THIS CIRCULAR IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION

If you are in any doubt as to any aspect of this circular, or as to the action to be taken, you should consult a licensed securities dealer, bank manager, solicitor, professional accountant or other professional adviser.

If you have sold or transferred all your shares in China National Aviation Company Limited, you should at once hand this circular together with the enclosed form of proxy to the purchaser or transferee or to the bank, licensed securities dealer or other agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.

中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED

(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

VERY SUBSTANTIAL DISPOSAL
SALE OF DRAGONAIR SHARES

VERY SUBSTANTIAL ACQUISITION
ACQUISITION OF CATHAY SHARES

Exclusive financial advisers

CICC
中國國際金融(香港)有限公司
CHINA INTERNATIONAL CAPITAL CORPORATION (HONGKONG) LIMITED

Merrill Lynch

China International Capital Corporation (Hong Kong) Limited

Merrill Lynch (Asia Pacific) Limited

Independent financial adviser

CLSA
ASIA-PACIFIC MARKETS

CLSA Equity Capital Markets Limited

A letter from the Independent Board Committee containing its recommendation to the Independent Shareholders is set out on pages 24 to 27 of this circular. A letter from CLSA, the independent financial adviser, containing its advice to the Independent Board Committee and the Independent Shareholders is set out on pages 28 to 53 of this circular.

A notice convening the EGM to be held on Tuesday, 22 August 2006 at 2:00 p.m. at Salon 6 (Level 3), JW Marriott Hotel Hong Kong, Pacific Place, 88 Queensway, Hong Kong is set out on page 278 of this circular. Whether or not you are able to attend the EGM, please complete the enclosed form of proxy in accordance with the instructions printed thereon and return it to the share registrar of the Company, Computershare Hong Kong Investor Services Limited, 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong as soon as possible and in any event not later than 48 hours before the time appointed for the holding of the EGM or any adjourned meeting thereof. Completion and return of the form of proxy will not preclude you from attending and voting in person at the EGM or any adjourned meeting thereof and, in such event, the relevant form of proxy shall be deemed to be revoked.

30 June 2006

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In this circular the following expressions have the following meanings unless the context requires otherwise:

Acquisition	the acquisition of 288,596,335 new Cathay Shares at HK$13.50 per share by the Company as contemplated under the Transaction
acting in concert	has the meaning ascribed to it in the Takeovers Code
Air China	Air China Limited, a company incorporated in the PRC and whose H shares are listed on the Exchange as its primary listing venue and on the Official List of the UK Listing Authority as its secondary listing venue
Air China H Shares	H shares of RMB1.00 each in the capital of Air China
Air Macau	Air Macau Company Limited, a company incorporated in Macau
associates	has the meaning ascribed to it in the Listing Rules
BACL	Beijing Air Catering Co., Ltd., a company incorporated in the PRC
Business Day	a day (other than a Saturday or Sunday) on which banks are open for business in Hong Kong
Cathay	Cathay Pacific Airways Limited, a company incorporated in Hong Kong and whose shares are listed on the Exchange
Cathay Board	the board of directors of Cathay
Cathay Group	Cathay and its subsidiaries
Cathay Share Capital	the issued share capital of Cathay from time to time
Cathay Shares	ordinary shares of HK$0.20 each in the capital of Cathay
CITIC Pacific	CITIC Pacific Limited, a company incorporated in Hong Kong and whose shares are listed on the Exchange
CLSA	CLSA Equity Capital Markets Limited, a licensed corporation under the SFO, licensed to conduct types 4 and 6 regulated activities under the SFO

CNACG	China National Aviation Corporation (Group) Limited, a company incorporated in Hong Kong
CNAC (Macau)	China National Aviation Corporation (Macau) Company Limited, a company incorporated in Macau
CNAH	China National Aviation Holding Company, a state-owned enterprise established in the PRC
Company or CNAC	China National Aviation Company Limited, a company incorporated in Hong Kong and whose shares are listed on the Exchange
Companies Ordinance	Companies Ordinance (Chapter 32 of the Laws of Hong Kong)
Completion	completion of the offer for Dragonair Shares, sale and purchase of Cathay Shares and subscription of Air China H Shares as referred to in this circular under the headings "Description of the Transaction – Disposal of Dragonair Shares and Acquisition of new Cathay Shares", "Description of the Transaction – Purchase of Cathay Shares" and "Description of the Transaction – Acquisition of additional Air China H Shares" respectively, which is expected to be around the end of September 2006
DAS	Dah Chong Hong – Dragonair Airport GSE Service Limited, a company incorporated in Hong Kong
DASL	DAS Aviation Support Limited, a company incorporated in Hong Kong
Directors	the directors of the Company
Disposal	the disposal of 216,447,251 Dragonair Shares by the Group to Cathay as contemplated under the Transaction
Dragonair	Hong Kong Dragon Airlines Limited, a company incorporated in Hong Kong
Dragonair Holidays	Dragonair Holidays Limited, a company incorporated in Hong Kong
Dragonair Minority Shareholders	each holder of Dragonair Shares other than SPAC, CITIC Pacific, the Company or Cathay, or any person who holds Dragonair Shares on their behalf, holding in aggregate 13,552,750 Dragonair Shares

Dragonair Shares	ordinary shares of HK$1.00 each in the capital of Dragonair
EGM	the extraordinary general meeting of the Company to be held to seek approval of the Independent Shareholders referred to this circular
Exchange	The Stock Exchange of Hong Kong Limited
Executive	the Executive Director of the Corporate Finance Division of the SFC
Group	the Company and its subsidiaries
Groupax	Groupax Limited, a company incorporated in Hong Kong
HAS	Hong Kong Airport Services Limited, a company incorporated in Hong Kong
HAS GSE	HAS GSE Solutions Limited, a company incorporated in Hong Kong
HIAS	Hong Kong International Airport Services Limited, a company incorporated in Hong Kong
HKAS	Hong Kong Accounting Standards
Hong Kong	Hong Kong SAR
Independent Board Committee	an independent committee of the Directors comprising Lok Kung Nam, Ho Tsu Kwok, Charles, Li Kwok Heem, John and Chan Ching Har, Eliza, all of whom are independent non-executive directors of the Company
Independent Shareholders	the shareholders of the Company other than Air China, Cathay (if it is still a shareholder at the relevant time) and Merrill Lynch, Pierce, Fenner & Smith Incorporated and their respective associates
JASL	Jardine Airport Services Limited, a company incorporated in Hong Kong
JATS	Jardine Air Terminal Services Limited, a company incorporated in Hong Kong
Joint Announcement	the joint announcement issued by Air China, Cathay, the Company, CITIC Pacific and SPAC on 8 June 2006 regarding, *inter alia*, the Restructuring Agreement and the Transaction

Last Trading Date	2 June 2006, being the last trading date prior to the suspension of trading of Cathay, Air China, the Company, CITIC Pacific and SPAC on 5 June 2006
Latest Practicable Date	26 June 2006, being the latest practicable date prior to the printing of this circular for ascertaining certain information referred to in this circular
Listing Rules	The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
LLSHK	LSG Lufthansa Service Hong Kong Limited, a company incorporated in Hong Kong
Macau	Macau SAR
Macau Asia Express	Macau Asia Express Limited, a company incorporated in Macau
Menzies Macau	Menzies Macau Airport Services Limited, a company incorporated in Macau
Model Code	Model Code for Securities Transactions by Directors of Listed Companies, being Appendix 10 of the Listing Rules
On Ling	On Ling Investments Limited, a company incorporated in the British Virgin Islands
Operating Agreement	the operating agreement dated 8 June 2006 between Air China and Cathay pursuant to which Air China and Cathay have agreed to co-operate in various operational areas
PRC	the People's Republic of China
Privatisation Announcement	the joint announcement issued by Air China and the Company on 21 June 2006 regarding the proposed pre-conditional privatisation of the Company by way of a scheme of arrangement under section 166 of the Companies Ordinance
Privatisation Proposals	the pre-conditional proposal of Air China to the shareholders of the Company (other than Air China) for the cancellation of all the shares in the Company held by them pursuant to a scheme of arrangement under section 166 of the Companies Ordinance and the proposal of Air China to the optionholders of the Company for cancellation of all the outstanding options, further details of which are set out in the Privatisation Announcement

Remaining Group	the Group excluding Dragonair and including Cathay Shares acquired through the Acquisition
Restructuring Agreement	the restructuring agreement dated 8 June 2006 between SPAC, CITIC Pacific, the Company, Air China and Cathay in relation to the Transaction
SAR	Special Administrative Region of the PRC
SFC	Securities and Futures Commission of Hong Kong
SFO	Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)
Shareholders Agreement	the shareholders agreement dated 8 June 2006 between SPAC, CITIC Pacific, the Company and Air China regulating their relationship as shareholders of Cathay following implementation of the Transaction
SPAC	Swire Pacific Limited, a company incorporated in Hong Kong and whose shares are listed on the Exchange
SWACL	Southwest Air Catering Company Limited, a company incorporated in the PRC
Takeovers Code	The Hong Kong Code on Takeovers and Mergers
Tradeport Hong Kong	Tradeport Hong Kong Limited, a company incorporated in Hong Kong
Transaction	the restructuring of the shareholdings in Dragonair and Cathay and the acquisition by Cathay of additional Air China H Shares, in each case in accordance with the terms of the Restructuring Agreement, but does not include the placing by SPAC and CITIC Pacific of Cathay Shares pursuant to the Restructuring Agreement
WCL	Wise Counsel Limited, a company incorporated in Hong Kong

中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED

(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

Executive Directors
Kong Dong *(Chairman)*
Chuang Shih Ping
Zhang Xianlin
Zhao Xiaohang
Tsang Hing Kwong, Thomas
Gu Tiefei

Independent Non-Executive Directors
Lok Kung Nam
Hu Hung Lick, Henry
Ho Tsu Kwok, Charles
Li Kwok Heem, John
Chan Ching Har, Eliza

Registered Office:
5th Floor
CNAC House
12 Tung Fai Road
Hong Kong International Airport
Lantau
Hong Kong

Principal Office:
5th Floor
CNAC House
12 Tung Fai Road
Hong Kong International Airport
Lantau
Hong Kong

30 June 2006

To the Shareholders

Dear Sir or Madam,

VERY SUBSTANTIAL DISPOSAL
SALE OF DRAGONAIR SHARES

VERY SUBSTANTIAL ACQUISITION
ACQUISITION OF CATHAY SHARES

INTRODUCTION

Reference is made to the Joint Announcement dated 8 June 2006 regarding, *inter alia*, the Restructuring Agreement entered into by the Company with Air China, Cathay, CITIC Pacific and SPAC on 8 June 2006 and the Transaction.

The purposes of this circular are:

(a) to provide you with further information relating to the Restructuring Agreement, the Disposal and the Acquisition, and other information required by the Listing Rules;

(b) to set out the letter of advice from CLSA to the Independent Board Committee and the Independent Shareholders, and the recommendation and opinion of the Independent Board Committee as advised by CLSA in relation to the Restructuring Agreement, the Disposal and the Acquisition; and

(c) to give you notice of the EGM to consider and, if thought fit, to approve the Restructuring Agreement and the Disposal and Acquisition contemplated thereunder.

DESCRIPTION OF THE TRANSACTION

Disposal of Dragonair Shares and Acquisition of new Cathay Shares

On 8 June 2006, Air China, Cathay, the Company, CITIC Pacific and SPAC entered into the Restructuring Agreement. Under the Restructuring Agreement, Cathay has, *inter alia*, offered to acquire 216,447,251 Dragonair Shares, representing all of the Group's 43.29% shareholding in Dragonair, from the Group, to be satisfied by the issue of 288,596,335 new Cathay Shares at an issue price of HK$13.50 per Cathay Share to the Company and cash consideration of HK$432,894,497.50, which has been accepted by the Company.

Under the Restructuring Agreement, Cathay has also offered to acquire the remaining Dragonair Shares from each of SPAC, CITIC Pacific and the Dragonair Minority Shareholders on the same basis and each of SPAC and CITIC Pacific has agreed to accept the offer. Upon Completion (on the basis that Cathay has acquired all the Dragonair Shares held by the Dragonair Minority Shareholders), Dragonair will become a wholly-owned subsidiary of Cathay.

The terms of the Transaction value 100% of the equity of Dragonair at HK$10 billion and the Group's 43.29% shareholding in Dragonair at approximately HK$4,329 million. This valuation represents a price-to-earnings ratio of 33.3 times Dragonair's reported earnings of HK$300.4 million for the year ended 31 December 2005. The valuation of Dragonair was determined following arm's length negotiation between the parties, based on the underlying value of Dragonair, as reflected in the market price of the Company, and having regard to the trading multiples of comparable airlines, in addition to considering the benefits to Cathay of full ownership of Dragonair and potential synergies arising from the combination of the businesses. The issue price of the new Cathay Shares was determined following arm's length negotiation between the parties, in particular with reference to the current and recent average trading price of Cathay Shares. The new Cathay Shares will rank *pari passu* in all respects with all other Cathay Shares in issue on the date of allotment and issue of such shares.

Purchase of Cathay Shares

Under the Restructuring Agreement, SPAC and CITIC Pacific have agreed to sell to Air China 40,128,292 and 359,170,636 Cathay Shares respectively. The consideration payable by Air China for such Cathay Shares is HK$13.50 per share.

Acquisition of Additional Air China H Shares

Under the Restructuring Agreement, Cathay has agreed to subscribe in cash for 1,179,151,364 Air China H Shares at an aggregate subscription price of HK$4.07 billion, representing HK$3.45 per Air China H Share. Immediately following completion of this subscription (assuming no further issue of shares by Air China before Completion, but subject to adjustments that may be made to fulfill the public float requirement), Cathay will have a 20% interest in the enlarged issued share capital of Air China.

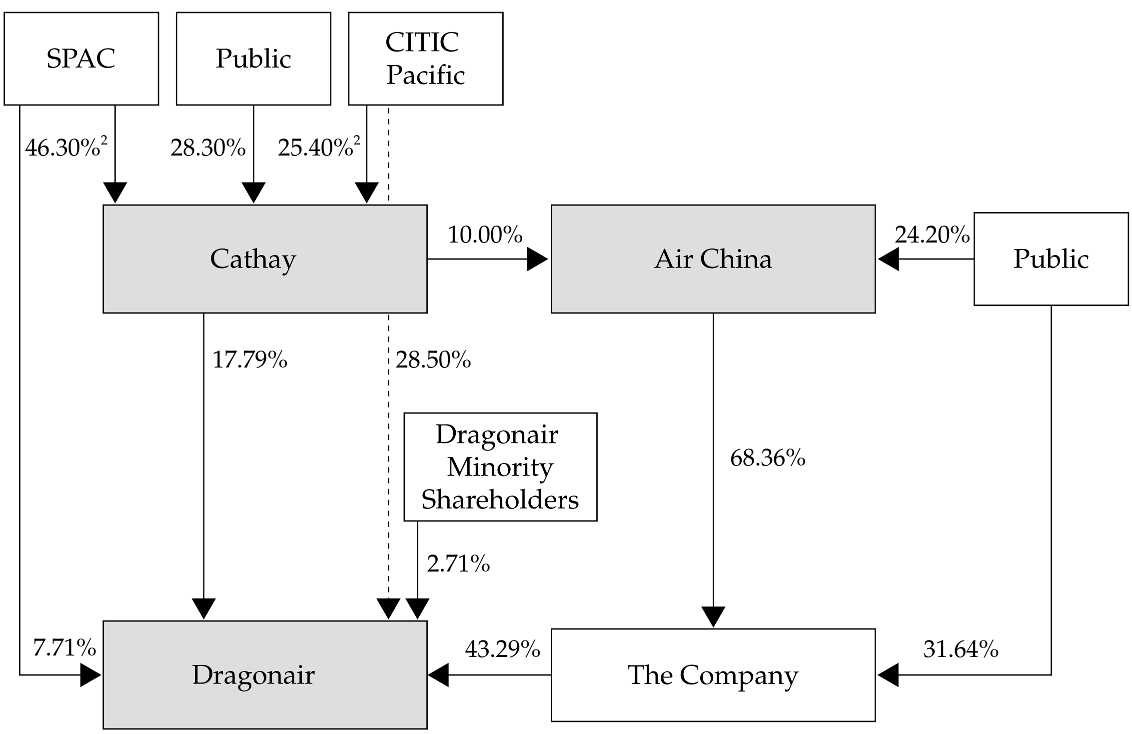
Special Dividend

Under the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share.

Shareholding Structures of Cathay, Dragonair and Air China

The shareholdings in Dragonair, Cathay and Air China (1) immediately prior to Completion and (2) immediately following Completion (on the basis that Cathay has acquired all the Dragonair Shares held by the Dragonair Minority Shareholders) are expected to be as follows:

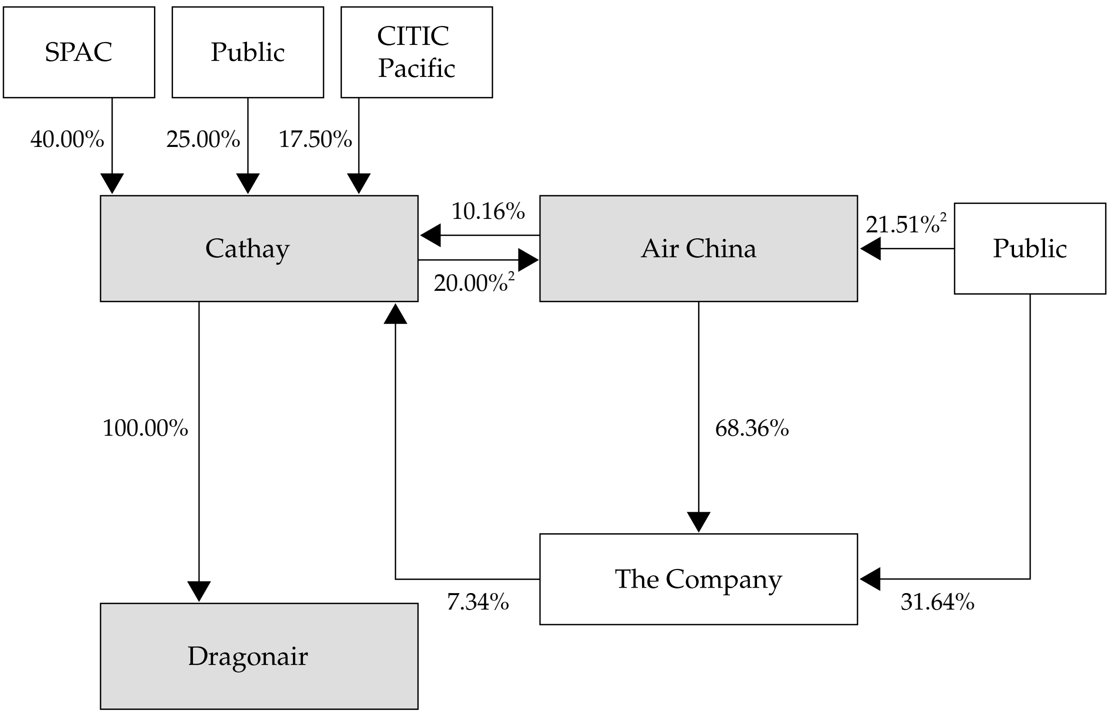
Shareholding structures of Cathay, Dragonair and Air China immediately prior to Completion[1]



1 *Assuming disposal of the shares in the Company held by Cathay and referred to in the section headed "Regulatory and Listing Rule Implications – Miscellaneous" below.*

2 *Assuming that placing by SPAC and CITIC Pacific of Cathay Shares pursuant to the Restructuring Agreement has not taken place.*

Shareholding structures of Cathay, Dragonair and Air China immediately following Completion[1]



[1] *Assuming disposal of the shares in the Company held by Cathay and referred to in the section headed "Regulatory and Listing Rule Implications – Miscellaneous" below.*

[2] *Subject to adjustments that may be made to fulfill the public float requirement.*

Shareholders Agreement

SPAC, the Company, CITIC Pacific and Air China have entered into the Shareholders Agreement for the purpose of regulating their relationship with each other as shareholders of Cathay and certain aspects of the affairs of, and their shareholdings in, Cathay, following completion of the Transaction.

Under the Shareholders Agreement, the parties have agreed that:

(i) the Cathay Board will, subject to adjustment in certain circumstances, consist of four non-executive directors nominated by SPAC, two non-executive directors nominated by each of CITIC Pacific and Air China, five executive directors nominated by SPAC and four independent non-executive directors;

(ii) to support, including by exercise (to the extent permitted by law and the Listing Rules) of their respective voting rights as shareholders of Cathay, the continuation and periodic renewal of the existing management arrangements for Cathay and its subsidiaries, including the services agreement between John Swire & Sons (H.K.) Limited and Cathay, and their extension to Dragonair and its subsidiaries substantially on their current terms; and

(iii) to support the implementation of the Operating Agreement and by exercise (to the extent permitted by law and the Listing Rules) of their respective voting rights as shareholders of Cathay, its continuation and any periodic renewal of it.

In addition, the parties have agreed to the following in relation to their shareholdings in Cathay:

(i) SPAC has agreed that the beneficial interest of SPAC and its group in the Cathay Share Capital will not exceed 44.90% (49.90% if (i) CITIC Pacific and its group or (ii) Air China and its group increase their respective combined aggregate beneficial interest in the Cathay Share Capital to above 22.45%), except with the prior written consent of the other parties;

(ii) Each of (i) CITIC Pacific and (ii) Air China and the Company have agreed that the combined aggregate beneficial interest of respectively CITIC Pacific and its group and Air China and its group in the Cathay Share Capital will not exceed 29.99%, except with the prior written consent of the other parties; and

(iii) CITIC Pacific, Air China and the Company have agreed that, except with the prior written consent of SPAC, their combined beneficial interest in the Cathay Share Capital (including those of their groups) will not exceed 40% or the percentage beneficial interest of SPAC and its group in the Cathay Share Capital (whichever is the lower).

(The undertakings by CITIC Pacific, Air China and the Company described in paragraphs (ii) and (iii) above will cease to apply if SPAC (and/or its group companies) disposes of Cathay Shares and as a result SPAC (together with its group) is beneficially interested in less than 30% of the Cathay Share Capital and Air China (together with its group) or CITIC Pacific (together with its group) is beneficially interested (whether or not as a result of such disposal by SPAC and/or its group companies) in more Cathay Shares than SPAC (together with its group). The undertakings by CITIC Pacific, Air China and the Company in paragraph (iii) above will also cease to apply if SPAC (together with its group) is beneficially interested in 44.50% or more of the Cathay Share Capital. The undertakings by SPAC, CITIC Pacific, Air China and the Company described above will cease to apply in favour of any shareholder which is a party to the Shareholders Agreement whose beneficial interest in the Cathay Share Capital (including that of its group) is less than 15%.)

Each party to the Shareholders Agreement has also agreed that so long as that party is beneficially interested (together with its group) (directly or indirectly) in 15% or more of the Cathay Share Capital, it will not make a takeover offer for Cathay or accept a takeover offer from a third party, unless that offer has been recommended by the Cathay Board.

CONDITIONS

Completion of the Transaction, (and the coming into effect of the Shareholders Agreement), is conditional upon satisfaction of the following conditions:–

(A) entering into the Shareholders Agreement and implementation of the Transaction not giving rise to an obligation on any of SPAC, CITIC Pacific, Air China or the Company to make a mandatory offer to acquire all the Cathay Shares under the Takeovers Code; in this connection the Executive has confirmed that, as SPAC and CITIC Pacific are concert parties in relation to the voting rights of Cathay and together hold more than 50% of the Cathay Shares, no such obligation will arise;

(B) Air China having obtained all necessary approvals of relevant regulatory bodies in the PRC;

(C) the Listing Committee of the Exchange having granted listing of and permission to deal in:

    (i) the new Cathay Shares to be issued to SPAC, CITIC Pacific, the Company, and the Dragonair Minority Shareholders described above; and

    (ii) the new Air China H Shares to be issued to Cathay described above;

(D) the independent shareholders of CITIC Pacific in general meeting having passed resolutions approving the sale by CITIC Pacific of its Dragonair Shares to Cathay and the acquisition of the new Cathay Shares to be issued by Cathay to CITIC Pacific as consideration for the Dragonair Shares sold by CITIC Pacific to Cathay, in each case as a connected transaction;

(E) the independent shareholders of the Company in general meeting having passed resolutions to approve the sale of the Company's Dragonair Shares to Cathay as a very substantial disposal and the acquisition of Cathay Shares by the Company as a very substantial acquisition;

(F) the independent shareholders of Cathay in general meeting having passed resolution(s) to approve the acquisition of Dragonair Shares by Cathay from SPAC and CITIC Pacific and the allotment and issue of new Cathay Shares by Cathay to SPAC and CITIC Pacific, in each case as a connected transaction and the shareholders of Cathay in general meeting having passed resolution(s) to approve the increase of the authorised share capital of Cathay and the allotment and issue of new Cathay Shares to SPAC and CITIC Pacific pursuant to Rule 13.36(1)(a) of the Listing Rules;

(G) the independent shareholders of Air China in general meeting having passed resolutions approving the sale of Dragonair Shares by the Company to Cathay, the acquisition of Cathay Shares by the Company, the acquisition by Air China of Cathay Shares from CITIC Pacific and the issue of Air China H Shares to

Cathay, in each case as a connected transaction, the shareholders of Air China in general meeting having passed a resolution approving the acquisition of Cathay Shares by the Company, the acquisition by Air China of Cathay Shares from CITIC Pacific and SPAC as a major transaction (when aggregated) and the shareholders of Air China in general meeting having passed a special resolution and the shareholders of Air China in separate class meetings having passed special resolutions, in each case approving the issue of additional Air China H Shares to Cathay in accordance with Air China's articles of association and applicable Listing Rules;

(H) Cathay being satisfied that it is entitled under Section 168 of the Companies Ordinance to acquire compulsorily all the Dragonair Shares held by each person who does not accept its offer for all the Dragonair Shares;

(I) Cathay being satisfied as to its due diligence investigations of Dragonair and Air China; and

(J) Air China being satisfied as to its due diligence investigations of Cathay.

Completion of the Transaction is expected to take place on the fifth Business Day following satisfaction of these conditions which is expected to be around the end of September 2006.

If the Restructuring Agreement has not become unconditional in all respects on or before 30 September 2006, the parties thereto shall consult in good faith with a view to determining whether the Transaction may proceed by way of alternative means or method or to extending such date. If the parties are unable to reach agreement on such alternative means or methods or such extension within 14 days (or such longer period as the parties may agree), the Restructuring Agreement shall automatically terminate.

REASONS FOR THE TRANSACTION

The executive Directors take the following views in relation to the reasons for the Transaction.

In recent years the Chinese aviation industry has experienced rapid growth and changes; the creation of three Chinese airline groups, the continuing liberalisation of the market to international airlines and the Chinese airlines' progressive increase in international destinations and frequencies of the international routes. In the context of these market developments, the competitive position of Dragonair has become increasingly challenging, especially in the face of intensive competition on its Hong Kong-China mainland routes.

Though operated by an excellent management team, Dragonair faces challenges in scale and its concentration in the Hong Kong-China mainland routes. In light of this competitive operational landscape, the Company believes that Dragonair would benefit from being under the direct management control of a single airline group. The executive Directors believe that the proposed realignment of shareholding structure, which puts Dragonair under Cathay, would provide Dragonair flexibility to react more rapidly in the fast changing market environment. In addition, as rising jet fuel cost has made every airline focus on cost-control, such realignment would allow Dragonair to achieve economies of scale under the management of one of the largest airlines in Asia Pacific. Such combination would create substantial synergies in marketing, operations, and fleet maintenance. Furthermore, the Transaction combines two networks which are complementary with each other – a Hong Kong hub with excellent coverage of both China mainland destinations and other international destinations. The Company believes that direct control of Dragonair by Cathay would allow Dragonair to secure its future growth and profitability in this rapidly changing operating landscape.

As a consequence of the Transaction, the Company will hold a 7.34% shareholding in Cathay, thereby exchanging an illiquid shareholding in an unlisted company (Dragonair) for a shareholding in a listed company (Cathay) whose shares enjoy a high level of trading liquidity on the Exchange. Furthermore, the Transaction will allow the Company to realise a gain of approximately HK$2,960 million to its consolidated income statement, and, together with the payment of the special dividend by Cathay, the Company will receive HK$525.2 million of cash proceeds. Going forward, the Company will benefit from its proportional share of dividend income from Cathay, which, as a result of its cooperation with Air China and its consolidation with Dragonair, will be able to deliver good value for its shareholders in the future.

The terms of the Transaction value 100% of the equity of Dragonair at HK$10 billion. This valuation represents a price-to-earnings ratio of 33.3 times Dragonair's reported earnings of HK$300.4 million for the year ended 31 December 2005. The Company believes that this valuation reflects not only the full intrinsic value of Dragonair but also a fair sharing of the synergies that Cathay anticipates to accrue from the combination of the two airlines.

The Directors also note that on 21 June 2006, Air China announced jointly with the Company that, subject to satisfaction or waiver of a pre-condition and certain conditions, Air China will privatise the Company by way of a scheme of arrangement under section 166 of the Companies Ordinance at HK$2.80 per share of the Company. The Privatisation Proposals are made at the request of the Directors who believe the Privatisation Proposals to be in the interest of the Company.

For shareholders of the Company, the price of HK$2.80 per share represents an excellent opportunity to exit from their investment in the Company and realise immediate cash proceeds. The price of HK$2.80 represents:

(i) a premium of approximately 71.8% over the initial public offering price of HK$1.63 per share of the Company;

(ii) a premium of approximately 65.9% over the average closing price of approximately HK$1.69 per share of the Company for the six months up to and including the Last Trading Date; and

(iii) an implied price-to-book multiple of 3.0x based on the net asset value of the Company (adjusted as for year-end dividends) of HK$3,092.7 million as at 31 December 2005.

As approximately 68.36% of the Company is already owned by Air China as at the Latest Practicable Date, it is unlikely that shareholders of the Company will receive any other offer from a third party to acquire the shares in the Company.

The Directors (other than the independent non-executive directors whose views are set out in the letter from the Independent Board Committee set out on pages 24 to 27 of this circular) have considered the Disposal and the Acquisition and, in light of the Privatisation Proposals, are of the opinion that the Disposal and the Acquisition and their terms are fair and reasonable and are in the interest of the shareholders of the Company as a whole.

FINANCIAL INFORMATION ON DRAGONAIR

Based on the audited consolidated financial statements of Dragonair for the year ended 31 December 2005, Dragonair had a consolidated net asset value of HK$3,155 million. Based on the audited consolidated financial statements of Dragonair for the years ended 31 December 2004 and 2005, the consolidated net profits of Dragonair before taxation were HK$765 million and HK$316 million respectively, and the consolidated net profits of Dragonair after taxation were HK$637 million and HK$300 million respectively.

At 31 December 2005, the Group's share of consolidated net asset value of Dragonair was HK$1,366 million. For the years ended 31 December 2004 and 2005, the Group's share of consolidated net profits of Dragonair were HK$276 million and HK$130 million respectively. For the year ended 31 December 2005, the Group received dividend income from Dragonair of HK$160 million. No dividend was received from Dragonair during the year ended 31 December 2004.

FINANCIAL INFORMATION ON CATHAY

Based on the audited consolidated financial statements of Cathay for the year ended 31 December 2005, Cathay had a consolidated net asset value (excluding minority interests) of HK$34,968 million. Based on the audited consolidated financial statements of Cathay for the years ended 31 December 2004 and 2005, the consolidated net profits of Cathay before taxation were HK$4,962 million and HK$3,968 million respectively, and the consolidated net profits of Cathay after taxation were HK$4,417 million and HK$3,298 million respectively.

INFORMATION ON THE PRINCIPAL BUSINESSES OF THE COMPANY, CATHAY, DRAGONAIR, SPAC, CITIC PACIFIC AND AIR CHINA

The principal business activity of the Company is investment holding, in the following business segments:–

Air Transportation Services

– Dragonair (of which the Group owns 43.29%)

- Air Macau (of which CNAC (Macau) owns 51%). CNAC (Macau) is wholly-owned by the Group
- Macau Asia Express (of which Air Macau owns 51% and Groupax indirectly owns 49%. Groupax is owned as to 36% by CNAC (Macau)

Airline Catering Services

- BACL (of which the Group owns 60%)
- SWACL (of which the Group owns 60%)
- LLSHK (of which the Group directly owns 20.2%, and indirectly owns 31.94% through Dragonair)

Airport Ground Handling Services

- JASL (of which the Company owns 50%)
- Menzies Macau (of which the Company indirectly owns 26% through CNAC (Macau), and indirectly owns 15% through Air Macau)

Logistics Services

- Tradeport Hong Kong (of which the Group owns 25%)

The principal business activities of Cathay and its subsidiary and associated companies are the operation of scheduled passenger airline, cargo airline and airline catering services. Cathay holds a 60% interest in AHK Air Hong Kong Limited (all-cargo carrier with a focus on express cargo services for DHL Express), a 100% interest in Cathay Pacific Catering Services (H.K.) Ltd., and a 70% interest in Hong Kong Airport Services Ltd. (largest franchised ramp handling company at the Hong Kong International Airport).

The principal business activity of Dragonair is the operation of scheduled passenger and cargo air transportation services, principally within the Asia region. Dragonair also holds interests in the following companies:–

Package Holiday Services

- Dragonair Holidays (of which Dragonair holds 100%)

Airport Services

- HIAS (of which Dragonair holds 100%)
- HAS (of which Dragonair holds 30%)
- HAS GSE (of which Dragonair holds 30%)
- DAS (of which Dragonair holds 30%)
- DASL (of which Dragonair holds 30%)

Catering Services

– LLSHK (of which Dragonair holds 31.94%)

The principal business activity of SPAC is investment holding. SPAC is a Hong Kong listed conglomerate, with diversified interests in property, aviation, beverages, marine services and trading and industrial. SPAC's operations are mainly based in China.

The principal business activity of CITIC Pacific is investment holding. CITIC Pacific is a Hong Kong listed conglomerate, with diversified interests in special steel manufacturing, property, power generation, aviation, civil infrastructure, communications, and marketing and distribution. CITIC Pacific's operations are mainly based in China.

The principal business activity of Air China is the operation of passenger and air cargo services and airline-related services. Air China is the national carrier of China, and is based in Beijing. The group of Air China also holds 22.8% of Shandong Airlines Co. Ltd. and 25% of Shenzhen Airlines Co. Ltd.

REGULATORY AND LISTING RULES IMPLICATIONS

Shareholder Approval

As the assets and revenue ratios set out in Rule 14.07 of the Listing Rules in respect of the Disposal are more than 75%, such sale constitutes a very substantial disposal for the Company for the purposes of the Listing Rules and is therefore subject to the approval of the shareholders of the Company. As the assets, profits and revenue ratios set out in Rule 14.07 of the Listing Rules in respect of the Acquisition are more than 100%, such acquisition constitutes a very substantial acquisition for the Company for the purposes of the Listing Rules and is therefore subject to the approval of the shareholders of the Company. If Cathay is a shareholder of the Company at the relevant time, it will be required to abstain from voting in respect of any shares in the Company held by it or on its behalf as a shareholder with a material interest in the Transaction. Air China, which is a party to the Restructuring Agreement, will be required to abstain from voting in respect of any shares in the Company held by it or on its behalf as a shareholder with a material interest in the Transaction. Merrill Lynch, Pierce, Fenner & Smith Incorporated, which is under the same control as Merrill Lynch (Asia Pacific) Limited, the financial adviser to the Company and Air China and presumed to be acting in concert with Air China in respect of the Privatisation Proposals, held 14,000 shares in the Company as at the Latest Practicable Date. It will abstain from voting in respect of any shares held by it in the Company.

The Independent Board Committee has been constituted to advise the Independent Shareholders in respect of the resolution to approve the Restructuring Agreement, the Disposal and the Acquisition. CLSA has been appointed as independent financial adviser to advise the Independent Board Committee and the Independent Shareholders on the Restructuring Agreement, the Disposal and the Acquisition.

Other regulatory matters

By reference to the audited consolidated net asset value of Dragonair as at 31 December 2005 and after taking into consideration the relevant costs of the Disposal (assuming that the Disposal and the execution of the Restructuring Agreement and the Shareholders Agreement had been completed on 31 December 2005), an unaudited proforma gain of approximately HK$2,960 million would be credited to the consolidated income statement of the Company. Since the carrying value of the attributable equity interest in Dragonair shared by the Group and the market value of Cathay Shares issued by Cathay as consideration of the acquisition of Dragonair Shares may change upon Completion, it is expected that the actual gain or loss arising from the sale of Dragonair Shares by the Company and the execution of the Restructuring Agreement and the Shareholders Agreement to be recorded in the consolidated income statement of the Company will be different from the aforesaid amount.

The Company will receive 288.6 million Cathay Shares and approximately HK$432.9 million in cash as consideration for the Disposal.

The Company's current intention is to hold these Cathay Shares as a long-term investment. With regards to the cash proceeds, the Company is currently considering appropriate uses of these funds in relation to the further development of its existing and other aviation related businesses. Should no attractive opportunities present themselves, the Company may consider distributing the excess cash to its shareholders in due course.

The Company confirms, to the best of the Directors' knowledge, information and belief having made all reasonable enquiries, Cathay, CITIC Pacific and SPAC are third parties independent of the Company and not connected persons of the Company.

Conditional Undertaking and Request for Privatisation of the Company

On Ling, which beneficially owns approximately 9.75% of the issued share capital of the Company, has given a conditional irrevocable undertaking to Air China and the Company to vote in favour of the shareholder's resolution to be proposed at the Company's shareholder's meeting to approve the Disposal and the Acquisition. The conditions precedent to On Ling's undertaking are:

(a) the publication of an announcement by or on behalf of Air China of a privatisation offer in cash for all the issued shares of the Company, other than those already owned by Air China and parties acting in concert with it, on terms no less favourable than HK$2.80 per share of the Company; and

(b) the independent financial adviser to the Independent Board Committee is of the opinion that the terms of the Disposal and the Acquisition and the privatisation referred to in paragraph (a) above from a financial perspective are fair and reasonable.

Following receipt of the conditional undertaking from On Ling, the Directors have requested Air China to privatise the Company by way of a scheme of arrangement, on the basis that the offer price will be HK$2.80 per share of the Company.

On 21 June 2006, Air China and the Company issued the Privatisation Announcement in relation to, *inter alia*, the proposed pre-conditional privatisation of the Company by Air China by way of a scheme of arrangement under section 166 of the Companies Ordinance at the price of HK$2.80 in cash per share of the Company and the proposal to purchase the outstanding options of the Company for cancellation in exchange for HK$1.66 in cash per option. Please refer to the Privatisation Announcement for further details.

As set out in the Privatisation Announcement, the making of the Privatisation Proposals is subject to satisfaction of a pre-condition (namely, the completion of the Transaction) and the implementation of the Privatisation Proposals is subject to satisfaction or waiver (as applicable) of certain conditions. In particular, if the Transaction is not completed, the Privatisation Proposals will not be made. Even if the Privatisation Proposals are made, the Privatisation Proposals may or may not become effective. Shareholders and optionholders in the Company are advised to exercise caution when dealing in shares and/or options of the Company.

As at the Latest Practicable Date, the Company has an issued share capital of HK$331,268,000 comprising 3,312,680,000 shares of the Company of HK$0.10 each and 104,378,000 outstanding options involving 104,378,000 shares of the Company of HK$0.10 each. Save as described above, the Company has no other options, warrants or other securities issued by the Company that carry a right to subscribe for or which are convertible into shares of the Company.

Miscellaneous

As at the Latest Practicable Date, Cathay held approximately 1.95% of the shares in the Company. Under Rule 25 of the Takeovers Code, Air China as offeror under the Privatisation Proposals is precluded from making arrangements with shareholders of the Company which have favourable conditions which are not to be extended to all shareholders of the Company. Given that the subscription by Cathay for Air China H Shares, the sales by SPAC and CITIC Pacific of Cathay Shares to Air China and the acquisition by Cathay of Dragonair Shares from the Company, each as contemplated under the Restructuring Agreement, are arrangements to which Rule 25 of the Takeovers Code may apply, Cathay has indicated in the Joint Announcement that it has decided to cease to be a shareholder in the Company and will donate all of its shares in the Company to a number of charities independent of Cathay and SPAC.

All references in this circular to the number of Cathay Shares and percentage holding in Cathay Shares following 8 June 2006 assume there will be no further issue of Cathay Shares pursuant to the exercise of share options granted under Cathay's share option scheme adopted on 10 March 1999 following 8 June 2006. All references in this circular to number of shares in Air China and percentage holding in shares in Air China following 8 June 2006 assume there will be no issue of A shares by Air China.

EFFECT OF DISPOSAL AND ACQUISITION

Business of the Remaining Group

The Transaction involves the sale of Dragonair Shares to Cathay in exchange for Cathay Shares. As Dragonair is an associated company of the Group, the Group's own main line of business and operations will remain unchanged after the Disposal. The Remaining Group will continue to be engaged in the following lines of operations:

Air Transportation Services

– Air Macau (of which CNAC (Macau) owns 51%). CNAC (Macau) is wholly-owned by the Group
– Macau Asia Express (of which Air Macau owns 51% and Groupax indirectly owns 49%. Groupax is owned as to 36% by CNAC (Macau))
– Cathay (of which the Group will own 7.34%)

Airline Catering Services

– BACL (of which the Group owns 60%)
– SWACL (of which the Group owns 60%)
– LLSHK (of which the Group owns 20.2%)

Airport Ground Handling Services

– JASL (of which the Company owns 50%)
– Menzies Macau (of which the Company indirectly owns 26% through CNAC (Macau), and indirectly owns 15% through Air Macau)

Logistics Services

– Tradeport Hong Kong (of which the Group owns 25%)

Detailed description and financial performance of each of the business lines has been laid out from page 116 to 172 in the section headed "Financial Information of the Group" in Appendix I to this circular.

Impact on Earnings

The sale of Dragonair Shares to Cathay in exchange for Cathay Shares will decrease the contribution from the associates but in return for the dividend income to be received from Cathay, a company with a steady dividend payout record.

As stated in the section headed "Unaudited Pro Forma Financial Information of the Group" in Appendix III to this circular, had the Disposal and Acquisition been completed at 1 January 2005, the Group's contribution from associates would be decreased by approximately HK$130 million and the Group's dividend income would be increased by approximately HK$188 million for the year ended 31 December 2005. In addition, had the Disposal and Acquisition been completed at 1 January 2005, the profit attributable to equity holders of the Company would be increased from approximately HK$225 million to approximately HK$3,596 million for the year ended 31 December 2005.

Impact on Assets and Liabilities

The Company recorded consolidated net assets (excluding minority interests) of HK$3,126 million as at 31 December 2005. The consolidated assets and liabilities of the Company as at 31 December 2005 were HK$4,217 million and HK$864 million respectively. As stated in the section headed "Unaudited Pro Forma Financial Information of the Group" in Appendix III to this circular, there would be a HK$2,960 million change in the consolidated net assets of the Company and the consolidated assets and liabilities of the Company would be HK$7,177 million and HK$864 million respectively, had the Disposal and Acquisition been completed on 31 December 2005. In addition, the consolidated net asset value of the Company would be increased from approximately HK$3,126 million to approximately HK$6,086 million had the Disposal and Acquisition been completed on 31 December 2005.

Gearing Position

Before the completion of the Disposal and Acquisition, the Group's operation was mainly financed by its internally generated funds. As at 31 December 2005, the Group had total borrowings of HK$25.4 million and cash and cash equivalents of HK$1,000 million. The gearing ratio (calculated on the total borrowings to the shareholders equity) of the Group was approximately 0.8%.

As stated in the section headed "Unaudited Pro Forma Financial Information of the Group" in Appendix III to this circular, had the Disposal and Acquisition been completed on 31 December 2005, the unaudited pro forma total borrowings of the Group would be status quo, cash and cash equivalents would be HK$1,416 million and shareholders' equity would be HK$6,086 million. The unaudited pro forma gearing ratio (calculated on the total borrowings to the shareholders equity) of the Group would be approximately 0.4%.

Liquidity, Financial Resources and Working Capital

The Group will continue to finance its operations through cash flow generated internally. As at 31 December 2005 on an unaudited pro forma basis, the Group would have a cash and cash equivalent position of HK$1,416 million and net current assets of approximately HK$1,108 million. The pro forma working capital would have remained strong, with current liabilities of approximately HK$675 million. Unaudited pro forma financial information are provided in the section headed "Unaudited Pro Forma Financial Information of the Group" in Appendix III to this circular.

Contingent Liabilities and Commitments

The contingent liabilities and commitments will remain unchanged for the Group after the completion of the Transaction. The contingent liabilities and commitments of the Group are provided on pages 117, 135, 136 and 155 in the section headed "Financial Information of the Group" in Appendix I to this circular.

Charge on Assets

The charge on assets of the Remaining Group will remain unchanged, which is provided on pages 118 and 136 in the section headed "Financial Information of the Group" in Appendix I to this circular.

Foreign Exchange and Currency Risks

The Remaining Group's foreign exchange and currency risks will be similar to that of the Group, which are provided on pages 118, 136 and 156 in the section headed "Financial Information of the Group" in Appendix I to this circular. As Dragonair is an associate company of the Group, its earning contribution would be subject to foreign exchange risks due to its ticket sales in foreign countries. After the Disposal and the Acquisition, Cathay's dividend payment will similarly be exposed to foreign exchange risks faced by the airline.

Human Resources

The staff level of the Group will remain unchanged after the completion of the Transaction, which is provided on pages 118, 136 and 156 in the section headed "Financial Information of the Group" in Appendix I to this circular. The Group currently has no intention to discontinue the employment of any employee of the Remaining Group as a result of the Transaction.

Financial and Trading Prospects of the Remaining Group

The executive Directors take the following views in relation to the financial and trading prospects of the Remaining Group.

The rapid economic growth in China and the increasing income of the China mainlanders are expected to boost the number of Chinese travellers to overseas destinations. In addition, the Macau Government is committed to promoting itself as a major leisure and gaming hub in Asia. These factors are expected to drive the traffic volume to and from Macau and thus boost the growth of the regional aviation industry. However, consistently high fuel prices will remain a significant challenge for airlines, and industry competition is also expected to intensify following the establishment of more airlines.

Air Macau is well positioned as the franchise carrier of Macau and a transit carrier within the Greater China region. Air Macau cargo service, established in 2004, increased frequencies and strengthened market share in Shenzhen, Shanghai, Xiamen and Taipei in

2005. At the same time, it launched a regular service to Phnom Penh, Cambodia, and operated charter services to Dhaka, Bangladesh. The Directors expect that it will continue to play an important role in air cargo transportation within the Pearl Delta region.

In order to cope with the changing demand of Asian travellers with regard to aviation services, the Group and Shun Tak Holdings Limited co-launched Macau Asia Express, a low-cost carrier based in Macau, in January 2006. The Group currently holds a 43.7% effective interest in the company. Macau Asia Express will complement Air Macau's services and focus on new destinations in Greater China and Asia. The company will integrate the expertise and resources of the Group and Shun Tak Holdings Limited in aviation services, aviation management, and in the gambling, entertainment and travel businesses in Macau, to provide travellers with affordable flight services and travel packages. The Group believes that the low-cost carrier will have significant potential in stimulating new traffic from the mass and cost-conscious travelers. The airline is expected to undertake its first commercial flight in the fourth quarter of 2006.

In addition, the Remaining Group will continue to streamline its business operations and strengthen its cost-control measures. The Remaining Group will also strive to capture business opportunities arising from the robust growth of the regional aviation and travel industries, with an aim to expand its income sources and maximise its profit. Having ensured a relatively stable position in the airline catering industry, the Remaining Group will allocate further resources for the expansion of its airline catering services, airport ground handling services, and other aviation-related businesses with focus in China mainland.

Subject to the shareholder approval and completion of the Transaction, the Remaining Group will maintain a 7.34% ownership in Cathay. With Dragonair under its full control, both Cathay and Dragonair are expected to become a stronger aviation group, and thus the Remaining Group intends to maintain its stake in Cathay as its long-term investment.

Looking forward, the Asian aviation industry will face a challenging yet prospering business environment. In view of uncertainties arising from fuel costs, the Remaining Group intends to implement a more effective fuel hedging programme, impose further fuel surcharge if regulatory bodies allow it, and implement more stringent cost-control measures.

Finally, on 21 June 2006, the Company jointly announced with Air China that, subject to satisfaction or waiver of a pre-condition and certain conditions, Air China will privatise the Company by way of a scheme of arrangement under section 166 of the Companies Ordinance. The Privatisation Proposals are made at the request of the Directors, who believe that the Privatisation Proposals to be in the interest of the Company. For the shareholders of the Company, the share proposal price of HK$2.80 per share represents an excellent opportunity to exit from their investment in the Company and realise immediate cash proceeds.

EGM

There is set out on page 278 a notice convening the EGM to be held on Tuesday, 22 August 2006 at 2:00 p.m. at Salon 6 (Level 3), JW Marriott Hotel Hong Kong, Pacific Place, 88 Queensway, Hong Kong, at which a resolution will be proposed to the shareholders of the Company to approve the Restructuring Agreement, and the Disposal and the Acquisition contemplated thereunder. The voting at the EGM will be taken by poll.

In accordance with the Listing Rules, Cathay, Air China and Merrill Lynch, Pierce, Fenner & Smith Incorporated which beneficially held approximately 1.95%, 68.4%, and 0.0004% respectively of the existing issued share capital of the Company as at the Latest Practicable Date, will (and in the case of Cathay, to the extent that Cathay will still be a shareholder of the Company as at the date of the EGM) abstain from voting on the resolution to approve the Restructuring Agreement, and the Disposal and the Acquisition contemplated thereunder at the EGM.

A form of proxy for use at the EGM is enclosed. Whether or not you are able to attend the EGM in person, you are requested to complete and return the form of proxy in accordance with the instructions printed thereon as soon as possible and in any event not later than 48 hours before the time appointed for the holding of the EGM or any adjourned meeting thereof. Completion and return of the form of proxy will not preclude you from attending and voting in person at the EGM or any adjourned meeting thereof and, in such event, the relevant form of proxy shall be deemed to be revoked.

RECOMMENDATION

Your attention is drawn to (i) the letter from the Independent Board Committee set out on pages 24 to 27 of this circular which contains its recommendation to the Independent Shareholders concerning the Restructuring Agreement, the Disposal and the Acquisition; and (ii) the letter from CLSA set out on pages 28 to 53 of this circular which contains their advice to the Independent Board Committee and the Independent Shareholders in relation to the Restructuring Agreement, the Disposal and the Acquisition, and the principal factors and reasons considered by them in formulating their advice.

ADDITIONAL INFORMATION

Your attention is also drawn to the information set out in the appendices to this circular and the notice of the EGM set out in this circular.

By order of the Board
China National Aviation Company Limited
Kong Dong
Chairman

中航興業有限公司
CHINA NATIONAL AVIATION COMPANY LIMITED
(incorporated in Hong Kong with limited liability)
(Stock Code: 1110)

30 June 2006

To the Independent Shareholders

Dear Sir or Madam,

VERY SUBSTANTIAL DISPOSAL
SALE OF DRAGONAIR SHARES

VERY SUBSTANTIAL ACQUISITION
ACQUISITION OF CATHAY SHARES

INTRODUCTION

We refer to the circular dated 30 June 2006 issued by the Company ("Circular") of which this letter forms part. Terms defined in the Circular and the Privatisation Announcement shall have the same meanings in this letter unless the context requires otherwise.

As Directors who are independent of the parties to the Transaction, we have been appointed as members of the Independent Board Committee for the purpose of advising Independent Shareholders in respect of the resolution to be proposed at the EGM to approve the Restructuring Agreement, the Disposal and the Acquisition.

CLSA has been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders as to whether or not the terms and conditions of the Restructuring Agreement, and more particularly, the Disposal Price of Dragonair Shares and the Acquisition Price of Cathay Shares, are on normal commercial terms and are fair and reasonable. Details of its advice and the principal factors taken into consideration in arriving at its recommendation are set out in the "Letter from CLSA" on pages 28 to 53 of the Circular. In formulating our advice and arriving at our recommendation, we have considered the terms and conditions of the Restructuring Agreement, the Disposal and the Acquisition, as well as the advice and recommendation of CLSA. We have also considered the other factors contained in the "Letter from the Board" on pages 6 to 23 of the Circular, and in particular the views of the executive Directors under the headings "Reasons for the Transaction" and "Financial and Trading Prospects of the Remaining Group".

The Privatisation Proposals are of significance to our advice and recommendation. The Privatisation Announcement was made on 21 June 2006 by Air China jointly with the Company and stated that, subject to completion of the transactions contemplated under the Restructuring Agreement (including the Disposal and the Acquisition), Air China will make proposals to privatise CNAC by means of a conditional scheme of arrangement at a price of HK$2.80 per Scheme Share under section 166 of the Companies Ordinance. The Privatisation Proposals were made at the request of the CNAC Board in light of the Transaction. The Privatisation Announcement states that "*The completion of the Restructuring will result in CNAC holding a 7.34% minority interest in Cathay, instead of 43.29% interest in Dragonair, thereby effectively becoming largely a passive investment holding company. In view of the subsequent material changes in CNAC's business and prospects, it is the view of the CNAC Directors that certain Scheme Shareholders may consider whether they would continue to hold their Scheme Shares*".

The Privatisation Proposals are subject to a number of conditions set out in the Privatisation Announcement including, among others:–

(A) the approval of the Scheme by a majority in number of the Independent Scheme Shareholders representing not less than three-fourths in value of the Scheme Shares held by Independent Scheme Shareholders, present and voting either in person or by proxy at the Court Meeting to approve the Scheme, provided that

 (i) the Scheme is approved by at least 75% of the votes attaching to Scheme Shares held by Independent Scheme Shareholders that are cast either in person or by proxy at the Court Meeting (by way of poll); and

 (ii) the number of votes cast against the resolution to approve the Scheme at the Court Meeting is not more than 104,803,800, representing 10% of the votes attaching to all Scheme Shares held by Independent Scheme Shareholders;

(B) the receipt of authorisations, consents and/or approvals from a number of PRC governmental and regulatory bodies; and

(C) no force majeure event having occurred which would render it impossible for Air China to implement the Privatisation Proposals.

The Independent Board Committee draws Independent Shareholders' attention to the opinion of CLSA (on page 52 of their letter) that

> *"Based on current market conditions as they exist as at the date of this letter and taking into account only the premiums represented by the Share Proposal Price (as defined in the Privatisation Announcement) as compared to the Company's historical share prices and premiums of going private transactions on the Main Board of the Exchange, we are of the opinion that, from a financial perspective, the Share Proposal Price of HK$2.80 is fair and reasonable."*

However, Independent Shareholders should be aware that, at the time of the EGM at which the resolution will be proposed to Independent Shareholders to approve the Restructuring Agreement, the Disposal and the Acquisition, there can be no assurance that the Privatisation Proposals will become effective. The conditions referred to above will not by that time have become capable of being satisfied.

The Independent Board Committee would like to draw Independent Shareholders' attention to the following factors which we believe are material to be taken into account by Independent Shareholders when voting at the EGM.

First, in our opinion, there is insufficient information currently available on the basis of which Independent Shareholders can assess reliably the future business and prospects of CNAC following the major change in its business that will result from the exchange of its 43.29% shareholding in Dragonair for a 7.34% shareholding in Cathay and HK$525.2 million in cash (including the Cathay special dividend). We have reached this opinion after taking into account the views of the executive Directors under the heading "Financial and Trading Prospects of the Remaining Group" in the Letter from the Board on pages 21 to 22 of the Circular. Further information may be available when the Scheme Document is despatched to the Company's shareholders. This will not, however, occur before the EGM to approve the Transaction which will take place on 22 August 2006. The Privatisation Announcement indicates that the Scheme Document will be despatched within seven days of Completion or as soon as practicable thereafter. Completion is expected to take place around the end of September 2006. In this regard, we draw Independent Shareholders' attention to the statement on page 51 of the Letter from CLSA that *"the completion of the Disposal and the Acquisition and the resulting effect on the Company's business and financial performance may have an impact on the trading price and liquidity of the Company's shares as a result of CNAC no longer holding a direct 43.29% shareholding in Dragonair".*

Secondly, the Privatisation Proposals are subject to the conditions referred to above and, accordingly, there can be no assurance that the Privatisation Proposals will become effective. In particular, if Shares representing approximately 3.16% of the issued Shares (being 10% of the votes attaching to all Scheme Shares held by Independent Scheme Shareholders) should vote against the Privatisation Proposals at the Court Meeting, the Privatisation Proposals will fail.

Thirdly, the Independent Board Committee has noted the recent substantial increases in the price of the Company's shares. These increases may be attributable (in whole or in part) to the public disclosure of the offer price under the conditional Privatisation Proposals.

In light of these factors, the Independent Board Committee has concluded as follows:–

1. Taking into account CLSA's advice, analysis and recommendation in the Letter from CLSA, and in particular CLSA's analysis of the Disposal Price of Dragonair Shares and the Acquisition Price of Cathay Shares under the headings "Disposal Price of Dragonair and Implied Multiples", and "Acquisition Price of Cathay and Implied Multiples", in our opinion the terms of the Restructuring Agreement, and more particularly the Disposal Price of Dragonair Shares and

the Acquisition Price of Cathay Shares, are fair and reasonable so far as the Independent Shareholders are concerned. Accordingly we recommend the Independent Shareholders to vote in favour of the resolution to be proposed at the EGM to approve the Restructuring Agreement, the Disposal and the Acquisition.

2. Having regard to (i) the substantial recent increases in the price of the Company's shares (ii) the fact that the Privatisation Proposals may or may not become effective and (iii) our opinion that there is insufficient information currently available on which Independent Shareholders can assess reliably the business and future prospects of CNAC following the Disposal and the Acquisition, as well as the possible impact of the Disposal and the Acquisition on the trading price and liquidity of the Company's shares referred to in the Letter from CLSA, it is open to Independent Shareholders to consider selling their Shares in the market in order to realise their investment in the Company if they are able to achieve an acceptable price.

3. Alternatively, it is open to Independent Shareholders to retain their Shares following the EGM and completion of the Transaction, and also to participate in the Privatisation Proposals as Scheme Shareholders. However, Independent Shareholders should take into account the possibility that, if the Privatisation Proposals do not become effective the price of the Company's shares could decline if no alternative offer is made to Independent Shareholders to acquire their Shares at a price comparable to that offered under the Privatisation Proposals. In this regard we note the statement on page 14 of the Letter from the Board that "*As approximately 68.36% of the Company is already owned by Air China as at the Latest Practicable Date, it is unlikely that shareholders of the Company will receive any other offer from a third party to acquire the shares in the Company.* Independent Shareholders should also take account of the possibility that, as mentioned in the Letter from CLSA, completion of the Disposal and the Acquisition may have an impact on the trading price and liquidity of the Company's shares. The Independent Board Committee considers that any such impact (the extent of which (if any) cannot at present be assessed) is more likely to be relevant if the Privatisation Proposals do not become effective.

Yours faithfully,
The Independent Board Committee of
China National Aviation Company Limited
Mr. Lok Kung Nam, Mr. Ho Tsu Kwok Charles,
Mr. Li Kwok Heem John and Ms. Chan Ching Ha Eliza
Independent non-executive Directors

The following is the full text of the letter from CLSA Equity Capital Markets Limited, the independent financial adviser to the Independent Board Committee, in relation to the Very Substantial Disposal – Sale of Dragonair Shares and the Very Substantial Acquisition – Acquisition of Cathay Shares, which has been prepared for the purpose of inclusion in the Circular.

CLSA
ASIA-PACIFIC MARKETS

30 June 2006

To the Independent Board Committee of China National Aviation Company Limited

Dear Sirs,

VERY SUBSTANTIAL DISPOSAL – SALE OF DRAGONAIR SHARES

VERY SUBSTANTIAL ACQUISITION – ACQUISITION OF CATHAY SHARES

INTRODUCTION

We refer to our engagement pursuant to which CLSA Equity Capital Markets Limited ("**CLSA**") has been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders as to whether or not the terms and conditions of the Restructuring Agreement and more particularly, the Disposal Price (as defined below) of Dragonair Shares and the Acquisition Price (as defined below) of Cathay Shares, as more particularly detailed herein below, are on normal commercial terms and are fair and reasonable.

This letter has been prepared for inclusion in the circular dated 30 June 2006 (the "**Circular**") issued by the Company to its Shareholders. Capitalised terms used in this letter shall have the same meanings as defined in the Circular unless the context otherwise requires.

INDEPENDENT BOARD COMMITTEE

Pursuant to the resolutions of the board of directors of the Company dated 1 June 2006 and 19 June 2006, the following independent non-executive directors of the Company, being Mr. Lok Kung Nam, Mr. Ho Tsu Kwok, Charles, Mr. Li Kwok Heem, John, and Ms. Chan Ching Har, Eliza, were appointed as members of the Independent Board Committee for the purposes of advising the Independent Shareholders in relation to the Restructuring Agreement, the Disposal and the Acquisition.

The remaining independent non-executive director of the Company, Mr. Hu Hung Lick, Henry has not been appointed as a member of the Independent Board Committee as Mr. Hu Hung Lick, Henry is also an independent non-executive director of Air China.

The Independent Board Committee has been constituted to advise the Independent Shareholders in respect of the resolution to approve the Restructuring Agreement, the Disposal and the Acquisition. We have been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders on the Restructuring Agreement, the Disposal and the Acquisition.

