



DIRECTORS' REPORT

The Directors have pleasure in presenting to shareholders their report, together with the audited accounts of the Group for the year ended 31st December, 2002.

PRINCIPAL ACTIVITIES AND GEOGRAPHICAL ANALYSIS OF OPERATIONS

The principal activity of the Company is investment holding. The principal activities of its subsidiaries and associated companies are airline operations and aviation related businesses which are set out in notes 14 and 15 to the accounts respectively. The Group's property holding business was vested to China National Aviation Corporation (Group) Limited on 25th March, 2002.

An analysis of the Group's performance for the year by business and geographical segments is set out in note 3 to the accounts.

RESULTS AND APPROPRIATIONS

The results of the Group for the year ended 31st December, 2002 and the state of the Group's affairs as at that date are set out in the accounts on pages 41 to 85.

The Directors have declared an interim dividend of HK0.6 cent per share, totalling HK\$19,916,000, which was paid on 3rd October, 2002.

The Directors recommend the payment of a final dividend of HK0.8 cent per share, totalling HK\$26,554,000.

RESERVES

Movements in the reserves of the Group and of the Company during the year are set out in note 20 to the accounts.

FIXED ASSETS

Details of the movements in fixed assets of the Group are set out in note 12 to the accounts.

SHARE CAPITAL

Details of the movements in share capital of the Company are set out in note 19 to the accounts.

DISTRIBUTABLE RESERVES

Distributable reserves of the Company at 31st December, 2002, calculated under Section 79B of the Hong Kong Companies Ordinance, amounted to HK\$660,641,000 (2001: HK\$221,194,000).

FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the last five financial years is set out on page 86.



SIGNIFICANT EVENT

Details of the significant event of the Group and of the Company that happened during the year are set out in note 2 to the accounts.

PURCHASE, SALE OR REDEMPTION OF SHARES

During the year under review, the Company has not redeemed any of its shares during the period. Save for share options exercised as mentioned below, neither the Company nor any of its subsidiaries has purchased or sold any of the Company's shares during the year ended 31st December, 2002.

SHARE OPTIONS

At an Annual General Meeting of the Company held on 29th May, 2002, a new share option scheme (the "Scheme") was approved and adopted to replace the old share option scheme adopted on 22nd October, 1997. The major terms of the Scheme are as follows;

1. The purpose of the Scheme is to provide incentives to participants to contribute to the prosperity, business development or growth of the Group and/or to enable the Group to recruit and/or retain high-calibre employees and attract resources that are valuable to the Group.
2. The participants of the Scheme are any Director, employee, supplier, customer or other relevant business partners of the Group as invited by the Board.
3. The subscription price determined by the Board will be the higher of (i) the closing price of the Company's share as stated in The Stock Exchange of Hong Kong Limited's ("Stock Exchange") daily quotations sheet on the date of grant; (ii) the average closing price of the Company's share as stated in the Stock Exchange's daily quotations sheets for the five business days immediately preceding the date of grant; and (iii) the nominal value of the Company's shares.
4. The acceptance of grant of share options must be made within 28 days from the date of grant with a non-refundable payment of HK\$1.00 from the grantee.
5. The maximum number of shares over which options may be granted under the Scheme shall not exceed 30% of the issued share capital of the Company from time to time. As at the date of this report, the maximum number of shares available for issue under the Scheme is 331,930,800, being 10% of the number of issued share capital of the Company.
6. The exercise period of any option granted under the Scheme must not exceed six years commencing on the date falling three months after the date of grant and expiring on the last day of the said period.
7. The Scheme shall be valid and effective till 28th May, 2012.

During the year under review, the Company has not granted any options under the Scheme, 84,126,000 new shares were issued at an aggregate price of HK\$87,491,040 for the share options exercised.



