

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Overview

As we and the Acquired Companies were under the common control of China Telecommunications Corporation, our acquisition of the Acquired Companies has been treated as a "combination of entities under common control", which was accounted for in a manner similar to a pooling-of-interests ("as-if-pooling-of-interests accounting"). Accordingly, the assets and liabilities of the Acquired Companies have been accounted for at historical amounts and our financial statements for the period prior to the acquisition have been restated to include the financial position and results of operations of the Acquired Companies on a combined basis. Unless otherwise indicated in this section, our financial data for the period prior to the acquisition are presented based on those restated amounts.

In 2003, our operating revenue increased while our operating expenses grew at a rate far below the rate at which our revenue increased. Our profit grew significantly. We continued to effectively control our capital expenditures. In addition, we had sufficient operating cash flow. In 2003, we successfully achieved our external expansion through our acquisition of the Acquired

Companies. We have maintained an optimised and sound capital structure after the completion of the acquisition of the Acquired Companies.

Our total operating revenue in 2003 grew 8.1% from 2002 to RMB118,451 million. Our operating expenses increased from 2002 by 2.9% to RMB86,003 million in 2003. Our net profit was RMB24,686 million and our basic earnings per share was RMB0.33 for 2003. Our EBITDA⁽¹⁾ was RMB65,369 million in 2003, with an EBITDA margin of 55.2%.

- (1) Our EBITDA represents profit before net finance costs, investment income, share of profit from associates, taxation, depreciation and amortisation and minority interests. As the telecommunications business is a capital-intensive industry, capital expenditures, the level of gearing and finance costs may have a significant impact on the net profit of companies with similar results. Therefore, we believe EBITDA may be helpful in analysing the operating results of a telecommunications service provider like us. Although EBITDA is widely used in the global telecommunications industry as a benchmark to reflect the operating performance, financing capability and liquidity, it is not regarded as a measure of operating performance and liquidity under generally accepted accounting principles. It also does not represent cash flows from operating activities. In addition, our EBITDA may not be comparable to similar indicators provided by other companies.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The table below sets forth our total operating revenue, operating expenses, operating profit and net profit, together with the respective figures expressed as a percentage of our total operating revenue for 2002 and 2003,

Year Ended 31 December				
	2002		2003	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Operating revenue	109,564	100.0%	118,451	100.0%
Operating expenses	83,567	76.3%	86,003	72.6%
Operating profit	25,997	23.7%	32,448	27.4%
Net profit	9,773	8.9%	24,686	20.8%

Operating Revenue

Our total operating revenue grew by RMB8,887 million, or 8.1%, from RMB109,564 million in 2002 to RMB118,451 million in 2003. As the main driving forces for the growth in our operating revenue, local telephone services revenue, Internet services revenue and

revenue from other businesses increased RMB3,015 million, RMB3,246 million and RMB3,121 million, respectively, from 2002. In 2003, our long distance services revenue decreased by 0.7% from 2002. Revenue from our managed data and interconnection services increased steadily, while revenue from our leased line services decreased.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The following table sets forth a breakdown of our operating revenue, together with the respective figures expressed as a percentage of our total operating revenue for 2002 and 2003.

Year Ended 31 December				
	2002		2003	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Wireline telephone services⁽¹⁾				
Local				
Installation fees	1,575	1.4%	1,831	1.5%
Monthly fees	18,998	17.4%	20,429	17.3%
Local usage fees	34,433	31.4%	35,761	30.2%
Sub-total	55,006	50.2%	58,021	49.0%
Domestic long distance ⁽²⁾	20,123	18.4%	19,888	16.8%
International, Hong Kong, Macau and Taiwan long distance ⁽²⁾	3,694	3.4%	3,770	3.2%
Interconnections	5,921	5.4%	6,444	5.4%
Upfront connection fees	8,554	7.8%	7,885	6.7%
Sub-total	93,298	85.2%	96,008	81.1%
Data and Internet services				
Internet	4,914	4.5%	8,160	6.9%
Managed data	2,431	2.2%	2,540	2.1%
Sub-total	7,345	6.7%	10,700	9.0%
Leased line services	4,214	3.8%	3,915	3.3%
Others⁽³⁾	4,707	4.3%	7,828	6.6%
Total operating revenue	109,564	100.0%	118,451	100.0%

(1) Includes revenue from our registered subscribers, public telephones and prepaid calling cards services.

