated number of inactive subscribers.

The number of our local access lines in service and usage of our local telephone services has grown at a compound annual growth rate in excess of 20% between 1999 and 2001. Managed data services also registered significant increases over the same period, while we experienced rapid growth in Internet access subscribers and usage. We began

offering broadband access services in 2000 and our subscribers for these services grew quickly from 9,900 as of December 31, 2000 to 824,480 as of June 30, 2002.

We believe there is significant potential for further growth in China's telecommunications market, due to the growth of China's economy and per capita GDP and the broader adoption of information technology and advanced communications services in China. The wireline penetration rate in our service regions is relatively low compared to those in more developed markets in Asia and elsewhere. This presents significant potential for further expansion of our wireline customer base.

### **Tariff Adjustments**

The Chinese government announced tariff adjustments in December 2000, which we implemented in our service regions between January and March of 2001. Please see the Sections headed "Business" and "Regulation" for a detailed discussion of these tariff adjustments. These adjustments have materially affected our results of operations, resulting in a decline of our total operating revenue in 2001. As these adjustments became effective at various times in the first half of 2001, our operating results in 2001 do not reflect the full impact of these adjustments on our financial results on an annual basis. In addition, as we implemented these tariff adjustments in the first half of 2001, we do not expect these adjustments to contribute to any further revenue decline on a period-to-period basis for periods after 2002.

The 2001 tariff adjustments increased the per minute usage tariff levels for intra-district local telephone services and substantially increased the monthly fee tariffs. These increases were partially offset by the impact of a reclassification of our calling districts that resulted in calls that were previously inter-district calls being treated as intra-district calls, and therefore subject to lower per minute usage tariffs.

The 2001 tariff adjustments also substantially decreased the tariffs for our domestic and international long distance services using public switched telephone networks, data and leased line services and deregulated the VoIP tariffs. These tariff decreases contributed to the decline in revenue from these services in 2001. We face significant competition in our long distance, data and leased line services. As the tariff adjustments substantially lowered the tariff levels for all providers of these services, we believe that the reduction of tariffs for these services partially lessened the competitive pressure we experienced from other providers of these services. We further believe that the tariff adjustments stimulated the usage of these services.

The tariff adjustments also substantially lowered the communications fees for dial-up Internet access. This further stimulated the rapid growth of on-line usage in China. The number of our dial-up Internet access subscribers increased from 5.2 million as of December 31, 2000 to 10.3 million as of June 30, 2002.

### **Our Reorganization and Asset Revaluation**

Prior to our Reorganization we conducted in preparation for this Global Offering, our operations were conducted by China Telecom Group and its predecessors. As part of our restructuring, China Telecom Group transferred to us assets and liabilities related to its

## FINANCIAL INFORMATION

operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province. Please see the Section headed “Our Reorganization” for a discussion of our Reorganization.

As part of our Reorganization, we entered into certain agreements and arrangements with China Telecommunications Corporation and its other subsidiaries. See the Section headed “Business—Connected Transactions” for further information. Except for the optic fiber and property leasing agreements, the expected effects of these agreements and arrangements are not reflected in our pro forma combined financial information because the effects of these changes on our combined financial statements are not factually supportable.

The effects of these agreements and arrangements, which took effect on January 1, 2002, are reflected in our income statement for the six months ended June 30, 2002. The amount paid to China Telecom Group for the provision of construction, engineering and information technology services, community services, ancillary services and centralized services in connection with our related party transactions increased by RMB434 million compared to those in the six months period ended on June 30, 2001. The net amount of the interconnection settlement paid to China Telecom Group in connection with our interconnection arrangements was RMB241 million. See Note 27 to Section V of Appendix I—“Accountants Report” included elsewhere in this prospectus.

In connection with our incorporation and Reorganization as required by the relevant PRC regulations, we engaged Beijing China Enterprise Appraisal Co., Ltd., an independent appraiser registered in the PRC, to conduct a valuation of each asset class of our property, plant and equipment on a depreciated replacement cost basis as of December 31, 2001. The total value of our property, plant and equipment as of December 31, 2001 was revalued to be RMB138,623 million. We recorded a non-cash charge to income of RMB11,930 million in 2001 with respect to the revaluation deficit in the carrying amount of certain property, plant and equipment below their historical cost bases. The revaluation deficit in the carrying amount was primarily due to the then-current market decline in the replacement cost of certain network switching equipment. In connection with the revaluation, we also recorded a credit to our revaluation reserve of RMB4,154 million in 2001 with respect to the surplus on revaluation of certain property, plant and equipment. The historical carrying amount of the Group’s property, plant and equipment as of December 31, 2001 and the revalued basis of these assets is as follows:

	Historical carrying amount	Revaluation surplus	Revaluation deficit	Revalued amount
	RMB million	RMB million	RMB million	RMB million
Buildings and improvements . . . . .	21,664	2,361	(238)	23,787
Telecommunications network and equipment . . . . .	118,579	1,653	(10,950)	109,282
Furniture, fixture, motor vehicles and other equipment . .	6,156	140	(742)	5,554
	<u>146,399</u>	<u>4,154</u>	<u>(11,930)</u>	<u>138,623</u>

In addition, as required by the relevant PRC regulations with respect to the restructuring, our land use rights were also revalued. The total amount of our land use rights was determined to be RMB14,939 million, an increase of RMB12,301 million over the historical carrying amounts of such land use rights. For financial reporting purposes, land use

rights are carried at historical cost, but as a result of the tax deductibility of the revalued amount, a deferred tax asset was created with a corresponding credit to equity. Please see Note 7 to Section V of Appendix I— “Accountants’ Report” included elsewhere in this prospectus for further information.

### **Pro Forma Adjustments and Their Financial Impact**

We have prepared unaudited pro forma combined financial information, as described below, to reflect the effects of our Reorganization in preparation for this Global Offering that are directly attributable to our Reorganization, are expected to have a continuing impact on us, and are factually supportable. We believe that these transactions will have an impact on our overall results of operations, and therefore, a pro forma presentation reflecting these transactions as if they occurred on January 1, 2001 is necessary to supplement our historical financial information. The expected effects of our new agreements and arrangements (other than the optic fiber and property leasing agreements) with China Telecom Group are not reflected in the pro forma combined financial information because the effects of these changes cannot be factually supported, reasonably estimated and/or do not result in any material change to our results of operations. The expected effects of our interconnection agreement with China Telecommunications Corporation in respect of calculating interconnection revenues and charges are not reflected in the pro forma combined financial information due to a lack of sufficient historical data.

*Revaluation of property, plant and equipment.* In connection with our Reorganization, our property, plant and equipment were revalued as of December 31, 2001, which resulted in a net revaluation deficit of RMB7,776 million. The pro forma adjustments reflect the reduction in depreciation charge resulting from the revaluation of our property, plant, and equipment as if the results of the revaluation had been recorded on January 1, 2001.

*Lease of inter-provincial transmission optic fibers.* In connection with our Reorganization, the inter-provincial transmission optic fibers associated with the operations of our predecessor in our service regions were not transferred to us but were retained by China Telecommunications Corporation. Under an optic fiber leasing agreement, we will lease the inter-provincial transmission optic fibers from China Telecommunications Corporation. The pro forma adjustments reflect the effects of the reduction in depreciation charge relating to the optic fibers and an increase in leasing expenses as if our Reorganization occurred and the leasing agreement took effect on January 1, 2001.

*Property leasing.* In connection with our Reorganization, certain properties and buildings associated with the operations of our predecessor in our service regions were not transferred to us but were retained by China Telecom Group. Under property leasing agreements between us and China Telecom Group, we will lease the properties and buildings from China Telecom Group. The amount to be paid by us to China Telecom Group will be based on market rates with reference to amounts stipulated by local price bureaus. The pro forma adjustments reflect the effects of the reduction in depreciation charge relating to these properties and buildings and an increase in rental expense as if our restructuring occurred and the property leasing agreements took effect on January 1, 2001.

*Long-term investments.* In connection with our Reorganization, certain long term investments and interests in associates that are unrelated to the telecommunications industry

---

## FINANCIAL INFORMATION

---

were not transferred to us but were retained by China Telecom Group. The pro forma adjustment reflects the reduction in investment income generated from these investments as if our Reorganization occurred on January 1, 2001.

*Tax effect.* The pro forma adjustment reflects the tax effect of the above pro forma adjustments using the statutory tax rate of 33%.

As a result of the foregoing pro forma adjustments, for the year ended December 31, 2001:

- our operating profit would have increased by 7.4%, or RMB1,339 million, from RMB18,098 million on a historical basis to RMB19,437 million on a pro forma basis under IFRS; and
- our net profit would have increased by 10.2%, or RMB703 million, from RMB6,883 million on a historical basis to RMB7,586 million on a pro forma basis under IFRS.

