Management Discussion and Analysis



2000

FANG Yunti

BUSINESS REVIEW

2005 has been a year in which macro-economic control measures, designed to place stronger emphasis on sustainability and equitability in the process of rapid economic development, were further strengthened and fine-tuned. Economic growth at the national level and the provincial level remained unabated, though Zhejiang Province's GDP growth rate, at 12.4%, was slightly lower than the growth rate of 14.3% achieved in 2004.

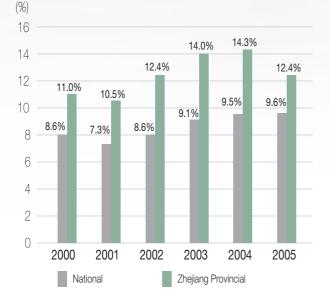
In contrast to the agricultural and industrial sectors in Zhejiang Province, the service sector underwent the highest rate of GDP growth in 2005, with modern logistics and tourism emerging as two of a handful new areas of growth in the provincial economy.

Traffic volume on the two expressways operated by the Group continued to grow in 2005, bringing growth on both toll income and income from other expressway-related business activities for the ninth consecutive year since the Company was established in 1997.

Revenue for the Group was Rmb3,456.4 million during the Period, representing an increase of 10.4% over 2004, with toll income continuing to partake as the dominate share of the overall income, constituting approximately 92.3% of the Group's total income. Income from other expressway-related business activities, however, grew at a higher rate than toll income. A detailed breakdown of the Group's revenue for the Period is set out below:

	2005 Rmb'000	2004 Rmb'000	% Change
Toll income			
Shanghai-Hangzhou-			
Ningbo			
Expressway	2,519,676	2,327,733	8.3%
Shangsan			
Expressway	830,994	739,221	12.4%
Other income			
Service areas			
business income	230,183	183,637	25.4%
Advertising			
business income	48,045	41,159	16.7%
Road maintenance			
income	2,568	7,244	-64.6%
Subtotal	3,631,466	3,298,994	10.1%
Less: Revenue taxes	(175,081)	(167,001)	4.8%
Revenue	3,456,385	3,131,993	10.4%

GDP Growth Rates



14 ZHEJIANG EXPRESSWAY CO., LTD.

EXPRESSWAY OPERATIONS

Traffic volume on the two expressways operated by the Group continued to grow during the Period, with average daily traffic in full-trip equivalents at 35,143 for the Shanghai-Hangzhou-Ningbo Expressway and 19,824 for the Shangsan Expressway, respectively. However, traffic volume growth rates were significantly lower compared to previous years, at 5.5% year-on-year for the Shanghai-Hangzhou-Ningbo Expressway and 4.9% year-on-year for the Shangsan Expressway.

Monthly average daily traffic volume on Shanghai-Hangzhou-Ningbo Expressway in 2005



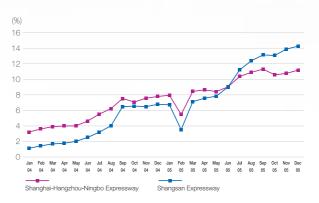
Monthly average daily traffic volume on Shangsan Expressway in 2005



Apart from the growing maturity of these expressway assets, a number of other factors have affected the traffic volume performance of the two expressways in 2005. Slower economic growth in Zhejiang Province as well as in the Yangtze River Delta Region in 2005 compared to 2004, coupled with a corresponding slowdown in new vehicle sales, has contributed to a slower growth in demand for road transport. Ongoing expresswaywidening projects along the Shanghai-Hangzhou-Ningbo Expressway and on neighboring expressways during the Period have also contributed to a certain degree of traffic diversions from the Shanghai-Hangzhou-Ningbo Expressway.

While the toll rates for expressways are generally higher than those for neighboring roads, the differences in toll rates for trucks were further narrowed at the start of 2005. As part of the integral policies of the government to tackle the practice of overloading trucks, the toll rates for trucks that are above 10 tons were lowered throughout Zhejiang Province at the beginning of 2005, with the toll rates for trucks on neighboring national and provincial roads reduced by an even greater amount than those for expressways, thereby further enhancing the relative competitiveness of national and provincial roads.