BASIS OF OUR OPINION

In formulating our opinion with regard to the Restructuring Agreement and more particularly, the Disposal and the Acquisition, we have relied on the information, opinions and facts supplied, and representations made to us by the Directors and representatives of the Company (including those contained or referred to in the Circular, the Joint Announcement and the Privatisation Announcement). We have assumed that all such information, opinions, facts and representations, which have been provided to us by the Directors, and representatives of the Company, and for which they are wholly responsible, are true and accurate in all material respects. We have also relied on certain information available to the public and we have assumed such information to be accurate and reliable, and we have not independently verified the accuracy of such information. Further, we have relied on the representations of the Directors that they have made all reasonable inquiries, and that, to the best of their knowledge and belief, there are no other facts, the omission of which would make any statement contained in the Circular, the Joint Announcement or the Privatisation Announcement untrue or misleading. We have also assumed that statements and representations made or referred to in the Circular, the Joint Announcement and the Privatisation Announcement were accurate at the time they were made and continue to be accurate at the date of despatch of the Circular.

We consider that we have reviewed sufficient information to enable us to reach an informed view regarding the Restructuring Agreement, the Disposal and the Acquisition to justify our recommendation, relying on the accuracy of the information provided in the Circular, the Joint Announcement and the Privatisation Announcement as well as to provide a reasonable basis for our advice. We have assumed that each of the agreements relating to the Transaction is enforceable against each of the parties thereto in accordance with its terms and that each of the parties will perform, and will be able to perform, its obligations thereunder, and as otherwise described in the Circular, in full when due. It is not within our terms of reference to comment on the commercial feasibility of the Restructuring Agreement, the Disposal and the Acquisition, which remains the responsibility of the Directors. As the independent financial adviser to the Independent Board Committee and the Independent Shareholders, we have not been involved in the negotiations in respect of the terms and conditions of the Transaction. Our opinion with regard to the terms and conditions thereof has been made on the assumption that all obligations to be performed by each of the parties to the Restructuring Agreement will be fully performed in accordance with the terms and conditions thereof. Further, we have no reason to suspect that any material facts or information have been omitted or withheld from the information supplied or opinions expressed to us nor to doubt the truth, accuracy and completeness of the information, facts and representations provided, or the reasonableness of the opinions expressed, to us by the Company, its Directors and its representatives. In line with normal practice, we have not, however, made any independent verification of the information and facts provided, representations made or opinions expressed by the Company, its

Directors and its representatives, nor have we conducted any form of independent investigation into the business affairs or assets and liabilities of the Group. Accordingly, we do not warrant the accuracy or completeness of any such information.

Our opinion is necessarily based upon market, economic and other conditions as they existed and could be evaluated on, and on the information publicly available to us as of, the date of this opinion. We have no obligation to update this opinion to take into account events occurring after the date that this opinion is delivered to the Independent Board Committee. As a result, circumstances could develop prior to completion of the Restructuring Agreement, the Disposal and the Acquisition that, if known to us at the time we rendered our opinion, would have altered our opinion.

Our opinion is also subject to the following qualifications:

(i) It is not possible to confirm whether or not the Restructuring Agreement, the Disposal and the Acquisition are in the interests of each individual Independent Shareholder and each Independent Shareholder should consider his/her/its vote on the merits or otherwise of the Restructuring Agreement, the Disposal and the Acquisition in his/her/its own circumstances and from his/her/its own point of view having regard to all the circumstances (and not only the financial perspective offered in this letter) as well as his/her/its own investment objectives;

(ii) We express no opinion as to whether the Restructuring Agreement, the Disposal and the Acquisition will be completed nor whether they will be successful;

(iii) Nothing contained in this letter should be construed as us expressing any view as to the trading price or market trends of any securities of the Company at any particular time; and

(iv) Nothing contained in this letter should be construed as a recommendation to hold, sell or buy any securities in the Company.

This letter is for the information of the Independent Board Committee solely in connection with their consideration of the Restructuring Agreement, the Disposal and the Acquisition and, except for its inclusion in the Circular and for references thereto in the letter from the Independent Board Committee set out in the Circular, is not to be quoted or referred to, in whole or in part, nor shall this letter be used for any other purpose, without our prior written consent.

CLSA is a licensed securities adviser and corporate finance adviser under the SFO and we, together with our affiliates, provide a full range of investment banking and brokerage services, which, in the course of normal trading activities, may from time to time effect transactions and hold securities, including derivative securities, of the Company, its subsidiaries or its substantial shareholder (as defined in the Listing Rules) or that of Air China, Cathay, CITIC Pacific or SPAC for the accounts of customers. CLSA will receive a fee from the Company for rendering this opinion. The Company has also agreed to indemnify CLSA and certain related persons against liabilities and expenses in connection with this engagement.

SUMMARY AND MATERIAL TERMS OF THE TRANSACTION

Detailed terms of the Transaction are as set out in the "Letter from the Board" in the Circular and Shareholders are strongly urged to read the entire "Letter from the Board" appearing in the Circular.

1. The Restructuring Agreement

Reference is made to the Joint Announcement dated 8 June 2006 pursuant to which it was disclosed that on 8 June 2006, Air China, Cathay, the Company, CITIC Pacific and SPAC entered into the Restructuring Agreement, the principal terms of which are set out below.

1.1. Disposal of Dragonair Shares and Acquisition of new Cathay Shares

Pursuant to the Restructuring Agreement, Cathay has, *inter alia*, offered to acquire 216,447,251 Dragonair Shares from the Group, representing all of the Group's 43.29% shareholding in Dragonair, to be satisfied by the issue of 288,596,335 new Cathay Shares at an issue price of HK$13.50 per Cathay Share to the Company and cash consideration of HK$432,894,497.50, which has been accepted by the Company. The terms of the Transaction value 100% of the equity of Dragonair at HK$10 billion and the Group's 43.29% shareholding in Dragonair at approximately HK$4,329 million.

Pursuant to the Restructuring Agreement, Cathay has also offered to acquire the remaining Dragonair Shares from each of SPAC, CITIC Pacific and the Dragonair Minority Shareholders on the same basis and each of SPAC and CITIC Pacific has agreed to accept the offer. Upon Completion (on the basis that Cathay has acquired all the Dragonair Shares held by the Dragonair Minority Shareholders), Dragonair will become a wholly-owned subsidiary of Cathay.

1.2. Purchase of Cathay Shares

Pursuant to the Restructuring Agreement, SPAC and CITIC Pacific have agreed to sell to Air China 40,128,292 and 359,170,636 Cathay Shares respectively. The consideration payable by Air China for such Cathay Shares is HK$13.50 per share.

1.3. Acquisition of Additional Air China H Shares

Pursuant to the Restructuring Agreement, Cathay has agreed to subscribe in cash for 1,179,151,364 Air China H Shares at an aggregate subscription price of HK$4.07 billion, representing HK$3.45 per Air China H Share. Immediately following completion of this subscription (assuming no further issue of shares by Air China before Completion, but subject to adjustments that may be made to fulfill the public float requirement), Cathay will have a 20% interest in the enlarged issued share capital of Air China.

1.4. Special Dividend

Pursuant to the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share.

1.5. Shareholding Structures of Cathay, Dragonair and Air China

The shareholdings in Dragonair, Cathay and Air China immediately prior to Completion and immediately following Completion (on the basis that Cathay has acquired all the Dragonair Shares held by the Dragonair Minority Shareholders) are set out in the section headed "Shareholding Structures of Cathay, Dragonair and Air China" in the "Letter from the Board" in the Circular.

2. Shareholders Agreement

As disclosed in the Joint Announcement on 8 June 2006, SPAC, the Company, CITIC Pacific and Air China also entered into the Shareholders Agreement for the purpose of regulating their relationship with each other as shareholders of Cathay and certain aspects of the affairs of, and their shareholdings in, Cathay, following completion of the Transaction.

Further details of the Shareholders Agreement are set out in the section headed "Shareholders Agreement" in the "Letter from the Board" in the Circular.

3. Conditions and Completion of the Transaction

Completion of the Transaction, (and the coming into effect of the Shareholders Agreement), is conditional upon satisfaction of a number of conditions which are set out in the section headed "Conditions" in the "Letter from the Board" in the Circular, including condition (E) that "the independent shareholders of the Company in general meeting having passed resolutions to approve the sale of the Company's Dragonair Shares to Cathay as a very substantial disposal and the acquisition of Cathay Shares by the Company as a very substantial acquisition".

Completion of the Transaction is expected to take place on the fifth Business Day following satisfaction of these conditions which is expected to be around the end of September 2006.

If the Restructuring Agreement has not become unconditional in all respects on or before 30 September 2006, the parties thereto shall consult in good faith with a view to determining whether the Transaction may proceed by way of alternative means or method or to extending such date. If the parties are unable to reach agreement on such alternative means or methods or such extension within 14 days (or such longer period as the parties may agree), the Restructuring Agreement shall automatically terminate.

4. Conditional Undertaking and Request for Privatisation of the Company

On Ling, which beneficially owns approximately 9.75% of the issued share capital of the Company, has given a conditional irrevocable undertaking to Air China and the Company to vote in favour of the shareholders' resolution to be proposed at the Company's shareholders' meeting to approve the Disposal and the Acquisition. The conditions precedent to On Ling's undertaking are:

(a) the publication of an announcement by or on behalf of Air China of a privatisation offer in cash for all the issued shares of the Company, other than those already owned by Air China and parties acting in concert with it, on terms no less favourable than HK$2.80 per share of the Company; and

(b) the independent financial adviser to the Independent Board Committee is of the opinion that the terms of the Disposal and the Acquisition and the privatisation referred to in paragraph (a) above from a financial perspective are fair and reasonable.

On 21 June 2006, Air China and the Company issued the Privatisation Announcement in relation to, *inter alia*, the proposed pre-conditional privatisation of the Company by Air China by way of a scheme of arrangement under section 166 of the Companies Ordinance at the price of HK$2.80 in cash per share of the Company and the proposal to purchase the outstanding options of the Company for cancellation in exchange for HK$1.66 in cash per option. Please refer to the Privatisation Announcement for further details.

As set out in the Privatisation Announcement, the making of the Privatisation Proposals is subject to satisfaction of a pre-condition (namely, the completion of the Transaction) and the implementation of the Privatisation Proposals is subject to satisfaction or waiver (as applicable) of certain conditions. In particular, if the Transaction is not completed, the Privatisation Proposals will not be made. Even if the Privatisation Proposals are made, the Privatisation Proposals may or may not become effective. Accordingly, Shareholders and optionholders in the Company are advised to exercise caution when dealing in shares and/or options of the Company.

5. Regulatory and Listing Rules Implications

As the assets and revenue ratios set out in Rule 14.07 of the Listing Rules in respect of the Disposal are more than 75%, such sale constitutes a very substantial disposal for the Company for the purposes of the Listing Rules and is therefore subject to the approval of the shareholders of the Company. As the assets, profits and revenue ratios set out in Rule 14.07 of the Listing Rules in respect of the Acquisition are more than 100%, such acquisition constitutes a very substantial acquisition for the Company for the purposes of the Listing Rules and is therefore subject to the approval of the shareholders of the Company.

If Cathay is a shareholder of the Company at the relevant time, it will be required to abstain from voting in respect of any shares in the Company held by it or on its behalf as a shareholder with a material interest in the Transaction. Air China, which is a party to the Restructuring Agreement, will be required to abstain from voting in respect of any shares in the Company held by it or on its behalf as a shareholder with a material interest in the Transaction. In addition, in accordance with the Listing Rules, Merrill Lynch, Pierce, Fenner & Smith Incorporated which is under the same control as Merrill Lynch (Asia Pacific) Limited, the financial adviser to Air China and the Company and which is interested in 14,000 shares in the Company will abstain from voting in respect of these shares.

PRINCIPAL FACTORS CONSIDERED

In considering whether or not the terms and conditions of the Restructuring Agreement and more particularly the Disposal and the Acquisition are on normal commercial terms and are fair and reasonable and in the interests of the Company and the Shareholders as a whole, we have taken into consideration, *inter alia*, the following factors:

1. Reasons for the Transaction

As stated in the "Letter from the Board", as set out in the Circular, the executive Directors take the following views in relation to the reasons for the Transaction.

As stated in the "Letter from the Board", as set out in the Circular, in recent years the Chinese aviation industry has experienced rapid growth and changes: The creation of three Chinese airline groups, the continuing liberalisation of the market to international airlines and the Chinese airlines' progressive increase in international destinations and frequencies of the international routes. We note that in the context of these market developments, as stated in the "Letter from the Board", the competitive position of Dragonair has become increasingly challenging, especially in the face of intensive competition on its Hong Kong–China mainland routes.

As stated in the "Letter from the Board", as set out in the Circular, although operated by an excellent management team, Dragonair faces challenges in scale and its concentration in the Hong Kong-China mainland routes. In light of this competitive operational landscape, the Company believes that Dragonair would benefit from being under the direct management control of a single airline group. The executive Directors believe that the proposed realignment of the shareholding structure, which puts Dragonair under Cathay, would provide Dragonair flexibility to react more rapidly in the fast changing market environment. In addition, as rising jet fuel cost has made every airline focus on cost-control, such realignment would allow Dragonair to achieve economies of scale under the management of one of the largest airlines in Asia Pacific. As stated in the "Letter from the Board", as set out in the Circular, such combination would create substantial synergies in marketing, operations, and fleet maintenance. Furthermore, the Transaction combines two networks which are complementary with each other – with a Hong Kong hub but with excellent coverage of both China mainland destinations and other international destinations. The Company believes that direct control of Dragonair by Cathay would allow Dragonair to secure its future growth and profitability in this rapidly changing operating landscape.

As stated in the "Letter from the Board", as set out in the Circular, as a consequence of the Transaction, the Company will hold a 7.34% shareholding in Cathay, thereby exchanging an illiquid shareholding in an unlisted company (Dragonair) for a shareholding in a listed company (Cathay) whose shares enjoy a high level of trading liquidity on the Exchange. Furthermore, the Transaction will allow the Company to realise a gain of approximately HK$2,960 million to its consolidated income statement, and, together with the payment of the special dividend by Cathay, the Company will receive HK$525.2 million of cash proceeds. As stated in the "Letter from the Board", as set out in the Circular, going forward, the Company will benefit from its proportional share of dividend income from Cathay, which, as a result of its cooperation with Air China and its consolidation with Dragonair, will be able to deliver good value for its shareholders in the future.

As stated in the "Letter from the Board", as set out in the Circular, the terms of the Transaction value 100% of the equity of Dragonair at HK$10 billion. This valuation represents a price-to-earnings ratio of 33.3 times Dragonair's reported earnings of HK$300.4 million for the year ended 31 December 2005. The Company believes that this valuation reflects not only the full intrinsic value of Dragonair but also a fair sharing of the synergies that Cathay anticipates to accrue from the combination of the two airlines.

2. The Disposal

2.1. Business of Dragonair

As stated in the "Letter from the Board", as set out in the Circular, and according to the Company's Annual Report for 2005, the principal business activity of Dragonair is the operation of scheduled passenger and cargo air transportation services, principally within the Asia region. Dragonair operates passenger services to 30 destinations in Asia, of which 22 are in China mainland. The majority of the income of Dragonair is derived from the provision of passenger and cargo air transportation services.

The following summarises Dragonair's principal operating subsidiaries and associates and their respective business activities:

Package Holiday Services

– Dragonair Holidays (of which Dragonair holds 100%): Principally provides packaged holiday services for Dragonair.

Airport Services

– HIAS (of which Dragonair holds 100%): Provides airport ground handling services in Hong Kong to Dragonair and other airlines.

– HAS (of which Dragonair holds 30%): Provides aircraft ramp handling operations and passenger and staff busing services at the Hong Kong International Airport.

– HAS GSE (of which Dragonair holds 30%): Principally provides spare parts for specialised ground equipment.

– DAS (of which Dragonair holds 30%): Provides ground support equipment and vehicles maintenance and repair services at the Hong Kong International Airport.

– DASL (of which Dragonair holds 30%): Principally engaged in the distribution of air cargo equipment and related spare parts.

Catering Services

– LLSHK (of which Dragonair holds 31.94%): Principally provides catering services in Hong Kong to Dragonair and other airlines.

2.2. *Historical Financial Performance of Dragonair*

As stated in the "Letter from the Board", as set out in the Circular, based on the audited consolidated financial statements of Dragonair for the year ended 31 December 2005, Dragonair had a consolidated net asset value of HK$3,155 million. Based on the audited consolidated financial statements of Dragonair for the years ended 31 December 2004 and 2005, the consolidated net profits of Dragonair before taxation were HK$765 million and HK$316 million respectively, and the consolidated net profits of Dragonair after taxation were HK$637 million and HK$300 million respectively.

At 31 December 2005, the Group's share of consolidated net asset value of Dragonair was HK$1,366 million. For the years ended 31 December 2004 and 2005, the Group's share of consolidated net profits of Dragonair was HK$276 million and HK$130 million respectively. For the year ended 31 December 2005, the Group received dividend income from Dragonair of HK$160 million. No dividend was received from Dragonair during the year ended 31 December 2004.

Further details of Dragonair's financial performance are set out in "Appendix I – Financial Information of the Group" in the Circular.

2.3. *Disposal Price of Dragonair and Implied Multiples*

2.3.1. Disposal Price of Dragonair Shares compared to Dragonair Comparable Companies

Based on the net profit attributable to Dragonair's shareholders for the year ended 31 December 2005 of HK$300 million and 500,000,000 Dragonair Shares in issue as at the Last Trading Date, the disposal price of HK$20.00 per Dragonair Share (the "**Disposal Price**") represents a price-to-earnings ratio ("**P/E**") of approximately 33.3 times.

Based on the net asset value for the year ended 31 December 2005 of HK$3,155 million and 500,000,000 Dragonair Shares in issue as at the Last Trading Date, the Disposal Price represents a price-to-book ratio ("**P/B**") of approximately 3.2 times.

In assessing the fairness and reasonableness of such valuation multiples, we have reviewed other listed companies in the region engaged in the passenger airline business. For this purpose, we have reviewed all passenger airline companies with a market capitalisation of over HK$4 billion as at the Last Trading Date. We consider the following comparisons relevant (the "**Dragonair Comparable Companies**"):

Company	**Approximate market capitalisation as at the Last Trading Date[1]**	**P/E[2]**	**P/B[2,3,4]**
	(HK$, million)	*(x)*	*(x)*
Singapore Airlines Limited	76,155	11.1	1.3
Cathay Pacific Airways Limited	43,801	13.3	1.3
Qantas Airways Limited	36,507	7.8	1.0
Air China Limited	29,243	12.6	1.5
Korean Air Lines Company Limited	19,543	11.2	0.6
Thai Airways International Public Company Limited	15,373	11.1	1.3
China Airlines Limited	13,260	82.1	1.0
Eva Airways Corp.	12,926	36.5	1.2
Asiana Airlines, Inc.	11,539	45.2	1.6
Jet Airways (India) Limited	10,821	14.2	3.2
China Southern Airlines Company Limited – H share	8,398	NM	0.9
Airasia Berhad	7,995	30.2	3.9
Malaysian Airline System Berhad	7,901	11.4	1.1
Air New Zealand Limited	6,037	6.8	0.8
China Eastern Airlines Corporation Limited – H share	5,451	NM	0.9
Average		**22.6**	**1.4**
Median		**12.6**	**1.2**
Dragonair	**10,000**	**33.3**	**3.2**

Notes:

1. *Being the closing share prices and, in the case of Dragonair, the Disposal Price, and the number of shares outstanding for the respective companies as at the Last Trading Date as disclosed in Bloomberg. Market capitalisation of the respective companies have been translated into Hong Kong dollars if the share price of the respective companies was not denominated in Hong Kong dollars, at the following rates:*

MYR:HKD 2.1298	*AUD:HKD 5.8353*	*SGD:HKD 4.9305*	*TWD:HKD 0.2419*
INR:HKD 0.1690	*NZD:HKD 4.8912*	*KRW:HKD 0.0082*	*THB:HKD 0.2033*

2. *Calculated based on the closing share price and published financial information contained in the annual reports of the respective companies available prior to the Last Trading Date.*

3. *Excludes minority interests.*

4. *Adjusted for dividends paid between the date of the latest annual financial statements and the Last Trading Date.*

As shown in the table above, the P/E and P/B represented by the Disposal Price are all higher than the average multiples of the Dragonair Comparable Companies and are all significantly higher than the median multiples of the Dragonair Comparable Companies. As such, based on the P/E and P/B multiples represented by the Disposal Price as compared to those of the Dragonair Comparable Companies, we are of the view that the Disposal Price is fair and reasonable so far as the Independent Shareholders are concerned.

2.3.2. Precedent Transactions in the Airline Industry

We have identified from publicly available sources[1] completed transactions since 1990 which involved the acquisition of more than 50% interest in air passenger businesses in Asia, with a transaction value of over US$50 million (approximately HK$389 million), and reviewed the available information for such transactions as summarised below (the "**Comparable Transactions**"):

Subject company	**Announcement date**	**% of interest acquired** *(%)*	**Transaction value[2]** *(HK$, million)*	**P/E[3,4]** *(x)*	**P/B[3,4]** *(x)*
Northern Airlines/ Xinjiang Airlines Group	12 November 2004	100.0	1,719.0	NM	1.0
Philippine Airlines Inc.	7 January 1992	67.0	2,843.9	12.9	1.8
China Xinhua Airlines	4 July 2001	51.0	880.2	NA	NA
China National Aviation (Macau)	8 February 2002	100.0	714.0	NA	NA
Average				**12.9**	**1.4**
Dragonair			**10,000.0**	**33.3**	**3.2**

Notes:

1. *Sources: Thomson One Banker, Bloomberg, relevant company circulars and announcements.*

2. *Transaction values of the respective companies, in the case of Dragonair, the value of 100% of equity of Dragonair under the terms of the Transaction, have been translated into Hong Kong dollars if acquisition price was not denominated in Hong Kong dollars, using the exchange rates of the day prior to the respective announcement date as follows:*

   RMB:HKD 0.9399 (for Northern Airlines/Xinjiang Airlines Group)
   RMB:HKD 0.9424 (for China Xinhua Airlines)
   PHP:HKD 0.29652

3. *Excludes minority interest.*

4. *Calculated based on the respective acquisition price per share (in the case of Dragonair, the Disposal Price) and the audited earnings and net asset value obtained from the latest financial statements of the respective companies published closest to the date of the announcement.*

As shown in the table above, the P/E represented by the Disposal Price is significantly higher than the P/E available for the Comparable Transactions (i.e. for Philippines Airlines Inc. announced on 7 January 1992). The P/B represented by the Disposal Price is also higher than the average P/B of Comparable Transactions. As such, based on the P/E and P/B multiples represented by the Disposal Price as compared to those of the Comparable Transactions, we are of the view that the Disposal Price is fair and reasonable so far as the Independent Shareholders are concerned.

3. The Acquisition

3.1. Business of Cathay

As stated in the "Letter from the Board", as set out in the Circular, the principal business activities of Cathay and its subsidiary and associated companies are the operation of scheduled passenger airline, cargo airline and airline catering services. According to Cathay's Annual Report for 2005, Cathay is based in Hong Kong, offering scheduled cargo and passenger services to 92 destinations around the world. As well as operating scheduled airline services, Cathay and its subsidiaries are engaged in other related areas including airline catering, aircraft handling and aircraft engineering. The airline operations are principally to and from Hong Kong, which is where most of the other activities of Cathay and its subsidiaries are also carried out. Cathay holds a 60% interest in AHK Air Hong Kong Limited (all-cargo carrier with a focus on express cargo services for DHL Express), a 100% interest in Cathay Pacific Catering Services (H.K.) Ltd., and a 70% interest in Hong Kong Airport Services Ltd. (largest franchised ramp handling company at the Hong Kong International Airport).

3.2. Historical Financial Performance of Cathay

Based on the audited consolidated financial statements of Cathay for the year ended 31 December 2005, Cathay had a consolidated net asset value (excluding minority interests) of HK$34,968 million. Based on the audited consolidated financial statements of Cathay for the years ended 31 December 2004 and 2005, the consolidated net profits of Cathay before taxation were HK$4,962 million and HK$3,968 million respectively, and the consolidated net profit of Cathay after taxation were HK$4,417 million and HK$3,298 million respectively.

Further details of Cathay's financial performance are set out in "Appendix II – Financial Information of Cathay" in the Circular.

3.3. Acquisition Price of Cathay and Implied Multiples

3.3.1. Acquisition Price of Cathay Shares Compared to Cathay Comparable Companies

Based on the net profit attributable to Cathay shareholders for the year ended 31 December 2005 of HK$3,298 million and 3,382,784,348 Cathay Shares in issue as at the Last Trading Date, the acquisition price of HK$13.50 per Cathay Share (the "**Acquisition Price**") represents a P/E of approximately 13.8 times.

Based on the adjusted net asset value for the year ended 31 December 2005 of HK$34,021 million (adjusted for dividends paid of HK$947.0 million) and 3,382,784,348 Cathay Shares in issue as at the Last Trading Date, the Acquisition Price represents a P/B of approximately 1.3 times.

On the basis of earnings before interest, taxes, depreciation, amortisation and operating lease rentals ("**EBITDAR**") for the year ended 31 December 2005 of HK$9,677 million and 3,382,784,348 Cathay Shares in issue as at the Last Trading Date, the Acquisition Price of HK$13.50 per Cathay Share represents an enterprise value to EBITDAR ("**EV/EBITDAR**") of approximately 6.7 times.

In assessing the fairness and reasonableness of such multiples to the Independent Shareholders, we have reviewed other listed companies world-wide engaged in the passenger airline business. For this purpose, we have reviewed all passenger airline companies with a market capitalisation of over

HK$10 billion as at the Last Trading Date. We consider the following comparisons relevant (the "**Cathay Comparable Companies**"):

Company	**Approximate market capitalisation as at the Last Trading Date**[1] *(HK$, million)*	**P/E**[2] *(x)*	**P/B**[2,3,4] *(x)*	**EV/EBITDAR**[2,4,5] *(x)*
Singapore Airlines Limited	76,155	11.1	1.3	5.9
Deutsche Lufthansa AG	63,282	13.9	1.5	2.9
British Airways Plc	57,423	8.6	2.1	4.1
Air France-KLM	45,461	12.4	0.9	5.3
Qantas Airways Limited	36,507	7.8	1.0	6.0
Air China Limited	29,243	12.6	1.5	7.5
Korean Air Lines Company Limited	19,543	11.2	0.6	7.6
Thai Airways International Public Company Limited	15,373	11.1	1.3	7.7
China Airlines Limited	13,260	82.1	1.0	14.8
Eva Airways Corp.	12,926	36.5	1.2	15.0
Asiana Airlines, Inc.	11,539	45.2	1.6	15.3
Jet Airways (India) Limited	10,821	14.2	3.2	8.4
Average		**22.2**	**1.4**	**8.4**
Median		**12.5**	**1.3**	**7.6**
Cathay	**53,066**	**13.8**	**1.3**	**6.7**

Notes:

1. *Being the closing share prices and, in the case of Cathay, the Acquisition Price, and the number of shares outstanding for the respective companies as at the Last Trading Date as disclosed in Bloomberg. Market capitalisation of the respective companies have been translated into Hong Kong dollars if the share price of the respective companies was not denominated in Hong Kong dollars, at the following rates:*

INR:HKD 0.1690	*AUD:HKD 5.8353*	*SGD:HKD 4.9305*	*TWD:HKD 0.2419*
MYR:HKD 2.1298	*NZD:HKD 4.8912*	*KRW:HKD 0.0082*	*THB:HKD 0.2033*
GBP:HKD 14.6015	*EUR:HKD 10.0214*		

2. *Calculated based on the closing share price and published financial information contained in the annual reports of the respective companies available prior to the Last Trading Date.*

3. *Excludes minority interests.*

4. *Adjusted for dividends paid between the date of the latest annual financial statements and the Last Trading Date.*

5. *Enterprise value includes operating lease rental capitalised at 8 times.*

As shown in the table above, the P/E represented by the Acquisition Price is significantly lower than the average P/E of the Cathay Comparable Companies but higher than the median P/E of the Cathay Comparable Companies. The P/B represented by the Acquisition Price is slightly lower than the average P/B of the Cathay Comparable Companies but equal to the median P/B of the Cathay Comparable Companies. However, the EV/EBITDAR represented by the Acquisition Price is lower than both the average and median EV/EBITDAR of the Cathay Comparable Companies. As such, based on the P/E, P/B and EV/EBITDAR multiples represented by the Acquisition Price as compared to those of the Cathay Comparable Companies, we are of the view that the Acquisition Price is fair and reasonable so far as the Independent Shareholders are concerned.

3.3.2. Acquisition Price of Cathay Shares Compared to Historical Share Price Performance

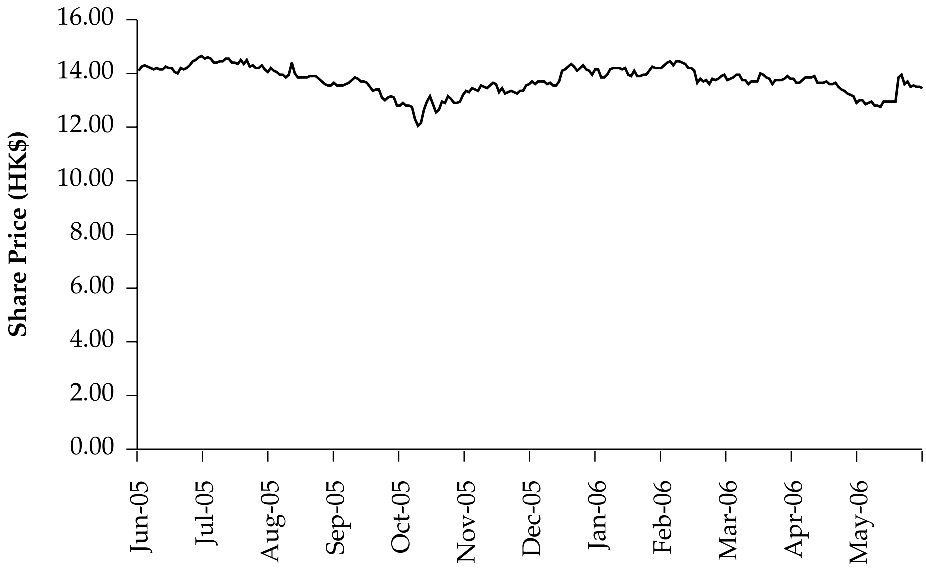
The table below states the closing price of Cathay Shares as at 20 June 2006, being the latest practicable date for this analysis, the Last Trading Date, as at 7 April 2006, being the latest trading date prior to the posting of the joint announcement made under Listing Rule 13.09 on 10 April 2006, the average closing price for the 10, 30, 60 and 180 trading-day period prior to and including the Last Trading Date and the average closing price for a period of twelve months from 21 June 2005 to 20 June 2006 (the "**Review Period**"), and the premium/discount which the Acquisition Price represents to such closing prices:

Date/ Corresponding Period	**Closing price/ average closing price** *(HK$)*	**Approximate premium of the Acquisition Price to the closing price/ average closing price** *(%)*
20 June 2006	13.50	0.0
Last Trading Date	12.95	4.2
7 April 2006	13.95	-3.2
10 trading-day period prior to the Last Trading Date	12.89	4.7
30 trading-day period prior to the Last Trading Date	13.36	1.1
60 trading-day period prior to the Last Trading Date	13.58	-0.6
180 trading-day period prior to the Last Trading Date	13.60	-0.7
Review Period	13.73	-1.7

Source: Bloomberg

As shown in the table above, the premium of the Acquisition Price to the closing price/average closing price for the respective periods range from -3.2% to approximately 4.7%.

The following chart sets out the daily historical closing prices of Cathay Shares traded on the Exchange during the Review Period:



Source: Bloomberg

The highest, lowest, month-end and average daily closing prices of Cathay Shares for each of the months during the Review Period and the Review Period were as follows:

	Highest closing price *(HK$)*	Lowest closing price *(HK$)*	Month/ period end closing price *(HK$)*	Average daily closing price *(HK$)*
2005				
June (from and including 21 June)	14.30	14.10	14.15	14.20
July	14.65	14.00	14.45	14.35
August	14.55	13.85	14.40	14.24
September	14.00	13.55	13.80	13.74
October	13.70	12.05	12.15	13.02
November	13.55	12.55	13.45	13.10
December	13.70	13.25	13.55	13.50
2006				
January	14.35	13.55	14.20	14.08
February	14.45	13.90	14.45	14.17
March	14.40	13.60	13.60	13.88
April	14.00	13.60	13.85	13.78
May	13.90	12.80	12.80	13.32
June (up to and including 20 June)	13.95	12.75	13.50	13.33
Review Period	14.65	12.05	13.50	13.73

Source: Bloomberg

During the Review Period, the closing price of Cathay Shares fluctuated within a range of HK$12.05 to HK$14.65, with the highest and lowest closing price on 20 July 2005 and 28 October 2005, respectively. The Acquisition Price of HK$13.50 per Cathay Share represents a premium of approximately 12.0% to the lowest closing price of HK$12.05, a discount of approximately 1.7% to the average closing price of approximately HK$13.73 and a discount of approximately 7.8% to the highest closing price of HK$14.65 during the Review Period. As such, based on the premium/discount represented by the Acquisition Price as compared to Cathay's share price performance during the Review Period, we are of the view that the Acquisition Price is fair and reasonable so far as the Independent Shareholders are concerned.

3.4. Special Dividend

As stated in the "Letter from the Board", as set out in the Circular, pursuant to the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share.

4. Effect of the Transaction on the Company

4.1. Business of the Remaining Group

As stated in the "Letter from the Board", as set out in the Circular, and according to the Company's Annual Report for 2005, the principal business activity of the Group is that of investment holding company. The Transaction involves the sale of Dragonair Shares to Cathay in exchange for Cathay Shares. According to the Board, as Dragonair is an associated company of the Group, the Group's own main line of business and operations will remain unchanged after the Disposal. The Remaining Group will be engaged in the following lines of operations:

Air Transportation Services

– Cathay (of which CNAC will own 7.34%).

– Air Macau (of which CNAC (Macau) owns 51%; CNAC (Macau) is wholly-owned by the Group): Provides airline operations.

– Macau Asia Express (of which Air Macau owns 51% and Groupax indirectly owns 49%; Groupax is owned as to 36% by CNAC (Macau)).

Airline Catering Services

– BACL (of which the Group owns 60%): Principally engaged in the provision of in-flight catering services and other related in-flight food and beverage services.

– SWACL (of which the Group owns 60%): Principally engaged in the production of food, beverages and in-flight services products, provision of other related services and the sale of its own products.

– LLSHK (of which the Group directly owns 20.2%): Principally engaged in the provision of catering services in Hong Kong to Dragonair and other airlines.

Airport Ground Handling Services

– JASL (of which the Company owns 50%): Principally engaged in the provision of airport ground handling services and through its subsidiary and jointly controlled entity, the provision of ramp handling services and ground support equipment maintenance services, respectively.

– Menzies Macau (of which the Company indirectly owns 26% through CNAC (Macau), and indirectly owns 15% through Air Macau): Provides Macau international airport with passenger, ramp handling, cargo and aircraft line maintenance services.

Logistics Services

– Tradeport Hong Kong (of which the Group owns 25%).

As stated in the "Letter from the Board", as set out in the Circular, following the completion of the Disposal and Acquisition, the Company's current intention is to hold the Cathay Shares as a long-term investment. With regards to the cash proceeds, the Company is currently considering appropriate uses of these funds in relation to the further development of its existing and other aviation related businesses. Should no attractive opportunities present themselves, the Company may consider distributing the excess cash to its shareholders in due course.

4.2. Financial Effects of the Disposal and the Acquisition on the Group

4.2.1. Impact on Earnings

As stated in the "Letter from the Board", as set out in the Circular, the sale of Dragonair Shares to Cathay in exchange for Cathay Shares will decrease the contribution from the associates but in return for the dividend income to be received from Cathay.

In reference to the unaudited pro forma financial information of the Group as set out in Appendix III of the Circular, had the Disposal and Acquisition been completed at 1 January 2005, the Group's contribution from associates would be decreased by approximately HK$130 million and the Group's dividend income would be increased by approximately HK$188 million for the year ended 31 December 2005.

4.2.2. Impact on Assets and Liabilities

As stated in the "Letter from the Board", as set out in the Circular, the Company recorded consolidated net assets (excluding minority interests) of HK$3,126 million as at 31 December 2005. The consolidated assets and liabilities of the Company as at 31 December 2005 were HK$4,217 million and HK$864 million, respectively. In reference to the unaudited pro forma financial information of the Group in Appendix III of the Circular, there would be an increase of HK$2,960 million in the consolidated net assets of the Company, and the consolidated assets and liabilities of the Company would be HK$7,177 million and HK$864 million, respectively, had the Disposal and Acquisition been completed on 31 December 2005. In addition, the consolidated net asset value of the Company would be increased from approximately HK$3,126 million to approximately HK$6,086 million had the Disposal and Acquisition been completed on 31 December 2005.

4.2.3. Gearing Position

As stated in the "Letter from the Board", as set out in the Circular, before the completion of the Disposal and Acquisition, the Group's operations were mainly financed by its internally generated funds. As at 31 December 2005, the Group had total borrowings of HK$25.4 million and cash and cash equivalents of HK$1,000 million. The gearing ratio (calculated on the total borrowings to the shareholders equity) of the Group was approximately 0.8%.

In reference to the unaudited pro forma financial information of the Group in Appendix III of the Circular, had the Disposal and Acquisition been completed on 31 December 2005, the unaudited pro forma total borrowings of the Group would have remained unchanged, cash and cash equivalents would be HK$1,416 million and shareholders' equity would be HK$6,086 million. The unaudited pro forma gearing ratio (calculated on the total borrowings to the shareholders' equity) of the Group would be approximately 0.4%.

4.2.4. Liquidity, Financial Resources and Working Capital

As stated in the "Letter from the Board", as set out in the Circular, the Group will continue to finance its operations through cash flow generated internally. As at 31 December 2005 on an unaudited pro forma basis, the Group would have a cash and cash equivalent position of HK$1,416 million and net current assets of approximately HK$1,108 million. The pro forma working capital would have remained strong, with current liabilities of approximately HK$675 million. Unaudited pro forma financial information are set out in "Appendix III – Unaudited Pro Forma Financial Information of the Group".

4.2.5. Contingent Liabilities and Commitments

As stated in the "Letter from the Board", as set out in the Circular, the contingent liabilities and commitments will remain unchanged from the Group after the completion of the Transaction. The contingent liabilities and commitments of the Group are set out in "Appendix I – Financial Information of the Group".

4.2.6. Charge on Assets

As stated in the "Letter from the Board", as set out in the Circular, the charge on assets of the Remaining Group will remain unchanged, which is set out in "Appendix I – Financial Information of the Group".

4.2.7. Foreign Exchange and Currency Risks

As stated in the "Letter from the Board", as set out in the Circular, the Remaining Group's foreign exchange and currency risks will be similar to that of the Group, which are set out in "Appendix I – Financial Information of the Group". As Dragonair is an associate company of the Group, its earning contribution would be subject to foreign exchange risks due to its ticket sales in foreign countries. After the Disposal and Acquisition, Cathay's dividend payment will similarly be exposed to foreign exchange risks faced by the airline.

4.3. Human Resources

As stated in the "Letter from the Board", as set out in the Circular, the staff level of the Group will remain unchanged after the completion of the proposed Transaction, which is set out in "Appendix I – Financial Information of the Group". The Group currently has no intention to discontinue the employment of any employee of the Remaining Group as a result of the proposed Transaction.

4.4. Financial and Trading Prospects of the Remaining Group

As stated in the "Letter from the Board", as set out in the Circular, the executive Directors take the following views in relation to the financial and trading prospect of the Remaining Group.

As stated in the "Letter from the Board", as set out in the Circular, the rapid economic growth in China and the increasing income of the China mainlanders are expected to boost the number of Chinese travellers to overseas destinations. In addition, the Macau Government is committed to promoting itself as a major leisure and gaming hub in Asia. These factors are expected to drive the traffic volume to and from Macau and thus boost the growth of the regional aviation industry. However, consistently high fuel prices will remain a significant challenge for airlines, and industry competition is also expected to intensify following the establishment of more airlines.

As stated in the "Letter from the Board", as set out in the Circular, Air Macau is well positioned as the franchise carrier of Macau and a transit carrier within the Greater China region. Air Macau cargo service, established in 2004, increased frequencies and strengthened market share in Shenzhen, Shanghai, Xiamen and Taipei in 2005. At the same time, it launched a regular service to Phnom Penh, Cambodia, and operated charter services to Dhaka, Bangladesh. The Directors expect that it will continue to play an important role in air cargo transportation within the Pearl Delta region.

As stated in the "Letter from the Board", as set out in the Circular, in order to cope with the changing demand of Asian travellers with regard to aviation services, the Group and Shun Tak Holdings Limited co-launched Macau Asia Express, a low-cost carrier based in Macau, in January 2006. The Group currently holds a 43.7% effective interest in the company. Macau Asia Express will complement Air Macau's services and focus on new destinations in Greater China and Asia. The company will integrate the expertise and resources of the Group and Shun Tak Holdings Limited in aviation services, aviation management, and in the gambling, entertainment and travel businesses in Macau, to provide travellers with affordable flight services and travel packages. The Group believes that the low-cost carrier will have significant potential in stimulating new traffic from the mass and cost-conscious travelers. The airline is expected to undertake its first commercial flight in the fourth quarter of 2006.

In addition, as stated in the "Letter from the Board", the Remaining Group will continue to streamline its business operations and strengthen its cost-control measures. The Remaining Group will also strive to capture business opportunities arising from the robust growth of the regional aviation and travel industries, with an aim to expand its income sources and maximise its profit. Having ensured a relatively stable position in the airline-catering industry, the Remaining Group will allocate further resources for the expansion of its airline-catering services, airport ground handling services, and other aviation-related businesses with focus in China mainland.

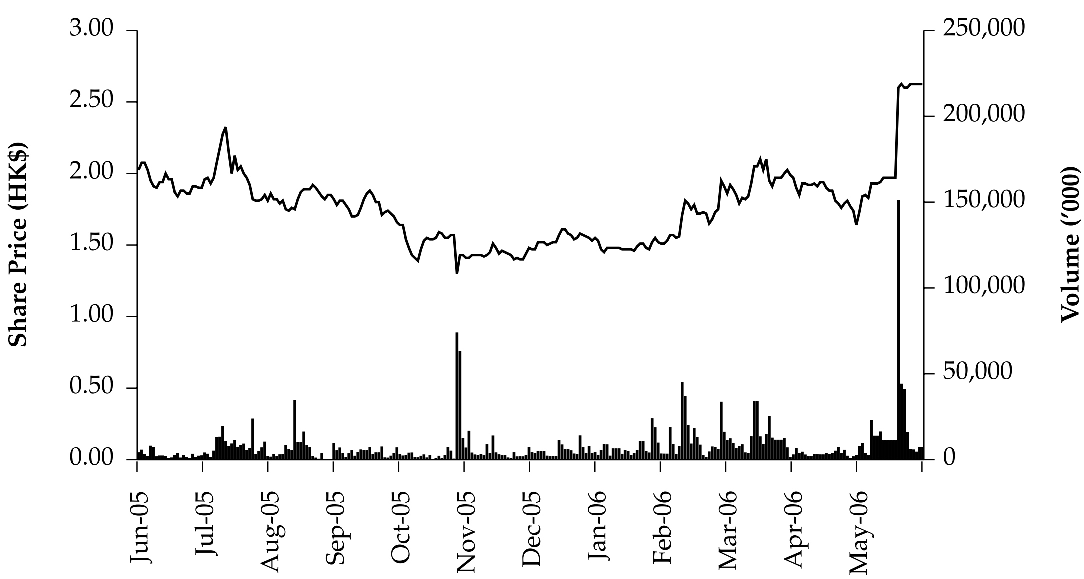
As stated in the "Letter from the Board", as set out in the Circular, subject to the shareholder approval and completion of the Transaction, the Remaining Group will maintain a 7.34% ownership in Cathay. With Dragonair under its full control, both Cathay and Dragonair are expected to become a stronger aviation group, and thus the Remaining Group intends to maintain its stake in Cathay as its long-term investment.

As stated in the "Letter from the Board", as set out in the Circular, looking forward, the Asian aviation industry will face a challenging yet prospering business environment. In view of uncertainties arising from fuel costs, the Remaining Group intends to implement a more effective fuel hedging programme, impose further fuel surcharge if regulatory bodies allow it and implement more stringent cost-control measures.

In addition, on 21 June 2006, the Company jointly announced with Air China that, subject to satisfaction or waiver of a pre-condition and certain conditions, Air China will privatise the Company by way of a scheme of arrangement under section 166 of the Companies Ordinance as stated in the Privatisation Announcement and in the "Letter from the Board" as set out in the Circular. For further details on the Privatisation Proposals, please refer to the Privatisation Announcement, the "Letter from the Board" as set out in the Circular and section 5 of our letter below.

4.5. Potential Impact on Trading Liquidity and Trading Multiples

The following chart sets out the daily historical closing prices and trading volumes of the Company's shares traded on the Exchange during the Review Period:



Source: Bloomberg

The average and month-end daily closing prices and the average and total traded volume of the Company's shares for each of the months during the Review Period were as follows:

	Average daily closing price *(HK$)*	Month/period-end closing price *(HK$)*	Average daily volume *('000)*	Total volume *('000)*
2005				
June (from and including 21 June)	1.99	1.94	4,240	33,918
July	1.95	2.28	4,121	86,533
August	1.91	1.76	6,963	160,149
September	1.82	1.71	6,172	135,790
October	1.67	1.47	3,725	78,226
November	1.49	1.43	10,118	222,600
December	1.46	1.52	3,611	79,435
2006				
January	1.53	1.48	6,089	133,949
February	1.51	1.56	7,864	157,277
March	1.79	1.84	12,763	293,553
April	1.98	1.92	11,708	234,164
May	1.85	1.93	5,538	127,364
June (up to and including 20 June)	2.34	2.63	24,861	348,056

Source: *Bloomberg*

The completion of the Disposal and the Acquisition and the resulting effect on the Company's business and financial performance may have an impact on the trading price and liquidity of the Company's shares as a result of CNAC no longer holding a direct 43.29% shareholding in Dragonair.

5. Proposed Privatisation of the Company

Reference is made to the Privatisation Announcement dated 21 June 2006 and jointly released by Air China and the Company in relation to, *inter alia*, the proposed pre-conditional privatisation of the Company by Air China by way of a scheme of arrangement under section 166 of the Companies Ordinance at the price of HK$2.80 in cash per share of the Company and the proposal to purchase the outstanding options of the Company for cancellation in exchange for HK$1.66 in cash per option. Please refer to the Privatisation Announcement for further details.

As stated in the "Letter from the Board", as set out in the Circular, On Ling, which beneficially owns approximately 9.75% of the issued share capital of the Company, has given a conditional irrevocable undertaking to Air China and the Company to vote in favour of the shareholder's resolution to be proposed at the Company's shareholders' meeting to approve the Disposal and the Acquisition. The conditions precedent to On Ling's undertaking are:

(a) the publication of an announcement by or on behalf of Air China of a privatisation offer in cash for all the issued shares of the Company, other than those already owned by Air China and parties acting in concert with it, on terms no less favourable than HK$2.80 per share of the Company; and

(b) the independent financial adviser to the Independent Board Committee is of the opinion that the terms of the Disposal and the Acquisition and the privatisation referred to in paragraph (a) above from a financial perspective are fair and reasonable.

Based on current market conditions as they exist as at the date of this letter and taking into account only the premiums represented by the Share Proposal Price (as defined in the Privatisation Announcement) as compared to the Company's historical share prices and premiums of going private transactions on the Main Board of the Exchange, we are of the opinion that, from a financial perspective, the Share Proposal Price of HK$2.80 is fair and reasonable.

Independent Shareholders should note that our full analysis of the Share Proposal Price and our opinion in respect thereof as to whether it is fair and reasonable will be set out in our letter of advice to the independent board committee to be contained in the Scheme Document to be issued to all shareholders in relation to the Privatisation Proposals (as defined in the Privatisation Announcement) which will be despatched following satisfaction of a pre-condition (namely, the completion of the Transaction).

CONCLUSION AND OPINION

In reaching our opinion (on the basis set out at the beginning of this letter), we have considered the above principal factors and reasons and, in particular, have taken into account the following in arriving at our opinion:

– the reasons for the Transaction, in particular the increasing competitive environment in the airline industry faced by Dragonair;

– the Disposal Price of Dragonair Shares representing a P/E of 33.3 times and P/B of 3.2 times, all being above the average multiples of 22.6 times and 1.4 times, respectively, and significantly above the median multiples of 12.6 times and 1.2 times, respectively, of the Dragonair Comparable Companies;

– the Disposal Price of Dragonair Shares representing a P/E above the P/E of 12.9 times available for Comparable Transactions (i.e. for Philippines Airlines Inc. announced on 7 January 1992) and a P/B above the average P/B of 1.4 times for Comparable Transactions;

– the Acquisition Price of Cathay Shares representing a P/E of 13.8 times, being significantly lower than the average P/E of 22.2 times for Cathay Comparable Companies, a P/B of 1.3 times, being slightly below the average P/B of 1.4 times for Cathay Comparable Companies and an EV/EBITDAR of 6.7 times, being below the average EV/EBITDAR of 8.4 times for Cathay Comparable Companies; and

– the Acquisition Price of Cathay Shares representing a premium of between approximately -7.8% and 12.0% to the highest and lowest closing price, respectively, during the Review Period, with the Acquisition Price representing a discount of 1.7% to the average closing price during the Review Period.

Having considered the above, we are of the opinion that the terms and conditions of the Restructuring Agreement and more particularly the Disposal Price of Dragonair Shares and the Acquisition Price of Cathay Shares are on normal commercial terms and are fair and reasonable. Accordingly, we advise the Independent Board Committee to recommend to the Independent Shareholders to vote in favour of the Restructuring Agreement and more particularly the Disposal and the Acquisition at the extraordinary general meeting to be convened at 2:00 p.m. on 22 August 2006.

Yours faithfully,
For and on behalf of
CLSA Equity Capital Markets Limited
Robert Reid
Managing Director

(A) ACCOUNTANTS' REPORT

The following is the reproduction of the text of the report, prepared for the sole purpose of inclusion in this circular, received from the auditors and reporting accountants, PricewaterhouseCoopers, Certified Public Accountants, Hong Kong.

PRICEWATERHOUSECOOPERS

羅兵咸永道會計師事務所

PricewaterhouseCoopers
22nd Floor, Prince's Building
Central, Hong Kong

30 June 2006

The Directors
China National Aviation Company Limited

Dear Sirs,

We set out below our report on the financial information relating to China National Aviation Company Limited (the "Company") and its subsidiaries (hereinafter collectively referred to as the "Group"), its jointly controlled entities and associates for each of the years ended 31 December 2003, 2004 and 2005 (the "Relevant Periods") for inclusion in the circular of the Company dated 30 June 2006 in connection with the proposed sale of the Group's entire interest in Hong Kong Dragon Airlines Limited ("Dragonair") and the proposed acquisition of shares of Cathay Pacific Airways Limited ("Cathay").

The Company was incorporated in Hong Kong on 3 February 1997 with limited liability under the Hong Kong Companies Ordinance. As at the date of this report, the Company had direct and indirect interests in the subsidiaries, jointly controlled entities and associates as set out in notes 19, 20 and 21 of Section II respectively below.

The Group, its jointly controlled entities and associates have adopted 31 December as their financial year end date. We have audited the consolidated financial statements of the Company for the Relevant Periods which have been prepared in accordance with generally accepted accounting principles in Hong Kong.

The financial information as set out in Sections I to II below (the "Financial Information") has been prepared based on the audited consolidated financial statements of the Company for each of the Relevant Periods, after making such adjustments as are appropriate.

For the purpose of this report, we have examined the Financial Information for the Relevant Periods and have carried out such additional procedures as are necessary in accordance with the Auditing Guidance 3.340 "Prospectuses and the Reporting Accountant" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

The directors of the Company (the "Directors") at the Relevant Periods are responsible for preparing these consolidated financial statements of the Company which give a true and fair view. In preparing these financial statements which give a true and fair view, it is fundamental that appropriate accounting policies are selected and applied consistently.

The Directors are also responsible for the preparation of the Financial Information. It is our responsibility to form an independent opinion, based on our examination, on the Financial Information and to report our opinion.

In our opinion, the Financial Information, for the purpose of this report, gives a true and fair view of the state of affairs of the Group and the Company at 31 December 2003, 2004, 2005 and of the results and cash flows of the Group for the Relevant Periods.

(I) FINANCIAL INFORMATION

(a) Consolidated income statements

The following is a summary of the consolidated income statements for the Relevant Periods, after making adjustments as are appropriate:

	Section II Note	Year ended 31 December 2003 HK$'000	2004 HK$'000	2005 HK$'000
Turnover	7	1,227,031	1,890,710	2,620,033
Other revenues	7	16,321	12,991	46,985
Total revenues		1,243,352	1,903,701	2,667,018
Other gains	8	9,970	10,047	39,268
Staff costs	9	(215,410)	(249,786)	(388,649)
Passenger catering and service costs		(79,223)	(103,353)	(237,545)
Fuel costs		(191,125)	(387,918)	(654,018)
Route operating costs		(309,515)	(437,812)	(529,051)
Aircraft maintenance costs		(153,868)	(139,719)	(226,553)
Aircraft leases and equipment costs		(324,903)	(355,718)	(444,882)
Depreciation and amortisation costs		(87,497)	(86,160)	(78,221)
Sales and promotion costs		(50,328)	(61,078)	(92,395)
Other operating costs		(65,036)	(75,471)	(107,289)
Total operating expenses		(1,476,905)	(1,897,015)	(2,758,603)
Operating (loss)/profit	10	(223,583)	16,733	(52,317)
Finance costs	11	–	(375)	(2,960)
Share of profits less losses of associates	21(a)	106,690	390,450	277,243
Profit before income tax		(116,893)	406,808	221,966
Income tax	12	30,188	(12,344)	(10,042)
(Loss)/profit for the year		(86,705)	394,464	211,924

		Year ended 31 December		
	Section II	**2003**	**2004**	**2005**
	Note	*HK$'000*	*HK$'000*	*HK$'000*
Attributable to:				
Equity holders of the Company	*13*	(17,295)	360,969	225,000
Minority interests		(69,410)	33,495	(13,076)
		(86,705)	394,464	211,924
Dividends	*14*	29,761	53,003	59,628
		HK cents	HK cents	HK cents
(Loss)/earnings per share	*15*			
– Basic		(0.52)	10.90	6.79
– Diluted		(0.52)	10.81	6.72

(b) Consolidated balance sheets

The following is a summary of the consolidated balance sheets at 31 December 2003, 2004 and 2005, after making adjustments as are appropriate:

		At 31 December		
	Section II	**2003**	**2004**	**2005**
	Note	*HK$'000*	*HK$'000*	*HK$'000*
ASSETS				
Non-current assets				
Property, plant and equipment	*16*	399,378	495,786	471,692
Land use right	*17*	–	2,355	2,274
Intangible assets	*18*	306,195	529,249	529,240
Interests in associates	*21(a)*	1,198,012	1,590,158	1,627,594
Loans to associates	*21(b)*	82,103	82,103	47,097
Lease and equipment deposits		83,041	68,762	60,109
Deferred income tax assets	*34*	30,333	21,777	23,427
Pledged bank deposits	*27*	25,637	67,455	88,943
		2,124,699	2,857,645	2,850,376
Current assets				
Loan to an associate	*22*	–	–	18,060
Investment securities	*23*	–	18,313	–
Derivative financial instruments	*24*	–	–	11,957
Inventories	*25*	50,824	54,045	53,273
Trade and other receivables	*26*	154,056	258,465	283,544
Cash and cash equivalents	*27*	1,036,929	746,793	999,833
		1,241,809	1,077,616	1,366,667
Total assets		3,366,508	3,935,261	4,217,043
EQUITY				
Capital and reserves attributable to the Company's equity holders				
Share capital	*28*	331,268	331,268	331,268
Reserves	*29*	2,284,260	2,589,813	2,761,442
Proposed final dividend	*29*	19,876	33,127	33,127
		2,635,404	2,954,208	3,125,837
Minority interests		248,797	282,292	227,352
Total equity		2,884,201	3,236,500	3,353,189

		At 31 December		
	Section II	**2003**	**2004**	**2005**
	Note	*HK$'000*	*HK$'000*	*HK$'000*
LIABILITIES				
Non-current liabilities				
Provision for overhaul and major checks	*30*	64,869	91,939	154,904
Provision for housing allowances	*31*	–	–	34,126
		64,869	91,939	189,030
Current liabilities				
Trade and other payables	*32*	309,382	416,572	514,623
Sales in advance of carriage		107,469	118,061	132,394
Current income tax liabilities		587	2,972	2,436
Short-term bank loans – unsecured	*33*	–	69,217	25,371
		417,438	606,822	674,824
Total liabilities		482,307	698,761	863,854
Total equity and liabilities		3,366,508	3,935,261	4,217,043
Net current assets		824,371	470,794	691,843
Total assets less current liabilities		2,949,070	3,328,439	3,542,219

(c) Balance sheets

The following is a summary of the balance sheets of the Company at 31 December 2003, 2004 and 2005, after making adjustments as are appropriate:

	Section II Note	At 31 December 2003 HK$'000	2004 HK$'000	2005 HK$'000
ASSETS				
Non-current assets				
Interests in subsidiaries	*19*	1,518,124	1,981,860	2,014,820
Interests in associates	*21(a)*	51,789	51,789	51,789
Loan to an associate	*21(b)*	37,560	34,560	–
		1,607,473	2,068,209	2,066,609
Current assets				
Loan to an associate	*22*	–	–	18,060
Trade and other receivables	*26*	4,664	687	921
Cash and cash equivalents	*27*	813,612	381,969	509,140
		818,276	382,656	528,121
Total assets		2,425,749	2,450,865	2,594,730
EQUITY				
Capital and reserves				
Share capital	*28*	331,268	331,268	331,268
Reserves	*29*	2,070,395	2,082,127	2,225,967
Proposed final dividend	*29*	19,876	33,127	33,127
Total equity		2,421,539	2,446,522	2,590,362
LIABILITIES				
Current liabilities				
Trade and other payables	*32*	4,210	4,343	4,368
Total equity and liabilities		2,425,749	2,450,865	2,594,730
Net current assets		814,066	378,313	523,753
Total assets less current liabilities		2,421,539	2,446,522	2,590,362

(d) Consolidated statements of changes in equity

The following is a summary of the consolidated statements of changes in equity for the Relevant Periods, after making adjustments as are appropriate:

	Attributable to the Company's equity holders				
	Share capital	**Other reserves**	**Retained earnings**	**Minority interests**	**Total**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Balance at 1 January 2003	331,931	1,442,404	921,785	318,207	3,014,327
Share of currency translation differences of associates	–	–	59	–	59
Share of deficit on revaluation of investment securities of an associate	–	(1,716)	–	–	(1,716)
Net (expense)/income recognised directly in equity	–	(1,716)	59	–	(1,657)
Loss for the year	–	–	(17,295)	(69,410)	(86,705)
Total recognised loss for 2003	–	(1,716)	(17,236)	(69,410)	(88,362)
Repurchase of own shares *(note 28(b))*	(663)	663	(5,325)	–	(5,325)
Dividends	–	–	(36,439)	–	(36,439)
Balance at 31 December 2003	331,268	1,441,351	862,785	248,797	2,884,201
Balance at 1 January 2004	331,268	1,441,351	862,785	248,797	2,884,201
Share of currency translation differences of associates	–	–	51	–	51
Share of deficit on revaluation of investment securities of an associate	–	(2,464)	–	–	(2,464)
Net (expense)/income recognised directly in equity	–	(2,464)	51	–	(2,413)
Profit for the year	–	–	360,969	33,495	394,464
Total recognised (loss)/income for 2004	–	(2,464)	361,020	33,495	392,051
Transfer	–	43	(43)	–	–
Dividends	–	–	(39,752)	–	(39,752)
Balance at 31 December 2004	331,268	1,438,930	1,184,010	282,292	3,236,500

	Attributable to the Company's equity holders				
	Share capital	Other reserves	Retained earnings	Minority interests	Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Balance at 1 January 2005	331,268	1,438,930	1,184,010	282,292	3,236,500
Share of opening adjustments on adoption of HKAS 39 by associates	–	(20,056)	1,033	–	(19,023)
Balance at 1 January 2005, as restated	331,268	1,418,874	1,185,043	282,292	3,217,477
Share of currency translation differences of associates	–	–	84	–	84
Share of fair value gains on derivative financial instruments of associates *(note 29 (b))*	–	25,319	–	–	25,319
Currency translation differences	–	(123)	–	–	(123)
Net income recognised directly in equity	–	25,196	84	–	25,280
Profit for the year	–	–	225,000	(13,076)	211,924
Total recognised income/(loss) for 2005	–	25,196	225,084	(13,076)	237,204
Transfer	–	6,599	(6,599)	–	–
Dividends	–	–	(59,628)	(41,864)	(101,492)
Balance at 31 December 2005	331,268	1,450,669	1,343,900	227,352	3,353,189

(e) Consolidated cash flow statements

The following is a summary of the consolidated cash flow statements for the Relevant Periods:

	Section II Note	2003 HK$'000	2004 HK$'000	2005 HK$'000
		Year ended 31 December		
Cash flows from operating activities				
Cash (used in)/generated from operations	*35(a)*	(100,629)	161,645	186,684
Overseas taxation paid		(9,953)	(1,009)	(12,228)
Interest paid		–	(375)	(2,960)
Net cash (used in)/from operating activities		(110,582)	160,261	171,496
Cash flows from investing activities				
Interest received		9,910	4,891	20,159
Purchase of an associate		–	(115,069)	–
Purchase of jointly controlled entities	*35(b)*	–	(326,753)	–
Sale of an investment security		–	–	19,520
Dividends received from associates		69,535	110,960	246,187
Increase in pledged deposits		(12,482)	(35,698)	(21,488)
Repayment of loan from an associate		(5,250)	–	16,500
Purchase of property, plant and equipment		(27,467)	(38,409)	(54,300)
Sale of property, plant and equipment		246	722	304
Net cash from/(used in) investing activities		34,492	(399,356)	226,882
Cash flows from financing activities				
Repurchase of own shares	*28(b)*	(5,325)	–	–
Dividends paid to Company's equity holders		(39,670)	(39,752)	(59,628)
Dividends paid to minority interests		–	–	(41,864)
Proceeds from short-term bank loans		–	–	35,926
Repayments of short-term bank loans		–	(11,289)	(79,772)
Net cash used in financing activities		(44,995)	(51,041)	(145,338)
Net (decrease)/increase in cash and cash equivalents		(121,085)	(290,136)	253,040
Cash and cash equivalents at 1 January		1,158,014	1,036,929	746,793
Cash and cash equivalents at 31 December	*27*	1,036,929	746,793	999,833

(II) NOTES TO THE FINANCIAL INFORMATION

1. General information

The Company is a limited liability company incorporated in Hong Kong on 3 February 1997, the shares of which were listed on the Main Board of The Stock Exchange of Hong Kong Limited in December 1997. The Group, its jointly controlled entities and its associates are principally engaged in the airline operations, airport ground handling services, airline catering services, logistics and other businesses.

