

## Management Discussion and Analysis



The following discussion and analysis should be read in conjunction with the financial statements of the Group prepared under International Financial Reporting Standards ("IFRSs") as set out on pages 39 to 101. The Group also prepares financial statements in accordance with PRC Accounting Rules and Regulations as set out on pages 103 to 182. IFRSs differ in certain material respects from PRC Accounting Rules and Regulations. For a discussion of the material differences between IFRSs and PRC Accounting Rules and Regulations relating to the Group, see supplementary information on pages 183 to 185 of this Annual Report.

### BUSINESS OVERVIEW

As a result of the growth in airline market, and acquisition of the airline operations and related assets of China Northern Airlines Company ("CNA") and Xinjiang Airlines Company ("XJA"), the Group's business benefited from the increase of transport capacity, passenger volume and cargo and mail carried. Nevertheless, the Group is facing pressure on its operation due to continuing increase of jet fuel cost and intensified competition.

With effect from 21 July 2005, China began to adopt a managed floating exchange rate system based on market supply and demand of currencies, which is subject to adjustments with reference to a basket of currencies. The exchange rate of Renminbi ("RMB") would no longer be pegged to US dollar only and a more flexible exchange rate system was established. The exchange rate of US dollar and RMB was at USD1.00: RMB8.11. Because the Group finances its aircraft acquisitions mainly through finance leases or bank loans in US dollars, and there are a substantial amount of transactions and obligations denominated in US dollars in relation to its global purchase of jet fuel, lease and purchase of aviation equipment as well as major repairs, in addition to the landing fees of its international flights in the airports of other countries, the Group benefited from the RMB appreciation. RMB appreciation has brought a one-off exchange gain to the Group and reduced its operating costs which are denominated in foreign currencies. On the other hand, RMB appreciation will also present the Group with a challenge in price competition in international route operations.

According to the Notice of the National Development and Reform Commission ("NDRC") and the Civil Aviation Administration of China ("CAAC") on Issues Relating to Introduction of the Fuel Surcharge for Domestic Routes, domestic airlines imposed fuel surcharges for all the domestic routes (excluding those from the mainland PRC to Hong Kong and Macau) with effect from 1 August 2005 (based on flight time). On 16 February 2006, the NDRC and CAAC released a supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, stating that due to the rising jet fuel price, the period of imposition of fuel surcharge by airlines was extended. On 28 March 2006, the NDRC and CAAC released another supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, thereby adjusting the amount of fuel surcharges from RMB20 to RMB30 per passenger for distance flown being less than 800 kilometres, and from RMB40 to RMB60 for distance exceeding 800 kilometres, during the period temporarily from 10 April 2006 to 10 October 2006. The introduction of fuel surcharge and the extension of the duration of the same will help relieve, to a certain extent, the burden of high jet fuel cost on the Group.

## Management Discussion and Analysis (Cont'd)

### OPERATING DATA SUMMARY

The following table sets forth certain financial information and operating data by geographic region:

	For the year ended 31 December		2005 vs 2004 Increase/ (decrease)
	2005	2004	%
<b>Traffic</b>			
Revenue passenger kilometres (RPK) (million)			
– Domestic	<b>51,472</b>	29,121	76.8
– Hong Kong and Macau	<b>1,549</b>	1,203	28.8
– International	<b>8,902</b>	6,872	29.5
<b>Total</b>	<b>61,923</b>	37,196	66.5
Revenue tonne kilometres (RTK) (million)			
– Domestic	<b>5,571</b>	3,206	73.8
– Hong Kong and Macau	<b>159</b>	120	32.5
– International	<b>1,554</b>	1,337	16.2
<b>Total</b>	<b>7,284</b>	4,663	56.2
Passengers carried (thousand)			
– Domestic	<b>39,545</b>	25,002	58.2
– Hong Kong and Macau	<b>1,556</b>	1,394	11.6
– International	<b>3,018</b>	1,811	66.6
<b>Total</b>	<b>44,119</b>	28,207	56.4

