

## I OPERATION REVIEW

The Company is one of the leading electric power generating equipment manufacturers in the PRC. The principal operations of the Company include hydro power generators, steam power generators, A.C. and D.C. electrical motors and controlling devices.

In 2005, all staff closely followed the Company's work directions and objectives for the year so that the Company overcame the difficulties in delivering products on a tight schedule and tight supply of raw materials. Income from principal operations exceeded RMB3 billion. Production volume of its power generating equipment surpassed 20,000 MW. The power generating equipment produced by the Company accumulated to more than 100,000 MW in 2005. The Company has maintained sustainable and rapid development.

In 2005, the Company produced 36 sets of hydro power generators accounting for production volume of 2,522.5 MW; 47 sets of steam power generators accounting for production volume of 17,755MW; 58 sets of A.C. motors accounting for production volume of 216.78 MW; 18 sets of D.C. motors accounting for production volume of 28.467 MW; and 234 sets of auxiliary machine equipment.

During the reporting period, the Company's operating results increased significantly due to the increase in production volume. In accordance with the HKGAAP, the Company achieved a turnover of RMB3,048 million, representing an increase of 48.58% as compared with that of the previous year. Profit after tax amounted to RMB535 million, representing an increase of 111.69% over last year. Earnings per share amounted to RMB1.188, representing an increase of RMB0.627 per share as compared with earnings per share of RMB0.561 in the previous year. In accordance with the PRC GAAP, the Company achieved sales income of RMB3,048 million, representing an increase of 48.58% as compared with that of the previous year. Net profit amounted to RMB528 million, representing an increase of 99.48% over that of last year. Earnings per share amounted to RMB1.173, representing an increase of RMB0.585 as compared with earnings per share of RMB0.588 in the previous year.

In 2005, the Company achieved relatively good results in its market development. The Company entered into contracts for various large hydro electric power generators including three sets of 700 MW hydro power generators in Xiaowan Plant, five sets of 350 MW electricity generators in Jinhong Plant, one set of 300 MW generator in Manwan Plant Phase II project and four sets of 600MW hydro power generators in Jinanqiao Plant. These also included four sets of 57MW pumped stream hydro power generators in Guangxi Qiaozhu Plant which is currently the generator with the largest single power generating capacity in the PRC, two sets of 1,000MW nuclear steam power generators in Guangdong Lingao Plant Phase II project with strategic importance and various sets of 600MW and 300MW steam power generators. The Company also obtained good results in exploring international market. The Company entered into contracts for two sets of 110MW hydro power generators in Vietnam Boxia River Plant which is the generator with the largest single generating capacity for export, two sets of 38MW hydro power generators in Lao Caide Plant and one set of 300MW steam power generator in Indian Amakanta Power Plant. The new order for the year amounted to RMB5,700 million.

# Report of the Board *(continued)*

## II PRINCIPAL OPERATIONS AND THE OPERATING STATUS

### 1. Principal operations by business and product

Unit: RMB'000

By business or products	Revenue from principal operations	Cost of principal operations	Principal operations' profit margin (%)	Increase/ (decrease) of revenue from principal operations as compared to last year (%)	Increase/ (decrease) of cost of principal operations as compared to last year (%)	Increase/ (decrease) of principal operations' profit margin as compared to last year (%)
<b>By business</b>						
Machinery manufacturing	3,047,858	2,094,602	31.28	48.58	59.96	A decrease of 4.89 percentage points
Including: connected transaction	191,419	180,089	5.92			
<b>By product</b>						
Electric power-generating equipment	2,902,404	1,986,808	31.55	50.77	62.11	A decrease of 4.79 percentage points
Technological renovation, provision of services and others	145,454	107,794	25.89	15.20	28.56	A decrease of 7.71 percentage points

### 2. Principal operations by region

Unit: RMB'000

By region	Revenue from principal operations	Increase/ (decrease) of revenue from principal operations as compared to last year (%)
The PRC	3,047,858	48.58