However, the toll rate reduction for trucks that are above 10 tons did have positive implications for expressway operators in addition to reducing overloading practices and resulting in a safer road traveling environment. The change has led to a continued increase in the proportion of trucks of over 10 tons amongst the traffic mix, resulting in a higher growth rate in toll income than in traffic volume. Toll income growth rates for the Shanghai-Hangzhou-Ningbo Expressway and the Shangsan Expressway during the Period were 8.3% and 12.4% year-on-year, respectively.



Trucks above 10 tons as a percentage to all vehicles

EXPRESSWAY-RELATED BUSINESS OPERATIONS

Apart from the expressway operations, the Group has also carried out other business operations such as gas stations, restaurants and shops in service areas as well as billboard advertising along the expressways operated by the Group.

Expanded shopping facilities and more flexible cooperative arrangements at the service areas helped the expressway-related business operations grew at a rate higher than the expressway operations in 2005 in terms of income. Revenue from the expressway-related business operations grew 21.0% during the Period to reach Rmb280.8 million, contributing to approximately 7.7% of the Group's total revenue.

LONG-TERM INVESTMENTS

Driven by continued traffic volume growth on the 9.45km Shida Road, Shida Co saw its revenue grew 9.3% to Rmb84.5 million in 2005. However, a higher maintenance cost during the Period has led to a reduction in profit after taxation by 17.0% to Rmb32.6 million.

Gas station operations carried out by Petroleum Co throughout Zhejiang Province were boosted by strong growth in demand for gasoline products in 2005. While revenue for the associate company grew 33.1% during the Period, rising global oil prices and a rigid price control regime imposed on domestic retail outlets nevertheless resulted in a reduction in the net profit by 12.8% to Rmb14.0 million. Amid growing competition in its field of computer networking and digital printing businesses, JoinHands Technology realized a net profit of Rmb3.3 million during the Period, representing a decrease of 14.1% over 2004, while its revenue fell by 36.1%.

EXPRESSWAY WIDENING PROJECT

Phase II of the project to widen the Shanghai-Hangzhou-Ningbo Expressway from four lanes to eight lanes, spanning approximately 95km between Dajing and Fengjing, was completed and opened to traffic in accordance with plan in November 2005, thereby significantly improving the traveling condition as well as increasing the expressway's capacity which in turn allows for further traffic volume growth in the future.

Phase III of the Widening Project, totaling approximately 84km between Guzhu and Duantang, progressed as planned during the Period, and is targeted for completion by the end of 2007.

Extensive onsite management measures were put in place to maintain a normal traffic flow on the Shanghai-Hangzhou-Ningbo Expressway as the widening works were being carried out. However, temporary disturbances to the traffic were inevitable, and the resulted inconvenience to the travelers did have a measurable negative impact on the traffic volume growth of the affected section of the expressway.

FINANCIAL ANALYSIS

The Group adopts a prudent but proactive financial policy with an aim to provide shareholders with sound returns over the long-term.

During the Period, net profit attributable to equity holders of the Company amounted to Rmb1,431.2 million, representing an increase of 16.8% over 2004, while earnings per share was Rmb32.95 cents (2004: Rmb28.22 cents per share). Return on equity for the Period increased from 11.4% to 12.8%.

PROFITABILITY

Our consistently profitable business performance in the last five years resulted in a compound annual growth rate of 17.1% and 11.7% in earnings per share and return on equity, respectively. Details are as follows:

	Year ended December 31,				
	2001	2002	2003	2004	2005
EPS (Rmb cents)	17.51	20.50	23.23	28.22	32.95
YoY Growth rate	19.6%	17.1%	13.3%	21.5%	16.8%
ROE	8.2%	9.2%	9.9%	11.4%	12.8%
YoY Growth rate	15.5%	12.2%	7.6%	15.2%	11.8%

The dividend payout ratio reached 66.8% during the Period, representing a stable dividend payout policy that the management maintained in past years. Details of dividends in the last five years are as follows:

	Year ended December 31,				
	2001	2002	2003	2004	2005 (Proposed)
Dividends (Rmb'000) Dividend payout ratio	434,311 57.1%	564,604 63.4%	651,467 64.6%	825,191 67.3%	955,485 66.8%

LIQUIDITY

The Group enjoyed strong cash inflow from its steady growth in toll income, with net cash inflow from operating activities amounting to Rmb1,983.3 million as at December 31, 2005, representing a year-on-year increase of 31.4%.