For further information, see Section II of Appendix II—“Additional Financial Information” included elsewhere in this prospectus.

### CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations contained elsewhere in this prospectus are based on our audited combined financial information which has been prepared in accordance with IFRS. Our reported financial condition and results of operations are sensitive to accounting methods, assumptions and estimates that underlie the preparation of our combined financial information. We base our assumptions and estimates on historical experience and on various other assumptions that we believe to be reasonable and which form the basis for making judgments about matters that are not readily apparent from other sources. On an on-going basis, our management evaluates its estimates. Actual results may differ from those estimates as facts, circumstances and conditions change.

The selection of critical accounting policies, the judgments and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing our combined financial information. Our principal accounting policies are set forth in detail in Note 2 to Section V of Appendix I—“Accountants’ Report” included elsewhere in this prospectus. We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our combined financial information.

#### ***Accounting for Long-lived Assets***

*Depreciation.* Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, after taking into account their estimated residual value. We review the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any reporting period. The useful lives are based on our historical experience with similar assets and taking into account anticipated technological changes. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates.

*Impairment.* The carrying amounts of long-lived assets, including property, plant and equipment, are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount of impairment loss is the difference between the carrying amounts of the assets and their recoverable amounts. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the assets are discounted to their present value, which requires significant judgment in terms of projection of cash flows for future years and the assumption on the pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the periods presented, no impairment losses were recognized in our audited combined statements of income.

*Revaluation.* As required by the relevant PRC rules and regulations, our property, plant and equipment were revalued as of December 31, 2001. Subsequent to that revaluation, property, plant and equipment are carried at the revalued amount, being the fair value as at the date of the revaluation, less subsequent accumulated depreciation and impairment losses. Revaluations will be performed with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. The results of subsequent revaluations may have an impact on our future results to the extent the fair values of our property, plant and equipment change significantly.

### ***Revenue Recognition***

We defer the recognition of upfront customer connection and installation fees and amortize them over the expected customer relationship period of ten years. The related direct incremental customer acquisition costs are also deferred and amortized over the same expected customer relationship period. We estimate the expected customer relationship period based on our historical customer retention experience and factoring in the expected level of future competition, the risk of technological or functional obsolescence to our services, technological innovation, and the expected changes in the regulatory and social environment. If our estimate of the expected customer relationship period changes as a result of increased competition, changes in telecommunications technology or other factors, the amount and timing of recognition of our deferred revenue may change for future periods.

### ***Provision for Doubtful Debts***

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make the required payments. We base our estimates on the aging of our accounts receivable balance, customer credit-worthiness, and historical write-off experience. If the financial condition of our customers were to deteriorate, actual write-offs might be higher than expected.

**Revenue and Expense Items**

*Operating Revenue.* Our revenue represents revenue from the provision of telecommunications services, net of business tax and government levies. Our principal sources of revenue include the following:

- *Local service fees.* Revenue from our local wireline telecommunications services comprises installation fees, monthly fees and usage fees. Installation fees represent the amortized amount of the upfront fees received for installation of wireline services. These upfront fees are deferred and recognized over ten years. Usage fees for local services include usage fees for telephone calls and communications fees for dial-up Internet access.
- *Domestic long distance services.* Revenue from our domestic long distance services consists of usage fees charged to our customers for their domestic long distance calls originated by our wireline subscribers within our service regions.
- *International long distance services.* Revenue from our international long distance services consists of usage fees charged to our customers for their international long distance calls originated by our wireline subscribers within our service regions, including those made to Hong Kong, Macau and Taiwan.
- *Interconnection services.* Revenue from our interconnection services consists of interconnection fees from other telecommunications operators.
- *Upfront connection fees.* Upfront connection fees represent the amortized amount of the upfront fees received for the initial activation of wireline services. These upfront fees are deferred and recognized over ten years. Effective on July 1, 2001, we ceased charging upfront connection fees to new subscribers. The amortized amount of upfront connection fees will be RMB6,018 million in the year 2002, RMB5,536 million in 2003, RMB4,785 million in 2004, RMB3,842 million in 2005, RMB2,814 million in 2006, RMB4,015 million in 2007 to 2011 and zero in the year 2012, based on a ten-year amortization period.
- *Internet services.* Revenue from our Internet access services represents network access fees that we receive for dial-up, dedicated and broadband Internet access services that we provide.
- *Managed data services.* Revenue from our managed data services represents fees that we charge for our DDN, frame relay and ATM services.
- *Leased line services.* Revenue from our leased line services represents fees that we receive from our customers, including other telecommunications operators, for our leased line services, including the lease of digital circuits, digital trunk lines and optic fibers.
- *Other services.* Other revenue primarily includes revenue from the provision of value-added telecommunications services and the sales and maintenance of certain customer-end equipment.

*Operating Expenses.* The key components of our operating expenses are:

- *Depreciation and amortization expenses.* Depreciation of our property, plant and equipment is calculated on a straight-line basis over their estimated useful lives, after taking into account their estimated residual value. Our property, plant and

equipment include buildings and improvements, telecommunication network plants, transmission and switching equipment, and furniture, fixture, motor vehicles and other equipment, and are depreciated using different depreciable lives. For example, our telecommunication network plants, transmission and switching equipment are depreciated over periods of six to ten years.

- *Network operations and support expenses.* Network operations and support expenses primarily consist of repair and maintenance expenses incurred in connection with the operation of our telecommunications networks, utility expenses, personnel expenses, cost of sales relating to customer-end equipment and prepaid telephone cards, and the amortized amount of telephone installation cost. For purposes of analyzing our historical operating results, personnel expenses have been excluded from network operations and support expenses and have been separately analyzed.
- *Selling, general and administrative expenses.* Selling, general and administrative expenses primarily consist of sales and marketing expenses, personnel expenses and general and administrative expenses and provisions for doubtful debts. Sales and marketing expenses include sales commissions paid to distributors and sales agents and advertisement and marketing expenses. General and administrative expenses include administrative, travel, meeting and insurance expenses. For purposes of analyzing our historical operating results, personnel expenses have been excluded from selling, general and administrative expenses and have been separately analyzed.
- *Personnel expenses.* Personnel expenses comprise employee wages, benefits and other related expenses, including benefits under our defined contribution retirement plans. For financial reporting purposes, personnel expenses are classified according to network operations and support and selling, general and administrative functions.
- *Interconnection charges and other expenses.* Interconnection and other expenses mainly include interconnection charges and other expenses such as charitable donations.

*Minority Interests.* The minority interests primarily relate to subsidiaries which were not wholly owned and were insignificant to our results of operation and financial position.

### Review of Historical Operating Results

#### ***Six Months Ended June 30, 2002 Compared to Six Months Ended June 30, 2001***

##### ***Operating Revenue***

Our operating revenue increased by 8.8%, from RMB33,877 million in the six months ended June 30, 2001 to RMB36,868 million in the six months ended June 30, 2002. This increase primarily reflected increases in revenue from monthly fees for local telephone services and revenue from Internet access services.

*Local Telephone Services.* Revenue from our local wireline telephone services increased by 13.2%, from RMB15,478 million in the six months ended June 30, 2001 to RMB17,517 million in the six months ended June 30, 2002. This increase was primarily due to

increases in monthly fee revenue and local usage fee revenue, resulting from an increase in the number of access lines in service. The number of access lines in service in our service regions increased from 44.3 million as of June 30, 2001 to 53.2 million as of June 30, 2002.

- *Installation Fees.* Revenue from the amortized amount of upfront installation fees increased by 27.9%, from RMB365 million in the six months ended June 30, 2001 to RMB467 million in the six months ended June 30, 2002. This increase was due to the increase in the number of access lines in service in recent years.
- *Monthly Fees.* Monthly fee revenue increased by 29.1%, from RMB4,713 million in the six months ended June 30, 2001 to RMB6,083 million in the six months ended June 30, 2002. This increase was primarily due to increases in the number of access lines in service and in the average monthly fee tariff under the 2001 tariff adjustments. Average monthly fees per line increased by 6.4%, from RMB18.7 in the six months ended June 30, 2001 to RMB19.9 in the six months ended June 30, 2002.
- *Local Usage Fees.* Revenue from local usage fees increased by 5.5%, from RMB10,400 million in the six months ended June 30, 2001 to RMB10,967 million in the six months ended June 30, 2002. This increase was primarily due to the increase in total usage volume by 19.3%, from 82.5 billion minutes in the six months ended June 30, 2001 to 98.4 billion minutes in the six months ended June 30, 2002, partially offset by the impact of a reclassification of our calling districts that resulted in calls that were previously inter-district calls being treated as lower priced intra-district calls.

