



**Wang Chang Shun**

Vice Chairman of the Board of Directors, President

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 29.7% of the Group's total operating revenue for both 2000 and 2001, and 35.0% and 34.2% of the Group's total passengers carried in 2000 and 2001, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB2,737 million and RMB3,185 million in 2000 and 2001, respectively, or 18.0% and 18.9% of the Group's total operating revenue.

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 accounting principles generally accepted 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 84 to 86 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'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 alternate 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.

## Management's Discussion and Analysis of

### 12 Financial Condition and Results of Operations (cont'd)

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 rentals, 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, operating lease rentals, 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 gain of RMB319 million and RMB297 million in 2000 and 2001, respectively. These amounts represented mainly unrealised exchange differences resulting from the retranslation of the foreign currency borrowings as of the year end of 2000 and 2001.

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 CAAC's policies with respect to domestic airfares, jet fuel prices and landing and navigation fees. The nature and extent of airline competition and the ability of Chinese airlines to expand are also affected by 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.



# Management's Discussion and Analysis of Financial Condition and Results of Operations (cont'd)

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## Certain Financial Information and Operating Data by Geographic Region

The following table sets forth certain financial information and operating data by geographic region for the years ended 31 December, 2000 and 2001:

	For the year ended 31 December,		2001 vs 2000 Increase/ (decrease)
	2001	2000	%
<b>Traffic</b>			
Revenue passenger kilometres (RPKs) (million)			
– Domestic	<b>19,447</b>	16,974	<b>14.6</b>
– Hong Kong regional	<b>1,060</b>	1,074	<b>(1.3)</b>
– International	<b>4,550</b>	3,605	<b>26.2</b>
Total	<b>25,057</b>	21,653	<b>15.7</b>
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Revenue tonne kilometres (RTKs) (million)			
– Domestic	<b>2,217</b>	1,941	<b>14.2</b>
– Hong Kong regional	<b>105</b>	107	<b>(1.9)</b>
– International	<b>712</b>	565	<b>26.0</b>
Total	<b>3,034</b>	2,613	<b>16.1</b>
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Passengers carried (thousand)			
– Domestic	<b>16,499</b>	14,450	<b>14.2</b>
– Hong Kong regional	<b>1,409</b>	1,444	<b>(2.4)</b>
– International	<b>1,213</b>	957	<b>26.8</b>
Total	<b>19,121</b>	16,851	<b>13.5</b>
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Cargo and mail carried (thousand tonnes)			
– Domestic	<b>348</b>	308	<b>13.0</b>
– Hong Kong regional	<b>14</b>	15	<b>(6.7)</b>
– International	<b>36</b>	30	<b>20.0</b>
Total	<b>398</b>	353	<b>12.7</b>
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<b>Capacity</b>			
Available seat kilometres (ASKs) (million)			
– Domestic	<b>31,393</b>	28,345	<b>10.8</b>
– Hong Kong regional	<b>1,690</b>	1,744	<b>(3.1)</b>
– International	<b>6,981</b>	5,742	<b>21.6</b>
Total	<b>40,064</b>	35,831	<b>11.8</b>
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Available tonne kilometres (ATKs) (million)			
– Domestic	<b>3,622</b>	3,322	<b>9.0</b>
– Hong Kong regional	<b>185</b>	198	<b>(6.6)</b>
– International	<b>1,317</b>	1,087	<b>21.2</b>
Total	<b>5,124</b>	4,607	<b>11.2</b>

# Management's Discussion and Analysis of

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## Financial Condition and Results of Operations (cont'd)

	For the year ended 31 December,	2001 vs 2000 Increase/ (decrease)
	2001	2000
		%
<b>Load factors</b>		
Passenger load factor (RPK/ASK) (%)		
– Domestic	<b>61.9</b>	59.9
– Hong Kong regional	<b>62.7</b>	61.6
– International	<b>65.2</b>	62.8
Total	<b>62.5</b>	60.4
<b>Overall load factor (RTK/ATK) (%)</b>		
– Domestic	<b>61.2</b>	58.4
– Hong Kong regional	<b>56.8</b>	54.0
– International	<b>54.1</b>	52.0
Total	<b>59.2</b>	56.7
<b>Yield</b>		
Yield per RPK (RMB)		
– Domestic	<b>0.62</b>	0.62
– Hong Kong regional	<b>1.06</b>	1.06
– International	<b>0.41</b>	0.43
Total	<b>0.60</b>	0.61
<b>Yield per RTK (RMB)</b>		
– Domestic	<b>5.83</b>	5.90
– Hong Kong regional	<b>11.26</b>	11.19
– International	<b>3.31</b>	3.63
Total	<b>5.43</b>	5.63
<b>Fleet</b>		
Total number of aircraft in service at year end		
– Boeing	<b>91</b>	89
– Airbus	<b>20</b>	20
Total	<b>111</b>	109
<b>Overall utilisation rate (hours per day)</b>		
– Boeing	<b>9.2</b>	8.8
– Airbus	<b>8.9</b>	8.2
Total	<b>9.1</b>	8.7
<b>Cost</b>		
– Operating cost per ASK (RMB)	<b>0.39</b>	0.39
– Operating cost per ATK (RMB)	<b>3.02</b>	3.04

