

Management's Discussion & Analysis of Financial Conditions and Results of Operations

SUMMARY

Our revenues in 2006 were RMB14,182.80 million, an increase of 7.2% from 2005. Cost of revenues was RMB11,423.60 million, an increase of 8.3% from 2005. Profit attributable to equity shareholders of the Company was RMB696.08 million, an increase of 16.5% from 2005. Earnings per share were RMB0.172.

REVENUES

Our revenues in 2006 were RMB14,182.80 million, an increase of 7.2% from 2005; of which, revenue from telecommunications infrastructure services was RMB7,472.43 million, an increase of 3.8% from 2005; revenue from business process outsourcing services was RMB5,153.54 million, an increase of 18.1% from 2005; revenue from applications, content and others was RMB1,556.83 million, a decrease of 6.8% from 2005. Business process outsourcing services were the major source of our revenues growth in 2006.

The following table sets forth a breakdown of our revenues for 2005 and 2006, together with their respective rates of change:

	2006	2005	Percentage change
<i>(RMB in thousands, except percentage data)</i>			
Telecommunications Infrastructure Services			
Design services	1,621,416	1,438,025	12.8%
Construction services	5,546,372	5,480,420	1.2%
Project supervision and management services	304,639	281,145	8.4%
	7,472,427	7,199,590	3.8%
Business Process Outsourcing Services			
Network maintenance	576,693	593,653	(2.9)%
Distribution of telecommunications services and products	3,516,023	2,576,583	36.5%
Facilities management	1,060,824	1,192,916	(11.1)%
	5,153,540	4,363,152	18.1%
Applications, Content and Others			
IT applications	567,397	670,923	(15.4)%
Internet service	343,769	336,815	2.1%
Voice VAS	274,196	226,127	21.3%
Others	371,471	435,684	(14.7)%
	1,556,833	1,669,549	(6.8)%
Total revenues	14,182,800	13,232,291	7.2%

Telecommunications Infrastructure Services

In 2006, our revenue from telecommunications infrastructure services was RMB7,472.43 million, which accounted for 52.7% of our revenues and an increase of 3.8% over RMB7,199.59 million for 2005. Revenue from this area was mainly derived from the capital expenditure of telecommunications operators. In 2006, when major telecommunications operators in the PRC have tightened control over their capital expenditure, the Company maintained a steady revenue growth in this area through active business expansion; of which, the revenue from design services was RMB1,621.42 million, representing an increase of 12.8% from 2005.

Business Process Outsourcing Services

In 2006, our revenue from business process outsourcing services was RMB5,153.54 million, which accounted for 36.3% of our revenues, representing an increase of 18.1% over RMB4,363.15 million for 2005; of which, revenue from distribution of telecommunications services and products was RMB3,516.02 million, representing an increase of 36.5% from 2005. The increase was mainly due to the rapid growth in our distribution business of PHS and other mobile handsets. Revenue from facilities management was RMB1,060.82 million, representing a decrease of 11.1% from 2005. The decrease was mainly due to the price fluctuation of part of our facilities management services in 2006.

Applications, Content and Others

Revenue from applications, content and others was RMB1,556.83 million, which accounted for 11.0% of our revenues, representing a decrease of 6.8% from RMB1,669.55 million for 2005. Among the business operations in this area, revenue from IT applications amounted to RMB567.40 million, representing a decrease of 15.4% from 2005, which was mainly due to an adjustment in the way we carried out business with clients in 2006. Accordingly, the cost of hardware and equipment included in the revenues was reduced.

COST OF REVENUES

Our cost of revenues in 2006 was RMB11,423.60 million, representing an increase of 8.3% from 2005 and which accounted for 80.5% of the revenues, representing a slight increase from 79.7% for 2005. Our gross profit margin in 2006 was 19.5%, representing a decrease of 0.8 percentage points from 20.3% for 2005.