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

(3) Includes primarily revenue from the provision of value-added telecommunications services, sale and repairs and maintenance of customer-end equipment, and lease of telecommunications network facilities.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Local Telephone Services

Our local telephone services remained our pillar business, with revenue growing by 5.5%, from RMB55,006 million in 2002 to RMB58,021 million in 2003, which contributed 49.0% to our total operating revenue. This was primarily due to subscriber growth and usage increase. As of the end of 2003, the total number of our local telephone access lines increased 21.30 million, or 22.0%, from 96.79 million in 2002 to 118 million in 2003. Based on our extensive distribution networks that are close to our customers and our various fee plans and product and service packages, we have effectively reduced the diversion to mobile services and achieved usage increase.

- *Installation Fees.* Upfront installation fees will be amortised over the expected customer relationship period of 10 years. Revenue from upfront installation fees increased by 16.3% from RMB1,575 million in 2002 to RMB1,831 million in 2003, mainly due to continuous increase in the number of access lines in recent years.
- *Monthly Fees.* Revenue from monthly fees increased RMB1,431 million, or 7.5%, from RMB18,998 million in 2002 to RMB20,429 million in 2003, which was primarily due to the increase in the number of our access lines in service.
- *Local Usage Fees.* Revenue from local usage fees increased RMB1,328 million, or 3.9%, from RMB34,433 million in 2002 to RMB35,761 million in 2003, primarily due to an increase in voice usage. Our local usage includes both local voice usage and dial-up

Internet usage. Our local usage in 2003 was 346.9 billion pulses and was at the same level as in 2002. While usage of dial-up Internet services (with a lower fee) decreased by 26.6% from 2002, our local voice usage increased 7.2% from 2002 to 294.2 billion pulses in 2003. As a result, our revenue from local usage fees increased in 2003.

Long Distance Telephone Services

Revenue from our long distance telephone services represented 20.0% of our total operating revenue in 2003 and decreased from RMB23,817 million in 2002 to RMB23,658 million in 2003, or 0.7%. This was due to a decrease in actual price caused by the increase in the proportion of VoIP calls. However, the decrease in our long distance services revenue was lower than the 2.4% decrease in 2002. We believe that the risk with regard to long distance telephone services was reduced. The continuous growth in China's economy drives the demand for long distance telephone services in China. We achieved a rapid increase in long distance telephone usage based on our product and service portfolios tailored to customers and our flexible fee strategies.

- *Domestic Long Distance Services.* Domestic long distance revenue decreased by 1.2% from RMB20,123 million in 2002 to RMB19,888 million in 2003. The total transmission volume for our domestic long distance services increased from 2002 by 15.0% to 53.8 billion minutes in 2003. The decrease in domestic long distance revenue was due to a decrease in actual price caused by the increase in the proportion of VoIP calls.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

- *International, Hong Kong, Macau and Taiwan Long Distance Services.* International, Hong Kong, Macau and Taiwan long distance services revenue increased by 2.1%, from RMB3,694 million in 2002 to RMB3,770 million in 2003. The transmission volume of our international, Hong Kong, Macau and Taiwan long distance services increased by 8.4% from 2002 to 1.62 billion minutes in 2003.

Internet and Managed Data Services

Total revenue from our Internet and managed data services increased by 45.7%, from RMB7,345 million in 2002 to RMB10,700 million in 2003, which represented 9.0% of our total operating revenue. We have an extensive local access network and service network, which provides strong support for meeting the increasing demand of our customers for Internet and managed data services.

