

# Chairman's Statement



## Dear Shareholders,

I am very encouraged to see the positive results of 2006 driven by our strategic transformation. In anticipation of rising challenges to our traditional wireline voice services business by mobile substitution, we decisively advocated and implemented strategic transformation two years ago, taking advantage of new business opportunities enhanced by the advancement of information technology. Aiming at the diverse needs of our customers, we continuously provided innovated products and services to delight and enhance value to them, leveraging our rich talents and network resources as well as our multi-services offering edge. These included improved high speed Internet experience, feeding information to our customers for their needs in daily life or business, providing IT and applications services to enhance their operating efficiency and business opportunities. Our above initiatives have not only abated the challenges on our traditional business operations, but also led to sustained growth in our overall revenue and profit. We firmly believe that as we further deepen our implementation of strategic transformation and progress our way to full services convergence offering, our customers' experience and value will be further enhanced, and our success and enhancement of shareholder value will follow.

## FINANCIAL RESULTS

In 2006, the Company achieved favorable financial performance. Operating revenues reached RMB175,093 million, an increase of 3.4% from 2005, in which the amortisation of upfront connection fees was RMB4,971 million. Excluding the upfront connection fees, operating revenues was RMB170,122 million, an increase of 4.7% from 2005; EBITDA<sup>1</sup> was RMB84,911 million, an increase of 3.8% from 2005; EBITDA margin<sup>1</sup> was 49.9%; profit attributable to equity holders of the Company<sup>1</sup> was RMB22,171 million, an increase of 4.9% from 2005; earnings per share<sup>1</sup> was RMB0.27. Capital expenditure decreased by 8.9% from 2005 to RMB49,085 million as a result of more effective expenditure control. Free cash flow<sup>2</sup> reached RMB29,072 million, an increase of 33.4% from 2005.

Taking into consideration the requirement for shareholders' return and the need to maintain capital flexibility for ensuring the sustainable development of the Company, the Board of Directors will recommend at the forthcoming Annual General Meeting that the dividend be further increased to an equivalent of HK\$0.085 per share, an increase of 13.3% from 2005.

## BUSINESS PERFORMANCE

In 2006, we firmly implemented our transformation strategy and strengthened our execution capability. In response to an increasingly competitive environment, we emphasized the profitable development of our voice business. Instead of directly competing on pricing and driving revenue growth solely based on subscriber base expansion, we accelerated the development of integrated information services and enriched the value content of the transformation business. Leveraging our multi-services offering edge, we consolidated our traditional business through integrated development while progressing our way towards an integrated information services provider. In 2006, business structure was further optimised, with revenue from non-voice business accounting for 29.0% of operating revenues (excluding the amortised upfront connection fees), an increase of around 5 percentage points. The integrated information services were promptly launched and started taking shape with its revenue accounting for 20.0% of value-added services ("VAS") revenue. Our customer base continued to expand in 2006. The number of access lines in service reached 223 million, a net increase of 12.95 million from 2005. The number of broadband subscribers reached 28.32 million, a net increase of 7.30 million from 2005.

<sup>1</sup> Including the amortisation of upfront connection fees, EBITDA was RMB89,882 million, EBITDA margin was 51.3%, profit attributable to equity holders of the Company was RMB27,142 million and earnings per share was RMB0.34.

<sup>2</sup> Free cash flow is calculated from EBITDA (excluding amortisation of upfront connection fees) minus capital expenditure and income tax.

# Chairman's Statement

In response to customers' needs, we continued to explore the potentials of integrated information services, such as "Best Tone" services. By leveraging our quality broadband access service, we strengthened our efforts in developing Internet value-added applications services, IT applications and services, and maintenance outsourcing services.

"Branding" is a collective reflection of corporate value. Effectively integrating services and products into customer brands is critical to enhancing customers' perception, psychological preference and product value. Riding on our reputable corporate and business brands, we established our customer branding structure with regard to various customer segments. For enterprise customers, we further enriched the services and applications of "BizNavigator" to enhance their value through our professional and customized information solutions. For household customers, we launched "One Home" to meet their diverse needs for communication and information services, leveraging our multi-services offering edge. We will closely monitor the development of the individual customer market and will launch our brand for individual customers in due course so as to establish a comprehensive customer branding structure.