The following table sets out a breakdown of our cost of revenues in 2005 and 2006 and their respective rates of change:

	2006	2005	Percentage change
	<i>(RMB in thousands except percentage data)</i>		
Direct personnel costs	2,604,229	2,521,904	3.3%
Depreciation and amortization	249,691	239,300	4.3%
Purchase of materials and telecommunications products	4,333,050	4,337,923	(0.1)%
Subcontracting charges	2,760,555	2,029,152	36.0%
Operating lease charges and others	1,476,071	1,416,101	4.2%
Total cost of revenues	11,423,596	10,544,380	8.3%

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Direct Personnel Costs

In 2006, direct personnel costs were RMB2,604.23 million, which accounted for 18.4% of revenues and an increase of 3.3% over RMB2,521.90 million for 2005. On the one hand, the Company controlled the total number of employees and endeavoured to control the growth of personnel costs at a rate less than the growth of revenues, while on the other hand, we reformed our remuneration system and provided initiatives such as training courses to incentivise the staff.

Depreciation and Amortization

In 2006, depreciation and amortization amounted to RMB249.69 million, which accounted for 1.8% of the revenues and an increase of 4.3% over RMB239.30 million for 2005.

Purchase of Materials and Telecommunications Products

In 2006, the cost of the purchase of materials and telecommunications products was RMB4,333.05 million, which accounted for 30.6% of revenues and a decrease of 0.1% from RMB4,337.92 million for 2005; of which, the cost of the purchase of construction materials was RMB2,006.52 million, a decrease of 29.6% from RMB2,850.96 million for 2005; and the cost of the purchase of telecommunications products was RMB2,326.53 million, an increase of 56.5% over RMB1,486.96 million for 2005.

Subcontracting Charges

In 2006, subcontracting charges were RMB2,760.56 million, which accounted for 19.5% of revenues and represented an increase of 36.0% over RMB2,029.15 million for 2005. The increase in subcontracting charges was mainly because we began demanding our subcontractors for our telecommunications infrastructure services to expand their scope of provision of materials to better manage our working capital in 2006.

Operating Lease Charges and Others

In 2006, operating lease charges and others were RMB1,476.07 million, which accounted for 10.4% of the revenues and represented an increase of 4.2% over RMB1,416.10 million for 2005.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Our selling, general and administrative expenses in 2006 were RMB1,890.70 million, which accounted for 13.3% of revenues and represented a decrease of 3.1% over RMB1,951.12 million for 2005, and of which, provision for bad debts decreased by RMB34.66 million from 2005 and repair and maintenance fee decreased by RMB12.97 million from 2005.

DEFICIT ON REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

Our deficit on revaluation of property, plant and equipment in 2006 as a result of restructuring was RMB105.30 million. The deficit was not a recurring item and it had been recognized as an expense in the income statement. Such decrease in the book value of the property, plant and equipment was mainly due to the decrease in value of buildings, furniture, equipment and vehicles, etc. on a replacement costs basis.

NET FINANCING INCOME

In 2006, our net financing income was RMB85.64 million, an increase of RMB47.24 million over RMB38.40 million for 2005, or 123.0%, and of which, interest income increased by RMB51.47 million, and net foreign exchange loss increased by RMB8.41 million. The increase in interest income was mainly attributed to the interest income accrued on the application money under our IPO in 2006.

INCOME TAX

Except for subsidiaries incorporated in Hainan province or high-technology zone or special economic region in the PRC which are subject to a preferential income tax rate of 15%, the Company and other subsidiaries of the Group are subject to an income tax rate of 33%. The income tax in 2006 was RMB280.71 million and our effective tax rate was 28.1%. The difference between our effective tax rate and the statutory tax rate was mainly due to the effect of the aforesaid preferential tax rate of the subsidiaries.

PROFIT ATTRIBUTABLE TO EQUITY SHAREHOLDERS

In 2006, profit attributable to equity shareholders was RMB696.08 million, an increase of 16.5% over RMB597.56 million for 2005.

CAPITAL EXPENDITURE

Exclusive of the expenditure on acquisition of certain assets during our restructuring, our capital expenditure for 2006 was RMB732.31 million, a decrease of 2.5% over RMB751.00 million for 2005. Our capital expenditure for 2006 accounted for 5.2% of our revenues. In 2006, our capital expenditure included the purchase of production equipments, facilities, machineries, vehicles, office equipments, plant and building and other operating assets.

