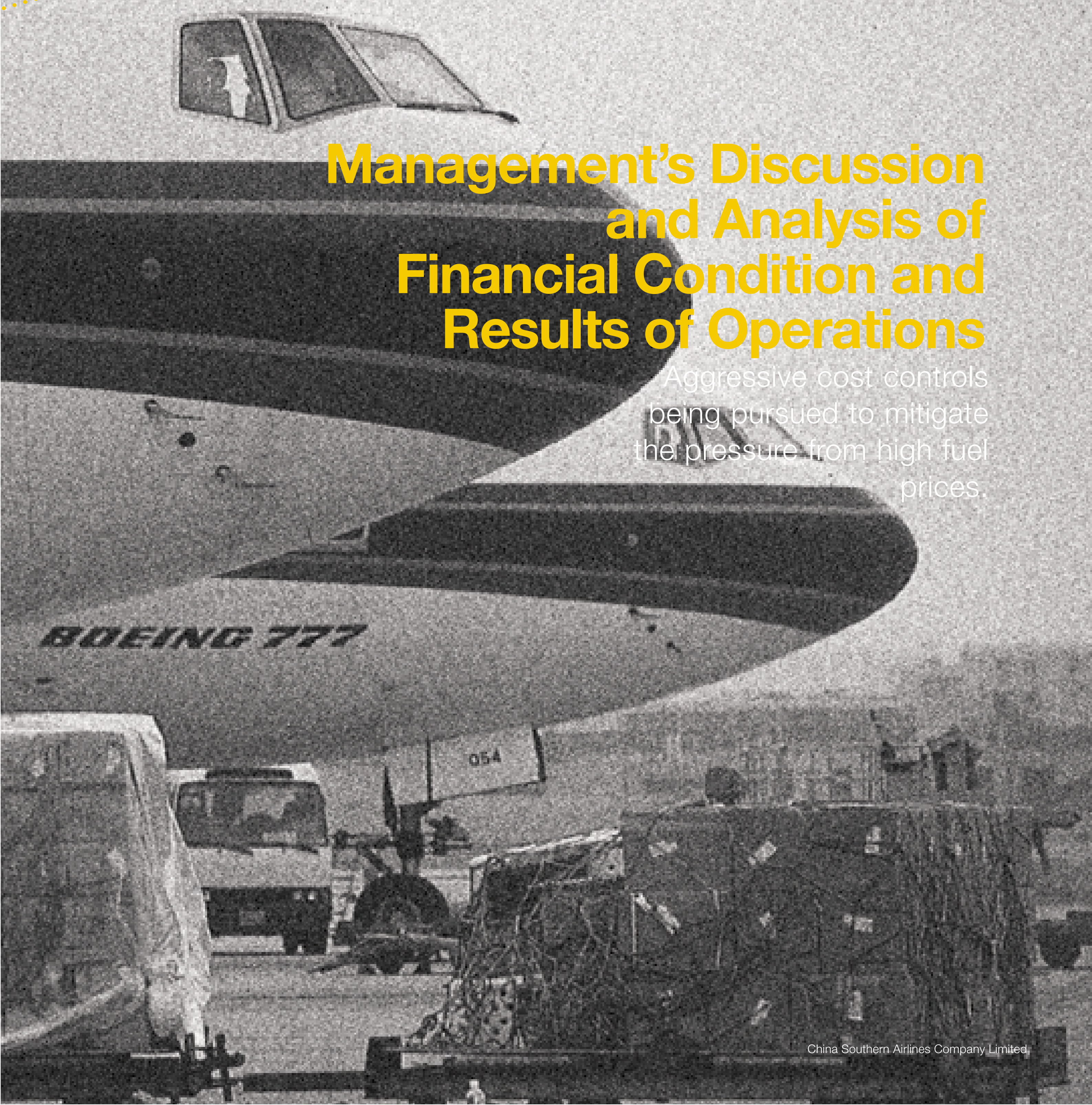
Management's Discussion and Analysis of Financial Condition and Results of Operations

Aggressive cost controls being pursued to mitigate the pressure from high fuel prices.



Wang Chang Shun
Vice Chairman of the Board of Directors, President

The following discussion and analysis should be read in conjunction with the consolidated financial statements of the Group contained elsewhere in this Annual Report. The Group maintains its books and accounts in accordance with generally accepted accounting principles in the PRC ("PRC GAAP") and prepares its financial statements in accordance with both PRC GAAP and IAS. The financial statements contained elsewhere in this Annual Report have been prepared in accordance with IAS. IAS differs in certain material respects from accounting principles generally accepted in the United States of America ("U.S. GAAP"). For a discussion of the material differences between IAS and U.S. GAAP relating to the Group, see the supplementary information for North American shareholders on pages 83 to 84 of this Annual Report.