- *Internet Services.* Revenue from our Internet access services continued to increase rapidly by 66.1%, or RMB3,246 million, from RMB4,914 million in 2002 to RMB8,160 million in 2003. Revenue from our Internet services as a percentage of our total operating revenue also increased from 4.5% in 2002 to 6.9% in 2003. This increase was primarily due to the significant increase in broadband revenue caused by the rapid expansion of our broadband subscriber base. The number of our broadband subscribers increased by 3.76 million from the end of 2002 to 5.63 million as of the end of 2003. We believe that revenue from our broadband

Internet services will remain a major driver for our revenue increase.

- *Managed Data Services.* Revenue from our managed data services increased by 4.5%, from RMB2,431 million in 2002 to RMB2,540 million in 2003. This increase was primarily due to an increase in our leased bandwidth of managed data services as a result of the continuous economic growth and an increase in the demand for managed data services in our service regions.

Leased Line, Interconnection and Other Services

- *Leased Line Services.* Revenue from leased line services decreased by 7.1% from RMB4,214 million in 2002 to RMB3,915 million in 2003. Usage of our leased line services in 2003 slightly increased from 2002. Demand for our leased line services from corporate customers continued to increase, although offset by the reduced volume of usage of other telecommunications operators since they increased use of their own networks. The decrease in revenue was mainly due to a decrease in price of our leased line services caused by a change in customer mix.
- *Interconnection Services.* Revenue from interconnection fees increased by 8.8%, from RMB5,921 million in 2002 to RMB6,444 million in 2003. This increase was primarily due to an increase in interconnection volume. In 2003, our net interconnection income (interconnection revenue deducted by

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

interconnection expenses) was RMB3,596 million, representing an increase of 16.3% compared to 2002.

- *Other Businesses.* Revenue from our other businesses increased by 66.3%, from RMB4,707 million in 2002 to RMB7,828 million in 2003. The increase was primarily due to an increase in revenue from our value-added services, and sale and repairs and maintenance of customer-end equipment. In 2003, increase in our revenue from value-added services contributed significantly to our total revenue growth, as we developed and promoted new value-added services

and continued to develop traditional value-added services.

Upfront Connection Fees

Upfront connection fees represent the amortised amount of the upfront fees received for the initial activation of wireline services, amortised over the expected customer relationship period of 10 years. Effective as of 1 July 2001, we ceased charging new subscribers upfront connection fees. Consequently, the amortised amount decreased by 7.8%, from RMB8,554 million in 2002 to RMB7,885 million in 2003.

The table below sets forth the amortisation of our upfront connection fees for each year from 2004 to 2011 based on a 10-year estimated amortisation period (with 2011 as the end of the amortisation period):

	For the Year ended 31 December							
	2004	2005	2006	2007	2008	2009	2010	2011
	(RMB in millions)							
Amortisation of								
upfront connection fees	6,815	5,475	4,048	2,738	1,690	955	414	83

Operating Expenses

In 2003, our operating expenses were RMB86,003 million, representing an increase of 2.9% from 2002, which is lower than the growth rate of our revenue in 2003. Our network operations and support expenses decreased and our depreciation

and amortisation expenses also decreased slightly in 2003. Our selling, general and administrative expenses and our personnel expenses increased, while our interconnection and other operating expenses remained at similar levels to those in 2002.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The following table sets forth a breakdown of our operating expenses, together with the respective figures expressed as a percentage of our total operating revenue for 2002 and 2003:

For the Year Ended 31 December				
	2002		2003	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Depreciation and amortisation	33,005	30.1%	32,921	27.8%
Network operations and support ⁽¹⁾	24,139	22.0%	22,759	19.2%
Selling, general and administrative ⁽¹⁾	10,235	9.4%	12,176	10.3%
Personnel	13,315	12.2%	15,251	12.9%
Interconnection and other operating expenses	2,873	2.6%	2,896	2.4%
Total operating expenses	83,567	76.3%	86,003	72.6%

(1) Excluding related personnel expenses.

