



## MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion and analysis should be read in conjunction with the financial statements of the Group prepared under IFRS as set out in pages 39 to 98. The Group also prepares financial statements in accordance with PRC Accounting Rules and Regulations as set out in pages 99 to 182. IFRS differs in certain material respects from accounting principles generally accepted in the United States of America ("U.S. GAAP") and PRC Accounting Rules and Regulations. For a discussion of the material differences between IFRS, U.S. GAAP and PRC Accounting Rules and Regulations relating to the Group, see supplementary information on pages 183 to 188 of this Annual Report.



**Wang Chang Shun**

*Vice Chairman of the Board  
of Directors, President*

### OVERVIEW

In 2003, the Group encountered the most unprecedented challenges and difficulties. The outbreak of the SARS earlier this year severely hit the PRC aviation industry. From April to June 2003, the Group's passenger volume and passenger load factor dropped which caused the revenue passenger kilometres ("RPK") for April, May and June of 2003 to fall by 40%, 83.5% and 61.5% respectively, as compared to the same period in 2002. In order to minimise the negative impact of SARS, the Group implemented various measures to adjust its operating capacity, for example by reducing the number of flights and suspending certain routes, in response to the reduced air traffic demand caused by the negative impact of SARS. The SARS was effectively under control in the PRC in July 2003 and the domestic market started to recover in the third quarter of 2003. The Group gradually resumed all its suspended flights since July 2003.

In order to alleviate the financial pressure suffered by the PRC civil aviation industry as a result of the SARS epidemic, the PRC government waived the levies of the CAAC Infrastructure Development Fund, sales tax and related supplementary taxes on passenger revenue payable by the PRC airlines, during the period from 1 May, 2003 to 31 December, 2003.

Besides, the political tension in the Middle East, in particular the Iraq war in March 2003, led to a surge in oil prices which in turn caused an increase in the Group's jet fuel cost.

The Group conducts a portion of its airline operations through the Airline Subsidiaries. Operating results for the Airline Subsidiaries are included in each of the years presented in the consolidated financial statements. The Airline Subsidiaries, which derive substantially all of their operating revenue from passenger traffic, accounted for 26.8% and 28.8% of the Group's total operating revenue, and 34.5% and 38.7% of the Group's total passengers carried, in 2002 and 2003, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB3,278 million and RMB3,460 million in 2002 and 2003, respectively, or 18.2% and 19.8% of the Group's total operating revenue.



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

The Group's operating revenue is substantially dependent on the passenger and cargo traffic volume carried, which is subject to seasonal and other changes in traffic patterns, the availability of appropriate time slots for the Group's flights and alternative routes, the degree of competition from other airlines and alternate means of transportation, as well as other factors that may influence passenger travel demand and cargo and mail volume. In particular, the Group's airline revenue is generally higher in the second and third quarters than in the first and fourth quarters.



Like most airlines, the Group is subject to a high degree of financial and operating leverage. A significant percentage of the Group's operating expenses is fixed costs that do not vary proportionally based on the Group's yields or the load factors. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs, operating lease payments, aircraft maintenance costs and labour for flight crew, cabin crew and ground personnel. Thus, a minor change in the Group's yields or load factors would have a material effect on the Group's results of operations. In addition, certain of these expenses, primarily financing costs and operating lease payments, labour costs and depreciation do not vary based on the number of flights flown. Thus, the Group's operating results can also be substantially affected by minor changes in aircraft utilisation rates. The Group is and will continue to be highly leveraged with substantial obligations denominated in foreign currencies and, accordingly, the results of its operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Group recognised a net exchange loss of RMB175 million and RMB164 million in 2002 and 2003, respectively. These amounts represented mainly unrealised exchange differences resulting from the retranslation of the foreign currency borrowings as of the years ended 2002 and 2003.



A number of other external variables, including political and economic conditions in China, tend to have a major impact on the Group's performance. The Group's financial performance is also significantly affected by factors arising from operating in a regulated industry. As substantially all aspects of the Group's airline operations are regulated by the PRC government, the Group's operating revenues and expenses are directly affected by the PRC government's policies with respect to domestic airfares, jet fuel prices and landing and navigation fees, among others. The nature and extent of airline competition and the ability of Chinese airlines to expand are also affected by CAAC's control over route allocations. Any changes in the PRC government's regulatory policies, or any implementation of such policies could have a significant impact on the Group's future operations and its ability to implement its operating strategy.

**MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)****Certain financial information and operating data by geographic region**

The following table sets forth certain financial information and operating data by geographic region for the years ended 31 December, 2002 and 2003:

	For the year end December 31,		2003 vs 2002
	2003	2002	% Increase/ (Decrease)
<b>Traffic</b>			
Revenue passenger kilometres (RPK) (million)			
– Domestic	21,294	22,092	(3.6)
– Hong Kong regional	778	1,081	(28.0)
– International	4,315	5,767	(25.2)
<b>Total</b>	<b>26,387</b>	<b>28,940</b>	<b>(8.8)</b>
Revenue tonne kilometres (RTK) (million)			
– Domestic	2,424	2,532	(4.3)
– Hong Kong regional	78	108	(27.8)
– International	1,059	974	8.7
<b>Total</b>	<b>3,561</b>	<b>3,614</b>	<b>(1.5)</b>
Passengers carried (thousand)			
– Domestic	18,259	18,535	(1.5)
– Hong Kong regional	1,019	1,369	(25.6)
– International	1,192	1,589	(25.0)
<b>Total</b>	<b>20,470</b>	<b>21,493</b>	<b>(4.8)</b>
Cargo and mail carried (thousand tonne)			
– Domestic	379	404	(6.2)
– Hong Kong regional	12	14	(14.3)
– International	73	52	40.4
<b>Total</b>	<b>464</b>	<b>470</b>	<b>(1.3)</b>



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

### Certain financial information and operating data by geographic region (cont'd)

	For the year end December 31,		2003 vs 2002
	2003	2002	% Increase/ (Decrease)
<b>Capacity</b>			
Available seat kilometres (ASK) (million)			
– Domestic	32,590	33,753	(3.4)
– Hong Kong regional	1,347	1,746	(22.9)
– International	6,930	8,746	(20.8)
<b>Total</b>	<b>40,867</b>	<b>44,245</b>	<b>(7.6)</b>
<b>Available tonne kilometres (ATK) (million)</b>			
– Domestic	3,772	3,924	(3.9)
– Hong Kong regional	150	193	(22.3)
– International	1,999	1,798	11.2
<b>Total</b>	<b>5,921</b>	<b>5,915</b>	<b>0.1</b>
<b>Load Factors</b>			
Passenger load factor (RPK/ASK) (%)			
– Domestic	65.3	65.5	(0.3)
– Hong Kong regional	57.8	61.9	(6.6)
– International	62.3	65.9	(5.5)
<b>Overall</b>	<b>64.6</b>	<b>65.4</b>	<b>(1.2)</b>
Overall load factor (RTK/ATK) (%)			
– Domestic	64.2	64.5	(0.5)
– Hong Kong regional	52.2	55.8	(6.5)
– International	53.0	54.2	(2.2)
<b>Overall</b>	<b>60.1</b>	<b>61.1</b>	<b>(1.6)</b>
<b>Yield</b>			
Yield per RPK (RMB)			
– Domestic	0.57	0.55	3.6
– Hong Kong regional	0.96	0.98	(2.0)
– International	0.47	0.42	11.9
<b>Overall</b>	<b>0.57</b>	<b>0.54</b>	<b>5.6</b>
Yield per RTK (RMB)			
– Domestic	5.40	5.21	3.6
– Hong Kong regional	10.35	10.36	(0.1)
– International	2.90	3.25	(10.8)
<b>Overall</b>	<b>4.76</b>	<b>4.84</b>	<b>(1.7)</b>

**MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)****Certain financial information and operating data by geographic region (cont'd)**

	For the year end December 31,		2003 vs 2002
	2003	2002	% Increase/ (Decrease)
<b>Fleet</b>			
Total number of aircraft in service at year end			
– Boeing	108	102	5.9
– Airbus	24	20	20.0
<b>Total</b>	<b>132</b>	<b>122</b>	<b>8.2</b>
<b>Overall utilisation rate (hours per day)</b>			
– Boeing	8.6	9.9	(13.2)
– Airbus	7.9	9.3	(15.6)
<b>Overall</b>	<b>8.5</b>	<b>9.8</b>	<b>(13.8)</b>
<b>Cost</b>			
– Operating cost per ASK (RMB)	0.42	0.36	16.7
– Operating cost per ATK (RMB)	2.87	2.70	6.3

