

General

This following analysis should be read in conjunction with the information in the audited financial statements contained in this annual report. The information presented below interprets the Company's financial statements prepared in accordance with IFRS.

The information set out in this management discussion and analysis does not form part of the financial statements audited by KPMG, the auditors of the Company, and is included for information purposes only.

Overview

The Company is one of the largest producers of ethylene, resins and plastics in the PRC. The vast majority of the Company's products fall within three principal product groups: (i) resins and plastics, (ii) synthetic rubber, and (iii) basic organic chemical products. In 2004, the Company accounted for approximately 12.8% of the total ethylene production in the PRC. The Company is a leading producer in the PRC of LDPE, cis-polybutadiene rubber, butyl rubber, phenol, acetone, SBS and polypropylene.

All of the Company's products are used in the production of a wide range of manufactured products, such as housewares, household electric appliances, toys, packaging materials and tires. Accordingly, the Company is subject to broad changes in the Chinese economy and benefits from China's consistently strong economic growth, but generally does not suffer from cyclical or other downturns in any particular segment of the economy. However, the Company is sensitive to price fluctuations in crude oil, which directly affect the prices it pays for raw materials.

The Company's principal raw material is cracking feedstock, substantially all of which is purchased from the Parent Company. The Company mainly uses light industrial oil as its cracking feedstock. The Company also uses naphtha, and VGO, cracking wax oil, and hydrogenated raffinate oil, which the Company developed and uses as substitutes of light industrial oil. Since the establishment of the Sinopec Group in 1998, prices of light industrial oil and naphtha have been determined jointly by the National Development and Reform Commission of the PRC and the Sinopec Group. During the Reporting Period, the average state price of light industrial oil fluctuated in line with the crude oil price and such average state price of light industrial oil for 2004 increased by 17.9%, as compared with the price in 2003. This increase has put pressure on the Company's margins.

Since the costs of raw materials are effectively beyond the Company's control, the Company generally seeks to increase profits by a combination of increased production volume, more efficient use of raw materials through more efficient procedures and technologies, by shifting production into higher margin products, and by strengthening its marketing efforts, particularly to minimize the lag between changes in customer demand and changes in the Company's production. During the Reporting Period, the Company organized the production carefully and guaranteed the high operational capabilities of its principal production facilities. Therefore, the production capacity for ethylene has increased even without major capital investment. These factors, together with strong price increases for the Company's products, more than offsetted the rise in raw material prices, resulting in positive results for 2004.



*Mr. Xu Hongxing
Executive Director
and General Manager*

Critical Accounting Policies

The Company's critical accounting policies are set out in note 2 of its financial statements. IFRS require that the Company adopts the accounting policies and estimation techniques that are most appropriate in the circumstances for the purpose of giving a true and fair view of its results and financial condition. However, different policies, estimation techniques and assumptions in critical areas could lead to materially different results. In particular:

a. Impairments

If circumstances indicate that the net book value of an asset may not be recoverable, this asset may be considered "impaired", and an impairment loss may be recognized in accordance with IAS 36 "Impairment of Assets". The carrying amounts of long-lived assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to recoverable amount. The amount of impairment loss is the difference between the carrying amount of the asset and its recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. It is difficult to precisely estimate selling price because quoted market prices for the Company's assets are not readily available. In determining the value in use, expected cash flows generated by the asset are discounted to their present value, which requires significant judgment in relation to sales volume, selling price and amount of operating costs.

b. Depreciation

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, after taking into account their estimated residual value. The Company reviews the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any Reporting Period. The useful lives are based on the Company's historical experience with similar assets and taking into account anticipated technological changes. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates.

c. Provision for Doubtful Debts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make the required payments. The Company bases its estimates on the aging of its accounts receivable balance, customer credit-worthiness, and historical write-off experience. If the financial condition of its customers were to deteriorate, actual write-offs might be higher than expected.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Operating Results