The address of the Company's registered office is 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau.

The Directors regard Air China Limited ("Air China"), a company incorporated in the People's Republic of China ("PRC") and listed on the Main Board of The Stock Exchange of Hong Kong Limited, as being the immediate holding company. The parent company of Air China is China National Aviation Holding Company ("CNAH"), a state-owned enterprise established in the PRC.

2. Basis of preparation

The financial information has been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRS") and Hong Kong Accounting Standards ("HKAS") and interpretations ("HKAS-Int") (collectively "HKFRSs") issued by the HKICPA. The financial information has been prepared under the historical cost convention except that, as disclosed in the accounting policies below, available-for-sale investments and derivative financial instruments are carried at fair value.

The preparation of the financial information in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial information, are disclosed in note 5.

3. Standards, interpretations and amendments to published standards that are not yet effective

The HKICPA has issued the following amendments, new standards and interpretations which are not yet effective as of the date of the Financial Information and will be relevant to the Group:

	Effective for accounting periods beginning on or after
HKFRS Interpretation 4 "Determining whether an Arrangement contains a Lease"	1 January 2006
Amendments to HKAS 19 "Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures"	1 January 2006
Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement":	
– Cash Flow Hedge Accounting of Forecast Intragroup Transactions	1 January 2006
– The Fair Value Option	1 January 2006
Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:	
– HKAS 1 "Presentation of Financial Statements"	1 January 2006
– HKAS 27 "Consolidated and Separate Financial Statements"	1 January 2006
– HKFRS 3 "Business Combinations"	1 January 2006
Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 4 "Insurance Contracts" – "Financial Guarantee Contracts"	1 January 2006
HKFRS 7 "Financial Instruments: Disclosures"	1 January 2007
Amendments to HKAS 1 "Presentation of Financial Statements: Capital Disclosures"	1 January 2007

The Group has not early adopted the above standards, interpretations and amendments in the Financial Information for the year ended 31 December 2005. The Group has already commenced an assessment of the related impact to the Group but is not yet in a position to state whether substantial changes to the Group's accounting policies and presentation of the Financial Information will be resulted.

4. Summary of significant accounting policies

The significant accounting policies applied in the preparation of the financial information are set out below:

4.1 Group accounting

The consolidated financial statements of the Company include the financial statements of the Company and its subsidiaries made up to 31 December.

(a) Subsidiaries

Subsidiaries are those entities in which the Company, directly or indirectly, controls the composition of the board of directors, controls more than half of the voting power or holds more than half of the issued share capital.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Intercompany transactions, balances and unrealised gains on transactions between group companies are eliminated. Unrealised losses are also eliminated but considered an impairment indicator of an impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

In the Company's balance sheet the investments in subsidiaries are stated at cost less provision for impairment losses. The results of subsidiaries are accounted for by the Company on the basis of dividend received and receivable.

(b) Associates

Associates are all entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill (net of any accumulated impairment loss) identified on acquisition.

The Group's share of its associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Group.

In the Company's balance sheet the interests in associates are stated at cost less provision for impairment losses. The results of associates are accounted for by the Company on the basis of dividend received and receivable.

(c) Jointly controlled entities

The Group's interests in jointly controlled entities are accounted for by proportionate consolidation. The Group combines its share of the jointly controlled entities' individual income and expenses, assets and liabilities and cash flows on a line-by-line basis with similar items in the Group's financial statements. The Group recognises the portion of gains or losses on the sale of assets by the Group to the jointly controlled entity that it is attributable to the other venturers. The Group does not recognise its share of profits or losses from the jointly controlled entity that result from the Group's purchase of assets from the jointly controlled entity until it resells the assets to an independent party. However, a loss on the transaction is recognised immediately if the loss provides evidence of a reduction in the net realisable value of current assets, or an impairment loss.

4.2 Segment reporting

In accordance with the Group's internal financial reporting policies, the Group has determined that the primary segment reporting is by business segments and the secondary segment reporting is by geographical segments.

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns that are different from those of segments operating in other economic environments.

Unallocated costs represent corporate expenses. Segment assets consist primarily of intangible assets, property, plant and equipment, land use right, lease and equipment deposits, derivative financial instruments, inventories, trade and other receivables and operating cash and mainly exclude interests in associates and non-operating bank balances and cash. Segment liabilities comprise operating liabilities and mainly exclude current income tax liabilities. Capital expenditure comprises additions to intangible assets, land use right and property, plant and equipment, including additions resulting from acquisitions through business combinations.

In respect of geographical segment reporting, turnover and operating profit by geographical segments is based on the following criteria:

(i) Traffic revenue from inbound and outbound services between Macau and overseas markets is attributed to the geographical area in which the relevant overseas origin/destination lies.

(ii) Revenue from sale of goods is attributed on the basis of where the goods are sold.

Total assets and capital expenditure are where the assets are located.

4.3 *Foreign currency translation*

(a) Functional and presentation currency

Items included in the financial statements of each entity in the Group are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The functional currency of the Company is Macau Patacas. As the Company is incorporated and listed in Hong Kong, the Directors regard Hong Kong dollar as the presentation currency of the Company. Accordingly, the Financial Information are presented in Hong Kong dollar.

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow hedges or qualifying net investment hedges.

Translation difference on non-monetary financial assets, such as equities classified as available-for-sale investments, are included in the investments revaluation reserve in equity.

(c) Group companies

The results and financial position of all the group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;

(ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and

(iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is sold, exchange differences that were recorded in equity are recognised in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

4.4 *Property, plant and equipment*

Buildings comprise mainly factories and offices. All property, plant and equipment are stated at historical cost less accumulated depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. Costs of regular major checks and overhauls are capitalised and amortised over the maintenance cycle. All other repairs and maintenance are expensed in the income statement during the financial period in which they are incurred.

Depreciation on property, plant and equipment is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives, as follows:

Buildings	20 to 30 years
Leasehold improvement	6 years
Aircraft and engines	10 to 20 years
Flight equipment and rotable spares	7 to 20 years
Machinery, other equipment, furniture and motor vehicles	3 to 20 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Where the carrying amount of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement.

4.5 *Land use right*

Land use right represents operating lease prepayment for land less accumulated amortisation and impairment losses. Amortisation is calculated using the straight-line method to allocate the cost of operating lease prepayment for land over the remaining lease term.

4.6 *Intangible assets*

(a) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiaries/associates/jointly controlled entities at the date of acquisition. Goodwill on acquisitions of subsidiaries and jointly controlled entities is included in intangible assets. Separately recognised goodwill on acquisitions of associates is included in interests in associates. Goodwill is carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Until 31 December 2004, goodwill was amortised using the straight-line method over its estimated useful lives or not more than 20 years and assessed for an indication of impartment at balance sheet date. From 1 January 2005 onwards, goodwill is not subject to amortisation and is tested annually for impairment.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. Each of those cash-generating units represents the Group's investment in operation of each country by each primary reporting segment (note 4.7).

(b) Trademark

Trademark is shown at historical cost. Trademark has a definite useful life and is carried at cost less accumulated amortisation. Amortisation is calculated using the straight-line method to allocate the cost of trademark over its estimated useful life.

4.7 *Impairment of non-financial assets*

Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment and are reviewed for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets other than goodwill that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

4.8 *Financial assets*

From 1 January 2003 to 31 December 2004, the Group classified its investment in securities, other than subsidiaries, jointly controlled entities and associates, as non-trading investment securities.

Investment securities were stated at cost less provision for diminution in value other than temporary in nature.

From 1 January 2005 onwards, the Group classifies its investments into: loans and receivables and available-for-sale investments. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition and re-evaluates this designation at every reporting date.

(a) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are included in current assets, except for maturities greater than 12 months after the balance sheet date. These are classified as non-current assets.

(b) Available-for-sale investments

Available-for-sale investments are non-derivative financial assets that are designated as available for sale or are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss.

Regular purchases and sales of investments are recognised on trade date – the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership. Available for-sale investments are subsequently carried at fair value. Loans and receivables are carried at amortised cost using the effective interest method. When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains or losses from investment securities.

The fair values of quoted investments are based on current bid prices. If the market for a financial asset is not active (and for unlisted securities), the Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, and option pricing models refined to reflect the issuer's specific circumstances.

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity securities classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered an indicator that the securities are impaired. If any such evidence exists for available-for-sale investments, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement – is removed from equity and recognised in the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement. Impairment testing of trade receivables is described in note 4.10.

4.9 Inventories

Inventories comprise expendable spare parts and supplies, are stated at the lower of cost and net realisable value, and are expensed when used in operations. Cost is calculated on the average cost basis except for aircraft spare parts, cost of which is calculated on the first-in-first-out basis. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

4.10 Trade and other receivables

Trade and other receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade and other receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivables is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the effective interest rate. The amount of the provision is recognised in the income statement.

4.11 Manufacturers' credits

Manufacturers' credits received in connection with leasing of aircraft, which the Group can apply those credits to reduce future costs of acquiring aircraft spares or rental payments, are either deferred and amortised as income or as a reduction of rental expenses for aircraft over relevant leases.

4.12 Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less.

4.13 Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, including fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

4.14 Deferred income tax

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries, associates and jointly controlled entities, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future.

4.15 Employee benefits

(i) Employee leave entitlements

Employee entitlements to annual leave are recognised when they accrue to employees of the Group. A provision is made for the estimated liability for annual leave as a result of services rendered by employees up to the balance sheet date.

Employee entitlements to sick leave and maternity or paternity leave are not recognised until the time of leave.

(ii) Retirement benefit costs

Contributions to the defined contribution schemes are charged to the income statement in the year in which the contributions relate.

(iii) Share-based compensation

The Group operates an equity-settled share-based compensation plan. The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non-market vesting conditions (for example, profitability and sales growth targets). Non-market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity over the remaining vesting period.

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

(iv) Housing allowances

A jointly controlled entity of the Group makes payments to certain of its eligible employees related to an one-off adjustment made to the housing benefits of these eligible employees as of 31 October 2005. The amount of the related obligation is re-measured annually by an independent qualified actuary using the projected unit credit method. Actuarial gains and losses arising from experience adjustments, and changes in actuarial assumptions, are recognised in the current period.

4.16 Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. Provisions are not recognised for future operating losses.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

4.17 Provision for overhaul and major checks

A provision is made for the estimated costs of major checks and overhauls required to be conducted to fulfill the requirements under the relevant leases based on the maintenance cycle of each aircraft under operating leases.

4.18 Contingent liabilities

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognised but is disclosed in the notes to the Financial Information. When a change in the probability of an outflow occurs so that outflow is probable, they will then be recognised as a provision.

4.19 Revenue recognition

Revenue comprises the fair value for the sale of goods and services, net of value-added tax, rebates and discounts and after eliminating sales within the Group. Ticket sales for transportation net yet provided are included in current liabilities as sales in advance of carriage. Revenues are recognised as follows:

(i) Passenger, cargo and mail revenues

Passenger, cargo and mail revenues are recognised when the transportation is provided.

(ii) Sale of goods

Revenue, net of sales discounts, from the sale of goods is recognised on the transfer of risks and rewards of ownership, which generally coincides with the time of delivery.

(iii) Inflight sales commission

Inflight sales commission is recognised when services are rendered.

(iv) Rental income

Rental income is recognised on a straight-line basis over the terms of the leases.

(v) Dividend income

Dividend income is recognised when the right to receive payment is established.

4.20 Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are expensed in the income statement on a straight-line basis over the period of the lease.

4.21 Borrowing costs

Borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalised as part of the cost of that asset.

All other borrowing costs are charged to the income statement in the period in which they are incurred.

4.22 Dividend distribution

Dividend distribution to the Company's equity holders is recognised as a liability in the Group's financial statements in the period in which the dividends are approved by the Company's equity holders.

4.23 Accounting for derivative financial instruments

Derivative financial instruments are designated 'hedging 'or 'non-hedging instruments'. The transactions that, according to the Group's policy for risk management, are able to meet the conditions for hedge accounting are classified as hedging transactions; the others, although set up for the purpose of managing risk (since the Group's policy does not permit speculative transactions), have been designated as 'non-hedging'.

From 1 January 2003 to 31 December 2004:

The Group records derivative financial instruments at cost. The gains and losses on derivative financial instruments are included in the income statement on maturity to match the underlying hedged transactions where relevant.

From 1 January 2005 onwards:

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement within 'other gains'.

5. Critical accounting estimates and judgements

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

(i) Impairment of goodwill

The Group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 4.6(a). The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates (note 18).

(ii) *Provision for overhaul and major checks*

The Group is required to perform relevant overhaul on engines and cycle checks on airframes during the lease period in order to fulfil certain requirements under the corresponding lease agreements and accordingly, provision is made for overhaul and major checks. The provision is made based on the estimated major checks and overhaul costs to completion over the proportion of monthly flying hours to remaining flying hours of the maintenance cycle. Significant judgment is required in determining the estimated major check costs and overhaul costs and the total flying hours in the maintenance cycle.

(iii) *Provision for housing allowances*

A jointly controlled entity provides cash allowances to its employees pursuant to a staff housing policy adopted during the year. The expected cost of providing these deferred housing allowances is calculated by an independent qualified actuary using the projected unit credit method, which involves a number of actuarial assumptions including the discount rate and employees' turnover rate before retirement.

6. Financial risk management

In the normal course of business, the Group is exposed to a variety of financial risks, including the effects of movements in foreign exchange rates, interest rates and jet fuel prices, insurance coverage risk and credit risk. These exposures are managed, sometimes with the use of derivative financial instruments.

(a) *Foreign currency risk*

The Group generates a portion of its venture from sales in certain foreign jurisdictions giving rise to exposures to risk from changes in foreign exchange rates. The currencies giving rise to this risk are primarily Taiwanese Dollars. The Group continuously monitors its foreign currency positions and does not consider that it has a significant exposure to risk from any currency.

The Group uses derivative financial instruments to hedge its exposure to foreign exchange risks arising from operational activities. In accordance with its treasury policy, the Group does not hold or issue derivative financial instruments for trading purpose.

(b) *Interest rate risk*

The Group did not have significant bank loans at the balance sheet date. Deposits placed with banks earn interest rates ranging from 0.001% to 4.15% per annum. The Group does not consider that it has a significant exposure to interest rate risk.

(c) *Fuel price risk*

In the normal course of business, the Group is exposed to fluctuations in jet fuel prices. At 31 December 2003, 2004 and 2005, the Group had one, two and six derivative contracts outstanding respectively to lock in future fuel price at a certain range. The Group receives from the counter-party the applicable difference between the fuel price and the strike price, subject to a cap, for the notional quantity if the fuel price rises above the strike price. In return, the Group pays the counter-party the difference between the fuel price and the strike price if the fuel price falls below the strike price.

The Group does not anticipate any material adverse effect on its financial position resulting from its involvement in this instrument, nor does it anticipate non-performance by any of its counter-party.

(d) *Insurance coverage risk*

A commercial airline is required to have adequate liability insurance cover. Following the "911" event, certain airlines have difficulties in securing adequate liability insurance cover. The Group is able to obtain the required liability insurance cover with increased premium rates. Part of the increased insurance charge is recovered from passengers through a surcharge.

(e) *Credit risk*

It is the Group's policy to obtain certain collateral from customers and counter-parties who require credit. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. At 31 December 2003, 2004 and 2005, there was no significant concentration of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

(f) *Fair value*

There were no material differences between the carrying amounts and estimated fair values of the Group's significant financial assets and liabilities at 31 December 2003, 2004 and 2005.

7. Revenues and segment information

Revenues recognised are as follows:

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Turnover			
Traffic revenues			
– Passenger services	984,211	1,355,391	1,544,125
– Cargo and mail services	242,820	516,372	807,259
Airline catering revenue	–	18,947	268,649
	1,227,031	1,890,710	2,620,033
Other revenues			
Inflight sales commission	1,861	3,136	5,453
Rental from sub-lease of aircraft	14,460	9,855	41,532
	16,321	12,991	46,985
Total revenues	1,243,352	1,903,701	2,667,018

The Group, its jointly controlled entities and its associates are organised into four main business segments including airline operation, airport ground handling, airline catering, logistics and other businesses.

Primary reporting format – Business segments

	Year ended and at 31 December 2003				
	Airline operation	**Airport ground handling**	**Airline catering**	**Logistics and other businesses**	**Total**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Segment revenues	1,243,352	–	–	–	1,243,352
Segment results	(193,390)	–	–	–	(193,390)
Interest income					9,172
Unallocated costs					(39,365)
Operating loss					(223,583)
Finance costs					–
Share of profits less losses of associates	32,102	84,152	–	(9,564)	106,690
Loss before income tax					(116,893)
Income tax					30,188
Loss for the year					(86,705)
Segment assets	931,323	–	–	–	931,323
Interests in associates	1,118,216	97,711	–	(17,915)	1,198,012
Loans to associates	–	34,560	–	47,543	82,103
Unallocated assets					1,155,070
Total assets					3,366,508
Segment liabilities	477,442	–	–	–	477,442
Unallocated liabilities					4,865
Total liabilities					482,307
Capital expenditure	27,467	–	–	–	27,467
Depreciation	68,519	–	–	–	68,519
Amortisation	138	–	–	–	138
Reversal of provision for impairment of trade receivables	(1,252)	–	–	–	(1,252)

	Year ended and at 31 December 2004				
	Airline operation *HK$'000*	**Airport ground handling** *HK$'000*	**Airline catering** *HK$'000*	**Logistics and other businesses** *HK$'000*	**Total** *HK$'000*
Segment revenues	1,884,754	–	18,947	–	1,903,701
Segment results	52,791	–	803	–	53,594
Interest income					4,891
Unallocated costs					(41,752)
Operating profit					16,733
Finance costs					(375)
Share of profits less losses of associates	275,547	122,915	44	(8,056)	390,450
Profit before income tax					406,808
Income tax					(12,344)
Profit for the year					394,464
Segment assets	1,093,645	–	479,918	–	1,573,563
Interests in associates	1,391,299	106,722	115,114	(22,977)	1,590,158
Loans to associates	–	34,560	–	47,543	82,103
Unallocated assets					689,437
Total assets					3,935,261
Segment liabilities	559,319	–	134,386	–	693,705
Unallocated liabilities					5,056
Total liabilities					698,761
Capital expenditure	38,251	–	127,584	–	165,835
Depreciation	64,740	–	1,266	–	66,006
Amortisation	45	–	1,269	–	1,314
Provision for impairment of trade receivables	1,175	–	235	–	1,410

	Year ended and at 31 December 2005				
	Airline operation	**Airport ground handling**	**Airline catering**	**Logistics and other businesses**	**Total**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Segment revenues	2,398,369	–	268,649	–	2,667,018
Segment results	(51,954)	–	1,789	–	(50,165)
Interest income					20,159
Unallocated costs					(22,311)
Operating loss					(52,317)
Finance costs					(2,960)
Share of profits less losses of associates	130,062	139,591	11,097	(3,507)	277,243
Profit before income tax					221,966
Income tax					(10,042)
Profit for the year					211,924
Segment assets	1,168,150	–	488,620	–	1,656,770
Interests in associates	1,365,917	165,445	122,178	(25,946)	1,627,594
Loans to associates	–	18,060	–	47,097	65,157
Unallocated assets					867,522
Total assets					4,217,043
Segment liabilities	741,313	–	115,658	–	856,971
Unallocated liabilities					6,883
Total liabilities					863,854
Capital expenditure	45,145	–	9,155	–	54,300
Depreciation	66,696	–	11,435	–	78,131
Amortisation	9	–	81	–	90
Provision for/(reversal of) impairment of trade receivables	3,599	–	(147)	–	3,452

Amortisation charge by business segments did not include goodwill arising from acquisitions of China National Aviation Corporation (Macau) Company Limited of HK$18,840,000 for the years ended 31 December 2003 and 2004 as the Directors consider that there is no meaningful basis for allocating such amortisation of goodwill between airline operation and airport ground handling businesses.

Secondary reporting format – Geographical segments

The Group and its jointly controlled entities operate in three main geographical areas including China mainland, Taiwan and other regions (mainly Macau, Thailand and Philippines). The airline operation business is mainly operated in places in China mainland, Taiwan and other regions. The airline catering business is operated in China mainland.

	Year ended 31 December					
	Segment revenues			Segment results		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
China mainland	489,377	772,856	1,223,674	(106,745)	(26,144)	(112,269)
Taiwan	651,251	1,025,639	1,301,998	(9,838)	134,486	140,221
Other regions	102,724	105,206	141,346	(76,807)	(54,748)	(78,117)
Total	1,243,352	1,903,701	2,667,018	(193,390)	53,594	(50,165)
Interest income				9,172	4,891	20,159
Unallocated costs				(39,365)	(41,752)	(22,311)
Operating (loss)/profit				(223,583)	16,733	(52,317)

The major revenue-earning assets of the Group are its aircraft fleet, all of which are registered in Macau. Since the Group's aircraft fleet is deployed flexibly across its route network, the Directors consider that there is no meaningful basis to allocating such assets to geographical segments.

The assets and capital expenditure of jointly controlled entities in respect of airline catering business are located in China mainland.

The assets and capital expenditure of the Group, other than those of jointly controlled entities and its aircraft fleet as mentioned in the above, are mainly located in Macau.

8. Other gains

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Derivative instruments	798	5,156	19,109
Interest income	9,172	4,891	20,159
	9,970	10,047	39,268

9. Staff costs

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Wages and salaries (including Directors' emoluments) *(note (a))*	211,345	248,528	324,664
Pension costs – defined contribution plans *(note (b))*	4,065	1,258	18,674
Housing allowances *(note (c))*	–	–	45,311
	215,410	249,786	388,649

(a) *Share options*

Total staff costs for the Relevant Periods do not include the amounts of benefits in kind provided to the Company's Directors in respect of the Company's share options being granted. Details of the Company's share options are set out in note 28(a) to the Financial Information.

(b) *Pension costs – Defined contribution plans*

The Company contributes to the mandatory provident fund scheme ("MPF Scheme") established under the Hong Kong Mandatory Provident Fund Scheme Ordinance which is available to eligible employees in Hong Kong.

The subsidiary in Macau operates defined contribution pension plans which are available to eligible employees. The assets of the plans are held separately from the subsidiary in independently administrated funds. Monthly contributions made by the subsidiary are calculated based on certain percentages of the applicable payroll costs or fixed sums as stipulated under the relevant requirements, as appropriate.

The jointly controlled entities in China mainland participate in defined contribution retirement schemes organised by the municipal governments of the provinces in which the jointly controlled entities operate.

The retirement benefit costs represent gross contributions paid and payable to the MPF Scheme in Hong Kong, the defined contribution pension plans in Macau and defined contribution retirement schemes in China mainland (collectively the "Retirement Schemes"). Contributions totalling HK$3,394,000, HK$2,502,000 and HK$2,215,000 payable to the Retirement Schemes are included in trade and other payables at 31 December 2003, 2004 and 2005 respectively. Forfeited contribution totalling HK$927,000, HK$1,490,000 and HK$1,553,000 were utilised respectively during the years ended 31 December 2003, 2004 and 2005 leaving HK$51,000 available at 31 December 2003 and no balance available at 31 December 2004 and 2005 to reduce future contributions.

(c) *Housing allowances*

During the year ended 31 December 2005, BACL, a jointly controlled entity of the Group, approved a staff housing policy (the "Staff Housing Policy"), pursuant to which those eligible employees as of 31 October 2005 who have not been allocated with any housing quarters or been allocated with housing quarters below the standard specified in the Staff Housing Policy were entitled to an one-off cash payment, which vests and is paid over a 10-year payment period. If an eligible employee leaves, for any reason other than normal retirement, during this period, the related obligation is forfeited. The amount of the one-off cash payment is calculated based on an eligible employee's years of services, position and other criteria as set out in the Staff Housing Policy. A liability has been established based on the actuarially determined obligation arising pursuant to the Staff Housing Policy.

(d) Directors' emoluments

The remuneration of each Director during the Relevant Periods is set out below:

Name	Fees	Other benefits	Total
	HK$'000	*HK$'000*	*HK$'000*
For the year ended 31 December 2003			
Executive Directors:			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	13,649	13,649
Zhang Xianlin	–	14,965	14,965
Tsang Hing Kwong, Thomas	61	14,715	14,776
Gu Tiefei	61	2,387	2,448
	122	47,766	47,888
Independent non-executive Directors:			
Lok Kung Nam	20	–	20
Hu Hung Lick, Henry	20	–	20
Ho Tsu Kwok, Charles	20	–	20
Li Kwok Heem, John	20	–	20
	80	–	80
	202	47,766	47,968
For the year ended 31 December 2004			
Executive Directors:			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	385	385
Zhang Xianlin	–	1,701	1,701
Zhao Xiaohang	–	547	547
Tsang Hing Kwong, Thomas	466	1,532	1,998
Gu Tiefei	70	385	455
	536	6,600	7,136
Independent non-executive Directors:			
Lok Kung Nam	40	–	40
Hu Hung Lick, Henry	40	–	40
Ho Tsu Kwok, Charles	40	–	40
Li Kwok Heem, John	40	–	40
Chan Ching Har, Eliza	14	–	14
	174	–	174
	710	6,600	7,310

Name	Fees	Other benefits	Total
	HK$'000	*HK$'000*	*HK$'000*
For the year ended 31 December 2005			
Executive Directors:			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	385	385
Zhang Xianlin	–	1,702	1,702
Zhao Xiaohang	–	937	937
Tsang Hing Kwong, Thomas	466	1,532	1,998
Gu Tiefei	70	385	455
	536	6,991	7,527
Independent non-executive Directors:			
Lok Kung Nam	60	–	60
Hu Hung Lick, Henry	60	–	60
Ho Tsu Kwok, Charles	60	–	60
Li Kwok Heem, John	60	–	60
Chan Ching Har, Eliza	60	–	60
	300	–	300
	836	6,991	7,827

Benefits in kind for the year ended 31 December 2003 included the aggregate fair value of the share options granted to Chuang Shih Ping, Zhang Xianlin, Tsang Hing Kwong, Thomas and Gu Tiefei of approximately HK$13,264,000, HK$13,264,000, HK$13,264,000 and HK$2,002,000 respectively under the Company's Share Option Scheme (note 28(a)) which had not been accounted for in the Group's financial statements pursuant to the transitional provisions of HKFRS 2. The Company did not grant any share options during the years ended 31 December 2004 and 2005.

(e) *Five highest paid individuals*

The five individuals whose emoluments were the highest in the Group for the year ended 31 December 2003 include five Directors and, for the years ended 31 December 2004 and 2005, include three Directors whose emoluments are set out in note 9(d) above. The emoluments payable to the remaining two individuals during the years ended 31 December 2004 and 2005 are as follows:

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Wages, salaries and allowances	–	3,059	3,108
Pension costs – defined contribution plans	–	155	207
	–	3,214	3,315

The emoluments of the employees fell within the following bands:

	Number of individuals		
	2003	2004	2005
Emolument bands			
HK$1,000,001 – HK$1,500,000	–	1	1
HK$1,500,001 – HK$2,000,000	–	1	1
	–	2	2

During the Relevant Periods, the Group did not pay to the Directors or the five highest paid individuals any inducement to join or upon joining the Group, or as compensation for loss of office. No Directors waived or agreed to waive any emoluments during the Relevant Periods.

10. Operating (loss)/profit

The following items have been included in arriving at operating (loss)/profit:

	Year ended 31 December		
	2003	2004	2005
	HK$'000	*HK$'000*	*HK$'000*
Crediting			
Gain on disposal of property, plant and equipment	–	–	41
Gain on disposal of an available-for-sale investment	–	–	1,207
Reversal of provision for impairment of trade receivables	1,252	–	–
Write-back of payables	–	–	1,794
Amortisation of manufacturers' credits	7,600	1,393	1,388
Net exchange gains	349	6,474	–
Charging			
Amortisation of intangible assets	18,978	20,144	9
Amortisation of land use right	–	10	81
Auditors' remuneration	1,312	1,275	1,710
Cost of inventories expensed	43,560	38,681	147,206
Depreciation of property, plant and equipment	68,519	66,006	78,131
Loss on disposal of property, plant and equipment	458	334	–
Operating lease rentals			
– Aircraft and related equipments	332,340	374,580	471,833
– Buildings	20,226	20,298	19,601
Provision for impairment of trade receivables	–	1,410	3,452
Provision for overhaul and major checks costs *(note 30)*	95,658	84,772	138,427
Net exchange losses	–	–	5,162

11. Finance costs

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Interest expenses on short-term bank loans	–	375	2,960

12. Income tax

Hong Kong profits tax has been provided at the rate of 17.5% on the estimated assessable profits for the Relevant Periods. On 7 July 2005, the Macau Legislative Assembly approved Law No. 4/2005 to reduce the Macau Complementary Tax rate from 15.75% to 12%, accordingly the Macau complementary tax has been provided at rates of 15.75%, 15.75% and 12% on the estimated assessable profits for the years ended 31 December 2003, 2004 and 2005 respectively.

The Group has two jointly controlled entities in China mainland, namely BACL and Southwest Air Catering Company Limited ("SWACL") which were acquired during the year ended 31 December 2004. Pursuant to the Circular (2001) No. 202 issued by the Ministry of Finance, State Administration of Taxation and General Administration of Customs, SWACL is subject to a reduced income tax rate of 15% for the years from 2001 to 2010. BACL is subject to the income tax rate of 27% for the two years ended 31 December 2004 and 2005.

Taxation outside Hong Kong and Macau has been calculated on the estimated assessable profits for the Relevant Periods at the rates of taxation prevailing in the countries in which the Group operates.

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Current income tax			
– Taxation outside Hong Kong and Macau	613	1,308	11,700
– Over provisions in prior years	(468)	(5)	(8)
Deferred income tax *(note 34)*	(30,333)	11,041	(1,650)
Income tax	(30,188)	12,344	10,042

Share of taxation of associates amounting to HK$16,501,000, HK$79,202,000 and HK$29,437,000 are included in the consolidated income statement as share of profits less losses of associates for the years ended 31 December 2003, 2004 and 2005 respectively.

The income tax on the Group's (loss)/profit before income tax differs from the theoretical amount that would arise using the tax rates prevailing in Macau, where the Group's principal subsidiary operates, as follows:

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
(Loss)/profit before income tax	(116,893)	406,808	221,966
Calculated at the tax rate of 15.75% (2004: 15.75%; 2005: 12%)	(18,411)	64,072	26,636
Tax effect on share of associates' profit less losses	(16,804)	(61,496)	(33,269)
Effect of different taxation rates in other territories	318	945	547
Income not subject to taxation	(1,319)	(737)	(1,841)
Expenses not deductible for taxation purposes	2,993	3,197	556
Tax losses not recognised	3,525	3,926	8,208
Write down of tax losses previously recognised *(note)*	–	2,608	4,619
Over provision for taxation in prior years	(468)	(5)	(8)
Decrease in taxation resulting from a reduction in tax rate	–	–	4,594
Others	(22)	(166)	–
Income tax	(30,188)	12,344	10,042

Note:

The Group re-assessed the recoverability of deferred income tax assets. The carrying amount of deferred income tax assets was written down to the extent that it is not probable that future taxable profit would be available against which the tax losses previously recognised could be utilised prior to their expiry.

13. Profit attributable to equity holders of the Company

The profit attributable to equity holders of the Company is dealt with in the financial statements of the Company to the extent of HK$36,173,000, HK$64,735,000 and HK$203,468,000 for the years ended 31 December 2003, 2004 and 2005 respectively.

14. Dividends

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Interim dividend, paid, of HK0.3 cent (2004: HK0.6 cent; 2005: HK0.8 cent) per share	9,938	19,876	26,501
Final dividend, proposed, of HK0.6 cent (2004: HK1.0 cent; 2005: HK1.0 cent) per share	19,876	33,127	33,127
Adjustment on 2002 final dividend due to the repurchase of shares	(53)	–	–
	29,761	53,003	59,628

15. (Loss)/earnings per share

Basic

Basic (loss)/earnings per share is calculated by dividing the (loss)/profit attributable to equity holders of the Company by the weighted average number of shares in issue during the year.

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
(Loss)/profit attributable to equity holders of the Company	(17,295)	360,969	225,000
Weighted average number of shares in issue (thousands)	3,314,824	3,312,680	3,312,680
Basic (loss)/earnings per share (HK cents per share)	(0.52)	10.90	6.79

Diluted

Diluted (loss)/earnings per share is calculated based on the (loss)/profit attributable to the equity holders of the Company and the weighted average number of shares in issue during the year, after adjusting for the number of dilutive potential shares deemed to be issued at no considerations as if all outstanding share options granted by the Company had been exercised.

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
(Loss)/profit attributable to the equity holders of the Company	(17,295)	360,969	225,000
Weighted average number of shares in issue (thousands)	3,314,824	3,312,680	3,312,680
Adjustment for assumed conversion of share options (thousands)	–	28,068	35,844
Weighted average number of shares for diluted earnings per share (thousands)	3,314,824	3,340,748	3,348,524
Diluted (loss)/earnings per share (HK cents per share)	(0.52)	10.81	6.72

16. Property, plant and equipment

	Group					
	Buildings (notes (i) and (ii))	Leasehold improvements	Aircraft and engines	Flight equipment and rotable spares	Machinery, other equipment, furniture and motor vehicles	Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
At 1 January 2003						
Cost	–	28,384	418,040	230,065	49,954	726,443
Accumulated depreciation	–	(22,924)	(105,277)	(125,380)	(31,728)	(285,309)
Net book amount	–	5,460	312,763	104,685	18,226	441,134
Year ended 31 December 2003						
Opening net book amount at 1 January 2003	–	5,460	312,763	104,685	18,226	441,134
Additions	–	2,598	–	15,887	8,982	27,467
Disposals	–	(24)	–	(604)	(76)	(704)
Depreciation	–	(1,350)	(31,849)	(29,542)	(5,778)	(68,519)
Closing net book amount at 31 December 2003	–	6,684	280,914	90,426	21,354	399,378
At 31 December 2003						
Cost	–	28,941	418,040	243,797	56,326	747,104
Accumulated depreciation	–	(22,257)	(137,126)	(153,371)	(34,972)	(347,726)
Net book amount	–	6,684	280,914	90,426	21,354	399,378
Year ended 31 December 2004						
Opening net book amount at 1 January 2004	–	6,684	280,914	90,426	21,354	399,378
Acquisition of jointly controlled entities *(note 35(b))*	87,393	–	–	–	37,668	125,061
Additions	13	1,229	12,160	3,868	21,139	38,409
Disposals	–	(597)	–	(158)	(301)	(1,056)
Depreciation	(534)	(1,465)	(31,809)	(23,246)	(8,952)	(66,006)
Closing net book amount at 31 December 2004	86,872	5,851	261,265	70,890	70,908	495,786
At 31 December 2004						
Cost	87,355	17,056	430,200	246,499	107,215	888,325
Accumulated depreciation	(483)	(11,205)	(168,935)	(175,609)	(36,307)	(392,539)
Net book amount	86,872	5,851	261,265	70,890	70,908	495,786

	Group						
	Buildings (notes (i) and (ii))	Leasehold improvements	Aircraft and engines	Flight equipment and rotable spares	Machinery, other equipment, furniture, and motor vehicles	Construction–in-progress	Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Year ended 31 December 2005							
Opening net book amount at 1 January 2005	86,872	5,851	261,265	70,890	70,908	–	495,786
Additions	286	1,285	25,029	15,708	10,177	1,815	54,300
Disposals	–	–	–	(131)	(132)	–	(263)
Depreciation	(5,786)	(1,577)	(31,681)	(23,354)	(15,733)	–	(78,131)
Closing net book amount at 31 December 2005	81,372	5,559	254,613	63,113	65,220	1,815	471,692
At 31 December 2005							
Cost	87,641	18,235	455,229	261,576	113,502	1,815	937,998
Accumulated depreciation	(6,269)	(12,676)	(200,616)	(198,463)	(48,282)	–	(466,306)
Net book amount	81,372	5,559	254,613	63,113	65,220	1,815	471,692

(i) At 31 December 2004 and 2005, property, plant and equipment included buildings of net book amount of approximately HK$40,763,000 and HK$37,988,000 respectively relating to the buildings of BACL situated on pieces of allocated land held by a related party. Air China, the immediate holding company of the Company, is procuring to transfer those land from the related party to Air China in order to ensure Air China will legally and/or beneficially own the interests and benefits of such land. Air China agrees that BACL can continue to use the land at nominal consideration until such time Air China obtains the legal title of the land. A lease agreement would then be entered into between Air China and BACL for a term of up to 30 April 2023 at a rent to be calculated on the basis of the original costs for obtaining such land use right. Accordingly, the Directors did not take into account any losses and costs arising from the inability to use any land currently used by BACL in the preparation of the Financial Information.

Air China has further agreed to complete, at its expense, the formal procedures for transferring the building ownership rights of part of the production facilities from Air China to BACL. Such part of the production facilities were agreed to be injected by Air China into BACL as part of its initial capital contribution when BACL was established. No lease agreement has been entered between BACL and Air China.

(ii) At 31 December 2004 and 2005, property, plant and equipment included buildings of net book amount of approximately HK$38,044,000 and HK$39,866,000 respectively relating to an inflight meals production building held by SWACL which was put into use in 2004. However, SWACL was advised by Chengdu Shuangliu International Airport on 7 August 2003 that this inflight meals production building is situated in an area where the extension of airport premises will be located. As a result, this inflight meals production building might need to be demolished on or before 2015.

The Directors consider that this is only a suggestion proposed by Chengdu Shuangliu International Airport and so far SWACL has not received any formal notification from the relevant government authorities regarding this. Nevertheless, the Directors consider that SWACL had obtained all necessary approvals before constructing this production building and they are confident that SWACL is able to receive fair compensations from Chengdu Shuangliu International Airport should SWACL be requested to demolish the production building. The Directors consider that this matter is currently at a preliminary stage of development, accordingly, it is too early to consider any potential impact to SWACL and the Group.

17. Land use right

The Group's interests in land use right in China mainland represent operating lease prepayments for land with a lease term of 50 years. The movement of land use right during the Relevant Periods is as follows:

		Group	
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
At 1 January	–	–	2,355
Acquisition of jointly controlled entities *(note 35(b))*	–	2,365	–
Amortisation	–	(10)	(81)
At 31 December	–	2,355	2,274

18. Intangible assets

			Group	
	Goodwill	**Trademark**	**Others**	**Total**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*
At 1 January 2003				
Cost	339,111	928	2,733	342,772
Accumulated amortisation	(14,130)	(928)	(2,541)	(17,599)
Net book amount	324,981	–	192	325,173
Year ended 31 December 2003				
Opening net book amount at 1 January 2003	324,981	–	192	325,173
Amortisation	(18,840)	–	(138)	(18,978)
Closing net book amount at 31 December 2003	306,141	–	54	306,195
At 31 December 2003				
Cost	339,111	928	2,733	342,772
Accumulated amortisation	(32,970)	(928)	(2,679)	(36,577)
Net book amount	306,141	–	54	306,195

	Group			
	Goodwill	Trademark	Others	Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*
Year ended 31 December 2004				
Opening net book amount at 1 January 2004	306,141	–	54	306,195
Acquisition of jointly controlled entities *(note 35(b))*	243,198	–	–	243,198
Amortisation	(20,099)	–	(45)	(20,144)
Closing net book amount at 31 December 2004	529,240	–	9	529,249
At 31 December 2004				
Cost	582,309	928	2,733	585,970
Accumulated amortisation	(53,069)	(928)	(2,724)	(56,721)
Net book amount	529,240	–	9	529,249
Year ended 31 December 2005				
Opening net book amount at 1 January 2005	529,240	–	9	529,249
Amortisation	–	–	(9)	(9)
Closing net book amount at 31 December 2005	529,240	–	–	529,240
At 31 December 2005				
Cost	529,240	–	–	529,240
Accumulated amortisation	–	–	–	–
Net book amount	529,240	–	–	529,240

Impairment tests for goodwill

Goodwill acquired through the business combinations has been allocated to the cash-generating unit ("CGU") within the business segments of airline operation, airport ground handling and airline catering.

The recoverable amount of CGU is determined based on value-in-use calculation. These calculations use cash flow projections based on actual financial results for the year ended 31 December 2005. Cash flows after one year up to the end of the franchise or joint venture periods are extrapolated using the estimated growth rates stated below.

Key assumptions used in the value-in-use calculation

	Airline operation	Airport ground handling	Airline catering
Growth rate	7%	4%	10%
Discount rate	10%	10%	10%

Management determined budgeted net margin based on the past performance and its expectations for the market development. The weighted average growth rates used are consistent with the industry forecasts. The discount rates used reflect specific risks relating to the relevant industry.

19. Interests in subsidiaries

	Company At 31 December 2003 HK$'000	2004 HK$'000	2005 HK$'000
Unlisted shares, at cost	803,666	803,666	803,666
Amounts due from subsidiaries	714,674	1,178,194	1,211,154
Amounts due to subsidiaries	(216)	–	–
	1,518,124	1,981,860	2,014,820

The amounts due from/(to) subsidiaries are unsecured, interest free and have no fixed terms of repayment. The Directors have confirmed that they will not request for repayment of the amounts due to the Company until such time as and when the subsidiaries are in a position to repay. Accordingly, the Directors classified these amounts due from subsidiaries as non-current assets

Details of the subsidiaries at 31 December 2003, 2004 and 2005 are set out below:

Name	Date of incorporation	Place of incorporation	Place of operation	Principal activities	Particulars of issued shares/capital	Group equity interest 2003	2004	2005
[1,2] Air Macau Company Limited	13 September 1994	Macau	Macau	Airline operator	4,000,000 ordinary shares of MOP100 each	51%	51%	51%
[2] China National Aviation Corporation (Macau) Company Limited	27 July 1993	Macau	Macau	Investment holding	Quota capital of MOP10,000,000	100%	100%	100%
Skylink Global Limited	2 January 2002	British Virgin Islands	Hong Kong	Investment holding	10 ordinary shares of US$1 each	100%	100%	100%
Fly Top Limited	2 March 2004	British Virgin Islands	Hong Kong	Investment holding	10 ordinary shares of US$1 each	–	100%	100%
Kingston International Limited	1 December 1989	British Virgin Islands	Hong Kong	Investment holding	2 ordinary shares of US$1 each	100%	100%	100%
Queenston International Limited	18 December 1989	British Virgin Islands	Hong Kong	Investment holding	2 ordinary shares of US$1 each	100%	100%	100%
Serfil Limited	3 January 1989	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US$1	100%	100%	100%
Skyrise Limited	30 March 1994	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US$1	100%	100%	100%
Wington Limited	21 November 1989	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US$1	100%	100%	100%

Name	Date of incorporation	Place of incorporation	Place of operation	Principal activities	Particulars of issued shares/capital	Group equity interest 2003	2004	2005
China National Aviation Logistics Company Limited	3 November 2000	Hong Kong	Hong Kong	Investment holding	2 ordinary shares of HK$10 each	100%	100%	100%
China National Aviation Technology Company Limited	26 April 2000	Hong Kong	Hong Kong	Investment holding	2 ordinary shares of HK$10 each	100%	100%	100%
[2] China National Aviation CyberWorks Limited	28 June 2000	Bermuda	Hong Kong	Dormant	1,000,000 ordinary shares of HK$0.1 each	100%	100%	100%

All subsidiaries are limited liability companies.

[1] Subsidiary not audited by PricewaterhouseCoopers, the net assets and turnover of which amounted to approximately 18% and 100% for the year ended 31 December 2003 (2004: 22% and 100%; 2005: 19% and 100%).

[2] Subsidiaries held indirectly by the Company.

20. Interests in jointly controlled entities

The following amounts represent the Group's proportionate share of the assets, liabilities, revenues and expenses of the jointly controlled entities and are included in the consolidated balance sheet and income statement:

	At and for the year ended 31 December 2003	2004	2005
	HK$'000	*HK$'000*	*HK$'000*
Non-current assets	–	135,026	137,247
Current assets	–	102,955	112,206
	–	237,981	249,453
Non-current liabilities	–	–	(34,126)
Current liabilities	–	(134,386)	(88,647)
	–	(134,386)	(122,773)
Net assets	–	103,595	126,680
Revenues	–	18,947	268,649
Other gains	–	78	365
Operating expenses	–	(16,883)	(266,860)
Finance costs	–	(375)	(2,960)
Profit/(loss) before income tax	–	1,767	(806)
Income tax	–	(247)	(134)
Net profit/(loss)	–	1,520	(940)

The following is a list of jointly controlled entities at 31 December 2003, 2004 and 2005:

Name	Place of establishment and operation	Principal activities	Percentage of interest in Ownership			Voting power			Profit sharing		
			2003	2004	2005	2003	2004	2005	2003	2004	2005
Beijing Air Catering Co., Ltd.	PRC	Airline catering	–	60%	60%	–	56%	56%	–	60%	60%
Southwest Air Catering Company Limited	PRC	Airline catering	–	60%	60%	–	60%	60%	–	60%	60%

21. Interests in associates and loans to associates

(a) Interests in associates

	Group 2003	2004	2005
	HK$'000	*HK$'000*	*HK$'000*
At 1 January	1,162,514	1,198,012	1,590,158
Share of opening adjustments on adoption of HKAS 39	–	–	(19,023)
	1,162,514	1,198,012	1,571,135
Acquisition of an associate	–	115,069	–
Share of profits less losses	106,690	390,450	277,243
Dividends received	(69,535)	(110,960)	(246,187)
Share of deficit on revaluation of investment securities	(1,716)	(2,464)	–
Share of fair value gains of derivative financial instruments	–	–	25,319
Share of currency translation differences not realised in net profit	59	51	84
At 31 December	1,198,012	1,590,158	1,627,594

Interests in associates above at 31 December 2004 and 2005 include goodwill of HK$52,708,000. No goodwill was included in interests in associates at 31 December 2003.

The shares of Tradeport Hong Kong Limited, an associate, held by the Group were pledged as securities for a banking facility granted to the associate (note 37).

	Company At 31 December 2003	2004	2005
	HK$'000	*HK$'000*	*HK$'000*
Unlisted shares, at cost	51,789	51,789	51,789

The financial information of the Group's interest in associates is set out as follows:

	At 31 December 2003		
	Dragonair	**Others**	**Total**
	HK$'000	*HK$'000*	*HK$'000*
Assets	4,631,659	351,313	4,982,972
Liabilities	3,513,443	271,517	3,784,960
Revenues	2,819,638	392,693	3,212,331
Net profit	32,102	74,588	106,690
Dividends	–	69,535	69,535

	At 31 December 2004		
	Dragonair	**Others**	**Total**
	HK$'000	*HK$'000*	*HK$'000*
Assets	4,979,952	504,957	5,484,909
Liabilities	3,588,653	358,806	3,947,459
Revenues	3,932,712	576,310	4,509,022
Net profit	275,547	114,903	390,450
Dividends	–	110,960	110,960

	At 31 December 2005		
	Dragonair	**Others**	**Total**
	HK$'000	*HK$'000*	*HK$'000*
Assets	4,815,526	555,995	5,371,521
Liabilities	3,449,609	347,026	3,796,635
Revenues	4,699,228	629,171	5,328,399
Net profit	130,061	147,182	277,243
Dividends	160,171	86,016	246,187

The following is a list of associates, all of which are unlisted, at 31 December 2003, 2004 and 2005:

Name	Place of incorporation and operation	Principal activities	Particulars of issued shares/capital	Group equity interest 2003	2004	2005
[1] Hong Kong Dragon Airlines Limited ("Dragonair")	Hong Kong	Airline operator	500,000,000 ordinary shares of HK$1 each	43.29%	43.29%	43.29%
[2] LSG Lufthansa Service Hong Kong Limited	Hong Kong	Airline catering	501 ordinary shares of HK$1 each	–	20.20%	20.20%
Jardine Airport Services Limited	Hong Kong	Airport ground handling services	1,000 ordinary shares of HK$10 each	50.00%	50.00%	50.00%
[2] Tradeport Hong Kong Limited	Hong Kong	Development and operation of a logistic center	400 ordinary shares of HK$1 each	25.00%	25.00%	25.00%
[2] Menzies Macau Airport Services Limited ("Menzies Macau")	Macau	Airport ground handling services	Quota capital of MOP10,000,000	33.65%	33.65%	33.65%
[2] Macau Aircraft Repair and Conversion Company Limited	Macau	Aircraft repair and conversion	Quota capital of MOP100,000	25.05%	25.05%	25.05%

[1] 1.47% of the Group's equity interest in Dragonair is held directly by the Company, while the remaining 41.82% is held indirectly through subsidiaries.

[2] Associates held indirectly by the Company.

(b) *Loans to associates*

The loans to associates are mainly denominated in Hong Kong dollar and are unsecured, interest free and have no fixed terms of repayment. The Directors have confirmed that they will not request for repayment of the loans due to the Company until such time as and when the associates are in a position to repay. Accordingly, the Directors classified these loans as non-current assets.

22. Loan to an associate

The loan to an associate is denominated in Hong Kong dollar and is unsecured, interest free and has no fixed terms of repayment.

23. Investment securities

	Group	At 31 December	
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Unlisted investment	–	18,313	–

Unlisted investment represented BACL's equity investment of 10% in 國航集團財務有限公司 ("Finance Company"). Pursuant to a share transfer agreement entered into between BACL and CNAH in August 2004, BACL agreed to dispose of its investment in the Finance Company to CNAH at a consideration of RMB34,561,000 (equivalent to HK$33,222,000). The disposal was completed in 2005.

24. Derivative financial instruments

	Group	At 31 December	
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Fuel price forward and option contracts	–	–	11,957

At 31 December 2003, 2004 and 2005, the Group had one, two and six derivative contracts outstanding, respectively, to lock in future fuel price at a certain range. According to the contracts, the Group is entitled to receive from the counter-party the applicable difference between the fuel price and the strike price for the notional quantity if the fuel prices rises above the strike price and pay the counter-party the difference between the fuel price and the strike price if the fuel price falls below the strike price. These contracts will be expired before the year ending 31 December 2006. The derivative contracts were not accounted for in the consolidated balance sheets at 31 December 2003 and 2004 under the transitional provisions of HKAS 39.

25. Inventories

	Group	At 31 December	
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Expendable spare parts and maintenance materials	40,870	41,205	40,071
Inflight/catering supplies	7,515	11,379	11,240
Others	2,439	1,461	1,962
	50,824	54,045	53,273

26. Trade and other receivables

	Group			Company		
	At 31 December			At 31 December		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Trade receivables *(notes a, c and d)*	114,112	184,304	204,991	–	–	–
Due from *(notes b and c)*:						
Immediate holding company	–	36,245	29,412	–	–	–
An associate	30	1,017	1,088	–	–	–
A fellow subsidiary	28	–	240	–	–	–
Related companies	44	3,934	1,994	–	–	–
Less: Provision for impairment of receivables	(2,672)	(4,218)	(4,467)	–	–	–
	111,542	221,282	233,258	–	–	–
Prepayments, deposits and other receivables	42,514	37,183	50,286	4,664	687	921
	154,056	258,465	283,544	4,664	687	921

(a) The credit terms granted to sales agents and other trade customers are generally ranging from 15 to 90 days.

(b) The amounts due from immediate holding company, an associate, a fellow subsidiary and related companies are unsecured, interest free and have credit periods ranging from 15 to 90 days.

(c) The age analysis of the net trade receivables with third parties, immediate holding company, an associate, a fellow subsidiary and related companies is as follows:

	Group		
	At 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Within 31 days	103,643	180,828	194,210
31 – 60 days	7,198	19,433	20,414
61 – 90 days	112	8,661	8,882
Over 90 days	589	12,360	9,752
	111,542	221,282	233,258

(d) There is no concentration of credit risk with respect to trade receivables, as the Group has a large number of customers, internationally dispensed.

(e) Approximately 62% and 19% of the gross trade receivables balance of the Group at 31 December 2003 (2004: 41% and 39%; 2005: 37% and 44%) are denominated in Taiwanese Dollars and Renminbi ("RMB") respectively. The remaining balances are mainly denominated in Macau Patacas and United States Dollar ("USD").

27. Cash and cash equivalents and pledged bank deposits

	Group			Company		
	At 31 December			At 31 December		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Cash at bank and in hand	100,952	260,314	365,532	–	45,710	25,884
Short-term bank deposits	961,614	553,934	723,244	813,612	336,259	483,256
Total	1,062,566	814,248	1,088,776	813,612	381,969	509,140
Less: Pledged bank deposits against						
– Financial derivative facilities	(4,571)	(4,897)	(4,724)	–	–	–
– Bank guarantees on aircraft leasing	(20,679)	(56,323)	(84,006)	–	–	–
– Others	(387)	(6,235)	(213)	–	–	–
Total pledged bank deposits	(25,637)	(67,455)	(88,943)	–	–	–
Cash and cash equivalents	1,036,929	746,793	999,833	813,612	381,969	509,140

Cash and cash equivalents and pledged bank deposits include HK$23,988,000, HK$81,855,000 and HK$250,442,000 which are denominated in RMB and are held by the Group and its jointly controlled entities with bank accounts operating in China mainland where exchange controls apply for the years ended 31 December 2003, 2004 and 2005 respectively.

The effective interest rate on short-term bank deposits was 0.184%, 1.016% and 3.587% for the years ended 31 December 2003, 2004 and 2005 respectively. These deposits have an average maturity of approximately 64 days, 45 days and 54 days respectively.

The total cash and bank balances are denominated in the following currencies:

	Group			Company		
	At 31 December			At 31 December		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Hong Kong dollar	757,069	287,410	376,551	751,528	276,091	368,787
RMB	25,177	203,467	322,817	–	–	–
USD	120,268	230,161	302,154	62,084	105,878	140,353
Others	160,052	93,210	87,254	–	–	–
	1,062,566	814,248	1,088,776	813,612	381,969	509,140

28. Share capital

	Ordinary shares of HK$0.10 each Number of shares	HK$'000
Authorised:		
At 1 January 2003, 2004, 2005 and 31 December 2005	4,000,000,000	400,000
Issued and fully paid:		
At 1 January 2003	3,319,308,000	331,931
Repurchase of own shares *(note b)*	(6,628,000)	(663)
At 1 January 2004, 2005 and 31 December 2005	3,312,680,000	331,268

(a) Share options

At an Annual General Meeting of the Company held on 29 May 2002, a share option scheme ("Share Option Scheme") was approved by the shareholders of the Company. Under the terms of the Share Option Scheme, the Directors may, at their discretion, grant to any Director, employee, supplier, customer or other relevant business partners of the Group, share options to subscribe for the Company's shares at the subscription price of the highest of (i) the closing price of the Company's shares as stated in The Stock Exchange of Hong Kong Limited's (the "Exchange") daily quotations sheets on the date of grant; (ii) the average closing price of the Company's shares as stated in the Exchange's daily quotations sheets for the five business days immediately preceding the date of grant; and (iii) the nominal value of the Company's shares. A nominal consideration at HK$1 was paid by the grantees for the acceptance of the grant of share options.

The maximum number of shares may be issued upon exercise of all outstanding options granted and yet to be exercised under the Share Option Scheme and any other share option scheme of the Group must not exceed 30% of the number of issued shares of the Company from time to time.

The total number of shares to be granted under the Share Option Scheme and any other share option scheme of the Group shall not exceed 331,268,000, representing 10% of the number of issued shares at the date of adoption of the Share Option Scheme.

An option may be exercised in accordance with the terms of the Share Option Scheme at any time during a period, in relation to the relevant option, to be notified by the Directors to the grantee, such period not exceeding six years commencing on the date falling three months after the date of grant and expiring on the last day of the said period.

The Share Option Scheme will remain in force for a period of ten years commencing on the date on which it was adopted.

Movements in the number of share options outstanding during the Relevant Periods and their related weighted average exercise price are as follows:

	2003		2004		2005	
	Weighted average price *HK$*	Number of options	Weighted average price *HK$*	Number of options	Weighted average price *HK$*	Number of options
At 1 January	0.992	147,059,800	1.064	136,729,800	1.140	104,378,000
Granted *(note (i))*	1.140	104,378,000	–	–	–	–
Lapsed	1.040	(114,708,000)	0.820	(32,351,800)	–	–
At 31 December *(note (ii))*	1.064	136,729,800	1.140	104,378,000	1.140	104,378,000

Notes:

(i) Share options were granted on 25 July 2003 at the exercise price of HK$1.140 per share and will expire on 25 October 2009. Consideration received was HK$4 in respect of the share options granted during the year ended 31 December 2003.

(ii) No share options were exercised during the Relevant Periods.

(iii) Share options outstanding at end of the Relevant Periods have the following terms:

Expiry date	Exercise Price *HK$*	Number of options 2003	2004	2005	Vested percentages 2003	2004	2005
Directors							
24 March 2004	0.820	32,351,800	–	–	100%	–	–
25 October 2009	1.140	104,378,000	104,378,000	104,378,000	100%	100%	100%
		136,729,800	104,378,000	104,378,000			

(b) *Repurchase of own shares*

In April 2003, the Company repurchased a total of 6,628,000 ordinary shares of the Company of HK$0.1 each at an aggregated consideration of HK$5,325,000. The highest and lowest prices per share paid for the repurchase were HK$0.83 and HK$0.77 respectively. The above shares repurchased were then cancelled.

29. Reserves

Group

	Share premium HK$'000	Capital redemption reserve HK$'000	Legal reserve HK$'000	Investments revaluation reserve HK$'000	Exchange reserve HK$'000	Cashflow hedge reserve HK$'000	Retained earnings HK$'000	Total HK$'000
Balance at 1 January 2003	1,434,558	–	3,666	4,180	–	–	921,785	2,364,189
Share of currency translation differences of associates	–	–	–	–	–	–	59	59
Share of deficit on revaluation of investments in securities of an associate	–	–	–	(1,716)	–	–	–	(1,716)
Net (expense)/income recognised directly in equity	–	–	–	(1,716)	–	–	59	(1,657)
Loss for the year	–	–	–	–	–	–	(17,295)	(17,295)
Total recognised loss for 2003	–	–	–	(1,716)	–	–	(17,236)	(18,952)
Repurchase of own shares *(note 28(b))*	–	663	–	–	–	–	(5,325)	(4,662)
Dividends	–	–	–	–	–	–	(36,439)	(36,439)
Balance at 31 December 2003	1,434,558	663	3,666	2,464	–	–	862,785	2,304,136
Representing:								
Proposed final dividend								19,876
Others								2,284,260
								2,304,136
Balance at 1 January 2004	1,434,558	663	3,666	2,464	–	–	862,785	2,304,136
Share of currency translation differences of associates	–	–	–	–	–	–	51	51
Share of deficit on revaluation of investments in securities of an associate	–	–	–	(2,464)	–	–	–	(2,464)
Net (expense)/income recognised directly in equity	–	–	–	(2,464)	–	–	51	(2,413)
Profit for the year	–	–	–	–	–	–	360,969	360,969
Total recognised (loss)/income for 2004	–	–	–	(2,464)	–	–	361,020	358,556
Transfer *(note a)*	–	–	43	–	–	–	(43)	–
Dividends	–	–	–	–	–	–	(39,752)	(39,752)
Balance at 31 December 2004	1,434,558	663	3,709	–	–	–	1,184,010	2,622,940
Representing:								
Proposed final dividend								33,127
Others								2,589,813
								2,622,940

	Share premium HK$'000	Capital redemption reserve HK$'000	Legal reserve HK$'000	Exchange reserve HK$'000	Cashflow hedge reserve HK$'000	Retained earnings HK$'000	Total HK$'000
Balance at 1 January 2005	1,434,558	663	3,709	–	–	1,184,010	2,622,940
Share of opening adjustments on adoption of HKAS 39 by associates *(note b)*	–	–	–	–	(20,056)	1,033	(19,023)
Balance at 1 January 2005, as restated	1,434,558	663	3,709	–	(20,056)	1,185,043	2,603,917
Share of currency translation differences of associates	–	–	–	–	–	84	84
Share of fair value gains of derivative financial instruments of associates	–	–	–	–	25,319	–	25,319
Currency translation differences	–	–	–	(123)	–	–	(123)
Net (expense)/income recognised directly in equity	–	–	–	(123)	25,319	84	25,280
Profit for the year	–	–	–	–	–	225,000	225,000
Total recognised (loss)/income for 2005	–	–	–	(123)	25,319	225,084	250,280
Transfer *(note a)*	–	–	6,599	–	–	(6,599)	–
Dividends	–	–	–	–	–	(59,628)	(59,628)
Balance at 31 December 2005	1,434,558	663	10,308	(123)	5,263	1,343,900	2,794,569
Representing:							
Proposed final dividend							33,127
Others							2,761,442
							2,794,569

(a) A subsidiary in Macau and jointly controlled entities in China mainland have transferred 10% of their profits to non-distributable legal reserve in accordance with local rules and regulations respectively.