*Domestic Long Distance Services.* Domestic long distance revenue decreased by 6.1%, from RMB7,611 million in the six months ended June 30, 2001 to RMB7,148 million in the six months ended June 30, 2002. This decrease was primarily due to tariff reduction and the increase in the usage of our VoIP services, which have substantially lower tariffs than those of long distance services using public switched telephone networks, as a percentage of our total domestic long distance usage. Total usage of domestic long distance services (including calls originated from wireline and mobile subscribers) increased by 7.9%, from 15.1 billion minutes in the six months ended June 30, 2001 to 16.3 billion minutes in the six months ended June 30, 2002.

*International Long Distance Services.* Revenue from international long distance services decreased by 9.3%, from RMB1,766 million in the six months ended June 30, 2001 to RMB1,601 million in the six months ended June 30, 2002. This revenue decrease was primarily due to tariff reduction and an increase in the usage of our lower priced VoIP services as a percentage of our total international long distance usage.

*Interconnection Services.* Revenue from interconnection fees increased by 13.1%, from RMB2,009 million in the six months ended June 30, 2001 to RMB2,272 million in the six months ended June 30, 2002. This increase primarily reflected the settlement revenue we began to receive from China Telecom Group and international operators under our interconnection agreement with China Telecom Group and our arrangement with China Telecom Group for apportionment of international settlement, which amounted to RMB1,012 million in the six months ended June 30, 2002. Such agreement and arrangement became

---

## FINANCIAL INFORMATION

---

effective on January 1, 2002. See the Sections headed “Business—Connected Transactions—Arrangements relating to the Reorganization and the Global Offering—Apportionment of International Settlement” and “Business—Connected Transactions—Ongoing Connected Transactions Between Us and China Telecommunications Corporation—Interconnection Agreement.” This increase was offset by the decrease in interconnection revenue from other operators of RMB749 million.

*Upfront Connection Fees.* The amortized amount of upfront connection fees received decreased by 4.6%, from RMB3,205 million in the six months ended June 30, 2001 to RMB3,058 million in the six months ended June 30, 2002 because we ceased charging upfront connection fees to new subscribers effective on July 1, 2001.

*Internet Services.* Internet access services revenue increased by 83.6%, from RMB907 million in the six months ended June 30, 2001 to RMB1,665 million in the six months ended June 30, 2002. This increase reflected the rapid increase in the number of broadband Internet access subscribers in the period. The number of our broadband Internet access subscribers increased from approximately 109,640 as of June 30, 2001 to approximately 824,480 as of June 30, 2002.

*Managed Data Services.* Revenue from managed data services increased by 19.3%, from RMB709 million in the six months ended June 30, 2001 to RMB846 million in the six months ended June 30, 2002. The primary reason for the increase was due to an increase in the usage of our managing data services in the period. The total leased bandwidth of our DDN services was 168,300 x64Kbps as of June 30, 2002, representing an increase of 33.8% from that as of June 30, 2001. The total leased bandwidth of our ATM services was 10,000 x2Mbps as of June 30, 2002, representing an increase of 212.5% from that as of June 30, 2001, and the total leased bandwidth of our frame relay services was 25,100 x128Kbps, representing an increase of 71.9% from that as of June 30, 2001.

*Leased Line Services.* Revenue from leased line services increased by 11.8%, from RMB1,391 million in the six months ended June 30, 2001 to RMB1,555 million in the six months ended June 30, 2002. This increase was primarily due to the increased leasing of our digital circuits by our corporate customers. The total leased bandwidth of our digital circuits increased by 22.9%, from 74,800 x2Mbps in the six months ended June 30, 2001 to 91,900 x2Mbps in the six months ended June 30, 2002.

*Other Services.* Revenue from other services increased by 50.6%, from RMB801 million in the six months ended June 30, 2001 to RMB1,206 million in the six months ended June 30, 2002. This increase was primarily due to the growth in our value-added telephone services and sales and rental revenue from customer-end equipment.

### ***Operating Expenses***

Total operating expenses increased by 7.2%, from RMB24,230 million in the six months ended June 30, 2001 to RMB25,970 million in the six months ended June 30, 2002. This increase was mainly due to increases in depreciation and amortization, personnel and interconnection expenses as a result of the growth of our business and the expansion of our customer base in the period.

---

## FINANCIAL INFORMATION

---

*Depreciation and Amortization.* Our depreciation and amortization expenses increased by 7.1%, from RMB9,365 million in the six months ended June 30, 2001 to RMB10,030 million in the six months ended June 30, 2002, mainly due to increases in capital expenditures in recent years.

*Network Operations and Support.* Excluding personnel related costs of RMB1,823 million and RMB2,046 million in the six months ended June 30, 2001 and 2002, respectively, our network operations and support expenses increased by 1.8%, from RMB7,830 million to RMB7,973 million in those periods. The related party transactions we entered into with China Telecom Group in connection with our Reorganization, including the leasing of inter-provincial transmission optic fibers and certain properties from China Telecom Group and the apportionment of the costs associated with operating international telecommunications facilities of China Telecom Group, took effect on January 1, 2002, for which expenses amounted to approximately RMB500 million in the six months ended June 30, 2002. These expenses were largely offset by a 8.1% decrease in our maintenance expenses, from RMB5,018 million in the six months ended June 30, 2001 to RMB4,612 million in the six months ended June 30, 2002, and a 2.0% decrease in our utility expenses, from RMB797 million in the six months ended June 30, 2001 to RMB781 million in the six months ended June 30, 2002.

*Selling, General and Administrative Expenses.* Excluding personnel related costs of RMB1,163 million and RMB1,347 million in the six months ended June 30, 2001 and 2002, respectively, our selling, general and administrative expenses decreased by 4.2%, from RMB3,308 million to RMB3,170 million in those periods.

*Personnel Expenses.* Personnel expenses increased by 13.6%, from RMB2,986 million in the six months ended June 30, 2001 to RMB3,393 million in the six months ended June 30, 2002, primarily due to the increase in employee compensation.

*Interconnection Charges and Other Expenses.* Interconnection and other expenses increased by 89.5%, from RMB741 million in the six months ended June 30, 2001 to RMB1,404 million in the six months ended June 30, 2002. This increase was primarily due to the settlement expenses we began to pay to China Telecom Group and international operators under our interconnection agreement with China Telecom Group and our arrangement with China Telecom Group for apportionment of international settlement, which amounted to RMB1,136 million in the six months ended June 30, 2002. Such agreement and arrangements became effective on January 1, 2002. See the Sections headed “Business—Connected Transactions—Arrangements relating to the Reorganization and the Global Offering—Apportionment of International Settlement” and “Business—Connected Transactions—Ongoing Connected Transactions Between Us and China Telecommunications Corporation—Interconnection Agreement.” This increase was partially offset by a decrease in domestic interconnection expenses payable to other operators of RMB469 million.

### ***Net Finance Costs/(Income)***

In the six months ended June 30, 2001, we had net finance income of RMB187 million, while in the six months ended June 30, 2002, we had net finance costs of RMB421 million.

This change was primarily due to a net foreign exchange gain of RMB221 million in the first half of 2001 and a net foreign exchange loss of RMB218 million in the first half of 2002. In addition, net interest expense increased from RMB143 million in the six months ended June 30, 2001 to RMB270 million in the six months ended June 30, 2002.

### ***Taxation***

Our statutory income tax rate is 33%. Our income tax expense increased by 10.7%, from RMB1,775 million in the six months ended June 30, 2001 to RMB1,965 million in the six months ended June 30, 2002. The effective tax rates were 17.8% and 18.7%, respectively. The difference between the statutory tax rate and our effective tax rate was primarily due to the preferential income tax rate of 15% applied to some of our subsidiaries located in special economic zones in China and the exclusion of the upfront connection fees and part of the usage fees from taxable revenue. See Note 21 to Section V of Appendix I—"Accountants Report" included elsewhere in this prospectus for further detail in respect of the reconciliation of our effective tax rate to the statutory tax rate of 33%.

### ***Net Profit***

Net Profit increased by 4.3%, from RMB8,137 million in the six months ended June 30, 2001 to RMB8,483 million in the six months ended June 30, 2002. This increase was primarily due to increased operating income, which was partially offset by the increase in net finance costs.

## ***Year Ended December 31, 2001 Compared to Year Ended December 31, 2000***

### ***Operating Revenue***

Our total operating revenue decreased by 3.5%, from RMB71,021 million in 2000 to RMB68,546 million in 2001. This decrease primarily reflected decreases in domestic long distance, international long distance, leased line and interconnection revenue. The decrease was partially offset by the steady growth in local wireline telephone services revenue and the rapid growth in Internet access revenue.

