You should read the following discussion in conjunction with the financial statements of the Company as of and for the years ended December 31, 2001, 2002 and 2003 and as of and for the three months ended March 31, 2003 and 2004, including the notes thereto, as set forth in the accountants' report included in Appendix I to this Prospectus. We have prepared the financial statements in accordance with IFRS, which may differ in material respects from generally accepted accounting principles in other jurisdictions, including the United States. However, there are no significant differences between IFRS and generally accepted accounting principles in Hong Kong with respect to the accounting policies applicable to the preparation of the financial statements of the Company.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are a leading provider of Internet services and mobile value-added services in China, with the largest IM community in China. Our primary business activities include Internet value-added services, mobile and telecommunications value-added services and online advertising.

We launched our basic IM service in February 1999. Since then, our Internet value-added services have evolved into a variety of value-added services for the QQ community, including email, various IM service packages, entertainment and information content services, chat rooms, dating services, casual games and massive multiple-player online games. Revenues from our Internet value-added services accounted for 31.3% of our total revenues in 2003 and 40.6% of our total revenues in the three months ended March 31, 2004. Revenues from our core Internet services, including QQ Membership, QQ Xing and QQ Show, accounted for approximately 85.2% of our revenues from our Internet value-added services in 2003 and approximately 89.4% of our revenues from our Internet value-added services in the three months ended March 31, 2004.

We commercially launched our mobile IM services in China in May 2000. Since then, our mobile and telecommunications value-added services have expanded to include mobile chat, IVR services, ringback tones, mobile music and pictures, mobile news and information content services, mobile games, and other telecommunications value-added services. Revenues from our mobile and telecommunications value-added services accounted for 63.6% of our total revenues in 2003 and 55.5% of our total revenues in the three months ended March 31, 2004. Revenues from our mobile IM service, Mobile QQ, accounted for approximately 71.1% of our revenues from our mobile and telecommunications value-added services in 2003 and approximately 47.1% of our revenues from our mobile and telecommunications value-added services in the three months ended March 31, 2004. In recent months, the growth in revenues from mobile and telecommunications value-added services has slowed due to the "cleaning up" of inactive customer accounts undertaken by mobile operators, which in turn has affected the number of subscriptions for some of our services such as Mobile QQ. The decrease in revenues from Mobile QQ, however, was offset by the launch of new services and the growth of other services.

We also offer online advertising on the space generated by our IM software client, such as log-on flashes, IM windows and system messages, and on the QQ.com portal. Revenues from online advertising accounted for 4.5% of our total revenues in 2003 and 3.2% of our total revenues in the three months ended March 31, 2004.

PRC regulations currently restrict foreign ownership of companies that provide telecommunications value-added services. Accordingly, our Internet and mobile value-added services and other telecommunications value-added services are provided by Tencent Computer under contractual arrangements with the Company and Tencent Technology. Although we do not hold any interest in Tencent Computer, our contractual arrangements with Tencent Computer allow us to consolidate its operating results for purposes of financial reporting under IFRS and the discussion in this “Financial Information” section. Shiji Kaixuan was established in January 2004 to provide value-added services, and has entered into similar contractual arrangements with the Company and Shidai Zhaoyang Technology. Accordingly, its operating results have been consolidated into our financial results for the three months ended March 31, 2004 and will continue to be consolidated into our financial results in future periods.

The Internet value-added services and mobile and telecommunications value-added services are offered through network platforms operated by third-party telecommunications operators in China. The telecommunications operators provide us access to their networks and customers, jointly market our services to their customers and are responsible for the billing and collection of fees for the services that we provide. In exchange, we share a portion of our fees with the operators. In particular, we work closely with China Mobile and China Unicom to offer many of our mobile value-added services. Substantially all of the fees for our mobile value-added services and a majority of the fees for our Internet value-added services are separately settled and collected for us by the 29 affiliates of China Mobile and 15 affiliates or branches of China Unicom.

As of March 31, 2004, we had approximately 291.3 million registered IM user accounts. During the 16-day period ended March 31, 2004, the peak number of simultaneous online user accounts was 6.1 million, the average number of daily user hours was 64.7 million and the average number of messages sent daily was 848.8 million. As of March 31, 2004, we had 7.3 million registered subscriptions for our fee-based Internet value-added services and 12.8 million registered subscriptions for fee-based mobile value-added services provided directly by us or through mobile operators. We recorded revenues of RMB735.0 million and profit for the year of RMB322.2 million for the year ended December 31, 2003, and revenues of RMB257.6 million and profit for the period of RMB107.3 million for the three months ended March 31, 2004.

Our ability to increase our profitability depends primarily on our ability to successfully increase the revenues we generate from providing our services and products without significantly increasing our costs. Our profitability is also dependent in general largely on the operating policies of telecommunications operators in China and the environment in which they operate, and in particular on our continuing cooperation with these telecommunications operators and the successful operation of our value-added services over their networks.

Because of the new and evolving nature of our value-added services and technologies and our early stage of development, we cannot assure you that our business model will prove to be successful or sustainable or that our current or future pricing levels will be sustainable. For a detailed discussion of the factors and uncertainties that may affect our business operations, see "Risk Factors — Risks Related to Our Business".

Road Map of Our Consolidated Profit and Loss Accounts

The following discussion highlights key line items in our consolidated profit and loss accounts (as to the basis on which our consolidated accounts are prepared, see "—Basis for Presentation of the Consolidated Financial Statements" below):

Revenues

We generate our revenues primarily from three major sources:

- Internet value-added services,
- mobile and telecommunications value-added services, and
- online advertising.

Internet Value-added Services. We derive our Internet value-added service revenues from services that enable communications, create communities and provide entertainment over the Internet. Specifically, we derive revenues mainly from monthly subscription fees for delivering our premium IM services, such as QQ Membership and QQ Xing, various community value-added services, such as QQ Dating and QQ E-card, and interactive entertainment, such as the QQ Show service. We also derive revenues from our online games, including MMOG and casual games, through the QQ game portal.

The majority of revenues from Internet value-added services is collected by telecommunications operators and the balance through other collection channels. For the Internet value-added services that we collect revenues through telecommunications operators, we typically enter into cooperation and revenue sharing agreements under which we share a portion of the services fees with the telecommunications operators. Under those agreements, the fees remitted to us are adjusted for fees that are not collectible from end-users and, with respect to the Internet value-added services provided through mobile operators, traffic imbalances between our network gateway and the mobile operators' network gateways. For a detailed discussion of the cooperation and revenue sharing arrangements including fees for traffic imbalances, see "— Cost of Revenues".

Customers can also purchase credits to use our various value-added services at different locations throughout China, including Internet cafes, convenience stores, supermarkets and bookstores. Customers then register their credits in our system and use the credits to play our online games and use other fee-based services. As an additional revenue collection channel for our Internet value-added services, we have developed IVR systems with China Telecom and China Netcom. The IVR systems allow customers to call specified phone numbers through fixed telephone lines and purchase credits by charging the fees to their monthly telephone bills and then use those credits for our Internet value-added services.

For a detailed discussion of how revenues from Internet value-added services are recognized in our financial statements, see “Critical Accounting Policies — Revenue Recognition — Internet Valued-added Services”.

Mobile and Telecommunications Value-Added Services. The majority of our revenues is generated from our mobile and telecommunications value-added services, including mobile IM services, mobile chat services, such as 161 Mobile Chat (which is co-branded with China Mobile) and Feichang QQ Nannu, and other mobile value-added services, such as mobile IVR services, music and picture/image downloads, mobile news and information content services and mobile games. The software for our mobile applications may be pre-installed directly in users’ handsets by device manufacturers, or alternatively may be downloaded by customers.

Historically, revenues from our mobile and telecommunications value-added services have been predominately derived from our mobile IM services, offered in China under the Mobile QQ brand. Although we anticipate that mobile IM services will continue to contribute to a significant portion of our mobile and telecommunications value-added service revenues, we have been able to generate new sources of revenues since 2001 by launching new mobile and telecommunications value-added services products, such as mobile chat services, mobile games and mobile music and image/picture download services and mobile IVR. Most of the revenues are collected on a monthly subscription basis, with certain portions billed on a per message basis.

We offer and deliver our mobile value-added telecommunications services in cooperation with 44 subsidiaries and branches of China Mobile and China Unicom. We typically enter into cooperation and revenue sharing agreements with these mobile operators under which we share with the mobile operators a portion of the fees for specified mobile value-added telecommunication services. Under those agreements, the amounts remitted to us are adjusted for amounts that are not collectible from end-users and traffic imbalances. For a detailed discussion of the cooperation and revenue sharing arrangements including fees for traffic imbalances, see “— Cost of Revenues”. The majority of our revenues from mobile and telecommunications value-added services are collected by China Mobile and China Unicom under these arrangements and the balance through other collection channels.