- *Depreciation and Amortisation.* Our depreciation and amortisation expenses was RMB32,921 million in 2003, decreased by 0.3% from 2002. The depreciation and amortisation expenses as a percentage of our operating revenue decreased from 30.1% in 2002 to 27.8% in 2003.
- *Network Operations and Support.* Our network operations and support expenses (excluding related personnel expenses) decreased by 5.7%, from RMB24,139 million in 2002 to RMB22,759 million in 2003, primarily due to a decrease in repair and maintenance expenses as a result of our further centralised control over network maintenance and resources

allocation. Our repair and maintenance expenses decreased by 21.8% from 2002 to RMB9,946 million in 2003.

- *Selling, General and Administrative Expenses.* Our selling, general and administrative expenses (excluding related personnel expenses) increased by 19.0%, from RMB10,235 million in 2002 to RMB12,176 million in 2003. The increase in our selling and marketing expenses was due to the expansion of our customer base, which is offset by a decrease in our general and administrative expenses due to our strict expenditure control. We have effectively controlled the increase in the selling, general and administrative expenses.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

- *Personnel Expenses.* Our personnel expenses increased by 14.5%, from RMB13,315 million in 2002 to RMB15,251 million in 2003. The increase was primarily due to the further reform of our compensation system after our listing which resulted in a merit-based mechanism and matched our employees' compensation with the prevailing market level. This enables us to maintain our strength in human resources management. We believe that with the further implementation of our compensation reform, the increase in our personnel expenses will gradually slow down.
- *Interconnection and Other Operating Expenses.* Our interconnection and other operating expenses in 2003 increased by RMB23 million, or 0.8%, from RMB2,873 million in 2002 to RMB2,896 million in 2003.

Net Finance Costs

Our net finance costs decreased by 15.4%, from RMB2,144 million in 2002 to RMB1,814 million in 2003. Our sufficient cash flows from operating activities enabled us to repay a large amount of bank loans. Since we have obtained and retained the highest credit ratings from domestic banks in China, we utilised short-term loans to partially replace our long-term loans subject to our financial risk control. This contributes to the decrease in our finance costs.

Income Tax

Our statutory tax rate is 33%. In 2003, our income tax expense was RMB5,933 million, with an effective tax rate of 19.3%. 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 from taxable revenue.

Net Profit

In 2003, our operating revenue grew steadily. Our operating expenses were under effective control and operating efficiency continued to improve. Our net profit reached RMB24,686 million, with net profit margin of 20.8%.

Capital Expenditures

Our capital expenditures decreased by 4.9%, from RMB45,014 million in 2002 to RMB42,819 million in 2003.

In 2003, we continued to implement our prudent policy on capital expenditures and further optimised the allocation of our capital expenditures. As one of our focuses, we continued to invest in our access network to respond to the rapid growth in demand of our wireline users, broadband users and managed data users and to strengthen our market leadership position. We fully utilised the capabilities of our existing networks to increase our network utilisation. We had also reduced acquisition cost of equipment through our strengthened project management and centralised purchasing program. The above measures had effectively increased our return on investments.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

We expect to fund our capital expenditure needs through a combination of cash flows generated from operating activities, short-term and long-term bank loans and other debt and equity financing. We believe we will have sufficient resources to meet our capital expenditure requirements in the foreseeable future.

Cash Flows and Capital Resources

Cash Flows

Our net cash outflow was RMB8,566 million in 2003, as opposed to a net cash inflow of RMB10,988 million in 2002, primarily due to, on the one hand, the net proceeds of RMB10,659 million raised from our initial public offering in 2002 and, on the other hand, our cash repayment of RMB11,000 million in 2003 as part of the acquisition consideration for the telecommunications businesses from our parent company.

