

Discussion of Selected Items in the Interim Results

1 Robust cash flow and solid capital structure

As a result of encouraging business growth, active cost controls and the realization of the benefits of economies of scale, the Group continued to record strong free cash flow in the first half of 2004. The Group's free cash flow (net cash flow from operating activities after deducting capital expenditure incurred) for the first six-month period of 2004 was RMB29,019 million. As at 30 June 2004, the total cash and bank balances of the Group were RMB73,738 million (before payment of initial consideration of US\$2,000 million for acquisition of the ten mobile telecommunications companies and other telecommunications assets completed on 1 July 2004), of which 87.5 per cent., 3.4 per cent. and 9.1 per cent. were denominated in RMB, US dollars and Hong Kong dollars, respectively. As at 30 June 2004, the Group's debt to capitalization ratio (capitalization represents the sum of total debt and shareholders' equity) was 15.2 per cent. Upon the completion of acquisition of the ten mobile telecommunications companies and other telecommunications assets on 1 July 2004, the Group's debt to capitalization ratio was 20.6 per cent.

At the end of June 2004, short-term and long-term borrowings of the Group totaled RMB38,365 million, representing a decrease of RMB6,235 million from year-end 2003. Of the Group's borrowings, 24.5 per cent. will mature within one year, 15.6 per cent. will mature after one year but within two years, 7.8 per cent. will mature after two years but within five years, and 52.1 per cent. will mature after five years. 45.9 per cent. and 54.1 per cent. of the borrowings were denominated in RMB (mainly represented by RMB denominated bonds, bank loans and finance leases) and US dollars (mainly represented by US dollar fixed rate notes, convertible notes and the balance of deferred consideration for the acquisition of the eight provincial mobile telecommunications companies in 2002), respectively. 45.6 per cent. of the total borrowings of the Group were made at floating interest rates. The average interest rate of borrowings (ratio of interest expenses to the average balance of borrowings, including capitalized interest) of the Group was approximately 4 per cent. in the first half of 2004, whereas the interest coverage multiple (ratio of profit before interest and tax to interest expenses) amounted to 35 times.

The Group will continue to pursue prudent financial policies, strictly control financial risks, maintain its strong cash-flow generating capability, realize its competitive advantages, allocate its resources in a scientific manner, maintain debt at a sustainable level, lower its overall cost of capital and reinforce and develop favourable economic efficiency, with a view to generating greater returns for our shareholders.

2 Capital expenditure

Capital expenditure for the first half of 2004 totaled approximately US\$2.7 billion, which was mainly used for the construction of GSM networks, support systems, transmission facilities, infrastructure buildings and for the development of new technologies and new businesses. Capital expenditure was financed primarily by cash flow generated from operations.

3 Personnel expenses

The Group augmented its efforts in human resources reform and enhanced closed-loop management of budget, performance evaluation and remuneration. While retaining and attracting talented staff, personnel expenses were satisfactorily controlled. Personnel expenses for the period were RMB4,307 million, representing an increase of 10.4 per cent. over the same period last year. In addition, personnel expenses only represent 5 per cent. of the Group's total operating revenue, which remains the same as that of the same period last year. The Group employed a total of 65,839 employees as of 30 June 2004. In order to align the interests of staff with those of shareholders, the Company adopted a share option scheme to grant share options to employees. Further details of the share option scheme and the share options granted are set forth in Note 16 of the "Notes to the Unaudited Interim Financial Statements" and in the section "Other Information — Directors', Chief Executive's and Employees' Rights to Acquire Shares" in this interim report.