On a periodic basis, we confirm with each mobile operator the subscription information and the data transmission volume between our network gateway and the operator’s network gateways. Each subsidiary or branch operator of China Mobile and China Unicom will also provide us with a summary report on a monthly basis as to the net fees payable to us by the subsidiary or branch operator, as the case may be. The level of detail and timing of the summaries vary among the subsidiaries and branch operators. We also receive information on customer payment status and coordinate with the mobile operators for final billing and collection of revenues.

For a detailed discussion of how revenues from mobile and telecommunications value-added services are recognized in our financial statements, see “Critical Accounting Policies — Revenue Recognition — Mobile and Telecommunications Value-added Services”.

Online Advertising. We derive all of our online advertising revenues from fees for advertisements placed on the space generated by our IM software client, such as log-on flashes, IM windows and system messages, and on the QQ.com portal.

Most of our advertising contracts are short-term contracts and are based on the actual time period that the advertisements appear on the advertising space rather than based on guaranteed minimum impressions. In general, we place advertisements and start to recognize the related revenues approximately 90 days after entering into the contract for such advertisement placement. To date, no advertisements have been provided for consideration other than cash.

For a detailed discussion of how revenues from online advertising are recognized in our financial statements, see "Critical Accounting Policies — Revenue Recognition — Online Advertising".

Other Services. Revenues from other services include sales of RTX which was commercially launched in September 2003 and revenues from trademark licensing.

Cost of Revenues

Cost of revenues consists of the direct costs for operating and offering our services and products, which consist primarily of the telecommunications operators' portion of revenues for the value-added services provided over their network platform, imbalance fees charged by the telecommunications operators, bandwidth and server custody fees, depreciation of our equipment, content costs, sales commissions and other direct costs. Staff costs that directly relate to the provision of our services and products are also included in cost of revenues.

A significant portion of our value-added services are offered through network platforms operated by third party telecommunications operators. We typically enter into cooperation and revenue sharing agreements with telecommunications operators for specific value-added services. Under those agreements, the operators provide us access to their network platforms, bill and collect the fees payable by our registered users and jointly market our value-added services to their customers. In exchange, we share with the operators a portion of the fees collected from the end-users of our value-added services. For example, with certain exceptions, we generally share with China Mobile and China Unicom 12% to 15% of the fees collected from customers of our value-added telecommunications services.

For the value-added services offered through mobile operators, in addition to their share of revenues, they also withhold and retain imbalance fees from the fees collected from end-users. Imbalance fee adjustments are made when the number of messages originating from our network platform exceeds the number of messages originating from the operator's network platform. In general, the number of messages originating from our platform exceeds the number of messages originating from mobile network platform. As a result, with certain exceptions, we are generally charged imbalance fee adjustments which are recorded as part of cost of revenues. The imbalance fees charged by China Mobile and China Unicom generally range from RMB0.04 to RMB0.08 per SMS message and from RMB0.20 to RMB0.25 per MMS message.

The amount of revenues shared with telecommunications operators for handling and fee collection commissions and network imbalance fees, all of which are inseparable and recorded as part of cost of revenues, was RMB9.6 million in 2001, RMB52.2 million in 2002, RMB164.8 million in 2003 and RMB60.7 million in the three months ended March 31, 2004.

We lease bandwidth from Internet data centers operated by network operators in China. In addition, we have network servers co-located in Internet data centers operated by network operators in China, for which we pay custody fees to such operators. These costs are recognized in full as incurred.

From time to time, we engage third parties to develop content. We also license and purchase content from third parties. This content is used across our services and products, including content for our Internet portal, online games, avatar images for the QQ Show service, ringback tones and music and image/picture content services.

We engage advertising agencies and other intermediaries to sell the advertising space generated by our IM software client, such as log-on flashes, IM windows and system messages, and the advertising space on our QQ.com portal. The commissions paid to advertising agencies and other sales intermediaries are recognized as cost of revenues.

Selling and Marketing Expenses

Selling and marketing expenses consist primarily of costs incurred with our promotional and marketing activities, such as purchasing third-party advertising, holding product launch events, printing sales brochures and related staff, travel and entertainment costs. In recent years, our selling and marketing expenses have increased as we continue to launch and promote new services and seek to extend our brand recognition.

General and Administrative Expenses

General and administrative expenses consist primarily of salary and welfare expenses that cannot be allocated to any particular line of business, such as the salary and welfare expenses related to our QQ.com portal and administrative staff, office rental, travel and entertainment expenses, consulting fees, office maintenance and other general office expenses. In addition, research and development expenses incurred in connection with basic research and development activities not directly linked to a product or service are recognized as part of general and administrative expenses.

Finance Income (Expenses)

Finance income (expenses) currently includes income derived from interest-earning assets, foreign currency exchange gains and losses and finance and borrowing costs. Until 2001, we had outstanding bank borrowings and convertible notes for which we incurred interest expenses. These interest-bearing liabilities were fully repaid or converted into share capital in 2001.

Taxation

Taxation represents only profits tax. Value-added tax on sales to third parties and business tax and related taxes are determined based on fixed percentages of our gross revenues, netted from revenues and not reflected in taxation.

Profits Tax. Under the current laws of the Cayman Islands, the Company is not subject to tax on income or capital gains. In addition, the intermediate holding companies incorporated in the British Virgin Islands are not subject to tax on income or capital gains.

Our revenues are primarily derived from our Group entities incorporated in the PRC. The Company, Tencent Technology and Shidai Zhaoyang Technology have entered into various technical and consulting service agreements and other agreements with Tencent Computer and Shiji Kaixuan, pursuant to which the Company, Tencent Technology and Shidai Zhaoyang Technology receive fees in an amount equal to the surplus cash generated by Tencent Computer and Shiji Kaixuan after taking into account Tencent Computer's and Shiji Kaixuan's forecast working capital needs, capital expenditures and other short-term anticipated expenditures.

PRC companies are generally subject to a 30% national enterprise income tax, or EIT, and a 3% local income tax. Tencent Computer, Tencent Technology, Shiji Kaixuan and Shidai Zhaoyang Technology, however, were all established in the Shenzhen Special Economic Zone of the PRC, and principally conduct, or will conduct, their business operations in this zone. As a result, they are, or will be, subject to the reduced EIT rate of 15% as approved by the tax authorities.

The EIT applicable to Tencent Computer is further subject to a tax holiday as a result of the application of the provisions stipulated in the tax circular, (深地稅二函) *Shendishuierhan* [2002] No. 128. Specifically, Tencent Computer is exempt from EIT for the first year of profitable operations after offsetting prior years' tax losses and is entitled to a 50% reduction in its EIT for the following two years. As a result of this tax holiday, Tencent Computer was exempt from EIT in the year ended December 31, 2002, which was the first year Tencent Computer achieved profitable operations after offsetting prior years' tax losses. In the year ended December 31, 2003, a 50% reduction applied to Tencent Computer's EIT, adjusting the rate to 7.5%. The same tax holiday will apply to Tencent Computer for the year ending December 31, 2004, but will not be applicable thereafter. Shiji Kaixuan intends to apply to the relevant tax authorities for tax holidays by applying similar provisions stipulated in the tax circular, *Shendishuierhan* [2002] No. 128 which would provide an exemption from EIT for the two years ending December 31, 2005. The Company cannot assure you that Shiji Kaixuan will be able to obtain the tax holiday treatment.

Tencent Technology is recognized as a "foreign-invested enterprise with productive sales income" under the provisions stipulated in the tax circular, (深地稅外函) *Shendishuiwaihan* [2003] No. 413. Specifically, Tencent Technology is exempt from EIT for its first two years of profitable operations after offsetting prior years' tax losses and is entitled to a 50% reduction in its EIT for the following three years. As a result of this tax holiday, Tencent Technology was exempt from EIT for the year ended December 31, 2003, which was the first year Tencent Technology achieved profitable operations after offsetting prior years' tax losses. It will be exempt from EIT for the year ending December 31, 2004. Thereafter, Tencent Technology expects to benefit from a 50% reduction in EIT until the year ending December 31, 2007. Shidai Zhaoyang Technology intends to apply to the relevant tax authorities for similar tax holidays during 2004. The Company cannot assure you that Shidai Zhaoyang Technology will be able to obtain the tax holiday treatment.

Upon the expiration of our various tax holiday treatments discussed above, our taxation will increase, impacting our profit for the year.

For a detailed discussion of the risks relating to the various tax holiday treatments, see "Risk Factors—Risks Related to Our Structure—The preferential tax treatment currently enjoyed by the WFOEs, Tencent Computer and Shiji Kaixuan may be challenged or revoked in the future, and the recognition of revenues outlined in our intra-group contracts could be challenged by tax authorities".