### 3. Financial analysis (under PRC GAAP)

- (1) The Company's profit from principal operations for the year amounted to RMB948,123,000, representing an increase of 30.01% from RMB729,262,000 of last year, which was attributable to a significant increase in sales revenue from principal operations.
- (2) The Company's profit from other operations for the year amounted to RMB63,839,000, representing an increase of 155.82% from RMB24,955,000 of last year, which was attributable to a considerable increase in profit from sales of leftover materials.
- (3) Net profit of the Company for the year amounted to RMB528,057,000, representing an increase of 99.40% from RMB264,721,000 of last year, which was attributable to: A. an increase of RMB218,861,000 in profit from principal operations; B. an increase of RMB38,884,000 in profit from other operations; C. a reduction of RMB17,457,000 in financial cost resulting from the increase in number of fixed deposits due to adjustment to structure of bank deposits.

## II PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

### 3. Financial analysis (under PRC GAAP)

- (4) The net increase in cash and cash equivalents for the year amounted to RMB751,098,000, representing a decrease of 143.96% from RMB1,708,777,000 of last year, which was attributable to: A. the considerable increase in fixed deposits of more than three months' term; B. the considerable increase in other restrictive cash and bank deposits including security deposits made for Bank Acceptance Bill, Project Bids, and Covenants of Contracts.
- (5) Total assets of the Company for the year amounted to RMB8,462,083,000, representing an increase of 32.76% from RMB6,374,067,000 of last year, which was attributable to: A. the increase of RMB729,647,000 in cash at bank and in hand over that of last year, due to the noticeable rise in deposits as a result of the signing of numerous sales contracts; B. the increase of RMB234,421,000 in prepayment due to the considerable rise in purchase of raw materials resulting from the signing of considerable sales contracts; C. the increase of RMB902,730,000 in inventories over that of last year due to the significantly increased reserve of raw materials and work in progress as a result of substantial growth in production tasks.
- (6) Total liabilities of the Company for the year amounted to RMB6,627,398,000, representing an increase of 29.87% from RMB5,103,098,000 of last year, which was mainly attributable to: the increase of RMB1,156,209,000 in receipts in advance over that of last year; the increase of RMB158,442,000 in notes payable over that of last year as a result of increased use of bank notes during the settlement period; the increase of RMB276,745,000 in prepayment over that of last year as a result of the significantly increased purchase of raw materials.
- (7) Shareholders' equity of the Company for the year amounted to RMB1,833,411,000, representing an increase of 44.37% from RMB1,269,939,000 of last year, which was mainly attributable to the significant increase in net profit.
- (8) During the year, the gearing ratio of the Company was 78.32%, basically unchanged as compared with the previous year.

### 4. Financial analysis (prepared under HK GAAP)

#### 4.1 Financial status

As at 31 December 2005, the current assets of the Group amounted to RMB7,706,536,000 (2004: RMB5,676,329,000). The items with relatively significant changes and the reasons are analysed as follows:

- (1) Cash and bank balances, and deposits in non-banking financial institution amounted to RMB1,916,230,000 (2004: RMB2,667,328,000) and fixed deposits of terms of three months' or above amounted to RMB1,957,009,000 (2004: RMB491,435,000). The Company transferred the funds not immediately used as working capital from savings account to fixed deposits account in order to improve the returns on the Company's assets.
- (2) Trade receivables amounted to RMB852,385,000 (2004: RMB718,272,000) as a result of significant increase in sales of the Company due to the favourable conditions in the electricity generating equipment market.
- (3) Inventories amounted to RMB1,794,023,000 (2004: RMB924,441,000) and payment in advance amounted to RMB713,701,000 (2004: RMB479,280,000). The increase was mainly due to the increase in the required minimum inventory level and increase in the required deposits for the purchase of raw materials for electricity generating equipment in view of the increasing sales volume of the Company.