*Local Telephone Services.* Revenue from our local wireline telephone services increased 10.8%, from RMB28,849 million in 2000 to RMB31,970 million in 2001. This increase resulted primarily from increases in revenue from monthly fees and local usage fees.

- *Installation Fees.* Revenue from the amortized amount of upfront installation fees increased by 33.8%, from RMB583 million in 2000 to RMB780 million in 2001. This increase was due to the increase in the number of access lines from 31.9 million as of December 31, 1999 to 48.5 million as of December 31, 2001.
- *Monthly Fees.* Monthly fees revenue increased by 31.2%, from RMB7,763 million in 2000 to RMB10,186 million in 2001. This increase was primarily due to an increase of 21.9% in the number of access lines in service, from 39.8 million as of December 31, 2000 to 48.5 million as of December 31, 2001. In addition, average monthly fees per line increased by 6.1%, from RMB18.1 in 2000 to RMB19.2 in 2001 due to increases in monthly fee tariffs as a result of the tariff adjustments in 2001.

---

## FINANCIAL INFORMATION

---

- *Local Usage Fees.* Revenue from local usage increased by 2.4%, from RMB20,503 million in 2000 to RMB21,004 million in 2001. Total usage volume, which includes usage for local call services and for dial-up Internet access, increased by 20.9%, from 141.9 billion minutes in 2000 to 171.5 billion minutes in 2001. Dial-up Internet usage increased 105.0%, from 22.2 billion minutes in 2000 to 45.5 billion minutes in 2001. Dial-up Internet usage, as a percentage of total local usage, increased from 15.6% in 2000 to 26.6% in 2001. Tariffs for the communications fees of dial-up Internet access were substantially lower than those for the usage fees for voice services.

*Domestic Long Distance Services.* Domestic long distance revenue decreased by 14.6%, from RMB17,190 million in 2000 to RMB14,676 million in 2001. This decrease was primarily due to substantial tariff reductions, as a result of the 2001 tariff adjustments. In addition, the usage of our VoIP domestic long distance services, which have substantially lower tariffs than those of long distance services using public switched telephone networks, as a percentage of the total usage of domestic long distance services increased from 8.1% in 2000 to 37.5% in 2001. Total usage of domestic long distance services (including calls originated from wireline and mobile subscribers) increased by 13.3%, from 27.0 billion minutes in 2000 to 30.6 billion minutes in 2001. The increase in usage of our VoIP services was not sufficient to offset the adverse impact on our revenue from the 23.0% decrease in usage of our long distance services using public switched telephone networks, from 24.8 billion minutes in 2000 to 19.1 billion minutes in 2001.

*International Long Distance Services.* Revenue from international long distance services decreased by 34.5%, from RMB5,177 million in 2000 to RMB3,392 million in 2001. This revenue decrease was due to increased competition, tariff reduction and the substantial increase in the usage of our VoIP services as a proportion of our total international long distance usage. The usage of our VoIP international long distance services as a percentage of the total usage of international long distance services increased from 9.2% in 2000 to 27.8% in 2001. Total usage of international long distance services (including calls originated from wireline and mobile subscribers) decreased by 0.7%, from 1.42 billion minutes in 2000 to 1.41 billion minutes in 2001. Since VoIP international long distance services had substantially lower tariffs than international long distance services using public switched telephone networks, the increase in the percentage of VoIP services further reduced the per minute revenue generated by our international long distance services.

*Interconnection Services.* Revenue from interconnection fees decreased by 21.7%, from RMB4,869 million in 2000 to RMB3,814 million in 2001. This decrease was primarily due to expansions in other operators' long-distance networks and the routing of long distance traffic to those networks, which reduced the usage of our long distance interconnection services. While revenue from local interconnection services increased, it was insufficient to offset the decrease in long distance interconnection services in 2001. As we have extensive local networks and a large wireline customer base, we expect that the increase in interconnection traffic will increase our revenue from local interconnection services and its proportion of our total interconnection services revenue.

*Upfront Connection Fees.* The amortized amount of upfront connection fees received decreased from RMB6,322 million in 2000 to RMB6,290 million in 2001.

---

## FINANCIAL INFORMATION

---

*Internet Services.* Internet access services revenue increased by 87.9%, from RMB1,144 million in 2000 to RMB2,150 million in 2001. This increase was primarily due to increased Internet access usage and our expanded subscriber base. Dial-up Internet access usage increased by 105.0%, from 22.2 billion minutes in 2000 to 45.5 billion minutes in 2001. Broadband access also increased rapidly, with the number of broadband subscribers increasing from 9,900 as of the end of 2000 to 396,540 as of the end of 2001.

*Managed Data Services.* Revenue from managed data services decreased by 15.6%, from RMB1,750 million in 2000 to RMB1,477 million in 2001. This decrease was primarily due to a substantial tariff reduction as a result of the 2001 tariff adjustments. We experienced an increase in usage that partially offset the effects of the tariff adjustments. The total leased bandwidth of our DDN services was 158,600 x64Kbps as of December 31, 2001, representing an increase of 53.8% from 2000. As of December 31, 2001, the total leased bandwidth of our ATM services was 7,800 x2Mbps, representing an increase of 500.0% from 2000 and the total leased bandwidth of frame relay services was 20,400 x128Kbps, representing an increase of 82.1% from 2000.

*Leased Line Services.* Revenue from leased line services decreased by 32.9%, from RMB4,268 million in 2000 to RMB2,862 million in 2001. This decrease was largely due to substantial tariff declines. For example, the monthly fee for the lease of intra-provincial 2-Mbps digital circuits was reduced from RMB14,180 to RMB6,000. The increase in the usage of leased line services was insufficient to offset the losses in revenue caused by the 2001 tariff adjustments.

*Other Services.* Other services revenue increased by 31.9%, from RMB1,452 million in 2000 to RMB1,915 million in 2001. This increase was primarily due to the rapid growth in value-added telephone services.

### ***Operating Expenses***

Total operating expenses increased by 6.4%, from RMB47,397 million in 2000 to RMB50,448 million in 2001, mainly due to increases in depreciation and amortization and network operations and support expenses.

*Depreciation and Amortization.* Our depreciation and amortization expenses increased by 11.9% from RMB17,386 million in 2000 to RMB19,451 million in 2001, mainly due to increases in capital expenditures in recent years.

*Network Operations and Support.* Excluding personnel related costs of RMB3,792 million in 2001 and RMB4,947 million in 2000, respectively, our network operations and support expenses increased 17.2%, from RMB14,057 million in 2000 to RMB16,477 million in 2001. Increased network operations and support expenses included maintenance expenses, which increased by 6.0%, from RMB9,650 million in 2000 to RMB10,225 million in 2001, and utility expenses, which increased by 22.3%, from RMB1,411 million in 2000 to RMB1,725 million in 2001. These expense increases were primarily due to the expansion of our customer base, the increase in the variety of services provided and the expansion of our networks. The number of our access lines in service increased by 21.9%, from 39.8 million as of December 31, 2000 to 48.5 million as of December 31, 2001. The total capacity of our local

switches increased by 20.4%, from 57.0 million lines as of December 31, 2000 to 68.6 million lines as of December 31, 2001. Although our overall network operations and support expenses increased, our network operations and support expenses per line or per unit of capacity decreased. Network operations and support expenses also increased due to the increase in the cost of sales of customer-end equipment and prepaid telephone cards and the amortized amount of telephone installation cost.

*Selling, General and Administrative Expenses.* Excluding personnel related costs of RMB2,415 million in 2001 and RMB2,847 million in 2000, respectively, selling, general and administrative expenses increased by 1.3%, from RMB6,896 million in 2000 to RMB6,986 million in 2001. Sales and marketing expenses increased by 4.0%, from RMB2,956 million in 2000 to RMB3,074 million in 2001. This increase was primarily due to a 27.3% increase in expenses relating to promotional and advertising activities, from RMB862 million in 2000 to RMB1,097 million in 2001. General and administrative expenses decreased by 0.7%, from RMB3,940 million in 2000 to RMB3,912 million in 2001. General and administrative expenses included provision for doubtful debt, which decreased from RMB223 million in 2000 to RMB186 million in 2001.

*Personnel Expenses.* Personnel expenses decreased by 20.4%, from RMB7,794 million in 2000 to RMB6,207 million in 2001. This decrease was primarily due to a regulatory change regarding employee housing benefits. In accordance with the relevant PRC regulations, we ceased the sale of staff quarters to our employees at subsidized prices beginning January 1, 2001. In 2000, we recorded an expense of approximately RMB1,400 million relating to the sale of staff quarters.