The table below sets forth the tax rates applicable to Tencent Computer, Tencent Technology, Shiji Kaixuan and Shidai Zhaoyang Technology for the periods indicated:

	Year ended December 31,	Year ending December 31,				
	2003	2004	2005	2006	2007	2008
Tencent Computer	7.5%	7.5%	15%	15%	15%	15%
Tencent Technology	—	—	7.5	7.5	7.5	15
Shiji Kaixuan[(1)]	N.A.[(2)]	15	15	15	15	15
Shidai Zhaoyang Technology[(1)]	N.A.[(2)]	15	15	15	15	15

Notes:

(1) Shiji Kaixuan and Shidai Zhaoyang Technology intend to apply for the tax holidays described in the preceding paragraphs. If such application is approved, (a) Shiji Kaixuan will be exempt from EIT for the first two years after establishment, and (b) Shidai Zhaoyang Technology will be exempt from EIT for the first two years of profitable operations after offsetting prior years' tax losses and will be subject to a reduced rate of 7.5% for three years after that exemption period.

(2) Shiji Kaixuan and Shidai Zhaoyang Technology were established in 2004.

For a detailed discussion of the risks related to our taxation, see "Risk Factors—Risks Related to Our Structure — The preferential tax treatment currently enjoyed by the WFOEs, Tencent Computer and Shiji Kaixuan may be challenged or revoked in the future, and the recognition of revenues outlined in our intra-group contracts could be challenged by the tax authorities".

The effective tax rates for the three years ended December 31, 2001, 2002, 2003 and for the three months ended March 31, 2003, and March 31, 2004 were 0%, 2.1%, 4.7%, 3.6%, and 5.9%, respectively. For the year ended December 31, 2003 and for the three months ended March 31, 2004, a substantial portion for the profit of the Group was reported by Tencent Technology, which was exempt from EIT under the tax holiday discussed above. Income tax for the year ended December 31, 2003 and for the three months ended March 31, 2004 was mainly levied at the reported profit of Tencent Computer, which also benefited from a 50% reduction of EIT under the tax holiday discussed above, at a reduced rate of 7.5%. For the year ended December 31, 2002, a significant portion of the profit of the Group was reported by Tencent Computer, which was exempt from EIT under the tax holiday discussed above. The 2002 tax expense related to deferred tax recognized on a temporary difference arising from the Structure Contract arrangements. For the year ended December 31, 2001, a substantial portion of the profits reported by the Group was offset by tax losses carried forward from prior years. Accordingly, no income tax was recorded.

As of December 31, 2003, we had fully utilized past years' tax losses to offset taxable profits derived from our operations and accordingly, we did not have any tax loss carryforwards.

Value-Added Tax and Related Taxes. Under PRC value-added tax ("VAT") temporary regulations, PRC companies, including Tencent Technology, Shidai Zhaoyang Technology, Tencent Computer and Shiji Kaixuan, are subject to output VAT, which is generally levied at 17% of the sales value. The output VAT is offset by the VAT paid by such PRC companies on their purchases. The PRC companies also accrue and pay city construction tax at a rate of 1%, and educational surcharge at a rate of 3%, of the net VAT amount payable. VAT and the related city construction tax and educational surcharge with respect to sales of goods are generally netted from our revenues.

VAT paid on inter-company transactions are recognized as general and administrative expenses. During the year ended December 31, 2003, two sets of software developed by Tencent Technology were transferred to Tencent Computer for an aggregate consideration of RMB185 million. VAT was levied at 17% on the consideration amounting to RMB31.5 million. Under the provisions stipulated in *Caishui* [2000] Document No. 25, which provides that the portion of VAT paid in excess of 3% on software products should be refunded, we received a tax rebate of RMB25.9 million. Accordingly, only RMB5.6 million was recorded as part of general and administrative expenses of the Group in the consolidated profit and loss account for the year ended December 31, 2003. For the three months ended March 31, 2004, net VAT of RMB2.1 million was recorded as part of general and administrative expenses on a similar basis in relation to additional software transferred from Tencent Technology to Tencent Computer for an aggregate consideration of RMB70.1 million.

Business Tax and Related Taxes. Tencent Technology, Shidai Zhaoyang Technology, Tencent Computer and Shiji Kaixuan are subject to business tax on the fee income received or receivable from the services they provide and on their income from the transfer of technology and licensing arrangements within the Group. The business tax rate varies according to the types of services, but averages around 5% for the Group to date. We intend to apply to the relevant tax authorities to reduce the business tax on some services, but cannot assure you that we will be able to obtain the reduced rate. The PRC companies also accrue and pay city construction tax at a rate of 1%, and educational surcharge at a rate of 3%, of business tax amount payable. Business tax and the related city construction tax and educational surcharge are netted from our revenues.

Basis for Presentation of the Consolidated Financial Statements

During the periods presented in the financial statements set forth in the accountants' report included in Appendix I to this Prospectus, the Company derived substantially all of its revenues under a series of contractual arrangements among the Company, Tencent Technology, which is a wholly owned subsidiary of the Company, and Tencent Computer. Under those agreements, the Company is able to recognize and receive the economic benefit of the business and operations of Tencent Computer. The agreements are designed to provide the Company and Tencent Technology with effective control over, and (to the extent permitted by PRC law) the right to acquire the equity interests in and assets of, Tencent Computer. Based on such contractual arrangements, we have concluded that it is appropriate to consolidate the financial statements of Tencent Computer, notwithstanding the lack of share ownership, because in substance, the contractual arrangements transfer the economic risks and benefits of Tencent Computer to the Company. In January 2004, Shiji Kaixuan was established with similar contractual arrangements made with the Company.

The consolidation of Tencent Computer and Shiji Kaixuan is in compliance with the requirements under IAS 27 of IFRS, which stipulate that a subsidiary can only be consolidated by its parent when the parent has control over the subsidiary. Under the requirements, control is presumed to exist when the parent owns more than half of the voting power or when the parent has (a) power over more than one half of the voting rights by virtue of any agreement with other investors; (b) power to govern the financial and operating policies of that subsidiary under a statute or an agreement; (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body; or (d) power to cast the majority of votes at meetings of the board of directors or equivalent government body.

The contractual arrangements under the Structure Contracts enable the Company to (a) control more than one half of the voting rights of Tencent Computer and Shiji Kaixuan; (b) govern Tencent Computer's and Shiji Kaixuan's financial and operating policies; (c) appoint or remove the majority of the members of Tencent Computer's and Shiji Kaixuan's Cooperation Committees; and (d) cast the majority of votes at meetings of such committees. These provisions have supported the consolidation of Tencent Computer and Shiji Kaixuan's by the Company under IFRS.

For a detailed discussion of the terms of, and the risks related to, the contractual arrangements, see "Our History and Structure", "Risk Factors — Risks Related to Our Structure" and "Structure Contracts" set forth in Appendix VI to this Prospectus.

In addition, upon the formation of the Company and Tencent Technology, both companies were under the control of the same shareholders of Tencent Computer in similar proportions. This was achieved via direct or indirect ownership as well as, in the case of the control over Tencent Computer, via contractual provisions. As a result, the transaction leading to the formation of the Group was accounted for as a business combination between entities under common control under a method similar to the uniting of interests method by recording assets and liabilities at predecessor carrying amounts. All periods are presented as if the three entities had always been combined because in management's belief it best reflects the substance of the formation.

Shiji Kaixuan was established and it commenced operations in January 2004. Shidai Zhaoyang Technology was incorporated in the PRC in January 2004 to provide technical and management consultancy services to both Tencent Computer and Shiji Kaixuan. Going forward, Tencent Technology will employ a substantial portion of our staff, hold all principal intellectual property rights and focus on the development of principal software for our operations, and Shidai Zhaoyang Technology will focus on providing technical and management consultancy services for the value-added telecommunications sector to Tencent

Computer and Shiji Kaixuan. The Company and its wholly owned subsidiaries, Tencent Technology and Shidai Zhaoyang Technology, have entered into similar contractual arrangements with Tencent Computer and Shiji Kaixuan, and therefore, the Company has consolidated the financial results of both Tencent Computer and Shiji Kaixuan for the three months ended March 31, 2004. During the three years ended December 31, 2003, Shidai Zhaoyang Technology and Shiji Kaixuan had not been established and there was no financial information presented in those financial statements.

As part of the consolidation under IFRS and for purposes of the discussion in this "Financial Information" section, we have eliminated all inter-company transactions and balances between the Company and the WFOEs, on the one hand, and Tencent Computer and Shiji Kaixuan, on the other hand, and have treated the revenues and expenses of Tencent Computer and Shiji Kaixuan as if they had been earned and incurred directly by the Company and as if the respective assets and liabilities of Tencent Computer and Shiji Kaixuan had been borne by the Company.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon the financial statements set forth in the accountants' report included in Appendix I to this Prospectus, which have been prepared in accordance with IFRS. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, bad debt, investments, intangible assets, income taxes, financing operations, restructuring, pensions, share-based compensation costs and other post-retirement benefits, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

In addition to the consolidation policy described in "— Basis for Presentation of the Consolidated Financial Statements" above, we believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

Internet Value-added Services. We recognize revenues from Internet value-added services based on the full amount of fees charged to end-users by telecommunications operators after the operators' adjustments for uncollectibles and after deducting the applicable business tax and related taxes. In general, uncollectible fees arise due to end-users payment delinquencies and to a lesser extent due to "dropped messages", which are messages that were sent to the mobile operators' system but were not delivered to the end-users. See "— Road Map to Our Profit and Loss Accounts — Taxation — Business Tax and Related Taxes" above for a detailed discussion on the adjustments for business tax and related taxes.