(b) The adoption of HKAS 39 has resulted in the recognition of financial instruments at fair value and the change in the recognition and measurement of hedging activities.

Company

	Share premium *HK$'000*	Capital redemption reserve *HK$'000*	Retained earnings *HK$'000*	Total *HK$'000*
At 1 January 2003	1,434,558	–	660,641	2,095,199
Profit for the year	–	–	36,173	36,173
Repurchase of own shares	–	663	(5,325)	(4,662)
Dividends	–	–	(36,439)	(36,439)
At 31 December 2003	1,434,558	663	655,050	2,090,271
Representing:				
Proposed final dividend				19,876
Others				2,070,395
				2,090,271
At 1 January 2004	1,434,558	663	655,050	2,090,271
Profit for the year	–	–	64,735	64,735
Dividends	–	–	(39,752)	(39,752)
At 31 December 2004	1,434,558	663	680,033	2,115,254
Representing:				
Proposed final dividend				33,127
Others				2,082,127
				2,115,254
At 1 January 2005	1,434,558	663	680,033	2,115,254
Profit for the year	–	–	203,468	203,468
Dividends	–	–	(59,628)	(59,628)
At 31 December 2005	1,434,558	663	823,873	2,259,094
Representing:				
Proposed final dividend				33,127
Others				2,225,967
				2,259,094

30. Provision for overhaul and major checks

	Group		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
At 1 January	53,695	64,869	91,939
Charged during the year *(note 10)*	95,658	84,772	138,427
Utilised during the year	(84,484)	(57,702)	(75,462)
At 31 December	64,869	91,939	154,904

31. Provision for housing allowances

	Group		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
At 1 January	–	–	–
Charged during the year *(note 9)*	–	–	45,311
Utilised during the year	–	–	(6,156)
At 31 December	–	–	39,155
Current portion included in other payables and accruals	–	–	(5,029)
	–	–	34,126

32. Trade and other payables

	Group At 31 December			Company At 31 December		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Trade payables *(note a)*	117,016	133,836	229,602	–	–	–
Due to *(notes a and b)*:						
Associates	13,869	14,698	14,075	–	–	–
Fellow subsidiaries	11,945	15,720	17,390	50	–	31
Immediate holding company	–	15,892	–	–	–	–
Related companies	63	4,039	11,878	–	–	–
Other payables and accruals	166,489	232,387	241,678	4,160	4,343	4,337
	309,382	416,572	514,623	4,210	4,343	4,368

(a) The age analysis of trade payable with third parties, an associate, fellow subsidiaries and related companies is as follows:

	Group			Company		
	At 31 December			At 31 December		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Within 31 days	68,208	103,314	191,664	–	–	–
31 – 60 days	36,030	39,569	47,243	–	–	–
61 – 90 days	11,392	12,393	17,038	–	–	–
Over 90 days	27,213	9,040	9,674	–	–	–
	142,843	164,316	265,619	–	–	–

(b) The amounts due to associates, fellow subsidiaries, immediate holding company and related companies are unsecured and interest free. Except for the amount due to immediate holding company at 31 December 2004 which had no fixed terms of repayment, other balances have the credit terms generally ranging from 30 to 90 days.

(c) Approximately 65% and 12% of the trade payables balance of the Group at 31 December 2003 (2004: 49% and 29%; 2005: 67% and 19%) are denominated in USD and RMB respectively. The remaining balances are mainly denominated in Macau Patacas and Taiwanese Dollars.

33. Short-term bank loans

	Group		
	At 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Short-term bank loans, unsecured	–	69,217	25,371

The average effective interest rate at the balance sheet date was 4.59% and 5.02% for the years ended 31 December 2004 and 2005 respectively.

The carrying amounts of short-term bank loans approximate their fair values and are denominated in RMB at 31 December 2004 and 2005.

34. Deferred income tax assets

Deferred income taxes are calculated in full on temporary differences under the liability method using the statutory profits tax rate prevailing in which the Group's principal operating subsidiary operates of 15.75%, 15.75% and 12% for the years ended 31 December 2003, 2004 and 2005 respectively.

The movement in deferred income tax assets during the Relevant Periods is as follows:

	Accelerated depreciation allowances	Provisions	Tax losses	Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*
Year ended 31 December 2003				
At 1 January 2003	–	–	–	–
Credited to income statement *(note 12)*	–	–	30,333	30,333
At 31 December 2003	–	–	30,333	30,333
Year ended 31 December 2004				
At 1 January 2004	–	–	30,333	30,333
Acquisition of jointly controlled entities *(note 35(b))*	2,438	47	–	2,485
(Charged)/credited to income statement *(note 12)*	(24)	22	(11,039)	(11,041)
At 31 December 2004	2,414	69	19,294	21,777
Year ended 31 December 2005				
At 1 January 2005	2,414	69	19,294	21,777
Decrease in opening deferred taxation resulting from a reduction in tax rate	–	–	(4,594)	(4,594)
Credited/(charged) to income statement	291	10,572	(4,619)	6,244
At 31 December 2005	2,705	10,641	10,081	23,427

	At 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Deferred tax assets to be recovered after more than 12 months	19,494	21,777	23,427

Deferred income tax assets are recognised for tax losses carry forwards to the extent that realisation of the related tax benefit through the future taxable profits is probable. The Group has unrecognised tax losses of HK$54,155,000, HK$78,703,000 and HK$141,638,000 for the years ended 31 December 2003, 2004 and 2005 respectively to carry forward against future taxable income, in which losses of HK$54,155,000, HK$70,923,000 and HK$90,185,000 have no expiry date and losses of HK$7,780,000 and HK$51,453,000 will be expired in 2007 and 2008 respectively.

The Company has not recognised tax losses of HK$54,155,000, HK$70,923,000 and HK$90,185,000 that can be carried forward against future taxable income for the years ended 31 December 2003, 2004 and 2005 respectively. These tax losses have no expiry date.

35. Notes to the consolidated cash flow statement

(a) Cash (used in)/generated from operations

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Operating (loss)/profit	(223,583)	16,733	(52,317)
Adjustments for:			
Depreciation	68,519	66,006	78,131
Amortisation of intangible assets	18,978	20,144	9
Amortisation of land use right	–	10	81
Gain on disposal of an available-for-sale investment	–	–	(1,207)
Fair value gains on derivative financial instruments	–	–	(10,593)
Loss/(gain) on disposal of property, plant and equipment	458	334	(41)
Provision for housing allowances	–	–	39,155
Provision for impairment of loan to an associate	–	–	446
Write-off of an investment security	–	249	–
Interest income	(9,172)	(4,891)	(20,159)
	(144,800)	98,585	33,505
Changes in working capital:			
Inventories	340	1,452	772
Lease and equipment deposits	5,214	14,279	8,653
Trade and other receivables	30,997	(30,321)	(26,443)
Trade and other payables	(4,780)	39,988	92,899
Sales in advance of carriage	1,226	10,592	14,333
Provision for overhaul and major checks	11,174	27,070	62,965
Cash (used in)/generated from operations	(100,629)	161,645	186,684

(b) Purchase of jointly controlled entities

In April 2004, the Group entered into share transfer contracts with Air China International Corporation ("Air China International") pursuant to which the Group agreed to acquire 60% of equity interests in BACL and SWACL from Air China International at the considerations of RMB294 million and RMB67 million respectively (the "BACL and SWACL Acquisitions"). The BACL and SWACL Acquisitions were completed on 16 November 2004.

Details of share of net assets of jointly controlled entities acquired and goodwill are as follows:

	2004
	HK$'000
Net assets acquired	
Property, plant and equipment *(note 16)*	125,061
Land use right	2,365
Deferred income tax assets *(note 34)*	2,485
Investment securities	18,562
Inventories	4,673
Trade and other receivables	74,088
Cash and cash equivalents	18,520
Pledged bank deposits	6,120
Trade and other payables	(51,386)
Amount due to immediate holding company	(15,892)
Short-term bank loans, unsecured	(80,506)
Current tax liabilities	(2,015)
	102,075
Goodwill *(note 18)*	243,198
	345,273
Satisfied by	
Cash	345,273

No intangible asset was individually identified and separately recognised in the Acquisitions as the Directors of the Company consider that no item can meet the identifiability criterion in the definition of an intangible asset.

Analysis of the net cash outflow in respect of the purchase of jointly controlled entities:

	2004
	HK$'000
Cash consideration	345,273
Cash and cash equivalents acquired	(18,520)
Net cash outflow in respect of the purchase of jointly controlled entities	326,753

36. Commitments

(a) On 16 February 2001, the Group entered into an agreement with third parties (the "Consortium Partners") in respect of the joint development and operation of Tradeport Logistics Centre at the South Commercial District of the Hong Kong International Airport (the "Project"). The Group, through its interest in Tradeport Hong Kong, an associate of the Group, has 25% effective interest in the Project. Initially, the maximum liability limit imposed by the Airport Authority Hong Kong was HK$780,000,000. On 17 March 2004, the Airport Authority Hong Kong agreed to reduce the maximum liability limit to HK$312,000,000. The Group's attributable share of capital commitments in respect of the Project was approximately HK$130,650,000 at 31 December 2003 and approximately HK$78,000,000 at 31 December 2004 and 2005.

In the event of default of any of the Consortium Partners, the Group will be required to provide additional funds for the Project. The Group and the Consortium Partners have jointly given a guarantee to the Airport Authority Hong Kong in respect of their obligations to provide sufficient funding for the Project. Should the Group be required to perform its obligations under the guarantee in the event of default of all of the Consortium Partners, the maximum amount of the additional liabilities assumed, in additional to the Group's estimated share of capital commitments as disclosed above, would be approximately HK$649,350,000 at 31 December 2003 and HK$234,000,000 at 31 December 2004 and 2005.

(b) Commitments under operating leases

The Group had future aggregate minimum lease payments under non-cancellable operating leases in respect of aircraft and related equipment as follows:

	Group		
	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Not later than one year	290,071	357,491	644,852
Later than one year and not later than five years	831,081	1,011,211	873,291
More than five years	609,249	407,760	265,202
	1,730,401	1,776,462	1,783,345

The above operating lease commitments included commitment for fixed rent only. Rentals payable in some cases include an additional rent, calculated according to exact flying hours, in excess of a fixed rent.

(c) Future minimum rental payments receivables

The Group had future minimum lease receipts under non-cancellable operating lease in respect of aircraft as follows:

	Group		
	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Not later than one year	–	10,241	14,617

(d) Capital commitments

The Group's attributable share of capital expenditure contracted for by the Group's jointly controlled entities but not yet incurred is as follows:

	Group		
	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Property, plant and equipment	–	–	3,966

37. Contingent liabilities

	Group and Company At 31 December 2003 HK$'000	2004 HK$'000	2005 HK$'000
Guarantee for banking facilities granted by bank to:			
– An associate	15,000	15,000	20,000
– A jointly controlled entity *(note)*	–	–	87,475
	15,000	15,000	107,475

Note:

At 31 December 2005, the Group had given to a bank for loan facilities granted to a jointly controlled entity of RMB115,000,000 (equivalent to approximately HK$110,545,000). Loans of RMB40,000,000 (equivalent to approximately HK$38,450,000) were drawdown by the jointly controlled entity at 31 December 2005. The Group's proportionate share of bank loans of HK$23,070,000 had been included in the consolidated balance sheet at 31 December 2005.

38. Related party transactions

The Group is part of a larger group of companies under Air China and has extensive transactions and relationships with members of the Air China group. Because of these relationships, it is possible that the terms of transactions between the Group and members of Air China group are not the same as those that would result from transactions with or among other related parties or wholly unrelated parties.

Air China is controlled by CNAH, a state-owned enterprise which is wholly owned by the PRC government. As the Company is indirectly controlled by the PRC government, state-owned enterprises and their subsidiaries, in addition to the group companies of Air China, directly or indirectly owned by the PRC government are also related parties of the Group.

A portion of the Group's business activities are conducted with other state-owned enterprises. For the purpose of related party transactions disclosure, the Group has identified, to the extent practicable, those corporate customers and suppliers which are state-owned enterprises based on their immediate ownership structure. It should be noted, however, that a substantial portion of the Group's business activities are conducted in the PRC and the influence of the PRC government in the Chinese economy is pervasive. In this regard, the PRC government indirectly holds interests in many companies. In addition, a portion of the Group's services provided are of a retail nature to end users, which include transactions with the employees of state-owned enterprises on corporate business, their key management personnel and close family members. Due to the vast volume and the pervasiveness of these transactions, the Group is unable to determine the aggregate amount of these transactions for disclosure. Therefore, the revenue from provision of services disclosed below does not include retail transactions with these related parties. However, the Group believes that meaningful information in respect of related party transactions has been adequately disclosed.

The following is a summary of significant transactions carried out with related parties in the ordinary course of business for the Relevant Periods:

(a) Revenue, other gains and expenses

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Revenue and other gains:			
Value of tickets sold to *(note i)*:			
– Immediate holding company	–	1,545	3,365
– An associate	550	2,032	1,391
– Fellow subsidiaries	4,201	3,395	2,944
– Related companies	15,468	7,755	8,568
Lease of an aircraft to immediate holding company *(note ii)*	–	9,855	41,532
Sales of goods *(note iii)*:			
– Immediate holding company	–	17,156	136,663
– An associate	–	2,428	10,979
– Related companies	–	142	3,417
– Other state-owned enterprises *(note xi)*	–	1,540	19,468
Interest income from other state-owned banks *(note xi)*	7,357	2,704	14,999

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Operating expenses:			
Management fee paid to fellow subsidiaries *(notes iv and v)*	9,600	9,600	9,600
Landing, loading, parking and other airport charges paid to:			
– A fellow subsidiary *(note vi)*	51,927	69,337	86,343
– Other state-owned enterprises *(note xi)*	25,220	34,811	40,976
Ground handling costs paid to an associate *(note vii)*	93,858	119,866	129,777
Technical and ground handling costs paid to an associate *(note viii)*	3,201	4,475	2,634
Inflight meal services expenses paid to a related company *(note ix)*	40,637	41,199	51,491
Lease rental paid to fellow subsidiaries *(note x)*	–	688	1,652
Fuel costs paid to an other state-owned enterprise *(note xi)*	13,548	10,236	85,409
Finance cost paid to other state-owned banks *(note xi)*	–	375	2,960
Project management fee paid to immediate holding company *(note xii)*	–	–	1,344

(i) Air tickets were sold to the related ticket sales agents in accordance with the pricing policy of the Group.

(ii) The Group entered into a lease agreement with Air China pursuant to which the Group leases aircraft to Air China at a monthly fee of US$359,000 (equivalent to approximately HK$2,796,000) with monthly maintenance hour charge of US$470 (equivalent to approximately HK$4,000) per block hour.

(iii) The inflight meal services rendered were charged at terms pursuant to agreements entered into by BACL and SWACL with relevant related parties.

(iv) Pursuant to the management services agreement dated 27 August 2003 entered into between the Company and China National Aviation Corporation (Group) Limited ("CNACG"), a fellow subsidiary, CNACG provided secretarial, personnel, accounting and general office administrative services to the Group for a period of two years from 1 July 2003 to 30 June 2005 at a monthly fee of HK$500,000.

On 28 July 2005, the Company and CNACG renewed the management services agreement with the same terms under the management services agreement dated 27 August 2003 for a period of three years from 1 July 2005 to 30 June 2008 at a monthly fee of HK$500,000.

(v) Pursuant to the management services agreement dated 25 March 2002 entered into between the Group and CNAC (Macau) Aviation Limited ("CNACAL"), a fellow subsidiary, CNACAL agreed to provide general management services including but not limited to secretarial, personnel, accounting and general office administrative services to CNAC Macau for a period of three years from 25 March 2002 to 24 March 2005 at a monthly fee of HK$300,000.

On 4 November 2005, CNAC Macau and CNACAL renewed the management services agreement with the same terms under the management services agreement dated 25 March 2002 for a period of three years from 25 March 2005 to 24 March 2008 at a monthly fee of HK$300,000.

(vi) The airport related charges paid to ADA-Administrative Airport Limited ("ADA") were at terms pursuant to the tariff published by the Macau Government in the government gazette.

(vii) The ground handling services rendered were charged at terms pursuant to agreements entered into by the Group with Menzies Macau.

(viii) The technical and ground handling services rendered were charged at terms pursuant to agreements entered into by the Group with Dragonair.

(ix) The inflight meal services rendered were charged at terms pursuant to agreements entered into by the Group with Macau Catering Services Company Limited, a 34.5% owned associate held by a minority shareholder of Air Macau.

(x) The Group entered into a lease agreement with Easy Advance Limited and Wise Advice Limited, fellow subsidiaries, pursuant to which Easy Advance Limited and Wise Advice Limited lease office premises and certain car parks to the Group at a monthly rental of MOP141,800 (equivalent to approximately HK$138,000).

(xi) The above transactions with other state-owned enterprises and banks were entered into in accordance with the terms as set out in the agreements governing the transactions or as mutually agreed between the parties.

(xii) On 4 November 2005, BACL entered into a project management services agreement with Air China Beijing Construction Base Command Centre ("Air China Command Centre"), a division of CNAH, for services relating to the phase 3 construction work in respect to the expansion of the ancillary facilities in the Beijing Capital International Airport ("Capital Airport") during its commencement, construction and post-completion stages.

Pursuant to the project management services agreement, total management fee is equivalent to 2.5% of the approved budget of the construction work for the project. The estimated construction cost as set out in the "Feasibility Study Report regarding the construction work of ancillary facilities of Air China in Capital Airport" of RMB310,850,000 (equivalent to approximately HK$300,000,000) is used as the base figure for determining the management fee as the construction budget is yet to approve. The amount represented 30% project management fee paid to Air China Command Centre upon signing of the project management services agreement.

(xiii) In April 2004, the Group entered into share transfer contracts with Air China International pursuant to which the Group agreed to acquire 60% of equity interests in BACL and SWACL from Air China International at considerations of RMB294 million and RMB67 million respectively. The transactions were completed in November 2004 (note 35(b)).

(xiv) In August 2004, the Group entered into sale and purchase agreements with CNACG pursuant to which the Group agreed to acquire 16% of equity interests in LLSHK from CNACG at a consideration of HK$89 million. The transaction was completed in December 2004.

(b) On 18 October 1997, the Company entered into a license agreement with China National Aviation Corporation ("CNA") pursuant to which CNA has agreed to grant a license to the Company, free or royalty, for the use of certain trademarks in Hong Kong, the Taiwan region and Macau so long as the Company is a subsidiary of CNACG ("Old License Agreement").

On 25 August 2004, CNACG entered into two license agreements with the Company pursuant to which CNACG has agreed to grant licenses to the Company, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as the Company is a direct or indirect subsidiary of CNAH ("New License Agreements").

No royalty charge was levied under the Old License Agreement and the New License Agreements in respect of the use of these trademarks during the period.

(c) Key management compensation

	Year ended 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Directors' fees	2,342	3,355	3,480
Salaries and other short-term employee benefits	6,345	7,066	7,457
	8,687	10,421	10,937

(d) Year-end balances arising from sales/purchases of goods/services with related parties comprised:

	At 31 December		
	2003	**2004**	**2005**
	HK$'000	*HK$'000*	*HK$'000*
Receivables from related parties *(note)*			
Immediate holding company	–	36,245	29,412
An associate	30	1,017	1,088
A fellow subsidiary	28	–	240
Related companies	44	3,934	1,994
Other state-owned enterprises	–	9,910	6,145
	102	51,106	38,879
Bank deposits			
Other state-owned banks	843,610	597,703	823,737
Payables to related parties *(note)*			
An associate	13,869	14,698	14,075
Fellow subsidiary	11,945	15,720	17,359
Related companies	63	62	4,583
Other state-owned enterprises	11,216	23,410	26,887
	37,093	53,890	62,904
Short-term bank loans			
Other state-owned banks	–	69,217	25,371

Note:

Repayment terms of these balances with the above related parties have been disclosed in notes 26 and 32.

(III) EVENTS AFTER THE BALANCE SHEET DATE

(a) On 24 January 2006, the Group entered into agreements ("Macau Asia Express Agreement") with Shun Tak Air Transport Limited and its subsidiaries respectively, to establish Macau Asia Express to engage in the business activities of operating low cost model air transport services based in Macau. The Group will hold 43.7% effective equity interest (including indirect interest) in Macau Asia Express. The aggregate initial investment to Macau Asia Express is up to approximately HK$234,000,000 and the Group's attributable share of the investment cost will be funded by the Group's internal resources. The completion of the establishment is subject to certain conditions to be fulfilled.

Macau Asia Express will be accounted for as a jointly controlled entity in accordance with HKAS 31 "Investments in joint ventures".

(b) On 8 June 2006, the Company entered into a conditional agreement with Cathay Pacific Airways Limited ("Cathay") pursuant to which the Company has agreed to dispose of the Group's entire interests in Dragonair, an associate of the Group, to Cathay at a consideration to be satisfied by a combination of the issue of 288,596,335 new shares by Cathay at an issue price of HK$13.50 per share and cash consideration of HK$432,894,498. The completion of this transaction (the "Completion") is subject to, amongst others, the approval of the shareholders of the Company.

Upon the Completion, the Company will hold 7.34% equity interests in Cathay and such investment will be classified as available-for-sale investment in the balance sheet and carried at fair value.

Details of the selected financial information of Dragonair are set out in Section II note 21(a) above.

(IV) SUBSEQUENT FINANCIAL STATEMENTS

No audited financial statements have been prepared for the Company and its subsidiaries in respect of any period subsequent to 31 December 2005 and up to the date of report.

Yours faithfully,
PricewaterhouseCoopers
Certified Public Accountants
Hong Kong

(B) WORKING CAPITAL STATEMENT

Taking into account the financial resources available to the Group, including internally generated funds and the estimated net proceeds of the Disposal, the Directors are of the opinion that the Group has sufficient working capital for its present requirements, that is for at least the next 12 months from the date of this circular.

(C) INDEBTEDNESS STATEMENT

Borrowings and pledged deposits

As at 30 April 2006, the Group and its jointly controlled entities had short-term bank loans denominated in Renminbi of approximately HK$20 million, which are repayable within one year.

As at 30 April 2006, the Group's bank deposits of approximately HK$101 million were pledged for bank guarantees on aircraft and warehouse leasing, and financial derivative facilities granted to the Group.

Contingent Liabilities

As at 30 April 2006, the Group had given a guarantee to bank for loan facilities granted to a jointly controlled entity of approximately HK$31 million. Loan of approximately HK$34 million were drawn down by the jointly controlled entity as at 30 April 2006. The Group's proportionate share of bank loans of approximately HK$20 million had been included in the indebtedness above.

Disclaimer

Except as disclosed above, as at 30 April 2006, the Group did not have any outstanding mortgages, charges, guarantees or other material contingent liabilities.

(D) MANAGEMENT DISCUSSION AND ANALYSIS FOR THE GROUP AND THE REMAINING GROUP

(a) For the year ended 31 December 2005

(1) In relation to the Group

Operations Review

The Group is engaged in the provision of **air transportation services** through

– Air Macau, CNAC (Macau)'s 51% owned subsidiary, and
– Dragonair, the Group's 43.29% owned associate;

The provision of **airline catering services** through

– BACL, the Group's 60% owned jointly controlled entity,
– SWACL, the Group's 60% owned jointly controlled entity, and
– LLSHK, the Group's 20.2% directly owned and 34.03% effectively owned associate;

The provision of **airport ground handling services** through

- JASL, the Group's 50% owned associate, and
- Menzies Macau, CNAC (Macau)'s 26% directly owned and 33.65% effectively owned associate;

and in **logistics services** through

- Tradeport Hong Kong, the Group's 25% owned associate.

Liquidity and Financial Resources

The Group generally financed its operations with cash flow generated internally. As at 31 December 2005, the Group had cash and cash equivalents of a total amount of approximately HK$1,000 million and net current assets of approximately HK$692 million. The Group consistently maintained a strong working capital during the year ended 31 December 2005. As at 31 December 2005, the current liabilities of the Group was approximately HK$675 million.

Contingent Liabilities and Commitments

As at 31 December 2005, the Group had given a guarantee to a bank for loan facilities granted to an associate totalling HK$20 million (2004: HK$15 million).

As at 31 December 2005, the Group had given a guarantee to a bank for loan facilities granted to a jointly controlled entity of RMB115 million (equivalent to approximately HK$111 million). Loans of RMB40 million (equivalent to approximately HK$38 million) were drawn down by the jointly controlled entity as at 31 December 2005 (2004: Nil). The Group's proportionate share of bank loans of HK$23 million had been included in the consolidated balance sheet as at 31 December 2005 (2004: Nil).

In February 2001, the Group together with the Tradeport Logistics Centre consortium partners jointly gave a guarantee to the Airport Authority Hong Kong in respect of their obligations to provide sufficient funding for the development of the Tradeport Logistics Centre. On 17 March 2004, the Airport Authority Hong Kong agreed to reduce the maximum liability limit from approximately HK$780 million to approximately HK$312 million. The Directors are of the opinion that, had the Group been required to perform its obligation under the guarantee in the event of default of all of the consortium partners, the maximum amount of the contingent liabilities assumed, including the Group's estimated share of capital commitments of approximately HK$78 million, would have been approximately HK$312 million.

The Group's attributable share of capital expenditure contracted for by the Group's jointly controlled entities at the balance sheet date but not yet incurred is as follows:

	2005	**2004**
	HK$'000	*HK$'000*
Property, plant and equipment	3,966	–

Charge On Assets

The shares of Tradeport Hong Kong held by the Group were pledged as securities for a banking facility granted to Tradeport Hong Kong.

Foreign Exchange and Currency Risks

The Group generates a portion of its revenue from ticket sales in certain foreign jurisdictions giving rise to exposures to fluctuation in foreign exchange rates. The Group continuously monitors its foreign currency positions and does not consider that it has a significant exposure to foreign exchange risk from any currency.

Human Resources

The bulk of human resources of the Company and their remuneration, amongst others, are covered by a management services agreement concluded with the Company's fellow subsidiary, CNACG. Likewise, CNAC (Macau) Aviation Limited also concluded a management services agreement with CNAC Macau. Both agreements were negotiated under normal commercial terms and conditions.

Air Macau, a 51% held subsidiary, employs about 961 staff (2004: about 830), of which about 206 (2004: about 178) are based outside Macau. Employees remunerated packages are designed and structured based on the foregoing market conditions, relevant laws and regulations, industry practices and standard, work performance, education or professional training background and past working experience.

As at 31 December 2005, BACL has 1,095 staff and SWACL has 685 staff.

Air Macau Company Limited

The Group owns a 51% shareholding in Air Macau through its wholly owned subsidiary CNAC (Macau). The airline was established in Macau in 1994 as a home based carrier and commenced commercial operation in November 1995 under a concession agreement with the Macau government, granting the airline the exclusive right to operate as Macau's home based carrier for a 25-year period, until the year 2020.

Principal activities of Air Macau include:

- the operation of an airline; and
- the provision of airport ground handling services through Menzies Macau, a 15% owned associate.

Route Profile:

- At the end of 2005 and 2004, the number of destinations served by Air Macau categorised by China mainland and non-China mainland destinations are summarised as follows:

	Licensed Passenger and Cargo	Number in services as at 31 December 2005	2004
Destinations:			
China mainland	37	10	8
Non-China mainland	46	5	5
Total	83	15	13

- Air Macau's passenger and freighter services operated a total of 23,770 flights (including charter flights) in 2005 between Macau and 26 destinations in Asia, encompassing Beijing, Chengdu, Haikou, Kunming, Guilin, Nanjing, Shanghai, Xiamen, Shenzhen, Nanning, Sanya, Zhengzhou, Taipei, Kaohsiung, Bangkok, Manila, Seoul, Busan, Gwangju, Siem Reap, Takamatsu, Okayama, Tokyo, Darwin, Phnom Penh, and Dhaka.

Fleet Profile:

- As at the end of 2005, Air Macau's fleet comprised of 18 aircraft (2004: 15). At the end of 2005 and 2004, Air Macau's fleet was as follows:

Aircraft Type	Number of aircraft as at 31 December 2005	2004
A319	5	4
A320	1	1
A321	7	6
B727 Freighter	0	1
A300B4 Freighter	5	3
Fleet total	18#	15

\# *Twelve (2004: ten) aircraft were under operating leases, while five A300B4 freighter (2004: one B727 freighter and three A300B4 freighters) were under wet lease, and one A321 (2004: one A321) was owned by Air Macau.*

Operating Summary:

		Year ended 31 December		
		2005	**2004**	**Change %**
Overall operating:				
Available tonne-kilometre (ATK)				
– Passenger aircraft	(million)	392.44	349.20	+12.38
– Freighter	(million)	206.92	117.14	+76.64
Aircraft utilisation				
– A319	(hr/day)	5.3	5.5	-3.64
– A320	(hr/day)	5.8	6.1	-4.92
– A321	(hr/day)	7.3	7.0	+4.29
– B757	(hr/day)	5.48	5.68	-3.52
– B727 freighter	(hr/day)	4.0	4.6	-13.04
– A300B4 freighter	(hr/day)	4.6	5.3	-13.21
Passenger services:				
Available seat kilometer (ASK)	(million)	3,425.4	3,068.2	+11.64
Total passengers carried	('000)	2,059.6	1,808.0	+13.92
Revenue passenger kilometer (RPK)	(million)	2,449.8	2,145.6	+14.18
Passenger yield per RPK	(avos)	65	65	–
Passenger load factor	(%)	72	70	+2 pt
Cargo services:				
Cargo tonne kilometre (CTK)				
– Passenger aircraft	(million)	22.5	23.2	-3.02
– Freighter	(million)	147.5	84.4	+74.76
Total cargo tonnes carried				
– Passenger aircraft	(tonnes)	19,251	19,601	-1.79
– Freighter	(tonnes)	132,662	83,683	+58.53
Cargo yield per CTK				
– Passenger aircraft	(avos)	505	497	+161
– Freighter	(avos)	485	488	-0.61
Cargo load factor				
– Passenger aircraft	(%)	45.1	54.8	-9.7 pt
– Freighter	(%)	71.3	72.1	-0.8 pt

- Air Macau carried more than 2 million passengers in 2005, an increase of more than 13.91% from 2004. Capacity of passenger services as measured by ASK increased by 11.64%, while passenger loading as measured by RPK rose by 14.18%. The higher rate of increase in RPK to ASK created a 2 percentage point increase in passenger load factor, to 72%.

- Passenger yield of 2005 was 65 cents per RPK, the same as that of 2004. Yield improvement was constrained as a result of competitive market dynamics and the depreciation of the Taiwan currency.

- Further expansion of the cargo business in 2005 was demonstrated by the 74.76% increase in freighter FTK. Tonnage uplift on freighters increased 58.53%, but the freighter load factor was 71.3%, 1.07% points lower compared to 2004.

Traffic Profile:

- The following table sets out Air Macau's traffic summary for the years ended 31 December 2005 and 2004 by geographical area, expressed as a percentage of the total volume of revenue passengers and cargo carried:

	Passenger Services Year ended 31 December		**Cargo Services Year ended 31 December**	
Routes	**2005**	**2004**	**2005**	**2004**
	%	%	%	%
China mainland	43	41	41	40
Taiwan region	50	52	58	59
Other destinations in Asia	6	6	1	1
Ad-hoc charters	1	1	–	–
Total	100	100	100	100

- In 2005, Air Macau increased its passenger services to Seoul, Korea by increasing the frequency from seven flights weekly to nine flights weekly. It operated a total of 194 segments on ad-hoc charter flights to destinations including Guilin, Zhengzhou and Nanning in China mainland, Siem Reap in Cambodia, Busan and Kwangju in Korea, Takamatsu, Okayama and Tokyo in Japan, Bangkok in Thailand, and Darwin in Australia. In February 2005, Air Macau launched its own frequent flyer program – "Privileges" – which has proved popular, with its membership as of 31 December 2005 reaching 52,000.

- During the year, Air Macau faced increased competition from low cost carriers. Moreover, the persistent high fuel costs and the depreciation of the Taiwan currency also added pressure to the carrier. In view of these challenges, the management took decisive and timely measures to improve efficiency and enhance productivity.

- The Cargo Department, set up in May 2004, increased frequencies and strengthened market share in Shenzhen, Shanghai, Xiamen and Taipei in 2005. At the same time, it launched a regular service to Phnom Penh, Cambodia and operated charter services to Dhaka, Bangladesh.

Cost Profile:

- The overall operating expenditure increased by 34.42% mainly due to high fuel prices.

- The following table sets out Air Macau's cost summary for the years ended 31 December 2005 and 2004:

	Year ended 31 December		
Expenditure	**2005**	**2004**	**Change**
	%	%	*% point*
Staff costs	11	13	-2
Passenger catering and service costs	4	5	-1
Fuel costs	27	21	+6
Route operating costs	21	24	-3
Aircraft maintenance costs	9	8	+1
Aircraft equipment costs	18	19	-1
Depreciation and amortisation costs	3	4	-1
Sales and promotion costs	4	3	+1
Other operating costs	3	3	–
Total	100	100	

- The increase in the fuel cost was mainly due to high fuel prices globally.

- The decrease in route operating cost and passenger catering and service costs was mainly due to price negotiation which reduced the contract rates, and a better incentive program.

- The increase in sales and promotion was in line with the development of the operation.

- The increase in aircraft equipment and maintenance costs was mainly caused by the increase in flight operations.

- The decrease in the depreciation and amortisation costs was the result of continuous stringent control measures on assets purchased.

Hong Kong Dragon Airlines Limited

The Group owns a 43.29% interest in Dragonair and remains its single largest shareholder. The principal activities of Dragonair are:

- the operation of an airline;

- the provision of holiday packages through Dragonair Holidays, a wholly-owned subsidiary of Dragonair;

- the provision of airport ground handling services through HIAS, its wholly-owned subsidiary;

- the provision of airline catering services through LLSHK, its 31.94% owned associate;

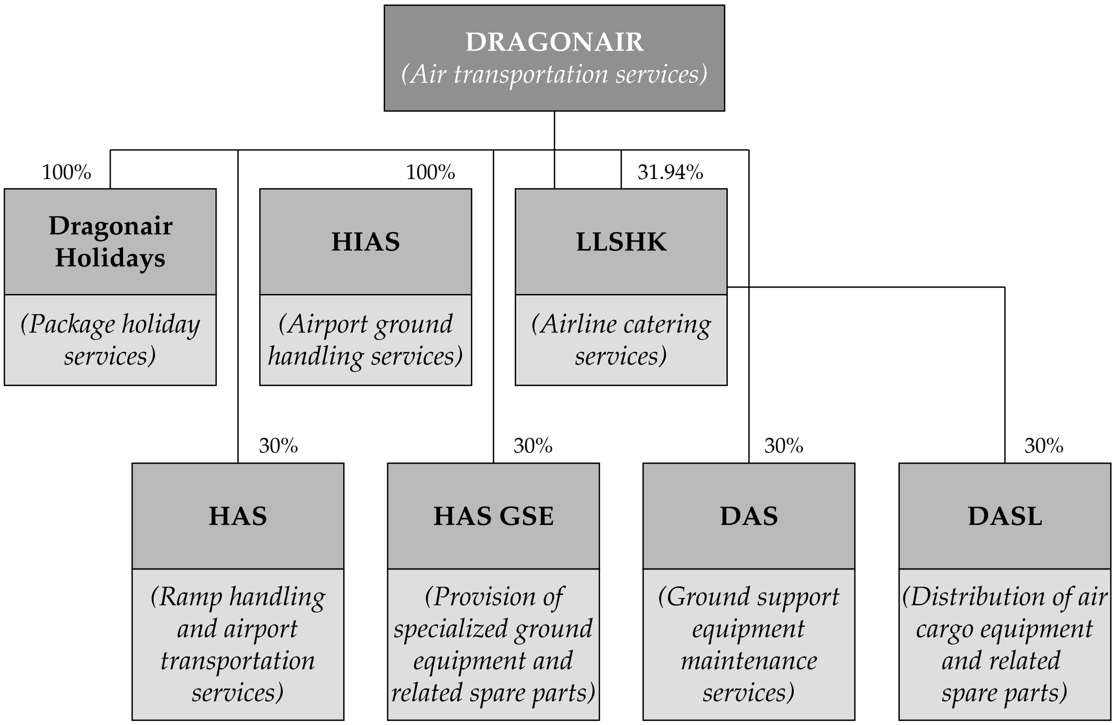
- the provision of ramp handling and airport transportation services through HAS, its 30% owned associate;

- the provision of specialised ground equipment and related spare parts through HAS GSE, its 30% owned associate;

- the provision of ground support equipment maintenance services through DAS, its 30% owned associate;

- distribution of air cargo equipment and related spare parts through DASL, its 30% owned associate.

The following chart sets out the current simplified corporate structure of Dragonair, its principal operating subsidiaries and associates and their respective activities:



The majority of the income of Dragonair is derived from the provision of passenger and cargo air transportation services. The following table sets out the composition of the profit before tax of Dragonair for the years ended 31 December 2005 and 2004, derived from its major business operations expressed as percentages of the total profit before tax of Dragonair:

	Year ended 31 December		
	2005	**2004**	**Change**
	%	%	*% point*
Airline operations	75.9	91.2	-15.3
HIAS	10.2	4.0	+6.2
LLSHK	6.5	2.1	+4.4
HAS	6.8	2.5	+4.3
HAS GSE	0.1	0.1	–
DAS	0.2	–	+0.2
DASL	0.3	0.1	+0.2
Total	100.0	100.0	

Profit before tax from airline operations was significantly affected by high fuel price in 2005. Fuel cost increased by 69.8% and represented 24% of total operating costs. As a result, Dragonair's share of its total profit before tax from the airline operations decreased from 91.2% in 2004 to 75.9% in 2005.

Air Transportation

Route Profile:

At the end of 2005 and 2004, the number of destinations serviced by Dragonair was as follows:

	Licensed		Number in service as at 31 December	
	Passenger and cargo	**All cargo**	**2005**	**2004**
Destinations:				
China mainland	50	–	22	21
Non-China mainland	42	23	14	15
Total	92	23	36	36

In 2005, Dragonair operated scheduled services to 36 destinations, 22 of which are in China mainland. Dragonair conducted a total of 20,093 round trips during 2005. The Shanghai route remained the most profitable route in 2005. Dragonair launched its trans-Pacific freighter services to New York in April 2005 using a wet-leased B747-400 freighter.

Fleet Profile:

During 2005, five aircraft were delivered including:

- Three A330s under operating lease, each in March, May and November 2005
- One A320 purchased in April 2005
- One B747-400 freighter under wet lease in April 2005

To better utilise the capacity originally intended for passenger service to Seoul, Dragonair has wet leased one A320 and one A330 to Air China from September 2005 onwards for two years. Dragonair's fleet at the end of 2005 comprised of 36 aircraft, as follows:

	Number of aircraft as at 31 December	
Aircraft type	**2005**	**2004**
A320	11	10
A321	6	6
A330	13	10
A300B4F	1	1
B747-200F	1	1
B747-300SF	3	3
B747-400F	1	0
Fleet Total	36#	31

\# *Eighteen aircraft are under operating leases (2004: fifteen), of which one A320 and one A330 were wet leased to Air China, five (2004: five) are under finance leases and seven are owned by Dragonair (2004: six). Four freighters were owned by Dragonair (2004: four) and two freighters were under wet lease (2004: one).*

Fleet Expansion Plan:

Year	**Purchase**	**Operating Lease**
2006	2 B747-400 converted freighters	3 A330s
2007	2 B747-400 converted freighters	
2008	1 B747-400 converted freighter	

To capture the business opportunities arising out of the continuous development of air cargo industry in the region, Dragonair has agreed to purchase five B747-400 converted freighters, which will be delivered from 2006 to 2008. However, the deferral of launching Sydney passenger service has resulted in additional surplus capacity. In this respect, one more A330 has been wet leased to Air China since February 2006 and another A330 from April 2006 for a period of 1.5 year and 2 years respectively.

Operating Summary:

		Year ended 31 December		
		2005	**2004**	**Change**
Overall operation:				
Available tonne kilometer (ATK)				
– Passenger aircraft	('000)	1,439,841	1,330,721	+8.2
– Freighter	('000)	1,588,580	1,099,467	+44.5
Revenue load factor	(%)	69.8	71.3	-1.5 pt
Aircraft utilization				
– A320	(hr/day)	8.5	7.9	+7.6
– A321	(hr/day)	9.5	9.5	–
– A330	(hr/day)	9.1	9.3	-2.2
– A300B4F	(hr/day)	7.9	6.0	+31.7
– B747-200F	(hr/day)	11.9	13.1	-9.2
– B747-300SF	(hr/day)	12.9	12.5	+3.2
– B747-400F	(hr/day)	14.8	–	N/A
Passenger services:				
Available seat kilometers (ASK)	('000)	10,064,986	9,175,702	+9.7
Total passengers carried		5,260,923	4,793,099	+9.8
Revenue passenger kilometre (RPK)	('000)	6,484,849	5,954,669	+8.9
Passenger yield per RPK	(HK cents)	88.7	86.2	+2.9
Passenger load factor	(%)	64.4	64.9	-0.5 pt
Cargo services:				
Cargo tonne kilometers (CTK)				
– Passenger aircraft	('000)	217,718	211,092	+3.1
– Freighter	('000)	1,191,012	875,562	+36.0
Total cargo tonnes carried				
– Passenger aircraft	(tonnes)	161,650	158,617	+1.9
– Freighter	(tonnes)	223,689	183,796	+21.7
Cargo yield per CTK				
– Passenger aircraft	(HK cents)	580	559	+3.6
– Freighter	(HK cents)	240	230	+4.3
Cargo load factor				
– Passenger aircraft	(%)	61.5	64.7	-3.2 pt
– Freighter	(%)	75.0	79.6	-4.6 pt

Dragonair carried 5.3 million passengers in 2005, an increase of 9.8% compared to 2004. The capacity of passenger services as measured by ASK rose by 9.7%, mainly due to an increase in the number of flights.

Passenger yield reported an increase of 2.9% over that of 2004 because of higher passenger fuel surcharges imposed in 2005.

In 2005, the capacity of freighter services as measured by ATK rose by 44.5% due to the full year impact of the introduction of a wet leased A300B4 freighter services to Osaka, Shanghai and Nanjing beginning in June 2004 and our freighter service to Frankfurt beginning in late July 2004. In addition, Dragonair has operated freighter services to New York a three times weekly since April 2005 using a B747-400 freighter under a wet lease agreement.

Cargo yield for passenger aircraft and cargo yield for freighters increased by 3.6% and 4.3% respectively from 2004. These increases were helped by the higher yield of more short-haul freighter services operated and the imposition of a higher cargo fuel surcharge in 2005.

In 2005, Dragonair's freighter aircraft utilisation rate increased by 3.4% whereas the cargo load factor for freighters dropped by 4.6 percentage points from those of 2004.

Traffic Profile:

The following table sets out Dragonair's traffic summary for the years ended 31 December 2005 and 2004 by geographical area, expressed as a percentage of the total number of passengers and tonnage of cargo carried:

	Passenger Services Year ended 31 December		**Cargo Services Year ended 31 December**	
Routes	**2005**	**2004**	**2005**	**2004**
	%	%	%	%
China mainland scheduled services	68.0	67.6	40.1	44.1
Taiwan region	22.6	22.0	21.2	21.9
Japan	2.9	2.2	9.6	8.8
Europe and Middle East	–	–	21.5	21.5
U.S.A	–	–	4.3	–
Other destinations	6.0	7.9	3.2	3.3
Ad-hoc charters	0.5	0.3	0.1	0.4
Total	100	100	100	100

Dragonair operates passenger services to 30 destinations in Asia, of which 22 are in China mainland. The airline's scheduled flights to Shanghai have increased to 108 per week during the 2005 winter schedule. Dragonair also provided additional flights to most China mainland routes to cope with growing traffic demand in 2005. However, Bangkok passenger services were reduced from two flights daily to seven flights a week, and narrow body aircraft was used since the end of March 2005.

Dragonair has suspended scheduled services to Phuket from January 2005 as the demand for air traffic to Phuket has remained low after the Tsunami in South Asia.

Cost Profile:

The following table sets out Dragonair's cost summary for the years ended 31 December 2005 and 2004:

	Year ended 31 December		
Expenditure	**2005**	**2004**	**Change**
	HK$'000	*HK$'000*	%
Staff costs	1,506,356	1,345,048	+12.0
Passenger catering and service costs	403,720	355,049	+13.7
Fuel costs	2,506,011	1,475,523	+69.8
Route operating costs	2,256,695	1,874,035	+20.4
Aircraft maintenance costs	1,262,476	1,146,098	+10.2
Aircraft lease charges	909,582	610,012	+49.1
Depreciation and amortisation costs	543,832	506,491	+7.4
Other operating costs	1,083,826	952,789	+13.8
Total	10,472,498	8,265,045	+26.7

Dragonair's staff costs increased by 12.0% mainly due to an increase in staff and crew numbers for the expanded operations in 2005.

Passenger catering and service costs increased by 13.7%, mainly attributable to a rising number of total passengers although this increase was partly offset by changes in catering standards for some short-haul routes.

Fuel costs rose significantly, mainly because of soaring fuel prices and higher fuel consumption resulting from more long-haul freighter services.

Route operating costs, which include landing, parking and ground handling charges, rose primarily due to an increased number of flights for passenger and freighter services.

During the year, aircraft maintenance costs increased by 10.2% over 2004. This was mainly due to the increase in the number of aircraft and higher aircraft utilisation in 2005. However, the increase was partly offset by the adoption of revised HKAS16 "Property, Plant and Equipment" ("PPE") which resulted in a change in accounting policy for major checks and overhauls of owned aircraft from "expense as and when incurred" in aircraft maintenance costs to "capitalise as PPE and depreciate over the maintenance cycle".

Aircraft lease charges increased mainly due to the increase in the number of aircraft leased in 2005.

Depreciation and amortisation costs increased due to the purchase of one A320 aircraft and the adoption of revised HKAS16.

The increase in other operating costs was mainly due to expanded operations. However, stringent cost-control measures have been implemented to minimise the impact

Dragonair Holidays Limited

Dragonair Holidays, a wholly-owned subsidiary of Dragonair, mainly provides packaged holidays services for Dragonair.

Hong Kong International Airport Services Limited

HIAS, a wholly-owned subsidiary of Dragonair, provides airport ground handling services in Hong Kong to Dragonair and other airlines.

Total number of third party aircraft movements serviced in 2005 was 9,344, an increase of 43.3% compared to 2004.

LSG Lufthansa Service Hong Kong Limited

LLSHK is a 31.94% owned associate of Dragonair. Its main business is to provide catering services to airline customers in Hong Kong.

The substantial increase in profit attributable from LLSHK was mainly due to increasing passenger traffic compared to 2004 and continuous implementation of cost-control measures.

Hong Kong Airport Services Limited

HAS, a 30% owned associate of Dragonair, provides aircraft ramp handling operations and passenger and staff busing services at the Hong Kong International Airport.

HAS is the largest ramp handling operator in Hong Kong, accounting for over 52% of the market in the Hong Kong International Airport. Approximately 6,200 flights are handled monthly.

HAS recorded a satisfactory profit in 2005 attributable to considerable traffic growth.

HAS GSE Solutions Limited

HAS GSE is a 30% owned associate of Dragonair. Its main business is to provide spare parts for specialised ground equipment.

A rise in net profit for the year compared to that of 2004 was due to an increase in ground support equipment and vehicles maintenance activities.

DAH Chong Hong – Dragonair Airport GSE Service Limited

DAS, a 30% owned associate of Dragonair, provides ground support equipment and vehicles maintenance and repair services at the Hong Kong International Airport.

DAS reported a profit for the year as compared to a loss in 2004 mainly due to an increase in maintenance activities from major customers

DAS Aviation Support Limited

DASL, a 30% owned associate of Dragonair, is mainly engaged in the distribution of air cargo equipment and related spare parts.

A decrease in net profit for the year as compared to 2004 was mainly due to a decrease in maintenance activities from major customers.

Beijing Air Catering Co., Ltd

BACL, the largest airline caterer in Beijing Capital International Airport with an approximately 77% market share, is a 60% owned jointly controlled entity of the Group. It is principally engaged in the provision of in-flight catering services and other related in-flight food and beverage services.

In 2005, BACL provided in-flight catering services for 101,724 flights, an increase of 10.5% over 2004. The total number of in-flight meals served increased 10% over 2004 to approximately 13.94 million, about 38,200 in-flight meals each day.

Construction of a catering building in Beijing Capital International Airport is expected to commence in the middle of 2006. The building, upon completion at the end of 2007, will occupy 80 acres with a building area of 37,500 square meters. The daily production capacity of the catering building is expected to reach 45,000 meals upon its commencement of operation.

Southwest Air Catering Company Limited

SWACL, the largest airline caterer in Chengdu Shuangliu International Airport, is a 60% owned jointly controlled entity of the Group. It is principally engaged in the production of food, beverages and in-flight services products, the provision of other related services and the sale of its own products.

In 2005, the total number of in-flight meals served by SWACL reached 4 million, an increase of 12.04% against 2004. The number of flights catered for rose approximately 37.05% to 27,616 flights.

The turnover of SWACL increased 23.06% to RMB90.41 million. In-flight catering and other business accounted for 76.54% and 23.46% of the turnover respectively.

The new catering building has strengthened production capacity of SWACL. Dragonair began using SWACL's in-flight catering services in August 2005. In October 2005, shareholders injected RMB50 million into SWACL.

Riding on the opportunities created by commencement of operations of new airlines in Chengdu, as well as the expansion of existing airlines, SWACL expects further business growth in 2006.

LSG Lufthansa Service Hong Kong Limited

LLSHK is a 34.03% effectively owned associate of the Group through direct shareholding of 20.2% and indirect shareholding of 13.83% through Dragonair. Its main business is to provide catering services in Hong Kong to Dragonair and other airline customers.

Aided by the rising traffic volume of existing customers, the number of meals served and the number of flights catered by LLSHK increased by 10.8% and 14.1% respectively during 2005.

Turnover and profit before tax for the year ended 31 December 2005 soared by 13.4% and 26.8% respectively compared to the same period in 2004. This growth was attributable to a boom in the airline catering business and complementary business, as well as the continuous implementation of cost saving measures.

LLSHK expects the performance in 2006 will be benefited from the growing of worldwide aviation traffic.

Jardine Airport Services Limited

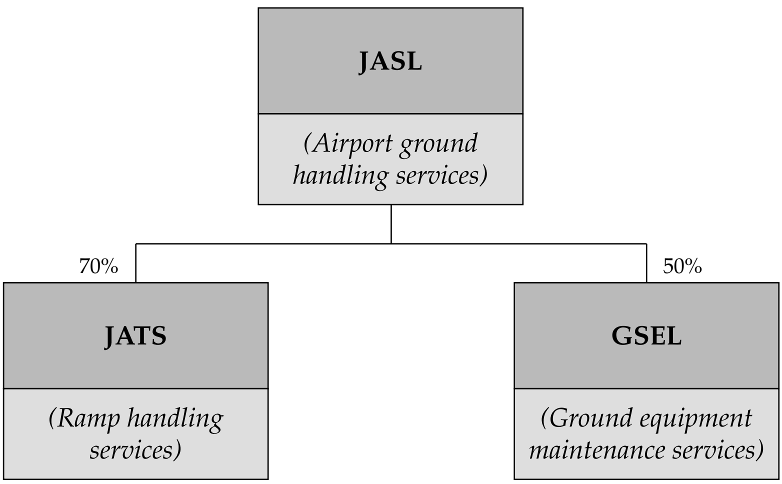
The Group owns a 50% interest in JASL. The principal activities of JASL are:

– the provision of airport ground handling services;

– the provision of ramp handling services through its 70% owned subsidiary company JATS; and

– the provision of ground support equipment maintenance services through its 50% owned jointly controlled entity GSEL.

The following chart sets out the simplified corporate structure of JASL and its subsidiaries as of 31 December 2005:



JASL provides airport ground handling services for 28 international airlines at the Hong Kong International Airport. The principal activities of JASL include the provision of check-in services, passenger reception services, baggage services, ticketing and flight information, management of flight operations, flight control and cargo documentation services.

JATS, a 70% owned subsidiary of JASL, has had a 10-year franchise from the Airport Authority Hong Kong to provide ramp handling services at the Hong Kong International Airport since July 1998. The other shareholders of JATS are China Airlines, United Airlines and GlobeGround GmbH.

The consolidated turnover of JASL and its subsidiaries rose 13.7% compared to 2004, mainly attributable to the steady increase in the number of flights by existing customers and new clients. JASL's consolidated profit before tax also rose thanks to the increase in flight frequency.

In 2005, JASL handled 68,650 aircraft movements, an increase of 16.4% compared to 2004, and maintained an approximately 49% share of the third party ground handling market at the airport. JATS handled 91,950 aircraft movements during the year, which accounted for an approximately 60% share of the third party ramp handling market at the Hong Kong International Airport.

Through strong support and business connections of its shareholders, JASL is actively pursuing new business opportunities in China mainland.

Menzies Macau Airport Services Limited

Menzies Macau is a 33.65% effectively owned associate of the Group through direct shareholding of 26% and indirect shareholding of 15% through Air Macau. It provides Macau International Airport with passenger, ramp handling, cargo and aircraft line maintenance services.

Menzies Macau handled a total of 21,575 aircraft turns, an increase of 11.84% compared to 2004 driven by the commencement of flight services by a foreign low cost carrier from Singapore to Macau in the first quarter of 2005. However, cargo tonnage fell 6.17% due to keen competition from the surrounding airports. In addition, 50% of the cargo volume that Menzies Macau handled was transfer cargo, with much lower handling charges than that of cargo terminating in Macau. As a result, the total revenue for the year ended 31 December 2005 was US$51 million or 3.61% less than 2004.

During the year, the Macau Government reduced the company tax rate from 15.75% to 12%, which contributed to a decrease in tax expenses of the company. Total net profit after tax for the year ended 31 December 2005 was US$24.5 million, up 10.86% against 2004.

As Macau Asia Express and other new foreign airlines plan to commence operations in Macau in the fourth quarter of 2006, Menzies Macau remains confident of its performance in 2006.

Tradeport Hong Kong Limited

The Group owns a 25% interest in Tradeport Hong Kong. Tradeport Logistics Centre at the Hong Kong International Airport commenced operations in March 2003.

For the year ended 31 December 2005, the consolidated revenue of Tradeport Hong Kong rose by 53% compared to 2004. Both the capacity utilisation and the revenue per pallet of Tradeport Logistics Centre grew significantly during the year. At the end of the year, capacity utilisation of the Tradeport Logistics Centre stood at 73% against 45% in 2004.

(2) In relation to the Remaining Group

Please refer to the section headed "Effect of Disposal and Acquisition" in the letter from the Board on pages 19 to 22 of this circular for the management discussion and analysis for the Remaining Group for the year ended 31 December 2005.

(b) For the year ended 31 December 2004

(1) In relation to the Group

Operations Review

The Group is engaged in the provision of **air transportation services** through

- Air Macau, CNAC (Macau)'s 51% owned subsidiary, and
- Dragonair, the Group's 43.29% owned associated company;

the provision of **airline catering services** through

- BACL, the Group's 60% owned jointly controlled entity,
- SWACL, the Group's 60% owned jointly controlled entity, and
- LLSHK, the Group's 20.2% directly owned associated company;

the provision of **airport ground handling services** through

- JASL, the Company's 50% owned associated company, and
- Menzies Macau, CNAC (Macau)'s 26% directly owned associated company;

and in **logistics services** through

- Tradeport Hong Kong, the Group's 25% owned associated company.

Liquidity and Financial Resources

The Group generally financed its operations with cash flow generated internally. As at 31 December 2004, the Group had cash and bank balances of a total amount of approximately HK$787 million and net current assets of approximately HK$563 million. The Group consistently maintained a strong working capital during the year under review. As at 31 December 2004, the current liabilities of the Group was approximately HK$472 million whilst the Group had no outstanding borrowings.

Contingent Liabilities and Commitments

As at 31 December 2004, the Group had given a guarantee of HK$15 million to a bank for the banking facilities provided to an associated company.

In February 2001, the Group together with the Tradeport Logistics Centre consortium partners jointly gave a guarantee to the Airport Authority Hong Kong in respect of their obligations to provide sufficient funding for the development of the Tradeport Logistics Centre. On 17 March 2004, the Airport Authority Hong Kong agreed to reduce the maximum liability limit from approximately HK$780 million to approximately HK$312 million. The Directors are of the opinion that, had the Group been required to perform its obligation under the guarantee in the event of default of all of the consortium partners, the maximum amount of the contingent liabilities assumed, including the Group's estimated share of capital commitments of approximately HK$78 million, would have been approximately HK$312 million.

Charge On Assets

The shares of Tradeport Hong Kong held by the Group were pledged as securities for a banking facility granted to Tradeport Hong Kong.

Foreign Exchange And Currency Risks

The Group generates a portion of its revenue from ticket sales in certain foreign jurisdictions giving rise to exposures to fluctuation in foreign exchange rates. The Group continuously monitors its foreign currency positions and does not consider that it has a significant exposure to foreign exchange risk from any currency.

Human Resources

The bulk of human resources of the Company and their remuneration, amongst others, are covered by a management services agreement concluded with CNACG. Likewise CNAC (Macau) also concluded a management services agreement with CNAC (Macau) Aviation Limited ("CNAC (Macau) Aviation"). Both agreements were negotiated under normal commercial terms and conditions.

Air Macau, a 51% held subsidiary, employs about 830 staff (2003: about 770), of which about 178 (2003: about 147) are based outside Macau. Employees remunerated packages are designed and structured based on the foregoing market conditions, relevant laws and regulations, industry practices and standard, work performance, education or professional training background and past working experience.

Air Macau Company Limited

The Group owns a 51% shareholding in Air Macau through its wholly owned subsidiary CNAC (Macau). Air Macau was established in Macau in 1994 as the home based carrier in Macau and commenced commercial operation in November 1995 under a concession agreement with the Macau government, granting the airline an exclusive right to operate as Macau's home based carrier for a 25-year period until the year 2020.

Principal activities of Air Macau include:

- the operation of airline; and
- the provision of airport ground handling services through Menzies Macau, a 15% owned associated company.

Route Profile:

- At the end of 2004 and 2003, the number of destinations served by Air Macau categorized by China mainland and non-China mainland destinations are summarised as follow:

	Licensed Passenger and Cargo	**Number in services as at 31 December**	
		2004	**2003**
Destinations:			
China mainland	31	8	10
Non-China mainland	38	5	5
Total	69	13	15

- Air Macau's passenger and freighter services operated a total of 21,222 flights (including charter flights) in 2004 between Macau and 16 destinations in Asia, encompassing Beijing, Chengdu, Haikou, Kunming, Guilin, Ningbo, Nanjing, Shanghai, Xiamen, Shenzhen, Taipei, Kaohsiung, Bangkok, Manila, Singapore and Seoul. However, two of these cities, Ningbo and Singapore were suspended during 2004.

Fleet Profile:

- As at the end of 2004, Air Macau's fleet comprised of 15 aircraft. One A319 was leased out in return for one A321 being leased-in as a process of phasing out the A319 aircraft. Three wide body freighters were acquired in April, May and December 2004 respectively.

- At the end of 2004 and 2003, Air Macau's fleet was as follows:

	Number of aircraft as at 31 December	
Aircraft Type	**2004**	**2003**
A319	4	5
A320	1	1
A321	6	5
B727 freighter	1	1
A300B4 freighter	3	0
Fleet Total	15#	12#

\# Ten (2003: ten) aircraft were under operating leases, while one B727 freighter (2003: one B727 freighter) and three A300B4 freighter (2003: nil) were under wet lease, and one A321 (2003: one A321) was owned by Air Macau.

- The process of replacing A319 with bigger aircraft will continue in 2005 in a bid to increase the flight capacity. Subject to the availability of the replacement aircraft, the management plans to phase out all the A319 aircraft by 2006. Two additional wide body aircraft have also been planned to operate high-density routes like Taipei, Shanghai and also be used to operate other new long haul routes.

- The management also plans to acquire one B747 freighter and to replace three A300B4 freighters by three A300-600R freighters in 2006 in order to expand the capacity of the freighter business.