As at December 31, 2005, current assets of the Group amounted to Rmb1,919.8 million in aggregate (2004: Rmb1,912.3 million), of which account receivables, other receivables and inventories accounted for 24.0% (2004: 21.6%).

FINANCIAL RESOURCES

As at December 31, 2005, the Group held Rmb1,441.2 million in cash and cash equivalents, time deposits and short-term investments (2004: Rmb1,480.2 million), with cash and cash equivalents accounting for 50.2%, time deposits 7.3% and short-term investments 42.5% of the total amount, respectively.

	As at D	ecember 31,
	2005 Rmb'000	2004 Rmb'000
Cash and cash equivalent		
Rmb	723,452	717,559
US\$ in Rmb equivalent	2	4,434
HK\$ in Rmb equivalent	59	6
Time deposits		
Rmb	105,632	81,740
Short term investments		
Rmb	612,097	676,447
Total	1,441,242	1,480,186
Rmb	1,441,181	1,475,746
US\$ in Rmb equivalent	2	4,434
HK\$ in Rmb equivalent	59	6

Among the Rmb612.1 million held in short-term investments as at December 31, 2005, 96.1% was held in government bonds, with the remaining 3.9% held in close-ended security investment funds.

The Directors do not expect the Company to experience any problem with financial resources in the foreseeable future.

BORROWINGS AND SOLVENCY

The Group adjusts its debt levels based on, among others, its cash flow, interest coverage ratio and the ratio of debt over capital.

As at December 31, 2005, interest-bearing borrowings for the Group totaled Rmb2,434.7 million (2004: Rmb2,443.5 million), amongst which Rmb886.5 million comprised short-term interest bearing borrowings (an increase of 12.5% year-on-year) and Rmb1,548.2 million comprised long-term borrowings (a decrease of 6.5% year-on-year). Details are as follows:

		Maturity Profiles			
	Gross amount Rmb'000	Within 1 year Rmb'000	2-5 years inclusive Rmb'000	Beyond 5 years Rmb'000	
Floating rates					
World Bank Ioan	732,137	188,740	372,815	170,582	
Fixed rates					
Commercial bank loans	630,000	630,000	_	—	
Government loans	72,600	67,800	4,800	—	
Corporate bonds	1,000,000	—	_	1,000,000	
Total as at December 31, 2005	2,434,737	886,540	377,615	1,170,582	
Total as at December 31, 2004	2,443,462	787,892	377,847	1,277,724	

During the Period, the interest rates of the Group's semiannual and annual domestic commercial bank borrowings, totaling Rmb630.0 million, were fixed between 4.698% and 5.580%; the interest rate for Rmb72.6 million government loans remained fixed at 3.000%; the annual coupon rate for the Rmb1 billion corporate bonds issued by the Company in 2003 for a term of 10 years was fixed at 4.290%, with interests payable annually. The floating rates of the Group's Rmb732.1 million World Bank loans, denominated in US dollars, varied from 4.110% to 4.590% during the Period.

Total interest expense for the Period amounted to Rmb107.2 million, while profit before interest and tax amounted to Rmb2,371.9 million, resulting in an interest cover ratio (profit before interest and tax over interest expenses) of 22.1 (2004: 19.4).

	2005 Rmb'000	2004 Rmb'000
Profit before tax and interest	2,371,858	2,002,663
Interest expenses	107,196	103,457
Interest cover ratio	22.1	19.4

Moreover, the asset-liability ratio, which represents the total liabilities over total assets, remained low at 24.2% (2004: 23.6%) as at December 31, 2005. The solvency of the Group remained strong during the Period.