We recognize revenues from Internet value-added services on an accrual basis as the services are rendered. With respect to revenues collected by the telecommunications operators on our behalf, revenues are recognized on the same basis as revenues for mobile and telecommunications value-added services described in further detail below. With respect to revenues collected from the sale of credits and through the IVR systems, revenues are deferred and recognized over the estimated consumption period on a straight-line basis.

Mobile and Telecommunications Value-added Services. We recognize mobile and telecommunications value-added services revenues based on the full amount of fees charged to end-users by mobile operators after the operators' adjustments for uncollectibles and after deducting the applicable business tax and related taxes. In general, uncollectible fees arise due to end-user payment delinquencies or "dropped messages". See "— Road Map to Our Profit and Loss Accounts — Taxation — Business Tax and Related Taxes" above for a detailed discussion of the adjustments relating to business tax and related taxes.

We recognize revenues from mobile and telecommunications value-added services on an accrual basis as the services are rendered. As noted above, we rely on information provided by mobile operators in their periodic statements for final billing, settlement and collection of revenues. For revenues not supported by statements from the mobile operators at the time of reporting our financial results, we estimate the amounts based on the number of subscriptions and the volume of data transmitted between our network gateway and the mobile operators' network gateways as confirmed with the operators. Management's estimates utilize the most recent three-month history of revenues actually derived from the operations and incorporate developing trends in customer payment delinquencies. Specifically, management estimates revenue performance based on the following factors:

- the operational raw data captured by the network gateway, which is the system capturing the transaction flows, and the server capturing the subscriber database maintained by the Group. The gateway records each single transaction processed by the mobile operators while the database maintains the number of subscribers of the Group;
- the monthly fixed subscription rates for certain services;
- the expected billable transaction volume; and
- the expected delinquency rates experienced in the recent three months.

Based on these factors, if revenues are not supported by the periodic statements received from the network operators, management estimates the amount of revenues for services rendered in a reporting period. The revenue estimation procedures are applied by management for each province or city where the Group has operations.

If actual revenues based on the statements subsequently received from the mobile operators are higher or lower than the estimated amounts, adjustments are made in revenues in the periods in which the statements are received. To date, we have not experienced any material discrepancy between the estimated revenues and actual revenues. The actual remittance to us by the mobile operators of our shares of the fees after all adjustments is typically made 30 to 90 days after services are rendered.

Online Advertising. We recognize revenues from online advertisements ratably over the period that the advertisement is displayed on our advertising space.

Business tax and related taxes payable on online advertising sales are netted from our revenues. For a detailed discussion of the business tax and related taxes, see "— Road Map of Our Consolidated Profit and Loss Accounts — Taxation — Business Tax and Related Taxes" above.

Research and Development Expenses

We generally recognize research and development expenditures as expenses as they are incurred. Costs incurred on development projects are recognized as intangible assets only when management can conclude that it is probable that the development project will be a success considering its commercial and technological feasibility and only if the cost can be measured reliably. During the periods presented in the financial statements set forth in the accountants' report included in Appendix I to this Prospectus, we have not capitalized any research and development expenses. We incurred research and development expenses of RMB26.0 million in 2003, RMB7.8 million in 2002 and RMB5.6 million in 2001, and RMB3.8 million and RMB12.6 million in the three months ended March 31, 2003 and 2004, respectively. The increase in research and development expenses during the three years ended December 31, 2003 was due to increase in headcount of personnel involved in research and development activities and the related direct operating costs such as depreciation of equipment employed in these activities.

Employee Benefits Costs Associated with Option Grants

In July 2001, the Company adopted the Pre-IPO Share Option Scheme in order to provide incentives to our employees. Under the scheme, our Board of Directors may grant options to subscribe for ordinary shares of the Company at an exercise price determined by the Board of Directors on the date of the grant. As of March 31, 2004 and the date of this Prospectus, 72,491,650 options and 72,386,370 options granted under the scheme were outstanding, respectively. Under the prevailing IFRS, there is no requirement for the Company to recognize any employee benefits costs associated with these option grants in the financial statements set forth in the accountants' report included in Appendix I to this Prospectus. However, the Company will start to account for such employee benefit costs in its financial statements for the financial year beginning January 1, 2005 under IFRS2 "Share-based payments". For a detailed discussion of the Pre-IPO Share Option Scheme, see "Pre-IPO Share Option Scheme" in Appendix VII to this Prospectus.

Consolidated Profit and Loss Accounts

The following table sets forth a summary of our audited consolidated profit and loss accounts for the years ended December 31, 2001, 2002 and 2003 and for the three months ended March 31, 2003 and 2004:

	Year ended December 31,			Three months ended March 31,	
	2001	2002	2003	2003	2004
	(RMB in thousands, except percentages)				
Revenues:					
Internet value-added services	944	40,819	229,690	33,012	104,586
Mobile and telecommunications value-added services	37,960	198,818	467,369	84,297	142,817
Online advertising	7,735	19,188	32,841	6,818	8,215
Others	2,437	4,282	5,057	866	1,935
Total revenues	49,076	263,107	734,957	124,993	257,553
Cost of revenues	(18,044)	(71,674)	(229,548)	(36,339)	(87,368)
Gross profit	31,032	191,433	505,409	88,654	170,185
Other operating (expenses)/income, net	(82)	(242)	(1,226)	36	18
Selling and marketing expenses	(4,312)	(19,437)	(55,967)	(12,313)	(23,044)
General and administrative expenses	(16,297)	(28,860)	(112,011)	(16,652)	(34,074)
Profit from operations	10,341	142,894	336,205	59,725	113,085
Finance (expenses)/income, net	(125)	871	2,004	(257)	931
Profit before tax	10,216	143,765	338,209	59,468	114,016
Taxation	—	(3,058)	(16,013)	(2,123)	(6,712)
Profit for the year/period	10,216	140,707	322,196	57,345	107,304
Margins:					
Gross profit as a percentage of revenues	63.2%	72.8%	68.8%	70.9%	66.1%
Profit from operations as a percentage of revenues	21.1	54.3	45.7	47.8	43.9
Profit for the year/period as a percentage of revenues	20.8	53.5	43.8	45.9	41.7

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Revenues. Revenues increased RMB471.9 million, or 179.4%, from RMB263.1 million in 2002 to RMB735.0 million in 2003. The following table sets forth our revenues by lines of business for the years ended December 31, 2002 and 2003:

	Year ended December 31,			
	2002		2003	
	Amount	% of total revenues	Amount	% of total revenues
	(RMB in thousands)			
Internet value-added services	40,819	15.5%	229,690	31.3%
Mobile and telecommunications value-added services	198,818	75.6	467,369	63.6
Online advertising	19,188	7.3	32,841	4.5
Others	4,282	1.6	5,057	0.6
Total revenues	263,107	100.0%	734,957	100.0%

Revenues from our Internet value-added services increased RMB188.9 million, or 463.0%, from RMB40.8 million in 2002 to RMB229.7 million in 2003. The significant increase in revenues reflected the growth in our fee-based Internet value-added services from 1.5 million registered subscriptions as of December 31, 2002 to 6.9 million registered subscriptions as of December 31, 2003. Growth in our premium IM services, QQ Membership and QQ Xing gained momentum in 2003 through various promotional activities. As our subscriber base grew, we were also able to increase revenues from our various community services and interactive entertainment. We began charging fees for QQ Dating in December 2002.

Revenues from mobile and telecommunications value-added services increased RMB268.6 million, or 135.1%, from RMB198.8 million in 2002 to RMB467.4 million in 2003. The increase in revenues reflected the growth in fee-based mobile and telecommunications value-added services provided directly by us or through mobile operators from 5.6 million registered subscriptions as of December 31, 2002 to 13.1 million registered subscriptions as of December 31, 2003. The rapid growth in the number of Mobile QQ subscriptions, together with growth in 161 Mobile Chat, and the expansion of our music and picture/image downloading services, contributed to the growth in revenues from mobile and telecommunications value-added services.

Revenues from online advertising increased RMB13.6 million, or 70.8%, from RMB19.2 million in 2002 to RMB32.8 million in 2003. The increase in revenues reflected our growing customer base and our increased pricing, as our IM services and QQ.com portal attracted more users. However, revenues from online advertising were lower in mid-2003 compared to the first and latter part of 2003 as the outbreak of the SARS epidemic negatively affected the general sentiment for advertising spending.

Revenues from other services increased RMB0.8 million, or 18.6%, from RMB4.3 million in 2002 to RMB5.1 million in 2003. The increase in revenues reflected sales of RTX which was commercially launched in September 2003, partially offset by a decrease in our revenues from trademark licensing as we became more selective in the licensing of our trademarks to third parties.