Operating Summary:

		Year ended 31 December		
		2004	**2003**	**Change %**
Overall operating:				
Available tonne kilometre (ATK)				
– Passenger aircraft	(million)	349.20	267.64	+30.5
– Freighter	(million)	117.14	30.56	+283.3
Aircraft utilization				
– A319	(hr/day)	5.5	4.5	+22.2
– A320	(hr/day)	6.1	5.3	+15.1
– A321	(hr/day)	7.0	5.8	+20.7
– B727 freighter	(hr/day)	4.6	4.9	-6.1
– B300B4 freighter	(hr/day)	5.3	–	N/A
Passenger services:				
Available seat kilometre (ASK)	(million)	3,068.2	2,371.4	+29.4
Total passengers carried	('000)	1,808.0	1,220.4	+48.1
Revenue passenger kilometre (RPK)	(million)	2,145.6	1,538.2	+39.5
Passenger yield per RPK	(avos)	65	65	–
Passenger load factor	(%)	70	65	+5 pt
Cargo services:				
Cargo tonne kilometre (CTK)				
– Passenger aircraft	(million)	23.2	22.4	+3.6
– Freighter	(million)	84.4	23.6	+257.6
Total cargo tonnes carried				
– Passenger aircraft	(tonnes)	19,601	18,351	+6.8
– Freighter	(tonnes)	83,683	37,242	+124.7
Cargo yield per CTK				
– Passenger aircraft	(avos)	497	477	+4.2
– Freighter	(avos)	488	557	-12.4
Cargo load factor				
– Passenger aircraft	(%)	55	74	-19 pt
– Freighter	(%)	72	77	-5 pt

- Air Macau carried more than 1.8 million passengers in 2004, an increase of 48.1% from 2003 mainly due to post SARS recovery as well as implementation of aggressive marketing and sales plans. Capacity of passenger services as measured by ASK increased 29.4%, while passenger loading as measured by RPK increased 39.5%. The higher rate of increase in RPK to ASK rendered a 5 percentage points increase in passenger load factor to 70%. Passenger yield of 2004 remained at 65 cents per RPK, same as that of 2003. This was due to the exercise of aggressive price promotion tactic, as the airline needed to consolidate strategic position, in its major markets – Taiwan, Shanghai and Macau. The expansion of cargo business in 2004 was demonstrated by the 257.6% increase in freighter's CTK. Such increase in capacity brought downward pressure in yield, which was diluted by 12.4% as compared with 2003. Tonnage for freighter increased 124.7%, yet freighter load factor declined by 5 percentage points to 72% when compared with the 2003 level.

Traffic Profile:

- The following table sets out Air Macau's traffic summary for the years ended 31 December 2004 and 2003 by geographical area, expressed as a percentage of the total volume of revenue passengers and cargo carried:

	Passenger Services Year ended 31 December		Cargo Services Year ended 31 December	
Routes	**2004**	**2003**	**2004**	**2003**
	%	%	%	%
China mainland	41	40	40	43
Taiwan region	52	51	59	55
Other destinations in Asia	6	8	1	2
Ad hoc charters	1	1	–	–
	100	100	100	100

- In 2004, Air Macau inaugurated twice daily passenger services between Shenzhen and Taipei via Macau for the convenience of the PRC-stationed Taiwanese businessmen who shuttle between work place and home now hassle free.

- The carrier also faced challenges posed by the low cost carriers, which have commenced their services in the region during the year. Meanwhile, with Air Macau's expanding fleet size, high service quality and wide destination coverage, the management is confident in maintaining the leading edge in the industry.

- The Cargo Department was set up in May 2004 to cater for increased freighter business and to implement aggressive cargo development plans.

Cost Profile:

- The overall operating expenditure increased by 27.8% due to the enhancement of operating activities.

- The following table sets out Air Macau's cost summary for the years ended 31 December 2004 and 2003:

	Year ended 31 December		
Expenditure	**2004**	**2003**	**Change**
	%	%	*% point*
Staff costs	13	15	-2
Passenger catering and service costs	5	6	-1
Fuel costs	21	13	8
Route operating costs	24	22	2
Aircraft maintenance costs	8	11	-3
Aircraft equipment costs	19	22	-3
Depreciation and amortisation costs	4	5	-1
Sales and promotion costs	3	3	–
Other operating costs	3	3	–
Total	100	100	

- Operating costs, such as staff costs, passenger catering and service, sales and promotion, that directly linked with level of operating activities increased in line with the overall flight increase.

- The increase in the percentage of fuel costs was mainly due to expensive fuel price as a result of social turbulence in Iraq and global fuel shortage.

- The decrease in aircraft maintenance costs was mainly due to the price reduction on maintenance package.

- The increase in aircraft equipment costs was due to the fleet expansion.

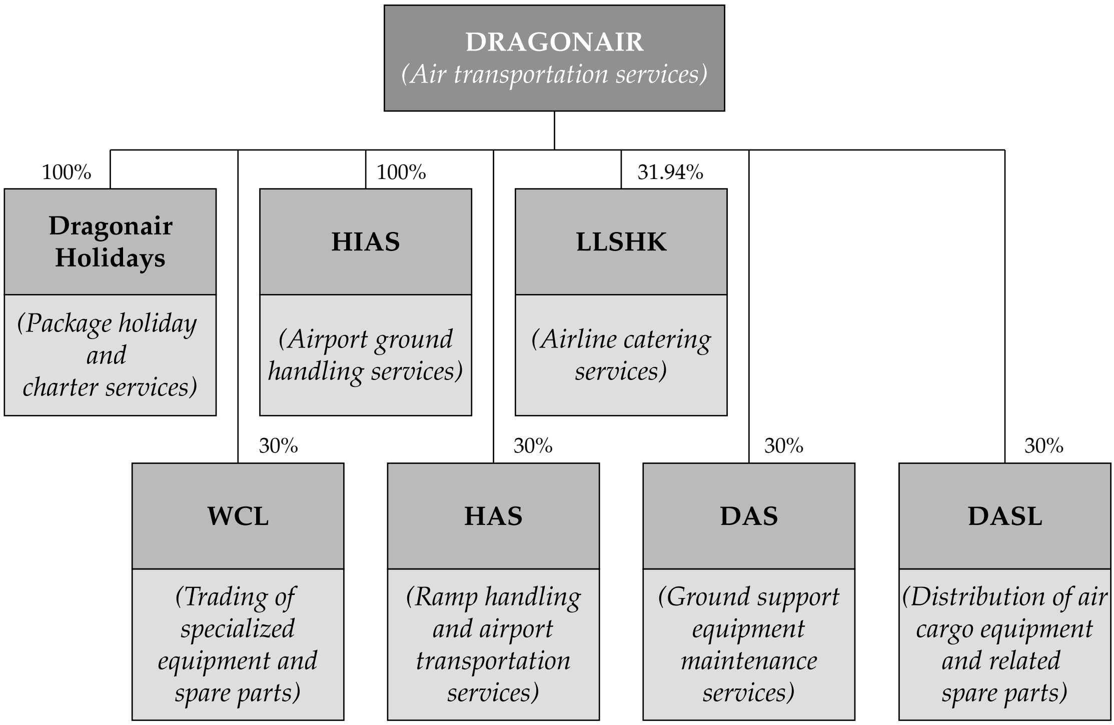
The decrease in the depreciation and amortisation costs was a result of strict control on asset purchased.

Hong Kong Dragon Airlines Limited

The Group owns a 43.29% interest in Dragonair and remains as its single largest shareholder. The principal activities of Dragonair are:

- the operation of airline;
- the provision of airport ground handling services through its wholly-owned subsidiary HIAS;
- the provision of airline catering services through its 31.94% owned associated company LLSHK;
- the provision of holiday packages and charter services through its wholly-owned subsidiary Dragonair Holidays;
- the provision of ramp handling and airport transportation services through its 30% owned associated company HAS;
- the provision of ground support equipment and vehicles maintenance and repair services through its 30% owned associated company DAS;
- the distribution of air cargo equipments and related spare parts through its 30% owned associated company DASL; and
- the trading of specialised equipment and spare parts through its 30% owned associated company WCL.

The following chart sets out the current simplified corporate structure of Dragonair, its principal operating subsidiaries operating subsidiaries and associated companies and their respective activities:



The majority of the income of Dragonair is derived from the provision of passenger and cargo air transportation services. The following table sets out the composition of the profit before taxation of Dragonair for the years ended 31 December 2004 and 2003 derived from its major business operations expressed as percentages of the total profit before taxation of Dragonair:

	Year ended 31 December		
	2004	**2003**	**Change**
	%	%	*% point*
Airline operations	91.2	43.7	+47.5
HIAS	4.0	32.7	-28.7
LLSHK	2.1	7.2	-5.1
DAS	–	–	–
HAS	2.5	14.2	-11.7
DASL	0.1	1.8	-1.7
WCL	0.1	0.4	-0.3
Total	100.0	100.0	

During the year, the profit before taxation from the airline operations increased significantly due to strong recovery of passenger traffic after the outbreak of SARS in 2003. As a result, its share of the total profit before taxation of Dragonair's airline operations had returned to a normal level of 91.2% in 2004 versus 43.7% in 2003.

Air Transportation

Route Profile:

- At the end of years 2004 and 2003, the number of destinations serviced by Dragonair analysed by China mainland and non-China mainland destinations are as follows:

	Licensed		Number in service as at 31 December	
	Passenger and cargo	All cargo	2004	2003
Destinations:				
China mainland	48	–	21	19
Non-China mainland	47	23	15	12
Total	95	23	36	31

In 2004, Dragonair operated scheduled services to 36 destinations of which 21 of them in China mainland. Dragonair performed 17,854 round trips in total for the year. Shanghai route remained the most profitable route for 2004. Dragonair would start up the freighter services to New York three times a week from April 2005 using a wet-leased B747-400 freighter.

Fleet Profile:

- At the end of year 2004, Dragonair's aircraft fleet comprised of 31 aircraft. For the expansion of the airline's passenger services and cargo services, there were three passenger aircraft and two freighters delivered in 2004 including:
  - One A330 under operating lease in March 2004
  - One A300B4 freighter under wet lease in June 2004
  - Two A320s under finance lease in July 2004
  - One purchased B747-200 freighter in July 2004.

• Dragonair's fleet at the end of years 2004 and 2003 was as follows:

	Number of aircraft as at 31 December	
Aircraft type	**2004**	**2003**
A320	10	8
A321	6	6
A330	10	9
A300B4 freighter	1	–
B747-200 freighter	1	–
B747-300 freighter	3	3
Fleet Total	31#	26#

Fifteen aircraft were under operating leases (2003: fourteen), five aircraft (2003: five) were under finance leases and six aircraft were owned by Dragonair (2003: four). Besides, there were four freighters owned by Dragonair (2003: three) and one freighter was under wet lease (2003: nil).

Fleet Expansion Plan:

Year	**Purchase**	**Operating Lease**	**Wet Lease**
2005	1 A320	3 A330	1 B747-400 freighter
2006	2 B747-400 freighter	3 A330	
2007	2 B747-400 freighter		

Dragonair has confirmed to purchase one additional A320, operating lease three A330s and wet lease one B747-400 freighter in the year 2005, so as to take advantage of the growth opportunities in the airline industry ahead.

Operating Summary:

		Year ended 31 December		
		2004	**2003**	**Change %**
Overall operation:				
Available tonne kilometre (ATK)				
– Passenger aircraft	('000)	1,330,721	954,216	+39.5
– Freighter	('000)	1,099,467	824,908	+33.3
Revenue load factor	(%)	71.3	67.6	+3.7 pt
Aircraft utilisation				
–A320	(hr/day)	7.9	5.8	+36.2
–A321	(hr/day)	9.5	6.0	+58.3
–A330	(hr/day)	9.3	8.1	+14.8
A300B4 freighter	(hr/day)	6.0	–	N/A
–B747-200 freighter	(hr/day)	13.1	–	N/A
–B747-300 freighter	(hr/day)	12.5	11.1	+12.6
Passenger services:				
Available seat kilometre (ASK)	('000)	9,175,702	6,482,984	+41.5
Total passengers carried		4,793,099	3,213,570	+49.2
Revenue passenger kilometre (RPK)	('000)	5,954,669	3,847,942	+54.7
Passenger yield per RPK	(HK cents)	86.2	88.2	-2.3
Passenger load factor	(%)	64.9	59.4	+5.5 pt
Cargo services:				
Cargo tonne kilometre (CTK)				
– Passenger aircraft	('000)	211,092	157,692	+33.9
– Freighter	('000)	875,562	701,888	+24.7
Total cargo tonnes carried				
– Passenger aircraft	(tonnes)	158,617	125,617	+26.3
– Freighter	(tonnes)	183,796	144,363	+27.3
Cargo yield per CTK				
– Passenger aircraft	(HK cents)	559	570	-1.9
– Freighter	(HK cents)	230	212	+8.5
Cargo load factor				
– Passenger aircraft	(%)	64.7	64.6	+0.1 pt
– Freighter	(%)	79.6	85.1	-5.5 pt

- Dragonair carried 4.8 million passengers in 2004, an increase of 49.2% from 2003. Capacity of passenger services as measured by ASK was increased by 41.5%, mainly due to a lower base for comparison. The adverse impact of SARS dampened the demand for passenger services in 2003.

- Passenger yield per RPK reported a decrease of 2.3% from 2003 level due to market competition, special offer and lower yield on a per kilometre basis for new services with longer sector length launched in 2004.

- In 2004, capacity of the freighter services as measured by ATK rose by 33.3% due to the wet lease of one A300B4 freighter to operate all-cargo services to Osaka, Shanghai and Nanjing since June 2004 and the freighter service to Frankfurt and London Stansted since late July 2004.

- Cargo yield for passenger aircraft decreased by 1.9% but cargo yield for freighter increased 8.5% from those of 2003. The increase in cargo yield for freighter was helped by the higher yield of more short-haul freighter services provided, and strengthening Euro and Yen against the US dollar in 2004.

- In 2004, Dragonair's passenger load factor increased by 5.5 percentage points. However, cargo load factor for freighter decreased by 5.5 percentage points from that of 2003.

Traffic Profile:

- The following table sets out Dragonair's traffic summary for the years ended 31 December 2004 and 2003 by geographical area, expressed as a percentage of the total number of passengers and cargo carried:

	Passenger Services Year ended 31 December		**Cargo Services Year ended 31 December**	
Routes	**2004**	**2003**	**2004**	**2003**
	%	%	%	%
China mainland	67.6	68.1	44.1	44.2
Taiwan region	22.0	23.6	21.9	23.3
Japan	2.2	0.5	8.8	8.4
Europe and Middle East	–	–	21.5	21.4
Other destinations	7.9	6.9	3.3	2.7
Ad hoc charters	0.3	0.9	0.4	–
Total	100.0	100.0	100.0	100.0

- Dragonair operates passenger services to 30 destinations in Asia, of which 21 are in China mainland. The airline's scheduled flights to Shanghai have been increased to 87 per week in the winter schedule of 2004. Dragonair also provided additional flights to most China mainland routes to cope with growing traffic demand in 2004. In addition, Dragonair signed a code share agreement with Air China in February 2004 covering the routes of Chengdu, Chongqing, Dalian and Tianjin. Except Tianjin, the other three routes are currently operated by Dragonair.

- Regarding services outside the Greater China region, Dragonair started the 7 flights a week new passenger service to Tokyo in April 2004.

- The airline has cancelled the scheduled services to Phuket from January 2005 onwards as the demand for air traffic to Phuket has been substantially reduced after the tsunami disasters in South Asia.

Cost Profile:

- The following table sets out Dragonair's cost summary for the years ended 31 December 2004 and 2003:

	Year ended 31 December		
Expenditure	**2004**	**2003**	**Change**
	HK$'000	*HK$'000*	%
Staff costs	1,345,048	1,079,521	+24.6
Passenger catering and service costs	323,564	224,294	+44.3
Fuel costs	1,475,523	791,724	+86.4
Route operating costs	1,648,903	1,212,642	+36.0
Aircraft maintenance costs	1,146,098	941,798	+21.7
Aircraft lease and finance charges	610,012	592,172	+3.0
Depreciation and amortisation costs	488,814	409,603	+19.3
Other operating costs	521,168	450,038	+15.8
Total	7,559,130	5,701,792	+32.6

- Dragonair's staff costs during the year rose by 24.6% from 2003's level due to increase in staff and crew number for the expanded operation and no pay leave scheme during SARS in 2003.

- Passenger catering and service costs edged up from 2003's level mainly because of increase in total passengers number. However, this was partly offset by change in catering requirements for some short-haul routes.

- Fuel costs surged significantly from that of 2003. This was mainly attributable to soaring fuel price in the market and rising fuel consumption resulting from more long-haul freighter services operated.

- Route operating costs which included landing, parking and ground handling charges, also moved higher, primarily due to increased number of flights for passenger services and freighter services.

- During the year, aircraft maintenance costs also edged up from 2003's level. This was mainly due to the increase in the number of aircraft and higher aircraft utilisation in 2004.

- Aircraft lease and finance charges rose mainly due to the increase in aircraft number. However, this was partly offset by decrease in operating lease charge after renewal of some lease agreements with lessor and lower finance charge under the low interest rate environment in 2004.

- Depreciation and amortisation costs increased due to the purchase of two passenger aircraft and one freighter as well as cabin reconfiguration programme for A330 aircraft.

- The increase in other operating costs was mainly due to expanded operation and launched expenses for new routes.

Hong Kong International Airport Services Limited

- HIAS, a wholly-owned subsidiary of Dragonair, provides airport ground handling services in Hong Kong to Dragonair and other airlines.

- Total number of third party aircraft movements serviced in 2004 was 6,521, an increase of 30.8% from 2003's level.

LSG Lufthansa Service Hong Kong Limited

- LLSHK is a 31.94% owned associated company of Dragonair. Its main business is to provide catering services to airline customers in Hong Kong.

- The substantial increase in profit attributable from LLSHK was mainly due to the increase in passenger traffic compared with 2003 which was dented by SARS.

Dragonair Holidays Limited

Dragonair Holidays, a wholly-owned subsidiary of Dragonair, mainly provides packaged holidays and charter services for Dragonair.

Hong Kong Airport Services Limited

- HAS, a 30% owned associated company of Dragonair, provides aircraft ramp handling operations and passenger and staff busing services at the Hong Kong International Airport.

- HAS is the largest ramp handling operator in Hong Kong, accounting for over 57.0% of the market in the Hong Kong International Airport. Approximately 5,700 flights are handled monthly.

- The considerable traffic growth in 2004, savings in equipment maintenance costs and staff costs contributed to a satisfactory profit.

Dah Chong Hong – Dragonair Airport Gse Service Limited

- DAS, a 30% owned associated company of Dragonair, provides ground support equipment and vehicles maintenance and repair services at the Hong Kong International Airport.

- DAS reported a loss for the year due to reduction in maintenance activities from a major customer.

DAS Aviation Support Limited

- DASL, a 30% owned associated company of Dragonair, distributes air cargo equipment and related spare parts.

- A drop in net profit for the year as compared to that of 2003 was due to decrease in maintenance activities from a major customer.

Wise Counsel Limited

- WCL is a 30% owned associated company of Dragonair. Its main business is to provide spare parts for specialised equipment.

- Higher net profit for the year as compared to that of 2003 was due to increase in ground support equipment and vehicles maintenance activities by customers.

Beijing Air Catering Co., Ltd.

- BACL, the largest airline caterer in Beijing Capital International Airport, is a newly acquired 60% owned jointly controlled entity of the Group. It is principally engaged in the provision of in-flight catering services and other related in-flight food and beverages services.

- In 2004, there was an increase of demand for airline catering services due to the recovery of the airline industry after the SARS period. The number of flights catered for by BACL was 91,273 flights, representing an increase of 16% when compared to that of 2003. In the year under review, the number of in-flight meals served by BACL increased to approximately 13.23 million meals, up by approximately 44.7% when compared to that of 2003.

- The turnover of BACL in 2004 was RMB346.6 million, representing an increase of 31.2% from 2003. The growth is mainly attributable to higher flight frequencies and passenger loads of the flights catered for by BACL.

- In March 2004, the expansion plan of Beijing Capital International Airport was approved by the National Development and Reform Commission, PRC. There will be a rising demand of airline catering services in Beijing Capital International Airport, which will further enhance the growth potential of BACL.

Southwest Air Catering Company Limited

- SWACL, the largest airline caterer in Chengdu Shuangliu International Airport, is a newly acquired 60% owned jointly controlled entity of the Group. It is principally engaged in the production of food, beverages and in-flight services products, the provision of other related services and the sale of its own products.

- In 2004, the number of in-flight meals served by SWACL increased by approximately 14.79% from approximately 3.11 million meals in 2003 to approximately 3.57 million meals, while the number of flights catered for by SWACL stood at 20,150, representing an increase of 12.25% from 17,951 in 2003.

- The turnover of SWACL in 2004 was RMB73.5 million, representing a increase of 15.2% from RMB63.8 million in 2003. The turnover of SWACL from in-flight meal business and other business accounted for 75.3% and 24.7% respectively.

- During the review period, with the finance charges incurred due to the investment of the new in-flight meals production building, and the depreciation costs and other related operating costs increased due to the commencement of operation of the building in June 2004, the net profit of SWACL decreased by approximately 67.2% from approximately RMB6.7 million in 2003 to approximately RMB2.2 million in 2004.

- The new in-flight meals production building has strengthened the production capacity of SWACL. SWACL is currently capable of handling 30,000 in-flight meals per day. The enlarged production capacity will enable SWACL to capitalise on the increasing business expected to be brought about by the expansion of the Chengdu Shuangliu International Airport in the coming years.

LSG Lufthansa Service Hong Kong Limited

- LLSHK is a 34.03% effectively owned associated company of the Group through direct shareholding of 20.2% and indirect shareholding of 13.83% through Dragonair. Its main business is to provide catering services in Hong Kong to Dragonair and other airline customers.

- Compared with 2003, the number of meals served and the number of flights catered for by LLSHK had increased by 48.3% and 40.6% respectively largely due to the recovery of the airline industry after SARS.

- Turnover and profit before taxation of LLSHK in 2004 had increased by 27.2% and 854.8% respectively compared with 2003, mainly due to strong recovery in air traffic after SARS and various cost saving measures implemented.

- Volume growth is expected in 2005 with the opening of Hong Kong Disneyland and more new routes to be launched by major customers.

Jardine Airport Services Limited

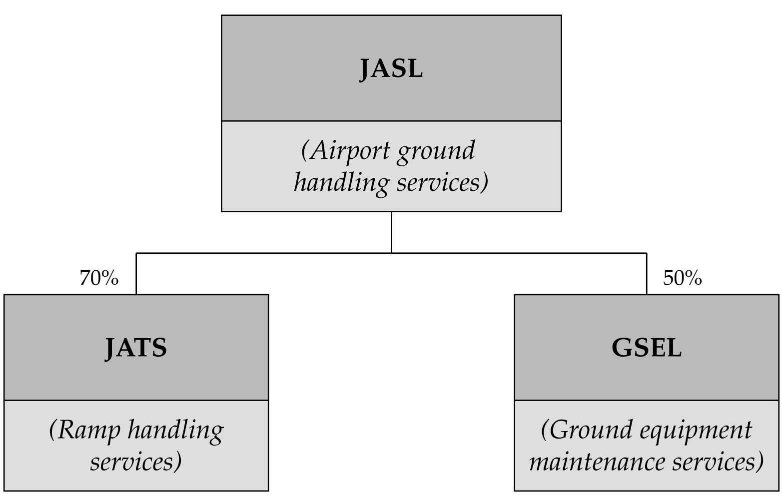
The Company owns a 50% interest in JASL. The principal activities of JASL are:

- the provision of airport ground handling services; and

- the provision of ramp handling services through its 70% owned subsidiary company JATS; and

- the provision of ground support equipment maintenance services through its 50% owned jointly controlled entity GSEL.

The following chart sets out the simplified corporate structure of JASL and its subsidiaries as at 31 December 2004:



- JASL provides airport ground handling services for 25 international airlines at the Hong Kong International Airport. The principal activities of JASL include the provision of check-in services, passenger reception services, baggage services, ticketing and flight information, management of flight operations, flight control and cargo documentation services.

- JATS, a 70% owned subsidiary company of JASL, has a 10-year franchise by the Airport Authority Hong Kong to provide ramp handling services at the Hong Kong International Airport since July 1998. The other shareholders of JATS are China Airlines, United Airlines and GlobeGround GmbH.

- The consolidated turnover of JASL and its subsidiaries increased by 28.3% from that of the preceding year, mainly due to favourable market conditions which have bounced back to the pre-SARS level. JASL's consolidated profit before taxation increased by 95.9% from that of the previous year, mainly due to the increase in flight frequencies handled.

- JASL handled 60,346 aircraft movements for the year, which represented a 35.5% increase from that of 2003, and maintained approximately 40% share of the third party ground handling market at the Hong Kong International Airport. JATS handled 79,800 aircraft movements for the year, which represented an approximately 60% share of the third party ramp handling market at the Hong Kong International Airport.

- In March 2004, JASL acquired a 50% interest of GSEL. The principal activity of the company is the provision of ground support equipment maintenance services. The other shareholder of GSEL is Castor Investments Limited, a wholly owned subsidiary of Cathay.

Menzies Macau Airport Services Ltd

- Menzies Macau is a 33.65% effectively owned associated company of the Group through direct shareholding of 26% and indirect shareholding of 15% through Air Macau. It provides Macau International Airport with passenger, ramp handling, cargo and aircraft line maintenance services.

- For the first quarter 2004, Menzies Macau recorded a slight decline of 8% in aircraft turns handled; but the cargo tonnage volume was increased by 47% as compared to the corresponding period in 2003. With the start of Air Macau and Shanghai Airlines freighter services in the second quarter, Menzies Macau experienced increased growth in the cargo activity. Menzies Macau also handled more passenger flights with added activity from the low cost carrier Air Asia which commenced flights to Macau in July 2004.

- For the year ended 31 December 2004, Menzies Macau provided ground services for a total of 19,291 aircrafts turns and 171,450 tonnes of cargo. As a result, the turnover and operating profit for 2004 were up by 21% and 26% respectively as compared with those for 2003, which have also exceeded the turnover and operating profit levels in 2002.

- Menzies Macau ended 2004 with a healthy performance and expects to see continued growth in the business and from cargo operations in 2005.

Tradeport Hong Kong Limited

- The Group owns a 25% interest in Tradeport Hong Kong. Tradeport Hong Kong's Logistics Centre at the Hong Kong International Airport commenced operations in March 2003.

- Tradeport Hong Kong ended the year with a strong note of securing three major long-term customer contracts in semi-conductor, aerospace and retail industries. The business activity of Tradeport Hong Kong has grown significantly during the year. The utilisation of the Logistics Centre and revenue per pallet shown continue growth throughout the year due to increased services and better space utilisation though material handling equipment.

(2) In relation to the Remaining Group

Had the Disposal and Acquisition been completed as at 1 January 2004, the Group would not hold any interest in Dragonair and would hold a minority stake in Cathay for the year ended 31 December 2004. Please refer to pages 228 to 243 in the section headed "Financial Information of Cathay" of Appendix II to this circular for a description of the performance of Cathay for the year ended 31 December 2004.

As Dragonair is an associate company of the Group, its earning contribution would be subject to foreign exchange risks due to its ticket sales in foreign countries. After the Disposal and the Acquisition, Cathay's dividend payment will similarly be exposed to foreign exchange risks faced by the airline.

Save for the above, the Directors are of the view that the management discussion and analysis set out above in relation to the Group for the year ended 31 December 2004 would be the same as that in relation to the Remaining Group for the year ended 31 December 2004.

(c) For the year ended 31 December 2003

(1) In relation to the Group

OPERATIONS REVIEW

The Group is engaged in the provision of **air transportation services** through

- Air Macau, CNAC (Macau)'s 51% owned subsidiary, and
- Dragonair, the Company's 43.29% owned associated company;

and in the provision of **airport ground handling services** through

- JASL, the Company's 50% owned associated company, and
- Menzies Macau, CNAC (Macau)'s 26% directly owned associated company;

and in **logistics services** through

- Tradeport Hong Kong, the Company's 25% owned associated company.

Liquidity and Financial Resources

The Group generally financed its operations with cash flow generated internally. As at 31 December 2003, the Group had cash and bank balances of a total amount of approximately HK$1,063 million and net current assets of approximately HK$824 million. The Group consistently maintained a strong working capital during the year under review. As at 31 December 2003, the current liabilities of the Group was approximately HK$417 million whilst the Group had no outstanding borrowings.

Contingent Liabilities and Commitments

As at 31 December 2003, the Group had given a guarantee of HK$15 million to a bank for the banking facilities provided to an associate.

In February 2001, the Group together with the logistics centre consortium partners had jointly given a guarantee to the Hong Kong Airport Authority in respect of their obligations to provide sufficient funding for the development of the logistics centre. The Directors are of the opinion that, had the Group been required to perform its obligation under the guarantee in the event of default of all of the consortium partners, the maximum amount of the contingent liabilities assumed, including the Group's estimated share of capital commitments of approximately HK$131 million, would have been approximately HK$780 million.

Foreign Exchange and Currency Risks

The Group generates a portion of its revenue from ticket sales in certain foreign jurisdictions giving rise to exposures to fluctuation in foreign exchange rates. The Group continuously monitors its foreign currency positions and does not consider that it has a significant exposure to foreign exchange risk from any currency.

Human Resources

The bulk of human resources of the Company and their remuneration, amongst others, are covered by a management services agreement concluded with the Company's immediate holding company, CNACG. Likewise CNAC (Macau) also concluded a management services agreement with CNAC (Macau) Aviation Limited ("CNAC (Macau) Aviation"). Both agreements were negotiated under normal commercial terms and conditions.

Air Macau, a 51% held subsidiary, employs about 770 staff (2002: about 800), of which about 147 (2002: about 147) are based outside Macau. Employees remunerated packages are designed and structured based on the foregoing market conditions, relevant laws and regulations, industry practices and standard, work performance, education or professional training background and past working experience.

Air Macau Company Limited

The Group owns 51% in shares of Air Macau through its wholly owned subsidiary CNAC (Macau). Air Macau was established in Macau in 1994 as the home based carrier in Macau and commenced commercial operation in November 1995 under a concession agreement with the Macau government that gives the airline an exclusive right to operate as Macau's home based carrier for a 25-year period until the year 2020.

The principal activities of Air Macau are:

- the operation of airline; and
- the provision of airport ground handling services through Menzies Macau, a 15% owned associated company.

Air Transportation

Route Profile:

- At the end of 2003 and 2002, the number of destinations served by Air Macau catagorised by China mainland and non-China mainland destinations are summarised as follows:

	Licensed Passenger and cargo	Number in service as at 31 December 2003	2002
Destinations:			
China mainland	31	10	9
Non-China mainland	38	5	7
Total	69	15	16

- Air Macau's passenger and freighter services operated a total of 14,431 flights (including charter flights) in 2003 between Macau and 15 destinations in Asia, which were Beijing, Guilin, Haikou, Kunming, Nanjing, Ningbo, Shanghai, Xiamen, Chengdu, Shenzhen, Taipei, Kaohsiung, Manila, Bangkok, and Singapore. Operations to Kota Kinabalu and Kuala Lumpur were suspended in 2003.

Fleet Profile:

- As at the end of 2003, Air Macau's fleet was comprised of 12 aircraft, including the three brand new A319s passenger aircraft received in January, February and July and one A321 passenger aircraft was replaced by a brand new one in February 2003. All of these new aircraft were under operating leases.

- At the end of 2003 and 2002, Air Macau's fleet was as follows:

Aircraft type	Number of aircraft as at 31 December 2003	2002
A319	5	2
A320	1	3
A321	5	5
B757	–	1
B727 freighter	1	1
Fleet total	12*	12*

* *Ten (2002: nine) aircraft were under operating leases, while one B727 freighter (2002: one B757 and one B727 freighter) was under wet lease, and one A321 (2002: one A321) was owned by Air Macau.*

Fleet expansion plan:

Year	Wet Lease	Return to Lessor
2004	2 A300 freighter	1 B727 freighter
2005	–	1 A320

Due to further expansion in freighter operation, Air Macau will acquire two A300 freighter to replace the existing wet-leased B727 freighter in 2004. All these new aircraft will be under wet leases.

Operating Summary:

		Year ended 31 December		
		2003	**2002**	**Change %**
Overall operating:				
Available tonne kilometre (ATK)				
Passenger aircraft	(million)	267.64	334.9	-20.1
Freighter	(million)	30.56	7.5	+307.5
Aircraft utilization				
A319	(hr/day)	4.5	6.5	-30.8
A320	(hr/day)	5.3	6.5	-18.5
A321	(hr/day)	5.8	7.2	-19.4
B757	(hr/day)	–	5.0	N/A
B727 freighter	(hr/day)	4.9	5.3	-7.5
Passenger services:				
Available seat kilometre (ASK)	(million)	2,371.4	2,925.4	-18.9
Total passengers carried	('000)	1,220.4	1,736.4	-29.7
Revenue passenger kilometre (RPK)	(million)	1,538.2	2,078.1	-25.9
Passenger yield per RPK	(avos)	65	70	-7.1
Passenger load factor	(%)	65	71	-6% pt.
Cargo services:				
Cargo tonne kilometre (CTK)				
Passenger aircraft	(million)	22.4	26.7	-16.1
Freighter	(million)	23.6	3.8	+521.1
Total cargo tonnes carried				
Passenger aircraft	(tonnes)	18,351	23,006	-20.2
Freighter	(tonnes)	37,242	6,250	+495.9
Cargo yield per CTK				
Passenger aircraft	(avos)	477	478	-0.2
Freighter	(avos)	557	779	-28.5
Cargo load factor				
Passenger aircraft	(%)	74	63	+11% pt.
Freighter	(%)	77	51	+26% pt.

- Air Macau carried over 1.22 million passengers in 2003, a decrease of 29.7% from that in 2002. Capacity of passenger services as measured by ASK had decreased by 18.9% in 2003 from 2002, mainly due to cancellation of flights as a result of the outbreak of SARS.

- The passenger yield reported a decrease of 7.1% from that of 2002 due to the special promotion campaigns launched after SARS and the keen market competition that Air Macau was facing during 2003.

- Cargo tonnage uplift increased by 90% to 55,593 tonnes in 2003. The year-on-year increase was mainly attributed to the strong market demand for air cargo services as well as the full year contribution from the wet-leased B727 freighter which commenced operation in October 2002 between Shenzhen and Taiwan via Macau.

Traffic Profile:

- The following table sets out Air Macau's traffic summary for the years ended 31 December 2003 and 2002 by geographical area, expressed as a percentage of the total volume of revenue passengers and cargo carried:

	Passenger Services Year ended 31 December		**Cargo Services Year ended 31 December**	
Routes	**2003**	**2002**	**2003**	**2002**
	%	%	%	%
China mainland scheduled services	40	38	48	36
China mainland programme charters	–	2	–	–
Taiwan region	51	53	52	60
Other destinations in Southeast Asia	8	7	–	4
Ad hoc charters	1	–	–	–
Total	100	100	100	100

- The operation of the carrier was seriously affected by the SARS outbreak that started causing grave impact from March until the latter half of June in 2003. Operations to many tourist destinations in China mainland were cancelled in May and June. Although the carrier was able to maintain operations to Shanghai, Xiamen, Taipei, Kaohsiung, Bangkok and Manila, frequencies were reduced. Kota Kinabalu operation was suspended in March.

- After the SARS period, the carrier strategically restructured its operation network and suspended Kuala Lumpur operation and code-shared with Silk Air on Singapore operation. Much resources were placed to enhance services between Taiwan region and Macau.

- All-cargo freighter services commenced in October 2002 was not significantly affected by the SARS outbreak. The carrier was able to maintain profitability from its freighter operation in 2003.

Cost Profile:

- The overall operating expenditure was reduced by about 9% due to flight cancellation during the SARS period and Air Macau's continuous implementation of cost reduction measures.

- The following table sets out Air Macau's cost summary for the years ended 31 December 2003 and 2002:

	Year ended 31 December		
Expenditure	**2003**	**2002**	**Change**
	%	%	*% point*
Staff costs	15	15	–
Passenger catering and service costs	6	7	-1
Fuel costs	13	11	+2
Route operating costs	22	23	-1
Aircraft maintenance costs	11	11	–
Aircraft equipment costs	22	20	+2
Depreciation and amortisation costs	5	4	+1
Sales and promotion costs	3	5	-2
Other operating costs	3	4	-1
Total	100	100	

- Operating costs, such as passenger catering and services, route operating, aircraft maintenance, sales and promotion, that directly linked with level of operating activities were reduced in line with the overall flight reduction.

- The decrease in sales and promotion costs was also due to the booking fee reduction through the computerised reservation system.

- Although the actual fuel consumption was reduced as the result of shrinking operation during the SARS period, the overall percentage of fuel cost had increased due to the higher system-wide fuel price.

- The percentage of fixed costs, such as aircraft equipment costs, depreciation and amortisation costs, had increased since such fixed costs had decreased in lesser proportion as compared with other direct operating costs.

- The increase in aircraft equipment costs percentage was also attributable to the full year cost effect from the wet-leased B727 freighter which commenced operation in October 2002.

Hong Kong Dragon Airlines Limited

The Group owns a 43.29% interest in Dragonair and is its single largest shareholder. The principal activities of Dragonair are:

- the operation of airline;

- the provision of airport ground handling services through its wholly-owned subsidiary HIAS;

- the provision of aircraft catering services through its 31.94% owned associated company LLSHK;

- the provision of holiday packages and charter services through its wholly-owned subsidiary Dragonair Holidays;

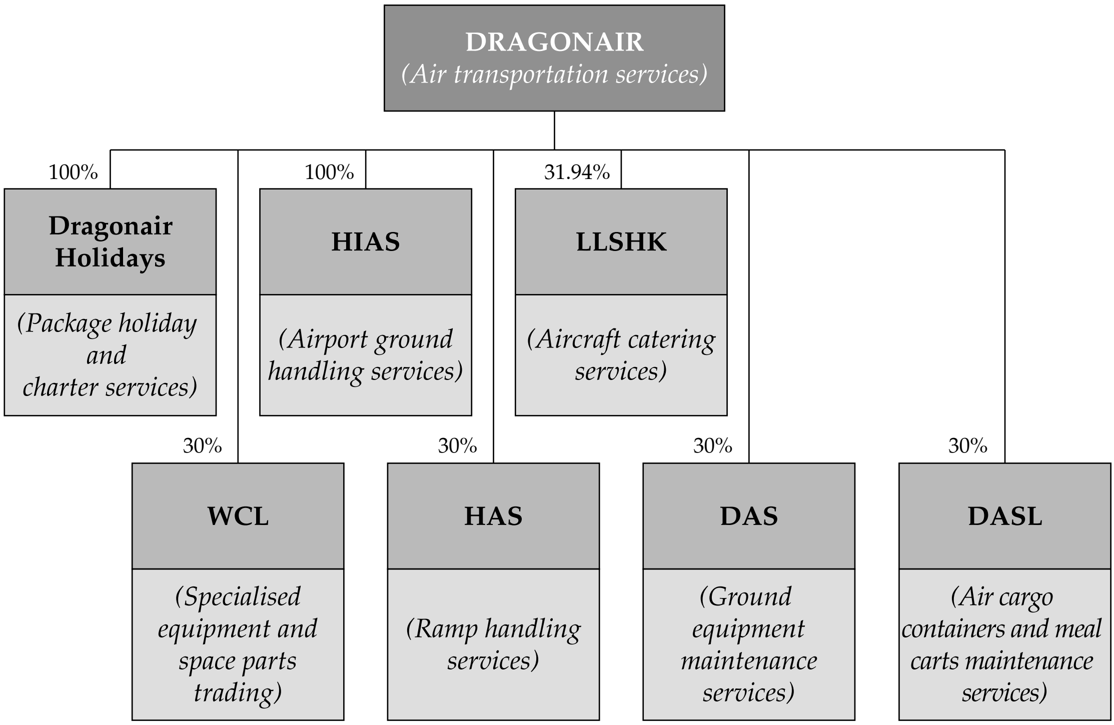
- the provision of ramp handling services through its 30% owned associated company HAS;

- the provision of ground support equipment and vehicles maintenance and repair services through its 30% owned associated company DAS;

- the provision of maintenance service for air cargo containers and meal carts, and sale of related spare parts through its 30% owned associated company DASL; and

- the trading of specialised equipment and spare parts through its 30% owned associated company WCL.

The following chart sets out the current simplified corporate structure of Dragonair, its principal operating subsidiaries and associated companies and their respective activities:



The majority of the income of Dragonair is derived from the provision of passenger and cargo air transportation services. The following table sets out the composition of the profit before taxation of Dragonair for the years ended 31 December 2003 and 2002 derived from its major business operations expressed as percentages of the total profit before taxation of Dragonair:

	Year ended 31 December		
	2003	**2002**	**Change**
	%	%	*% point*
Airline operations	43.7	90.2	-46.5
HIAS	32.7	4.2	+28.5
LLSHK	7.2	2.8	+4.4
DAS	0.0	0.1	-0.1
HAS	14.2	2.5	+11.7
DASL	1.8	0.1	+1.7
WCL	0.4	0.1	+0.3
Total	100.0	100.0	

During the year, the profit before taxation from the airline operations substantially decreased mainly due to the outbreak of SARS from April to June 2003 but was partly offset by the good performance of the freighter operation. Overall, the share of the total profit before taxation of Dragonair's airline operations was decreased from 90.2% in 2002 to 43.7% in 2003.

Air Transportation

Route Profile:

- At the end of 2003 and 2002, the number of destinations served by Dragonair as analysed by China mainland and non-China mainland destinations are summarised as follows:

	Licensed		**Number in service as at 31 December**	
	Passenger and cargo	**All cargo**	**2003**	**2002**
Destinations:				
China mainland	48	–	19	18
Non-China mainland	41	23	12	14
Total	89	23	31	32

- In 2003, Dragonair operated scheduled services to 31 destinations internationally, 19 of which were in China mainland. Dragonair performed 12,389 round trips in total for the year (2002: 12,834). Shanghai route remained to be the most profitable route for 2003.

Fleet Profile:

- At the end of 2003, Dragonair's aircraft fleet was comprised of 26 aircraft, including two purchased A321 passenger aircraft acquired during the year for the expansion of the airline's passenger services.

- At the end of 2003 and 2002, Dragonair's fleet was as follows:

	Number of aircraft as at 31 December	
	2003	**2002**
Aircraft type		
A320	8	8
A321	6	4
A330	9	9
B747 freighter	3	3
Fleet Total	26*	24*

* *Fourteen aircraft were under operating leases (2002: fourteen), while two A320s (2002: two A320s) and three A330s (2002: three A330s) were under finance leases, two A321s (2002: nil), two A330s (2002: two A330s) and three B747 freighter (2002: three B747 freighter) aircraft were owned by Dragonair.*

- Two A321s were purchased in September and October 2003 respectively.

Fleet Expansion Plan:

Year	**Purchase**	**Operating Lease**	**Wet Lease**
2004	2 A320 1 B747 freighter	1 A330	1 A300 freighter
2005	1 A320	3 A330	–
2006	–	3 A330	–

- To prepare for the opportunities ahead, Dragonair had confirmed to purchase two additional A320s, lease one A330, and wet lease one A300 freighter. Dragonair had already purchased one B747 freighter, which was scheduled for delivery in 2004.

Operating Summary:

		Year ended 31 December		
		2003	2002	Change %
Overall operation:				
Available tonne kilometre (ATK)				
Passenger aircraft	('000)	954,216	943,078	+1.2
Freighter	('000)	824,908	582,751	+41.6
Revenue load factor	%	67.6	71.2	-3.6 pt
Aircraft utilization				
A320	(hr/day)	5.8	7.7	-24.7
A321	(hr/day)	6.0	8.2	-26.8
A330	(hr/day)	8.1	8.5	-4.7
B747 freighter	(hr/day)	11.1	11.4	-2.6
Passenger services:	('000)	6,482,984	6,657,431	-2.6
Available seat kilometre (ASK)				
Total passengers carried		3,213,570	3,620,420	-11.2
Revenue passenger kilometre (RPK)	('000)	3,847,942	4,348,167	-11.5
Passenger yield per RPK	(HK cents)	88.2	96.5	-8.6
Passenger load factor	(%)	59.4	65.3	-5.9 pt
Cargo services:				
Cargo tonne kilometre (CTK)				
Passenger aircraft	('000)	157,692	136,867	+15.2
Freighter	('000)	701,888	509,668	+37.7
Total cargo tonnes carried				
Passenger aircraft	(tonnes)	125,617	113,359	+10.8
Freighter	(tonnes)	144,363	80,106	+80.2
Cargo yield per CTK				
Passenger aircraft	(HK cents)	570	561	+1.6
Freighter	(HK cents)	212	174	+21.8
Cargo load factor				
Passenger aircraft	(%)	64.6	59.3	+5.3 pt
Freighter	(%)	85.1	87.5	-2.4 pt

- Dragonair carried 3.2 million passengers in 2003, a decrease of 11.2% from 2002. Capacity of passenger services as measured by ASK had decreased by 2.6%, mainly due to the decrease in demand of passenger services during the SARS outbreak period in 2003.

- Passenger yield reported a decrease of 8.6% from that of 2002 due to a series of special offers launched to stimulate passenger traffic after SARS.

- In 2003, the capacity of the freighter services as measured by ATK raised by 41.6% due to the increase in long-haul cargo services with the introduction of the third freighter in November 2002, resulting in a substantial growth of 39.5% in cargo uplift during the year.

- The cargo yield for passenger aircraft and freighter increased by 1.6% and 21.8% respectively from those of 2002. The increase in cargo yield for freighter was attributed by the higher yield from more short-haul freighter services operated and the strong Euro in 2003.

- In 2003, Dragonair's freighter aircraft utilisation rate and cargo load factor for freighter had decreased by 2.6% and 2.4 percentage points from those of 2002 respectively. The decrease in utilisation was due to more ground time needed to do more checks in 2003.

Traffic Profile:

- The following table sets out Dragonair's traffic summary for the years ended 31 December 2003 and 2002 by geographical area, expressed as a percentage of the total volume of revenue passengers and cargo carried:

	Passenger Services Year ended 31 December		**Cargo Services Year ended 31 December**	
Routes	**2003**	**2002**	**2003**	**2002**
	%	%	%	%
China mainland	68.1	72.1	44.2	46.3
Taiwan region	23.6	20.8	23.3	18.6
Japan	0.5	2.1	8.4	9.2
Europe and Middle East	–	–	21.4	22.7
Other destinations	6.9	4.5	2.7	3.1
Ad hoc charters	0.9	0.5	–	0.1
Total	100.0	100.0	100.0	100.0

- Dragonair operated passenger services to 27 destinations in Asia, of which 19 were in China mainland. The airline's scheduled flights to Beijing and Shanghai had been increased to 56 and 74 per week respectively in 2003. Dragonair added flights to most of its China mainland routes to cope with the growing traffic demand in 2003. The twice a day passenger service to Bangkok had started in November 2003. Services to Sendai and Hiroshima had been suspended since the

SARS outbreak in April 2003. The joint venture service with Malaysian Airlines to Kuching had been suspended since April 2003.

- Dragonair's freighter operation was less affected by SARS. Dragonair maintained freighter services to seven international and regional destinations throughout the year, namely Dubai, Amsterdam, Manchester, Osaka, Shanghai, Xiamen and Taipei.

Cost Profile:

- The following table sets out Dragonair's cost summary for the years ended 31 December 2003 and 2002:

	Year ended 31 December		
Expenditure	**2003**	**2002**	**Change**
	HK$'000	*HK$'000*	%
Staff costs	1,079,521	1,024,495	+5.4
Passenger catering and service costs	224,294	238,632	-6.0
Fuel costs	791,724	625,919	+26.5
Route operating costs	1,212,642	1,120,870	+8.2
Aircraft maintenance costs	941,798	901,200	+4.5
Aircraft equipment costs	592,172	577,636	+2.5
Depreciation and amortisation costs	409,603	315,637	+29.8
Other operating costs	450,038	403,580	+11.5
Total	5,701,792	5,207,969	+9.5

- Dragonair's staff costs during the year had increased from 2002's level due to the increase in staff and crew number for the expanded operation but were partly offset by the tight cost-control measures implemented.

- Passenger catering and service costs had decreased from 2002's level mainly attributable to the decrease in number of passengers carried.

- Fuel costs were higher than that of 2002. This was mainly attributable to the higher system-wide fuel price and the higher fuel consumption for aircraft resulting from more long-haul freighter services operated.

- Route operating costs which included landing and parking charges and ground handling charges, had increased primarily due to the expanded operation for freighter services.

- During the year, aircraft maintenance costs had increased from 2002's level. This was mainly due to the increase in the number of aircraft, the increase in the number of major checks done for both Airbus and Boeing fleet, and the full year operational cost incurred by the third purchased freighter in 2003.

- In 2003, aircraft equipment costs had increased mainly due to the increase in aircraft number and the additional rental cost for more V2500 spare engines needed in the first quarter of 2003, but were partly offset by the reduction in operating lease rental cost for five passenger aircraft after renewal of the lease agreement.

- The increase in other operating costs was mainly due to the expanded operation and sales incentive programme launched for cargo services.

Hong Kong International Airport Services Limited

- HIAS, a wholly-owned subsidiary of Dragonair, provides airport ground handling services in Hong Kong to Dragonair and other airlines.

- The total number of third party aircraft movements served by HIAS in 2003 was 4,987 (2002: 4,752), an increase of 4.9% from 2002's level.

LSG Lufthansa Service Hong Kong Limited

- LLSHK is a 31.94% owned associated company of Dragonair. Its main business is to provide catering services to Dragonair and other airline customers in Hong Kong.

- The decrease in profit contribution from LLSHK was mainly due to reduction in flight frequencies as well as airlines' cost saving measures implemented during the SARS outbreak period.

Dragonair Holidays Limited

- Dragonair Holidays, a wholly-owned subsidiary of Dragonair, mainly provides packaged holidays and charter services for Dragonair.

Hong Kong Airport Services Limited

- HAS, a 30% owned associated company of Dragonair, provides aircraft ramp handling and transportation services at the HK Airport.

- HAS is the leading franchised ramp handling operator at the HK Airport, commanding over 50% of the market. It handled nearly 54,000 flights in 2003.

- During the year, the substantial decrease in passenger traffic operated by airlines had led to a year-on-year decrease in HAS' net profit.

Dah Chong Hong – Dragonair Airport GSE Service Limited

- DAS, a 30% owned associated company of Dragonair, provides ground support equipment and vehicles maintenance and repair services at the HK Airport.

- DAS reported a decrease in net profit for the year as compared to that of 2002 due to the reduction of maintenance activities from the ground handling companies in 2003.

DAS Aviation Support Limited

- DASL, a 30% owned associated company of Dragonair, provides maintenance services for air cargo containers, pallets and meal carts, etc. and engages in the sales of related spare parts.

- The increase in DASL's net profit for the year as compared to that of 2002 was mainly due to cost reduction and increase in other incomes.

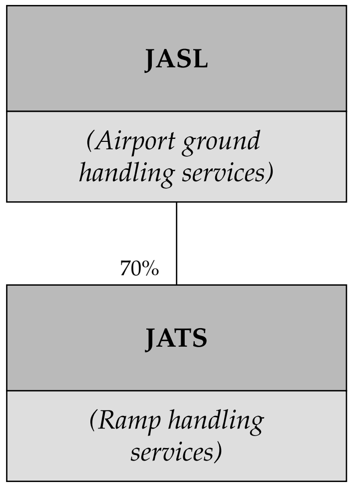
Wise Counsel Limited

- WCL, a 30% owned associated company of Dragonair, specialises in airport ground services equipment and spare parts trading.

- The lower net profit for the year as compared to that of 2002 was due to the decrease in ground support equipment and vehicles maintenance activities.

Jardine Airport Services Limited

- The Company owns 50% of JASL. The following chart sets out the simplified corporate structure of JASL and its subsidiary as at 31 December 2003:



- JASL provides airport ground handling services to 22 international airlines at the HK Airport. The principal activities of JASL include the provision of check-in services, passenger reception services, baggage services, ticketing and flight information, management of flight operations, flight control and cargo documentation services.

- JATS, a 70% owned subsidiary company of JASL, has a 10-year franchise by the Airport Authority to provide ramp handling services at the HK Airport since July 1998. The other shareholders of JATS are China Airlines, United Airlines and GlobeGround GmbH.

- The consolidated turnover of JASL and its subsidiaries reported a decrease of 20.5% from that of the preceding year, mainly due to the negative impact of the SARS outbreak and the disposal of Jardine Airport Services Australia Pty. Ltd in September 2002. JASL's consolidated profit before taxation (and before exceptional item) reduced by 29% from that of the previous year, mainly due to the reduction of the flight frequencies handled.

- JASL handled 44,550 (2002: 50,954) aircraft movements for the year, which represented a 12.6% decrease from that of 2002, and maintained approximately 40% share of the third party ground handling market at the HK Airport. JATS handled 63,144 (2002: 71,736) aircraft movements for the year, which represented approximately 60% share of the third party ramp handling market at the HK Airport.

- In May 2003, JATS sold its entire shareholding in Jardine Skyporters Limited.

- Through strong support and business connections of its shareholders, JASL is actively pursuing new business opportunities in China mainland.

Menzies Macau Airport Services Limited

- Menzies Macau, CNAC (Macau)'s 26% directly owned ground handling services provider at the Macau International Airport ("Macau Airport"), provides Macau Airport with passenger, ramp handling, cargo and aircraft line maintenance services.

- For the first quarter of 2003, Menzies Macau reported an increase of 4% and 2% in turnover and operating profit respectively as compared to the same period of 2002. However, with the outbreak of SARS in April, Menzies Macau began to experience a drastic downturn in operation. There was an average of 60% of scheduled flights being cancelled, resulting in major reduction of revenue, and Menzies Macau suffering a reduction of 69% in operating profit for the second quarter as compared to that of 2002.

- During the third quarter of 2003, the passenger flight activities were slowly recovering and got back closer to a more normal level towards the end of the third quarter. The freighter flight activities had however increased in the last quarter and Menzies Macau reported a cargo revenue increase of 36% as compared to the same period of 2002.

- For 2003, Menzies Macau handled 14,587 (2002: 17,250) aircraft movements, representing a decrease of 15.4% as compared to those for 2002. The amount of cargo handled by Menzies Macau in 2003 was 107,800 (2002: 97,180) tonnes, up by 11.1% from that in 2002.

- Menzies Macau is accredited with ISO 9001, ISO 9002 and AHS 1000. All of these accreditations are subject to regular audits, ensuring a high standard of management system and quality of customer service at all times.

Tradeport Hong Kong Limited

- Tradeport Hong Kong's new logistics centre commenced operations in the second quarter of 2003 during the SARS period, as such business take up was below expectations. However, during the third and fourth quarters, several major contracts were signed.

- Contracts signed had predominately been with major multinational companies focusing on accessing to the burgeoning China market while at the same time being able to conveniently reach out to the Asian or global markets.

- At the end of 2003, the building occupancy stood at approximately 40% and Tradeport Hong Kong's marketing plan was being further developed to focus more on various key market sectors such as semi-conductor, data storage and other high-value products.

(2) In relation to the Remaining Group

Had the Disposal and Acquisition been completed as at 1 January 2003, the Group would not hold any interest in Dragonair and would hold a minority stake in Cathay for the year ended 31 December 2003. Please refer to pages 244 to 261 in the section headed "Financial Information of Cathay" of Appendix II to this circular for a description of the performance of Cathay for the year ended 31 December 2003.

As Dragonair is an associate company of the Group, its earning contribution would be subject to foreign exchange risks due to its ticket sales in foreign countries. After the Disposal and the Acquisition, Cathay's dividend payment will similarly be exposed to foreign exchange risks faced by the airline.

Save for the above, the Directors are of the view that the management discussion and analysis set out above in relation to the Group for the year ended 31 December 2003 would be the same as that in relation to the Remaining Group for the year ended 31 December 2003.

(A) SUMMARY OF CONSOLIDATED FINANCIAL STATEMENTS

The following audited consolidated profit and loss accounts of the Cathay Group for the three years ended 31 December 2005 and the consolidated balance sheets of the Cathay Group as at 31 December 2005, 2004 and 2003 are extracted from Cathay's annual reports for the year ended 31 December 2005, 31 December 2004 and 31 December 2003.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

	For the years ended 31 December		
	2005	**2004**	**2003**
	HK$M	*HK$M*	*HK$M*
Turnover			
Passenger services	30,274	26,407	18,663
Cargo services	12,852	11,395	9,913
Catering, recoveries and other services	7,783	4,959	1,002
Total turnover	50,909	42,761	29,578
Expenses			
Staff	(9,025)	(8,842)	(8,035)
Inflight service and passenger expenses	(2,033)	(1,758)	(1,223)
Landing, parking and route expenses	(6,947)	(6,121)	(4,193)
Fuel	(15,588)	(9,321)	(5,236)
Aircraft maintenance	(4,527)	(3,784)	(2,856)
Aircraft depreciation and operating leases	(4,893)	(4,379)	(3,988)
Other depreciation and operating leases	(790)	(814)	(872)
Commissions	(555)	(529)	(400)
Others	(2,408)	(1,966)	(550)
Operating expenses	(46,766)	(37,514)	(27,353)
Operating profit	4,143	5,247	2,225
Finance charges	(1,605)	(1,628)	(1,807)
Finance income	1,161	1,045	1,187
Net finance charges	(444)	(583)	(620)
Share of profits of associates	269	298	151
Profit before tax	3,968	4,962	1,756
Taxation	(500)	(446)	(409)
Profit for the year	3,468	4,516	1,347
Profit attributable to			
Cathay shareholders	3,298	4,417	1,303
Minority interests	170	99	44
	3,468	4,516	1,347
Dividends			
Interim – paid	676	674	100
Final – proposed	947	1,520	572
Special – paid	–	–	943
	1,623	2,194	1,615
Earnings per share			
Basic	97.7¢	131.4¢	39.0¢
Diluted	97.4¢	130.7¢	38.8¢
Dividend per share	48.0¢	65.0¢	48.0¢

CONSOLIDATED BALANCE SHEET

	As at 31 December		
	2005	**2004**	**2003**
	HK$M	*HK$M*	*HK$M*
ASSETS AND LIABILITIES			
Non-current assets and liabilities			
Fixed assets	50,156	50,259	51,357
Intangible assets	260	348	405
Investments in associates	1,731	1,743	1,661
Other long-term receivables and investments	5,453	5,589	1,263
	57,600	57,939	54,686
Long-term liabilities	(27,745)	(27,698)	(33,022)
Related pledged security deposits	8,853	10,036	11,604
Net long-term liabilities	(18,892)	(17,662)	(21,418)
Retirement benefit obligations	(72)	(102)	(181)
Deferred taxation	(6,460)	(7,280)	(7,762)
	(25,424)	(25,044)	(29,361)
Net non-current assets	32,176	32,895	25,325
Current assets and liabilities			
Stock	657	524	398
Trade and other receivables	6,538	5,347	4,753
Liquid funds	13,459	11,474	15,200
	20,654	17,345	20,351
Current portion of long-term liabilities	(4,849)	(7,096)	(6,754)
Related pledged security deposits	1,286	2,127	1,875
Net current portion of long-term liabilities	(3,563)	(4,969)	(4,879)
Trade and other payables	(7,625)	(7,163)	(5,543)
Unearned transportation revenue	(3,864)	(3,622)	(2,839)
Taxation	(2,527)	(1,497)	(1,259)
	(17,579)	(17,251)	(14,520)
Net current assets	3,075	94	5,831
Net assets	35,251	32,989	31,156
CAPITAL AND RESERVES			
Share capital	676	674	669
Reserves	34,292	32,181	30,383
Funds attributable to Cathay shareholders	34,968	32,855	31,052
Minority interests	283	134	104
Total equity	35,251	32,989	31,156

(B) CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005

The following audited financial statements of the Cathay Group are extracted from Cathay's annual report for the year ended 31 December 2005.

Consolidated Profit and Loss Account
for the year ended 31st December 2005

	Note	2005 HK$M	2004 HK$M	2005 US$M	2004 US$M
Turnover					
Passenger services		30,274	26,407	3,881	3,386
Cargo services		12,852	11,395	1,648	1,461
Catering, recoveries and other services		7,783	4,959	998	635
Total turnover	1	50,909	42,761	6,527	5,482
Expenses					
Staff		(9,025)	(8,842)	(1,157)	(1,134)
Inflight service and passenger expenses		(2,033)	(1,758)	(261)	(225)
Landing, parking and route expenses		(6,947)	(6,121)	(891)	(785)
Fuel		(15,588)	(9,321)	(1,999)	(1,195)
Aircraft maintenance		(4,527)	(3,784)	(580)	(485)
Aircraft depreciation and operating leases		(4,893)	(4,379)	(627)	(561)
Other depreciation and operating leases		(790)	(814)	(101)	(104)
Commissions		(555)	(529)	(71)	(68)
Others		(2,408)	(1,966)	(309)	(252)
Operating expenses		(46,766)	(37,514)	(5,996)	(4,809)
Operating profit	2	4,143	5,247	531	673
Finance charges		(1,605)	(1,628)	(206)	(209)
Finance income		1,161	1,045	149	134
Net finance charges	3	(444)	(583)	(57)	(75)
Share of profits of associates	11	269	298	35	38
Profit before tax		3,968	4,962	509	636
Taxation	4	(500)	(446)	(64)	(57)
Profit for the year		3,468	4,516	445	579
Profit attributable to					
Cathay shareholders	5	3,298	4,417	423	566
Minority interests		170	99	22	13
		3,468	4,516	445	579
Dividends					
Interim – paid	6	676	674	87	86
Final – proposed	6	947	1,520	121	195
		1,623	2,194	208	281
Earnings per share					
Basic	7	97.7¢	131.4¢	12.5¢	16.8¢
Diluted	7	97.4¢	130.7¢	12.5¢	16.8¢
Dividend per share	6	48.0¢	65.0¢	6.2¢	8.3¢

The accounts are prepared and presented in HK$, the functional currency. The US$ figures are shown only as supplementary information and are translated at HK$7.8.