**2003 COMPARED WITH 2002**

The Group recorded a net loss of RMB358 million for 2003, as compared to a net profit of RMB576 million for 2002. The Group's operating revenue decreased by RMB549 million or 3.0% from RMB18,019 million in 2002 to RMB17,470 million in 2003. Passenger load factor decreased by 0.8 percentage point from 65.4% in 2002 to 64.6% in 2003. Passenger yield (in passenger revenue per RPK) increased by 5.6% from RMB0.54 in 2002 to RMB0.57 in 2003. Average yield (in traffic revenue per RTK) decreased by 1.7% from RMB4.84 in 2002 to RMB4.76 in 2003. Operating expenses increased by RMB1,021 million or 6.4% from RMB15,993 million in 2002 to RMB17,014 million in 2003. As operating revenue decreased while operating expenses increased, operating profit decreased by 77.5% from RMB2,026 million in 2002 to RMB456 million in 2003. The Group's net non-operating expenses increased by 9.1%, from RMB887 million in 2002 to RMB967 million in 2003, mainly due to a decrease in gain on disposal of fixed assets of RMB193 million, partly offset by a decrease in interest expense of RMB135 million. Overall, the Group recorded a net loss of RMB358 million in 2003, as compared to a net profit of RMB576 million in 2002.

**OPERATING REVENUE**

Substantially all of the Group's operating revenue is attributable to airline operations. Traffic revenue in 2003 and 2002 accounted for 97.1% and 97.0% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 88.5% and 11.5% respectively of total traffic revenue in 2003. The balance of the Group's operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services and for air catering services and net income from lease arrangements.



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

Operating revenue decreased by 3.0% from RMB18,019 million in 2002 to RMB17,470 million in 2003. This decrease was primarily due to a 4.4% fall in passenger revenue from RMB15,696 million in 2002 to RMB15,010 million in 2003 resulting from lower traffic volume caused by SARS. The total number of passengers carried decreased by 4.8% to 20.5 million passengers in 2003. RPKs decreased by 8.8% from 28,940 million in 2002 to 26,387 million in 2003, primarily as a result of a decrease in passengers carried. However, passenger yield increased by 5.6% from RMB0.54 in 2002 to RMB0.57 in 2003, mainly as the result of the exemption of CAAC Infrastructure Development Fund and sales tax during the period from 1 May, 2003 to 31 December, 2003.

Domestic passenger revenue, which accounted for 81.6% of the total passenger revenue in 2003, increased slightly by 0.1% from RMB12,234 million in 2002 to RMB12,242 million in 2003. Domestic passenger traffic in RPKs decreased by 3.6%, mainly due to a decrease in passengers carried. Passenger yield, however, increased from RMB0.55 in 2002 to RMB0.57 in 2003, mainly as the result of the aforesaid exemption of CAAC Infrastructure Development Fund and sales tax.

Hong Kong passenger revenue, which accounted for 5.0% of total passenger revenue, decreased by 28.9% from RMB1,055 million in 2002 to RMB750 million in 2003. For Hong Kong flights, passenger traffic in RPKs decreased by 28.0%, while passenger capacity in ASKs decreased by 22.9%, resulting in a 4.1 percentage point decrease in passenger load factor from 2002. Passenger yield decreased from RMB0.98 in 2002 to RMB0.96 in 2003 mainly due to slack in traffic volume.

International passenger revenue, which accounted for 13.4% of total passenger revenue, decreased by 16.2% from RMB2,407 million in 2002 to RMB2,018 million in 2003. For international flights, passenger traffic in RPKs decreased by 25.2%, while passenger capacity in ASKs decreased by 20.8%, resulting in a 3.6 percentage point fall in passenger load factor from 2002. Passenger yield increased by 11.9% from RMB0.42 in 2002 to RMB0.47 in 2003 mainly as the result of the aforesaid exemption of CAAC Infrastructure Development Fund and sales tax.