Cost of revenues. Cost of revenues increased RMB157.8 million, or 220.1%, from RMB71.7 million in 2002 to RMB229.5 million in 2003. The increase principally reflected the growth in telecommunications operators' revenue share and imbalance fees, bandwidth and server custody fees and staff costs directly attributable to our services and products. These costs will continue to increase as we grow our business. As a percentage of revenues, cost of revenues increased from 27.2% in 2002 to 31.2% in 2003.

The following table sets forth our cost of revenues by lines of business for the years ended December 31, 2002 and 2003:

	Year ended December 31,			
	2002		2003	
	Amount	% of segment revenues	Amount	% of segment revenues
	(RMB in thousands)			
Internet value-added services	14,848	36.4%	75,489	32.9%
Mobile and telecommunications value-added services	49,856	25.1	141,916	30.4
Online advertising	6,970	36.3	10,499	32.0
Others	—	—	1,644	32.5
Total cost of revenues	71,674		229,548	

Cost of revenues for our Internet value-added services increased RMB60.7 million, or 410.1%, from RMB14.8 million in 2002 to RMB75.5 million in 2003. The amount of fees retained by mobile operators for their share of revenues increased as the fees collected through that channel increased. Moreover, imbalance fees to mobile operators increased as the increased usage of Internet value-added services offered through mobile operators created a larger traffic imbalance and the rate of imbalance fees charged by a number of mobile operators increased. As our subscriber base for and number of, Internet value-added services increased, we also had to increase the number of employees responsible for operating those services. In addition, we started to license a MMOG from a third party and increased the amount of content purchased for our QQ.com portal. As a percentage of revenues generated from the same segment, cost of revenues decreased from 36.4% for 2002 to 32.9% for 2003 primarily as a result of the proportionately higher growth in revenues in 2003.

Cost of revenues for our mobile and telecommunications value-added services increased RMB92.0 million, or 184.4%, from RMB49.9 million in 2002 to RMB141.9 million in 2003. The amount of fees retained by mobile operators for their share of revenues and imbalance fees increased generally in line with the growth in our revenues from the services provided through those operators. As a percentage of revenues generated from the same segment, cost of revenues increased from 25.1% for 2002 to 30.4% for 2003 mainly due to the increased number of development and technical staff in 2003 to commercialize and launch a number of new services and to further improve our existing services.

Cost of revenues for online advertising increased RMB3.5 million, or 50.0%, from RMB7.0 million in 2002 to RMB10.5 million in 2003. The increase mainly reflects the increased rate of sales commissions paid to advertising agencies as competition increased to obtain advertising contracts and the increased sales volume. In addition, staff costs for our online advertising increased as we retained more development and technical staff to support our online advertising business. As a percentage of revenues generated from the same segment, however, cost of revenues decreased from 36.3% for 2002 to 32.0% for 2003 mainly due to the proportionately higher growth in revenues in 2003.

Cost of revenues for our other businesses in 2003 included mainly costs associated with the commercialization of and the sales and support staff associated with RTX, which we began selling in September 2003.

Other operating expenses. Other operating expenses increased RMB1.0 million, or 500%, from RMB0.2 million in 2002 to RMB1.2 million in 2003. In 2003, we recognized a loss of RMB1.0 million on the disposal of certain fixed assets.

Selling and marketing expenses. Selling and marketing expenses increased RMB36.6 million, or 188.7%, from RMB19.4 million in 2002 to RMB56.0 million in 2003. The increase principally reflected increases in promotional and advertising activities and related staff costs as we launched a larger number of products and services and sought to further enhance our market presence during 2003. As a percentage of revenues, selling and marketing expenses increased from 7.4% in 2002 to 7.6% in 2003 mainly because promotional and advertising expenses and related staff expenses increased faster than the growth of our revenues.

General and administrative expenses. General and administrative expenses increased RMB83.1 million, or 287.5%, from RMB28.9 million in 2002 to RMB112.0 million in 2003. The increase reflected the increase in research and development expenses from RMB7.8 million in 2002 to RMB26.0 million in 2003 as a result of an increase in the number of research and development staff. Our research and development activities in 2003 primarily focused on developing new technologies, services and products, such as Tencent Messenger, QQ Mail, online and mobile games, and RTX, and improving the IM platform to support a richer and more secure and efficient user experience. In addition, costs relating to technical personnel supporting our overall business, which are accounted for as part of research and development expenses, increased as our business expanded in 2003.

Staff costs also increased as we increased the number of our general and administrative staff, as well as staff relating to our redesign and launch of the QQ.com portal in 2003. We also incurred expenses in connection with the renovations to our Beijing and Shenzhen offices and advisory fees in connection with our reorganization and preparation to become a publicly-held company. In 2003, we recorded RMB 5.6 million for net VAT paid on inter-company software sales.

As a percentage of revenues, general and administrative expenses increased from 11.0% in 2002 to 15.2% in 2003, primarily because staff costs and research and development expenses grew faster than the growth in revenues and the incurrence of a higher level of office maintenance expenses at our previous office space in Shenzhen and consultancy expenses and VAT on inter-company software sales in 2003. See "— Road Map of Our Consolidated Profit and Loss Accounts —Taxation —Value Tax and Related Tax."

Finance income. Net finance income increased RMB1.1 million, or 122.2%, from RMB0.9 million in 2002 to RMB2.0 million in 2003. The increase principally reflected an increase in interest income of RMB1.6 million attributable to higher levels of cash being deposited in banks. The increase in interest income was partially offset by a RMB0.4 million increase in net exchange losses in 2003.

Profit before tax. As a result of the factors described above, profit before tax increased RMB194.4 million, or 135.2%, from RMB143.8 million in 2002 to RMB338.2 million in 2003. As a percentage of revenues, profit before tax decreased from 54.6% in 2002 to 46.0% in 2003, mainly because selling and marketing expenses as well as general and administrative expenses increased faster than the growth in our revenues.

Taxation. We recorded profit taxes of RMB16.0 million in 2003 compared to RMB3.1 million in 2002. Profit taxes in 2002 were lower due to the application of prior years' tax losses. For a detailed discussion of our tax holidays, see "— Road Map of Our Consolidated Profit and Loss Accounts — Taxation — Profits Tax" above.

Profit for the year. As a result of the factors discussed above, profit for the year increased RMB181.5 million, or 129.0%, from RMB140.7 million in 2002 to RMB322.2 million in 2003. As a percentage of revenues, profit for the year decreased from 53.5% in 2002 to 43.8% in 2003 primarily as a result of a higher proportional increase in expenses in 2003 as discussed above.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Revenues. Revenues increased RMB214.0 million, or 435.8%, from RMB49.1 million in 2001 to RMB263.1 million in 2002. The following table sets forth our revenues by lines of business for the years ended December 31, 2001 and 2002:

	Year ended December 31,			
	2001		2002	
	Amount	% of total revenues	Amount	% of total revenues
		(RMB in thousands)		
Internet value-added services	944	1.9%	40,819	15.5%
Mobile and telecommunications value-added services	37,960	77.3	198,818	75.6
Online advertising	7,735	15.8	19,188	7.3
Others	2,437	5.0	4,282	1.6
Total revenues	49,076	100.0%	263,107	100.0%

Revenues from Internet value-added services increased RMB39.9 million, or 4,433.3%, from RMB0.9 million in 2001 to RMB40.8 million in 2002. We increased our revenues in 2002 as we started to charge fees for our IM services in March 2002. In 2001, revenues from Internet value-added services were mostly activation fees for the basic online accounts.

Revenues from mobile and telecommunications value-added services increased RMB160.8 million, or 423.2%, from RMB38.0 million in 2001 to RMB198.8 million in 2002. The increase reflected the significant growth in fee-based mobile and telecommunications value-added services provided directly by us or through mobile operators from 1.4 million registered subscriptions as of December 31, 2001 to 5.6 million registered subscriptions as of December 31, 2002. In addition, we began recognizing revenues from our Feichang QQ Nannu mobile chat services in December 2001 and from our mobile content services in February 2002.

Revenues from online advertising increased RMB11.5 million, or 149.4%, from RMB7.7 million in 2001 to RMB19.2 million in 2002. Our revenues from online advertising increased in 2002 due to the increased number of contracts and increased advertising service pricing.

Revenues from other services increased RMB1.9 million, or 79.2%, from RMB2.4 million in 2001 to RMB4.3 million in 2002. The increase reflected a considerable increase in our revenues from licensing our trademarks to consumer product manufacturers.

Cost of revenues. Cost of revenues increased RMB53.7 million, or 298.3%, from RMB18.0 million in 2001 to RMB71.7 million in 2002. As a percentage of revenues, cost of revenues decreased from 36.8% in 2001 to 27.2% in 2002 as our revenues grew significantly in 2002.