Consolidated Balance Sheet

at 31st December 2005

	Note	2005 HK$M	2004 HK$M	2005 US$M	2004 US$M
ASSETS AND LIABILITIES					
Non-current assets and liabilities					
Fixed assets	8	50,156	50,259	6,430	6,443
Intangible assets	9	260	348	33	45
Investments in associates	11	1,731	1,743	222	223
Other long-term receivables and investments	12	5,453	5,589	699	717
		57,600	57,939	7,384	7,428
Long-term liabilities		(27,745)	(27,698)	(3,557)	(3,551)
Related pledged security deposits		8,853	10,036	1,135	1,287
Net long-term liabilities	13	(18,892)	(17,662)	(2,422)	(2,264)
Retirement benefit obligations	14	(72)	(102)	(9)	(13)
Deferred taxation	15	(6,460)	(7,280)	(828)	(934)
		(25,424)	(25,044)	(3,259)	(3,211)
Net non-current assets		32,176	32,895	4,125	4,217
Current assets and liabilities					
Stock		657	524	84	67
Trade and other receivables	16	6,538	5,347	838	686
Liquid funds	17	13,459	11,474	1,726	1,471
		20,654	17,345	2,648	2,224
Current portion of long-term liabilities		(4,849)	(7,096)	(622)	(910)
Related pledged security deposits		1,286	2,127	165	273
Net current portion of long-term liabilities	13	(3,563)	(4,969)	(457)	(637)
Trade and other payables	18	(7,625)	(7,163)	(978)	(919)
Unearned transportation revenue		(3,864)	(3,622)	(495)	(464)
Taxation		(2,527)	(1,497)	(324)	(192)
		(17,579)	(17,251)	(2,254)	(2,212)
Net current assets		3,075	94	394	12
Net assets		35,251	32,989	4,519	4,229
CAPITAL AND RESERVES					
Share capital	19	676	674	87	86
Reserves	20	34,292	32,181	4,396	4,126
Funds attributable to Cathay shareholders		34,968	32,855	4,483	4,212
Minority interests		283	134	36	17
Total equity		35,251	32,989	4,519	4,229

The accounts are prepared and presented in HK$, the functional currency. The US$ figures are shown only as supplementary information and are translated at HK$7.8.

Company Balance Sheet

at 31st December 2005

	Note	2005 HK$M	2004 HK$M	2005 US$M	2004 US$M
ASSETS AND LIABILITIES					
Non-current assets and liabilities					
Fixed assets	8	41,680	41,701	5,343	5,346
Intangible assets	9	83	172	11	22
Investments in subsidiaries	10	11,360	13,108	1,456	1,680
Investments in associates	11	60	61	8	8
Other long-term receivables and investments	12	3,792	3,890	486	499
		56,975	58,932	7,304	7,555
Long-term liabilities		(25,503)	(26,040)	(3,269)	(3,338)
Related pledged security deposits		3,200	3,575	410	458
Net long-term liabilities	13	(22,303)	(22,465)	(2,859)	(2,880)
Retirement benefit obligations	14	(127)	(166)	(16)	(21)
Deferred taxation	15	(6,234)	(7,113)	(799)	(912)
		(28,664)	(29,744)	(3,674)	(3,813)
Net non-current assets		28,311	29,188	3,630	3,742
Current assets and liabilities					
Stock		643	509	82	65
Trade and other receivables	16	6,166	5,038	790	646
Liquid funds	17	4,887	3,244	627	416
		11,696	8,791	1,499	1,127
Current portion of long-term liabilities		(4,807)	(6,327)	(616)	(811)
Related pledged security deposits		400	769	51	98
Net current portion of long-term liabilities	13	(4,407)	(5,558)	(565)	(713)
Trade and other payables	18	(7,565)	(7,021)	(971)	(900)
Unearned transportation revenue		(3,864)	(3,622)	(495)	(464)
Taxation		(2,484)	(1,457)	(318)	(187)
		(18,320)	(17,658)	(2,349)	(2,264)
Net current liabilities		(6,624)	(8,867)	(850)	(1,137)
Net assets		21,687	20,321	2,780	2,605
CAPITAL AND RESERVES					
Share capital	19	676	674	87	86
Reserves	20	21,011	19,647	2,693	2,519
Total equity		21,687	20,321	2,780	2,605

The accounts are prepared and presented in HK$, the functional currency. The US$ figures are shown only as supplementary information and are translated at HK$7.8.

Consolidated Cash Flow Statement
for the year ended 31st December 2005

	Note	2005 HK$M	2004 HK$M	2005 US$M	2004 US$M
Operating activities					
Cash generated from operations	*21*	8,706	10,595	1,116	1,359
Dividends received from associates	*11*	170	122	22	16
Interest received		163	59	21	8
Net interest paid		(671)	(786)	(86)	(101)
Tax paid		(971)	(785)	(125)	(101)
Net cash inflow from operating activities		7,397	9,205	948	1,181
Investing activities					
Receipts from disposal of an investment		117	–	15	–
Receipts from capital reduction, loan and disposal of associates		108	69	14	9
Sales of fixed assets		21	54	3	7
Payments for fixed and intangible assets		(4,354)	(4,064)	(558)	(521)
Net increase in long-term receivables and investments		(232)	(2,692)	(30)	(345)
Net (increase)/decrease in liquid funds other than cash and cash equivalents		(120)	884	(15)	113
Net cash outflow from investing activities		(4,460)	(5,749)	(571)	(737)
Financing activities					
New financing		5,486	1,746	703	224
Net cash benefit from financing arrangements		343	51	44	7
Shares issued	*19*	78	199	10	25
Loan and finance lease repayments		(4,807)	(6,247)	(616)	(801)
Security deposits placed		(91)	(94)	(11)	(12)
Dividends paid					
– to Cathay shareholders		(2,196)	(2,189)	(282)	(281)
– to minority interests		(21)	(69)	(3)	(9)
Net cash outflow from financing activities		(1,208)	(6,603)	(155)	(847)
Increase/(decrease) in cash and cash equivalents		1,729	(3,147)	222	(403)
Cash and cash equivalents at 1st January		2,657	5,649	341	724
Effect of exchange differences		(119)	155	(16)	20
Cash and cash equivalents at 31st December	*22*	4,267	2,657	547	341

The accounts are prepared and presented in HK$, the functional currency. The US$ figures are shown only as supplementary information and are translated at HK$7.8.

Consolidated Statement of Changes in Equity

for the year ended 31st December 2005

	Attributable to Cathay shareholders							Minority interests	Total equity
				Non-distributable					
	Share capital	Retained profit	Share premium	Investment revaluation reserve	Cash flow hedge reserve	Capital redemption reserve and others	Total		
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
At 31st December 2004	674	25,496	7,455	493	(1,285)	22	32,855	134	32,989
Prior year adjustment for financial derivatives	–	(106)	–	–	–	–	(106)	–	(106)
At 1st January 2005	674	25,390	7,455	493	(1,285)	22	32,749	134	32,883
Changes in cash flow hedges									
– recognised during the year	–	–	–	–	1,212	–	1,212	–	1,212
– deferred tax recognised	–	–	–	–	(165)	–	(165)	–	(165)
– transferred to profit for the year	–	–	–	–	268	–	268	–	268
Revaluation deficit recognised during the year	–	–	–	(265)	–	–	(265)	–	(265)
Exchange differences	–	–	–	–	–	(11)	(11)	–	(11)
Net (loss)/gain recognised directly in equity	–	–	–	(265)	1,315	(11)	1,039	–	1,039
Profit for the year	–	3,298	–	–	–	–	3,298	170	3,468
Total recognised profit/(loss) for the year	–	3,298	–	(265)	1,315	(11)	4,337	170	4,507
2004 final dividend	–	(1,520)	–	–	–	–	(1,520)	–	(1,520)
2005 interim dividend	–	(676)	–	–	–	–	(676)	–	(676)
Dividends paid to minority interests	–	–	–	–	–	–	–	(21)	(21)
Share options exercised	2	–	76	–	–	–	78	–	78
Total transactions with shareholders	2	(2,196)	76	–	–	–	(2,118)	(21)	(2,139)
At 31st December 2005	676	26,492	7,531	228	30	11	34,968	283	35,251

for the year ended 31st December 2004

	Attributable to Cathay shareholders							Minority interests	Total equity
				Non-distributable					
	Share capital	Retained profit	Share premium	Investment revaluation reserve	Cash flow hedge reserve	Capital redemption reserve and others	Total		
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
At 31st December 2003	669	23,518	7,261	354	(770)	20	31,052	104	31,156
Prior year adjustment on Asia Miles	–	(250)	–	–	–	–	(250)	–	(250)
At 1st January 2004	669	23,268	7,261	354	(770)	20	30,802	104	30,906
Exchange differences on cash flow hedges									
– recognised during the year	–	–	–	–	(966)	–	(966)	–	(966)
– deferred tax recognised	–	–	–	–	68	–	68	–	68
– transferred to profit for the year	–	–	–	–	383	–	383	–	383
Revaluation surplus recognised during the year	–	–	–	139	–	–	139	–	139
Exchange differences	–	–	–	–	–	15	15	–	15
Capital reserve written back on disposal of an associate	–	–	–	–	–	(13)	(13)	–	(13)
Net gain/(loss) recognised directly in equity	–	–	–	139	(515)	2	(374)	–	(374)
Profit for the year	–	4,417	–	–	–	–	4,417	99	4,516
Total recognised profit/(loss) for the year	–	4,417	–	139	(515)	2	4,043	99	4,142
2003 final dividend	–	(1,515)	–	–	–	–	(1,515)	–	(1,515)
2004 interim dividend	–	(674)	–	–	–	–	(674)	–	(674)
Dividends paid to minority interests	–	–	–	–	–	–	–	(69)	(69)
Share options exercised	5	–	194	–	–	–	199	–	199
Total transactions with shareholders	5	(2,189)	194	–	–	–	(1,990)	(69)	(2,059)
At 31st December 2004	674	25,496	7,455	493	(1,285)	22	32,855	134	32,989

Company Statement of Changes in Equity
for the year ended 31st December 2005

	Share capital	Retained profit	Share premium	Non-distributable Investment revaluation reserve	Non-distributable Cash flow hedge reserve	Non-distributable Capital redemption reserve	Total equity
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
At 31st December 2004	674	13,123	7,455	469	(1,421)	21	20,321
Prior year adjustment for financial derivatives	–	(106)	–	–	–	–	(106)
At 1st January 2005	674	13,017	7,455	469	(1,421)	21	20,215
Changes in cash flow hedges							
– recognised during the year	–	–	–	–	1,210	–	1,210
– deferred tax recognised	–	–	–	–	(165)	–	(165)
– transferred to profit for the year	–	–	–	–	441	–	441
Revaluation deficit recognised during the year	–	–	–	(267)	–	–	(267)
Net (loss)/gain recognised directly in equity	–	–	–	(267)	1,486	–	1,219
Profit for the year	–	2,371	–	–	–	–	2,371
Total recognised profit/(loss) for the year	–	2,371	–	(267)	1,486	–	3,590
2004 final dividend	–	(1,520)	–	–	–	–	(1,520)
2005 interim dividend	–	(676)	–	–	–	–	(676)
Share options exercised	2	–	76	–	–	–	78
Total transactions with shareholders	2	(2,196)	76	–	–	–	(2,118)
At 31st December 2005	676	13,192	7,531	202	65	21	21,687

for the year ended 31st December 2004

				Non-distributable			
	Share capital	Retained profit	Share premium	Investment revaluation reserve	Cash flow hedge reserve	Capital redemption reserve	Total equity
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
At 31st December 2003	669	11,781	7,261	349	(813)	21	19,268
Prior year adjustment on Asia Miles	–	(250)	–	–	–	–	(250)
At 1st January 2004	669	11,531	7,261	349	(813)	21	19,018
Exchange differences on cash flow hedges							
– recognised during the year	–	–	–	–	(1,058)	–	(1,058)
– deferred tax recognised	–	–	–	–	68	–	68
– transferred to profit for the year	–	–	–	–	382	–	382
Revaluation surplus recognised during the year	–	–	–	120	–	–	120
Net gain/(loss) recognised directly in equity	–	–	–	120	(608)	–	(488)
Profit for the year	–	3,781	–	–	–	–	3,781
Total recognised profit/(loss) for the year	–	3,781	–	120	(608)	–	3,293
2003 final dividend	–	(1,515)	–	–	–	–	(1,515)
2004 interim dividend	–	(674)	–	–	–	–	(674)
Share options exercised	5	–	194	–	–	–	199
Total transactions with shareholders	5	(2,189)	194	–	–	–	(1,990)
At 31st December 2004	674	13,123	7,455	469	(1,421)	21	20,321

Notes to the Accounts

1. TURNOVER

Turnover comprises revenue from transportation services, airline catering, recoveries and other services provided to third parties. Recoveries have been included in the 2004 comparatives.

(a) Primary reporting by geographical segment

	2005	**2004**
	HK$M	*HK$M*
Turnover by origin of sale:		
North Asia		
– Hong Kong and China mainland	20,256	17,242
– Japan, Korea and Taiwan	8,432	7,346
South West Pacific and South Africa	3,747	3,215
Europe	6,150	5,100
South East Asia and Middle East	5,870	4,699
North America	6,454	5,159
	50,909	42,761

South West Pacific and South Africa includes Australia, New Zealand and Southern Africa. Europe includes Continental Europe, the United Kingdom, Scandinavia, Russia, Baltic and Turkey. South East Asia and Middle East includes Singapore, Indonesia, Malaysia, Thailand, the Philippines, Vietnam, Indian sub-continent and Middle East. North America includes U.S.A., Canada and Latin America.

Analysis of turnover and profit by geographical segment:

The analysis of turnover by origin of sale is derived by allocating revenue to the area in which the sale was made. Management considers that it is not meaningful to allocate cost on this basis and accordingly segment results are not disclosed.

Analysis of net assets by geographical segment:

The major revenue earning asset is the aircraft fleet which is registered in Hong Kong and is employed across its worldwide route network. Management considers that there is no suitable basis for allocating such assets and related liabilities to geographical segments. Accordingly, segment assets, segment liabilities and other segment information is not disclosed.

(b) Secondary reporting by business segment

	2005	2004
	HK$M	*HK$M*
Revenue-external sales		
– Passenger services	30,274	26,407
– Cargo services	12,852	11,395
	43,126	37,802
Unallocated revenue		
– Catering, recoveries and other services	7,783	4,959
	50,909	42,761

Cathay Group is engaged in two main business segments: in passenger business through Cathay and in freight traffic through Cathay and a subsidiary. Catering services, recoveries and other airline supporting services which supplement Cathay Group's main operating business are included in unallocated revenue.

Analysis of net assets by business segment:

The major revenue earning asset is the aircraft fleet which is jointly used by the passenger services and cargo services segments. Management considers it is not appropriate to allocate such assets between the two segments as there is no suitable basis for so doing. Accordingly, analysis of net assets by business segment is not disclosed.

2. OPERATING PROFIT

	2005	2004
	HK$M	*HK$M*
Operating profit has been arrived at after charging/(crediting):		
Depreciation of fixed assets		
– Leased	1,853	1,855
– Owned	2,110	1,909
Amortisation of intangible assets	44	84
Operating lease rentals		
– Land and buildings	382	363
– Aircraft and related equipment	1,258	948
– Others	36	34
Operating lease income		
– Aircraft and related equipment	(11)	(23)
Cost of stock expensed	1,427	1,224
Exchange differences	(156)	(199)
Auditors' remuneration	6	6
Income from unlisted investments	(119)	(103)
Income from listed investments	(6)	(3)
Share of associates' tax	50	58

3. NET FINANCE CHARGES

	2005	2004
	HK$M	*HK$M*
Net interest charges comprise:		
– Obligations under finance leases	1,436	1,522
– Interest income on related security deposits, notes and bonds	(726)	(837)
	710	685
– Bank loans and overdrafts	117	92
– Other loans wholly repayable within five years	39	8
– Other loans not wholly repayable within five years	–	6
	866	791
Income from liquid funds:		
– Funds with investment managers and other liquid investments	(259)	(122)
– Bank deposits and other receivables	(169)	(86)
	(428)	(208)
Financial derivatives:		
– Interest income	(7)	–
– Interest expenses	13	–
	6	–
	444	583

Finance income and charges relating to defeasance arrangements have been netted off in the above figures.

4. TAXATION

	2005	2004
	HK$M	*HK$M*
Current tax expenses		
– Hong Kong profits tax	61	55
– Overseas tax	327	276
– (Over)/under provisions for prior years	(72)	24
Deferred tax		
– Origination and reversal of temporary differences	184	91
	500	446

Hong Kong profits tax is calculated at 17.5% (2004: 17.5%) on the estimated assessable profits for the year. Overseas tax is calculated at rates of tax applicable in countries to which Cathay Group is assessable for tax. Tax provisions are reviewed regularly to take into account changes in legislation, practice and status of negotiations.

A reconciliation between tax charge and accounting profit at applicable tax rates is as follows:

	2005	2004
	HK$M	*HK$M*
Consolidated profit before tax	3,968	4,962
Notional tax calculated at Hong Kong profits tax rate of 17.5% (2004: 17.5%)	(694)	(868)
Expenses not deductible for tax purposes	(184)	(168)
Tax provisions over/(under) provided in prior years	72	(24)
Effect of different tax rates in overseas jurisdictions	294	432
(Unused tax losses not recognised)/tax losses recognised	(97)	63
Income not subject to tax	109	119
Tax charge	(500)	(446)

Further information on deferred tax is shown in note 15 to the accounts.

5. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to Cathay shareholders, a profit of HK$2,371 million (2004: HK$3,781 million) has been dealt with in the accounts of Cathay.

6. DIVIDENDS

	2005	2004
	HK$M	*HK$M*
2005 interim dividend paid on 3rd October 2005 of HK¢20 per share (2004: HK¢20 per share)	676	674
2005 final dividend proposed on 8th March 2006 of HK¢28 per share (2004: HK¢45 per share)	947	1,520
	1,623	2,194

7. EARNINGS PER SHARE

Basic earnings per share and diluted earnings per share are calculated by dividing the profit attributable to Cathay shareholders of HK$3,298 million (2004: HK$4,417 million) by the daily weighted average number of shares in issue throughout the year of 3,377 million (2004: 3,362 million) shares and 3,386 million (2004: 3,379 million) shares respectively with the latter adjusted for the effects of the share options.

	2005	2004
	Million	*Million*
Weighted average number of ordinary shares used in calculating basic earnings per share	3,377	3,362
Deemed issue of ordinary shares for no consideration	9	17
Weighted average number of ordinary shares used in calculating diluted earnings per share	3,386	3,379

8. FIXED ASSETS

	Aircraft and related equipment		Other equipment		Buildings	
	Owned	**Leased**	**Owned**	**Leased**	**Owned**	**Total**
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
Cathay Group						
Cost						
At 1st January 2005	29,557	43,181	2,304	547	4,522	80,111
Exchange differences	3	–	2	–	2	7
Additions	3,448	435	118	–	–	4,001
Disposals	(244)	–	(95)	–	(2)	(341)
Transfers	2,506	(2,506)	–	–	–	–
At 31st December 2005	35,270	41,110	2,329	547	4,522	83,778
At 31st December 2003	24,760	44,109	2,328	547	6,292	78,036
Reclassification of leasehold land	–	–	–	–	(1,767)	(1,767)
At 1st January 2004	24,760	44,109	2,328	547	4,525	76,269
Exchange differences	2	–	3	–	5	10
Additions	3,798	446	84	–	1	4,329
Disposals	(377)	–	(111)	–	(9)	(497)
Transfers	1,374	(1,374)	–	–	–	–
At 31st December 2004	29,557	43,181	2,304	547	4,522	80,111
Accumulated depreciation						
At 1st January 2005	13,833	12,942	1,556	258	1,263	29,852
Exchange differences	–	–	1	–	1	2
Charge for the year	1,805	1,830	144	23	161	3,963
Disposals	(99)	–	(94)	–	(2)	(195)
Transfers	2,286	(2,286)	–	–	–	–
At 31st December 2005	17,825	12,486	1,607	281	1,423	33,622
At 31st December 2003	11,591	12,055	1,517	234	1,282	26,679
Reclassification of leasehold land	–	–	–	–	(181)	(181)
At 1st January 2004	11,591	12,055	1,517	234	1,101	26,498
Exchange differences	–	–	2	–	2	4
Charge for the year	1,600	1,831	147	24	162	3,764
Disposals	(302)	–	(110)	–	(2)	(414)
Transfers	944	(944)	–	–	–	–
At 31st December 2004	13,833	12,942	1,556	258	1,263	29,852
Net book value						
At 31st December 2005	17,445	28,624	722	266	3,099	50,156
At 31st December 2004	15,724	30,239	748	289	3,259	50,259

	Aircraft and related equipment		Other equipment		Buildings	
	Owned	Leased	Owned	Leased	Owned	Total
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*	*HK$M*
Cathay						
Cost						
At 1st January 2005	22,240	44,238	787	547	399	68,211
Additions	3,674	–	65	–	–	3,739
Disposals	(240)	–	(79)	–	(2)	(321)
Transfers	2,913	(2,913)	–	–	–	–
At 31st December 2005	28,587	41,325	773	547	397	71,629
At 1st January 2004	19,054	46,007	850	547	408	66,866
Additions	1,641	–	45	–	–	1,686
Disposals	(224)	–	(108)	–	(9)	(341)
Transfers	1,769	(1,769)	–	–	–	–
At 31st December 2004	22,240	44,238	787	547	399	68,211
Accumulated depreciation						
At 1st January 2005	11,495	13,748	668	258	341	26,510
Charge for the year	1,650	1,874	50	23	22	3,619
Disposals	(99)	–	(79)	–	(2)	(180)
Transfers	2,286	(2,286)	–	–	–	–
At 31st December 2005	15,332	13,336	639	281	361	29,949
At 1st January 2004	9,232	12,774	718	234	320	23,278
Charge for the year	1,468	1,918	57	24	23	3,490
Disposals	(149)	–	(107)	–	(2)	(258)
Transfers	944	(944)	–	–	–	–
At 31st December 2004	11,495	13,748	668	258	341	26,510
Net book value						
At 31st December 2005	13,255	27,989	134	266	36	41,680
At 31st December 2004	10,745	30,490	119	289	58	41,701

(a) Finance leased assets

Certain aircraft are subject to leases with purchase options to be exercised at the end of the respective leases. The remaining lease terms range from 1 to 12 years. Some of the rent payments are on a floating basis which are generally linked to market rates of interest. All leases permit subleasing rights subject to appropriate consent from lessors. Early repayment penalties would be payable on some of the leases should they be terminated prior to their specified expiry dates.

(b) Operating leased assets

Certain aircraft, buildings and other equipment are under operating leases.

Under the operating lease arrangements for aircraft, the lease rentals are fixed and subleasing is not allowed. At 31st December 2005, three B747-400s (2004: three), four A340-300s (2004: four), three A340-600s (2004: three) and three A330-300s (2004: nil), all with purchase options, held under operating leases were not capitalised. The estimated capitalised value of these leases being the present value of the aggregate future lease payments is HK$2,347 million (2004: HK$1,315 million).

Operating leases for buildings and other equipment are normally set with fixed rental payments with options to renew the leases upon expiry at new terms.

The future minimum lease payments payable under operating leases committed as at 31st December 2005 for each of the following periods are as follows:

	2005	**2004**
	HK$M	*HK$M*
Aircraft and related equipment:		
– within one year	941	1,144
– after one year but within five years	3,880	1,883
– after five years	4,706	389
	9,527	3,416
Buildings and other equipment:		
– within one year	232	261
– after one year but within five years	339	418
– after five years	129	175
	700	854
	10,227	4,270

(c) Advance payments are made to manufacturers for aircraft and related equipment to be delivered in future years. Advance payments included in owned aircraft and related equipment amounted to HK$2,036 million (2004: HK$2,698 million) for Cathay Group and HK$222 million (2004: HK$197 million) for Cathay. No depreciation is provided on these advance payments.

(d) Security, including charges over the assets concerned and relevant insurance policies, is provided to the leasing companies or other parties that provide the underlying finance. Further information is provided under note 13 to the accounts.

9. INTANGIBLE ASSETS

	Cathay Group: Goodwill *HK$M*	Cathay Group: Computer systems *HK$M*	Cathay Group: Total *HK$M*	Cathay: Computer systems *HK$M*
Cost				
At 31st December 2004	358	640	998	617
Elimination of accumulated amortisation	(182)	–	(182)	–
At 1st January 2005	176	640	816	617
Additions	–	61	61	60
Disposals	–	(119)	(119)	(119)
At 31st December 2005	176	582	758	558
At 1st January 2004	362	665	1,027	642
Additions	–	27	27	27
Disposals	(4)	(52)	(56)	(52)
At 31st December 2004	358	640	998	617
Accumulated amortisation				
At 31st December 2004	182	468	650	445
Elimination of accumulated amortisation	(182)	–	(182)	–
At 1st January 2005	–	468	468	445
Charge for the year	–	44	44	44
Disposals	–	(14)	(14)	(14)
At 31st December 2005	–	498	498	475
At 1st January 2004	169	453	622	431
Charge for the year	17	67	84	66
Disposals	(4)	(52)	(56)	(52)
At 31st December 2004	182	468	650	445
Net book value				
At 31st December 2005	176	84	260	83
At 31st December 2004	176	172	348	172

10. SUBSIDIARIES

	Cathay	
	2005	**2004**
	HK$M	*HK$M*
Unlisted shares at cost	214	214
Net amounts due (to)/from subsidiaries		
– Loan accounts	(4,327)	(6,318)
– Current accounts	253	530
Other investments	15,220	18,682
	11,360	13,108

11. ASSOCIATES

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Hong Kong listed shares at cost (Market value: HK$2,716 million, 2004: HK$1,913 million)	–	–	52	52
Unlisted shares at cost	–	–	17	26
Share of net assets				
– listed in Hong Kong	975	863	–	–
– unlisted	755	773	–	–
	1,730	1,636	69	78
Less: Impairment loss	–	–	(9)	(17)
Loans to associates	1	107	–	–
	1,731	1,743	60	61
Share of profits of associates				
– listed	170	120	–	–
– unlisted	99	178	–	–
	269	298	–	–
Dividends received and receivable from associates	170	122	63	97

	2005	2004
	HK$M	*HK$M*
Summarised financial information of associates:		
Assets	16,615	16,413
Liabilities	(8,913)	(9,213)
Equity	7,702	7,200
Turnover	14,092	11,710
Profit for the year	1,101	1,230

12. OTHER LONG-TERM RECEIVABLES AND INVESTMENTS

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Staff housing loans and other receivables	506	403	500	395
Investments at fair value				
– listed in Hong Kong	2,489	2,891	2,311	2,715
– listed outside Hong Kong	–	51	–	49
– unlisted	981	731	981	731
Leasehold land rental prepayments	1,477	1,513	–	–
	5,453	5,589	3,792	3,890

Leasehold land is held under medium-term leases in Hong Kong with a total unamortised value of HK$1,513 million (2004: HK$1,549 million).

13. LONG-TERM LIABILITIES

		2005		2004	
		Current	Non-current	Current	Non-current
	Note	*HK$M*	*HK$M*	*HK$M*	*HK$M*
Cathay Group					
Long-term loans	*(a)*	1,652	4,611	1,229	2,765
Obligations under finance leases	*(b)*	1,911	14,281	3,740	14,897
		3,563	18,892	4,969	17,662
Cathay					
Long-term loans	*(a)*	1,388	3,648	478	1,514
Obligations under finance leases	*(b)*	3,019	18,655	5,080	20,951
		4,407	22,303	5,558	22,465

(a) Long-term loans

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Bank loans				
– secured	3,416	2,328	2,255	673
– unsecured	1,423	894	1,423	894
Other loans				
– secured	309	425	309	425
– unsecured	1,115	347	1,049	–
	6,263	3,994	5,036	1,992
Amount due within one year included under current liabilities	(1,652)	(1,229)	(1,388)	(478)
	4,611	2,765	3,648	1,514
Repayable as follows:				
Bank loans				
– within one year	1,556	846	1,324	409
– after one year but within two years	299	1,376	205	1,137
– after two years but within five years	1,561	528	1,135	11
– after five years	1,423	472	1,014	10
	4,839	3,222	3,678	1,567
Other loans				
– within one year	96	383	64	69
– after one year but within two years	69	74	69	74
– after two years but within five years	1,259	266	1,225	233
– after five years	–	49	–	49
	1,424	772	1,358	425
Amount due within one year included under current liabilities	(1,652)	(1,229)	(1,388)	(478)
	4,611	2,765	3,648	1,514

Borrowings other than bank loans are repayable on various dates up to 2010 at interest rates between 0% and 7% per annum while bank loans are repayable up to 2018.

Long-term loans and other liabilities of Cathay Group and Cathay not wholly repayable within five years amounted to HK$2,707 million and HK$2,040 million respectively (2004: HK$999 million and HK$279 million).

As at 31st December 2005, Cathay Group and Cathay had long-term liabilities which were defeased by funds and other investments totalling HK$19,873 million (2004: HK$23,234 million). Accordingly, these liabilities and the related funds, as well as related expenditure and income, have been netted off in the accounts.

(b) Obligations under finance leases

Cathay Group has commitments under finance lease agreements in respect of aircraft and related equipment expiring during the years 2006 to 2017. The future payments under these finance leases are as follows:

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Within one year	4,029	6,899	4,170	6,826
After one year but within two years	4,097	3,892	4,152	4,212
After two years but within five years	9,758	9,498	11,638	11,162
After five years	16,056	19,015	14,893	19,679
Total future payments	33,940	39,304	34,853	41,879
Interest charges relating to future periods	(7,609)	(8,504)	(9,579)	(11,504)
Present value of future payments	26,331	30,800	25,274	30,375
Security deposits, notes and zero coupon bonds	(10,139)	(12,163)	(3,600)	(4,344)
Amounts due within one year included under current liabilities	(1,911)	(3,740)	(3,019)	(5,080)
	14,281	14,897	18,655	20,951

The present value of future payments is repayable as follows:

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Within one year	3,197	5,867	3,419	5,849
After one year but within two years	3,261	3,054	3,445	3,426
After two years but within five years	7,658	7,405	9,529	9,050
After five years	12,215	14,474	8,881	12,050
	26,331	30,800	25,274	30,375

As at 31st December 2005, Cathay Group and Cathay had obligations under finance leases which were defeased by funds and other investments amounting to HK$8,507 million and HK$1,080 million respectively (2004: HK$8,735 million and HK$1,556 million). Accordingly these liabilities and the related funds, as well as related expenditure and income, have been netted off in the accounts.

(c) Long-term liabilities by currency at the year end are summarised below:

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
US dollar	16,045	11,030	19,145	15,204
Euro	2,746	5,733	3,459	6,623
Hong Kong dollar	1,457	1,094	1,424	894
Singapore dollar	1,049	360	1,049	360
Pound sterling	688	990	688	990
Japanese yen	470	1,808	945	2,336
Others	–	1,616	–	1,616
	22,455	22,631	26,710	28,023

Further information on long-term liabilities is shown in note 27 to the accounts.

14. RETIREMENT BENEFITS

Cathay Group operates various defined benefit and defined contribution retirement schemes for its employees in Hong Kong and in certain overseas locations. The assets of these schemes are held in funds administered by independent trustees. The retirement schemes in Hong Kong are registered under and comply with the Occupational Retirement Schemes Ordinance and the Mandatory Provident Fund Schemes Ordinance ("MPFSO"). Most of the employees engaged outside Hong Kong are covered by appropriate local arrangements.

Cathay Group operates the following principal schemes:

(a) Defined benefit retirement schemes

The Swire Group Retirement Benefit Scheme ("SGRBS") in Hong Kong, in which Cathay and Cathay Pacific Catering Services (H.K.) Limited ("CPCS") are participating employers, provides resignation and retirement benefits to its members, which include the Cathay's cabin attendants who joined before September 1996 and other locally engaged employees who joined before June 1997, upon their cessation of service. Cathay and CPCS meet the full cost of all benefits due by SGRBS to their employee members who are not required to contribute to the scheme.

Staff employed by Cathay in Hong Kong on expatriate terms before April 1993 were eligible to join another scheme, the Cathay Pacific Airways Limited Retirement Scheme ("CPALRS"). Both members and Cathay contribute to CPALRS.

The latest actuarial valuation of CPALRS was completed by a qualified actuary, Watson Wyatt Hong Kong Limited ("Wyatt"), as at 31st December 2005 using the projected unit credit method. Wyatt completed their most recent actuarial valuation of the portion of SGRBS funds specifically designated for Cathay's employees as at 31st December 2003. The figures for SGRBS disclosed as at 31st December 2005 were provided by Cannon Trustees Limited, the administration manager. Cathay Group's obligations are 101% (2004: 96%) covered by the plan assets held by the trustees.

	2005		2004	
	SGRBS	CPALRS	SGRBS	CPALRS
The principal actuarial assumptions are:				
Discount rate used	4.25%	4%	3.75%	2.75%
Expected return on plan assets	6%	6%	6%	6%
Future salary increases	2-5%	2-5%	2-5%	2-5%

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Net liability recognised in the balance sheet:				
Present value of funded obligations	7,341	7,227	6,818	6,825
Fair value of plan assets	(7,387)	(6,933)	(6,833)	(6,415)
	(46)	294	(15)	410
Net unrecognised actuarial gains/(losses)	118	(192)	142	(244)
	72	102	127	166

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Movements in net retirement benefit liability comprise:				
At 1st January	102	181	166	224
Movements for the year				
– net expenses recognised in the profit and loss account	267	380	246	373
– contributions paid	(297)	(459)	(285)	(431)
At 31st December	72	102	127	166

	2005	2004
	HK$M	*HK$M*
Net expenses recognised in Cathay Group profit and loss account:		
Current service cost	382	454
Interest on obligations	297	287
Expected return on plan assets	(411)	(361)
Actuarial gain recognised	(1)	–
Total included in staff costs	267	380
Actual return on plan assets	590	845

The difference between the fair value of the schemes' assets and the present value of the accrued past services liabilities at the date of an actuarial valuation is taken into consideration when determining future funding levels in order to ensure that the schemes will be able to meet liabilities as they become due. The contributions are calculated based upon funding recommendations arising from actuarial valuations.

(b) Defined contribution retirement schemes

Staff employed by Cathay in Hong Kong on expatriate terms are eligible to join a defined contribution retirement scheme, the CPA Provident Fund 1993. All staff employed in Hong Kong are eligible to join the CPA Provident Fund.

Under the terms of these schemes, other than Cathay contribution, staff may elect to contribute from 0% to 10% of the monthly salary. During the year, the benefits forfeited in accordance with the schemes' rules amounted to HK$12 million (2004: HK$11 million) which have been applied towards the contributions payable by Cathay.

A mandatory provident fund ("MPF") scheme was established under the MPFSO in December 2000. Where staff elect to join the MPF scheme, both Cathay and staff are required to contribute 5% of the employees' relevant income (capped at HK$20,000). Staff may elect to contribute more than the minimum as a voluntary contribution.

Contributions to defined contribution retirement schemes charged to Cathay Group profit and loss account are HK$386 million (2004: HK$351 million).

15. DEFERRED TAXATION

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Deferred tax assets:				
– Retirement benefits	(15)	(23)	(24)	(34)
– Provisions	(19)	(15)	(19)	(14)
– Tax losses	(307)	(125)	(219)	(43)
– Cash flow hedges	–	(158)	–	(158)
Deferred tax liabilities:				
– Accelerated tax depreciation	1,311	949	1,006	710
– Cash flow hedges	7	–	7	–
Provision in respect of certain lease arrangements	5,483	6,652	5,483	6,652
	6,460	7,280	6,234	7,113

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Movements in deferred taxation comprise:				
At 1st January	7,280	7,762	7,113	7,617
Movements for the year				
– transfer from profit and loss account				
– deferred tax expenses *(note 4)*	184	91	125	69
– operating expenses	173	163	173	163
– transferred to cash flow hedge reserve	165	(68)	165	(68)
– initial cash benefit from lease arrangements	343	–	343	–
Current portion of provision in respect of certain lease arrangements included under current liabilities – taxation	(1,685)	(668)	(1,685)	(668)
At 31st December	6,460	7,280	6,234	7,113

Cathay Group has certain tax losses which do not expire under current tax legislation, a deferred tax asset has been recognised to the extent that recoverability is considered probable.

The provision in respect of certain lease arrangements equates to payments which are expected to be made during the years 2007 to 2016 (2004: 2006 to 2014) as follows:

	2005	2004
	HK$M	*HK$M*
After one year but within five years	3,444	4,548
After five years but within ten years	1,770	2,104
After ten years	269	–
	5,483	6,652

16. TRADE AND OTHER RECEIVABLES

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Trade debtors	3,448	3,151	3,304	2,999
Derivative financial assets	886	–	886	–
Other receivables and prepayments	2,192	2,185	1,976	2,039
Due from associates	12	11	–	–
	6,538	5,347	6,166	5,038

As at 31st December 2005, derivative financial assets of Cathay Group and Cathay accounted for as held for trading amounted to HK$119 million.

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Analysis of trade debtors by age:				
Current	3,408	3,108	3,277	2,979
One to three months overdue	38	37	26	20
More than three months overdue	2	6	1	–
	3,448	3,151	3,304	2,999

17. LIQUID FUNDS

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Short-term deposits and bank balances	4,321	2,687	3,761	2,023
Short-term deposits maturing beyond three months when placed	557	691	547	676
Funds with investment managers				
– debt securities listed outside Hong Kong	6,036	6,035	–	–
– bank deposits	713	208	–	–
Other liquid investments				
– debt securities listed outside Hong Kong	55	54	–	–
– bank deposits	1,777	1,799	579	545
	13,459	11,474	4,887	3,244

Included in other liquid investments are bank deposits of HK$1,754 million (2004: HK$1,799 million) and debt securities of HK$55 million (2004: HK$54 million) which are pledged as part of long-term financing arrangements. The arrangements provide that these deposits and debt securities must be maintained at specified levels for the duration of the financing. Other than Hong Kong dollars, liquid funds were mainly denominated in US dollars and Renminbi of HK$8,993 million and HK$1,178 million respectively.

18. TRADE AND OTHER PAYABLES

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Trade creditors	3,019	2,447	2,802	2,252
Derivative financial liabilities	313	–	313	–
Other payables	3,937	4,308	4,106	4,391
Due to associates	211	265	204	258
Due to other related companies	91	113	91	113
Bank overdrafts-unsecured	54	30	49	7
	7,625	7,163	7,565	7,021

As at 31st December 2005, derivative financial liabilities of Cathay Group and Cathay accounted for as held for trading amounted to HK$66 million.

	Cathay Group		Cathay	
	2005	2004	2005	2004
	HK$M	*HK$M*	*HK$M*	*HK$M*
Analysis of trade creditors by age:				
Current	2,421	1,956	2,226	1,779
One to three months overdue	463	396	449	382
More than three months overdue	135	95	127	91
	3,019	2,447	2,802	2,252

19. SHARE CAPITAL

	2005		2004	
	Number of shares	*HK$M*	*Number of shares*	*HK$M*
Authorised (HK$0.20 each)	3,900,000,000	780	3,900,000,000	780
Issued and fully paid (HK$0.20 each)				
At 1st January	3,370,215,348	674	3,343,515,048	669
Share options exercised	10,417,000	2	26,700,300	5
At 31st December	3,380,632,348	676	3,370,215,348	674

Cathay adopted a share option scheme (the "Scheme") on 10th March 1999 for the purpose of providing flight deck crew with an incentive to contribute towards Cathay's results. All participants of the Scheme were flight deck crew who paid HK$1 each on acceptance of their share options and were granted options to subscribe for shares of Cathay at a price not less than the higher of 80% of the average of the closing prices of Cathay's shares on the Stock Exchange on the five trading days immediately preceding the date of grant, and the nominal value of the shares. The Scheme had been closed and no share options were available for issue under the Scheme during the year. The entitlement of each participant has not exceeded 0.32% of the maximum aggregate number of shares in respect of which options have been granted under the Scheme.

Options to subscribe for a total of 68,327,000 shares at the exercise price of HK$7.47 per share were granted under the Scheme on the date of grant 15th March 1999. Other than in limited circumstances, the options in relation to 50% of the shares became exercisable on 15th March 2002, and the balance on 15th March 2004. The options will, except in limited circumstances, be exercisable until 14th March 2009.

HKFRS 2 "Share-based Payment" does not apply to this Scheme as share options were granted before 7th November 2002.

Upon exercise of share options, equity is increased by the number of options exercised at the exercise price.

	2005	2004
	Number of shares	*Number of shares*
Movements in options outstanding comprise:		
At 1st January	26,494,500	53,194,800
Options exercised	(10,417,000)	(26,700,300)
At 31st December	16,077,500	26,494,500
Options vested at 31st December	16,077,500	26,494,500

No option was granted under the Scheme during the year.

	2005	2004
Details of share options exercised during the year:		
Exercise date	7/1/05- 25/11/05	6/1/04- 31/12/04
Proceeds received (HK$)	77,814,990	199,451,241
Weighted average closing share price immediately before the exercise date (HK$)	14.46	15.07

20. RESERVES

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Retained profit	26,492	25,496	13,192	13,123
Share premium	7,531	7,455	7,531	7,455
Investment revaluation reserve	228	493	202	469
Cash flow hedge reserve	30	(1,285)	65	(1,421)
Capital redemption reserve and others	11	22	21	21
	34,292	32,181	21,011	19,647

Investment revaluation reserve relates to changes in the fair value of long-term investments.

Capital redemption reserve and others include the capital redemption reserve of HK$21 million (2004: HK$21 million) and exchange differences arising from revaluation of foreign investments.

The cash flow hedge reserve relates to the effective portion of the cumulative net change in fair values of hedging instruments and exchange differences on borrowings and lease obligations which are arranged in foreign currencies such that repayments can be met by anticipated operating cash flows.

The cash flow hedge reserve is expected to be credited/(charged) to operating profit as noted below when the hedged transactions affect the profit and loss account.

	Total
	HK$M
2006	63
2007	66
2008	(43)
2009	(59)
2010	3
	30

The actual amount ultimately recognised in operating profit will depend upon the fair values of the hedging instruments at the time that the hedged transactions affect the profit and loss account.

21. RECONCILIATION OF OPERATING PROFIT TO CASH GENERATED FROM OPERATIONS

	2005	2004
	HK$M	*HK$M*
Operating profit	4,143	5,247
Depreciation	3,963	3,764
Amortisation of intangible assets	44	84
Loss on disposal of fixed assets and intangible assets	230	29
Profit on disposal of an investment	(66)	–
Currency adjustments and other items not involving cash flows	373	437
Increase in stock	(133)	(126)
Increase in trade debtors, other receivables and prepayments	(1,190)	(557)
(Decrease)/increase in net amounts due to related companies and associates	(77)	115
Increase in trade creditors and other payables	514	1,488
Increase in unearned transportation revenue	242	783
Non-operating movements in debtors and creditors	663	(669)
Cash generated from operations	8,706	10,595

22. ANALYSIS OF CASH AND CASH EQUIVALENTS

	2005	2004
	HK$M	*HK$M*
Short-term deposits and bank balances	4,321	2,687
Bank overdrafts	(54)	(30)
	4,267	2,657

23. DIRECTORS' AND EXECUTIVE OFFICERS' REMUNERATION

(a) Directors' remuneration disclosed pursuant to the Listing Rules is as follows:

	Cash				Non-cash			
	Basic salary/ Directors' fee*	Bonus	Allowances & benefits	Contributions to retirement schemes	Bonus paid into retirement schemes	Housing benefits	2005 Total	2004 Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
Executive Directors								
David Turnbull	1,193	739	20	250	234	836	3,272	11,302
Robert Atkinson	1,740	1,060	209	365	626	1,984	5,984	5,894
Philip Chen	3,400	3,409	2,124	359	–	–	9,292	9,186
Derek Cridland	1,786	1,317	320	12	–	985	4,420	4,435
Tony Tyler	2,850	1,942	222	599	735	2,185	8,533	7,663
Non-Executive Directors								
Martin Cubbon	–	–	–	–	–	–	–	–
Henry Fan	160*	–	–	–	–	–	160	160
James Hughes-Hallett	–	–	–	–	–	–	–	–
Vernon Moore	310*	–	–	–	–	–	310	310
Raymond Yuen	900	660	806	95	–	–	2,461	1,992
Carl Yung	160*	–	–	–	–	–	160	160
Zhang Xianlin	160*	–	–	–	–	–	160	160
Independent Non-Executive Directors								
Peter Lee	360*	–	–	–	–	–	360	360
Raymond Or	310*	–	–	–	–	–	310	310
Jack So	310*	–	–	–	–	–	310	310
Tung Chee Chen	210*	–	–	–	–	–	210	210
Total	13,849	9,127	3,701	1,680	1,595	5,990	35,942	42,452

For Directors employed by the Swire group, the remuneration disclosed represents the amount charged to Cathay. Bonus is related to services for 2004 but paid and charged to Cathay in 2005. Allowances and benefits of Philip Chen and Raymond Yuen include housing allowances of HK$2,040,000 and HK$300,000 respectively.

(b) Executive Officers' remuneration disclosed as recommended by the Listing Rules is as follows:

	Cash				Non-cash			
	Basic salary	Bonus	Allowances & benefits	Contributions to retirement schemes	Bonus paid into retirement schemes	Housing benefits	2005 Total	2004 Total
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
James Barrington	1,289	663	701	271	498	1,246	4,668	4,141
William Chau	1,348	1,103	600	222	–	–	3,273	3,169
Quince Chong (from July 2004)	1,248	920	600	125	–	–	2,893	1,276
Ronald Mathison (from June 2004)	1,113	562	284	233	428	949	3,569	1,874
Edward Nicol	1,394	976	328	293	620	1,936	5,547	5,282
Nick Rhodes	1,363	886	866	286	540	1,348	5,289	4,838
Augustus Tang	1,706	1,322	600	281	–	–	3,909	3,658
Robert Cutler (up to July 2004)	–	–	–	–	–	–	–	3,753
Total	9,461	6,432	3,979	1,711	2,086	5,479	29,148	27,991

Bonus disclosed is related to services for 2004 and paid in 2005.

24. EMPLOYEE INFORMATION

(a) The five highest paid individuals of Cathay included three Directors (2004: four) and two Executive Officers (2004: one), whose emoluments are set out in note 23 above.

(b) The table below sets out the number of individuals, including those who have retired or resigned during the year, in each employment category whose total remuneration for the year fell into the following ranges:

	2005			2004		
HK$'000	Director	Flight staff	Other staff	Director	Flight staff	Other staff
0 – 1,000	11	7,337	7,189	11	6,719	7,124
1,001 – 1,500	–	443	175	–	388	185
1,501 – 2,000	–	487	78	1	398	59
2,001 – 2,500	1	183	18	–	130	19
2,501 – 3,000	–	156	7	–	173	9
3,001 – 3,500	1	134	7	–	133	9
3,501 – 4,000	–	40	4	–	36	4
4,001 – 4,500	1	4	3	1	4	3
4,501 – 5,000	–	1	1	–	3	1
5,001 – 5,500	–	–	1	–	–	2
5,501 – 6,000	1	–	1	1	–	–
7,501 – 8,000	–	–	–	1	–	–
8,501 – 9,000	1	–	–	–	–	–
9,001 – 9,500	1	–	–	1	–	–
11,001 – 11,500	–	–	–	1	–	–
	17	8,785	7,484	17	7,984	7,415

25. RELATED PARTY TRANSACTIONS

(a) Material transactions between Cathay Group and associates and other related parties which were carried out in the normal course of business on commercial terms are summarised below:

	2005		2004	
	Associates	**Other related parties**	**Associates**	**Other related parties**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Turnover	103	–	92	–
Aircraft maintenance costs	967	–	886	–
Route operating costs	183	–	227	–
Dividends received	(170)	–	(122)	–
Fixed assets purchase	5	–	31	–

(b) Other transactions with related parties

(i) Cathay had an agreement for services ("JSSHK Services Agreement") with JSSHK. Under the JSSHK Services Agreement, Cathay paid fees and reimbursed costs to JSSHK in exchange for services provided. Service fees calculated at 2.5% of Cathay Group's profit before tax, results of associates, minority interests, and any profits and losses on disposal of fixed assets were paid annually. Service fees paid for the year ended 31st December 2005 were HK$101 million (2004: HK$124 million) and expenses of HK$106 million (2004: HK$115 million) were reimbursed at cost; in addition, HK$47 million (2004: HK$51 million) in respect of shared administrative services were reimbursed.

Transactions under the JSSHK Services Agreement are continuing connected transactions, in respect of which Cathay has complied with the disclosure requirements in accordance with Chapter 14A of the Listing Rules. For definition of terms.

(ii) Cathay had certain agreements for maintenance services ("Old Agreements") with HAECO. Under the Old Agreements, Cathay paid fees to HAECO in exchange for maintenance services provided to Cathay's aircraft fleet. The Old Agreements were terminated on 31st December 2005 and were replaced by the New Agreements which took effect from 1st January 2006. Service fees paid to HAECO for the year ended 31st December 2005 were HK$949 million (2004: HK$869 million).

Transactions under the Old Agreements were not connected transactions or continuing connected transactions which gave rise to any disclosure or other obligations under Chapter 14A of the Listing Rules.

(iii) Cathay received agency commission and service fees from Dragonair. Service fees were received in respect of computer support, engineering, station and ground services provided to Dragonair. All these transactions were conducted in the ordinary course of business and on normal commercial terms. A total of HK$215 million was received from Dragonair for these transactions in 2005 (2004: HK$180 million). Dragonair is also a partner of the Asia Miles frequent-flyer programme.

(c) Amounts due from and due to associates and other related companies at 31st December 2005 are disclosed in notes 16 and 18 to the accounts. These balances arising in the normal course of business are non-interest bearing and have no fixed repayment terms.

(d) Guarantees given by Cathay in respect of bank loan facilities held by an associate at 31st December 2005 are disclosed in note 26 to the accounts.

(e) There were no material transactions with Directors and Executive Officers except for those relating to shareholdings. Remuneration of Directors and Executive Officers is disclosed in note 23 to the accounts.

26. COMMITMENTS AND CONTINGENCIES

(a) Outstanding commitments for capital expenditure authorised at the year end but not provided for in the accounts:

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Authorised and contracted for	16,724	7,218	1,958	1,193
Authorised but not contracted for	1,034	9	1,032	–
	17,758	7,227	2,990	1,193

Operating lease commitments are shown in note 8 to the accounts.

(b) Guarantees in respect of lease obligations, bank loans and other liabilities outstanding at the year end:

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Subsidiaries	–	–	2,311	1,523
Associate	18	20	18	20
Staff	200	415	200	400
	218	435	2,529	1,943

(c) Cathay has under certain circumstances undertaken to maintain specified rates of return within Cathay Group's leasing arrangements. The Directors do not consider that an estimate of the potential financial effect of these contingencies can practically be made.

(d) Cathay files tax returns in many jurisdictions and in certain of these the returns have remained in dispute for a number of years. Provisions have been made to cover the expected outcome of the disputes to the extent that outcomes are likely and reliable estimates can be made. However, the final outcomes are subject to uncertainties and resulting liabilities may exceed provisions.

27. FINANCIAL RISK MANAGEMENT

In the normal course of business, Cathay Group is exposed to fluctuations in foreign exchange rates, interest rates and jet fuel prices. These exposures are managed, sometimes with the use of derivative financial instruments, by the Treasury Department of Cathay in accordance with the policies approved by the Finance Committee.

Derivative financial instruments are used solely for financial risk management purposes and Cathay Group does not hold or issue derivative financial instruments for trading purposes. Derivative financial instruments which constitute a hedge do not expose Cathay Group to market risk since any change in their market value will be offset by a compensating change in the market value of the hedged items. Exposure to foreign exchange rates, interest rates and jet fuel price movements are regularly reviewed and positions are amended in compliance with internal guidelines and limits.

(a) Credit risk

Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis.

Cathay Group normally grants a credit term of 30 days to customers or follows the local industry standard with the debt in certain circumstances being partially protected by bank guarantees or other monetary collateral.

Trade debtors mainly represented passenger and freight sales due from agents and amounts due from airlines for interline services provided. The majority of the agents are connected to the settlement systems operated by the IATA which is responsible for checking the credit worthiness of such agents and collecting bank guarantees or other monetary collateral according to local industry practice. In most cases amounts due from airlines are settled on net basis via an IATA clearing house. The credit risk with regard to individual agents and airlines is relatively low.

To manage credit risk, derivative financial transactions, deposits and funds are only carried out with financial institutions which have high credit ratings and all counterparties are subject to prescribed trading limits which are regularly reviewed. Risk exposures are monitored regularly by reference to market values.

At the balance sheet date there was no significant concentration of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivative financial instruments, in the balance sheet and the amount of guarantees granted as disclosed in note 26 to the accounts. Collateral and guarantees received in respect of credit terms granted as at 31st December 2005 is HK$2,602 million.

(b) Liquidity risk

Cathay Group's policy is to monitor liquidity and compliance with lending covenants, so as to ensure sufficient liquid funds and adequate funding lines from financial institutions to meet liquidity requirements in both the short and long term. The payment profile of financial liabilities is outlined in notes 13 and 18 to the accounts. Settlement of these liabilities as they fall due will primarily be through liquid funds being funds generated from operations.

(c) Foreign currency risk

As an international airline, Cathay Group's revenue streams are denominated in a number of foreign currencies resulting in exposure to foreign exchange rate fluctuations. The currencies giving rise to this risk are primarily Japanese Yen, Euros, Taiwanese dollars and Australian dollars. To manage this exposure assets are, where possible, financed in those foreign currencies in which net operating surpluses are anticipated, thus establishing a natural hedge. In addition, Cathay Group uses currency derivatives to reduce anticipated foreign currency surpluses. The use of foreign currency borrowings and currency derivatives to hedge future operating revenues is a key component of the financial risk management process, as exchange differences realised on the repayment of financial commitments are effectively matched by the change in value of the foreign currency earnings used to make those repayments.

(d) Interest rate risk

Interest rate swaps are used to manage the interest rate profile of interest-bearing financial liabilities on a currency by currency basis to maintain an appropriate fixed rate and floating rate ratio.

The table below indicates the effective interest rates of interest-bearing financial liabilities and interest-earning financial assets as at the balance sheet date and the period in which they are repriced or mature whichever
is earlier:

				2005			
	Fixed/ Floating	Effective interest rate (%)	Within one year *HK$M*	After one year but within two years *HK$M*	After two years but within five years *HK$M*	After five years *HK$M*	Total *HK$M*
Cathay Group							
Bank loans	Floating	3.20-5.28	(4,839)	–	–	–	(4,839)
Other loans	Fixed	0-7.00	(32)	–	(1,083)	–	(1,115)
Other loans	Floating	2.68-2.83	(309)	–	–	–	(309)
Obligations under finance leases	Fixed	1.64-8.75	(422)	(1,305)	(2,918)	(10,659)	(15,304)
Obligations under finance leases	Floating	1.77-5.33	(11,027)	–	–	–	(11,027)
Pledged security deposits	Fixed	3.25-8.75	570	811	1,307	7,347	10,035
Pledged security deposits	Floating	4.07	104	–	–	–	104
Currency swap	Floating	1.29-9.12	1,098	(78)	(411)	(398)	211
Interest rate swap	Fixed	3.45-6.43	1,860	(702)	(773)	(385)	–
Liquid funds	Fixed	2.27	–	–	23	–	23
Liquid funds	Floating	0-7.45	13,436	–	–	–	13,436
Bank overdrafts	Floating	0-9.25	(54)	–	–	–	(54)

				2004			
	Fixed/ Floating	Effective interest rate (%)	Within one year *HK$M*	After one year but within two years *HK$M*	After two years but within five years *HK$M*	After five years *HK$M*	Total *HK$M*
Cathay Group							
Bank loans	Floating	0.71-5.07	(3,222)	–	–	–	(3,222)
Other loans	Fixed	0-7.00	(314)	–	(33)	–	(347)
Other loans	Floating	2.71-2.73	(425)	–	–	–	(425)
Obligations under finance leases	Fixed	1.29-10.65	(732)	(406)	(3,305)	(13,567)	(18,010)
Obligations under finance leases	Floating	1.80-6.77	(12,790)	–	–	–	(12,790)
Pledged security deposits	Fixed	3.25-10.10	1,109	622	1,469	8,696	11,896
Pledged security deposits	Floating	1.95-2.85	267	–	–	–	267
Interest rate swap	Fixed	2.28-8.16	1,731	(362)	(385)	(984)	–
Liquid funds	Floating	0-6.43	11,474	–	–	–	11,474
Bank overdrafts	Floating	0	(30)	–	–	–	(30)

	Fixed/ Floating	Effective interest rate (%)	2005 Within one year HK$M	After one year but within two years HK$M	After two years but within five years HK$M	After five years HK$M	Total HK$M
Cathay							
Bank loans	Floating	4.08-5.28	(3,678)	–	–	–	(3,678)
Other loans	Fixed	3.06	–	–	(1,049)	–	(1,049)
Other loans	Floating	2.68-2.83	(309)	–	–	–	(309)
Obligations under finance leases	Fixed	1.64-11.19	(650)	(1,305)	(3,628)	(9,418)	(15,001)
Obligations under finance leases	Floating	1.77-5.33	(10,273)	–	–	–	(10,273)
Pledged security deposits	Fixed	3.79-8.75	188	811	757	1,844	3,600
Currency swap	Floating	1.29-9.12	1,098	(78)	(411)	(398)	211
Interest rate swap	Fixed	3.45-6.43	1,860	(702)	(773)	(385)	–
Liquid funds	Fixed	2.27	–	–	23	–	23
Liquid funds	Floating	0-7.45	4,864	–	–	–	4,864
Bank overdrafts	Floating	0-9.25	(49)	–	–	–	(49)

	Fixed/ Floating	Effective interest rate (%)	2004 Within one year HK$M	After one year but within two years HK$M	After two years but within five years HK$M	After five years HK$M	Total HK$M
Cathay							
Bank loans	Floating	0.71-5.07	(1,567)	–	–	–	(1,567)
Other loans	Floating	2.71-2.73	(425)	–	–	–	(425)
Obligations under finance leases	Fixed	1.29-11.19	(798)	(604)	(3,205)	(12,928)	(17,535)
Obligations under finance leases	Floating	1.80-6.77	(12,840)	–	–	–	(12,840)
Pledged security deposits	Fixed	3.79-9.19	386	266	840	2,852	4,344
Interest rate swap	Fixed	2.28-8.16	1,731	(362)	(385)	(984)	–
Liquid funds	Floating	0-6.43	3,244	–	–	–	3,244
Bank overdrafts	Floating	0	(7)	–	–	–	(7)

(e) Fuel price risk

Exposure to fluctuations in the fuel price is managed by the use of fuel derivatives. Cathay Group's policy is to reduce exposure by hedging a percentage of its anticipated fuel consumption. Around 26.3% of the anticipated fuel consumption for 2006 and 1.8% for 2007 were hedged at the balance sheet date.

(f) Fair values

The fair values of the following financial instruments differ from their carrying amounts shown in the balance sheet:

	Carrying amount 2005 *HK$M*	Fair value 2005 *HK$M*	Carrying amount 2004 *HK$M*	Fair value 2004 *HK$M*
Cathay Group				
Bank loans	4,839	4,909	3,222	3,273
Other loans	1,424	1,434	772	783
Obligations under finance leases	26,331	27,463	30,800	32,863
Pledged security deposits	(10,139)	(10,992)	(12,163)	(13,485)

	Carrying amount 2005 *HK$M*	Fair value 2005 *HK$M*	Carrying amount 2004 *HK$M*	Fair value 2004 *HK$M*
Cathay				
Bank loans	3,678	3,720	1,567	1,586
Other loans	1,358	1,369	425	436
Obligations under finance leases	25,274	28,730	30,375	35,216
Pledged security deposits	(3,600)	(4,119)	(4,344)	(5,038)

The carrying amounts of other financial assets and liabilities are considered to be reasonable approximations to their fair values.

28. IMPACT OF NEW ACCOUNTING STANDARDS

With the adoption of the new and revised HKAS and HKFRS and their transitional provisions as described in accounting policies 2, 6, 10, and 15, the consolidated profit and loss account for 2005 and 2004 has been affected as follows:

	2005				2004
	HKFRS3	**HKAS39**	**HKAS1**	**Total**	**HKAS1**
	HK$M	*HK$M*	*HK$M*	*HK$M*	*HK$M*
Turnover					
Passenger services	–	(20)	–	(20)	–
Cargo services	–	(4)	–	(4)	–
Catering, recoveries and other services	–	–	6,446	6,446	3,696
Total turnover	–	(24)	6,446	6,422	3,696
Expenses					
Staff	–	–	–	–	–
Inflight service and passenger expenses	–	–	(250)	(250)	(192)
Landing, parking and route expenses	–	–	(970)	(970)	(797)
Fuel	–	(107)	(3,948)	(4,055)	(1,485)
Aircraft maintenance	–	–	–	–	–
Aircraft depreciation and operating leases	–	–	(11)	(11)	(23)
Other depreciation and operating leases	17	–	–	17	–
Commissions	–	–	–	–	–
Others	–	251	(1,267)	(1,016)	(1,199)
Operating expenses	17	144	(6,446)	(6,285)	(3,696)
Operating profit	17	120	–	137	–
Finance charges	–	72	–	72	–
Finance income	–	7	–	7	–
Net finance charges	–	79	–	79	–
Share of profits of associates	–	–	(50)	(50)	(58)
Profit before tax	17	199	(50)	166	(58)
Taxation	–	–	50	50	58
Profit for the year	17	199	–	216	–
Profit attributable to					
Cathay shareholders	17	199	–	216	–
Minority interests	–	–	–	–	–
	17	199	–	216	–
Earnings per share					
Basic	0.5¢	5.9¢	–	6.4¢	–
Diluted	0.5¢	5.9¢	–	6.4¢	–

29. IMPACT OF FURTHER NEW ACCOUNTING STANDARDS

HKICPA has issued new and revised HKAS and HKFRS which become effective for accounting periods beginning on or after 1st January 2006 and which are not adopted in these financial statements. The following new accounting standards are relevant to Cathay Group:

(a) HKFRS 7 "Financial Instruments: Disclosures" will become effective for accounting periods beginning on or after 1st January 2007. Adoption of this new accounting standard will result in different disclosures with respect to financial instruments and financial risks. The accounting standard will have no impact on either the results or financial position of Cathay Group.