## Management Discussion and Analysis (Cont'd)



## OPERATING DATA SUMMARY (cont'd)

	For the year ended 31 December		2005 vs 2004 Increase/ (decrease) %
	2005	2004	
<b>Traffic</b> (cont'd)			
Cargo and mail carried (thousand tonnes)			
– Domestic	639	442	44.6
– Hong Kong and Macau	19	15	26.7
– International	117	88	33.0
<b>Total</b>	<b>775</b>	<b>545</b>	<b>42.2</b>
<b>Capacity</b>			
Available seat kilometres (ASK) (million)			
– Domestic	72,107	41,330	74.5
– Hong Kong and Macau	2,656	1,896	40.1
– International	13,598	10,543	29.0
<b>Total</b>	<b>88,361</b>	<b>53,769</b>	<b>64.3</b>
Available tonne kilometres (ATK) (million)			
– Domestic	8,352	4,773	75.0
– Hong Kong and Macau	315	211	49.3
– International	2,842	2,462	15.4
<b>Total</b>	<b>11,509</b>	<b>7,446</b>	<b>54.6</b>
<b>Load factor</b>			
Passenger load factor (RPK/ASK) (%)			
– Domestic	71.4	70.5	1.3
– Hong Kong and Macau	58.3	63.4	(8.0)
– International	65.5	65.2	0.5
Overall	70.1	69.2	1.3
Overall load factor (RTK/ATK) (%)			
– Domestic	66.7	67.2	(0.7)
– Hong Kong and Macau	50.4	56.9	(11.4)
– International	54.7	54.3	0.7
Overall	63.3	62.6	1.1

## Management Discussion and Analysis (Cont'd)

### OPERATING DATA SUMMARY (cont'd)

	For the year ended 31 December		2005 vs 2004 Increase/ (decrease)
	2005	2004	%
<b>Yield</b>			
Yield per RPK (RMB)			
– Domestic	<b>0.55</b>	0.58	(5.2)
– Hong Kong and Macau	<b>0.77</b>	0.92	(16.3)
– International	<b>0.56</b>	0.46	21.7
Overall	<b>0.55</b>	0.57	(3.5)
<b>Yield per RTK (RMB)</b>			
– Domestic	<b>5.30</b>	5.53	(4.2)
– Hong Kong and Macau	<b>8.18</b>	9.83	(16.8)
– International	<b>4.24</b>	3.31	28.1
Overall	<b>5.14</b>	5.01	2.6
<b>Fleet</b>			
Total number of aircraft at year end			
– Boeing	<b>140</b>	137	2.2
– Airbus	<b>71</b>	46	54.3
– McDonnell Douglas	<b>36</b>	35	2.9
– Others	<b>14</b>	13	7.7
Total	<b>261</b>	231	13.0
<b>Overall utilisation rate (hours per day)</b>			
– Boeing	<b>10.1</b>	10.0	1.0
– Airbus	<b>9.3</b>	9.2	1.1
– McDonnell Douglas	<b>8.9</b>	–	Not applicable
Overall	<b>9.6</b>	9.9	(3.0)
<b>Cost</b>			
– Operating cost per ASK (RMB)	<b>0.45</b>	0.43	4.7
– Operating cost per ATK (RMB)	<b>3.44</b>	3.10	11.0

## Management Discussion and Analysis (Cont'd)



### FINANCIAL PERFORMANCE

The loss for 2005 attributable to equity shareholders of the Company is RMB1,848 million, as compared to a loss of RMB48 million for 2004. The scale of operations increased as a result of acquisition of the airline operations and related assets of CNA and XJA on 31 December 2004. The Group's operating revenue increased by RMB14,319 million or 59.7% from RMB23,974 million in 2004 to RMB38,293 million in 2005. Passenger load factor increased by 0.9 percentage point from 69.2% in 2004 to 70.1% in 2005. Passenger yield (in passenger revenue per RPK) decreased slightly by 3.5% to RMB0.55. Average yield (in traffic revenue per RTK) increased by 2.6%

