



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

With aggressive cost controls
to meet challenges



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The following discussion and analysis should be read in conjunction with the 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 IFRS. The financial statements contained elsewhere in this Annual Report have been prepared in accordance with IFRS. IFRS differs in certain material respects from accounting principles generally accepted in the United States of America ("U.S. GAAP").

Overview

During the year, with the PRC government continued measures to maintain the momentum of economic growth, the PRC aviation market continued to show steady growth, as evidenced by a rise in passenger load factor of the Group. However, passenger yield per RPK decreased as a result of increased competition among the PRC airlines. On the international front, traffic volume increased significantly 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 29.7% and 26.8% of the Group's total operating revenue, and 34.2% and 34.5% of the Group's total passengers carried, in 2001 and 2002, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB3,185 million and RMB3,278 million in 2001 and 2002, respectively, or 18.9% and 18.2% of the Group's total operating revenue.

The Group's operating revenue is substantially dependent on the passenger and cargo traffic volume carried, 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.

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 yields or

load factors. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs, operating lease payments, aircraft maintenance costs and labour costs 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 do not vary based on the number of flights 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 RMB297 million and a net exchange loss of RMB175 million in 2001 and 2002, respectively. These amounts represented mainly unrealised exchange differences resulting from the retranslation of the foreign currency borrowings as at the years ended 2001 and 2002.

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 Civil Aviation Administration of China (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, among others. 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.



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, 2001 and 2002:

	For the year ended		2002 vs 2001
	31 December,	2001	Increase/ (decrease) %
Traffic	2002	2001	%
Revenue passenger kilometres (RPK) (million)			
– Domestic	22,092	19,447	13.6
– Hong Kong regional	1,081	1,060	2.0
– International	5,767	4,550	26.7
Total	28,940	25,057	15.5
Revenue tonne kilometres (RTK) (million)			
– Domestic	2,532	2,217	14.2
– Hong Kong regional	108	105	2.9
– International	974	712	36.8
Total	3,614	3,034	19.1
Passengers carried (thousand)			
– Domestic	18,535	16,499	12.3
– Hong Kong regional	1,369	1,409	(2.8)
– International	1,589	1,213	31.0
Total	21,493	19,121	12.4
Cargo and mail carried (thousand tonne)			
– Domestic	404	348	16.1
– Hong Kong regional	14	14	–
– International	52	36	44.4
Total	470	398	18.1

Certain Financial Information and Operating Data by Geographic Region (cont'd)

	For the year ended		2002 vs 2001
	31 December,		Increase/ (decrease)
	2002	2001	%
Capacity			
Available seat kilometres (ASK) (million)			
– Domestic	33,753	31,393	7.5
– Hong Kong regional	1,746	1,690	3.3
– International	8,746	6,981	25.3
Total	44,245	40,064	10.4
Available tonne kilometres (ATK) (million)			
– Domestic	3,924	3,622	8.3
– Hong Kong regional	193	185	4.3
– International	1,798	1,317	36.5
Total	5,915	5,124	15.4

	For the year ended		2002 vs 2001
	31 December,		Increase/ (decrease)
	2002	2001	%
Load factors			
Passenger load factor (RPK/ASK) (%)			
– Domestic	65.5	61.9	5.8
– Hong Kong regional	61.9	62.7	(1.3)
– International	65.9	65.2	1.1
Total	65.4	62.5	4.6
Overall load factor (RTK/ATK) (%)			
– Domestic	64.5	61.2	5.4
– Hong Kong regional	55.8	56.8	(1.8)
– International	54.2	54.1	0.2
Total	61.1	59.2	3.2

Certain Financial Information and Operating Data by Geographic Region (cont'd)

	For the year ended		2002 vs 2001
	31 December,		Increase/ (decrease)
	2002	2001	%
Yield			
Yield per RPK (RMB)			
– Domestic	0.55	0.62	(11.3)
– Hong Kong regional	0.98	1.06	(7.5)
– International	0.42	0.41	2.4
Total	0.54	0.60	(10.0)
Yield per RTK (RMB)			
– Domestic	5.21	5.83	(10.6)
– Hong Kong regional	10.36	11.26	(8.0)
– International	3.25	3.31	(1.8)
Total	4.84	5.43	(10.9)
Fleet			
Total number of aircraft in service at year end			
– Boeing	102	91	12.1
– Airbus	20	20	–
Total	122	111	9.9
Overall utilisation rate (hours per day)			
– Boeing	9.9	9.2	7.6
– Airbus	9.3	8.9	4.5
	9.8	9.1	7.7
Cost			
– Operating cost per ASK (RMB)	0.36	0.39	(7.7)
– Operating cost per ATK (RMB)	2.70	3.02	(10.6)