CAPITAL STRUCTURE

As at December 31, 2005, the Group had Rmb12,363.9 million total equity (including minority interests), Rmb1,702.6 million fixed-rate liabilities, Rmb732.1 million floating-rate liabilities and Rmb1,513.1 million interest-free liabilities, representing 75.8%, 10.4%, 4.5% and 9.3% of the Group's capital, respectively.

	As at Decemb	er 31, 2005	As at December 31, 2004		
	Rmb'000	%	Rmb'000	%	
Total equity	12,363,868	75.8%	11,812,506	76.4%	
Fixed rate liabilities	1,702,600	10.4%	1,642,600	10.62%	
Floating rate liabilities	732,137	4.5%	800,862	5.18%	
Interest-free liabilities	1,513,051	9.3%	1,205,471	7.8%	
Total	16,311,656	100.0%	15,461,439	100.0%	
Long-term interest-					
bearing liabilities	1,548,199	9.5%	1,655,517	10.7%	
Gearing ratio 1 (Note)	31.99	%	30.9%		
Gearing ratio 2 (Note)	12.5%		14.0%		
Asset-liability ratio	24.29	%	23.6%		

Note: Gearing ratio 1 represents the sum of fixed rate liabilities, floating rate liabilities and interest-free liabilities to the total equity; gearing ratio 2 represents the total amount of the long-term interest-bearing liabilities to the total equity.

CAPITAL EXPENDITURE COMMITMENTS AND UTILIZATION

As at December 31, 2005, total capital expenditure commitments of the Group and the Company stood at Rmb4,086.8 million and Rmb3,130.3 million, respectively. Of the total capital expenditure commitments of the Group, approximately 57.8% will be applied toward the Widening Project, while 27.2% will be applied toward the construction of Jiashao Expressway.

Total capital expenditure incurred by the Group and by the Company during the Period amounted to Rmb1,449.3 million and Rmb764.4 million, respectively, with the Widening Project alone having utilized Rmb1,266.6 million. The Group will rely upon its internal resources to fund its capital expenditure commitments, with a preference for debt financing to meet any shortfall.

	As at December 31, 2005					
	Commitments Rmb'000	Group Utilization Rmb'000	Balance Rmb'000	Commitments Rmb'000	Company Utilization Rmb'000	Balance Rmb'000
Expressway Widening Project						
From Dajing to Fengjing	2,508,190	1,607,290	900,900	_	_	_
From Guzhu to Duantang	2,300,000	841,067	1,458,933	2,300,000	841,067	1,458,933
Acquisition of additional 18.4%						
equity interest in Shangsan Co	485,000	—	485,000	485,000	—	485,000
Renovation of Service Area	1,371	1,371	—	—	—	—
Remaining construction works						
of the Shangsan Expressway	47,667	3,290	44,377	—	—	—
Purchase of machinery	87,250		87,250	76,000	—	76,000
Jiashao Expressway Project	1,145,375	35,000	1,110,375	1,145,375	35,000	1,110,375
Total	6,574,853	2,488,018	4,086,835	4,006,375	876,067	3,130,308

CONTINGENT LIABILITIES AND PLEDGE OF ASSETS

At December 31, 2005, the PRC Government Bonds (being the treasury bonds issued by the PRC Government) of an approximate aggregate amount of RMB587 million were held in the Company's investment account with Kinghing Securities Co., Ltd. ("Kinghing Securities"). Prior to the date of the Acquisition Agreements, Kinghing Securities had pledged the PRC Government Bonds as security for certain third party repo trading transactions entered into by it through the Shanghai branch of the PRC Securities Registration and Clearing Co., Ltd. Subsequent to the pledging of the PRC Government Bonds, Kinghing Trust Investment Co., Ltd., the largest equity owner of Kinghing Securities at the relevant time, had misappropriated funds of Kinghing Securities such that Kinghing Securities currently does not have sufficient funds to settle the relevant repo trading transactions, and as a result, the security over the PRC Government Bonds may be enforced. In light of the above circumstances, the Company has decided to participate in the restructuring of Kinghing Securities,

through which additional RMB600 million capital contribution will be injected by Shangsan into Kinghing Securities, with a view to enabling Kinghing Securities to settle the repo trading transactions and obtaining the release of the security over the PRC Government Bonds beneficially owned by the Company. As of the date of this approval of the financial statements, such pledge on the PRC Government Bonds has been released. Other than aforementioned, the Group did not have any contingent liabilities nor any pledge of assets as at December 31, 2005 (2004: Nil).