## 2001 Compared with 2000

The Group recorded a net profit of RMB340 million for 2001, as compared to a net profit of RMB502 million for 2000. The Group's operating revenue increased by RMB1,702 million or 11.2% from RMB15,178 million in 2000 to RMB16,880 million in 2001. Passenger load factor increased by 2.1 percentage point from 60.4% in 2000 to 62.5% in 2001. Passenger yield (in passenger revenue per RPK) decreased by 1.6% from RMB0.61 in 2000 to RMB0.60 in 2001. Average yield (in traffic revenue per RTK) decreased by 3.6% from RMB5.63 in 2000 to RMB5.43 in 2001. Operating expenses increased by RMB1,483 million or 10.6% from RMB13,996 million in 2000 to RMB15,479 million in 2001. Of the increase in operating expenses, an approximate amount of RMB243 million was attributable to the increase in aircraft repair and maintenance expense and the remaining amount of approximately RMB1,240 million was primarily due to operational growth. As operating revenue increased more than operating expenses, operating profit increased by 18.5% from RMB1,182 million in 2000 to RMB1,401 million in 2001. The Group's net non-operating expenses increased by 141.3%, from RMB251 million in 2000 to RMB605 million in 2001, mainly reflecting a drop in gain on sale of aircraft under sale and leaseback transactions of RMB318 million and a loss on sale of staff quarters of RMB111 million. Overall, the Group's net profit decreased by 32.2%, from RMB502 million in 2000 to RMB340 million in 2001.

## Operating Revenue

Substantially all of the Group's operating revenue is attributable to airline operations. Traffic revenue in 2001 and 2000 accounted for 97.5% and 96.9% respectively of total operating revenue. Passenger revenue and cargo and mail revenue accounted for 91.5% and 8.5% respectively of total traffic revenue in 2001. The balance of the Group's operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines that operate flights in and out of airports in Southern China (including the airports in Guangzhou, Shenzhen, Xiamen and Wuhan), air catering services and aircraft lease income.

Operating revenue increased by 11.2% from RMB15,178 million in 2000 to RMB16,880 million in 2001. This increase was primarily due to a 13.6% rise in passenger revenue from RMB13,255 million in 2000 to RMB15,056 million in 2001, primarily as a result of higher traffic volume. The total number of passengers carried increased by 13.5% to 19.12 million passengers in 2001. RPKs increased by 15.7% from RMB21,653 million in 2000 to RMB25,057 million in 2001, primarily as a result of an increase in passengers carried. However, passenger yield decreased by 1.6% from RMB0.61 in 2000 to RMB0.60 in 2001, primarily as a result of a fall in the average fares of international passenger traffic.

Domestic passenger revenue, which accounted for 80.1% of total passenger revenue in 2001, increased by 14.2% from RMB10,564 million in 2000 to RMB12,068 million in 2001. For the Group's domestic routes, passenger traffic in RPKs increased by 14.6%, while passenger capacity in ASKs increased by 10.8%, resulting in a 2.0 percentage point increase in passenger load factor, or an increase of 3.3% from 2000. Passenger yield remained unchanged at RMB0.62.

Hong Kong passenger revenue, which accounted for 7.5% of total passenger revenue, decreased by 1.3% from RMB1,143 million in 2000 to RMB1,128 million in 2001. For Hong Kong flights, passenger traffic in RPKs decreased by 1.3%, while passenger capacity in ASKs decreased by 3.1% resulting in a 1.1 percentage point increase in passenger load factor, or an increase of 1.8% from 2000. Passenger yield remained unchanged at RMB1.06.

International passenger revenue, which accounted for 12.4% of total passenger revenue, increased by 20.2% from RMB1,548 million in 2000 to RMB1,860 million in 2001. For international flights, passenger traffic in RPKs increased by 26.2%, while passenger capacity in ASKs increased by 21.6%, resulting in a 2.4 percentage point gain in passenger load factor, or an increase of 3.8% from 2000. Passenger yield decreased by 4.7% from RMB0.43 in 2000 to RMB0.41 in 2001, principally as a result of larger fare discounts being offered on the long-haul flights, especially on the two new routes to Australia, with a view to establishing the market share.