*Interconnection Charges and Other Expenses.* Interconnection and other expenses increased by 5.0%, from RMB1,264 million in 2000 to RMB1,327 million in 2001. This increase was primarily due to the increased local interconnection expenses caused by the general expansion of the customer bases of other operators.

### ***Deficit on Revaluation of Property, Plant and Equipment***

In connection with our incorporation and Reorganization, as required by the relevant PRC regulations, we engaged Beijing China Enterprise Appraisal Co., Ltd. to conduct a valuation of each asset class of our property, plant and equipment on a depreciated cost basis as of December 31, 2001. We recorded a charge to income of RMB11,930 million in 2001 with respect to the revaluation deficit in the carrying amount of certain property, plant and equipment below their historical cost bases. Please see Note 3 to Section V of Appendix I—"Accountants' Report" included elsewhere in this prospectus for further information on the revaluation.

### ***Taxation***

Our statutory income tax rate is 33%. Our income tax expense was RMB4,857 million in 2000, whereas we recorded an income tax benefit of RMB69 million in 2001. The effective tax rates were 20.1% and negative 1.0%, respectively. The difference between the statutory tax rate and our effective tax rate was primarily due to the preferential income tax rate of 15% applied to some of our subsidiaries located in special economic zones in China and the

exclusion of the upfront connection fees and part of the usage fees from taxable revenue. See Note 21 to Section V of Appendix I—"Accountants' Report" included elsewhere in this prospectus for further detail in respect of the reconciliation of our effective tax rate to the statutory tax rate of 33%.

### ***Net Profit***

Net profit decreased by 64.2%, from RMB19,219 million in 2000 to RMB6,883 million in 2001. This reduction was principally due to the revaluation deficit charge of RMB11,930 million resulting from the revaluation of our property, plant and equipment as of December 31, 2001, net of related income tax. In addition, our net profit also decreased due to the effects of the 2001 tariff adjustments.

## ***Year Ended December 31, 2000 Compared to Year Ended December 31, 1999***

### ***Operating Revenue***

Our total operating revenue increased from RMB65,291 million in 1999 to RMB71,021 million in 2000, an increase of 8.8%. This increase reflected increases in local telephone, domestic long distance, interconnection, Internet and managed data service revenue, which were partially offset by decreases in international long distance and leased line service revenue.

*Local Telephone Services.* Revenue from local wireline telecommunications services increased by 12.5%, from RMB25,642 million in 1999 to RMB28,849 million in 2000. The increase in monthly fees and local usage fees was mainly due to an increase in our total number of access lines in service.

- *Installation Fees.* Revenue from the amortized amount of upfront installation fees increased by 31.9%, from RMB442 million in 1999 to RMB583 million in 2000. This increase was primarily due to the rapid growth in the number of access lines in service in recent years.
- *Monthly Fees.* Monthly fees increased by 13.7%, from RMB6,829 million in 1999 to RMB7,763 million in 2000. The main reason for this increase was an increase of 24.8% in the number of our access lines in service, from 31.9 million as of December 31, 1999 to 39.8 million as of December 31, 2000.
- *Local Usage Fees.* Local usage fees increased by 11.6%, from RMB18,371 million in 1999 to RMB20,503 million in 2000. This increase was primarily due to a 26.9% increase in total local usage, from 111.8 billion minutes in 1999 to 141.9 billion minutes in 2000. Dial-up Internet usage increased 296.1%, from 5.6 billion minutes in 1999 to 22.2 billion minutes in 2000. Dial-up Internet usage, as a percentage of total local usage, increased from 5.0% in 1999 to 15.7% in 2000. Tariffs for the communications fees of dial-up Internet access were substantially lower than the usage fees for voice services.

*Domestic Long Distance Services.* Revenue from domestic long distance services increased by 12.9%, from RMB15,220 million in 1999 to RMB17,190 million in 2000, primarily as a result of an increase in total usage. Total usage of our domestic long distance services

---

## FINANCIAL INFORMATION

---

(including calls originated from wireline and mobile subscribers) increased by 17.9%, from 22.9 billion minutes in 1999 to 27.0 billion minutes in 2000. We began to offer VoIP services in 1999 on a trial basis. The usage of our VoIP domestic long distance services increased substantially in 2000, from 3 million minutes in 1999 to 2,187 million minutes in 2000. The tariffs for VoIP long distance services were substantially lower than the tariffs for long distance services using public switched telephone networks.

*International Long Distance Services.* Revenue from international long distance services decreased by 14.3%, from RMB6,043 million in 1999 to RMB5,177 million in 2000. This decrease was primarily due to increased competition and the increase in the usage of our VoIP services as a proportion of our total international long distance services. Usage of our VoIP international long distance services increased from 0.2 million minutes in 1999 to 130.9 million minutes in 2000. Total usage of international long distance services (including calls originated from wireline and mobile subscribers) increased by 10.9%, from 1.28 billion minutes in 1999 to 1.42 billion minutes in 2000. Since VoIP international long distance services had substantially lower tariffs than international long distance services using public switched telephone networks, the increase in the percentage of VoIP services further reduced the per minute revenue generated by our international long distance services.

*Interconnection Services.* Revenue from interconnection services increased by 1.9%, from RMB4,779 million in 1999 to RMB4,869 million in 2000.

*Upfront Connection Fees.* Revenue from the amortized amount of upfront connection fees increased by 6.7% from RMB5,923 million in 1999 to RMB6,322 million in 2000, as the number of our access lines in service increased in recent years.

*Internet Services.* Revenue from Internet access rapidly increased by 163.0%, from RMB435 million in 1999 to RMB1,144 million in 2000. This increase was primarily due to the rapid growth in the number of subscribers and usage of Internet access. The number of our dial-up Internet access subscribers increased from 1.4 million as of the end of 1999 to 5.2 million as of the end of 2000. Dial-up access usage increased by 296.1%, from 5.6 billion minutes in 1999 to 22.2 billion minutes in 2000.

*Managed Data Services.* Managed data revenue increased by 22.5%, from RMB1,429 million in 1999 to RMB1,750 million in 2000. The primary reason for this increase was the growth in usage, partially offset by a decrease in tariffs. For example, the total leased bandwidth of our DDN services was 103,100 x64Kbps in 2000, an increase of 46.2% from 1999. The total leased bandwidth of our frame relay services grew to 11,200 x128Kbps in 2000, an increase of 83.6% from 1999. The total leased bandwidth of our ATM services was 1,300 x2Mbps in 2000, an increase of 116.7% from 1999.

*Leased Line Services.* Revenue from leased line services decreased by 6.2%, from RMB4,549 million in 1999 to RMB4,268 million in 2000. This decrease was primarily due to the reduction in tariffs as a result of tariff adjustments and increased competition.

*Other Services.* Other services revenue increased by 14.2%, from RMB1,271 million in 1999 to RMB1,452 million in 2000. This increase was primarily due to the growth in value-added telephone services.

***Operating Expenses***

Our total operating expenses increased by 21.8%, from RMB38,929 million in 1999 to RMB47,397 million in 2000, mainly due to increases in depreciation and amortization expenses and network operations and support expenses.

*Depreciation and Amortization.* Depreciation and amortization expenses increased by 16.7%, from RMB14,903 million in 1999 to RMB17,386 million in 2000. This increase was primarily due to our increased capital expenditures for network expansions and improvements in response to an increase in the number of our access lines in service and usage in recent years.

*Network Operations and Support.* Excluding personnel related costs of RMB4,947 million and RMB4,231 million in 2000 and 1999, respectively, our network operations and support expenses increased 23.8%, from RMB11,353 million in 1999 to RMB14,057 million in 2000. The major components of our network operations and support expenses were maintenance expenses, which increased 19.0%, from RMB8,107 million in 1999 to RMB9,650 million in 2000, and utility expenses, which increased 24.1%, from RMB1,137 million in 1999 to RMB1,411 million in 2000. Increases in these expenditures were mainly attributable to the increase of the number of access lines, increase of the variety of services provided and the expansion of our networks. From 1999 to 2000, the number of our access lines in service increased by 7.9 million and the capacity of local switches increased by 9.1 million lines, an increase of 24.8% and 19.2%, respectively. Although our total network operations and support expenses increased, expenses per line or per unit of capacity decreased.

*Selling, General and Administrative Expenses.* Excluding personnel related costs of RMB2,847 million and RMB2,063 million in 2000 and 1999, respectively, selling, general and administrative expenses increased by 25.6%, from RMB5,490 million in 1999 to RMB6,896 million in 2000. Sales and marketing expenses increased by 38.1%, from RMB2,140 million in 1999 to RMB2,956 million in 2000. This increase was primarily due to increases in expenses related to promotional and advertising activities. General and administrative expenses increased by 17.6%, from RMB3,350 million in 1999 to RMB3,940 million in 2000.