(b) Amendment to HKAS 19 Employee Benefits "Actuarial Gains and Losses, Group Plans and Disclosures" will become effective for accounting periods beginning on or after 1st January 2006. The amendment introduces an additional option to recognise all actuarial gains and losses arising in post-employment defined benefit plans as they occur, outside the profit or loss in a statement of recognised income and expense. Cathay Group is in the process of making an assessment on the impact of this additional option on both the results and the financial position of Cathay Group.

(C) MANAGEMENT DISCUSSION AND ANALYSIS

The following information have been extracted from Cathay's annual reports for the year ended 31 December 2005, 31 December 2004 and 31 December 2003.

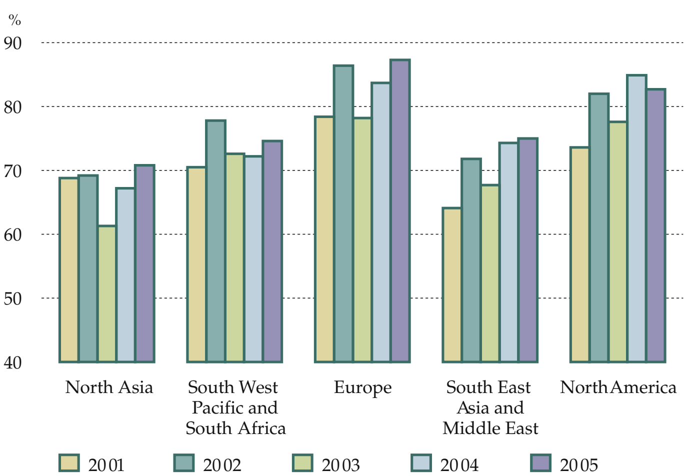
(a) For the year ended 31 December 2005

REVIEW OF OPERATIONS

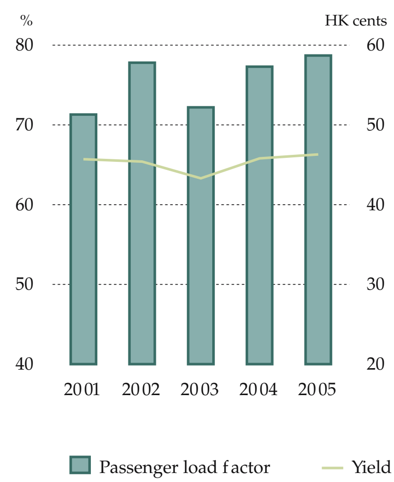
Passenger Services

During 2005, Cathay achieved its highest ever passenger revenue with record passenger numbers and an average 78.7% load factor. Yield improved by 1.1% to HK46.3 cents, driven by buoyant passenger demand and good front-end loads, which were sustained throughout the year. However, economy class yield remained under steady pressure, with increased competition on virtually every sector. Capacity increased 11.8% with additional services and aircraft. A third daily service to Los Angeles added strength to North America, now its second largest sales area.

Load factor by region



Passenger load factor and yield



Available seat kilometers ("ASK"), load factor and yield by region:

	ASK (million)			Load factor (%)			Yield
	2005	2004	Change	2005	2004	Change	Change
North Asia	13,057	12,290	+6.2%	70.8	67.2	+3.6%pt	+1.8%
South West Pacific and South Africa	14,656	12,466	+17.6%	74.6	72.2	+2.4%pt	–3.6%
Europe	16,181	15,194	+6.5%	87.3	83.7	+3.6%pt	–1.2%
South East Asia and Middle East	17,376	15,764	+10.2%	75.0	74.3	+0.7%pt	–1.1%
North America	21,496	18,348	+17.2%	82.7	84.9	–2.2%pt	+8.1%
Overall	82,766	74,062	+11.8%	78.7	77.3	+1.4%pt	+1.1%

Comments by region are as follows:

North Asia

- The increased frequency of Beijing flights to 14 a week and the introduction of its codeshare service with Air China strengthened Hong Kong's hub connections to the capital. A thrice-weekly flight was added to Xiamen.

- Economic recovery supported a rebound in the outbound market from Japan with high passenger growth to Europe.

- It added three additional flights a week to Nagoya.

- Interest in Korea, raised by the recent popularity of Korean food and culture in Hong Kong, stimulated leisure traffic. A fifth daily service was added to Seoul in January 2006.

South West Pacific and South Africa

- It consolidated its third daily service to Sydney even as competition increased from a number of carriers.

- It added a fourth flight a week to Perth, bringing the number of direct services it operates to six cities in Australia to 52 each week.

- Services to Africa gained strength and it made Johannesburg a daily operation.

Europe

- Loads to Europe, in particular the United Kingdom, remained high throughout the year.

- It launched a fourth daily service to London on 1 December. Flights to London now depart from Hong Kong morning, afternoon and evening.

- Services to Rome will increase from five a week to seven and those to Frankfurt will increase from seven to 11 a week starting from the last week of March 2006.

- Services to Amsterdam became a daily operation.

South East Asia and Middle East

- Ho Chi Minh City became a double-daily service as it ended its joint venture with Vietnam Airlines on this route while retaining its codeshare arrangement.

- The performance of services to the Philippines showed encouraging improvement.

- A second daily non-stop service started to Jakarta.

- Services to Singapore increased by seven more flights a week.

North America

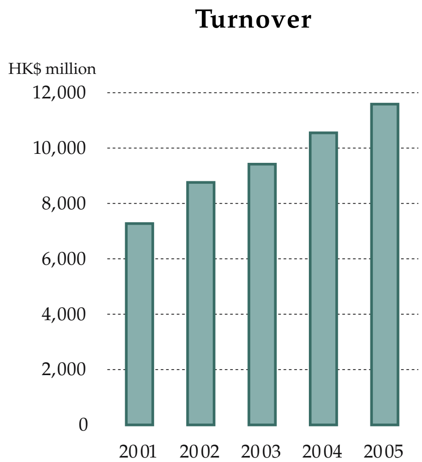
- The North American market performed well as revenue growth outpaced increased capacity. It was its second largest sales territory during the year.

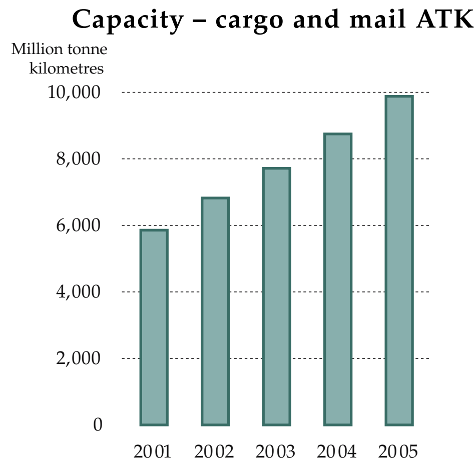
- All United States services enjoyed strong support from business passengers.

- It now operates three daily non-stop services to Los Angeles. Cathay is the only airline to fly non-stop from Hong Kong to this United States gateway.

Cargo Services

Cathay sets new revenue and tonnage records as capacity increased by 12.9%. Cargo yield dipped by 0.6% to HK$1.75. Volumes were boosted by transshipment cargo to and from Shanghai, following the introduction of a daily freighter service in January 2005. A new service to Dallas and Atlanta commenced in November. Growth out of China slowed in the second half in the face of high fuel prices, but the long-term growth prospects for air cargo remain positive. Hong Kong remains the primary gateway to the Pearl River Delta despite increased competition from new airports in the region.





	ASK (million)			Load factor (%)			Yield
	2005	2004	Change	2005	2004	Change	Change
Cathay	9,879	8,748	+12.9%	67.0	68.7	–1.7%pt	–0.6%

- The world's first B747-400BCF passenger-to-freighter conversion aircraft entered service in December. At the end of 2005 Cathay operated a fleet of seven B747-400 and seven B747-200 freighters.

- Yield and load factors declined as a result of weak demand out of Europe, the United States and Australia with traditional directional imbalances exaggerated by large increases in competitor capacity.

- Cathay launched a three-times-weekly service to Dallas, continuing on to Atlanta. The two new destinations will also bring new opportunities to connect with transshipments from South and Central America.

- Overnight express operations on behalf of DHL were launched to Shanghai, Beijing and Nagoya in March, further developing Hong Kong as a regional express cargo hub.

- High fuel prices negatively affected the profitability of Cathay's freighter services. The adverse impact of high fuel prices was only partially offset by fuel surcharges passed on to customers.

Review of subsidiaries and associates

AHK Air Hong Kong Limited ("AHK")

- AHK, in which Cathay holds a 60% interest, is an all-cargo carrier with a major focus on expenses cargo services for DHL Express.

- During the year, AHK further expanded its overnight express cargo network to Seoul, increasing the number of destinations it serves in Asia to seven, together with Bangkok, Osaka, Penang, Singapore, Taipei and Tokyo.

- The airline took delivery of two new A300-600 freighters in February and March, increasing the fleet size to six. Two more A300-600 freighters will be delivered in 2006.

- With network expansion, capacity increased by 44.1%. Load factor increased by 8.3 percentage points while yield decreased by 8.7%.

- AHK recorded a higher profit in 2005 despite the adverse impact of higher fuel prices.

Cathay Pacific Catering Services (H.K.) Limited ("CPCS")

- CPCS, a wholly owned subsidiary of Cathay, is the principal flight kitchen in Hong Kong.

- The company produced a record 19.8 million meals in 2005 and accounts for 71% of the airline catering market in Hong Kong. Business volume increased by 12% over 2004.

- The company recorded a satisfactory result in 2005 despite a series of food scares in Hong Kong. However, the profit margin decreased with higher crude oil prices and cost-saving campaigns of customer airlines seeking to compensate for higher fuel prices.

- The performance of other inflight catering kitchens in Asia and Canada are also encouraging.

Hong Kong Airport Services Limited ("HAS")

- HAS, in which Cathay holds a 70% interest, is the largest franchised ramp handling company at HKIA.

- Cathay recorded a healthy growth in revenue as it handled a record number of flights.

- With continuous stringent cost-controls and an improving business environment, HAS achieved a record profit in 2005.

Hong Kong Aircraft Engineering Company Limited ("HAECO")

- HAECO, in which Cathay holds a 27% interest, provides aircraft maintenance, modification and overhaul services at HKIA.

- Cathay achieved a consolidated profit attributable to its shareholders of HK$618 million, a 41.1% increase on the previous year.

- Line maintenance business continued to grow as a result of the increase in aircraft traffic through HKIA. Hangar capacity was fully utilized throughout the year due to strong market demand for heavy maintenance work.

- Construction of the new two-storey office on the cargo apron and the second hangar at HKIA is making good progress. Openings are scheduled in the second half of 2006. HAECO's headcount at HKIA increased by 12% during 2005 to meet the demand and in preparation for the second hangar.

- Taikoo (Xiamen) Aircraft Engineering Company Limited ("TAECO"), 54.6% owned by HAECO and 9% owned by Cathay, had a good year as a result of a high utilization of its facilities. Its fourth hangar was opened on 19th December and construction was started on a fifth hangar. This fifth hangar is expected to open by mid-2007. TAECO has a contract with Boeing to convert B747-400 passenger aircraft into freighters. The first of these converted aircraft was redelivered to Cathay in December 2005.

- Hong Kong Aero Engine Services Limited, HAECO's jointly controlled company with Rolls-Royce plc and SIA Engineering Pte Limited, experienced high work volumes and achieved good results.

Dragonair

- Dragonair, in which Cathay holds an 18% interest, operates passenger services to 30 destinations in Asia, including 22 in China mainland. Dragonair also provides freighter services to ten destinations covering cities in Asia, Europe, Middle East and the United States.

- Dragonair recorded an 18.0% increase in passenger revenue on 2005, due to an increase in passenger services capacity to China mainland and full-year impact of the new passenger service to Tokyo, which commenced in April 2004. Cathay carried more than 5.0 million revenue passengers in 2005, a 9.9% increase over 2004, and passenger yield increased by 2.9%.

- Cathay uplifted 385,000 tonnes of cargo in 2005, 12.5% higher than in 2004. Cargo revenue increased by 27.9% due to the higher tonnage carried by new passenger and freighter services. With the substantial increase in cargo capacity in the market, cargo load factor decreased by 3.7 percentage points to 72.5%. Cargo yield remained at the same level as last year.

- Higher fuel prices have affected Dragonair significantly, with the system-wide fuel price increasing by 43.4% over 2004. Fuel now accounts for 26.0% of total operating costs, 6.8 percentage points higher than in 2004. However, a fuel hedging programme and fuel surcharges passed on to customers helped to mitigate part of the adverse impact of soaring fuel prices.

- Dragonair has suspended scheduled services to Phuket since January 2005, as the demand for air traffic to Phuket substantially reduced after the Indian Ocean tsunami. The Bangkok passenger service has also been reduced from double-daily to a daily flight and was downgraded to a narrow body aircraft. Dragonair increased its Shanghai passenger service frequency to 16 a day frequencies to most other China mainland destinations also increased.

- Dragonair started its first trans-Pacific freighter service to New York in April using a wet-leased B747-400 freighter.

- Cathay took delivery of three A330s and one A320 during the year. At end of 2005, Dragonair had a passenger aircraft fleet of 11 A320s, six A321s and 13 A330s. Among them, one A320 and one A330 were wet leased to Air-China from September 2005 onwards. It also had four B747 freighters.

- The codeshare agreement with Air China was expanded in 2005 to cover Beijing. Hangzhou and Wuhan in addition to the existing routes to Chengdu, Chongqing, Dalian and Tianjin.

- Dragonair celebrated its 20th anniversary in May 2005. During these 20 years, Dragonair has developed into a full service passenger carrier with a dedicated freighter fleet serving major markets of the world. Despite the impact of higher fuel costs, management remains optimistic for the airline’s future and 2006 will see continued expansion of freighter services and stringent cost-control.

	ASK/ATK* (million)			Load factor (%)			Yield
	2005	2004	Change	2005	2004	Change	Change
Passenger services	10,065	9,176	+9.7%	64.4	64.9	–0.5% pt	+2.9%
Cargo services	1,942	1,425	+36.3%	72.5	76.2	–3.7% pt	–

* *Capacities of passenger and cargo services are measured in available seat kilometres ("ASK") and available tonne kilometres ("ATK") respectively*

Fleet profile as at 31 December 2005:

	Number as at 31 December 2005				Firm orders				Expiry of operating leases		
		Leased									
Aircraft type	Owned	Finance	Operating	Total	'06	'07	'08 & beyond	Total	'06	'07	'08 & beyond
A320	3	2	6	11					2	4	
A321	2		4	6						4	
A330	2	3	8	13	3*			3		1	7
B747-200F	1			1							
B747-300SF	3			3							
B747-400F					2	2	1	5			
Total	11	5	18	34	5	2	1	8	2	9	7

* *Aircraft will be on operating lease.*

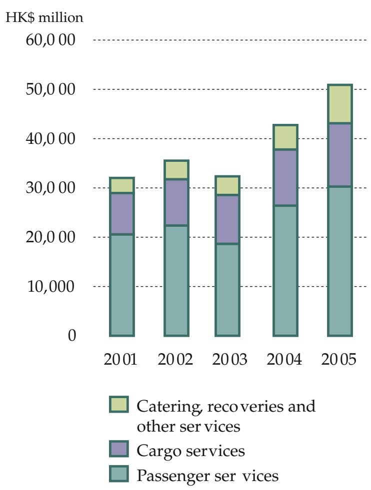
FINANCIAL REVIEW

The Cathay Group reported an attributable profit of HK$3,298 million against a profit of HK$4,417 million in 2004. The substantial decrease in profit reflects the adverse effect of high fuel prices on its profitability.

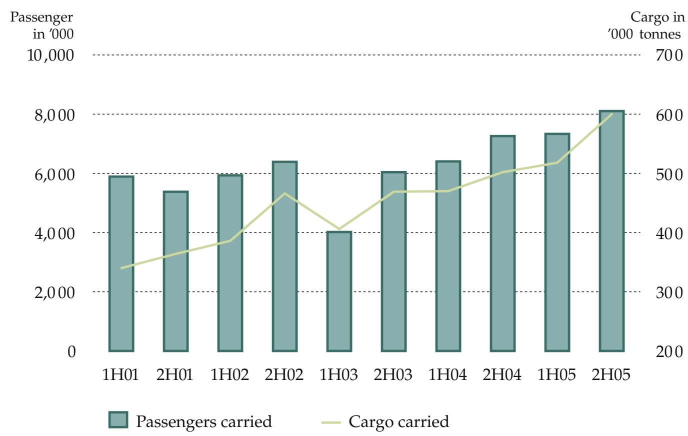
Turnover

	Cathay Group		Cathay	
	2005	**2004**	**2005**	**2004**
	HK$M	*HK$M*	*HK$M*	*HK$M*
Passenger services	30,274	26,407	30,274	26,407
Cargo services	12,852	11,395	11,585	10,549
Catering, recoveries and other services	7,783	4,959	6,529	3,774
Turnover	50,909	42,761	48,388	40,730

Cathay Group turnover



Cathay passengers and cargo carried



- The Cathay Group turnover rose by 19.1% on 2004.

- Passenger turnover increased significantly by 14.6% to HK$30,274 million as a result of strong demand. The number of passengers carried increased by 13.0% to 15.4 million and revenue passenger kilometres increased by 13.7%.

- Passenger load factor increased by 1.4 percentage points to 78.7% while capacity, in terms of available seat kilometres, increased by 11.8%.

- Passenger yield increased by 1.1% to HK¢46.3.

- First and business class revenues increased by 19.1% and the front-end load factor increased from 63.1% to 66.0%. Economy class revenue increased by 12.5% and the economy class load factor increased from 80.0% to 80.9%.

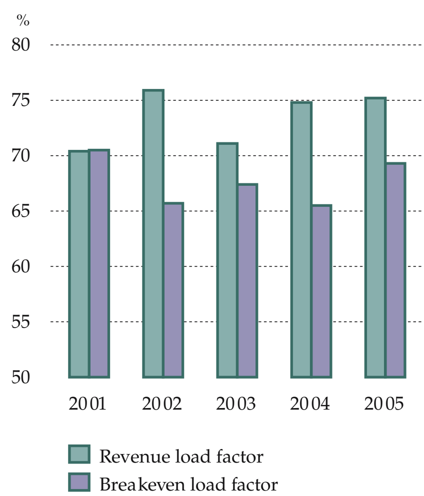
- Cathay's cargo turnover increased by 9.8% to HK$11,585 million as the demand of exports from China mainland through Hong Kong remained strong though slowed in the second half in the face of high fuel prices.

- Cathay's cargo load factor decreased by 1.7 percentage points while capacity increased by 12.9%. Cargo yield decreased by 0.6% to HK$1.75.

- The improvement in Cathay's traffic turnover can be analysed as follows:

		HK$M
+11.8%	Passenger capacity	3,086
+12.9%	Cargo and mail capacity	1,364
+1.4% pt	Passenger load factor	501
–1.7% pt	Cargo and mail load factor	(291)
+1.1%	Passenger yield	279
–0.6%	Cargo and mail yield	(36)
		4,903

Revenue and breakeven load factor



- Revenue load factor increased by 0.4 percentage points to 75.2% while the breakeven load factor increased by 3.8 percentage points to 69.3%.

- The annualised revenue effect on changes in yield and load factor is set out below:

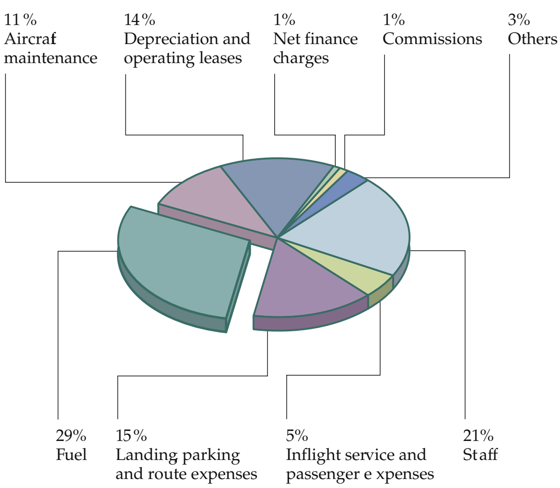
	HK$M
+ 1% point in passenger load factor	383
+ 1% point in cargo and mail load factor	173
+ HK¢1 in passenger yield	651
+ HK¢1 in cargo and mail yield	66

Operating expenses

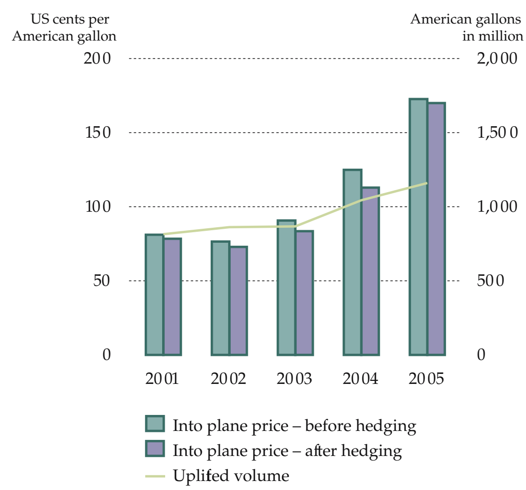
Net operating expenses after deduction of the Cathay Group recoveries HK$6,446 million (2004: HK$3,696 million) and of Cathay recoveries HK$6,529 million (2004: HK$3,774 million) are analysed as follows:

	Cathay Group			Cathay		
	2005	2004	Change	2005	2004	Change
	HK$M	*HK$M*		*HK$M*	*HK$M*	
Staff	9,025	8,842	+2.1%	8,132	7,985	+1.8%
Inflight service and passenger expenses	1,783	1,566	+13.9%	1,783	1,566	+13.9%
Landing parking and route expenses	5,977	5,324	+12.3%	5,832	5,209	+12.0%
Fuel	11,640	7,836	+48.5%	11,400	7,704	+48.0%
Aircraft maintenance	4,527	3,784	+19.6%	4,459	3,768	+18.3%
Aircraft depreciation and operating leases	4,882	4,356	+12.1%	4,755	4,206	+13.1%
Other depreciation and operating leases	790	814	–2.9%	590	595	–0.8%
Commissions	555	529	+4.9%	555	529	+4.9%
Exchange gain	(156)	(199)	–21.6%	(148)	(201)	–26.4%
Others	1,297	966	+34.3%	1,147	820	+39.9%
Net operating expenses	40,320	33,818	+19.2%	38,505	32,181	+19.7%
Net finance charges	444	583	–23.8%	361	556	–35.1%
Total net operating expenses	40,764	34,401	+18.5%	38,866	32,737	+18.7%

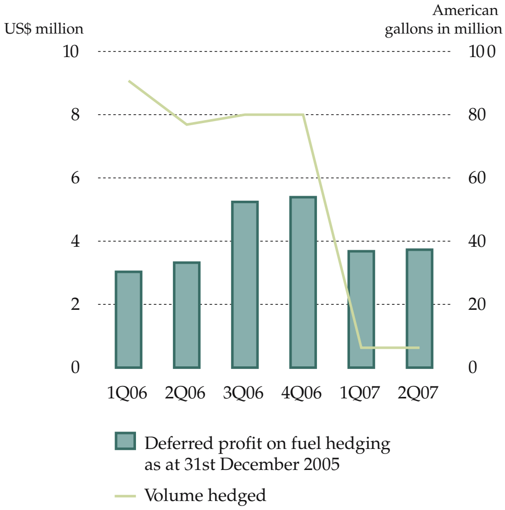
Cathay: total net operating expenses



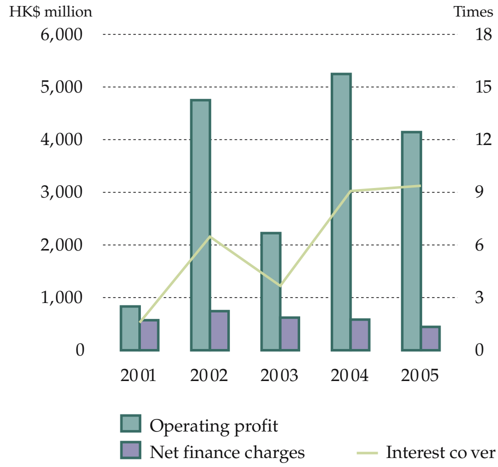
Cathay: fuel price and consumption



Cathay: fuel hedging



Cathay Group interest cover



- Staff costs increased due to an increase in average staff numbers and backdated salary payments to cabin crew.

- Inflight service and passenger expenses rose due to a 13% increase in passenger numbers.

- Landing, parking and route expenses increased as a result of additional flights.

- Fuel costs increased due to a 38% increase in the average into plane fuel price to US$1.73 per American gallon and an 11.2% increase in consumption to 1,160 million American gallons.

- Aircraft maintenance increased as a result of the fleet expansion.

- Aircraft depreciation and operating leases increased due to the new aircraft deliveries.

- Net finance charges decreased due to lower average net borrowings.

- Cathay's cost per ATK increased from HK$2.07 to HK$2.19 due to higher fuel prices.

Associates

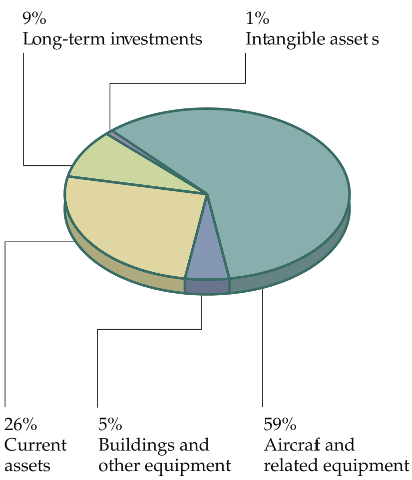
- The share of profits from associates decreased by 9.7% to HK$269 million.

- HAECO reported a higher profit than 2004 and this partially outweighed the lower profit from Dragonair which was adversely affected by higher fuel costs.

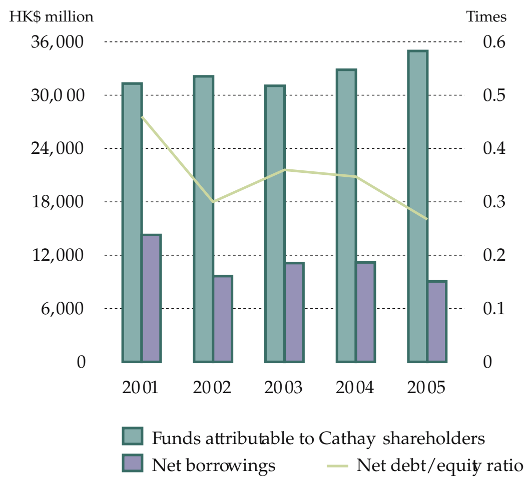
Taxation

- Despite reduced profit, the tax charge of HK$500 million was HK$54 million higher than the previous year as a result of both increased overseas charges and deferred tax liabilities on accelerated tax depreciation.

Cathay Group total assets



Cathay Group net debt and equity



Dividends

- Dividends paid and proposed for the year are HK$1,623 million representing a dividend cover of 2.0 times.

- Dividends per share decreased from HK¢65 to HK¢48.

Assets

- Total assets as at 31 December 2005 amounted to HK$78,254 million.

- During the year, additions to fixed assets were HK$4,001 million, comprising HK$3,883 million for aircraft and related equipment and HK$118 million for other equipment.

Borrowings and capital

- Borrowings decreased by 0.8% to HK$22,455 million compared with HK$22,631 million in 2004.

- Borrowings are mainly denominated in US dollars, Hong Kong dollars, Singapore dollars and Euros, and are fully repayable by 2018 with 51% at fixed rates of interest net of derivatives.

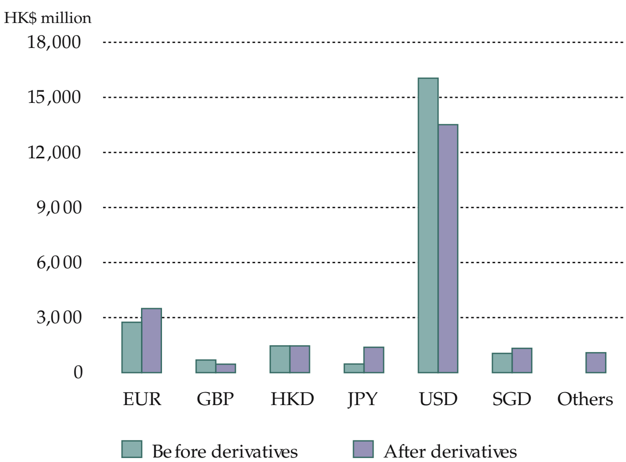
- Liquid funds, 67% of which are denominated in US dollars, increased by 17.3% to HK$13,459 million.

- Net borrowings decreased by 19.1% to HK$9,050 million.

- Funds attributable to Cathay shareholders increased by 6.4% to HK$34,968 million.

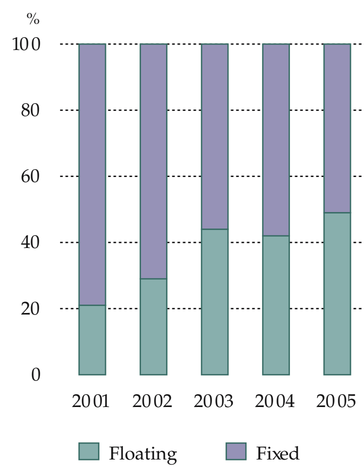
- Net debt/equity ratio decreased from 0.34 times to 0.26 times.

Cathay Group borrowings before and after derivatives



Others include CAD, KRW, NZD and TWD.

Cathay Group interest rate profile: borrowings



Value Added

The following table summarises the distribution of the Cathay Group's value added in 2004 and 2005.

	2005	2004
	HK$M	*HK$M*
Total revenue	50,909	42.761
Less: Purchases of goods and services	(33,778)	(24,908)
Value added by the Cathay Group	17,131	17,853
Add: Share of profits of associates	269	298
Total value added available for distribution	17,400	18,151
Applied as follows:		
To employees		
– Salaries and other staff costs	9,025	8,842
To governments		
– Corporation taxes	500	446
To providers of capital		
– Dividends – paid	676	674
– proposed	947	1,520
– Minority interests	170	99
– Net finance charges	444	583
Retained for re-investment and future growth		
– Depreciation	3,963	3,764
– Profit after dividends	1,675	2,223
Total value added	17,400	18,151

- The Cathay Group value added decreased by HK$751 million mainly due to an increase in the cost of fuel.

- Dividends paid and proposed decreased by HK$571 million while the amount retained for re-investment and future growth decreased by HK$349 million.

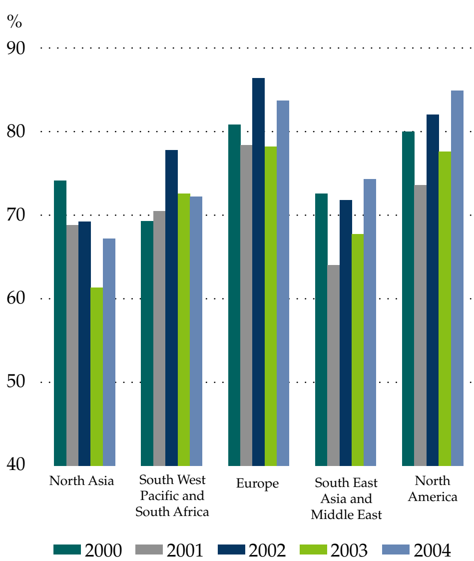
(b) For the year ended 31 December 2004

REVIEW OF OPERATIONS

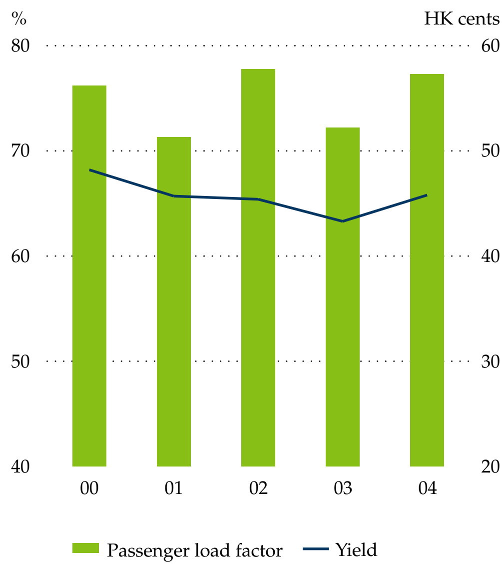
Passenger services

New records were set for both passenger numbers and passenger revenue as capacity increased 24.9% over 2003. Additional frequencies were added to a number of routes, a non-stop service was launched to New York and new codeshare services commenced to Barcelona, Madrid and Moscow. Demand from both business and leisure travellers remained strong throughout the year. The average load factor was 77.3%. Passenger yield increased 5.8% to HK45.8 cents.

LOAD FACTOR BY REGION



PASSENGER LOAD FACTOR AND YIELD



Available Seat Kilometres (ASK"), Load Factor and Yield by Region:

	ATK (million)			Load factor (%)			Yield
	2004	2003	Change	2004	2003	Change	Change
North Asia	12,290	9,436	+30.2%	67.2	61.3	+5.9%pt	–1.1%
South West Pacific and South Africa	12,466	10,109	+23.3%	72.2	72.6	–0.4%pt	+9.1%
Europe	15,194	12,712	+19.5%	83.7	78.2	+5.5%pt	+13.1%
South East Asia and Middle East	15,764	12,775	+23.4%	74.3	67.7	+6.6%pt	–1.7%
North America	18,348	14,248	+28.8%	84.9	77.6	+7.3%pt	+9.2%
Overall	74,062	59,280	+24.9%	77.3	72.2	+5.1%pt	+5.8%

Comments by region are as follows:

North Asia

- Cathay now operates a daily service to Beijing, further strengthening Hong Kong's connections to China mainland.

- The introduction of visa-free entry into Japan spurred demand among Hong Kong leisure travellers. With an improving Japanese economy, demand from Japan also increased.

- Competition and additional capacity in the Taiwan market placed further pressure on yield.

South West Pacific and South Africa

- Cathay launched a third daily service to Sydney, more than any other airline, and added capacity to Brisbane and Melbourne. A fourth weekly service to Perth will commence in 2005.

- Another two flights to Auckland were added to the winter schedule to make it a 12 times weekly service.

- The South African market performed well with high first and business class load factors.

Europe

- Load factors to and from Europe remained high throughout the year with sustained demand from both leisure and business travellers.

- This demand coupled with favourable currency movements helped to raise yield, especially during the second half of the year.

South East Asia and Middle East

- A number of new carriers entered the market in the region and the additional capacity put pressure on yield.

- Campaigns to grow the leisure travel market between Singapore and Hong Kong stimulated demand.

- Extra flights were launched to Denpasar in the summer and to Surabaya in the winter.

- The market responded well to the new thrice weekly service between Singapore and Colombo which, with the current Colombo to Bangkok flights, created a daily Sri Lanka service.

- The Middle East performed well throughout the year and services were added to Bahrain, Dubai and Riyadh.

North America

- Passenger numbers increased on all Canadian routes, though competition from other airlines maintained pressure on yield.

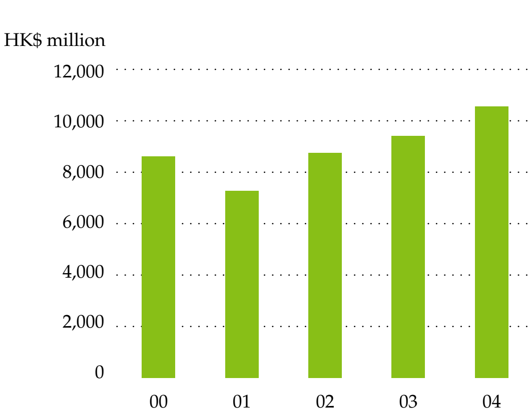
- Strong support from business travellers to and from the United States raised both revenue and yield.

- In addition to Cathay's daily service via Vancouver, Cathay launched a daily non-stop service between Hong Kong and New York. Both flights were successful with high load factors in first and business class.

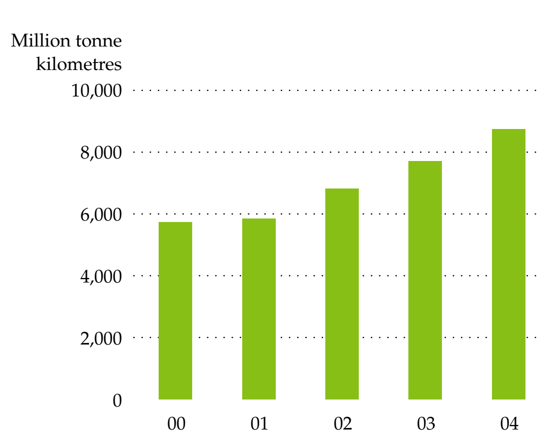
Cargo Services

It was a record year for cargo tonnage and revenue. Hong Kong continues to play an important role as the gateway to the Pearl River Delta, with demand on trunk services to Europe, Japan and the United States remaining strong. The launch of freighter services to Shanghai in January 2005 was another positive step forward in the Mainland market. AHK now operates a fleet of five A300-600 aircraft, and has confirmed orders for three more, enabling it to develop Hong Kong as an express cargo hub. Cargo yield decreased 1.1% to HK$1.76.

TURNOVER



CAPACITY – CARGO AND MAIL ATK



- At the end of 2004 Cathay operated a fleet of five B747- 400 and seven B747-200 freighter aircraft following the return of one leased B747-200 from AHK.

- Three additional wet-leased B747- 200 freighters provided additional capacity.

- A new B747-400 freighter was delivered in February 2005.

- Cathay is the world's first airline to take part in the new B747-400 passenger-to-freighter conversion programme and have so far committed to convert six aircraft with options to convert six more. The first conversion will be completed this year.

- During 2004, Cathay carried 972,416 tonnes of freight, setting a new annual record. Cargo ATKs grew by 13.4% while load factor for the year remained at 68.7%.

- Cargo revenue grew by 12.0% to HK$10,549 million, a new record.

- The adverse effect of higher fuel prices was partially relieved by cargo fuel surcharges.

- A thrice weekly freighter service was launched to Munich, strengthening Cathay's European operations.

- Freighter services to Shanghai commenced in January 2005.

	ATK (million)			Load factor (%)			Yield
	2004	2003	Change	2004	2003	Change	Change
Cathay	8,748	7,715	+13.4%	68.7	68.7	–	–1.1%

Review of subsidiaries and associates

AHK

- AHK, in which Cathay holds a 60% interest, is an all cargo carrier with a major focus on express cargo services for DHL Express.

- During the year, AHK expanded its express cargo network to Osaka, Penang and Taipei. It commenced operations to Seoul in February 2005. Together with Bangkok, Singapore and Tokyo, the company is now serving seven cities in Asia.

- The company took delivery of four A300-600 freighters in the second half of the year, replacing previously wet-leased aircraft. Another four A300-600 freighters will be delivered, two in 2005 and two in 2006. A B747- 200 freighter was returned to Cathay in mid October.

- Capacity, due to the network expansion, increased by 47.4% over 2003 whilst the load factor increased by 2.0 percentage points.

- Yield increased by 12.0% due to the expansion of the high yield express cargo business.

- AHK recorded a higher profit in 2004 as compared to 2003.

CPCS

- CPCS, a wholly owned subsidiary of Cathay, is the principal flight kitchen in Hong Kong.

- The company produced 17.7 million meals and accounts for 70% of the airline catering market in Hong Kong. Business volume increased by 35% over 2003.

- The company recorded a satisfactory profit in 2004 despite reducing meal prices and experiencing increased costs arising from the higher crude oil price and strong currencies.

- The performance of other inflight catering kitchens in Asia and Canada also recorded a healthy recovery from 2003 when the industry was badly affected by SARS.

HAS

- HAS, in which Cathay holds a 70% interest, is the largest franchised ramp handling company at Hong Kong International Airport.

- The company handled a record number of flights.

- As a result of the improving business environment and the continuation of stringent cost-controls, HAS achieved a record profit in 2004 despite operating in a very competitive market.

HAECO

- HAECO, in which Cathay holds a 27% interest, provides aircraft maintenance, modification and overhaul services at Hong Kong International Airport.

- The company achieved a consolidated profit after tax of HK$438 million, 27% above last year.

- HAECO has signed an agreement with the Airport Authority Hong Kong to build a second hangar at Hong Kong International Airport (HKIA). The new hangar, which is scheduled to open in early 2007, will strengthen HKIA's status as an aircraft maintenance hub.

- Taikoo (Xiamen) Aircraft Engineering Company Limited, 54% owned by HAECO and 9% owned by Cathay, had a profitable year. A fourth hangar is scheduled to open in early 2006.

- Hong Kong Aero Engine Services Limited, HAECO's joint venture with Rolls-Royce plc and SIA Engineering Pte Limited, continued to achieve good results through high workloads.

Dragonair

- Dragonair, in which Cathay holds a 22% interest, operates passenger services to 30 destinations in Asia, including 21 in China mainland. Dragonair also provides freighter services to ten destinations in Europe, Middle East, Japan, Taiwan and China mainland.

- Dragonair reported an improved profit in 2004 due to a strong recovery in passenger traffic after SARS together with the launch of new routes.

- Dragonair recorded a 51.3% increase in passenger revenue in 2004. Passenger numbers and load factor increased by 49.2% and 5.5 percentage points respectively while yield decreased by 2.3%.

- Dragonair uplifted 342,413 tonnes of cargo in 2004, 26.8% higher than 2003. Cargo revenue increased by 33.8% with the addition of a fourth freighter in July 2004. Cargo load factor decreased by 4.2 percentage points to 76.2%. Cargo yield increased by 5.8%.

- Dragonair increased the weekly passenger services to Shanghai to 87 and frequencies to most other China mainland destinations were also increased. The company temporarily suspended scheduled services to Phuket as demand for air traffic fell substantially following the tsunami disaster.

- Dragonair took delivery of one A330, two A320s and one B747-200F during the year, increasing the fleet size to 30 by end of 2004.

- With the relaxation of Individual Travel Scheme to more provinces in China mainland and the implementation of the Closer Economic Partnership Arrangement, Dragonair continues to be optimistic about the demand for air travel between Hong Kong and China mainland.

	ATK/ATK*(million)			Load factor (%)			Yield
	2004	2003	Change	2004	2003	Change	Change
Passenger services	9,176	6,483	+41.5%	64.9	59.4	+5.5%pt	–2.3%
Cargo services	1,425	1,069	+33.3%	76.2	80.4	–4.2%pt	+5.8%

* *Capacities of passenger and cargo services are measured in available seat kilometres ("ASK") and available tonne kilometres ("ATK") respectively.*

Fleet Profile

	Number as at 31 December 2004									
		Leased			Firm orders				Expiry of operating leases	
Aircraft type	Owned	Finance	Operating	Total	'05	'06	'07 & beyond	Total	'06	'07 & beyond
A320	2	2	6	10	1			1	2	4
A321	2		4	6						4
A330	2	3	5	10	3*	3*		6	1	4
B747-200F	1			1						
B747-300SF	3			3						
B747-400SF						2	3	5		
Total	10	5	15	30	4	5	3	12	3	12

* *Aircraft will be on operating lease.*

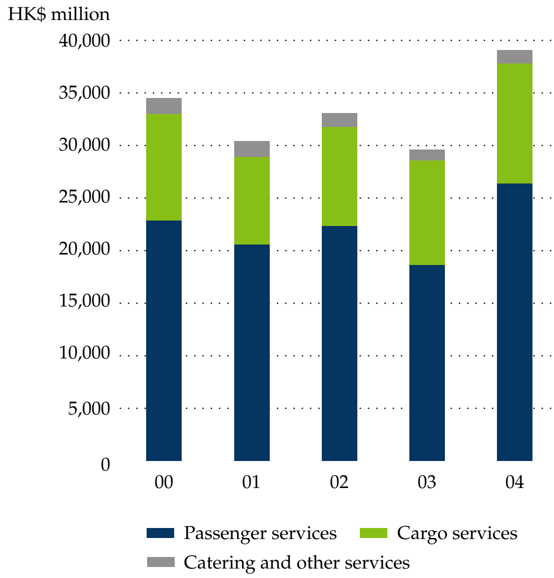
FINANCIAL REVIEW

Cathay Group reported an attributable profit of HK$4,417 million against a profit of HK$1,303 million in 2003. The substantial increase in profit reflects strong traffic demand.

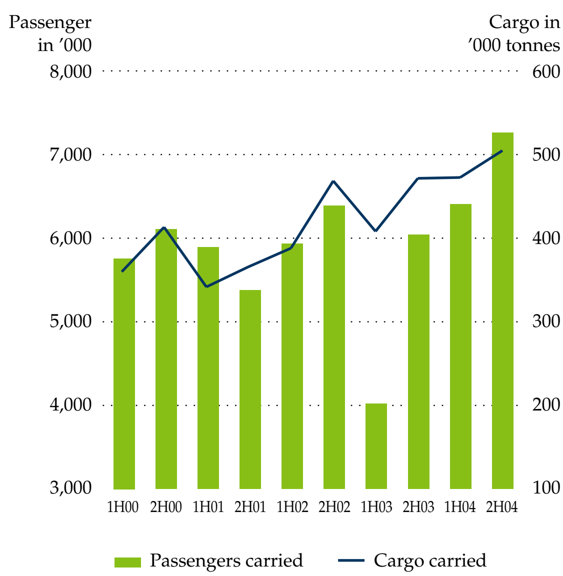
Turnover

	Cathay Group		Cathay	
	2004	2003	2004	2003
	HK$M	*HK$M*	*HK$M*	*HK$M*
Passenger services	26,407	18,663	26,407	18,663
Cargo services	11,395	9,913	10,549	9,417
Catering and other services	1,263	1,002	–	–
Turnover	39,065	29,578	36,956	28,080

CATHAY GROUP TURNOVER



CATHAY PASSENGERS AND CARGO CARRIED



- Cathy Group turnover rose by 32.1% on 2003.

- Passenger turnover increased significantly by 41.5% to HK$26,407 million as a result of improved demand. The number of passengers carried increased by 35.8% to 13.7 million and revenue passenger kilometres increased by 33.9%.

- Passenger load factor increased by 5.1 percentage points to 77.3% while capacity, in terms of available seat kilometres, increased by 24.9%.

- Passenger yield increased by 5.8% to HK¢45.8.

- First and business class revenues increased by 45.0% and the front end load factor increased from 57.6% to 63.1%. Economy class revenue increased by 39.9% and the economy class load factor increased from 75.0% to 80.0%.

- Cathay's cargo turnover increased by 12.0% to HK$10,549 million. The improvement represents the continued growth in exports from Southern China to Europe, Japan and the United States through Hong Kong.

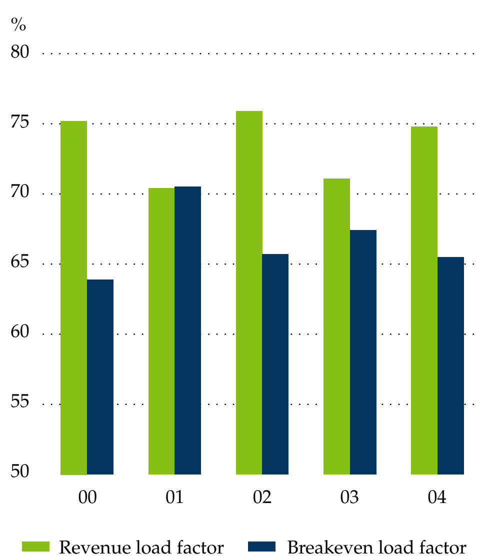
- Cathay's cargo load factor remained at 68.7% while capacity increased by 13.4%. Cargo yield decreased by 1.1% to HK$1.76.

The improvement in Cathay's turnover can be analysed as follows:

		HK$M
+24.9%	Passenger capacity	4,624
+13.4%	Cargo and mail capacity	1,261
+5.1% pt	Passenger load factor	1,693
–	Cargo and mail load factor	–
+5.8%	Passenger yield	1,427
–1.1%	Cargo and mail yield	(129)
		8,876

- Revenue load factor increased by 3.7 percentage points to 74.8% while the breakeven load factor fell by 1.9 percentage points to 65.5%.

REVENUE AND BREAKEVEN LOAD FACTOR



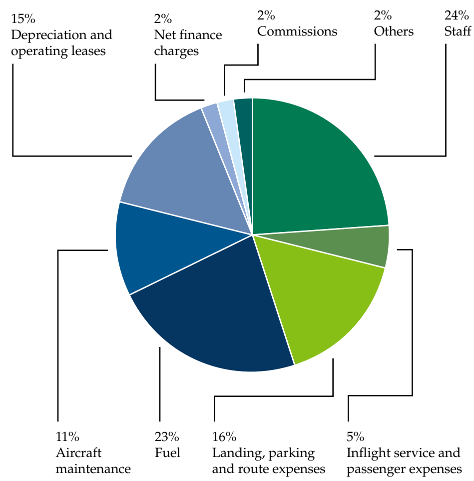
The annualised revenue effect on changes in yield and load factor is set out below:

	HK$M
+1 percentage point in passenger load factor	340
+1 percentage point in cargo and mail load factor	154
+HK ¢1 in passenger yield	573
+HK ¢1 in cargo and mail yield	60

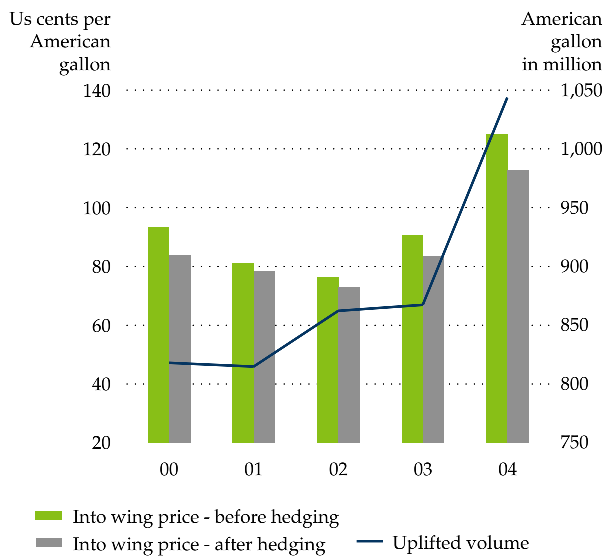
Operating Expenses

	Cathay Group			Cathay		
	2004	**2003**	**Change**	**2004**	**2003**	**Change**
	HK$M	*HK$M*		*HK$M*	*HK$M*	
Staff	8,842	8,035	+10.0%	7,985	7,318	+9.1%
Inflight service and passenger expenses	1,566	1,223	+28.0%	1,566	1,223	+28.0%
Landing, parking and route expenses	5,324	4,193	+27.0%	5,209	4,106	+26.9%
Fuel	7,836	5,236	+49.7%	7,704	5,164	49.2%
Aircraft maintenance	3,784	2,856	+32.5%	3,768	2,853	32.1%
Aircraft depreciation and operating leases	4,356	3,988	+9.2%	4,206	3,931	+7.0%
Other depreciation and operating leases	814	872	–6.7%	595	649	–8.3%
Commissions	529	400	+32.3%	529	398	+32.9%
Exchange gain	(199)	(244)	–18.4%	(201)	(247)	–18.6%
Others	966	794	+21.7%	820	721	+13.7%
Operating expenses	33,818	27,353	+23.6%	32,181	26,116	+23.2%
Net finance charges	583	620	–6.0%	556	606	–8.3%
Total operating expenses	34,401	27,973	+23.0%	32,737	26,722	+22.5%

CATHAY TOTAL OPERATING EXPENSES



CATHAY: FUEL PRICE AND CONSUMPTION



- Staff costs increased due to an increase in average staff numbers and the resumption of bonus and profit share payments.

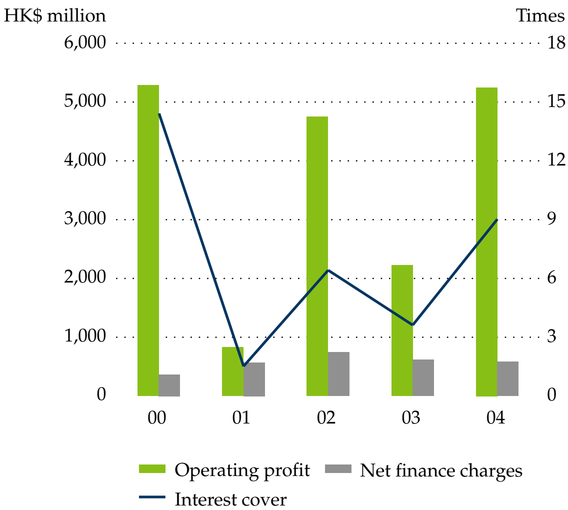
- Inflight service and passenger expenses increased due to the increase in passenger numbers.

- Landing, parking and route expenses rose as a result of increased operations.

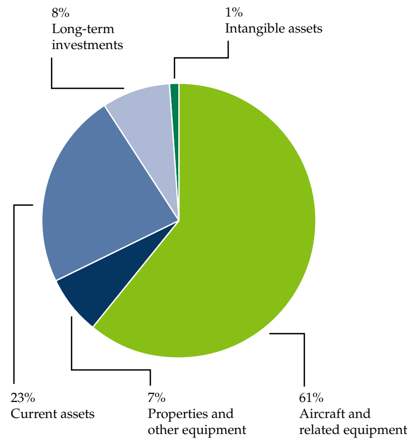
- Fuel costs increased mainly due to the 38% increase in the average fuel price.

- Aircraft maintenance increased as a result of the fleet expansion and increased operations.

CATHAY GROUP INTEREST COVER



CATHAY GROUP TOTAL ASSETS



- Aircraft depreciation and operating leases increased due to the new aircraft deliveries.
- Net finance charges decreased due to the lower average net borrowings.
- Cathay's cost per ATK increased from HK$2.00 to HK$2.07 due to higher fuel prices.

Associated Companies

- The share of profits from associated companies increased by 135.8% to HK$356 million.
- Both HAECO and Dragonair reported higher profits than 2003 as a result of improved traffic and the improved business environment in Hong Kong.

Taxation

- The tax charge of HK$504 million was HK$95 million higher than the previous year as a result of increased profit.

Dividends

- Dividends paid and proposed for the year are HK$2,191 million representing a dividend cover of 2.0 times.
- Dividends per share increased from HK¢48 to HK¢65.

Assets

- Total assets as at 31 December 2004 amounted to HK$75,284 million.

- During the year, additions to fixed assets were HK$4,329 million, comprising HK$4,244 million for aircraft and related equipment and HK$85 million for other equipment and properties.

Borrowings and Capital

- Borrowings decreased by 13.9% to HK$22,631 million compared with HK$26,297 million in 2003.

- Borrowings are mainly denominated in US dollar, Euro, Japanese yen and Sterling, and are fully repayable by 2018 with 58% at fixed rates of interest.

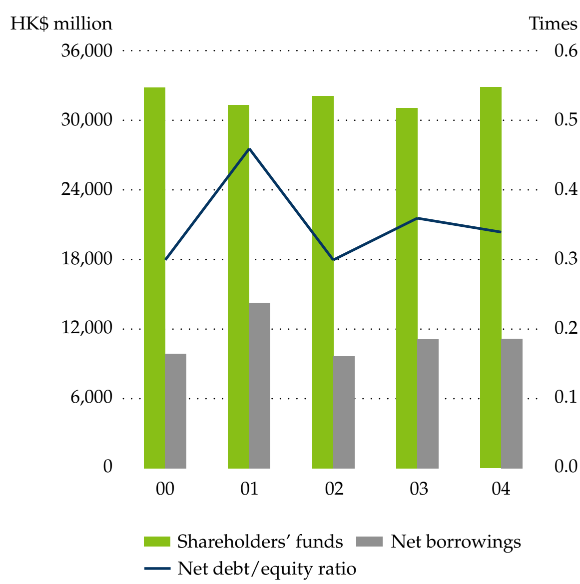
- Liquid funds, 73% of which are denominated in US dollar, decreased by 24.5% to HK$11,474 million.

- Net borrowings increased by 0.7% to HK$11,187 million.

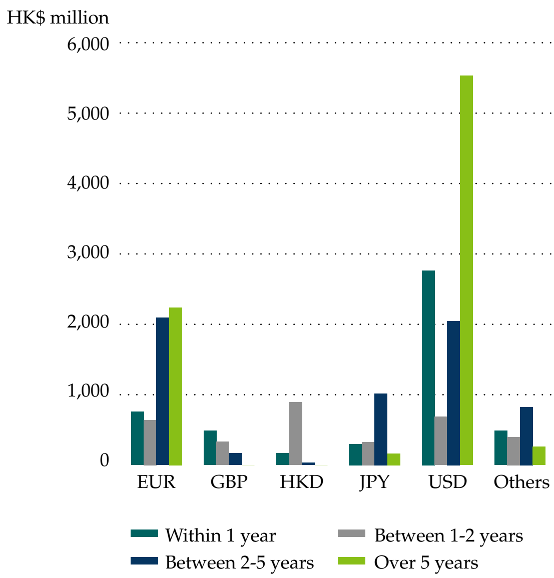
- Cathay's Group's shareholders' funds increased by 5.8% to HK$32,855 million.

- Net debt/equity ratio decreased from 0.36 times to 0.34 times.

CATHAY GROUP NET DEBT AND EQUITY



CATHAY GROUP MATURITY PROFILE BY CURRENCY: BORROWINGS



Others include AUD, CAD, KRW, NZD, SGD and TWD.

Financial Risk Management Policy

- In the normal course of business Cathay is exposed to movements in foreign exchange rates, interest rates and jet fuel prices.

- These exposures are managed, sometimes with the use of derivative financial instruments, in accordance with policies approved by the Finance Committee.

- Derivative financial instruments are used solely for financial risk management purposes and the company does not hold or issue derivative financial instruments for trading purposes.

- Derivative financial instruments which constitute a hedge do not expose Cathay to market risk since any change in their market value will be offset by a compensating change in the market value of the asset, liability or transaction being hedged.

- Exposures to movements in foreign exchange rates, interest rates and jet fuel prices are regularly reviewed and positions are amended in compliance with policy guidelines.

- To manage credit risk, transactions are only carried out with financial institutions of high repute and all counterparties are subject to prescribed trading limits which are regularly reviewed. Risk exposures are monitored regularly by reference to market values.

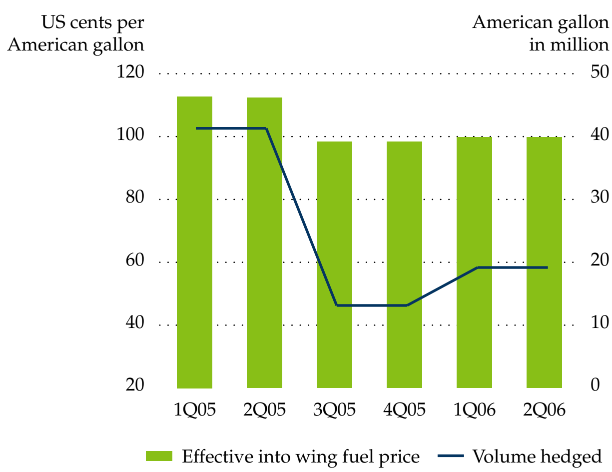
Management of Currency Exposures

- As an international airline, Cathay's revenue streams are denominated in a number of foreign currencies resulting in exposure to fluctuations in foreign exchange rates.

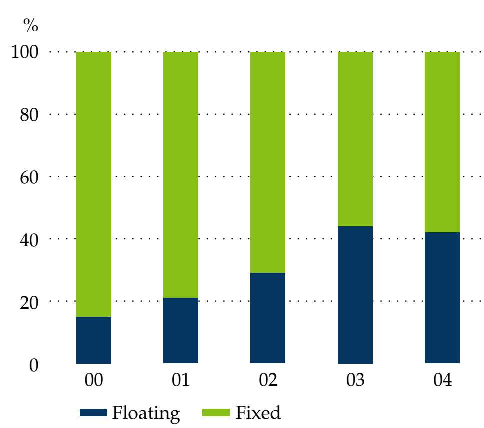
- To manage this exposure, assets are, where possible, financed in those foreign currencies in which net operating surpluses are anticipated, thereby establishing a natural hedge. In addition, Cathay uses currency derivatives to reduce anticipated foreign currency surpluses.

The use of foreign currency borrowings and currency derivatives to hedge future operating revenues is a key component of the financial risk management process. Exchange differences realised on the repayment of financial commitments are effectively matched by the change in value of the foreign currency earnings used to make those repayments.

CATHAY FUEL HEDGING



CATHAY GROUP INTEREST RATE PROFILE: BORROWINGS



Value Added

The following table summarises the distribution of the Cathay Group's value added in 2003 and 2004.