The following table sets forth our cost of revenues by lines of business for the years ended December 31, 2001 and 2002:

	Year ended December 31,			
	2001		2002	
	Amount	% of segment revenues	Amount	% of segment revenues
	(RMB in thousands)			
Internet value-added services	4,223	447.4%	14,848	36.4%
Mobile and telecommunications value-added services	10,801	28.5	49,856	25.1
Online advertising	3,020	39.0	6,970	36.3
Total cost of revenues	18,044		71,674	

Cost of revenues for our Internet value-added services increased RMB10.6 million, or 252.4%, from RMB4.2 million in 2001 to RMB14.8 million in 2002, as we started the commercial operations of our Internet value-added services in 2002. Cost of revenues for our Internet value-added services in 2001 was mostly incurred in connection with the trial phase of our Internet value-added services and products.

Cost of revenues for our mobile and telecommunications value-added services increased RMB39.1 million, or 362.0%, from RMB10.8 million in 2001 to RMB49.9 million in 2002. The increase mainly reflected the increase in the amount of fees retained by mobile operators for their share of revenues and imbalance fees, which in turn increased in line with the growth in our revenues from the services provided through those operators. As a percentage of revenues generated from the same segment, cost of revenues decreased from 28.5% for 2001 to 25.1% for 2002 mainly due to the proportionately higher growth of revenues in 2002.

Cost of revenues for online advertising increased RMB4.0 million, or 133.3%, from RMB3.0 million in 2001 to RMB7.0 million in 2002. The increase reflected the overall growth in our advertising sales and the increased advertising agency commissions paid to third parties as we entered into contracts with larger corporate accounts, for which we generally pay higher commission rates. In addition, staff costs for our online advertising increased as we recruited more development and technical staff to support our online advertising business. As a percentage of revenues generated from the same segment, however, cost of revenues decreased from 39.0% for 2001 to 36.3% for 2002 mainly due to proportionately higher growth of revenues in 2002.

Other operating expenses. Other operating expenses increased RMB0.1 million, or 100.0%, from RMB0.1 million in 2001 to RMB0.2 million in 2002.

Selling and marketing expenses. Selling and marketing expenses increased RMB15.1 million, or 351.2%, from RMB4.3 million in 2001 to RMB19.4 million in 2002. The increase principally reflected our increased promotion and advertising efforts in 2002 to further establish the Tencent and QQ brand among consumers and also our increased marketing activities as we launched several new services in 2002. As a percentage of revenues, selling and marketing expenses decreased from 8.8% in 2001 to 7.4% in 2002 due to the proportionately higher growth of our revenues in 2002.

General and administrative expenses. General and administrative expenses increased RMB12.6 million, or 77.3%, from RMB16.3 million in 2001 to RMB28.9 million in 2002. The increase principally reflected increased consulting fees, office lease expenses and staff costs to support our business expansion in 2002. Our communications costs and travel and entertainment costs also increased as we expanded our businesses.

We spent RMB7.8 million in 2002 compared to RMB5.6 million in 2001 on research and development activities. Most of our research and development efforts in 2002 focused on further development of our core IM technologies and the development of the RTX software.

As a percentage of revenues, general and administrative expenses decreased from 33.2% in 2001 to 11.0% in 2002 due to the proportionately higher growth of our net revenues in 2002.

Finance (expenses)/income, net. We recorded net finance income of RMB0.9 million in 2002 compared to net finance expenses of RMB0.1 million in 2001. The improvement was principally due to the repayment of short-term bank loans in January 2001 and the conversion of convertible notes in June 2001 for which we incurred an aggregate interest expense of RMB0.6 million in 2001 and also reflected an increase in interest income of RMB0.5 million attributable to higher levels of cash being deposited in banks. The improvement in net interest income was partially offset by a net exchange loss of RMB31,000 for 2002 compared to a net exchange gain of RMB0.1 million for 2001.

Profit before tax. Profit before tax increased RMB133.6 million, or 1,309.8%, from RMB10.2 million in 2001 to RMB143.8 million in 2002. The increase principally reflected the increase in revenues.

Taxation. In 2001, we did not incur any profits taxes as a result of utilizing previous years' tax losses. In 2002, the provision for taxation was mainly for deferred tax liabilities of RMB3.1 million for the additional tax liabilities of the Company in connection with the payments to be made from Tencent Computer to Tencent Technology pursuant to the Structure Contracts, which payments were subsequently made in 2003. See "— Road Map of Our Consolidated Profit and Loss Accounts — Taxation — Profits Tax" above for a detailed discussion of the various tax holidays applicable to us.

Profit for the year. As a result of the various factors discussed above, profit for the year increased RMB130.5 million, or 1,279.4%, from RMB10.2 million in 2001 to RMB140.7 million in 2002. As a percentage of revenues, profit for the year increased from 20.8% in 2001 to 53.5% in 2002 primarily as a result of a higher proportional increase in revenues in 2002 as discussed above.

Consolidated Quarterly Results of Operations

The following table sets forth our consolidated quarterly results of operations for each of the five quarters ended March 31, 2004. We believe such consolidated quarterly results of operations may be useful for investors to understand the most recent trends of our business and operations. The consolidated quarterly results of operations for the three months ended March 31, 2003 and 2004 are derived from our audited consolidated financial statements set forth in the accountants' report included in Appendix I to this Prospectus. The historical quarterly results of operations for the three quarters ended June 30, September 30 and December 31, 2003 are unaudited. We believe that the unaudited historical quarterly results of operations have been prepared on the same basis as the audited consolidated financial statements set forth in the accountants' report included in Appendix I to this Prospectus, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts below to present fairly the consolidated quarterly results of operations. Our results of operations have varied and will continue to vary from quarter to quarter and therefore are not necessarily indicative of our results of operations for the full year or for any future period. Please see the section entitled "Risk Factors". You should read the consolidated quarterly results of operations together with our audited consolidated financial statements and the notes thereto included in the accountants' report included in Appendix I to this Prospectus.

	Three months ended				
	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003	March 31, 2004
	(audited)	(unaudited)	(unaudited)	(unaudited)	(audited)
			(RMB in thousands)		
Revenues:					
Internet value-added services	33,012	47,898	70,608	78,172	104,586
Mobile and telecommunications value-added services	84,297	115,086	125,798	142,188	142,817
Online advertising	6,818	8,529	7,720	9,774	8,215
Others	866	646	1,931	1,614	1,935
Total revenues	124,993	172,159	206,057	231,748	257,553
Cost of revenues	(36,339)	(51,437)	(66,978)	(74,794)	(87,368)
Gross profit	88,654	120,722	139,079	156,954	170,185
Other operating profit/(losses), net	36	(1,182)	35	(115)	18
Selling and marketing expenses	(12,313)	(10,970)	(15,255)	(17,429)	(23,044)
General and administrative expenses	(16,652)	(22,502)	(32,384)	(40,473)	(34,074)
Profit from operations	59,725	86,068	91,475	98,937	113,085
Finance (expenses)/income, net	(257)	494	1,196	571	931
Profit before tax	59,468	86,562	92,671	99,508	114,016
Taxation	(2,123)	(4,342)	(4,531)	(5,017)	(6,712)
Profit for the period	57,345	82,220	88,140	94,491	107,304

Our present intention is to make voluntary disclosure of our unaudited quarterly results following the Listing.

Three Months Ended March 31, 2004 (Audited) Compared to Three Months Ended March 31, 2003 (Audited)

Revenues. Revenues increased RMB132.6 million, or 106.1%, from RMB125.0 million in the three months ended March 31, 2003 to RMB257.6 million in the three months ended March 31, 2004.

Revenues from our Internet value-added services increased RMB71.6 million, or 217.0%, from RMB33.0 million in the three months ended March 31, 2003 to RMB104.6 million in the three months ended March 31, 2004. The significant increase in revenues reflected the growth in our fee-based Internet value-added services from 3.5 million registered subscriptions as of March 31, 2003 to 7.3 million registered subscriptions as of March 31, 2004. Growth in our premium IM services, QQ Membership and QQ Xing, increased significantly in the second half of 2003 through various promotional activities and enhanced functionalities. As our subscriber base grew, we were also able to increase revenues from fees for new services, including QQ Show, E-Cards and MMOG after the first quarter of 2003.

Revenues from mobile and telecommunications value-added services increased RMB58.5 million, or 69.4%, from RMB84.3 million in the three months ended March 31, 2003 to RMB142.8 million in the three months ended March 31, 2004. The increase in revenues reflected the growth in fee-based mobile and telecommunications value-added services provided directly by us or through mobile operators from 7.9 million registered subscriptions as of March 31, 2003 to 12.8 million registered subscriptions as of March 31, 2004. Growth of 161 Mobile Chat and the expansion of our music and picture/image downloading services also contributed to the increase in revenues from mobile and telecommunications value-added services.

Revenues from online advertising increased RMB1.4 million, or 20.6%, from RMB6.8 million in the three months ended March 31, 2003 to RMB8.2 million in the three months ended March 31, 2004. The increase in revenues primarily reflected the increase in pricing of advertisements.

Revenues from other services increased RMB1.0 million, or 111.1%, from RMB0.9 million in the three months ended March 31, 2003 to RMB1.9 million in the three months ended March 31, 2004. The increase in revenues reflected sales of RTX which was commercially launched in September 2003 and the increase in our revenues from trademark licensing income.