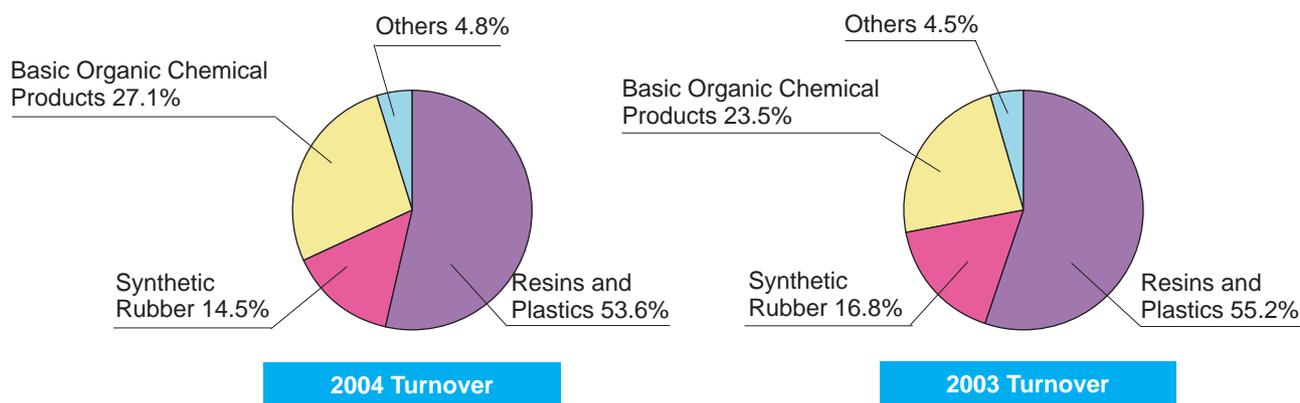
For the year ended 31 December 2004, the Company's sales increased to RMB 17,939.8 million in 2004 from RMB 11,473.9 million in 2003, representing an increase of 56.4%. This increase in sales was largely attributable to the substantial increase of the market prices of major products of the Company in 2004, with the business cycle of the petrochemical industry near its peak. Due to the substantial increase in crude oil price in the international market and the strong domestic demand for petrochemical products, petrochemical products in China maintained at a high price level in 2004, which resulted in an increase of 36.7% in the weighted average sales price of the eight principal products of the Company as compared with that of 2003 (representing 78.6% of the total sales revenue of each of 2003 and 2004). During the Reporting Period, the Company organized the production carefully and guaranteed the high operational capabilities of its principal production facilities. As a result, the production volume of the eight principal products of the Company increased and the sales volume of such products increased by approximately 14.4% in 2004 as compared with that in 2003. Therefore, the Company's sales revenue has increased by a significant margin. During the Reporting Period, the profit before taxation of the Company was RMB 4,257.3 million, a 385.4% increase in profits (in the amount of RMB 3,380.2 million) as compared with the profit before taxation of RMB 877.1 million recorded in 2003. The Company recorded a net profit of RMB 2,895.9 million in 2004, a 356.8% increase (in the amount of RMB 2,262.0 million) as compared with a net profit of RMB 633.9 million in 2003.



The following table sets forth a summary of the income statements for the years of 2004 and 2003:

	<u>2004</u> RMB'000	<u>2003</u> RMB'000
Turnover	17,939,821	11,473,928
Cost of sales	<u>(12,758,732)</u>	<u>(9,723,562)</u>
Gross profit	5,181,089	1,750,366
Selling, general and administrative expenses	(785,300)	(721,418)
Other operating (expenses)/income, net	<u>(49,035)</u>	<u>14,095</u>
Profit from operations	4,346,754	1,043,043
Net financing costs	<u>(89,500)</u>	<u>(165,936)</u>
Profit from ordinary activities before taxation	4,257,254	877,107
Income tax expense	<u>(1,361,395)</u>	<u>(243,222)</u>
Profit attributable to shareholders	<u><u>2,895,859</u></u>	<u><u>633,885</u></u>
Basic earnings per share	<u><u>RMB 0.86</u></u>	<u><u>RMB 0.19</u></u>
Basic earnings per ADS	<u><u>RMB 42.91</u></u>	<u><u>RMB 9.39</u></u>

MANAGEMENT'S DISCUSSION AND ANALYSIS



The following table sets forth a summary of the financial data of the Company for the past five years, respectively:

	<u>2004</u>	2003	2002	2001	2000
	<u>RMB'000</u>	RMB'000	RMB'000	RMB'000	RMB'000
Total assets	10,140,566	9,545,311	10,259,807	10,758,196	8,649,826
Total liabilities	1,757,575	3,889,479	5,237,860	5,945,348	3,429,551
Net assets	<u>8,382,991</u>	<u>5,655,832</u>	<u>5,021,947</u>	<u>4,812,848</u>	<u>5,220,275</u>
Turnover	<u>17,939,821</u>	<u>11,473,928</u>	<u>9,443,061</u>	<u>5,975,255</u>	<u>7,852,913</u>
Profit /(loss) from operations	<u>4,346,754</u>	<u>1,043,043</u>	<u>541,558</u>	<u>(350,644)</u>	<u>623,056</u>
Profit /(loss) attributable to shareholders	<u>2,895,859</u>	<u>633,885</u>	<u>209,099</u>	<u>(272,467)</u>	<u>358,731</u>
Dividends attributable to the year	<u>No dividend declared</u>	<u>168,700</u>	<u>No dividend declared</u>	<u>No dividend declared</u>	<u>134,960</u>

The following table sets forth the Company's turnover, net of value-added tax ("VAT"), by principal product groups for the years of 2004 and 2003:

	<u>2004</u>		<u>2003</u>	
	<u>Turnover</u>	<u>Percentage</u>	Turnover	Percentage
	<u>RMB'000</u>	<u>of Turnover</u>	RMB'000	of Turnover
Resins and Plastics	9,621,409	53.6	6,332,332	55.2
Synthetic Rubber	2,594,692	14.5	1,923,773	16.8
Basic Organic Chemical Products	4,859,694	27.1	2,700,036	23.5
Others	864,026	4.8	517,787	4.5
Total	<u>17,939,821</u>	<u>100.0</u>	<u>11,473,928</u>	<u>100.0</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table sets forth the Company's sales, net of VAT, by geographical analysis for the years of 2004 and 2003:

	2004		2003	
	Turnover (RMB Million)	Percentage of Turnover	Turnover (RMB Million)	Percentage of Turnover
Northeastern China	358.8	2.0	218.0	1.9
Northern China	10,997.1	61.3	6,586.0	57.4
Eastern China	4,951.4	27.6	3,430.7	29.9
Central-southern China	1,058.4	5.9	814.6	7.1
Northwestern China	35.9	0.2	22.9	0.2
Southwestern China	305.0	1.7	252.5	2.2
Exports	233.2	1.3	149.2	1.3
Total	<u>17,939.8</u>	<u>100.0</u>	<u>11,473.9</u>	<u>100.0</u>

The following table sets forth the percentages of total turnover of the principal operating expenses associated with the Company's business:

	2004 Percentage	2003 Percentage
Turnover	100.0	100.0
Less expenditure		
Raw materials	(52.9)	(59.2)
Utility (fuels and power) expenses	(7.4)	(10.7)
Depreciation	(5.2)	(7.8)
Wages and bonus	(2.2)	(2.5)
Other overheads	(3.8)	(5.1)
Selling, general and administrative expenses	(4.0)	(5.7)
Other operating (expenses)/income, net	<u>(0.3)</u>	<u>0.1</u>
Operating margin	<u>24.2</u>	<u>9.1</u>

Raw material expenses were the largest component of the operating expenses. In 2004 and 2003, 51.3% and 51.2%, respectively, of the cost of sales were expenses relating to purchases of cracking feedstock. In 2004, the total cracking feedstock expense was RMB 6,550.8 million, as compared with RMB 4,975.6 million in 2003, representing an increase of RMB 1,575.2 million, or 31.7%. This increase was largely due to the significant increase in the price of cracking feedstock in 2004. Along with the changes in the prices of crude oil and domestic finished oil, the price of light industrial oil, the principal raw material of the Company, increased from RMB 2,670 per ton at the beginning of 2004 to RMB 3,570 per ton (including 17% VAT) at the end of 2004, and the average price of the cracking feedstock in 2004 increased by 16.5% as compared with the price in 2003.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table sets forth the changes in the state price of light industrial oil, the principal raw material of the Company, in 2004 and 2003 (including VAT):