*Personnel Expenses.* Personnel expenses increased by 23.8%, from RMB6,294 million in 1999 to RMB7,794 million in 2000. This increase was primarily due to an increase in employees' housing benefits by RMB1,056 million.

*Interconnection Charges and Other Expenses.* Interconnection charges and other expenses increased 42.2%, from RMB889 million in 1999 to RMB1,264 million in 2000. This increase was primarily due to the increased interconnection expenses, which was caused by the expansion of the subscriber bases of other operators.

***Net Finance Costs/(Income)***

In 1999, we had net finance costs of RMB516 million, while in 2000, we had net finance income of RMB298 million. This change was primarily due to a net foreign exchange loss of RMB415 million in 1999 and a net foreign exchange gain of RMB320 million in 2000. See Note 20 to Section V of Appendix I—"Accountants' Report" included elsewhere in this prospectus.

***Taxation***

Income tax expense decreased by 11.0%, from RMB5,459 million in 1999 to RMB4,857 million in 2000. The effective tax rates in 1999 and 2000 were 21.0% and 20.1%, respectively. See Note 21 to Section V of Appendix I—"Accountants' Report" contained elsewhere in this prospectus for further details in respect of the reconciliation of our effective tax rate to the statutory tax rate of 33%.

***Net Profit***

Net profit decreased by 5.8%, from RMB20,409 million in 1999 to RMB19,219 million in 2000. This decrease was primarily due to increased depreciation and amortization and network operation and support expenses in 2000.

**Disclosure of certain advances and financial assistance related matters**

The Directors have confirmed that they are not aware of any circumstances which, had we been required to comply with Practice Note 19 of the Hong Kong Listing Rules, would have given rise to a disclosure requirement under that Practice Note.

**CAPITALIZATION**

The following table sets forth our cash and cash equivalents, short-term debt and capitalization as of June 30, 2002. Our capitalization is presented:

- on an actual basis; and
- on an as adjusted basis to reflect the Global Offering, assuming an initial public offering price of HK\$1.58 per H share, the mid-point of the estimated offer price range, and after deducting estimated underwriting fees and commissions and other expenses payable by us in relation to the Global Offering, as if such sale occurred, and assuming the Joint Global Coordinators (on behalf of the International Underwriters and the US Underwriters) do not exercise the Over-allotment Option. See the Section headed "Use of Proceeds."

## FINANCIAL INFORMATION

You should read this table in conjunction with the discussions included elsewhere in the Section headed “Financial Information” and our audited combined financial information included in Appendix I—“Accountants’ Report.”

	As of June 30, 2002	
	Actual	As Adjusted
	RMB	RMB
	(in millions)	
<b>Cash and cash equivalents</b> .....	<u>2,640</u>	<u>27,322</u>
<b>Short-term debt:</b>		
Short-term debt .....	14,316	14,316
Current portion of long-term debt .....	<u>2,779</u>	<u>2,779</u>
Total short-term debt .....	<u>17,095</u>	<u>17,095</u>
<b>Capitalization:</b>		
Long-term debt, excluding current portion .....	6,567	6,567
Owner’s equity .....	<u>105,968</u>	<u>130,650</u>
Total capitalization .....	<u>112,535</u>	<u>137,217</u>

None of our total short-term debt as of June 30, 2002 was secured. Of our total long-term debt as of June 30, 2002, RMB6 million was secured.

## INDEBTEDNESS

Our indebtedness as of the dates indicated was as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	(RMB in millions)			
Short-term debt .....	9,811	12,194	18,827	14,316
Current portion of long-term debt .....	3,009	3,174	3,621	2,779
Long-term debt, excluding current portion .....	<u>12,108</u>	<u>10,068</u>	<u>7,101</u>	<u>6,567</u>
Total debt .....	<u>24,928</u>	<u>25,436</u>	<u>29,549</u>	<u>23,662</u>

The following table sets forth our gearing ratio as of the dates indicated:

	December 31,			June 30,
	1999	2000	2001	2002
Gearing ratio <sup>(1)</sup> .....	13.7%	12.9%	15.6%	12.6%

(1) Calculated as:

$$\frac{\text{short-term debt} + \text{long-term debt}}{\text{total assets}} \times 100\%$$

We finance a significant portion of our business operations with short-term loans obtained from commercial banks in China. We have established and maintained high credit ratings with our principal domestic commercial lenders, which have facilitated our ability to obtain credit on favorable terms to meet our financing requirements. Our short-term debt increased 91.9% from RMB9,811 million as of December 31, 1999 to RMB18,827 million as of December 31, 2001. Short-term loans constituted approximately 20.7% of our total

## FINANCIAL INFORMATION

liabilities as of December 31, 2001. Our short-term debt decreased by RMB4,511 million, from RMB18,827 million as of December 31, 2001 to RMB14,316 million as of June 30, 2002, and our long-term debt decreased by RMB1,376 million, from RMB10,722 million as of December 31, 2001 to RMB9,346 million as of June 30, 2002. Our short-term debt as a portion of our total bank borrowings decreased from 63.7% as of December 31, 2001 to 60.5% as of June 30, 2002. If we are unable to roll over, extend or refinance in a timely manner a significant amount of our short-term borrowings, we may be unable to meet our debt servicing, accounts payable and other obligations. Our debt-to-assets ratio (defined as the percentage of the aggregated amount of short-term debt, current portion of long-term debt and long-term debt divided by total assets) was 13.7% as of December 31, 1999, 12.9% as of December 31, 2000, 15.6% as of December 31, 2001 and 12.6% as of June 30, 2002.

Our short-term and long-term debt do not contain any financial covenants which materially restrict our operations. We do not have any financial instruments held for trading purposes, and as of December 31, 1999, 2000 and 2001 and June 30, 2002, we did not hold any derivative instruments.

At the close of business on July 31, 2002, being the latest practicable date for the purpose of this indebtedness statement, we had the following outstanding borrowings:

<b>Short-term debt</b>		<b>RMB millions</b>
Short-term bank loans		16,771
Current portion of long-term bank loans		3,151
		<u>19,922</u>
<b>Long-term debt</b>		<b>RMB millions</b>
	<b>Interest rate and final maturity</b>	
Long-term bank loans		
Renminbi denominated	Interest rates ranging from 4.8% to 8.0% per annum with maturities through 2007	4,773
US Dollar denominated	Interest rates ranging from 2.0% to 8.3% per annum with maturities through 2021	1,845
Japanese Yen denominated	Interest rates ranging from 2.5% to 3.5% per annum with maturities through 2022	2,665
		<u>9,283</u>
Less: current portion		<u>(3,151)</u>
		<u>6,132</u>

As of July 31, 2002, long-term bank loans of RMB6 million were secured by certain of our property, plant and equipment. The net book value of such property, plant and equipment amounted to RMB14 million as of July 31, 2002.

In addition, we had, as of July 31, 2002, finance lease obligations of RMB27 million, operating lease commitments of RMB1,539 million, contracted capital commitments of RMB3,388 million and contingent liabilities of RMB263 million for guarantees given to banks in respect of banking facilities granted to China Telecom Group and our investees. All such guarantees are expected to be released prior to the Listing Date.

## FINANCIAL INFORMATION

### ***Contractual Obligations and Commercial Commitments***

The following table sets forth our contractual obligations as of June 30, 2002:

<b>Contractual Obligations:</b>	<b>Payments Due by Period</b>					
	<b>Total</b>	<b>Within 1 year</b>	<b>From July 1, 2003 to December 31, 2004</b>	<b>2005</b>	<b>2006</b>	<b>Thereafter</b>
			<b>(RMB in millions)</b>			
Short-term debt .....	14,316	14,316	—	—	—	—
Long-term debt .....	9,346	2,779	3,232	464	256	2,615
Finance lease obligations .....	28	28	—	—	—	—
Operating lease commitments .....	1,590	505	517	103	68	397
Capital commitments .....	3,541	3,541	—	—	—	—
Total contractual cash obligations ....	28,821	21,169	3,749	567	324	3,012

The following table sets forth our commercial commitments as of June 30, 2002:

<b>Other Commercial Commitments:</b>	<b>Amount of Commitment Expiration Per Period</b>					
	<b>Total</b>	<b>Within 1 year</b>	<b>From July 1, 2003 to December 31, 2004</b>	<b>2005</b>	<b>2006</b>	<b>Thereafter</b>
			<b>(RMB in millions)</b>			
Guarantees .....	263	263	—	—	—	—
Total commercial commitments .....	263	263	—	—	—	—