## II PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

### 4. Financial analysis (prepared under HK GAAP) *(continued)*

#### 4.1 Financial status *(continued)*

As at 31 December 2005, the current liabilities of the Company amounted to RMB6,627,398,000 (2004: RMB5,076,256,000). The items with relatively significant changes and the reasons are analysed as follows:

- (1) Trade payables amounted to RMB450,198,000 (2004: RMB173,453,000). The increase was mainly due to the increase in normal balances of trade payables resulting from the significant increase in purchases for raw materials in meeting the increase in the Company's product sales.
- (2) Receipts in advance (inclusive of receipts in advance for construction contracts) amounted to RMB5,462,552,000 (2004: RMB4,311,496,000). The increase was mainly due to the increase in the number of payable items and amount under the Company's contracts on hand. Given the present and future cash flow planning, the Company expects that it has sufficient repayment ability to maintain its high speed development.

#### 4.2 Capital structure

As at 31 December 2005, the liability ratio of the Company was 398.19% (2004: 421.22%). The decrease as compared with 2004 was mainly attributable to the increase in bills payable, receipts in advance and reserves over those of last year, all these reflected the favorable conditions of market demand of the Company; the improvement of the Company's operation management and the emphasis on financial management by way of using bills payable in the purchase of raw materials in the operation to enhance the returns on assets. The debt to equity ratio was 0.59% (2004: 3.28%) which was a result of the Company's efforts in reducing its loans. At present, the Company has a strong debt repayment ability and is has a better fund raising ability in the future.

#### 4.3 Cash flows

As at 31 December 2005, the cash and cash equivalents of the Company decreased by RMB751,098,000 as compared with that of the last year (2004: an increase by RMB1,708,778,000). The net cash inflow from operations of the year amounted to RMB966,819,000 (2004: RMB2,585,100,000), the decrease was mainly due to the significant increase in purchases and production expenditure. During the year, the other cash outflow including transfer of fixed deposits with terms exceeding three months amounted to RMB1,480,745,000, capital expenditures such as the purchase of fixed assets and intangible assets amounted to RMB192,916,000, the repayment of long-term and short-term loans amounted to RMB40,000,000 and the payment of dividend for the year 2004 amounted to RMB54,000,000.

#### 4.4 Gearing ratio

The total assets and total liability of the year amounted to RMB8,462,888,000 and RMB6,763,159,000 respectively. Accordingly, the gearing ratio was 79.92%.

#### 4.5 During the reporting period, the Company did not pledge any of its assets.

#### 4.6 The risk in fluctuation of exchange rate and any related hedging

The amount of deposit in foreign currency was minimal, therefore the Company was less susceptible to exchange rate fluctuation.

In 2005, a significant increase in net loss arising from translation of currency is recorded when compared with the preceding year, which was mainly due to appreciation of Renminbi. Since the Company's raw material procurement costs was mainly denominated in foreign currencies, the prepayment and trade payable would be subject to foreign exchange rate fluctuation. The amount of loss arising from translation of foreign currencies was higher than the gain because the amount of prepayment denominated in foreign currencies is higher than trade payable denominated in foreign currencies.

#### 4.7 Contingent liabilities

As of the end of the period, the Company had incurred no contingent liability.

## II PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

### 5. Structure of assets

Unit: RMB'000

Item	Amount		Percentage in the total assets (%)		
	2005	2004	2005	2004	Increase (decrease) %
Bills receivables	18,629	35,924	0.22	0.56	-60.71
Accounts receivables	852,385	718,272	10.07	11.27	-10.65
Other receivables	39,532	19,078	0.47	0.30	56.67
Prepayments	713,701	479,280	8.43	7.52	12.10
Inventories	2,053,892	1,151,162	24.27	18.06	34.39
Long-term equity investment	7,070	654	0.08	0.01	700.00
Fixed assets	569,034	516,552	6.72	8.10	-17.04
Construction in progress	120,565	107,720	1.42	1.69	-15.98
Short-term borrowings	10,000	56,841	0.12	0.89	-86.52
Long-term borrowings	0	0	0.00	0.00	0.00
Total assets	8,462,083	6,374,067			