We had adjusted our investment structure and focus in line with our strategic transformation and business development, with resources allocation skewed towards high-return projects. We increased investment for strategic and transformation businesses, ensuring adequate investment in the underlying network and advancing our network capability on providing integrated services. At the same time, we optimized resource allocation and reduced investment in traditional business infrastructure including network, buildings and pipelines. We invigorated existing network resources and increased the utilization of our traditional network. In 2006, we basically completed our intelligent network upgrade, further optimising our IP network. We also incorporated soft-switches into our network with scale, strengthening our capabilities on providing integrated and differentiated services.

In 2006, we actively enhanced our human resources management system by strengthening employment reform, improving performance appraisal management, enhancing incentive schemes and refining remuneration mechanisms and fringe benefits. We closely monitored our employee numbers and structure and sourced for experienced personnel to join our Company. To promote the development of our transformation business, we implemented reforms on personnel management, employment and remuneration systems for the new and developing businesses.

We seized competitive advantage in the value chain by leveraging third parties' strategic resources and strength. In appreciation of the importance of the joint efforts of the value chain in promoting the development of information services, we effectively joined together various strategic resources. We established close relationship with leading contents and services providers, and strengthened cooperation with equipment manufacturers for the development of new businesses and new terminals to further enhance our competitiveness along the value chain.

We further strengthened precision management and optimised resources allocation. We continued to enhance the organisation and control of logistics, capital and information flows. In 2006, the IT systems had achieved initial transform from being product-oriented to customer-oriented, from supporting a unitary product to accommodating integrated products and services packages. Significant progress was made in the development of the provincial-centralised customer relation management system and the billing system for integrated services. These had enhanced our precision management, marketing and servicing capabilities. With the implementation of stringent financial control, our capital resources and costs were skewed towards high-growth and high return business and operating units. We also improved our assessment system for business performance to enhance corporate value.

## CORPORATE GOVERNANCE

We are firmly committed to continuously improving corporate governance. Starting from 2006, we further enhanced our transparency by publishing monthly subscriber numbers and disclosing additional quarterly key business and financial metrics. We continued to hold our Annual General Meeting in Hong Kong and fully utilised our corporate website to enhance interactive communications with shareholders. Over the years, we continued to improve our internal control systems covering financial reporting, compliance, operational controls and risk management functions, with reference to international best practices and relevant regulatory requirements. We implemented strict reviews of internal controls and established standing mechanisms to further improve operational efficiencies, reduce corporate risks so as to safeguard the interests of our shareholders.

## OUTLOOK FOR 2007

We have clearly noticed from a global perspective that following the rapid expansion of mobile business, the deployment of ever-changing IP applications, and the acceleration of convergence of "triple-play" networks, transformation has become the global development trend of the telecommunications industry. It will be increasingly common for telecommunications operators to develop full-services operation.

Following the comprehensive implementation of China's "Eleventh Five-Year Plan", the entire telecommunications industry in China will aim to change its mode of growth and explore new areas of development to achieve sustainable growth and promote prosperity of the country. In recent years, the informatisation process has continued to accelerate in China with the rapidly growing demand for information infrastructure, information technology and applications services by the government, enterprises and households. This brings tremendous business opportunities for us. However, we also well realise the irreversible trend of mobile substitution and increasingly intensified competition in the telecommunications industry. We shall strive to grasp every opportunity to accomplish new developments, leveraging our motivated and innovative talents.

Looking ahead, we are fully confident. We shall continue to progress our strategic transformation and further innovate to improve our systems and mechanisms. We shall also fully implement brand oriented operations and continue to strengthen our strategic execution capabilities to enhance value for our customers, our company and our shareholders altogether.

Finally, I would like to take this opportunity to express my sincere appreciation to all of our shareholders, directors, members of the Supervisory Committee as well as our employees and customers.



**Wang Xiaochu**

*Chairman and Chief Executive Officer*

Beijing, PRC  
26 March 2007

↑ 25%

Non-voice revenue increased by 25%  
and represented 29% of operating revenues



*We are no longer a telephone-lines  
company providing call business only.*

*Our intelligent networks and systems could now  
support a great variety of services to satisfy diverse needs of  
our customers' everyday life covering communications,  
entertainment, information, high speed access to Internet. It  
could also enhance our business customers on capturing  
business opportunities and improving productivity. Our  
continuous investment in enhancing our networks and  
systems has been laying a solid foundation for our future full  
services convergence offering.*