Cargo and mail revenue, which accounted for 11.5% of the Group's total traffic revenue and 11.1% of total operating revenue, increased by 9.5% from RMB1,786 million in 2002 to RMB1,955 million in 2003. The increase was primarily due to the full year effect of the opening of two international cargo routes to Los Angeles of the United States of America and Leige of Belgium in late 2002.

Other operating revenue decreased by 6.0% from RMB537 million in 2002 to RMB505 million in 2003. The decrease was primarily due to a decrease in aircraft short-term lease income of RMB46 million.

### OPERATING EXPENSES

Substantially all of the Group's operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repair and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group's flight operations (collectively, "flight operations expenses") include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group's aircraft (collectively, "repairs and maintenance expenses") include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group's aircraft and traffic servicing operations (collectively "aircraft and traffic servicing expenses") include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group's operating expenses result from promotional and marketing activities



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

(collectively, “promotional and marketing expenses”) such as sales commissions, fees for use of the CAAC’s reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

Total operating expenses in 2003 amounted to RMB17,014 million, representing an increase of 6.4% or RMB1,021 million over 2002, primarily due to the combined effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue increased from 88.8% in 2002 to 97.4% in 2003.

Flight operations expenses, which accounted for 41.6% of total operating expenses, increased by 5.0% from RMB6,733 million in 2002 to RMB7,070 million in 2003, primarily as a result of increases in jet fuel costs and operating lease payments, partly offset by a decrease in catering expenses. Jet fuel costs, which accounted for 54.7% of flight operations expenses, increased by 9.9% from RMB3,519 million in 2002 to RMB3,867 million in 2003 mainly as a result of increased jet fuel prices. Operating lease payments increased by 8.4% from RMB1,417 million in 2002 to RMB1,536 million in 2003, primarily due to the full year effect of the addition of new operating leases in respect four Boeing 757-200 aircraft in late 2002 and four Airbus 319-100 aircraft and three Boeing 737-700 aircraft during 2003. Catering expenses decreased by 18.4% from RMB625 million in 2002 to RMB510 million in 2003, primarily reflecting a tighter cost controls exercised by the Group. Aircraft insurance costs decreased by 23.4% from RMB256 million in 2002 to RMB196 million in 2003, primarily because of a reduction in the rate of aircraft insurance premiums prescribed by the PRC insurance company. Labour costs for flight personnel decreased by 6.8% from RMB781 million in 2002 to RMB728 million in 2003, largely due to a decrease in flight hours.

Maintenance expenses which accounted for 15.2% of total operating expenses, increased by 11.0% from RMB2,333 million in 2002 to RMB2,589 million in 2003. The increase was primarily attributable to an 11.3% increase in aircraft maintenance and repair charges from RMB2,135 million in 2002 to RMB2,377 million in 2003, mainly as the result of the effect of fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 16.3% of total operating expenses, increased by 10.2% from RMB2,511 million in 2002 to RMB2,767 million in 2003. The increase primarily resulted from an 8.9% rise in landing and navigation fees from RMB2,354 million in 2002 to RMB2,563 million in 2003, due to an increase in the charge rate for domestic landing and navigation fees effective September 2002.

Promotional and marketing expenses, which accounted for 8.7% of total operating expenses, decreased by 1.3% from RMB1,500 million in 2002 to RMB1,480 million in 2003. The decrease was due to 9.3% decrease in labour costs from RMB248 million in 2002 to RMB225 million in 2003, as fewer bonuses were given because of reduced sales volume in 2003.

General and administrative expenses, which accounted for 6.2% of the total operating expenses, decreased slightly by 0.7% from RMB1,060 million in 2002 to RMB1,053 million in 2003. This was mainly due to a decrease in scale of operations during SARS period.

Depreciation and amortisation, which accounted for 12.0% of total operating expenses, increased by 10.8% from RMB1,840 million in 2002 to RMB2,038 million in 2003. This increase was primarily as a result of the additions of aircraft during 2003.



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

### OPERATING PROFIT

Operating profit decreased by 77.5% from RMB2,026 million in 2002 to RMB456 million in 2003. This was mainly because operating revenue decreased by RMB549 million or 3.0% from 2002 while operating expenses increased by RMB1,021 million or 6.4% over the same period.