Unit: RMB per ton

Month Year	1	2	3	4	5	6	7	8	9	10	11	12
2003	2,575	2,765	2,765	2,765	2,475	2,475	2,475	2,475	2,475	2,475	2,475	2,670
2004	2,670	2,670	2,670	2,870	2,970	2,970	2,970	2,970	3,210	3,270	3,570	3,570

Since significant portions of the Company's expenses were either fixed (as in the case of depreciation expense for a given piece of equipment) or consisted of stable unit costs (as in the case of cracking feedstock), fluctuations in sales (particularly those principally caused by changes in sales volume) or raw material prices will cause fluctuations in profitability. In 2004, due to the large increase in the sales of the Company as well as the significant increase in the price of principal products of the Company, the operations margin of the Company increased from 9.1% in 2003 to 24.2% in 2004.

Year ended 31 December 2004 compared with year ended 31 December 2003

Turnover increased to RMB 17,939.8 million in 2004 from RMB 11,473.9 million in 2003, representing an increase of RMB 6,465.9 million, or 56.4%. The increase in the turnover was mainly due to the large increase in the prices of the principal products of the Company in 2004. Due to substantial increase of crude oil in the international market and strong demand in the domestic petrochemical market, petrochemical products in China maintained a high price level in 2004, which resulted in an increase of 36.7% in the weighted average sales price of the eight principal products of the Company as compared with that of 2003 (representing 78.6% of the total sales revenue of each of 2003 and 2004).

Sales of resins and plastics, which accounted for 53.6% of the Company's total sales, increased by approximately 51.9% from RMB 6,332.3 million in 2003 to RMB 9,621.4 million in 2004. This increase was principally attributable to the 39.9% increase in the weighted average price for resin and plastic products of the Company in 2004 as compared with that of 2003.

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Sales of synthetic rubber, which accounted for 14.5% of the Company's total sales, increased by approximately 34.9% from RMB 1,923.8 million in 2003 to RMB 2,594.7 million in 2004. This increase was primarily due to a 19.6% increase in the sale price of synthetic rubber products in 2004 as compared with that of 2003.

In 2004, sales of basic organic chemical products, which accounted for 27.1% of the Company's total sales, increased by approximately 80.0% from RMB 2,700.0 million in 2003 to RMB 4,859.7 million in 2004. This increase was primarily a result of an increase in the price of the basic organic chemical products of the Company.

Sales of other products, which accounted for 4.8% of the Company's total sales, increased by approximately 66.9% to RMB 864.0 million in 2004 from RMB 517.8 million in 2003. This increase was primarily due to the significant increase in the price of petrochemical products.

Cost of sales increased by 31.2% to RMB 12,758.7 million in 2004 up from RMB 9,723.6 million in 2003. This increase was mainly due to the increase in the prices for raw materials. The Company's gross margin increased by 196.0% from RMB 1,750.4 million in 2003 to RMB 5,181.1 million in 2004. The gross profit rose from 15.3% in 2003 to 28.9% in 2004. The main reason for this increase was that with the business cycle of the petrochemical industry near its peak, the increase in the production volume of the Company's principal products and significant rising of weighted average sales price offsetted the increase in the price of raw materials.

Selling, general and administrative expenses increased by RMB 63.9 million (8.9%) to RMB 785.3 million in 2004 from RMB 721.4 million in 2003. This increase in selling, general and administrative expenses was primarily due to a small increase in employees' wages and bonuses.

The Company's profit from operations in 2004 was RMB 4,346.8 million, representing an increase of 316.7% when compared with the RMB 1,043.0 million from operations in 2003. The Company's operating margin increased to 24.2% in 2004, as compared with 9.1% in 2003. The increase in operating margin reflected the realization of the benefits from the economies of scale of the Company and the control of costs and expenses.

Net financing costs in 2004 decreased by RMB 76.4 million from RMB 165.9 million in 2003 to RMB 89.5 million in 2004. This decrease was primarily due to the repayment of certain bank loans in 2004 along with the increase of cash generated from operating activities and the corresponding significant decrease in expenditure of loan interest.

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In 2004, the Company recorded a profit before taxation of RMB 4,257.3 million, representing an increase of 385.4% when compared with the profit before taxation of RMB 877.1 million in 2003. The Company's net profit for 2003 was RMB 633.9 million, and the net profit for 2004 was RMB 2,895.9 million, representing an increase of 356.8% when compared with that of 2003. The net profit margin for 2004 increased to 16.1% as compared with 5.5% for 2003.