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SHARE OPTIONS (CONT'D)

Details of the share options outstanding as at 31st December, 2002 under the old share option scheme are as follows:

	Options held at 1st January, 2002	Options granted during the year	Options exercised during the year	Options held at 31st December, 2002	Exercise price HK\$	Grant date	Exercisable from until	
Directors:								
Kong Dong	32,351,800	–	–	32,351,800	0.82	24/09/2001	25/03/2002	24/03/2004
Chuang Shih Ping	38,236,000	–	–	38,236,000	1.04	04/01/2001	12/07/2001	11/07/2003
Zhang Xianlin	38,236,000	–	–	38,236,000	1.04	04/01/2001	12/07/2001	11/07/2003
Tsang Hing Kwong, Thomas	38,236,000	–	–	38,236,000	1.04	04/01/2001	12/07/2001	11/07/2003
Continuous contract employees in aggregate:								
	84,126,000	–	84,126,000 ¹	–	1.04	04/01/2001	12/07/2001	11/07/2003
Total:	231,185,800	–	84,126,000¹	147,059,800				

Note:

- Exercise date was 4th April, 2002. At the date before the options were exercised, the market value per share was HK\$1.56.

DIRECTORS

The Directors during the year and up to the date of this report are:

Kong Dong
 Chuang Shih Ping
 Zhang Xianlin
 Tsang Hing Kwong, Thomas
 Gu Tiefei
 Lok Kung Nam*
 Hu Hung Lick, Henry*
 Ho Tsu Kwok, Charles*
 Li Kwok Heem, John*

* independent Non-Executive Directors

In accordance with Article 98 of the Company's Articles of Association, Messrs. Lok Kung Nam, Hu Hung Lick, Henry and Ho Tsu Kwok, Charles retire by rotation at the forthcoming annual general meeting and, being eligible, offer themselves for re-election.



DIRECTORS' SERVICE CONTRACTS

None of the Directors who are proposed for re-election at the forthcoming annual general meeting has a service contract with the Company or any of its subsidiaries which is not determinable within one year without payment of compensation, other than statutory compensation.

DIRECTORS' INTERESTS IN CONTRACTS

No contracts of significance in relation to the Group's business to which the Company, its fellow subsidiaries, its subsidiaries or its holding company was a party and in which a Director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

BIOGRAPHICAL DETAILS OF DIRECTORS AND SENIOR MANAGEMENT

Brief biographical details of Directors and senior management are set out on pages 29 to 31.

DIRECTORS' INTERESTS IN EQUITY OR DEBT SECURITIES

As at 31st December, 2002, none of the Directors nor the chief executive had any interest in shares of the Company according to the register maintained under Section 29 of the Securities (Disclosure of Interests) Ordinance.

The interests of the Directors in the share options of the Company are separately disclosed in the "Share Options" above.

Apart from the disclosed under the headings "Share Options" above, at no time during the year was the Company, its fellow subsidiaries, its subsidiaries or its holding company a party to any arrangement to enable any Director or chief executive of the Company or his spouse or children under 18 years of age to acquire benefits by means of acquisition of shares in, or debentures of, the Company or any other body corporate.

DIRECTORS' INTEREST IN COMPETING BUSINESS

Set out below is information disclosed pursuant to paragraph 8.10(2) of the Rules Governing the Listing of Securities of the Stock Exchange (the "Listing Rules"):-

Mr. Kong Dong is the Deputy General Manager of CNAH, which is the ultimate holding company of the Company and Air China, both CNAH and Air China are state-owned enterprises established in the PRC. Air China is engaged in the business of passenger and cargo air transportation services and airport ground handling services and CNAH is its ultimate holding company. As such the business activities of CNAH contribute competing business to the Group.

Mr. Kong is not directly involved in managing of Air China's business. The Group is therefore capable of carrying on such business independently of, and at arm's length from the said competing business.



DIRECTORS' REPORT

SUBSTANTIAL SHAREHOLDERS

The register of substantial shareholders maintained under Section 16(1) of the Securities (Disclosure of Interests) Ordinance shows that as at 31st December, 2002, the Company had been notified of the following substantial shareholders' interests, being 10% or more of the Company's issued share capital. These interests are in addition to those disclosed above in respect of the Directors and chief executive:

Name	No. of Shares
China National Aviation Holding Company (note)	2,280,458,000
China National Aviation Corporation (Group) Limited (note)	2,280,458,000
China National Aviation Corporation (note)	2,280,458,000

Note: The entire issued share capital of China National Aviation Corporation (Group) Limited is beneficially owned by China National Aviation Corporation. China National Aviation Corporation is in turn wholly-owned by China National Aviation Holding Company, a state-owned enterprise established in the People's Republic of China. Accordingly, the interests of China National Aviation Corporation (Group) Limited, China National Aviation Corporation and China National Aviation Holding Company in the Company duplicate to each other.