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CASH FLOWS AND CAPITAL RESOURCES

Cash Flows

In 2006, our net cash inflow was RMB3,385.11 million. In 2005, our net cash outflow was RMB830.11 million. By the end of 2006, the amount of our cash and cash equivalents was RMB7,071.03 million, of which 55.3% was accounted for in Renminbi, and 44.6% was accounted for in Hong Kong dollars.

The following table sets out our cash flow position in 2005 and 2006:

	2006	2005
	<i>(RMB in thousands)</i>	
Net cash generated from operating activities	499,471	275,170
Net cash used in investing activities	(631,582)	(276,593)
Net cash generated from/(used in) financing activities	3,517,224	(828,682)
Net increase/(decrease) in cash and cash equivalents	3,385,113	(830,105)

In 2006, net cash generated from operating activities was RMB499.47 million, an increase of RMB224.30 million from RMB275.17 million for 2005. The significant increase in net cash inflow from operating activities was mainly due to the steady development of our operations and the improvement of our working capital management.

In 2006, net cash used in investing activities was RMB631.58 million, an increase of RMB354.99 million over 2005, which was mainly due to the acquisition of the shareholding and individual assets of relevant subsidiaries during our group restructuring for listing.

In 2006, net cash generated from financing activities was RMB3,517.22 million. In 2005, net cash used in financing activities was RMB828.68 million. Our net cash generated from financing activities was mainly due to our successful IPO in December 2006, raising cash of RMB3,081.04 million.

Working Capital

By the end of 2006, our working capital (non-cash current assets minus operating current liabilities) deficit was RMB534.76 million, an increase of RMB133.46 million from the deficit of RMB401.30 million in 2005. The increase was mainly due to our strengthening the management of prepayments and obtaining more favourable credit terms.

Indebtedness

By the end of 2006, our total indebtedness was RMB95.50 million, all of which was short-term fixed interest rate loans denominated in Renminbi, representing a decrease of RMB114.05 million from RMB209.55 million in 2005. Given our increase in net cash inflow from operating activities and our improvement in operational efficiency, the Company repaid short-term loans upon maturity and reduced new borrowings.

By end of 2006, our gearing ratio⁽¹⁾ was 0.6%, a decrease of 1 percentage point from 1.6% in 2005.

⁽¹⁾ Gearing ratio equals to total debts divided by total assets at the end of each financial year.

CONTRACTUAL OBLIGATIONS

The following table sets out our contractual obligations as of 31 December 2006:

	Total	2007	2008	2009	2010	After 2010
	<i>(RMB in thousands)</i>					
Short-term debt	95,500	95,500	–	–	–	–
Operating lease commitments	171,249	58,832	42,697	30,114	19,879	19,727
Capital commitments	112,153	112,153	–	–	–	–
Of which:						
Authorized and contracted	75,184	75,184	–	–	–	–
Authorized but not contracted	36,969	36,969	–	–	–	–
Total of contractual obligations	378,902	266,485	42,697	30,114	19,879	19,727

EXCHANGE RATE

Most of the Company's revenues and expenses are settled in Renminbi, therefore the risks associated with foreign currency exchange rate has no significant effect on our business performance.

With the increasing pace of the market-oriented reforms of Chinese currency exchange rate, the Renminbi has kept appreciating in value against the Hong Kong dollar since mid-2005. By the end of 2006, the nominal value of our Hong Kong dollar deposits was HKD3,139.19 million. The Company has recognized exchange rate loss on our Hong Kong dollar deposits based on the exchange rate at 31 December 2006.

Applications, Content and Other (ACO) Services 🌳



We offer a variety of IT applications, Internet services, value added voice services, and other services for telecommunications operators and corporate customers, as well as the public.

IT Applications

We offer information technology applications services, including system integration, communications network support services and software and hardware development to telecommunications operators and other corporate users.

Value Added Voice Services

- Upon the demand of telecommunications operators and other corporate customers, we provide marketing, customer and after-sale services on behalf of our customers through our call centers.
- Interactive voice response services (IVR). We provide information services handled and recorded by service officers to telecommunication operators, government agencies and corporate customers.
- Ring tones and colourful back tones services for telephony users' subscription.

Internet Services

We offer Internet services independently or jointly with telecommunications operators, such as ICP content provision, Internet resources provision, e-commerce (such as certificate authentication and electronic payment services), and Internet cafes.