Cargo and mail revenue, which accounted for 8.5% of the Group's total traffic revenue and 8.3% of total operating revenue, decreased by 3.1% from RMB1,451 million in 2000 to RMB1,406 million in 2001. This decrease was primarily due to increased competition in domestic and international markets. In order to maintain its market share, larger discounts were given by the Group, resulting in a drop of yield per RTK of 17.4%.

Other operating revenue decreased by 11.4% from RMB472 million in 2000 to RMB418 million in 2001. This decrease was primarily due to a drop in aircraft lease income of RMB45 million.

### Operating Expenses

Substantially all of the Group's operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repairs and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group's flight operations (collectively, "flight operation expenses") include fuel costs, operating lease rentals, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group's aircraft (collectively, "maintenance expenses") include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group's aircraft and traffic servicing operations (collectively "aircraft and traffic servicing expenses") include landing and navigation fees, rental

payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group's operating expenses result from promotional and marketing activities (collectively, "promotional and marketing expenses") such as sales commissions, fees for use of the CAAC's reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

Total operating expenses in 2001 amounted to RMB15,479 million, representing an increase of 10.6% or RMB1,483 million over 2000, primarily due to the combined effect of the growth in operations and increases in operating lease rentals and repair and maintenance expenses. Total operating expenses as a percentage of total operating revenue decreased from 92.2% in 2000 to 91.7% in 2001 as the increase in operating revenue exceeded the increase in operating expenses.

Flight operation expenses, which accounted for 44.6% of total operating expenses, increased by 13.0% from RMB6,109 million in 2000 to RMB6,906 million in 2001, primarily as a result of an increase in fuel costs, operating lease rentals, catering expenses, aircraft insurance costs and labour costs for flight personnel. Fuel costs, which accounted for 51.4% of flight operations expenses, increased by 9.5% from RMB3,240 million in 2000 to RMB3,549 million in 2001 as a result of the traffic capacity growth. Operating lease rentals increased by 18.4% from RMB1,616 million in 2000 to RMB1,913 million in 2001, due primarily to the full year effect of five Boeing 737-300/37K aircraft wet leased from Zhongyuan Airlines commencing in 2000. Catering expenses increased by 14.5% from RMB484 million in 2000 to RMB554 million in 2001, reflecting primarily an increase in number of passengers carried. Aircraft insurance costs increased by 44.7% from RMB85 million in 2000 to RMB123 million in 2001, due largely to a rise in aircraft insurance premiums levied on PRC airlines by the People's Insurance (Property) Company of China as a result of the 911 incident. Labour costs for flight personnel increased by 14.1% from RMB576 million in 2000 to RMB657 million in 2001, due largely to an increase in flight hours as well as an increase in bonuses for flight personnel.

Maintenance expenses which accounted for 13.0% of total operating expenses, increased by 14.6% from RMB1,759 million in 2000 to RMB2,015 million in 2001. The increase was primarily attributable to a 15.2% increase in aircraft maintenance and repair charges from RMB1,602 million in 2000 to RMB1,845 million in 2001, mainly as a result of the effect of fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 14.8% of total operating expenses, increased by 11.0% from RMB2,069 million in 2000 to RMB2,298 million in 2001. The increase was resulted from a 10.3% rise in landing and navigation fees from RMB1,955 million in 2000 to RMB2,157 million in 2001, as the number of flights increased.

Promotional and marketing expenses, which accounted for 10.0% of total operating expenses, increased by 11.8% from RMB1,378 million in 2000 to RMB1,541 million in 2001. The increase was due to a 11.2% increase in commission and bonuses paid to sales agents, which was resulted from a rise in traffic revenue and increased competition.

General and administrative expenses, which accounted for 5.9% of total operating expenses, increased by 10.3% from RMB809 million in 2000 to RMB892 million in 2001. This was mainly due to an increase in staff salaries and welfare benefits of 10.9% from RMB357 million in 2000 to RMB396 million in 2001 and increased scale of operations.

Depreciation and amortisation, which accounted for 11.7% of total operating expenses, decreased by 2.6% from RMB1,864 million in 2000 to RMB1,815 million in 2001. This was primarily as a result of the disposal of four Boeing 757-200 aircraft and two Airbus 320-200 aircraft under sale and leaseback transactions in 2000 and 2001 respectively and full depreciation of certain old flight equipment during 2001.