Save as aforesaid or as otherwise disclosed herein and apart from intra-group liabilities, our Company and its subsidiaries did not have, at the close of business on July 31, 2002, outstanding liabilities or any mortgages, charges, debentures or other loan capital, bank overdrafts, loans, liabilities under acceptance or other similar indebtedness, hire purchase and finance lease commitments or any guarantees or other material contingent liabilities.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Cash Flows and Working Capital***

The following table summarizes our cash flows for the periods indicated:

	<b>Year Ended December 31,</b>			<b>Six Months Ended June 30,</b>	
	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2001</b>	<b>2002</b>
	<b>(RMB in Millions)</b>				
Cash flows from operating activities .....	37,379	38,255	32,761	17,863	17,449
Net cash used in investing activities .....	(25,234)	(31,736)	(35,399)	(16,819)	(10,995)
Net cash used in financing activities .....	(9,176)	(8,109)	(7,341)	(2,445)	(7,696)
Increase/(decrease) in cash and cash equivalents .....	2,969	(1,590)	(9,979)	(1,401)	(1,242)

Our principal source of liquidity is cash generated from our operations. Cash flow from our operating activities was RMB37,379 million in 1999, RMB38,255 million in 2000 and RMB32,761 million in 2001. Cash flow from our operating activities decreased by 14.4%, from RMB38,255 million in 2000 to RMB32,761 million in 2001. This decrease was caused by a decrease in total operating revenue and an increase in operating expenses. Cash flow from our operating activities decreased by 2.3%, from RMB17,863 million in the six months ended June 30, 2001 to RMB17,449 million in the six months ended June 30, 2002.

---

## FINANCIAL INFORMATION

---

Net cash used in investing activities was RMB25,234 million in 1999, RMB31,736 million in 2000 and RMB35,399 million in 2001. The primary reason for the increases from 1999 to 2001 was the increases in capital expenditures, which increased from RMB25,773 million in 1999 to RMB30,618 million in 2000 and to RMB34,610 million in 2001. Net cash used in investing activities decreased 34.6%, from RMB16,819 million in the six months ended June 30, 2001 to RMB10,995 million in the six months ended June 30, 2002 because we continued to centralize and strengthen our control over capital expenditures and enhance the use of return on investment analysis and other financial control measures in investment planning.

Net cash used in financing activities was RMB9,176 million in 1999, RMB8,109 million in 2000 and RMB7,341 million in 2001. We had a decrease in net borrowings in bank loans (defined as proceeds received from bank loans minus cash paid to repay bank loans) in 1999 of RMB466 million, an increase in 2000 of RMB875 million and an increase in 2001 of RMB4,444 million, which resulted in an increase in outstanding bank loans for the three years ended December 31, 2001 of RMB4,853 million. Net cash used in financing activities increased by RMB5,251 million, or 214.8%, from RMB2,445 million in the six months ended June 30, 2001 to RMB7,696 million in the six months ended June 30, 2002. This increase was primarily due to an increase of RMB7,368 million to repay bank loans, partially offset by a decrease of RMB2,536 million in distributions to our parent.

The net amount of cash distributed to our owner (defined as owner's cash distributions minus owner's contributions) was RMB8,193 million in 1999, RMB8,515 million in 2000 and RMB11,480 million in 2001. Cash distributions to our owner were RMB11,308 million in 1999, RMB12,261 million in 2000 and RMB14,483 million in 2001, representing an increase of RMB953 million from 2000 compared to 1999 and RMB2,222 million from 2001 compared to 2000. After the completion of this Global Offering, distributions to our shareholders will be subject to the discretion of our board of directors and in accordance with our dividend policy. See the Section headed "Dividend Policy."

Cash and cash equivalents were RMB15,451 million as of December 31, 1999, RMB13,861 million as of December 31, 2000, RMB3,882 million as of December 31, 2001 and RMB2,640 million as of June 30, 2002. The RMB9,979 million decrease in the amount of cash and cash equivalents for the year ended December 31, 2001 was primarily due to an increase in cash distributions to our owner in 2001, a decrease in the amount of cash provided by our operating activities, an increase in capital expenditures and improved financial management in reducing our cash balances.

## FINANCIAL INFORMATION

The following table sets forth information relating to our inventory turnover, accounts receivable turnover and accounts payable turnover as of the dates indicated:

	December 31,			June 30,
	1999	2000	2001	2002
		(days)		
Inventory turnover <sup>(1)</sup> . . . . .	6	7	8	5
Accounts receivable turnover <sup>(2)</sup> . . . . .	38	37	30	34
Accounts payable turnover <sup>(3)</sup> . . . . .	39	52	79	56

(1) Calculated as:

$$\frac{\text{inventory}}{\text{operating revenue}} \times 365 \text{ days}$$

(2) This refers to the collection period, and is calculated as:

$$\frac{\text{accounts receivable}}{\text{operating revenue}} \times 365 \text{ days}$$

(3) This refers to the average payment period, and is calculated as:

$$\frac{\text{accounts payable}}{\text{operating revenue}} \times 365 \text{ days}$$

Our working capital (defined as current assets minus current liabilities) was a deficit of RMB8,008 million as of December 31, 1999, a deficit of RMB17,098 million as of December 31, 2000, a deficit of RMB43,316 million as of December 31, 2001 and a deficit of RMB35,973 million as of June 30, 2002. The substantial increases in working capital deficit from 1999 to 2001 were the net result of our increased use of short-term debt and reduced cash balances. In addition, from December 31, 1999 to December 31, 2001, our net accounts receivable decreased by RMB1,202 million, and our accounts payable increased by RMB7,967 million. Our working capital deficit as of June 30, 2002 decreased, as compared to that as of December 31, 2001, primarily due to an increase in our net accounts receivable and decreases in our short-term debt and accounts payable.

We primarily rely on cash flows from operating activities and short-term and long-term bank borrowings and other financings for our liquidity needs. We believe we have access to sufficient financing sources to satisfy our working capital requirements.

## CAPITAL EXPENDITURES

The following table sets forth our historical and planned capital expenditure requirements for the periods indicated. Actual future capital expenditures for the periods after June 30, 2002 may differ from the amounts indicated below.

	Year Ended December 31,					
	1999	2000	2001	2002 (Planned)	2003 (Planned)	2004 (Planned)
				(RMB in millions)		
Total capital expenditures . . . . .	25,554	34,310	40,028	28,988	27,943	26,878

The total amount of our capital expenditures was RMB8,314 million in the six months ended 30 June, 2002. We have historically increased the level of our capital expenditures for network infrastructure. Our increased expenditures for wireline networks have been mainly due to the increase in our expenditures on access networks and transmission networks to support the increasing number of our subscribers. As we have improved the operating efficiency of our existing network infrastructure, we have been, and will continue to be, able to

## FINANCIAL INFORMATION

reduce the amount of our capital expenditures. We increased our capital expenditures on our data and Internet networks in 2001 in order to service the rapidly growing number of our data and Internet subscribers, including broadband access subscribers. In addition, we increased our expenditures for operations support systems as part of our efforts to facilitate the use of information technology by our customers and improve customer service and operations management. We have also implemented additional cost control efforts with respect to non-network related construction such as office buildings.

We intend to improve network efficiency as well as develop new services utilizing our existing networks, allowing us to increase our revenues while controlling our level of capital expenditures. In addition, we intend to increasingly direct our future capital expenditures to the development of broadband access, Internet and managed data infrastructure to capture potential growth opportunities while continuing to invest in our wireline telephone networks.

### WORKING CAPITAL

We expect to fund our working capital needs with a combination of cash generated from operating activities, short-term and long-term bank loans and other debt and equity financing. Taking into account the net proceeds of the Global Offering (see the Section headed “Use of Proceeds”) and such sources, the Directors are of the opinion that the Company and its subsidiaries have sufficient working capital for their present requirements.

### ADJUSTED NET TANGIBLE ASSETS

The following statement of adjusted net tangible assets of our Company is based on the net tangible assets of our Company as of June 30, 2002 as set out in Appendix I—“Accountants’ Report,” included elsewhere in this prospectus adjusted as described below:

	<b>RMB millions</b>
Combined net tangible assets of our Company as at June 30, 2002 as set out in the Accountants’ Report in Appendix I .....	105,968
Estimated net proceeds from the Global Offering <sup>(1)</sup> .....	24,682
Adjusted net tangible assets .....	<u>130,650</u>
Adjusted net tangible assets value per H Share (based on 83,588,470,803 Shares in issue immediately after the Global Offering <sup>(2)</sup> ) .....	<u>RMB1.56</u>

- (1) No account has been taken of the H Shares which may be issued pursuant to the Over-allotment Option. The estimated net proceeds from the Global Offering assumes an Offer Price of HK\$1.58 per H Share being the midpoint of the estimated Offer Price range of HK\$1.47 to HK\$1.69 per H Share.
- (2) If the Over-allotment Option is exercised in full, the adjusted net tangible asset value per Share will be increased, while the earnings per Share will be diluted correspondingly.
- (3) The properties of the Group were valued by Chesterton Petty Limited as of June 30, 2002, their report is set out in Appendix IV. There has been an immaterial deficit of RMB605 million arising from this valuation compared to the carrying amounts of the properties other than land use rights as of June 30, 2002. The land use rights were not revalued for financial reporting purposes, but were carried at cost—see Notes 2(h) and 7 of Section V of Appendix I—“Accountants’ Report.” Pursuant to Rule 5.01 of the Hong Kong Listing Rules, land use rights were revalued as at June 30, 2002. Such revalued amount of the land use rights has been determined at RMB15,138 million, whilst the book value of such land use rights was RMB2,630 million.