MANAGEMENT CONTRACTS

There exist agreements for general management services, in respect of which CNACG and CNAC (Macau) Aviation provide secretarial, personnel, accounting and general office administrative services to the Company and CNAC Macau on monthly fees of HK\$500,000 and HK\$300,000 respectively. Details of which are set out in notes 29(i) and (ii) to the accounts.

Save as disclosed above, no contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

MAJOR CUSTOMERS AND SUPPLIERS

As set out in the section headed "Principal Activities and Geographical Analysis of Operations" above, the Group's turnover and operating profit are mainly derived from its airline operations.

During the year, the Group sold less than 18% of its goods and services to its 5 largest customers.

The largest supplier and the five largest suppliers combined represented 19% and 55% respectively of the Group's total purchases for the year.

None of the directors, their associates or any shareholder (which to the knowledge of the directors owns more than 5% of the company's share capital) had an interest in the major suppliers or customers noted above except that the Company owns 33.65% effective interests in one of the five largest suppliers and the Company's immediate holding company effectively owns 51% effective interests in another one of the five largest suppliers, which together contributed 18% of the Group's total purchases.



CONNECTED TRANSACTIONS

Connected transactions disclosed in accordance with Chapter 14 of the Listing Rules are as follows:

1. The Company and CNAC entered into a licence agreement dated 18th October, 1997 pursuant to which CNAC has agreed to grant a licence to the Company, free of royalty, for the use of certain trade marks in Hong Kong, the Taiwan region and Macau so long as the Company is a subsidiary of CNACG. The Company has applied for a waiver for strict compliance with the Listing Rules. The independent Non-Executive Directors have reviewed the transaction and are of the opinion that it had been entered into by the Group in the ordinary course of business; in accordance with the terms of the agreement governing such transaction; and on terms that were fair and reasonable so far as the shareholders of the Company were concerned.
2. On 3rd August, 2001, the Company and CNACG entered into a management services agreement pursuant to which CNACG has agreed to provide secretarial, personnel, accounting and general office administrative services to the Group for a period of two years from 1st July, 2001 to 30th June, 2003 and CNACG would be paid by the Company in respect of the services a monthly fee of HK\$500,000. A press notice was published on 7th August, 2001. Total management fee paid during the year amounted to HK\$6,000,000.
3. On 30th November, 2001, the Group entered into two lease agreements with CNAC HK, a fellow subsidiary of the Company, pursuant to which the Group leased certain of its properties to CNAC HK. The lease agreements were entered into on normal commercial terms and the rent of each lease was determined based on the prevailing market rental values of these leased properties as advised by DTZ Debenham Tie Leung Limited. A press notice was published on 3rd December, 2001. The aforesaid properties were subsequently vested in CNACG on 25th March, 2002.
4. Upon completion of the Acquisition on 25th March, 2002, certain on-going connected transactions constituted connected transactions of the Company for the purpose of the Listing Rules, details of which are as follows:
 - (a) Airport charges and airport fees that invoiced and collected by ADA – Administration of Airports Limited (“ADA”), a 51% owned subsidiary of CNAC (Macau) Aviation (a wholly-owned subsidiary of CNACG), on behalf of Macau International Airport Company (“MIAC”), the developer and owner of Macau International Airport. Since the Company and CNAC (Macau) Aviation are both subsidiaries of CNACG, ADA is a connected person (as defined under the Listing Rules) of the Group. Further, Sociedale de Turismo e Diversaes de Macau (“STDM”), which has a 15% shareholding interest in Air Macau, has an approximately 33% shareholding in MIAC and hence, MIAC is also a connected person of the Group. As a result, the payment of airport charges and airport fees constitutes connected transactions under the Listing Rules.