2002 Compared with 2001

The Group recorded a net profit of RMB576 million for 2002, as compared to a net profit of RMB340 million for 2001. The Group's operating revenue increased by RMB1,139 million or 6.7% from RMB16,880 million in 2001 to RMB18,019 million in 2002. Passenger load factor increased by 2.9 percentage points from 62.5% in 2001 to 65.4% in 2002. Passenger yield (in passenger revenue per RPK) decreased by 10.0% from RMB0.60 in 2001 to RMB0.54 in 2002. Average yield (in traffic revenue per RTK) decreased by 10.9% from RMB5.43 in 2001 to RMB4.84 in 2002. Operating expenses increased by RMB514 million or 3.3% from RMB15,479 million in 2001 to RMB15,993 million in 2002. As operating revenue increased more than operating expenses, operating profit increased by 44.7% from RMB1,401 million in 2001 to RMB2,026 million in 2002. The Group's net non-operating expenses increased by 46.5%, from RMB605 million in 2001 to RMB887 million in 2002, mainly due to an unfavourable movement in exchange differences of RMB472 million, partly offset by a gain on disposal of four Boeing 757-200 aircraft of RMB199 million. Overall, the Group's net profit increased by 69.2%, from RMB340 million in 2001 to RMB576 million in 2002.

Operating Revenue

Substantially all of the Group's operating revenue is attributable to its airline operations. Traffic revenue in 2002 and 2001 accounted for 97.0% and 97.5% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 89.8% and 10.2% respectively of total traffic revenue in 2002. 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 6.7% from RMB16,880 million in 2001 to RMB18,019 million in 2002. This increase was primarily due to a 4.3% rise in passenger revenue from RMB15,055 million in 2001 to RMB15,696 million in 2002 due to higher traffic volume. The total number of passengers carried increased by 12.4% to 21.49 million passengers in 2002. RPKs increased by 15.5% from 25,057 million in 2001 to 28,940 million in 2002, primarily as a result of an increase in passengers carried. However, passenger yield decreased by 10.0% from RMB0.60 in 2001 to RMB0.54 in 2002, mainly as a result of a fall in the average fares resulting from increased competition.

Domestic passenger revenue, which accounted for 78.0% of total passenger revenue in 2002, increased by 1.4% from RMB12,068 million in 2001 to RMB12,234 million in 2002. For the Group's domestic routes, passenger traffic in RPKs increased by 13.6%, while passenger capacity in ASKs increased by 7.5%, resulting in 3.6 percentage points increase in passenger load factor, or an increase of 5.8% from 2001. Passenger yield, however, decreased from RMB0.62 in 2001 to RMB0.55 in 2002 mainly as a result of increased competition among the PRC airlines.

Hong Kong passenger revenue, which accounted for 6.7% of total passenger revenue, decreased by 6.5% from RMB1,128 million in 2001 to RMB1,055 million in 2002. For Hong Kong flights, passenger traffic in RPKs increased by 2.0%, while passenger capacity in ASKs

increased by 3.3%, resulting in 0.8 percentage point decrease in passenger load factor, or a decrease of 1.3% from 2001. Passenger yield decreased from RMB1.06 in 2001 to RMB0.98 in 2002 mainly due to slack in traffic volume.

International passenger revenue, which accounted for 15.3% of total passenger revenue, increased by 29.4% from RMB1,860 million in 2001 to RMB2,407 million in 2002. For international flights, passenger traffic in RPKs increased by 26.7%, while passenger capacity in ASKs increased by 25.3%, resulting in a 0.7 percentage point gain in passenger load factor, or an increase of 1.1% from 2001. Passenger yield increased slightly by 2.4% from RMB0.41 in 2001 to RMB0.42 in 2002.

Cargo and mail revenue, which accounted for 10.2% of the Group's total traffic revenue and 9.9% of total operating revenue, increased by 27.0% from RMB1,406 million in 2001 to RMB1,786 million in 2002. The increase was primarily due to the opening of two international cargo routes in 2002.

Other operating revenue increased by 28.4% from RMB418 million in 2001 to RMB537 million in 2002. The increase was primarily due to increase in fees charged for ground services rendered to other Chinese airlines as the traffic volume increased as well as an income from a lease arrangement effected during the year.

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 operations expenses") include fuel costs, operating lease payments, 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, "promotion and sales 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 2002 amounted to RMB15,993 million, representing an increase of 3.3% or RMB514 million over 2001, primarily due to the combined effect of the growth in operations and increase in maintenance expenses. Total operating expenses as a percentage of total operating revenue decreased from 91.7% in 2001 to 88.76% in 2002 as the increase in operating revenue exceeded the increase in operating expenses.

Flight operation expenses, which accounted for 42.1% of total operating expenses, decreased by 2.5% from RMB6,906 million in 2001 to RMB6,733 million in 2002, mainly due to a decrease in operating lease rentals. Fuel costs, which accounted for 52.3% of flight operations expenses decreased by 0.8% from RMB3,549 million in 2001 to RMB3,519 million in 2002 mainly resulting from decreased fuel prices. Operating lease rentals decreased by 25.9% from RMB1,913 million in 2001 to RMB1,417 million in 2002, primarily due to the termination of wet leases of five Boeing 737-300/37K aircraft from Zhongyuan Airlines in January 2002. Catering expenses increased by 12.8% from RMB554 million in 2001 to RMB625 million in 2002, reflecting primarily an increase in number of passengers carried. Aircraft insurance costs increased by 108.1% from RMB123 million in 2001 to RMB256 million in 2002, largely due to a rise in the rates of aircraft insurance premiums subsequent to the 911 incident of the United States. Labour costs for flight personnel increased by 18.9% from RMB657 million in 2001 to RMB781 million in 2002, largely due to an increase in flight hours as well as an increase in bonuses for flight personnel.