### MARKET RISKS

Our primary market risk exposures are fluctuations in exchange rates and interest rates.

## FINANCIAL INFORMATION

### **Foreign Exchange Rate Risk**

We conduct our business primarily in Renminbi, which is also our functional and reporting currency. The Renminbi is not a fully-convertible currency. Although the Renminbi to United States dollar exchange rate has been relatively stable since 1994, we cannot predict nor give any assurance of its future stability. Fluctuations in exchange rates may adversely affect the value, translated or converted into US dollars or Hong Kong dollars, of our net assets, earnings and any declared dividends. We cannot give any assurance that any future movements in the exchange rate of the Renminbi against the US dollar or other foreign currencies will not adversely affect our results of operations and financial condition. See the Section headed “Risk Factors—Risks Relating to the PRC—Government control of currency conversion may adversely affect our operations and financial results;—Fluctuation of the Renminbi could materially affect our financial condition and results of operations.”

The following table provides information regarding our financial instruments that are sensitive to foreign exchange rates as of December 31, 2001. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates.

	Expected Maturity							Fair Value
	2002	2003	2004	2005	2006	Thereafter	Total	
	(RMB equivalent in millions, except interest rates)							
<b>Assets:</b>								
Cash and cash equivalents								
US dollars .....	82	—	—	—	—	—	82	82
HK dollars .....	26	—	—	—	—	—	26	26
Time deposits								
US dollars .....	234	—	—	—	—	—	234	234
<b>Liabilities:</b>								
US dollar denominated loans								
Fixed rate .....	507	436	291	151	81	264	1,730	1,792
Average rate .....	3.6%	4.0%	4.0%	4.3%	4.6%	4.1%		
Variable rate .....	15	28	24	25	28	287	407	408
Average rate <sup>(1)</sup> .....	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%		
Japanese yen denominated								
Loans								
Fixed rate .....	122	144	139	139	139	1,861	2,544	2,920
Average rate .....	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%		

(1) The average interest rates for variable rate loans are calculated based on the rates reported as of December 31, 2001.

### **Interest Rate Risk**

The PBOC has the sole authority in China to establish the official interest rates for Renminbi-denominated loans. Financial institutions in China set their effective interest rates within the range established by the PBOC. Interest rates and payment methods on loans denominated in foreign currencies are set by financial institutions based on interest rate changes in the international financial market, cost of funds, risk levels and other factors.

We are exposed to interest rate risk resulting from fluctuations in interest rates on our short-term and long-term debts. Increases in interest rates will increase the cost of new

## FINANCIAL INFORMATION

borrowing and the interest expense with respect to outstanding floating rate debt. As of December 31, 2001, our debt consisted of fixed and variable rate debt obligations with maturities from 2002 to 2022.

The following table presents cash flows and related weighted average interest rates by expected maturity dates of our interest rate sensitive financial instruments as of December 31, 2001:

	Expected Maturity							
	2002	2003	2004	2005	2006	Thereafter	Total	Fair Value
	(RMB equivalent in millions, except interest rates)							
<b>Liabilities:</b>								
RMB denominated loans								
Fixed rate . . . . .	3,398	6	—	10	10	—	3,424	3,423
Average rate . . . . .	5.5%	2.4%	—	2.4%	2.4%	—		
Variable rate . . . . .	18,406	2,181	852	—	5	—	21,444	21,444
Average rate <sup>(1)</sup> . . . . .	5.5%	5.9%	5.5%	—	5.9%	—		
US dollar denominated loans								
Fixed rate . . . . .	507	436	291	151	81	264	1,730	1,792
Average rate . . . . .	3.6%	4.0%	4.0%	4.3%	4.6%	4.1%		
Variable rate . . . . .	15	28	24	25	28	287	407	408
Average rate <sup>(1)</sup> . . . . .	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%		
Japanese yen denominated								
Loans								
Fixed rate . . . . .	122	144	139	139	139	1,861	2,544	2,920
Average rate <sup>(1)</sup> . . . . .	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%		

(1) The average interest rates for variable rate loans are calculated based on the rates reported as of December 31, 2001.

### ***Inflation***

In recent years, China has not experienced significant inflation, and thus inflation has not had a significant effect on our business during the past three years. According to the China Statistical Bureau, China's overall national inflation rate, as represented by the general consumer price index, was approximately 0.7% and 0.4% in 2001 and 2000, respectively. In 1999, China experienced deflation of 1.4%.

## **PROFIT FORECAST AND DIVIDEND POLICY**

### **Profit Forecast**

We believe that, in the absence of unforeseen circumstances and on the bases and assumptions set out in Appendix III—"Profit Forecast," our combined profit after taxation and minority interests but before extraordinary items for the year ending December 31, 2002 is unlikely to be less than RMB16,497 million under IFRS. We are currently unaware of any extraordinary items which have arisen or are likely to arise in respect of the year ending December 31, 2002 that would affect the prospective financial information presented. On the basis of the prospective financial information and the weighted average number of Shares expected to be issued and outstanding during the current financial year of 70,618 million Shares (assuming the Joint Global Coordinators (on behalf of the International Underwriters and US Underwriters) do not exercise the Over-allotment Option), the forecast earnings per

Share on a weighted average basis for the year ending December 31, 2002 is unlikely to be less than RMB0.2336 under IFRS.

On a pro-forma fully diluted basis and on the assumption that we had been listed since January 1, 2002 and a total of 83,588,470,803 Shares were issued and outstanding during the entire year (taking no account of any H Shares which may be issued upon exercise of the Over-allotment Option) the forecast earnings per Share for the year ending December 31, 2002 is unlikely to be less than RMB0.1974 representing (upon conversion into Hong Kong dollars at the PBOC Rate of HK\$1.00 to RMB1.0608 prevailing on October 10, 2002) a price/earnings multiple of 7.9 times and 9.1 times if the offer price is HK\$1.47 per H Share and HK\$1.69 per H Share, respectively.

The texts of letters from the reporting accountants, KPMG, and from the Joint Sponsors in respect of the profit forecast are set out in Appendix III—"Profit Forecast."

### **Dividend Policy**

Our Board will declare dividends, if any, in Renminbi with respect to the H shares on a per Share basis and will pay such dividends in Hong Kong dollars. Any final dividend for a fiscal year will be subject to shareholders' approval. Under the PRC Company Law and our Articles of Association, all of our shareholders have equal rights to dividends and distributions. Holders of the H Shares will share proportionately on a per Share basis in all dividends and other distributions declared by our Board.

In accordance with the dividend policy set forth below, our Board currently intends to recommend at the relevant shareholders' meeting an annual dividend of approximately HK\$0.065 per H share for each of the years 2002 and 2003. As we would not have been listed for the whole of the year ending December 31, 2002, the dividend payment for the year 2002 will be pro rated based on the period from the Listing Date to December 31, 2002. Our Board will review our dividend policy from time to time in light of the factors enumerated below for periods following the year 2003:

- our financial results;
- our shareholders' interests;
- general business conditions and strategies;
- our capital requirements;
- contractual restrictions on the payment of dividends by us to our shareholders or by our subsidiaries to us;
- possible effects on our credit worthiness; and
- other factors our Board may deem relevant.

In accordance with applicable requirements of the PRC Company Law, we may only distribute dividends after we have made allowance for:

- recovery of losses, if any;
- allocation to the statutory common reserve funds; and
- allocation to a discretionary common reserve fund if approved by our shareholders and after allocation is made to the statutory common reserve funds.

---

## FINANCIAL INFORMATION

---

The minimum and maximum aggregate allocations to the statutory funds are 15% and 20%, respectively, of our net profit determined in accordance with PRC GAAP. Under PRC law, our distributable earnings will be equal to our net profit, as determined in accordance with PRC GAAP or IFRS, whichever is lower, less allocations to the statutory and discretionary funds. If we record no net profit for the year, we may not normally distribute dividends for the year.