from RMB5.01 in 2004 to RMB5.14 in 2005. Operating expenses increased by RMB16,533 million or 71.7% from RMB23,065 million in 2004 to RMB39,598 million in 2005. As the increase in operating revenue is smaller than the increase in operating expenses, operating profit decreased by 243.6% from an operating profit of RMB909 million in 2004 to an operating loss of RMB1,305 million in 2005. The Group's net non-operating expenses decreased by 20.5%, from RMB689 million in 2004 to RMB548 million in 2005, mainly attributable to the combined effect of increase in exchange gain of RMB1,279 million, increase in interest expense of RMB925 million and a decrease in share of results of associates of RMB295 million.

### OPERATING REVENUE

Substantially all of the Group's operating revenue is attributable to airline and airline related operations. Traffic revenue accounted for 97.7% and 97.4% of total operating revenue in 2005 and 2004 respectively. Passenger revenue and, cargo and mail revenue accounted for 91.7% and 8.3% respectively of total traffic revenue in 2005 and 2004 respectively. The other operating revenue is mainly derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

Operating revenue increased by 59.7% from RMB23,974 million in 2004 to RMB38,293 million in 2005. The increase was primarily due to a 62.7% rise in passenger revenue from RMB21,100 million in 2004 to RMB34,328 million in 2005 resulting from increased traffic volume. The total number of passengers carried increased by 56.4% to 44.12 million passengers in 2005. RPKs increased by 66.5% from 37,196 million in 2004 to RMB61,923 million in 2005, primarily as a result of the increase in passengers carried. Passenger yield decreased slightly by RMB0.02.

Domestic passenger revenue, which accounted for 82.1% of the total passenger revenue in 2005, increased by 67.1% from RMB16,869 million in 2004 to RMB28,182 million in 2005. Domestic passenger traffic in RPKs increased by 76.8%, mainly due to an increase in passengers carried. Domestic passenger yield decreased slightly by RMB0.03 to RMB0.55 in 2005.

## Management Discussion and Analysis (Cont'd)



Hong Kong and Macau passenger revenue, which accounted for 3.5% of total passenger revenue, increased by 8.2% from RMB1,104 million in 2004 to RMB1,194 million in 2005. For Hong Kong and Macau flights, passenger traffic in RPKs increased by 28.8%, while passenger capacity in ASKs increased by 40.1%, resulting in a 5.1 percentage point decrease in passenger load factor from 2004. Passenger yield decreased from RMB0.92 in 2004 to RMB0.77 in 2005 mainly due to intensified competition among airlines.



International passenger revenue, which accounted for 14.4% of total passenger revenue, increased by 58.4% from RMB3,127 million in 2004 to RMB4,952 million in 2005. For international flights, passenger traffic in RPKs increased by 29.5%, while passenger capacity in ASKs increased by 29.0%, resulting in a 0.3 percentage point rise in passenger load factor from 2004. Passenger yield increased by 21.7% from RMB0.46 in 2004 to RMB0.56 in 2005 mainly resulted from higher ticket price and the increases in traffic derived from short haul routes which generally had a higher yield than long haul routes.

Cargo and mail revenue, which accounted for 8.3% of the Group's total traffic revenue and 8.1% of total operating revenue, increased by 37.7% from RMB2,244 million in 2004 to RMB3,091 million in 2005. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 38.7% from RMB630 million in 2004 to RMB874 million in 2005. The increase was primarily due to the general growth in income from various auxiliary operations.

### OPERATING EXPENSES

Total operating expenses in 2005 amounted to RMB39,598 million, representing an increase of 71.7% or RMB16,533 million over 2004, primarily due to the total effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue increased from 96.2% in 2004 to 103.4% in 2005.