## Operating Profit

Operating profit increased by 18.5% from RMB1,182 million in 2000 to RMB1,401 million in 2001, as operating revenue increased by RMB1,702 million or 11.2% from 2000, while operating expenses increased by RMB1,483 million or 10.6% over the same period.

## Non-operating Income/(Expenses)

Interest expense decreased by 13.1% from RMB1,074 million in 2000 to RMB934 million in 2001, mainly reflecting the scheduled debt repayments during the year.

Interest income decreased by 44.8% from RMB90 million in 2000 to RMB50 million in 2001. This was mainly attributable to a decrease in domestic deposit rates as well as a fall in cash balances.

The Group recognised a net loss on sale of fixed assets of RMB56 million in 2001, mainly resulting from the net effect of a loss of RMB111 million on disposal of staff quarters and a gain of RMB60 million on disposal of two Airbus 320-200 aircraft under sale and leaseback arrangements.

During 2001, the Group recorded a net exchange gain of RMB297 million predominantly due to its Japanese yen denominated borrowings as a result of the Japanese yen depreciation. Such amount comprised mostly unrealised translation gains.



### Taxation

The Group is subject to PRC income tax at a rate of 33%.

Taxation expense decreased by 5.4% from RMB339 million in 2000 to RMB321 million in 2001, reflecting primarily a decrease in profit before taxation. A deferred tax asset of RMB176 million was recognised at 31 December, 2001 in respect of the unrelieved PRC tax losses brought forward from prior years. Such tax losses are available for carry-forward to offset against future PRC taxable profits for a maximum period of 5 years.

### Minority Interests

Minority interests increased by 48.5% from RMB91 million in 2000 to RMB135 million in 2001, primarily as a result of an increase in net profits of the Group's Airline Subsidiaries.

### Liquidity, Financial Resources and Capital Structure

As at 31 December, 2001, the Group's borrowings totaled RMB14,949 million, representing a decrease of RMB815 million from RMB15,764 million last year. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen, with almost all being fixed interest rate borrowings. Of such borrowings, RMB3,629 million, RMB2,362 million, RMB1,820 million, RMB1,658 million and RMB5,480 million will be repayable in 2002, 2003, 2004, 2005, 2006 and thereafter respectively. As at 31 December, 2001, cash and cash equivalents of the Group totalled RMB2,818 million, a decrease of 32.9% from RMB4,197 million last year. Of such balance 9.2% was denominated in foreign currencies (mainly in United States dollars). Net debts (total borrowings net of cash and cash equivalents) increased by 4.9% to RMB12,131 million from RMB11,567 million last year.

As at 31 December, 2001, the Group's shareholders' equity amounted to RMB9,221 million, representing an increase of RMB340 million from RMB8,881 million last year.

Net debt/equity ratio of the Group at 31 December, 2001 was 1.32 times, as compared to 1.30 times last year.

### Financial Risk Management Policy

In the normal course of business, the Group is exposed to fluctuations in foreign currencies and jet fuel prices. The Group's exposure to foreign currencies was primarily as a result of its foreign currency debts. Depreciation or appreciation of the Renminbi against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, entering into forward foreign exchange contracts with authorised PRC banks.

The Group is required to procure a majority of its jet fuel consumption domestically at PRC spot market prices. There are currently no effective means available to manage the Group's exposure associated with the fluctuations in domestic jet fuel prices.



## Charges on Assets

As at 31 December, 2001, aircraft of the Group with an aggregate carrying value of approximately RMB14,295 million (2000: RMB15,616 million) were pledged as collateral under certain loan and lease agreements. Details of charges are set out in notes 10, 21 and 22 to the financial statements.

## Commitments and Contingencies

At 31 December, 2001, the Group had capital commitments of RMB16,067 million. Of such amount, RMB12,053 million was related to the acquisition of aircraft and related flight equipment and RMB3,496 million was related to the Group's facilities and equipment to be constructed and installed at the Guangzhou new airport. The remaining amount of RMB518 million was related to the Group's other airport and office facilities and equipment, overhaul and maintenance bases and training facilities. The Group's capital expenditures are generally subject to receipt of various approvals of the PRC Government and may be subject to change depending on the timing of such approvals, prevailing market condition, the availability of financing and other relevant factors.

As at 31 December, 2001, the Group was committed to make a capital contribution of RMB82 million and RMB304 million respectively to jointly controlled entity and associated company.

Details of the capital and investing commitments are set out in note 29 to the financial statements.

Major contingent liabilities of the Group at 31 December, 2001 are set out in note 30 to the financial statements.