- (1) The percentage of bills receivables in total assets for the year decreased by 60.71% as compared with last year, mainly due to the increase in endorsement of bills during the daily settlement.
- (2) The percentage of accounts receivables in total assets for the year decreased by 10.65% as compared with last year, mainly due to the higher increase in total assets than that of accounts receivables.
- (3) The percentage of other receivables in total assets for the year increased by 56.67% as compared with last year, mainly due to the significant increase in provision of interests of fixed deposits in other receivables.
- (4) The percentage of prepayments in total assets for the year increased by 12.10% as compared with last year, mainly due to the considerable rise in purchase of raw materials resulting from the signing of considerable sales contracts.
- (5) The percentage of inventories in total assets for the year increased by 34.39% as compared with last year, mainly due to the significantly increased reserve of raw materials and work in progress as a result of substantial growth in production tasks.
- (6) The percentage of long-term equity investment in total assets for the year increased by 700.00% as compared with last year, mainly due to the Company's contribution of RMB6,375,000 as at December 2005 as a result of establishment of a joint venture company jointly invested by the Company and a French Company, JEUMONT. S. A.
- (7) The percentage of fixed assets in total assets for the year decreased by 17.04% as compared with last year, mainly due to the higher increase in total assets than that of fixed assets.
- (8) The percentage of construction in progress in total assets for the year decreased by 15.98% as compared with last year, mainly due to the higher increase in total assets than that of construction in progress.
- (9) The percentage of short-term borrowings in total assets for the year decreased by 86.52% as compared with last year, mainly due to the repayment of numerous short-term borrowings.

## Report of the Board *(continued)*

### II PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

#### 6. Expenses for the period and income tax

Unit: RMB'000

Item	2005	2004	Increase (decrease) %
Operating expenses	<b>20,989</b>	15,512	35.31
Management expenses	<b>410,287</b>	429,585	-4.49
Financial expenses	<b>-30,618</b>	-13,161	-132.64
Income tax	<b>82,213</b>	59,004	39.33
Net cash flows from operating activities	<b>996,865</b>	2,515,137	-60.37
Net cash flows from investing activities	<b>-1,634,684</b>	-421,178	-288.12
Net cash flows from financing activities	<b>-112,677</b>	-385,026	70.74

- (1) Operating expenses for the year increased by 35.31% as compared with last year, mainly due to the increase in salary, welfare fee, business expenses and travelling expenses for marketing personnel as a result of the considerable growth in the Company's production and operation.
- (2) Management expenses for the year decreased by 4.49% as compared with last year, mainly due to the considerable reduction of loss from bad debts.
- (3) Financial expenses for the year decreased by 132.64% as compared with last year, mainly due to the considerably increased interests income as a result of the substantial increase in fixed deposits.
- (4) Income tax for the year increased by 39.33% as compared with last year, mainly due to the significant rise in total profit.
- (5) The net cash flows from operating activities for the year decreased by 60.37% as compared with last year, mainly due to the significantly increased cash paid for goods and services as a result of substantial growth in production tasks.
- (6) The net cash flows from investing activities for the year decreased by 288.12% as compared with last year, mainly due to the significant increase in other cash paid relating to investing activities as a result of transferral of numerous current deposits to fixed deposits.
- (7) The net cash flows from financing activities for the year increased by 70.74% as compared with last year, mainly due to the considerable year-on-year reduction in cash paid for repayment of debts.

## II PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

### 7. Operating status and results of major holding companies

Unit: RMB'000

Name	Nature of businesses	Major products and services	Registered capital	Total assets	Net profit
DFEM Control Equipment Company Limited	Manufacturing	Design, manufacture and sale of control equipment in relation to power generators and A.C and D.C. motors	13,000	176,364	383
DFEM Power Equipment Company Limited	Manufacturing	Design, manufacture and sale of Large and medium A.C. and D.C. motors, small hydro-power motors and specialised generators	42,754	263,477	23,160
DFEM Tooling and Moulding Company Limited	Manufacturing	Design, manufacture and sale of industrial tool and knife tool; process and sale of ordinary machinery and machinery accessories	14,600	31,380	384
DFEM Equipment Engineering Company Limited	Manufacturing	Overhaul of electrical machinery, technological transformation; installation and test run of complete set of electrical machinery; design, manufacture and sale of complete set of electrical machinery control system; environmental protection equipment; design, manufacture, installation and sale of special equipment etc.; manufacture and sale of machinery spare parts and general spare parts; technical consultancy and service for electrical machinery	13,500	19,188	208