FOREIGN EXCHANGE EXPOSURE

As at December 31, 2005, the Group held a US dollardenominated World Bank Ioan of approximately Rmb732.1 million. Except for the repayment of the World Bank Ioan in US dollars as well as dividend payments to overseas shareholders in Hong Kong dollars, the principal operations of the Group were settled in Renminbi.

The appreciation of Renminbi against the US dollar during the Period resulted in an exchange gain of Rmb19.2 million for the Group. Although the Directors do not foresee any material foreign exchange risks for the Group, there is no assurance that any further changes in the foreign exchange environment will not adversely affect the operating results of the Group in the future.

HUMAN RESOURCES

During the Period, the Group employed an addition 284 employees to support its expanded operations of maintenance facilities and service areas. As at December 31, 2005, there were a total of 3,028 employees within the Group, amongst whom 215 were administrative staff, 430 were engineering technicians, and 2,383 were staff working in the fields of toll collection, maintenance and service areas. Total remuneration for the Group's employees for the Period amounted to Rmb138.7 million, representing an increase of 17.5% over 2004.

In addition to basic salaries, overall remuneration of the Group's employees included bonuses that reflected business performance of the Company and its subsidiaries as well as individual performance. For members of the management team, bonuses were also devised to reflect the share price performance of the Company during the Period.

Aside from organizing regular training programs for the employees, the Company also sponsored external training programs taken up by employees' initiatives, with the aim of improving both the professional qualifications as well as the personal well-being of the employees.

OUTLOOK FOR 2006

The completion of Phase II of the Widening Project on the Shanghai-Hangzhou-Ningbo Expressway has already given a boost to traffic volume growth along the section between Dajing and Fengjing. However, the ongoing construction works under Phase III of the Widening Project may adversely affect the normal traffic volume growth along the section between Guzhu and Duantang before its completion by the end of 2007. Expressway-related business operations are expected to continued to expand, though a slower rate compared to the past few years following the opening to traffic of new service areas along neighboring expressways. Nevertheless, the overall demand for such services is growing and the Company intends to tap into the growth potential by expanding its existing service areas while adding new service areas.

On the macro side, 2006 is the first year in the Eleventh Five-year National Economic Development Plan where steady economic growth has been set as one of the key objectives. For Zhejiang Province, the plan translates into a target of an average annual GDP growth rate of 9% for the next five years as the provincial economy heads toward a period of rapid industrialization and urbanization.

The forecasted strong economic growth in Zhejiang Province is expected to generate a steady growth in demand for road transport that will be met with a continuous addition of new roads to the existing network as well as renovated national and provincial roads. Although the new roads coming into operation will enhance the overall network of the existing expressways in the long run, it is expected that the overall supply of new road capacities will increase at a rate higher than that of demand growth, which means that traffic volume growth on these expressways, including the ones operated by the Group, will only be moderate in the short run.

To compensate for its additional investment for widening the Shanghai-Hangzhou-Ningbo Expressway from four lanes to eight lanes, the Company will be applying for an extension to its concession period for expressway operation and toll collection, though there is no assurance that the relevant government authorities will approve any or part of the request.

Three Pools Mirroring the Moon:

At a mid-autumn moonlit night, when the moon rises high up in the sky, the full moon, the pagodas and the clouds are all mirrored in the water, the calm water in a charming scene that defies any effort of description.

Customers

For customers, Zhejiang Expressway means an expressway operator committed to pursuing excellent services. We endeavor to establish a brand name that is identified with quality service, whilst relentlessly enhancing our expressway facilities and related complementary services, with an aim to provide safe, comfortable and efficient traveling conditions to road users. What's more, we never cease to innovate and improve ourselves, so that we will be able to meet the ever-rising expectations of our customers.