Overview

During the year, economic conditions in the PRC and other Asian regions continued to show steady improvement, leading to an increase in demand for aviation services as evidenced by a rise in passenger load factor of the Group. To increase the efficiency and global competitiveness of PRC domestic airlines, the PRC Government continues to pursue measures to maintain the momentum of economic growth and to streamline the airline industry through Mergers and Restructuring. On the international front, passenger load factor increased as a result of growth in demand for Southeast Asian routes and other international routes operated by the Group.

The Group conducts a portion of its airline operations through the Airline Subsidiaries. Operating results for the Airline Subsidiaries are included in each of the years presented in the consolidated financial statements. The Airline Subsidiaries, which derive substantially all of their operating revenue from passenger traffic, accounted for 32.5% and 29.7% of the Group's total operating revenue, and 38.1% and 35.2% of the Group's total passengers carried, in 1999 and 2000, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB2,530 million and RMB2,737 million in 1999 and 2000, respectively, or 19.0% and 18.0% of the Group's total operating revenue.

The Group's operating revenue is substantially dependent on overall passenger and cargo traffic volume, which is subject to seasonal and other changes in traffic patterns, the availability of appropriate time slots for the Group's flights and alternative routes, the degree of competition from other airlines and alternative means of transportation, as well as other factors that may influence passenger travel demand and cargo and mail volume. In particular, the Group's airline revenue is generally higher in the second and third quarters than in the first and fourth quarters.

Like most airlines, the Group is subject to a high degree of financial and operating leverage. A significant percentage of the Group's operating expenses is fixed costs that do not vary proportionally based on the Group's load factors or the number of passengers carried. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs and operating lease payments, aircraft maintenance costs and labour for flight crew, cabin crew and ground personnel. Thus, a minor change in the Group's yields or load factors would have a material effect on the Group's results of operations. In addition, certain of these expenses, primarily financing costs and operating lease payments, labour costs, and depreciation and amortisation of aircraft and flight equipment, do not vary based on the number of flight flown. Thus, the Group's operating results can also be substantially affected by minor changes in aircraft utilisation rates. The Group is and will continue to be highly leveraged with substantial obligations denominated in foreign currencies and, accordingly, the results of its operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Group recognised a net exchange loss of RMB427 million and a net exchange gain of RMB319 million in 1999 and 2000, respectively. These amounts represented mainly unrealised exchange differences resulting from the retranslation of the foreign currency borrowings as of the years ended 1999 and 2000.

A number of other external variables, including political and economic conditions in China, tend to have a major impact on the Group's performance. The Group's financial performance is also significantly affected by factors arising from operating in a regulated industry. As substantially all aspects of the Group's airline operations are regulated by the CAAC, the Group's operating revenues and expenses are directly affected by the CAAC's policies with respect to domestic airfares, jet fuel prices and landing and navigation fees, among others. The nature and extent of airline competition and the ability of Chinese airlines to expand are also affected by the CAAC's control over route allocations. Any changes in the CAAC's regulatory policies, or any implementation of such policies could have a significant impact on the Group's future operations and its ability to implement its operating strategy.

In compliance with the PRC rules and regulations governing initial public offerings of shares by PRC joint stock limited companies, the fixed assets of the Group at 31 December, 1996, were revalued to reflect their current fair value and such revaluation has been included in the PRC GAAP and IAS financial statements of the Group as at such date. The 1996 revaluation resulted in an overall net increase in carrying amount of the Group's fixed assets of RMB614 million on that date and an increase in annual depreciation expense in subsequent years. In 2000, the net effect of the 1996 revaluation was the increase in depreciation expense of approximately RMB68 million (1999: RMB74 million). In accordance with IAS 16 "Property, plant and equipment", revaluation is performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. In accordance with the revaluation performed by the directors in respect of fixed assets held by the Group as at 31 December, 2000, the carrying amounts of fixed assets did not differ materially from their respective fair value. See Note 10 to the consolidated financial statements. The above revaluations would not be recorded under U.S. GAAP because, under U.S. GAAP, fixed assets are generally required to be stated at historical cost. Furthermore, the effect on future depreciation expense under IAS described above would be excluded from the U.S. GAAP consolidated profit and loss account. However, a deferred tax asset related to the exclusion of the net revaluation reserve would be created under U.S. GAAP. Under U.S. GAAP, this asset would be realised in the future to the extent that the revalued tax bases of the Group's fixed assets under PRC tax rules are utilised. See Supplementary Information for North American Shareholders contained elsewhere in this report.