### 8. Major suppliers and customers

Unit: RMB'000

Purchase from the top 5 suppliers	421,255	Percentage in the total purchase	17.85%
Sales to the top 5 customers	668,663	Percentage in the total sales	21.94%

## III. INVESTMENT OF THE COMPANY

As reviewed and approved by the Board of the Company at the 20th meeting held on 28 October 2005, the Company resolved to establish a joint venture company, AREVA-DONG FANG Reactor Coolout Pumps Company Limited, with a French company JELLMONT S. A. The total proposed investment of the joint venture company amounted to Euro 10 million. The registered capital of the joint venture company amounted to RMB42,500,000. The joint venture company would engage in the design, manufacture, examination and testing, marketing and after-sale services of reactor coolant pumps ("RCP") for nuclear power stations and shall provide nuclear power stations with that kind of system equipment and spare parts. Details of the investment were included in the announcement dated 16 November 2005 published in China Securities, Shanghai Securities, Wen Wei Po and The Standard.

The actual investment in 2005 amounted to RMB165,081,000, comprising mainly: basic construction with actual investment amounting to RMB45,508,000, technological renovation project with actual investment amounting to RMB79,976,000, renewal of equipment with actual investment amounting to RMB4,672,000, technology measures with actual investment amounting to RMB19,442,000, additions of electric and measuring equipment with actual investment amounting to RMB8,610,000 and renovation of equipment with actual investment amounting to RMB6,868,000. The completion of these projects enhanced the overall production capacity and manufacturing skills of the Company.

During the reporting period, the Company had no proceeds raised and funds brought forward from previous periods.

## IV. DAILY MANAGEMENT BY THE BOARD

### 1. Board meetings and resolutions passed

- (1) The 15th meeting of the fourth Board was held on 18 January 2005 for considering and approving the Company's 2005 administrative guidelines and objectives, fixed assets investment plan for 2005, the proposed write-off of certain accounts receivables of more than three years' terms, and the proposed issue of announcement of expected earnings.
- (2) The 16th meeting of the fourth Board was held on 21 March 2005 for considering and approving the 2004 financial statements of the Company, the 2004 profit after taxation distribution plan of the Company, the full text of 2004 annual report and its summary, the 2005 financial budget of the Company, the proposed appointment of accountants, proposed amendments to the Articles of Association, the holding of the 2004 annual general meeting, and the proposal relating to connected transactions between the Company and four subsidiaries of DFEW.
- (3) The 17th meeting of the fourth Board was held on 11 April 2005 for considering and approving in writing the proposed amendments to the Articles of Association and the holding of 2005 extraordinary general meeting.
- (4) The 18th meeting of the fourth Board was held on 27 April 2005 for considering and approving the first quarterly report of the Company for 2005, application to the banks for banking facilities, and investments on certain equipment.
- (5) The 19th meeting of the fourth Board was held on 24 August 2005 for considering and approving the proposal of resignation of relevant directors, the proposed write-off of relevant fixed assets (including construction in progress), the unaudited interim financial statements for 2005, the interim profit appropriation plan for 2005, the interim report for 2005 and its summary, and investments on certain equipment.
- (6) The 20th meeting of the fourth Board was held on 28 October 2005 for considering and approving the third quarterly report for 2005, deposits placed with DFEC Finance Company, the joint investment in construction of RCP projects; the Management Methods for Labour Contracts and ancillary methods, the proposed re-election of the Board and the Supervisory Committee; holding of the Second 2005 extraordinary general meeting, and proposed appointment of accountants for merger.
- (7) The 21st meeting of the fourth Board was held on 17 November 2005 for considering and approving in writing the Report of Transfer regarding State-owned Legal Person Shares Issued by the Board of Dongfang Electrical Machinery Company Limited to its Shareholders.
- (8) The 22nd meeting of the fourth Board was held on 1 December 2005 for reporting the list of candidates for members of the fifth Board and Supervisory Committee nominated by the controlling shareholder and for considering and approving the proposed nomination of candidates for independent directors of the fifth Board, the proposal relating to the remuneration of members of the fifth Board and Supervisory Committee, and the Supplemental Announcement in Relation to the Second 2005 Extraordinary General Meeting of Dongfang Electrical Machinery Company Limited.
- (9) The first meeting of the fifth Board was held on 22 December 2005 to elect Zhu Yuanchao as Chairman; to appoint Han Zhiqiao as General Manager; to appoint Zhang Tiande, Gong Dan, He Jianhua, Liu Hui and Xia Xiaoqiang as Deputy General Manager; to appoint Gong Dan as the Secretary to the Board and appoint Huang Yong as Representative of Security Affairs; to determine the remuneration of the senior management; and to determine the composition of special committees under the Board.