The following table summarises our cash flows for 2002 and 2003:

	For the Year Ended 31 December	
	2002	2003
	(RMB in millions)	
Cash flows from operating activities	52,158	46,884
Net cash used in investing activities	(47,060)	(40,781)
Net cash from/(used in) financing activities	5,890	(14,669)
Net increase/(decrease) in cash and cash equivalents	10,988	(8,566)

Our principal source of liquidity was our cash flows from operating activities, which reached RMB46,884 million in 2003, a decrease of RMB5,274 million from RMB52,158 million in 2002. This decrease was primarily due to our income tax payment of RMB6,461 million in 2003, an increase of RMB5,795 million from 2002.

Due to a further decrease in our capital expenditures, net cash used in investing activities decreased by RMB6,279 million, from RMB47,060 million in 2002 to RMB40,781 million in 2003.

Our net cash used in financing activities was RMB14,669 million in 2003, as compared with a net cash inflow of RMB5,890 million in 2002. This change was primarily due to, on the one hand, the net proceeds raised from our initial public offering in 2002 and, on the other hand, our cash payment in 2003 as part of the acquisition consideration for the telecommunications businesses from our parent company. In addition, we repaid certain amount of our bank loans in 2003. Our net repayment of bank loans (the difference between the proceeds from bank loans and the cash repayment for such bank loans) increased from RMB1,096 million in 2002 to RMB2,722 million in 2003.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Working Capital

Our working capital (total current assets minus total current liabilities) deficit was RMB71,162 million as of 31 December 2003, representing an increase of RMB5,314 million, compared with the deficit of RMB65,848 million in 2002. The increase in our working capital deficit was primarily due to our cash payment of RMB11,000 million as part of the acquisition consideration for the telecommunications businesses from our parent company.

As of the end of 2003, our cash and cash equivalents reached RMB10,119 million.

Indebtedness

Our indebtedness as of the end of 2002 and 2003 was as follows:

	As of 31 December	
	2002	2003
	(RMB in millions)	
Short-term debt	40,336	40,097
Long-term debt maturing within a year	5,674	6,434
Long-term debt (excluding current portion)	17,594	49,665
Total debt	63,604	96,196

Our total debt increased by RMB32,592 million to RMB96,196 million as of the end of 2003, primarily due to the deferred consideration of RMB35,000 million to China Telecommunications Corporation as part of our acquisition consideration for the telecommunications businesses in the six regions. Consequently, our debt-to-asset ratio (total debt divided by total assets) increased from 20.9% in 2002 to 31.5% in 2003, which we believe is a further optimisation of capital structure.

Excluding the deferred consideration of RMB35,000 million for the acquisition consideration, our long-term debt (including current portion) decreased from RMB23,268 million as of 31 December 2002, to RMB21,099 million as of 31 December 2003, while our short-term debt decreased from RMB40,336 million as of 31 December 2002, to RMB40,097 million as of 31 December 2003, reflecting our sound financial condition.

Of our total debt as of 31 December 2003, 94.4%, 3.0%, 2.1% and 0.5% were denominated in Renminbi, Japanese yen, U.S. dollars and Euro, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Contractual Obligations

The following table sets forth our contractual obligations as of 31 December 2003:

		Payable in				
	Total	2004	2005	2006	2007	Thereafter
	(RMB in millions)					
Short-term debt	40,097	40,097	—	—	—	—
Long-term debt	56,099	6,434	5,386	5,590	1,060	37,629
Operating lease commitments	1,192	500	200	117	113	262
Capital commitments	6,204	6,204	—	—	—	—
Guarantees	—	—	—	—	—	—
Total contractual obligations	103,592	53,235	5,586	5,707	1,173	37,891

We will further streamline our financial management system, improve our internal control system, strengthen the centralisation of financial management and overall budgeting management, continue the implementation of prudent capital expenditure policies, optimise our capital structure, and effectively control our operating expenses, in order to create higher value for our shareholders.