Maintenance expenses which accounted for 14.6% of total operating expenses, increased by 15.8% from RMB2,015 million in 2001 to RMB2,333 million in 2002. The increase was primarily attributable to a 15.7% increase in aircraft maintenance and repair charges from RMB1,845 million in 2001 to RMB2,135 million in 2002, mainly as a result of the effect of fleet expansion in recent years and the growth in operations.

Aircraft and traffic servicing expenses, which accounted for 15.7% of total operating expenses, increased by 9.3% from RMB2,298 million in 2001 to RMB2,511 million in 2002. The increase primarily resulted from 9.1% rise in landing and navigation fees from RMB2,157 million in 2001 to RMB2,353 million in 2002, as the number of flights increased.

Promotional and sales expenses, which accounted for 9.4% of total operating expenses, decreased by 2.7% from RMB1,541 million in 2001 to RMB1,500 million in 2002. The decrease was due to 15.9% decrease in sale commissions and bonuses paid to sales agents because of tighter cost controls exercised by the Group.

General and administrative expenses, which accounted for 6.6% of total operating expenses, increased by 18.8% from RMB892 million in 2001 to RMB1,060 million in 2002. This was mainly due to an increase in staff salaries and welfare benefits of 27.8% from RMB439 million in 2001 to RMB561 million in 2002 and increased scale of operations.

Depreciation and amortisation, which accounted for 11.5% of total operating expenses, increased by 1.4% from RMB1,815 million in 2001 to RMB1,840 million in 2002. This was primarily as a result of the additions of aircraft during 2002.

Operating Profit

Operating profit increased by 44.7% from RMB1,401 million in 2001 to RMB2,026 million in 2002, as operating revenue increased by RMB1,139 million or 6.7% from 2001, while operating expenses increased by RMB514 million or 3.3% over the same period.

Non-operating Income/(Expenses)

Interest expense increased by 2.7% from RMB934 million in 2001 to RMB959 million in 2002, mainly reflecting the additional bank loans borrowed to finance the acquisitions of aircraft, partly offset by scheduled debt repayments during the year.

Interest income increased by 5.5% from RMB50 million in 2001 to RMB53 million in 2002. This was mainly due to an increase in cash balances.

The Group recognised a net gain on sale of fixed assets of RMB171 million in 2002, mainly resulting from disposal of four Boeing 757-200 aircraft.

During 2002, the Group recorded a net exchange loss of RMB175 million predominantly due to its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealised translation loss.

Taxation

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

Taxation expense increased by 24.2% from RMB321 million in 2001 to RMB398 million in 2002, reflecting primarily an increase in profit before taxation. A deferred tax asset of RMB149 million was recognised at 31 December, 2002 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 22.7% from RMB135 million in 2001 to RMB165 million in 2002, 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, 2002, the Group's borrowings totalled RMB19,275 million, representing an increase of RMB4,326 million from RMB14,949 million last year. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen and Renminbi, with a significant portion being fixed interest rate borrowings. Of such borrowings, RMB6,807 million, RMB2,115 million, RMB2,111 million, RMB2,061 million and RMB6,181 million will be repayable in 2003, 2004, 2005, 2006, 2007 and thereafter respectively. As at 31 December, 2002, cash and cash equivalents of the Group totalling RMB3,771 million, of which 23.7% were denominated in foreign currencies (mainly in United States dollars), increased by 33.8% from RMB2,819 million last year. Net debts (total borrowings net of cash and cash equivalents) increased by 27.8% to RMB15,504 million.

As at 31 December, 2002, the Group's shareholders' equity amounted to RMB9,613 million, representing an increase of RMB391 million from RMB9,222 million last year.

Net debt/equity ratio of the Group at 31 December, 2002 was 1.61 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 the result of its having 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, 2002, certain aircraft of the Group with an aggregate carrying value of approximately RMB14,783 million (2001: RMB14,295 million) were pledged as collateral under certain loan and lease agreements. Details of charges are set out in note 10, 21 and 22 to the financial statements.

Commitments and Contingencies

As at 31 December, 2002, the Group had capital commitments of approximately RMB9,548 million. Of such amounts, RMB5,876 million is related to the acquisition of aircraft and related flight equipment and RMB3,127 million is related to the Group's facilities and equipment to be constructed and installed at the Guangzhou new international airport. The remaining amounts of RMB545 million is 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, 2002, the Group was committed to make a capital contribution of approximately RMB60 million and RMB201 million to its 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, 2002 are set out in note 30 to the financial statements.