Cost of revenues. Cost of revenues increased RMB51.1 million, or 140.8%, from RMB36.3 million in the three months ended March 31, 2003 to RMB87.4 million in the three months ended March 31, 2004. The increase principally reflected the increases in telecommunications operators' revenue share and imbalance fees and staff costs directly attributable to our services and products. As a percentage of revenues, cost of revenues increased from 29.1% in the three months ended March 31, 2003 to 33.9% in the three months ended March 31, 2004 as certain services with higher revenue shares for telecommunications operators contributed to a larger portion of our product mix.

Selling and marketing expenses. Selling and marketing expenses increased RMB10.7 million, or 87.0%, from RMB12.3 million for the three months ended March 31, 2003 to

RMB23.0 million for the three months ended March 31, 2004. The increase principally reflected increases in promotional and advertising activities and related staff costs as we had more products and services to promote. As a percentage of revenues, selling and marketing expenses decreased from 9.9% in the three months ended March 31, 2003 to 8.9% in the three months ended March 31, 2004, mainly due to the faster growth in revenues than the increases in selling and marketing expenses.

General and administrative expenses. General and administrative expenses increased RMB17.4 million, or 104.2%, from RMB16.7 million for the three months ended March 31, 2003 to RMB34.1 million for the three months ended March 31, 2004. The increase reflected the increase in research and development expenses from RMB3.8 million for the three months ended March 31, 2003 to RMB12.5 million for the three months ended March 31, 2004 as a result of an increase in the number of research and development staff and technical personnel supporting our overall business. Staff costs also increased as a result of a higher number of staff and salary increases. In the three months ended March 31, 2004, we recorded RMB2.1 million for net VAT paid on inter-company software sales.

Taxation. We recorded profit taxes of RMB6.7 million in the three months ended March 31, 2004 compared to RMB2.1 million in the three months ended March 31, 2003. For a detailed discussion of our tax holidays, see "—Road Map of Our Consolidated Profit and Loss Accounts—Taxation—Profits Tax" above.

Profit for the period. As a result of the factors discussed above, profit for the period increased RMB50.0 million, or 87.3%, from RMB57.3 million for the three months ended March 31, 2003 to RMB107.3 million for the three months ended March 31, 2004. As a percentage of revenues, profit for the period decreased from 45.9% for the three months ended March 31, 2003 to 41.7% for the three months ended March 31, 2004 primarily as a result of a higher proportional increase in cost of revenues in the three months ended March 31, 2004 as discussed above.

Liquidity and Capital Resources

On a consolidated basis, we currently fund our operations primarily from operating cash flow. Our cash requirements relate primarily to:

- our working capital requirements, such as staff costs, bandwidth leasing and server custody fees, sales and marketing expenses, research and development, and
- costs associated with the expansion of our business, such as the purchase of servers.

We had cash and cash equivalents of RMB329.3 million as of March 31, 2004, RMB325.6 million as of December 31, 2003, RMB45.3 million as of December 31, 2002 and RMB39.7 million as of December 31, 2001.

In the opinion of our Directors, the working capital available to our Group is sufficient for its present requirements, that is for at least the next 12 months from the date of this Prospectus. In addition, we believe the contractual arrangements provide for sufficient transfer of funds to satisfy the working capital needs of the Company, the WFOEs, Tencent Computer and Shiji Kaixuan on a non-consolidated basis.

Since the Company's establishment, Tencent Computer has endeavored to transfer to Tencent Technology all of its surplus cash after taking into account its forecast working capital needs, capital expenditures and other short-term anticipated expenditures. These payments have been made as fees paid to the Company under various consultancy services contracts and as payments made to Tencent Technology under several software sales contracts. Tencent Computer has never made any cash distributions or distributions in kind of its profits to its shareholders.

In early 2004, each of Tencent Computer and Shiji Kaixuan entered into various domain name and trademark licenses, software sales and consultancy services contracts with the Company and the WFOEs. These contracts are designed to facilitate the payment to the Company and the WFOEs of the surplus cash generated by each of Tencent Computer and Shiji Kaixuan after taking into account Tencent Computer's and Shiji Kaixuan's forecast working capital needs, capital expenditures and other short-term anticipated expenditures. Tencent Computer and Shiji Kaixuan will make payments under these contracts primarily to Tencent Technology and Shidai Zhaoyang Technology. These payments made by Tencent Computer and Shiji Kaixuan will constitute most of the income of the Tencent Technology and Shidai Zhaoyang Technology. Each of Tencent Technology and Shidai Zhaoyang Technology may pay this income, after deduction of expenses and taxes, as dividends to its sole shareholder, which is a wholly owned subsidiary of the Company.

The ratio of current assets to current liabilities was 6.1 times as of March 31, 2004, 4.7 times as of the end of 2003, 13.8 times as of the end of 2002 and 2.8 times as of the end of 2001. The ratio as of the end of 2002 was higher than that as of the end of 2001 due to the relatively high level of term deposits and cash and cash equivalents balances maintained by the Group as of December 31, 2002, reflecting the positive cash flow generated from improved operating results during 2002. Although current assets, including cash and cash equivalents, continued to increase in 2003 and in the three months ended March 31, 2004, current liabilities also increased significantly, reflecting the increased scale of operations of the Group and the ratio of current assets to current liabilities as of the end of 2003 and as of March 31, 2004 decreased as compared to that as of the end of 2002.

The debtor turnover days, which are calculated by the amount of accounts receivable at the end of the period/year divided by the amount of revenues for the period/year multiplied by the number of days in the period, were 63 days in 2001, 82 days in 2002, 50 days in 2003 and 47 days in the three months ended March 31, 2004. The mobile operators generally make payments to the Group 30 to 90 days after services were rendered, which turnover period is considered normal for the type of transactions conducted by the Group in the PRC. The turnover ratio for 2002 was comparatively higher than 2001 and 2003 and the three months ended March 31, 2004 as the Group expanded its services to certain cities and provinces of the PRC in cooperation with the local subsidiaries and branches of the mobile operators in these areas in 2002. The Group had to incur relatively longer time to reconcile the payments with these operators which had led to a relatively longer turnover period than in 2001, 2003 and in the three-month period ended March 31, 2004.

Cash Flow

The following table sets forth our cash flow information for the three years ended December 31, 2003 and for the three months ended March 31, 2003 and 2004:

	Year ended December 31,			Three months ended March 31,	
	2001	2002	2003	2003	2004
	(RMB in thousands)				
Net cash generated from operating activities	20,756	91,759	352,409	47,707	57,288
Net cash used in investment activities	(11,061)	(95,147)	(23,888)	(3,422)	(26,570)
Net cash generated from/(used in) financing activities	8,119	8,919	(48,189)	(10,334)	(26,972)
Cash and cash equivalents at beginning of year/period	21,909	39,723	45,254	45,254	325,586
Cash and cash equivalents at end of year/period	39,723	45,254	325,586	79,205	329,332

The increase in cash generated from operating activities in 2003 compared to 2002 primarily reflected increased profit for the year and an increase in other payables and accruals and other taxes payable, partially offset by an increase in accounts receivable.

Our accounts receivable have steadily increased in 2002 and 2003, primarily due to an increase in our revenues. The increase in taxes payable in 2003 was due to the profits tax provision on taxable profits of Tencent Technology and business tax and VAT payable on revenues derived by Tencent Technology and Tencent Computer. The increase in other payables and accruals in 2003 was due to increased provision made for staff costs and related welfare expenses and general and administrative expenses. On the other hand, we did not have any trade payable balances as of December 31, 2001, 2002 and 2003 and March 31, 2004 as we settled our outstanding balances before each year-end.

Cash used in investing activities in 2002 and 2003 reflect the purchase of a large amount of computer equipment in connection with the expansion of our business in each of those two years. In 2002, our cash used in investing activities was also affected by our deposit of cash in term deposits with initial terms of over three months, which are categorized as investments because of the longer maturity of the deposits. Those deposits were made as part of our cash management program, and in 2003 a portion of those deposits were moved to current deposit accounts.

We used RMB48.2 million of cash in financing activities in 2003 compared to cash generated from financing activities of RMB8.9 million in 2002 and RMB8.1 million in 2001. In 2003, the Company applied RMB37.9 million to redeem ordinary shares from certain of our shareholders and paid dividends of RMB10.3 million to shareholders. Cash generated from financing activities for 2001 and 2002 reflected the receipt of consideration of RMB8.9 million each year for the issuance of ordinary shares. Cash generated from the issuance of ordinary shares in 2001, however, was partially offset by the repayment of short-term bank loans of RMB0.8 million in January 2001.

As of March 31, 2004, we had a RMB17.7 million contractual commitment to acquire fixed assets. We spent approximately RMB50.8 million for the year ended December 31, 2003 and RMB13.3 million for the three months ended March 31, 2004 for computer hardware and software. As our business grows, we plan to spend approximately RMB72.1 million in 2004 towards purchases of additional computer hardware and software in order to accommodate the expected increase in the use of our IM services and the traffic on our websites.