### NON-OPERATING INCOME/(EXPENSES)

Interest expense decreased by 14.1% from RMB959 million in 2002 to RMB824 million in 2003, mainly reflecting the combined effect of scheduled debt repayments and the replacement of certain RMB denominated bank loans with US\$ denominated bank loans with lower interest rates.

Interest income decreased by 75.2% from RMB53 million in 2002 to RMB13 million in 2003. This was mainly attributable to a decrease in average cash balances.

The Group recorded a net loss on sale of fixed assets of RMB22 million in 2003, mainly resulting from retirement of two old Boeing 737-200 aircraft.

During 2003, the Group recorded a net exchange loss of RMB164 million predominantly due to its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealised translation loss.

### TAXATION

On 17 October, 2003, the Company's registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document "Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043", the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective from 1 October, 2003. As a result, the Company's income tax rate has been changed to 15% from 33% beginning from that date.

The Group recorded an income tax credit of RMB324 million for 2003 compared to an income tax expense of RMB398 million for 2002. As a result of the reduction in income tax rate, the Company's net deferred taxation liability balance brought forward from 31 December, 2002 of RMB507 million was reduced by RMB392 million and a net deferred tax credit of RMB392 million was recognised in 2003 for such reduction in income tax rate accordingly.

### MINORITY INTERESTS

Minority interests increased by 3.6% from RMB165 million in 2002 to RMB171 million in 2003, primarily reflecting the net profits earned by certain of the Group's airline subsidiaries for the year.



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

### LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As at 31 December, 2003, the Group's borrowings totalled RMB18,460 million, representing a decrease of RMB815 million from RMB19,275 million last year. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen and Renminbi, with a significant portion being fixed interest rate borrowings. Of such borrowings, RMB8,395 million, RMB1,716 million, RMB1,601 million, RMB1,660 million and RMB5,088 million will be repayable in 2004, 2005, 2006, 2007, 2008 and thereafter respectively. As at 31 December, 2003, cash and cash equivalents of the Group totalling RMB2,080 million, of which 22.2% were denominated in foreign currencies, decreased by 44.8% from RMB3,771 million last year. Net debts (total borrowings net of cash and cash equivalents) increased by 5.7% to RMB16,380 million.

As at 31 December, 2003, the Group's shareholders' equity amounted to RMB11,896 million, representing an increase of RMB2,283 million from RMB9,613 million last year. The increase was mainly due to the issuance of 1,000,000,000 A shares with an issue price of RMB2.70 per share by way of public offering in July 2003 in the PRC.

Net debt/equity ratio of the Group at 31 December, 2003 was 1.38 times, as compared to 1.61 times last year.

### FINANCIAL RISK MANAGEMENT POLICY

In the normal course of business, the Group is exposed to fluctuations in foreign currencies and jet fuel prices. The Group's exposure to foreign currencies was as a result of its debt which are denominated in foreign currencies. Depreciation or appreciation of the RMB against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, by entering into forward foreign exchange contracts with certain authorised PRC banks.

The Group is required to procure a majority of its jet fuel consumption domestically at PRC spot market prices. There are currently no effective means available to manage the Group's exposure to the fluctuations in domestic jet fuel prices.

### CHARGES ON ASSETS

As at 31 December, 2003, certain aircraft of the Group with an aggregate carrying value of approximately RMB14,576 million (2002: RMB14,783 million) were mortgaged under certain loan and lease agreements. Details of charges are set out in notes 10, 21 and 22 to the consolidated financial statements.

### COMMITMENTS AND CONTINGENCIES

At December 31, 2003, the Group had capital commitments of approximately RMB13,628 million. Of such amounts, RMB10,615 million related to the acquisition of aircraft and related flight equipment and RMB2,072 million related to the Group's facilities and equipment to be constructed and installed at the Guangzhou new airport. The remaining amount of RMB941 million related to the Group's other airports and office facilities and equipment, overhaul and maintenance bases and training facilities.



## MANAGEMENT DISCUSSION AND ANALYSIS (Cont'd)

As at 31 December, 2003, the Group was committed to make a capital contribution of approximately RMB446 million to its jointly controlled entities.

Details of the capital and investing commitments are set out in note 29 to the consolidated financial statements.

Major contingent liabilities of the Group at 31 December, 2003 are set out in note 30 to the consolidated financial statements.