Announcements of the discloseable resolutions passed at the abovementioned Board meetings were published in Shanghai Securities Post, China Securities Journal, Wen Wei Po and The Standard on the day following the holding of each meeting.

### 2. Implementation of resolutions passed at general meetings by the Board

The Board of the Company has strictly implemented all resolutions passed at the general meeting during the reporting period and will continue to honestly and diligently serving the Company and its shareholders for their maximized interests.



### V. PROSPECT FOR THE NEW YEAR AND FUTURE

In the coming years, based on the macro economic development trend and the Eleventh Five Year Development Plan for the electricity industry, the country's electricity construction will follow the policy of "striving for development of hydro electricity generation, enhancing the development of coal electricity generation, actively developing nuclear electricity generation, appropriately developing natural gas electricity generation, speeding up the exploration of new energy, placing emphasis on environmental protection, enhancing the efficiency of energy utilisation". The electricity generating equipment will be refined towards the direction of high generating ratio, high effectiveness, large capacity, low pollution to achieve highly effective energy savings and environmental protection. Hydro electricity generation will be mainly based on superlarge capacity items. Various large hydro electricity generators of 70 MW in Three Gorges Underground Plant, Xiluodu Plant and Xiangjiabei Plant will commence construction and tendering. The market demand is anticipated to be booming. There will be further development in the markets for the nuclear electricity generator with production of 100MW, 100MW ultra-supercritical steam power generator, heavy power generator and super pumped storage hydro power generator. In view of the continuous recovery of the world economy, the electricity markets in South Asia, Southeast Asia, Middle East, Africa and South America starts to accelerate in development and the demand for electricity generating equipment is growing. Accordingly, it can be expected that the coming years will be a period of opportunities for fast development of those enterprises in the field of electricity generating equipment.

The year 2006 represents the first year of the country's Eleventh Five Year Plan. It is also the starting year for the Company to build up on its previous success to achieve continuous breakthrough and move forward to a new development stage. The Company will focus on refining management, improving efficiency, enhancing overall operating effectiveness, utilising its resources fully, exploring potential capacity, ensuring satisfactory completion of its production targets, seizing the strategic importance, paying attention to both internal and external operating environments, continuously perfecting market structure, actively searching for new ideas, striving for breakthrough, strengthening proactive development capacity, tightening supervision and control, promoting the improvement in both quality and efficiency, striving for further reform, exploring new operating mechanism, speeding up the development of human resources, establishing a sound enterprise culture and achieving the first-class quality.

During the period of the Eleventh Five Year Plan, the Company will focus on and strengthen its principal business of electricity generating equipment, dedicate more effort in technology development, achieve the target set in all aspects, strive for expanding the market share in the domestic market, actively explore the international markets, strive to enhance the overall competitive capability and promote the continuous healthy development of the Company in order to establish the Company as a first-class electricity generating equipment enterprise in the world.