As of March 31, 2004, we had lease commitments for office rentals of RMB15.4 million payable within one year and RMB31.7 million payable after one year and within five years. In December 2003, we signed a three-year lease for new office space in Shenzhen, which has been reflected in the lease commitment amounts as of March 31, 2004. We moved to the new office space in May 2004 and we plan to terminate our previous lease commitment in Shenzhen but do not expect to incur any material expense in connection with the termination. In addition, we currently expect leasehold improvements amounting to approximately RMB13.4 million to be made for the new office space in 2004.

As of March 31, 2004, we had commitments for bandwidth leasing of RMB52.1 million.

Except as indicated above, we do not have any other material commitments.

Shareholders' Equity

As of March 31, 2004, our consolidated shareholders' equity was RMB550.3 million.

As of December 31, 2001, the amount of shareholders' equity reported at the Company-only level was higher than the amount reported for our consolidated accounts, including Tencent Technology and Tencent Computer. However, the Company concluded that it was not necessary to make provisions for impairment loss against the investment and current account amounts maintained with these two companies by the Company as of December 31, 2001. The core operations of the Group have been substantially undertaken by these two companies for the three years ended December 31, 2003 and the three months ended March 31, 2004, from which the economic benefits of the whole Group are derived. As a result, the Company does not expect to encounter any recoverability problem associated with the balances.

Net Current Assets as at the Latest Practicable Date

As of April 30, 2004, the consolidated net current assets of the Group were approximately RMB496 million. The key components include cash and cash equivalents of approximately RMB348 million, term deposits with initial term of over three months of approximately RMB43 million, prepayments, deposits and other receivables of approximately RMB63 million, and accounts receivable of approximately RMB129 million, net of other payables and accruals of approximately RMB80 million and income and other taxes payable of approximately RMB7 million. The term deposits were placed with banks for earning interest income from surplus cash retained by the Group. In the opinion of our Directors, the working capital available to our Group is sufficient for its present requirements, that is for at least the next 12 months from the date of this Prospectus. Although we have not approved any specific plans, we intend to use our cash and cash equivalents and term deposits to pursue and finance new strategic initiatives and to organically grow and expand the existing business. To the extent that we do not use our cash and cash equivalents and term deposits for such purposes, we will continue to hold the unused amounts or distribute them to Shareholders.

Quantitative and Qualitative Disclosure about Market Risk

Interest Rate Risk

Our income and operating cash flow are substantially independent of changes in market interest rate. We currently do not have any interest-bearing borrowings. Our exposure to market rate risk for changes in interest rates relates primarily to the interest income generated by our excess cash invested in short-term money market accounts and certificates of deposit. We have not used interest rate swaps to hedge our exposure because we consider our interest rate risk to be minimal. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates. However, our future interest income may fall short of expectations due to changes in interest rates.

Foreign Currency Exchange Risk

As substantially all of our revenues and most of our expenses are denominated in Renminbi, to date, we have not had any material foreign exchange gains or losses in connection with our operations. A large portion of our cash, however, is held in deposits denominated in U.S. dollars in order to facilitate remittance of funds outside of the PRC. We held cash in bank and short-term deposits of RMB128.9 million and RMB75.7 million denominated in U.S. dollars as of December 31, 2003 and March 31, 2004, respectively, and such U.S. dollar denominated deposits incurred an exchange loss of RMB0.4 million and an exchange gain of RMB0.1 million for the year ended December 31, 2003 and the three months ended March 31, 2004, respectively. We have not used any forward contracts, currency borrowings or other means to hedge our exposure because we consider our foreign currency exchange risk to be minimal. However, we may experience economic loss as a result of any foreign currency exchange rate fluctuations in connection with our operations or our deposits.

INDEBTEDNESS STATEMENT

As of the close of business on April 30, 2004, being the latest practicable date for the purpose of this indebtedness statement prior to the publication of this Prospectus, we did not have any outstanding loan capital issued or agreed to be issued, bank overdrafts, loans, debt securities, borrowings or other similar indebtedness, liabilities under acceptance (other than normal trade bills) or acceptance credits, debentures, mortgages, charges, finance leases or hire purchase commitments or other material contingent liabilities.

CONTINGENT LIABILITY STATEMENT

As at the close of business on April 30, 2004, being the latest practicable date for the purpose of this contingent liability statement prior to the publication of this Prospectus, we did not have any material contingent liabilities or guarantees.

PROFIT FORECAST FOR THE YEAR ENDING DECEMBER 31, 2004

We forecast that, on the bases and assumptions set out in Appendix II to this Prospectus and in the absence of unforeseen circumstances, our consolidated profit attributable to shareholders for the year ending December 31, 2004 will not be less than RMB444 million. The profit forecast of the Group has been prepared by Directors based on the audited accounts of the Group for the three-month period from January 1, 2004 to March 31, 2004, the unaudited management accounts of the Group for the month of April, 2004 and the forecast results of the Group for the remaining eight-month period from May 1, 2004 to December 31, 2004. At present, we are not aware of, nor do we expect, any extraordinary items which have arisen or are likely to arise in respect of the forecast period.

Please refer to Appendix II of the Prospectus for details.

PROSPECTIVE 2004 BASIC EARNINGS PER SHARE

On the basis of the above profit forecast and assuming a weighted average number of 1,680,641,260 Shares expected to be issued and outstanding during 2004 (assuming the Offering had taken place on January 1, 2004, the Over-allotment Option and the options granted under Pre-IPO Share Option Scheme are not exercised, and taking no account of options which may be granted under the Share Option Scheme), our prospective earnings per Share is approximately RMB0.26/HK$0.25 for the year ending December 31, 2004.

DIVIDENDS AND DIVIDEND POLICY

In January 2003, the Board of Directors declared and the Company paid a dividend in the aggregate amount equal to RMB10.3 million, or equal to RMB0.008 per ordinary share (post share-splits). In addition, in January 2004, the Board of Directors declared and the Company paid a dividend in the aggregate amount equal to RMB28.9 million, or equal to RMB0.023 per ordinary share (post-share splits). The Company has not declared any dividends in the past three years and the three months ended March 31, 2004 other than the dividends described above.

The Company currently intends to pay annual cash dividends of not less than 10% of our consolidated profit attributable to shareholders for the applicable year. However, the determination to pay such dividends will be made at the discretion of our Board of Directors and will be based upon our earnings, cash flow, financial condition, capital requirements, statutory fund reserve requirements and any other conditions that our Board of Directors deems relevant. The payment of dividends may be limited by legal restrictions and by financing agreements that we may enter into in the future.

DISTRIBUTABLE RESERVES

The Company's distributable reserves consist of the share premium, capital reserve and retained earnings. Under the Companies Law, the share premium account is distributable to the Shareholders if immediately following the date on which the dividend is proposed to be distributed, the Company will be in a position to pay off its debts as they fall due in the ordinary course of business.

As of March 31, 2004, the Company, on a non-consolidated basis, had RMB113.8 million in reserves available for distribution to Shareholders.

NO MATERIAL ADVERSE CHANGE

We confirm that there is no material adverse change in our financial or trading position since March 31, 2004 (being the date to which our latest consolidated financial results were prepared as set forth in the accountants' report in Appendix I to this Prospectus).

UNAUDITED PRO FORMA NET TANGIBLE ASSETS

The following statement of unaudited pro forma net tangible assets of the Group is based on the audited consolidated net assets of the Group as at March 31, 2004, as shown in the accountants' report, the text of which is set out in Appendix I to this Prospectus, and adjusted as follows:

	Audited net tangible assets of the Group as at March 31, 2004	Estimated net proceeds from the Offering	Unaudited pro forma net tangible assets	Unaudited pro forma net tangible assets per Share	
		(Note 1)		(Note 2)	
	RMB'000	RMB'000	RMB'000	RMB	HK$
Based on an Offer Price of HK$2.77 per Share . . .	550,326	1,134,720	1,685,046	1.00	0.95
Based on an Offer Price of HK$3.70 per Share . . .	550,326	1,532,347	2,082,673	1.24	1.17

Notes:

(1) The estimated net proceeds from the Offering are based on the Offer Price of HK$2.77/HK$3.70 per Share, after deduction of the underwriting fees and other related expenses payable by the Company. No account has been taken of the Shares which may be issued pursuant to any exercise of Over-allotment Option or pursuant to any exercise of options which have been granted under the Pre-IPO Share Option Scheme or which may be granted under the Share Option Scheme. If the Over-allotment Option is exercised in full, the pro forma adjusted net tangible asset value per Share will be increased.

(2) The unaudited pro forma net tangible asset value per Share is arrived at after the adjustments referred to in the preceding paragraph and on the basis that 1,680,641,260 Shares are in issue and that the Over-allotment Option is not exercised.

DISCLOSURE REQUIRED UNDER THE LISTING RULES

We have confirmed that as of April 30, 2004, we are not aware of any circumstance that would give rise to a disclosure requirement under Rules 13.11 to 13.22 of Chapter 13 of the Listing Rules.