The airport charges and airport fees paid to ADA for the period from 25th March, 2002 to 31st December, 2002 totalling HK\$81,045,000 did not exceed 10% of the consolidated turnover of the Company for the year ended 31st December, 2002.



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CONNECTED TRANSACTIONS (CONT'D)

- (b) Air Macau continues to purchase in-flight meals from Macau Catering Services Company Limited ("MCS"), an associate of STDM, pursuant to a catering services agreement that took effect from 1st November, 2001.

The aggregate of the in-flight meal services expenses paid to MCS for the period from 25th March, 2002 to 31st December, 2002 totalling HK\$43,965,000 did not exceed 5% of the consolidated turnover of the Company for the year ended 31st December, 2002.

- (c) CNAC Macau and CNAC (Macau) Aviation entered into a three-year management services agreement pursuant to which CNAC (Macau) Aviation provides general management services including secretarial, personnel, accounting and general office administrative services, to CNAC Macau, at a monthly fee of HK\$300,000.

The aggregate of the services fees paid during the period from 25th March, 2002 to 31st December, 2002 totalling HK\$2,768,000 did not exceed the higher of either (i) HK\$10 million; or (ii) 3% of the consolidated net tangible assets of the Company as at 31st December, 2002.

- (d) Air Macau has entered into sales arrangement with certain ticket sales agents, the number of which may be varied from time to time according to the business needs of Air Macau, for the sale of air tickets (including cargo transport). During the year, Air Macau either sold the air tickets to the ultimate consumers through the ticket sales agents and paid to the ticket sales agents commission fees at rates of 7% to 9% of the value of tickets sold; or sold the air tickets to the ticket sales agents at fixed prices, so that the ticket sales agents might on-sale the same to ultimate consumers at prices determined by the ticket sales agents. Such ticket sales agents include those who are also associates of CNACG or CNAC, the immediate holding company of CNACG.

The aggregate of the commission paid or payable to, and value of tickets sold to those agents for the period from 25th March, 2002 to 31st December, 2002 totalling HK\$16,711,000 did not exceed the higher of either (i) HK\$10 million; or (ii) 3% of the consolidated net tangible assets of the Company as at 31st December, 2002.

The Company has obtained a waiver from the Stock Exchange for strict compliance with the requirements under Chapter 14 of the Listing Rules on the above-mentioned on-going connected transactions.

The independent Non-Executive Directors have reviewed these transactions and confirmed that in their opinion, these transactions were carried out:

- (i) in the ordinary and usual course of business;
- (ii) either on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the Company than terms available to or from (as appropriate) independent third parties; and



CONNECTED TRANSACTIONS (CONT'D)

- (iii) in accordance with the relevant agreement (if applicable) on terms that are fair and reasonable and in the interests of the independent shareholders of the Company as whole.

The auditors of the Company have been engaged by the Company to conduct procedures on the above-mentioned on-going connected transactions and reported in a letter to the Board stating that these transactions (a) had received the approval of the Board; (b) had been entered into in accordance with the terms of the agreements governing such transactions or where there is no agreement, on the pricing policies of the Group; and (c) had not exceeded the respective cap amounts as stipulated in the waiver letter from the Stock Exchange for the year ended 31st December, 2002.

CORPORATE GOVERNANCE

None of the Directors of the Company is aware of any information that would reasonably indicate that the Company is not, or was not at any time during the year ended 31st December, 2002, in compliance with the Code of Best Practice as set out in the Listing Rules, except that the Non-Executive Directors were not appointed for specific terms but appointed to their offices for such terms and subject to retirement by rotation in accordance with Article 98 of the Company's Articles of Association.

AUDIT COMMITTEE

The Audit Committee has reviewed with management the accounting principles and practices adopted by the Group and discussed auditing, internal control and financial reporting matters including the review of the financial statements of the Group for the year ended 31st December, 2002.

AUDITORS

The accounts have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for re-appointment.

On behalf of the Board

Kong Dong

Chairman

Hong Kong, 28th March, 2003