Flight operations expenses, which accounted for 49.0% of total operating expenses, increased by 86.2% from RMB10,418 million in 2004 to RMB19,394 million in 2005, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses and labour costs for flight personnel. Jet fuel costs, which accounted for 61.5% of flight operations expenses, increased by 97.2% from RMB6,050 million in 2004 to RMB11,929 million in 2005 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 50.0% from RMB1,665 million in 2004 to RMB2,497 million in 2005 primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 69.6% from RMB705 million in 2004 to



## Management Discussion and Analysis (Cont'd)



RMB1,196 million in 2005 due to the increase in number of passengers carried. Aircraft insurance costs decreased by 43.2% from RMB185 million in 2004 to RMB105 million in 2005, mainly because of the decrease in insurance premiums in 2005. Labour costs for flight personnel increased by 57.8% from RMB1,026 million in 2004 to RMB1,619 million in 2005, largely due to the increase in flying hours and allowance standard.

Maintenance expenses which accounted for 11.6% of total operating expenses, increased by 32.7% from RMB3,459 million in 2004 to RMB4,589 million in 2005. The increase was mainly attributable to the fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 14.5% of total operating expenses, increased by 64.4% from RMB3,503 million in 2004 to RMB5,759 million in 2005. The increase primarily resulted from a 51.8% rise in landing and navigation fees from RMB3,222 million in 2004 to RMB4,891 million in 2005, due to an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 7.0% of total operating expenses, increased by 43.3% from RMB1,940 million in 2004 to RMB2,780 million in 2005. The increase was mainly resulted from the increase in sales volume, resulting in a 41.5% increase in sales commission expenses from RMB1,062 million in 2004 to RMB1,503 million in 2005.

General and administrative expenses, which accounted for 6.2% of the total operating expenses, increased by 85.7% from RMB1,323 million in 2004 to RMB2,457 million in 2005. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 11.2% of total operating expenses, increased by 84.0% from RMB2,413 million in 2004 to RMB4,440 million in 2005, mainly resulting from the additional depreciation charge on aircraft delivered in 2004 and 2005.

### **OPERATING (LOSS)/PROFIT**

There is an operating loss of RMB1,305 million in 2005 as compared to an operating profit of RMB909 million in 2004. This was mainly because operating revenue increased by RMB14,319 million or 59.7% in 2005 while operating expenses increased by RMB16,533 million or 71.7% in the same period.

### **NON-OPERATING INCOME/(EXPENSES)**

Interest expense increased by 133.9% from RMB691 million in 2004 to RMB1,616 million in 2005, mainly due to the increase in loans and lease obligations and interest rate. Interest income increased by 150.0% from RMB22 million in 2004 to RMB55 million in 2005, mainly attributable to the increase of interest rate.

During 2005, the Group recorded a net exchange gain of RMB1,220 million (2004: Net exchange loss of RMB59 million) mainly resulted from Renminbi appreciation in July 2005. Such amount represents mainly unrealised translation exchange gain, resulting from exchange gains on translated year end foreign currency denominated liabilities, rather than foreign exchange transactions incurred during the year.

### **TAXATION**

The statutory income tax rate in the PRC is 33%. Except for certain branches and subsidiaries, the Company and its subsidiaries are entitled to enjoy a preferential tax rate of 15% pursuant to approval documents issued by the relevant tax authorities.

Income tax benefit for the year amounted to RMB7 million (2004: income tax expense of RMB65 million). This is mainly attributable to the recognition of RMB159 million deferred tax assets in respect of a portion of tax losses.

## Management Discussion and Analysis (Cont'd)

### LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As at 31 December 2005, the Group's net current liabilities amounted to RMB25,907 million (2004: RMB18,855 million). For the year ended 31 December 2005, the Group recorded a net cash inflow from operating activities of RMB3,835 million (2004: RMB3,596 million), a net cash outflow from investing activities and financing activities of RMB4,017 million (2004: RMB2,593 million) and a decrease in cash and cash equivalents of RMB182 million (2004: an increase of RMB1,003 million).

In 2006 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain adequate external finance to meet its committed future capital expenditures. The Group has obtained firm commitments from its principal bankers to renew its short-term bank loans outstanding at 31 December 2005 when they fall due during 2006. In relation to its future capital commitments and other financing requirements, the Group has already entered into loan financing agreements with several PRC banks up to an approximate amount of RMB44,704 million under which the banks would provide loan finance during 2006 and thereafter. The directors of the Company believe that such financing will be available to the Group.

The directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the twelve months ending 31 December 2006. Based on such forecast, the directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during that period. In preparing the cash flow forecast, the directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loan finance which may impact the operations of the Group during the next twelve-month period. The directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

As at 31 December 2005, the Group's borrowings totalled RMB44,795 million, representing an increase of RMB9,599 million from RMB35,196 million at 31 December 2004. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen, Hong Kong dollars and Renminbi. Of such borrowings, RMB19,597 million, RMB7,245 million, RMB4,762 million, RMB2,812 million and RMB10,379 million will be repayable in 2006, 2007, 2008, 2009, 2010 and thereafter respectively. As at 31 December 2005, cash and cash equivalents of the Group totalling RMB2,901 million, of which 20.4% were denominated in foreign currencies, decreased by 5.9% from RMB3,083 million at 31 December 2004.

Net debts (total borrowings net of cash and cash equivalents) increased by 30.5% to RMB41,894 million at 31 December 2005.

As at 31 December 2005, total equity attributable to equity shareholders of the Company amounted to RMB10,000 million, representing a decrease of RMB1,848 million from RMB11,848 million at 31 December 2004. Total equity at 31 December 2005 amounted to RMB11,936 million (2004: RMB13,903 million).

Ratio of net debt to total equity of the Group at 31 December 2005 was 3.5 times, as compared to 2.3 times at 31 December 2004.



## Management Discussion and Analysis (Cont'd)



### FINANCIAL RISK MANAGEMENT POLICY

The Group is exposed to fluctuations in foreign currencies and jet fuel prices. The Group's exposure to fluctuations in foreign currencies is a result of its debts which are denominated in foreign currencies. Depreciation or appreciation of the RMB against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, by entering into forward foreign exchange contracts with certain authorised PRC banks. The Group is required to procure a majority of its jet fuel domestically at PRC spot market prices. There are currently no effective means available to manage the Group's exposure to the fluctuations in domestic jet fuel prices.

### CHARGE ON ASSETS

As at 31 December 2005, certain aircraft of the Group with an aggregate carrying value of approximately RMB30,408 million (2004: RMB23,562 million) were mortgaged under certain loan and lease agreements.

### COMMITMENTS AND CONTINGENCIES

#### Commitments

As at 31 December 2005, the Group had capital commitments of approximately RMB47,803 million. Of such amounts, RMB45,628 million related to the acquisition of aircraft and related flight equipment, RMB840 million related to the Group's facilities and equipment to be constructed and installed at the Guangzhou Baiyun International Airport and RMB1,335 million for other projects.

As at 31 December 2005, the Group was committed to make capital contributions to its jointly controlled entities amounted to approximately RMB83 million.

#### Contingent Liabilities

Pursuant to the reorganisation of CSAHC effected in 1995, the Company assumed the airline and airline-related businesses together with the relevant assets and liabilities from CSAHC. The Company has been advised by its PRC lawyers that, except for liabilities constituting or arising out of or relating to the businesses assumed by the Company in the reorganisation, no other liabilities were assumed by the Company, and the Company is not jointly and severally liable for other debts and obligations incurred by CSAHC prior to the Reorganisation. There are not, however, any definitive PRC regulations or other pronouncements confirming such conclusion.

The Group leases from CSAHC certain land in Guangzhou and certain land and buildings in Wuhan and Haikou. The Group has a significant investment in buildings and other leasehold improvements located on such land. However, such land in Guangzhou and such land and buildings in Wuhan and Haikou lack adequate documentation evidencing CSAHC's rights thereto.

The Group cannot predict the magnitude of the effect on its financial condition or results of operations to the extent that their uses of one or more of above parcels of land or the related facilities were successfully challenged. Pursuant to an indemnification agreement dated 22 May 1997 entered into between the Company and CSAHC, CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge or interference with the Group's use of any of its land and buildings.