Liquidity and Capital Resources

The Company has principally relied on cash generated from operating activities, bank loans and share capital to finance its capital expenditures and working capital.

The Company's net cash flow derived from operating activities is generally much higher than its net profit, mainly due to substantial depreciation. In 2004, the Company's net cash flow from operating activities was RMB 3,200.1 million, with an increase of RMB 1,583.5 million as compared with the RMB 1,616.6 million net cash flow in 2003. The net cash flow in 2004 was adjusted primarily by profit before taxation of RMB 4,257.3 million and depreciation expenditure of RMB 931.6 million. As of 31 December 2004, the accounts receivable and bills receivable of the Company amounted to RMB 864.9 million, equivalent to a sales volume of approximately 17 days in 2004.

In 2004, the net cash used in investing activities amounted to RMB 440.3 million. These were mainly used in technical improvement for various production facilities and purchase of certain equipment, which guaranteed the high operational capacities of the Company's principal production facilities during the Reporting Period.

The Company's short-term and long-term loans are primarily obtained from PRC financial institutions. In 2004, the Company repaid a total of RMB 1,590.0 million of its short-term loans and RMB 1,083.5 million of its long-term loans, while it borrowed RMB 620.0 million in short-term loans and RMB 182.1 million in long-term loans. As of 31 December 2004, the Company's total loans taken from banks were RMB 813.4 million (including RMB 100 million in short-term loans and RMB 9.2 million in long-term loans due within one year), a 69.7% decrease from the RMB 2,684.8 million in bank loans (including RMB 1,070.0 million in short-term loans and RMB 18.4 million in long-term loans due within one year) as of 31 December 2003. This was primarily due to the substantial decrease in bank loans resulting from repayment, an increase in the cash generated from operating activities, and a decrease in cash expenditure for investment as the Company did not carry out any major project involving capital expenditure in 2004.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Company expects to incur capital expenditures of RMB 400.0 million in 2005, of RMB 400.0 million in 2006 and of RMB 500.0 million in 2007. These capital expenditures will mainly be used for the technical improvement projects of the Company. The Company believes that its net cash flow from operating activities and new bank loans will be sufficient to cover the Company's expected capital expenditures for the above periods.

Gearing Ratio

The Company's gearing ratio was 9.7% in 2004, as compared with 47.5% in 2003. Such decrease was mainly due to the decrease in both long-term and short-term debts caused by repayment of most of the bank loans as a result of an increase in cash generated from operating activities in 2004.

The gearing ratio is calculated by dividing the total amount of both long-term and short-term bank loans by the shareholders' equity.

Dividend Policy

Following the establishment of the Company as a joint stock limited company in April 1997, the distribution of the Company's dividends is considered annually by the Board and decided by the shareholders in a general meeting. Payment of future dividends will depend upon the profits, financial conditions, future earnings and other factors of the Company.

Contingent Liabilities

As of 31 December 2004, the Company had no significant contingent liabilities.

Purchase, Sale and Investment

For the year ended 31 December 2004, there was no material purchase, sale or investment in connection with the Company's subsidiaries and associates.

Pledges of Assets

As of 31 December 2004, there was no significant pledge of assets by the Company.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Exposure to Fluctuations in Exchange Rates and Any Related Hedges

The Company is exposed to exchange rate risk primarily due to its foreign currency denominated long-term debts and, to a limited extent, its cash and cash equivalents being denominated in foreign currencies. The Company had not been engaged in any foreign currency hedging activity for the year ended 31 December 2004.

Contractual Obligations

The following table sets forth our obligations to make future payments under contracts as of 31 December 2004.

As of 31 December 2004 payment due by period

	<u>Total</u>	<u>2005</u>	<u>2006</u>
	RMB'000	RMB'000	RMB'000
Contractual obligations (1):			
Short-term debts	100,000	100,000	-
Long-term debts	<u>713,356</u>	<u>9,203</u>	<u>704,153</u>
Total contractual obligations	<u><u>813,356</u></u>	<u><u>109,203</u></u>	<u><u>704,153</u></u>

(1) Contractual obligations represent on-balance sheet contractual liability as of 31 December 2004.