	2004	2003
	HK$M	*HK$M*
Total revenue	39,065	29,578
Less: Purchases of goods and services	(21,281)	(15,846)
Value added by Cathay Group	17,784	13,732
Add: Income from investments	106	273
Share of profits of associated companies	356	151
Total value added available for distribution	18,246	14,156
Applied as follows:		
To employees		
Salaries and other staff costs	8,842	8,035
To governments		
Corporation taxes	504	409
To providers of capital		
Dividends – paid	674	100
– proposed	1,517	1,515
Minority interests	99	44
Net finance charges	583	620
Retained for re-investment and future growth		
Depreciation	3,801	3,745
Profit /(loss) after dividends	2,226	(312)
Total value added	18,246	14,156

– The Cathay Group value added increased by HK$4,090 million mainly due to an increase in revenue.

– Dividends paid and proposed increased by HK$576 million while the amount retained for re-investment and future growth increased by HK$2,594 million.

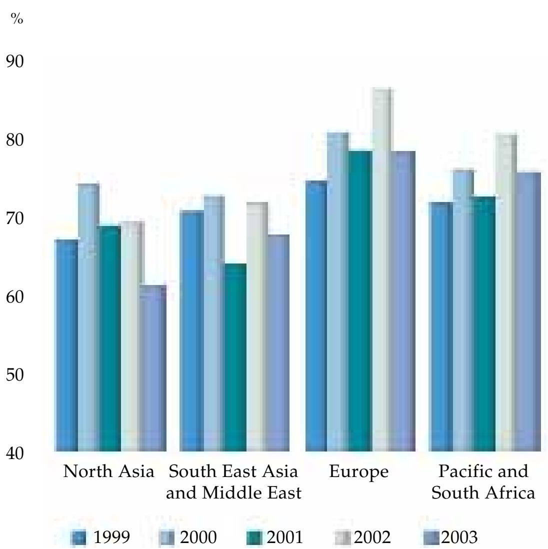
(c) For the year ended 31 December 2003

REVIEW OF OPERATIONS

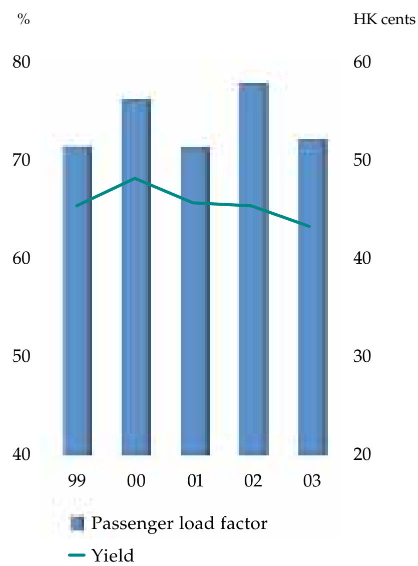
Passenger services

Due to the impact of SARS the year saw an 18.4% decrease to 10.1 million in the number of passengers carried. During the SARS crisis Cathay reduced its passenger schedule by 45% and parked 22 aircraft. All suspended services were restored by the end of September and additional services were added to the winter schedule. Passenger numbers and yield improved in the fourth quarter of the year. Passenger yield for 2003 declined 4.6% to HK43.3 cents.

Load factor by region



Passenger load factor and yield



Available seat kilometres ("ASK"), load factor and yield by region:

	ASK (million)			Load factor (%)			Yield
	2003	2002	Change	2003	2002	Change	Change
North Asia	9,436	11,022	–14.4%	61.3	69.2	–7.9% pt	–9.2%
South East Asia and Middle East	12,775	14,063	–9.2%	67.7	71.8	–4.1% pt	–3.8%
Europe	12,712	13,291	–4.4%	78.2	86.4	–8.2% pt	+4.4%
Pacific and South Africa	24,357	24,674	–1.3%	75.6	80.4	–4.8% pt	–0.1%
Overall	59,280	63,050	–6.0%	72.2	77.8	–5.6% pt	–4.6%

Comments by region are as follows:

North Asia

- Passenger yields and volumes from Japan were depressed by a general reluctance to travel in the wake of SARS.

- Following SARS, Korea's leisure travel market recovered faster than the business market.

- Taipei remained strong despite sustained pressure on yields in a highly competitive market.

South East Asia and Middle East

- After SARS, markets in the Middle East were well supported by high volumes of contract workers while business travel recovered at a slower rate.

- South East Asian routes experienced a healthy recovery in the second half, helped by pricing initiatives.

- Strong growth in the Indian market continued to support passenger yields.

- A large proportion of long haul passengers connect through our hub at Hong Kong International Airport to destinations in South East Asia and the Middle East.

Europe

- The resumption of trade shows in Hong Kong and China mainland and the lifting of corporate travel restrictions increased business travel in the second half of the year.

- Following SARS, business traffic on the European routes rebounded strongly.

- With strong demand on the London route, services were increased in August to three times daily. All three daily services performed well.

- A fifth weekly service was added to Rome following Cathay's first codeshare with **one**world partner Qantas.

- Strong European currencies helped to increase their dollar revenues.

Pacific and South Africa

- Australia and New Zealand performed well and additional services were launched to Auckland and Melbourne.

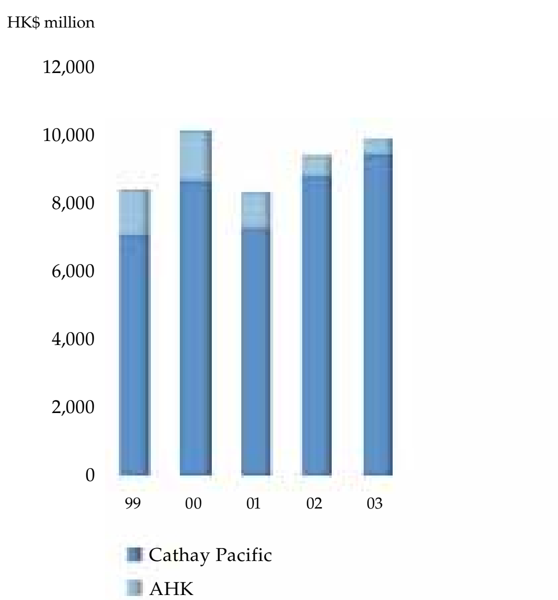
- A sixth weekly service was launched to Johannesburg. The route continued to perform well.

- The transpacific market recovered swiftly after SARS and Los Angeles was returned to a double-daily service at the end of September.

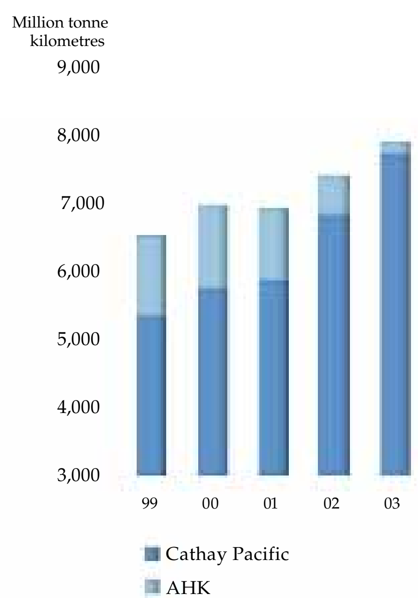
Cargo services

2003 was a good year for cargo, both in terms of revenue and freight tonnage. Growth was driven by demand for goods exported through Hong Kong, in particular to markets in Europe, Japan and the United States. Cargo revenue contributed 33.5% to the Cathay Group turnover.

Turnover



Capacity – cargo and mail ATK



	ATK (million)			Load factor (%)			Yield
	2003	2002	Change	2003	2002	Change	Change
Cathay	7,715	6,822	+13.1%	68.7	71.2	–2.5% pt	–1.1%
AHK	176	585	–69.9%	56.9	69.1	–12.2% pt	+218.1%

Cathay

- Cathay operates a fleet of five B747-400 and six B747-200 freighters to 25 destinations worldwide. Freight is also carried in the belly holds of their passenger aircraft.

- During 2003, 874,724 tonnes of freight was carried, setting a new annual record. Cargo ATKs grew by 13.1%, due mainly to the integration of AHK's European operations. Load factor for the year dropped to 68.7%.

- Revenue in 2003 grew by 7.5% due to a strong growth in exports from Hong Kong to Europe, the United States and Asian destinations.

- The war in the Middle East had no effect on cargo operations. However, SARS caused a significant reduction in Cathay's passenger schedule, resulting in a reduction in cargo capacity of 15% during the affected period. A previously parked B747-200 freighter was reactivated in May.

- Osaka and Singapore were added to Cathay's freighter network during the year.

- During the year, frequencies to Brussels, Manchester, Milan and cities in the United States increased as demand in these markets grew.

- Cargo yield was maintained at HK$1.78 with the dilutionary impact of additional lower yield long haul services being offset by favourable currencies.

- Cathay is to be the launch customer for Boeing's freighter conversion program for the B747-400 passenger aircraft. The conversion will be undertaken by Taikoo (Xiamen) Aircraft Engineering Company Limited ("TAECO") with the first aircraft expected to be delivered in December 2005 and another five by 2007.

AHK

- In March, DHL International Limited ("DHL") acquired an additional 10% shareholding in AHK from Cathay. DHL now has a 40% interest in AHK.

- AHK continues to operate scheduled services to Osaka and Seoul and charter flights for Cathay using a B747-200 freighter.

- AHK commenced a four times weekly express cargo service to Bangkok in March while a five times weekly service to Singapore was started in October.

- Capacity, due to the full year effect of the return of two B747-200 freighters to Cathay, fell by 69.9% over 2002 whilst the load factor decreased by 12.2 percentage points.

- Yield increased due to the transfer of the lower yielding European services to Cathay in 2002.

- AHK recorded a satisfactory profit in 2003.

CPCS

- CPCS, a wholly owned subsidiary of Cathay, is the principal flight kitchen in Hong Kong.

- The company produced 13 million meals and accounts for 72% of the airline catering market in Hong Kong.

- The performance of the company was seriously affected by the SARS outbreak in March and stringent cost-controls were implemented. Recovery was seen in the second half as passenger traffic picked up, though pressure on meal prices continued.

HAS

- HAS, in which Cathay holds a 70% interest, is the largest franchised ramp handling company at Hong Kong International Airport.

- Services include aircraft loading, passenger steps and air-bridge operation, baggage handling, passenger and staff buses, aircraft load control and cargo and mail delivery.

- The total number of flights handled in 2003 was lower than in the previous year due to flight cancellations resulting from the SARS outbreak.

- In the circumstances HAS reported a satisfactory profit for the year.

HAECO

- HAECO, in which Cathay holds a 27% interest, provides aircraft maintenance, modification and overhaul services at Hong Kong International Airport.

- The company achieved a consolidated profit after tax of HK$345 million, 25.8% below last year, reflecting the effect of the SARS outbreak on business volumes.

- TAECO, 49% owned by HAECO and 9% owned by Cathay, had a profitable year. A third hangar was opened in 2003.

- Hong Kong Aero Engine Services Limited, HAECO's joint venture with Rolls-Royce plc and SIA Engineering Pte Limited, continued to achieve good results with high workloads.

Dragonair

	ASK/ATK* (million)			Load factor (%)			Yield
	2003	2002	Change	2003	2002	Change	Change
Passenger services	6,483	6,657	–2.6%	59.4	65.3	–5.9%pt	–8.6%
Cargo services	1,069	814	+31.3%	80.4	79.5	+0.9%pt	+8.6%

* *Capacities of passenger and cargo services are measured in available seat kilometres ("ASK") and available tonne kilometres ("ATK") respectively.*

- Dragonair, in which Cathay holds a 19% interest, offers passenger services to 28 destinations in Asia, including 20 in China mainland. Dragonair also provides freighter services to seven destinations in Europe, Middle East, Japan, Taiwan and China mainland.

- Dragonair's result was seriously affected by the SARS outbreak. However, the company returned to profit as the demand for passenger travel recovered in the second half of the year.

- Dragonair recorded an 11.1% decrease in passenger numbers in 2003. Passenger yield decreased by 8.6% as a result of special offers to stimulate passenger traffic. Passenger load factor, despite flight cancellations, was down by 5.9 percentage points to 59.4% in 2003.

- Cargo services were less affected by the SARS outbreak. The company carried 269,980 tonnes of cargo in 2003, 39.5% higher than last year. Cargo load factor increased by 0.9 percentage point to 80.4% while capacity increased by 31.3% as a result of the third freighter joining the fleet in late 2002. Cargo yield increased by 8.6% due to a higher proportion of regional freighter services.

- From the winter season, Dragonair increased weekly frequencies of passenger services to Beijing and Shanghai to 56 and 74 respectively. To cope with growing traffic demand, frequencies on most China mainland routes were also increased. The company commenced its twice daily passenger service to Bangkok in November. Services to Sendai and Hiroshima have been suspended since the SARS outbreak in April. The joint venture service with Malaysian Airlines to Kuching was also terminated in April.

Fleet profile as at 31 December 2003:

	Number as at 31 December 2003							Expiry of operating leases	
		Leased			Firm orders				
Aircraft type	Owned	Finance	Operating	Total	'04	'05	Total	'05	'06 & beyond
A320		2	6	8	2	1	3		6
A321	2		4	6					4
A330	2	3	4	9	1	3	4*	1	3
B747-200F					1		1		
B747-300F	3			3					
Total	7	5	14	26	4	4	8	1	13

* *Aircraft will be on operating lease.*

- Dragonair took delivery of two A321s and as a result the fleet size increased to 26 at the end of 2003.

- A cabin and inflight entertainment upgrade across the A330 fleet is to be completed by the end of 2004.

- With the relaxation on individual travel from China mainland to Hong Kong and the signing of the Closer Economic Partnership Arrangement, Dragonair is optimistic about the demand for air travel between Hong Kong and China mainland.

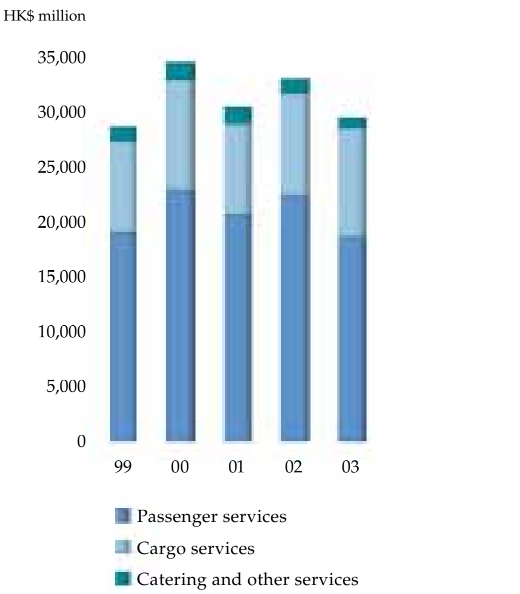
FINANCIAL REVIEW

The Cathay Group reported an attributable profit of HK$1,303 million against a profit of HK$3,983 million in 2002. The significant decrease in profit was due to the sharp fall in passenger numbers during the SARS outbreak.

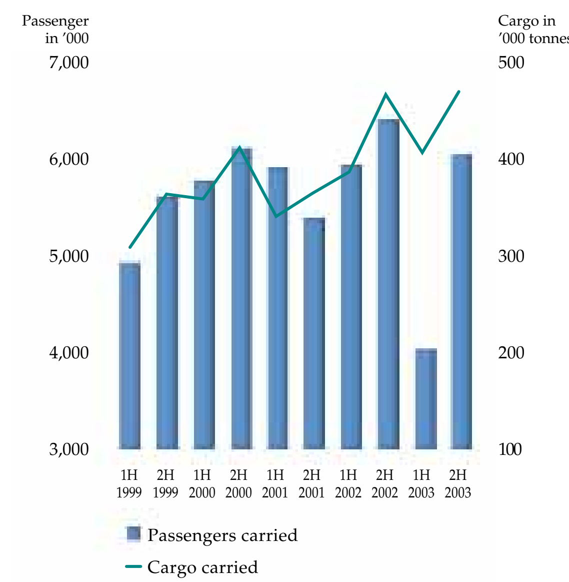
Turnover

	Cathay Group		Cathay	
	2003	2002	2003	2002
	HK$M	*HK$M*	*HK$M*	*HK$M*
Passenger services	18,663	22,376	18,663	22,376
Cargo services	9,913	9,387	9,417	8,758
Catering and other services	1,002	1,327	–	–
Turnover	29,578	33,090	28,080	31,134

Cathay Group turnover



Cathay passengers and cargo carried



- Cathay Group turnover reduced by 10.6% on 2002.

- Passenger services turnover decreased significantly by 16.6% to HK$18,663 million mainly due to a reduction in passenger numbers after the SARS outbreak. The number of passengers carried decreased by 18.4% to 10.1 million while the passenger traffic in revenue passenger kilometres decreased by 12.8%.

- Despite the 6.0% reduction in capacity in terms of available seat kilometres, the passenger load factor still decreased by 5.6 percentage points to 72.2%.

- Passenger yield decreased by 4.6% to HK¢43.3 as a result of special offers.

- First and business class revenues reduced by 13.4% and the front end load factor decreased from 58.9% to 57.6%. Economy class revenue also decreased by 18.2% and the economy class load factor dropped from 81.8% to 75.0%.

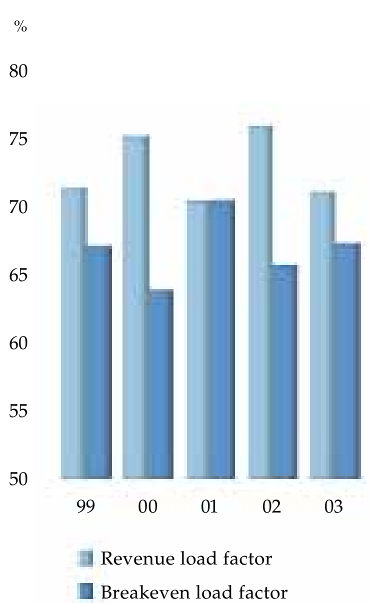
- Cathay's cargo turnover increased by 7.5% to HK$9,417 million. The improvement represents the continued growth in exports from Hong Kong and additional traffic following the integration of AHK's European operations.

- Cathay's cargo load factor decreased by 2.5 percentage points to 68.7% whilst capacity increased by 13.1%. Cargo yield also declined by 1.1% to HK$1.78.

The reduction in Cathay's turnover can be analysed as follows:

		HK$M
–6.0%	Passenger capacity	(1,330)
+13.1%	Cargo and mail capacity	1,147
–5.6% pt	Passenger load factor	(1,522)
–2.5% pt	Cargo and mail load factor	(345)
–4.6%	Passenger yield	(861)
–1.1%	Cargo and mail yield	(143)
		(3,054)

Revenue and breakeven load factor



- Revenue load factor decreased by 4.8 percentage points to 71.1% while the breakeven load factor rose by 1.7 percentage points to 67.4%.

- The annualised revenue effect on changes in yield and load factor is set out below:

	HK$M
+ 1 percentage point in passenger load factor	257
+ 1 percentage point in cargo and mail load factor	137
+ HK¢1 in passenger yield	428
+ HK¢1 in cargo and mail yield	53

Operating expenses

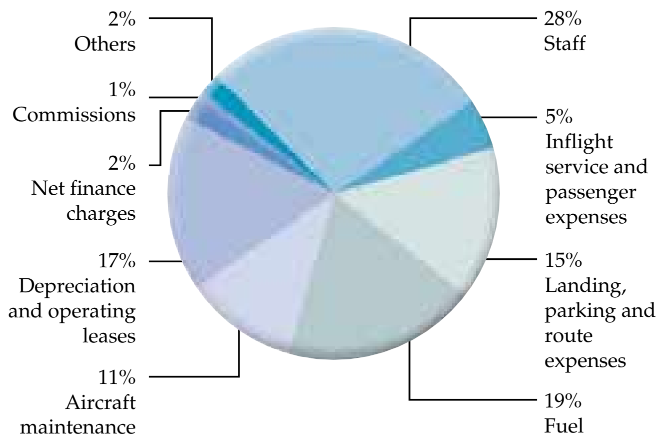
	Cathay Group			Cathay		
	2003	**2002**	**Change**	**2003**	**2002**	**Change**
	HK$M	*HK$M*		*HK$M*	*HK$M*	
Staff	8,035	7,918	+1.5%	7,318	7,130	+2.6%
Inflight service and passenger expenses	1,223	1,464	–16.5%	1,223	1,464	–16.5%
Landing, parking and route expenses	4,193	4,649	–9.8%	4,106	4,468	–8.1%
Fuel	5,236	4,895	+7.0%	5,164	4,735	+9.1%
Aircraft maintenance	2,856	3,312	–13.8%	2,853	3,194	–10.7%
Aircraft depreciation and operating leases	3,988	3,711	+7.5%	3,931	3,624	+8.5%
Other depreciation and operating leases	872	1,009	–13.6%	649	765	–15.2%
Commissions	400	501	–20.2%	398	498	–20.1%
Exchange gain	(244)	(179)	+36.3%	(247)	(169)	+46.2%
Others	794	1,060	–25.1%	721	913	–21.0%
Operating expenses	27,353	28,340	–3.5%	26,116	26,622	–1.9%
Net finance charges	620	743	–16.6%	606	723	–16.2%
Total operating expenses	27,973	29,083	–3.8%	26,722	27,345	–2.3%

- Staff costs increased due to an increase in average staff numbers.

- Inflight service and passenger expenses decreased due to a reduction in passenger numbers and cost-control initiatives.

- Landing, parking and route expenses fell as a result of flight cancellations.

Cathay: total operating expenses

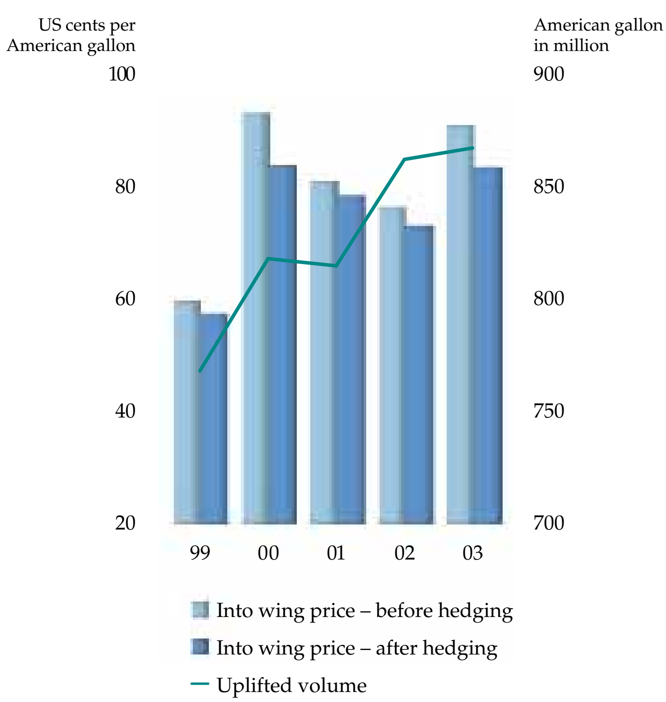


- Fuel costs increased mainly due to the 18.5% increase in the average fuel price.

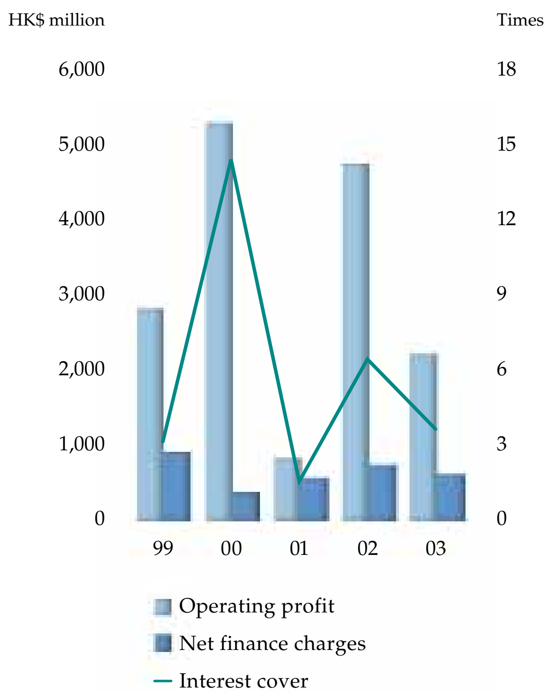
- Aircraft maintenance decreased as a result of flight cancellations and the temporary parking of aircraft.

- Aircraft depreciation and operating leases increased due to the new aircraft deliveries

Cathay: fuel price and consumption



Cathay Group interest cover



- Net finance charges decreased due to the lower average net borrowings.

- Cathay's cost per ATK reduced from HK$2.13 to HK$2.00 due to more cargo flights and cost saving initiatives.

Associated companies

- The share of profits from associated companies reduced by 53.2% to HK$126 million.

- Dragonair's result was adversely affected by the SARS outbreak in Hong Kong, China Mainland and Taiwan.

- HAECO reported a lower profit than 2002 largely due to flight cancellations.

Taxation

- Despite reduced profits the tax charge at HK$409 million was HK$81 million higher than in the previous year as a result of both increased overseas charges and prior year under provisions.

Dividends

- Dividends paid and proposed for the year are HK$1,604 million representing a dividend cover of 0.8 times.

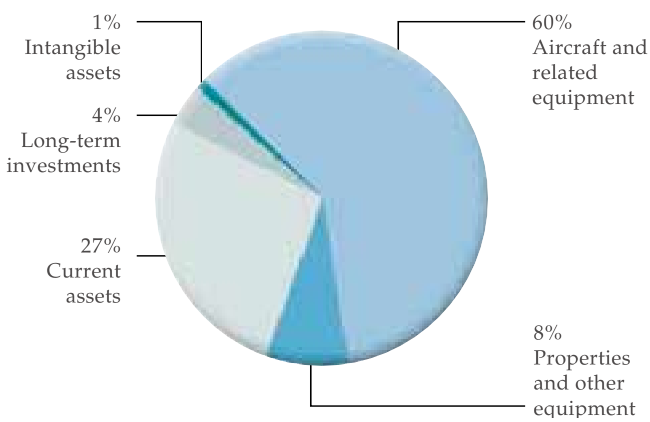
- Dividends per share increased from HK¢44 to HK¢48.

Assets

- Total assets as at 31 December 2003 amounted to HK$75,037 million.

- During the year, additions to fixed assets were HK$5,121 million, comprising HK$5,027 million for aircraft and related equipment and HK$94 million for properties and other equipment.

Cathay Group total assets



Borrowings and Capital

- Borrowings increased by 15.3% to HK$26,297 million compared with HK$22,810 million in 2002.

- Borrowings are mainly denominated in US dollar, Japanese yen, Sterling and Euro, and are fully repayable by 2017 with 56% at fixed rates of interest.

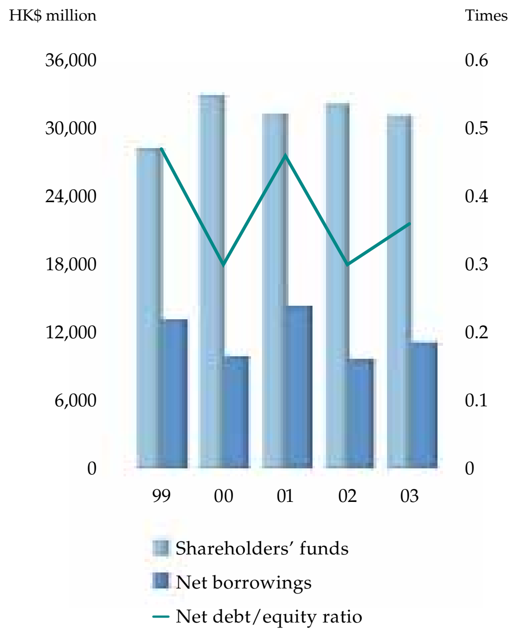
- Liquid funds, 66% of which are denominated in US dollar, increased by 15.3% to HK$15,200 million.

- Net borrowings increased by 15.2% to HK$11,111 million.

- Cathay Group's shareholders' funds decreased by 3.3% to HK$31,052 million.

Net debt/equity ratio increased from 0.30 times to 0.36 times.

Cathay Group net debt and equity



Financial risk management policy

- In the normal course of business Cathay is exposed to movements in foreign exchange rates, interest rates and jet fuel prices.

- These exposures are managed, sometimes with the use of derivative financial instruments, in accordance with policies approved by the Finance Committee.

- Derivative financial instruments are used solely for financial risk management purposes and Cathay does not hold or issue derivative financial instruments for trading purposes.

- Derivative financial instruments which constitute a hedge do not expose Cathay to market risk since any change in their market value will be offset by a compensating change in the market value of the asset, liability or transaction being hedged.

- Exposures to movements in foreign exchange rates, interest rates and jet fuel prices are regularly reviewed and positions are amended in compliance with policy guidelines.

- To manage credit risk, transactions are only carried out with financial institutions of high repute and all counterparties are subject to prescribed trading limits which are regularly reviewed. Risk exposures are monitored regularly by reference to market values.

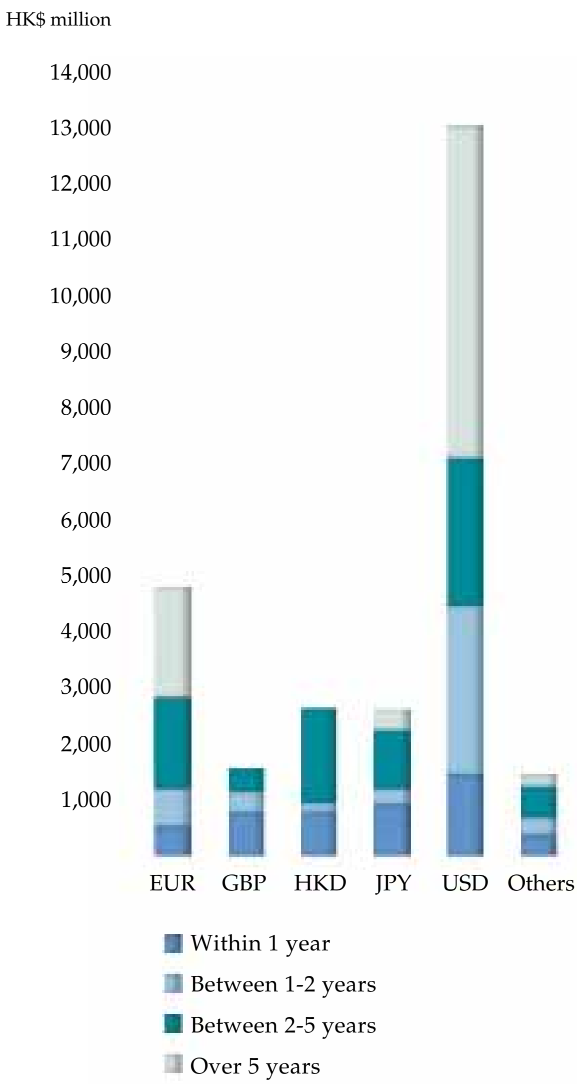
Management of currency exposures

- As an international airline, Cathay's revenue streams are denominated in a number of foreign currencies resulting in exposure to fluctuations in foreign exchange rates.

- To manage this exposure assets are, where possible, financed in those foreign currencies in which net operating surpluses are anticipated, thereby establishing a natural hedge. In addition, Cathay uses currency derivatives to reduce anticipated foreign currency surpluses.

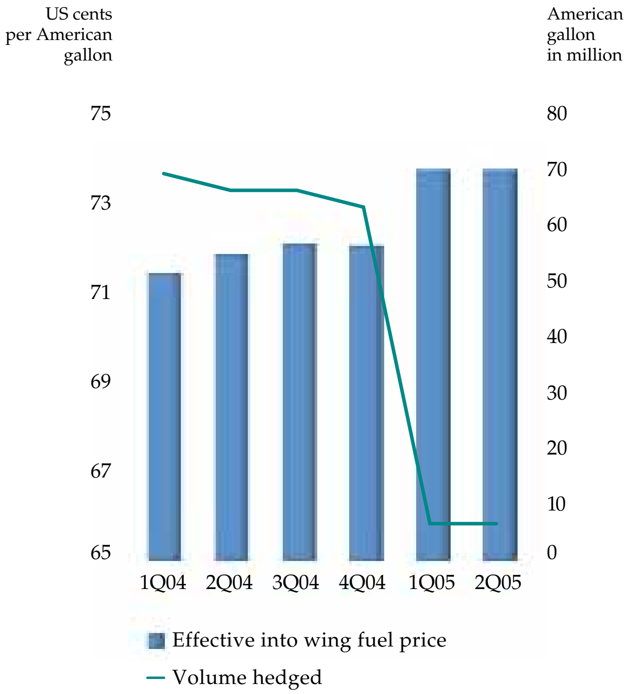
- The use of foreign currency borrowings and currency derivatives to hedge future operating revenues is a key component of the financial risk management process. Exchange differences realised on the repayment of financial commitments are effectively matched by the change in value of the foreign currency earnings used to make those repayments.

Cathay Group maturity profile by currency: borrowings

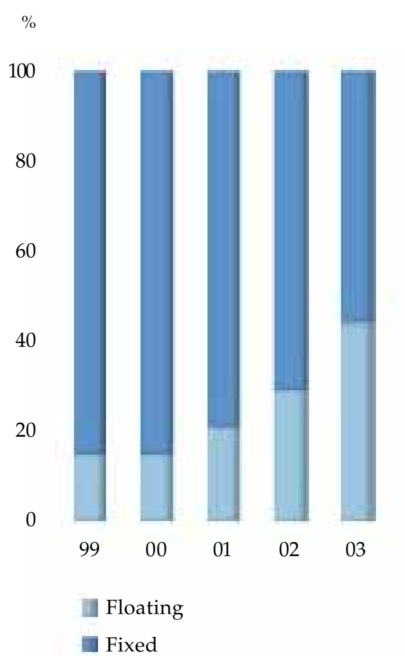


Others include AUD, CAD, KRW, NZD, SGD and TWD.

Cathay: fuel hedging



Cathay Group interest rate profile: borrowings



Value added

The following table summarises the distribution of the Cathay Group's value added in 2002 and 2003.

	2003	**2002**
	HK$M	*HK$M*
Total revenue	29,578	33,090
Less: Purchases of goods and services	(15,846)	(16,688)
Value added by the Cathay Group	13,732	16,402
Add: Income from investments	273	95
Share of profits of associated companies	151	324
Total value added available for distribution	14,156	16,821
Applied as follows:		
To employees		
– Salaries and other staff costs	8,035	7,918
To government		
– Corporation taxes	409	328
To providers of capital		
– Dividends – paid	100	534
– proposed	1,504	935
– Minority interests	44	20
– Net finance charges	620	743
Retained for re-investment and future growth		
– Depreciation	3,745	3,829
– (Loss)/profit after dividends	(301)	2,514
Total value added	14,156	16,821

- Cathay Group value added decreased by HK$2,665 million mainly due to a reduction in revenue partly offset by cost savings.

- Dividends paid and proposed increased by HK$135 million while the amount retained for re-investment and future growth decreased by HK$2,899 million.

A. UNAUDITED PRO FORMA FINANCIAL INFORMATION

I. UNAUDITED PRO FORMA CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2005

The following is an illustrative and pro forma consolidated income statement of the Company which has been prepared on the basis of the notes set out below for the purpose of illustrating the effect of the Disposal and Acquisition as if it had taken place on 1 January 2005. This unaudited pro forma financial information has been prepared for illustrative purposes only and because of its hypothetical nature, it may not give a true picture of the financial results of the Group had the Disposal and Acquisition been completed at 1 January 2005 or at any future dates.

	Before Disposal and Acquisition	Pro forma adjustments			After Disposal and Acquisition
	HK$'000	*HK$'000*	*HK$'000*	*HK$'000*	*HK$'000*
	(Note 1)	*(Note 2)*	*(Note 3)*	*(Note 4)*	
Turnover	2,620,033				2,620,033
Other revenues	46,985			187,588	234,573
Total revenues	2,667,018				2,854,606
Other gains	39,268		3,286,915		3,326,183
Staff costs	(388,649)				(388,649)
Passenger catering and service costs	(237,545)				(237,545)
Fuel costs	(654,018)				(654,018)
Route operating costs	(529,051)				(529,051)
Aircraft maintenance costs	(226,553)				(226,553)
Aircraft leases and equipment costs	(444,882)				(444,882)
Depreciation and amortisation costs	(78,221)				(78,221)
Sales and promotion costs	(92,395)				(92,395)
Other operating costs	(107,289)				(107,289)
Total operating expenses	(2,758,603)				(2,758,603)
Operating (loss)/profit	(52,317)				3,422,186
Finance costs	(2,960)				(2,960)
Share of profits less losses of associates	277,243	(130,061)			147,182
Profit before income tax	221,966				3,566,408
Income tax	(10,042)				(10,042)
Profit for the year	211,924				3,556,366
Attributable to:					
Equity holders of the Company	225,000				3,569,442
Minority interests	(13,076)				(13,076)
	211,924				3,556,366

Notes to the unaudited pro forma consolidated income statement

1. The consolidated income statement for the year ended 31 December 2005 has been extracted from the accountants' report of the Group as set out in Appendix I to this circular.

2. The adjustment relates to the exclusion of the Group's share of Dragonair's profit from the Company's consolidated income statement for the year ended 31 December 2005 as if the Disposal had been taken place on 1 January 2005.

3. The adjustment reflects the estimated gain on the Disposal which is determined based on the aggregate of (1) the fair value of 288,596,335 new Cathay Shares based on the closing market price at 1 January 2005 and (2) cash consideration of HK$432,894,498; less (3) the Group's Share of net asset value of Dragonair at 1 January 2005 and (4) estimated expenses of HK$17,100,000 directly attributable to the Disposal.

   Since the fair value of Cathay Shares and the net asset value of Dragonair at the date of Completion may be substantially different from their respective values used in the preparation of the unaudited pro forma financial information, the final amount of the gain on the Disposal will be different from those presented above.

4. The adjustment relates to the recognition of dividend income from Cathay in respect of 2004 final dividend of HK$0.45 per Cathay Share and 2005 interim dividend of HK$0.20 per Cathay Share declared by Cathay during the year ended 31 December 2005 as if the Acquisition had been completed on 1 January 2005.

5. Under the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following the Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share. Such special dividend has not been reflected in the unaudited pro forma consolidated income statement.

6. No adjustment has been made to reflect any trading result or other transaction of the Group entered into subsequent to 31 December 2005.

II. UNAUDITED PRO FORMA CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 2005

The following is an illustrative and pro forma consolidated balance sheet of the Company which has been prepared on the basis of the notes set out below for the purpose of illustrating the effect of the Disposal and Acquisition as if it had taken place on 31 December 2005. This unaudited pro forma financial information has been prepared for illustrative purposes only and because of its hypothetical nature, it may not give a true picture of the financial position of the Group had the Disposal and Acquisition been completed at 31 December 2005 or at any future dates.

	Before Disposal and Acquisition	Pro forma adjustment	After Disposal and Acquisition
	HK$'000	*HK$'000*	*HK$'000*
	(Note 1)	*(Note 2)*	
ASSETS			
Non-current assets			
Property, plant and equipment	471,692		471,692
Land use right	2,274		2,274
Intangible assets	529,240		529,240
Interests in associates	1,627,594	(1,365,917) (a)	261,677
Loans to associates	47,097		47,097
Available-for-sale investment	–	3,910,480 (b)	3,910,480
Lease and equipment deposits	60,109		60,109
Deferred income tax assets	23,427		23,427
Pledged bank deposits	88,943		88,943
	2,850,376		5,394,939
Current assets			
Loan to an associate	18,060		18,060
Derivative financial instruments	11,957		11,957
Inventories	53,273		53,273
Trade and other receivables	283,544		283,544
Cash and cash equivalents	999,833	415,794 (c)	1,415,627
	1,366,667		1,782,461
Total assets	4,217,043		7,177,400

	Before Disposal and Acquisition *HK$'000* *(Note 1)*	Pro forma adjustment *HK$'000* *(Note 2)*	After Disposal and Acquisition *HK$'000*
EQUITY			
Capital and reserves attributable to the Company's equity holders			
Share capital	(331,268)		(331,268)
Reserves	(2,761,442)	(2,960,357) *(d)*	(5,721,799)
Proposed final dividend	(33,127)		(33,127)
	(3,125,837)		(6,086,194)
Minority interests	(227,352)		(227,352)
Total equity	(3,353,189)		(6,313,546)
LIABILITIES			
Non-current liabilities			
Provision for overhaul and major checks	(154,904)		(154,904)
Provision for housing allowances	(34,126)		(34,126)
	(189,030)		(189,030)
Current liabilities			
Trade and other payables	(514,623)		(514,623)
Sales in advance of carriage	(132,394)		(132,394)
Current income tax liabilities	(2,436)		(2,436)
Short-term bank loans – unsecured	(25,371)		(25,371)
	(674,824)		(674,824)
Total liabilities	(863,854)		(863,854)
Total equity and liabilities	(4,217,043)		(7,177,400)
Net current assets	691,843		1,107,637
Total assets less current liabilities	3,542,219		6,502,576

Notes to the unaudited pro forma consolidated balance sheet

1. The consolidated balance sheet at 31 December 2005 has been extracted from the accountants' report of the Group as set out in Appendix I to this circular.

2. (a) The adjustment reflects the Disposal of Dragonair, representing the net asset value of Dragonair based on the financial information of the Group at 31 December 2005 as set out in Appendix I to this circular.

   (b) The adjustment reflects the fair value of the 288,596,335 new Cathay Shares based on the closing market price at 31 December 2005 of HK$13.55 per share.

   (c) The adjustment reflects the cash consideration of HK$432,894,498 net of expenses of approximately HK$17,100,000 directly attributable to the Disposal.

   (d) The adjustment reflects the estimated gain on the Disposal which is determined based on the aggregate of (1) the fair value of 288,596,335 new Cathay Shares based on the closing market price at 31 December 2005 and (2) cash consideration of HK$432,894,498; less (3) the Group's share of net asset value of Dragonair at 31 December 2005 and (4) estimated expenses of HK$17,100,000 directly attributable to the Disposal.

   Since the fair value of Cathay Shares and the net asset value of Dragonair at the date of Completion may be substantially different from their respective values used in the preparation of the unaudited pro forma financial information, the final amount of the gain on the Disposal and the amount of available-for-sale investment will be different from those presented above.

3. Under the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following the Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share. Such special dividend has not been reflected in the unaudited pro forma consolidated balance sheet.

4. No adjustment has been made to reflect any trading position or other transaction of the Group entered into subsequent to 31 December 2005.

III. UNAUDITED PRO FORMA CONSOLIDATED CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2005

The following is an illustrative and pro forma consolidated cash flow statement of the Company which has been prepared on the basis of the notes set out below for the purpose of illustrating the effect of the Disposal and Acquisition as if it had taken place on 1 January 2005. This unaudited pro forma financial information has been prepared for illustrative purposes only and because of its hypothetical nature, it may not give a true picture of the cash flow of the Group had the Disposal and Acquisition been completed at 1 January 2005 or at any future dates.

	Before Disposal and Acquisition	Pro forma adjustments			After Disposal and Acquisition
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
	(Note 1)	*(Note 2)*	*(Note 3)*	*(Note 4)*	
Cash flows from operating activities					
Cash generated from operations	186,684				186,684
Overseas taxation paid	(12,228)				(12,228)
Interest paid	(2,960)				(2,960)
Net cash from operating activities	171,496				171,496
Cash flows from investing activities					
Interest received	20,159				20,159
Cash consideration received on the Disposal, net of expenses directly attributable to the Disposal	–	415,794			415,794
Sale of an investment security	19,520				19,520
Dividends received from associates	246,187		(160,171)		86,016
Dividends received from an available-for-sale investment	–			187,588	187,588
Increase in pledged deposits	(21,488)				(21,488)
Repayment of loan from an associate	16,500				16,500
Purchase of property, plant and equipment	(54,300)				(54,300)
Sale of property, plant and equipment	304				304
Net cash from investing activities	226,882				670,093
Cash flow from financing activities					
Dividends paid to Company's equity holders	(59,628)				(59,628)
Dividends paid to minority interests	(41,864)				(41,864)
Proceeds from short-term bank loans	35,926				35,926
Repayments of short-term bank loans	(79,772)				(79,772)
Net cash used in financing activities	(145,338)				(145,338)
Net increase in cash and cash equivalents	253,040				696,251
Cash and cash equivalents at 1 January 2005	746,793				746,793
Cash and cash equivalents at 31 December 2005	999,833				1,443,044

Notes to the unaudited pro forma consolidated cash flow statement

1. The consolidated cash flow statement for the year ended 31 December 2005 has been extracted from the accountants' report of the Group as set out in Appendix I to this circular.

2. The adjustment reflects the cash consideration of HK$432,894,498 net of expenses of approximately HK$17,100,000 directly attributable to the Disposal.

3. The adjustment relates to the exclusion of 2004 interim dividend received from Dragonair.

4. The adjustment relates to the recognition of dividend income from Cathay in respect of 2004 final dividend of HK$0.45 per Cathay Share and 2005 interim dividend of HK$0.20 per Cathay Share declared by Cathay during the year ended 31 December 2005 as if the Acquisition had been completed on 1 January 2005.

5. Under the Restructuring Agreement, SPAC and CITIC Pacific have agreed to recommend to the Cathay Board that as soon as practicable following the Completion and in any event, no later than 60 days following Completion, Cathay will pay a special interim dividend of HK$0.32 per Cathay Share. Such special dividend has not been reflected in the unaudited pro forma consolidated cash flow statement.

6. No adjustment has been made to reflect any cash flow or other transaction of the Group entered into subsequent to 31 December 2005.

B. LETTER ON UNAUDITED PRO FORMA FINANCIAL INFORMATION

The following is the reproduction of the text of a report received from PricewaterhouseCoopers, Certified Public Accountants, Hong Kong, for the purpose of incorporation in this circular.

PRICEWATERHOUSECOOPERS

羅兵咸永道會計師事務所

PricewaterhouseCoopers
22nd Floor, Prince's Building
Central, Hong Kong

30 June 2006

The Directors
China National Aviation Company Limited

Dear Sirs,

We report on the unaudited pro forma financial information of China National Aviation Company Limited (the "Company"), its subsidiaries (hereinafter collectively referred to as the "Group") and its jointly controlled entities set out on pages 262 to 268 under the heading of "Unaudited Pro Forma Financial Information of the Group" in Appendix III of the Company's circular dated 30 June 2006, in connection with the proposed sale of the Group's entire interest in Hong Kong Dragon Airlines Limited and the proposed acquisition of shares of Cathay Pacific Airways Limited (the "Disposal and Acquisition") (the "Circular"). The unaudited pro forma financial information has been prepared by the directors of the Company (the "Directors"), for illustrative purposes only, to provide information on how the Disposal and Acquisition might have affected the relevant financial information of the Group.

Respective Responsibilities of Directors and Reporting Accountants

It is the responsibility solely of the Directors to prepare the unaudited pro forma financial information in accordance with paragraph 4.29 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("the Listing Rules") and Accounting Guideline 7 "Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars" issued by the Hong Kong Institute of Certified Public Accountants (the "HKICPA").

It is our responsibility to form an opinion, as required by paragraph 4.29(7) of the Listing Rules, on the unaudited pro forma financial information and to report our opinion to you. We do not accept any responsibility for any reports previously given by us on any financial information used in the compilation of the unaudited pro forma financial information beyond that owed to those to whom those reports were addressed by us at the dates of their issue.

Basis of opinion

We conducted our work in accordance with Hong Kong Standard on Investment Circular Reporting Engagements 300 "Accountants' Reports on Pro Forma Financial Information in Investment Circulars" issued by the HKICPA. Our work, which involved no independent examination of any of the underlying financial information, consisted primarily of comparing the unadjusted financial information with the source documents, considering the evidence supporting the adjustments and discussing the unaudited pro forma financial information with the Directors.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the unaudited pro forma financial information has been properly compiled by the Directors on the basis stated, that such basis is consistent with the accounting policies of the Group and that the adjustments are appropriate for the purposes of the unaudited pro forma financial information as disclosed pursuant to paragraph 4.29(1) of the Listing Rules.

The unaudited pro forma financial information is for illustrative purposes only, based on the judgements and assumptions of the Directors, and because of its hypothetical nature, it does not provide any assurance or indication that any event will take place in the future and may not be indicative of:

– the financial position of the Group at 31 December 2005 or any future date, or

– the results or cash flows of the Group for the year ended 31 December 2005 or any future periods.

Opinion

In our opinion:

(a) the unaudited pro forma financial information has been properly compiled by the Directors on the basis stated;

(b) such basis is consistent with the accounting policies of the Group; and

(c) the adjustments are appropriate for the purposes of the unaudited pro forma financial information as disclosed pursuant to paragraph 4.29(1) of the Listing Rules.

Yours faithfully,
PricewaterhouseCoopers
Certified Public Accountants
Hong Kong

RESPONSIBILITY STATEMENT

This document includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Company. The Directors collectively and individually accept full responsibility for the accuracy of the information contained in this document and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts the omission of which would make any statement herein misleading.

DISCLOSURE OF INTERESTS

(a) Interests of Directors and Chief Executive

Apart from the interests of the Directors in the share options of the Company as disclosed below, as at the Latest Practicable Date, none of the Directors or chief executives of the Company had any interests or short positions in the shares, underlying shares and debentures of the Company or any associated corporation (within the meaning of Part XV of the SFO), which (a) were required to be notified to the Company and the Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short positions which they have taken or deemed to have taken under such provisions of the SFO); or (b) were required pursuant to section 352 of the SFO to be entered in the register referred to therein; or (c) were required, pursuant to the Model Code to be notified to the Company and the Exchange.

Name of Option holder	Number of Options	Exercise price *HK$*	Grant date	Exercise period
Chuang Shih Ping	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Zhang Xianlin	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Tsang Hing Kwong, Thomas	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Gu Tiefei	5,000,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Total:	104,378,000			

(b) Interests of Substantial Shareholders

Save as disclosed below, the Directors and chief executives of the Company are not aware that there was any person who, as at the Latest Practicable Date, had an interest or short position in the shares and underlying shares (including options) of the Company which would fall to be disclosed to the Company under Divisions 2 and 3 of Part XV of the SFO:

Substantial Shareholders	Capacity	Number of shares	Percentage of the issued share capital
China National Aviation Holding Company	Attributable interest	2,264,628,000 *(note 1)*	68.4%
Air China	Beneficial owner	2,264,628,000 *(note 2)*	68.4%
Best Strikes Limited	Beneficial owner	187,656,000	5.6%
On Ling	Attributable interest	322,856,000 *(note 3)*	9.7%
Novel Investments Holdings Limited	Attributable interest	322,856,000 *(note 3)*	9.7%
Novel Enterprises Limited	Attributable interest	322,856,000 *(note 3)*	9.7%
Novel Enterprises (BVI) Limited	Attributable interest	322,856,000 *(note 3)*	9.7%
Novel Credit Limited	Attributable interest	322,856,000 *(note 3)*	9.7%
Novel Holdings (BVI) Limited	Attributable interest	322,856,000 *(note 3)*	9.7%
Westleigh Limited	Attributable interest	322,856,000 *(note 3)*	9.7%

Notes:

1. A state-owned enterprise established in the PRC. It owns approximately 51.16% of the total issued share capital of Air China and the entire issued share capital of China National Aviation Corporation (Group) Limited, a company incorporated in Hong Kong, which in turn owns approximately 14.64% of the total issued share capital of Air China. Accordingly its interests in the Company duplicate with those interests of Air China.

2. A joint stock limited company incorporated in the PRC with its H shares listed in Hong Kong and London. China National Aviation Corporation (Group) Limited, the Company's former immediate controlling shareholder, transferred its approximately 69% shareholding interest in the Company to Air China in September 2004 by way of a capital contribution in return for Air China's non-H foreign shares, as such Air China becomes the immediate controlling shareholder of the Company. Its interest in the Company duplicates with those interests of CNAH.

3. 5.6% of the interest held by each of these companies in the Company duplicates with Best Strikes Limited's interest in the Company. The interests of these companies in the Company also duplicate each other.

(c) Interests of Substantial Shareholders in the Company's subsidiaries

So far as is known to any Director or chief executive of the Company, as at the Latest Practicable Date, the following persons were directly or indirectly interested in 10% or more of the issued capital carrying rights to vote at general meetings of the following subsidiaries of the Company:

Name of subsidiary	Name of shareholder	Percentage of shareholding
Air Macau	Servico, Administracao e Participacoes, Limitada	20%
	Sociedade de Turismo e Diversoes de Macau	14%
Macau Asia Express	Starpax Limited	48%

Save as disclosed above, as at the Latest Practicable Date, no other person has an interest or short position in the shares or underlying shares of the Company which would fall to be disclosed to the Company under Divisions 2 and 3 of Part XV of the SFO or who is directly or indirectly interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any member of the Group.

DIRECTORS' INTERESTS IN COMPETING BUSINESSES

Pursuant to paragraph 8.10(2) of the Listing Rules, Mr. Kong Dong disclosed that he is the Deputy General Manager of CNAH, the ultimate holding company of the Company, and the Vice Chairman and a non-executive director of Air China. CNAH is a state-owned enterprise established in the PRC. Air China is engaged in the business of passenger and cargo air transportation services and airport ground handling services and CNAH is its ultimate holding company. As such the business activities of CNAH and Air China compete, or are likely to compete, either directly or indirectly, with the business of the Group.

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

SERVICE CONTRACTS

None of the Directors has a service contract with the Company or any of its subsidiaries which is not determinable within one year without payment of compensation, other than statutory compensation.

MATERIAL ADVERSE CHANGE

As at the Latest Practicable Date, the Directors are not aware of any material adverse change in the financial or trading position of the Group since 31 December 2005, being the date to which the latest published audited accounts of the Group were made up.

LITIGATION

As at the Latest Practicable Date, no member of the Group was engaged in any litigation or arbitration of material importance and there is no litigation or claims of material importance known to the Directors to be pending or threatened by or against any member of the Group.

EXPERTS

The following is the qualification of the experts which have given opinions or advice which are contained in this circular:

Name	Qualification
PricewaterhouseCoopers	Certified Public Accountants
CLSA	a licensed corporation under the SFO, licensed to conduct types 4 and 6 regulated activities under the SFO.

Each of PricewaterhouseCoopers and CLSA has given and has not withdrawn its written consent to the issue of this circular with the inclusion herein of its opinion, letter and report and references to its name in the form and context in which they respectively appear in this circular.

As at the Latest Practicable Date, CLSA Capital Limited (a sister company to CLSA under common ownership) which operates as a proprietary trading vehicle of the group is interested in 1,970,000 shares in the Company.

Save as disclosed above, at the Latest Practicable Date, each of PricewaterhouseCoopers and CLSA did not have any shareholding interest, directly or indirectly, in any member of the Group nor the right (whether legally enforceable or not) to subscribe for or to nominate any person to subscribe for securities in any members of the Group.

MATERIAL CONTRACTS

The following material contracts, not being contracts entered into in the ordinary course of business of the Group, have been entered into by members of the Group within two years preceding the date of this circular:

(a) Two sale and purchase agreements were entered into by Fly Top Limited ("Fly Top") on 19 August 2004 pursuant to which Fly Top agreed to acquire 16% and 4.2% equity interest in LLSHK from CNACG and Hong Kong International Air Catering Limited at the consideration of HK$89 million and HK$24.5 million respectively.

(b) An aircraft wet lease agreement was entered into by Air Macau and Air China on 15 March 2005 pursuant to which Air Macau leases aircraft to Air China at a monthly fee of US$358,500 (equivalent to approximately HK$2,796,000) with maintenance hour charge of US$470 (equivalent to approximately HK$4,000) per block hour for the period from 20 October 2004 to 19 April 2005. The lease agreement was then extended by a wet lease extension agreement entered into by the same parties on 13 April 2005 for the period from 20 April 2005 to 19 October 2005.

(c) A project management services agreement was entered into by BACL and Air China Beijing Construction Base Command Centre ("Air China Command Centre") on 4 November 2005, pursuant to which Air China Command Centre agreed to provide services in respect of phase 3 of the construction work for the expansion of the ancillary facilities in the Beijing Capital International Airport and BACL agreed to pay a management fee which is equivalent to 2.5% of the approved budget of the construction for the such project.

(d) On 24 January 2006, the Group entered into a joint venture agreement and a Groupax joint venture agreement pursuant to which Shun Tak Air Transport Limited and its subsidiaries agreed to establish Macau Asia Express to engage in the business activities of operating low cost model air transport services based in Macau. The aggregate initial investment in Macau Asia Express is up to approximately HK$234,000,000.

(e) The Restructuring Agreement.

(f) The Shareholders Agreement.

DOCUMENT AVAILABLE FOR INSPECTION

Copies of the following documents will be made available for inspection during normal business hours at the registered office of the Company at 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau, Hong Kong on weekdays other than public holidays from the date of this circular up to and including 22 August 2006:

(a) the Restructuring Agreement;

(b) the Shareholders Agreement;

(c) the memorandum and articles of association of the Company;

(d) the material contracts referred to in the paragraph headed "Material Contracts" in this appendix;

(e) the accountants' report of the Group prepared by PricewaterhouseCoopers, the text of which is set out in Appendix I to this circular and the related statement of adjustments;

(f) the letter issued by PricewaterhouseCoopers in respect of the unaudited pro forma financial information of the Group, the text of which is set out in Appendix III to this circular;

(g) the annual reports of the Company for the years ended 31 December 2005 and 31 December 2004;

(h) the letter from the Independent Board Committee to the Independent Shareholders, the text of which is set out on pages 24 to 27 in this circular;

(i) the letter from CLSA, the text of which is set out from pages 28 to 53 in this circular; and

(j) the circular of the Company dated 2 May 2006 in relation to a connected transaction (airport fees transaction and its new annual cap and ongoing connected transactions) and the circular of the Company dated 6 March 2006 in relation to a discloseable transaction (establishment of Macau Asia Express).

POLL PROCEDURE

Under Article 68 of the Company's articles of association, at any general meeting, a resolution put to the vote of the meeting shall be decided on a show of hands unless a poll is required under the Listing Rules or a poll is (before or on the declaration of the result of the show of hands) demanded by:–

(i) the chairman of the meeting; or

(ii) at least three members present in person or by proxy or by duly authorised corporate representative for the time being entitled to vote at the meeting; or

(iii) any member or members present in person or by proxy or by duly authorised corporate representative and representing not less than one-tenth of the total voting rights of all members having the right to vote at the meeting; or

(iv) a member or members present in person or by proxy or by duly authorised corporate representative and holding shares in the Company conferring a right to vote at the meeting being shares on which an aggregate sum has been paid up equal to not less than one-tenth of the total sum paid up on all shares conferring that right.

MISCELLANEOUS

1. There is no contract or arrangement entered into by any member of the Group subsisting at the date of this circular in which any Director is materially interested and which is significant to the business of the Group.

2. As at the Latest Practicable Date, neither PricewaterhouseCoopers, CLSA nor any Director had any direct or indirect interests in any assets which had been acquired, disposed of by or leased to, or which were proposed to be acquired, disposed of by or leased to, any member of the Group since 31 December 2005, being the date to which the latest published audited accounts of the Group were made up.

3. The Secretary of the Company is Mr. Li Man Kit, ACIS, ACS.

4. The qualified accountant of the Company appointed pursuant to Rule 3.24 of the Listing Rules is Mr. Ng Wai Shun, Johnson, CPA, FCCA, ACIS, ACS.

5. The registered address and the head office of the Company are at 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau, Hong Kong.

6. The Company's share registrars and transfer office is Computershare Hong Kong Investor Services Limited, 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong.

中航興業有限公司
CHINA NATIONAL AVIATION COMPANY LIMITED
(incorporated in Hong Kong with limited liability)
(Stock Code: 1110)

NOTICE OF EXTRAORDINARY GENERAL MEETING

NOTICE IS HEREBY GIVEN that an Extraordinary General Meeting of the shareholders of China National Aviation Company Limited will be held at Salon 6 (Level 3), JW Marriott Hotel Hong Kong, Pacific Place, 88 Queensway, Hong Kong on Tuesday, 22 August 2006 at 2:00 p.m. for the purpose of considering and, if thought fit, passing, with or without modifications, the following resolutions as ordinary resolutions:

ORDINARY RESOLUTION

"THAT:

the entering into by the Company of the restructuring agreement dated 8 June 2006 between Cathay Pacific Airways Limited, Air China Limited, Swire Pacific Limited, CITIC Pacific Limited and the Company (a copy of which agreement has been produced to the meeting marked "A" and signed by the chairman of the meeting for the purpose of identification) and the implementation of the transactions contemplated thereunder, including in particular the disposal by the Company to Cathay Pacific Airways Limited of 216,447,251 shares of HK$1.00 each in Hong Kong Dragon Airlines Limited, the acquisition of 288,596,335 new shares of HK$0.20 each in Cathay Pacific Airways Limited and the receipt of cash consideration of HK$432,894,497.50, each be and is hereby approved."

By order of the Board
China National Aviation Company Limited
Li Man Kit
Company Secretary

Hong Kong, 30 June 2006

Notes:

1. Any member entitled to attend and vote at the meeting convened by the above notice is entitled to appoint one or more proxies to attend and, on a poll, vote instead of him. A proxy need not be a member of the Company.

2. All proxies must be deposited with the Registrars, Computershare Hong Kong Investor Services Limited, 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong, not less than 48 hours before the time appointed for the meeting or any adjourned meeting thereof.

3. The vote at the Extraordinary General Meeting will be taken by poll.